

PO-CH/NL/0644 PART A

POCH/NL/0644  
PART. A

POCH/NL/0644  
PART. A

CHANCELLORS  
1988 & POLAND  
PAPERS.

5-12 88

AD's 254B NAJY  
22-11-96

THIS FOLDER HAS BEEN  
REGISTERED ON THE  
REGISTRY SYSTEM

POLAND

rp

THE INSTITUTE OF INTERNATIONAL FINANCE, INC.  
2000 PENNSYLVANIA AVENUE, N.W. SUITE 8500  
WASHINGTON, D.C. 20006

CONFIDENTIAL: FOR USE OF IIF MEMBERS ONLY

POLAND(88)1(R)

January 22, 1988

POLAND: COUNTRY REPORT

Summary Appraisal

The rescheduling agreements with commercial banks and Paris Club creditors are expected to see Poland through 1988 without new arrears. Amortization payments will rise sharply in 1989.

Economic growth in Poland slowed in 1987 with production constrained by reduced availability of imported inputs. Wages increased less rapidly than prices for the first time since 1982, resulting in a moderate decline in real incomes. Coal exports continued to decline, but other convertible currency exports grew 13 percent in 1987. Poland's trade deficit with socialist countries narrowed further. The convertible currency current account deficit in 1987 was \$0.8 billion, including \$2.9 billion in interest due. The financing of this deficit required rescheduling of two-thirds of the interest payment obligations.

Despite defeat in a referendum vote in November 1987, plans for the second stage of economic reform remain in place. Only the time schedule of planned consumer price increases was extended.

The World Bank has concluded preparations for project loans in the amount of \$250 million and is awaiting progress in Poland's relations with the IMF. A stand-by program is under discussion with the IMF.

Our outlook is based on economic data available to the Institute at the end of 1987 and the policies actually in place. On that basis, continued slowing of economic growth, some further decline in real incomes, and a strong surge in consumer prices is in prospect. The convertible currency current account deficit is likely to increase to over \$1 billion. Poland is expected to finance this deficit without incurring new arrears because one-half of the \$3 billion interest obligations in 1988 has been rescheduled. In the absence of IMF and World Bank financing, the government would need to use about \$400 million of reserves.

Realization of the official Polish scenario projecting current account balance by 1991, which has been endorsed by the World Bank, depends upon the government adopting structural reform measures and more realistic macroeconomic policies supported by substantial World Bank and IMF financing.

DOMESTIC ECONOMY & EXTERNAL TRADE	1986	1987e	1988f
Real GDP % change	5.1	3.5	3.0
Consumer price % change	14.7	27.0	40.0
General government borrowing % GDP	1.1	1.7	
Domestic credit % change	25.2	35.9	
Short-term interest rate	6.0	6.0	
Exports: volume % change	1.4	4.4	3.6
Imports: volume % change	-1.9	2.6	2.7
Terms of trade % change	-5.4	-6.3	-5.6
Exchange rate, average (Z/\$)	175	260	400
EXTERNAL BALANCE (\$ million)			
Trade Balance	1035	900	700
Exports	5316	5800	6200
Imports	-4281	-4900	-5500
Current Account Balance	-665	-780	-1240
Non-debt-creating flows, net	0	0	0
Borrowing from official creditors, net	1616	5112	1375
Borrowing from private creditors, net	-52	-482	-325
Commercial banks	392	-87	-125
Resident lending abroad, net	-211	-250	-200
Interest arrears	-1100	-3300	0
Errors and omissions	239	0	0
Change in reserves (- = increase)	173	-300	390
EXTERNAL LIABILITIES & ASSETS (\$ million)			
Total External Debt	33528	39398	40104
Total debt % exports goods & services	589.6	634.4	607.6
Official creditors	21878	27042	28117
Private creditors	11650	12356	11987
Commercial banks	8617	9409	9250
Official reserves (excluding gold)	698	1000	610
Reserves % imports goods & services	9.1	11.7	6.5
DEBT SERVICE PAYMENTS (\$ million)			
Gross interest payments	2734	2920	2990
Total amortization payments	715	975	720
Debt service % exports goods & services	56.6	58.1	52.3

e = estimate, f = forecast

THE INSTITUTE OF INTERNATIONAL FINANCE, INC.  
2000 PENNSYLVANIA AVENUE, N.W. SUITE 8500  
WASHINGTON, D.C. 20006

CONFIDENTIAL: FOR USE OF IIF MEMBERS ONLY  
POLAND(88)1(R)

January 22, 1988

POLAND: COUNTRY REPORT

This report reviews developments at a time when economic reform plans have been amended as a result of a referendum in November 1987 and when Poland's relations with the IMF and the World Bank have yet to be clarified. It is based on a visit to Warsaw during December 7-11, 1987. Mission participants were Klaus Friedrich and Keith Savard of the Institute, Alfred Apholte, Dresdner Bank, and Dalibor Kolcava, Swiss Bank Corporation. The group had discussions with officials at Bank Handlowy, the National Bank of Poland, the Ministry of Finance and the Planning Commission.

Recent Economic Developments

1. Demand, Output and Prices

Real GDP grew by 3.5 percent in 1987, down from over 5 percent growth in 1986 (see Table 1). Domestic demand rose by about 4 percent, and the external sector made a small negative contribution to GDP growth as exports declined. While real exports to the

Table 1

Domestic Economic Indicators  
(percent change from previous year)

	1984	1985	1986	1987e	1988f
Real GDP (1982 prices)	5.6	3.6	5.1	3.5	3.0
Domestic demand	5.0	4.0	5.0	3.9	3.1
Change in net foreign bal. (% GDP)	0.8	-1.2	0.2	-0.3	-0.1
Exports of goods and services	11.9	0.3	3.9	-0.6	0.9
Imports of goods and services	9.4	6.8	3.4	0.8	1.3
Industrial production	5.4	3.8	4.2	2.5	2.5
Consumer prices	15.4	14.6	14.7	27.0	40.0
Nominal earnings*	13.7	19.9	21.1	22.0	36.0

e = estimate, f = forecast

\*Socialized sector.

convertible currency area performed well with 4.4 percent growth in 1987, it appears that real exports to socialist countries declined.

Industrial production growth fell to 2.5 percent in 1987 from over 4 percent in the previous year. One factor constraining industrial production in Poland has been the availability of imported inputs. The growth of real imports in 1986-87 slowed to under 3 percent from more than 8 percent in 1984-85. Industrial production growth declined from 5 percent to about 3 percent in the same period.

Consumer price inflation accelerated sharply from a 14.7 percent annual average in 1986 to 27 percent in 1987. This includes increases in administered prices, about half the value of sales in consumer goods and services in 1987. The remaining half is covered by a contract price system, which still entails some forms of price regulations, although their scope was reduced further in 1987. Increases were especially steep in fuels and housing costs.

Nominal earnings in the socialized sector rose by 22 percent in 1987. In view of the consumer price inflation rate of 27 percent, this implies a 5 percent reduction in real incomes in the socialized sector. Nominal incomes in the non-socialized sector, accounting for one-third of total employment, rose somewhat faster, so that the decline in economy-wide real incomes averaged about 2 percent in 1987. This was the first decline in overall real incomes since the crisis year of 1982.

## 2. Balance of Payments

The convertible currency trade balance deteriorated slightly in 1987 to a surplus of \$0.9 billion (see Table 2). In volume terms, exports grew by 4.4 percent while imports

Table 2

Current Account Balance: Convertible Currency  
(billions of dollars)

	1985	1986	1987e	1988f
Trade balance	1.1	1.0	0.9	0.7
Exports	5.1	5.3	5.8	6.2
Imports	-4.0	-4.3	-4.9	-5.5
Balance on services and income	-2.5	-2.6	-2.8	-2.9
of which:				
Total interest due	-2.6	-2.7	-2.9	-3.0
Interest paid	-1.2	-1.1	-1.0	-1.5
Interest unpaid/rescheduled	-1.4	-1.6	-1.9	-1.5
Net transfers	0.8	0.9	1.1	1.0
Current account balance	-0.6	-0.7	-0.8	-1.2
Memorandum:				
Export volume % change	-6.5	1.4	4.4	3.6
Import volume % change	13.4	-1.9	2.6	2.7
Terms of trade % change	14.1	-5.4	-6.3	-5.6

e = estimate, f = forecast

increased by only 2.6 percent. Adverse developments in Poland's terms of trade caused the value of the trade balance in dollars to deteriorate. Coal exports fell 7 percent in 1987 and the share of coal in convertible currency exports fell to 16 percent. Convertible currency exports other than coal rose almost 13 percent.

Poland's trade with socialist countries accounts for roughly one-half of total trade (see Table 3). During the current decade, Poland has had deficits in its non-convertible currency trade, particularly with the Soviet Union. In 1987, the value of Poland's non-convertible currency imports declined by \$1 billion, mainly because of a fall in import prices. The price of oil, which accounts for one-fifth of imports from socialist countries, fell by over 25 percent. Non-convertible currency exports fell by \$0.8 billion in 1987. The decline in value of both imports and exports should also be seen in the context of valuation methods. Transactions with the non-convertible currency area are denominated in transferable rubles and are converted into U.S. dollar equivalents at the cross rate implicit in official Polish quotations for the ruble and the dollar. As the zloty has depreciated more rapidly against the dollar than the ruble, the dollar equivalent of Poland's non-convertible currency trade has declined more sharply than the corresponding value in transferable rubles. Nevertheless, the gradual decline of the deficit over the past several years suggests some medium-term Soviet policy response to the deterioration of its own overall external position.

Table 3  
Trade and Services Balance: Non-Convertible Currency  
(billions of dollars)

	1985	1986	1987e	1988f
Trade balance	-0.6	-0.4	-0.2	0.0
Exports	5.8	6.2	5.4	5.4
Imports	-6.4	-6.6	-5.6	-5.4
Services balance	0.2	0.2	0.2	0.2
Memorandum:				
Export volume % change	8.1	7.6	-4.0	-0.5
Import volume % change	4.6	9.4	-0.7	0.4

e = estimate, f = forecast

The convertible currency current account deficit, including \$2.9 billion in interest due, increased by about \$100 million to \$0.8 billion in 1987. The financing picture in 1987 was dominated by the rescheduling agreements (see Table 4). Interest capitalized by the Paris Club amounted to about \$5.4 billion, of which \$3.3 billion was in arrears at the end of 1986. Paris Club creditors received \$200 million in repayments including \$145 million from the 1981 agreement. The commercial banks received about \$90 million in net repayments. Net repayment of suppliers' credits amounted to almost \$400 million.



Table 4

External Financing: Convertible Currency  
(millions of dollars)

	1986	1987 <sup>e</sup>	1988 <sup>f</sup>
Current account balance	-665	-780	-1240
External borrowing, net	<u>464</u>	<u>1330</u>	<u>1050</u>
IMF, net	0	0	0
Multilateral organizations (CMEA)	<u>-74</u>	<u>-40</u>	<u>-50</u>
Disbursements	34	100	100
Repayments	-108	-140	-150
Due	-298	-140	-150
Rescheduled	190	0	0
Official bilateral	<u>590</u>	<u>1852</u>	<u>1425</u>
Disbursements	50	10	100
Rescheduled/postponed interest	1876	5342	1470
Interest arrears	-1100	-3300	0
Repayments	-236	-200	-145
Due	-1023	-1517	-1170
Rescheduled/postponed	787	1317	1025
Commercial banks	<u>392</u>	<u>-87</u>	<u>-125</u>
Disbursements	437	50	0
Repayments	-45	-137	-125
Due	-900	-473	-125
Rescheduled/postponed	855	336	0
Other private, net	-444	-395	-200
Resident lending abroad, net	-211	-250	-200
Errors and omissions	239	0	0
Change in reserves (- = increase)	173	-300	390

c = estimate, f = forecast

### 3. Paris Club Rescheduling

In mid-December 1987, Poland came to terms with the Paris Club. The agreement covers arrears for 1986 and 1987 and principal and interest obligations originally due in 1988. The \$8.8 billion covered will be paid over ten years with five years grace. Under this agreement, Paris Club creditors will receive about \$900 million in debt service payments by March 1989. This includes one-half of the arrears from the 1981 agreement (\$290 million) to be paid in four equal installments from November 1987 to February 1988. It further includes \$500 million rescheduled interest payments in 1988, and \$100 million payable in the first quarter of 1989. The anticipated signing of the bilaterals will virtually eliminate Poland's interest arrears as of end-1987.

#### 4. Commercial Bank Rescheduling

In July 1987, a draft agreement was reached rescheduling \$8.2 billion of Poland's debt to about 550 banks. Obligations falling due from December 1987 to 1993 are to be paid over 15 years on a sliding scale from 1 percent in 1989 to 14 percent in 2002. The interest rate is to be set at 15/16 percentage points above LIBOR. There will be two tranches. The first consolidates principal payments falling due through the end of 1990. The second tranche reschedules 1991-93 maturities and is conditional on an IMF stand-by arrangement or EFF facility being in place. Under this agreement, Poland's repayments to the banks will remain at or below \$150 million per year through 1993. The signing of this agreement appeared close at hand at end-January 1988.

#### 5. External Debt

External convertible currency debt at the end of 1987 is estimated at \$39.4 billion (see Table 5). By far the largest part of the \$5.9 billion increase from end-1986 to end-1987 is due to valuation changes of debt components denominated in non-dollar currencies. Net borrowing during 1987, mainly interest capitalization and some amortization payments, added about \$1.3 billion to the stock of debt. About 70 percent of total 1987 debt was owed to official creditors with the Paris Club's share being 60 percent. Commercial bank creditors held 23 percent of total Polish debt at the end of 1987. Amortization payments through 1988 are greatly reduced by rescheduling (see Table 6). Paris Club obligations will rise sharply next year and thereafter.

Table 5

Convertible Currency External Debt and Reserves  
(billions of dollars)

	1986	1987e	1988f
Total external debt	<u>33.5</u>	<u>39.4</u>	<u>40.1</u>
(% of exports, goods & services)	(589)	(634)	(608)
Paris Club	19.2	24.1	25.3
Commercial banks	8.6	9.4	9.2
Multilateral organizations (CMEA)	2.6	2.9	2.8
Other private	3.0	2.9	2.7
International reserves excluding gold	<u>0.7</u>	<u>1.0</u>	<u>0.6</u>

e = estimate, f = forecast

Table 6

**Projected Amortization Payments\***  
(billions of dollars)

	1988	1989	1990	1991	1992
Total payments	720	1483	2894	2837	3149
IMF/IBRD	0	0	0	0	100
Other multilateral (CMEA)	150	121	136	372	391
Official bilateral	145	1047	2459	2306	2380
Commercial banks	125	125	125	125	150
Other	300	190	174	34	128

\*End-1987 external debt and exchange rates.

### Use of Policy Instruments

#### 1. Exchange Rate Policy

In the course of 1987, the zloty was devalued against the U.S. dollar by 62 percent in frequent small steps. Depreciation of the effective nominal rate was even higher. Against the SDR, for example, the zloty fell by about 90 percent. This implies a relatively sharp depreciation of the real effective exchange rate, a result produced by aggressive implementation of an exchange rate policy which sought to keep at least 80 percent of Poland's exports profitable. While the real effective depreciation implied by official nominal rate changes and the change in domestic prices appears larger than required to achieve the profitability target, domestic prices do not always fully reflect real scarcities. When export firms, for example, were permitted to sell their retention quotas of convertible currency for zloties in a free auction market in the second half of 1987, zloty prices of convertible currencies were reportedly three to four times the official exchange rate. This indicates that while official exchange rate policy is moving in an appropriate direction, the system still contains serious imbalances.

#### 2. The Second Stage of Economic Reform

In October 1987, the Polish government issued a report which detailed an extensive list of economic reform measures. The objectives of reform were to stimulate the supply side by market oriented liberalization, to restructure prices and incomes and to liberalize major aspects of the central planning system. Some progress along these lines was made by late 1987. Branch ministries were consolidated into one single Ministry of Industry. Total resources devoted to administering industry were reduced. Restrictions on setting up private enterprise using private capital were eased, as were the procedures for gaining export licenses. A beginning was made in restructuring the banking system by establishing a separate Export Development Bank, and a General Savings Bank was split off from the National Bank of Poland. Plans to set up seven to nine commercial banks appear well advanced.

The most important specific measure of the original 1987 reform plan was to raise consumer prices by as much as 100 percent. The purpose of the measure was to change relative prices in a way that would reduce excess demand in certain targeted areas. The effect on aggregate real income was to be offset by compensatory wage increases.

### 3. The Referendum

On November 29, 1987, economic reform, including the plan to drastically raise consumer prices, was submitted to a referendum. While a majority of those voting (66 percent) approved, the reform proposal did not gain the required majority of those eligible to vote since the participation rate was 67 percent. The authorities were quick to announce that defeat of the referendum did not spell the end of economic reform. Rather, the time horizon on some measures, notably the planned consumer price increases, would be extended. Many of the broader structural reform plans were to be retained.

In retrospect, many of the measures planned for the original second stage reform were ambitious and would probably not have been carried out on schedule even if the referendum had passed. Fuel prices, for example, which remained slated for major increases even after the referendum, have not been raised as planned in January 1988. While the referendum was an important event in the political struggle for popular support of economic and social reform, its outcome is likely to have only limited impact on medium-term economic developments.

On the whole, actual progress in restructuring the Polish economy has so far been slow, especially when compared with officially announced intentions and programs. There is still little tangible evidence that the entire Polish government has both the will and the political power to tackle fundamental reform.

### 4. Relations with the World Bank

In August 1987, the World Bank completed a report on Poland, which dealt in considerable detail with economic reform, overall investment efficiency and external adjustment. The report endorses official Polish projections of achieving convertible currency current account balance by 1991, based on average real export growth of 6.4 percent and real import growth of 3.7 percent and no change in terms of trade. The World Bank, however, conditions its endorsement on improved access to international credit to ease constraints on imported inputs needed in export production, on progress of reform, especially in reducing centralized allocation of imports, and on liberalization of the exchange rate regime.

The World Bank has identified a number of export related projects for loans in the amount of about \$250 million. In early 1988, those project loans appear ready for approval provided that IMF agreement with the World Bank's relatively positive position on Poland is forthcoming. While what constitutes IMF approval may not necessarily be a stand-by or EFF program in place, some further convergence of IMF and Polish positions on policy is probably required.

## 5. Relations with the IMF

Poland became a member in 1986 and original expectations of an early agreement on an IMF program proved premature. The IMF wanted the current account to be brought into balance over a much shorter time horizon than was originally acceptable to a government unwilling or unable to impose the concomitant degree of restraint on domestic demand. This disagreement may have been reconciled by the Polish authorities' recent acceptance of the World Bank scenario calling for current account balance by 1991. What remains in question is the IMF's judgment of the adequacy of current and planned policies. The IMF staff is currently (January 1988) evaluating the results of its November 1987 mission to Poland, but further delay is likely before a program can be agreed on.

### Outlook

In the current year, real GDP growth will slow somewhat further to about 3 percent, with domestic absorption likely to decelerate again as it did in 1987. Consumer prices, under the post-referendum plan, could rise by about 40 to 45 percent. Wages fund increases in the socialized sector appear scheduled for a 36 percent increase. Other wages will likely increase somewhat faster, so that overall real wages may decline about 3 percent.

The official outlook providing for current account balance in 1991 without resorting to import compression appears overly optimistic when judged not against plans and programs but against economic data and policies actually in place as of end-1987. On that basis, a current account deficit of over \$1 billion is projected for 1988. In the absence of major structural change, the average import content of convertible currency exports will remain high and officially projected export growth rates will require larger import growth rates than officially projected.

Even so, Poland may be expected to finance its 1988 current account deficit under the terms of its rescheduling agreements without incurring interest arrears. The Paris Club has rescheduled \$1.5 billion in interest due in 1988 and will receive \$145 million in repayments under the 1981 agreement. Net payments to commercial banks are estimated at \$125 million. Such financing requires, however, that international reserves, which increased by \$300 million in 1987, fall by at least that amount in 1988 (see Table 4). In this financing outlook, no World Bank or IMF disbursements are assumed for 1988.

It should be noted that this outlook is based on actual data and policies in place by late 1987 and does not incorporate the scenario of wide ranging liberalization and export promotion that provides the basis for the more optimistic official Polish and World Bank outlook. This does not mean that the potential for a better outcome is nonexistent in our view. Compared with the bleak prospects of recent years, Poland is moving closer to a position where major creditors and international organizations can collectively contribute to improving the country's economic situation. The interdependent components necessary for sustained progress include:

- (a) a stronger commitment by the Polish government to implement planned reform measures;
- (b) debt restructuring that establishes a reasonable relationship between obligations and ability to pay;
- (c) World Bank involvement in project financing;
- (d) an IMF program supporting macro-adjustment policies.

If all of the above components are put in place in 1988, a credible first step toward the goal of current account balance by 1991 and the ability thereby implied to pay full interest on all external debt will have been made. With the 1987 rescheduling agreements signed and the World Bank close to go ahead, the focus in early 1988 is on the IMF. The IMF is seeking policy commitments by the Polish authorities to assure appropriate macropolicies, but agreement on a program is still not certain.

CODE	DOMESTIC ECONOMY & EXTERNAL TRADE	1981	1982	1983	1984	1985	1986	1987e	1988f
=====									
DOMESTIC ECONOMY (1982 prices)									
-----									
E100	Real GDP (zloty billion)	5643	5374	5673	5993	6210	6527	6755	6958
E101	Real GDP % change	-10.0	-4.8	5.6	5.6	3.6	5.1	3.5	3.0
-----									
E200	Domestic demand % change	-8.7	-9.3	5.2	5.0	4.0	5.0	3.9	3.1
E210	Private consumption % change	-3.6	-12.5	5.4	4.3	2.6	3.0		
E220	Public consumption % change	-4.5	2.4	3.1	7.5	7.7	18.7		
E230	Gross fixed capital % change	-19.1	-13.7	8.8	9.8	4.3	4.3		
E240	Change in stockbuilding (% GDP)	-1.2	2.3	-0.5	-0.6	0.5	0.1		
E300	Exports of goods and services % change	-18.2	6.2	9.2	11.9	0.3	3.9	-0.6	0.9
E310	Imports of goods and services % change	-19.7	-13.4	5.8	9.4	6.8	3.4	0.8	1.3
E320	Change net foreign balance % GDP	0.7	3.8	0.8	0.8	-1.2	0.2	-0.3	-0.1
-----									
E400	Nominal GDP (zloty billion)	2753	5546	6924	8576	10367	12953	17428	25132
E401	Nominal GDP % change	9.6	101.5	24.8	23.9	20.9	24.9	34.6	44.2
E410	GDP deflator % change	21.8	111.6	18.3	17.2	16.7	18.9	30.0	40.0
E420	Nominal GDP (\$ billion)	53.81	65.39	75.63	75.73	70.46	73.89	67.03	62.83
E600	Average nominal earnings % change	27.4	56.0	27.5	13.7	19.9	21.1	22.0	36.0
E700	Industrial production % change	-13.6	-1.7	6.5	5.4	3.8	4.2	2.5	2.5
-----									
EXTERNAL TRADE									
-----									
T100	Goods exports: volume % change	-22.1	0.9	12.4	9.0	-6.5	1.4	4.4	3.6
T110	Goods exports: unit value % change	-19.9	-9.4	-5.9	1.6	2.9	2.4	4.5	3.1
T200	Goods imports: volume % change	-31.5	-24.2	6.6	7.4	13.4	-1.9	2.6	2.7
T210	Goods imports: unit value % change	-3.4	-2.6	-14.6	-5.6	-9.8	8.2	11.6	9.3
T300	Terms of trade % change	-17.0	-7.0	10.3	7.7	14.1	-5.4	-6.3	-5.6
T400	Exchange rate, end period (Z/\$)	55.84	86.45	98.37	126.24	147.88	197.62	320.00	600.00
T410	Exchange rate, average (Z/\$)	51.15	84.82	91.55	113.24	147.14	175.29	260.00	400.00
T500	Export market % change	-0.8	-0.3	1.7	6.3	4.4	4.6	3.3	2.9
T600	Competitiveness index (1980 = 100)	115.4	151.2	168.4	169.0	150.6	114.9	85.1	69.4
T610	Trading partners' prices % change	-8.8	-2.6	-1.6	-5.6	0.8	30.8	18.3	11.6

=====

e = estimate, f = forecast

CODE	EXTERNAL BALANCE (\$ million)	1981	1982	1983	1984	1985	1986	1987e	1988f
B100	Trade Balance (\$ million)	-822	268	916	1380	1088	1035	900	700
B110	Merchandise exports	4971	4543	4806	5324	5120	5316	5800	6200
B111	Coal exports		951	1003	1282	1205	1001	930	930
B120	Merchandise imports	-5793	-4275	-3890	-3944	-4032	-4281	-4900	-5500
B200	Balance on Services, Income & Transfers	-2213	-2540	-2328	-2154	-1706	-1700	-1679	-1940
B210	Services & income receipts	770	557	772	713	722	773	900	890
B212	Exports of services	443	315	457	343	356	371	410	400
B214	Interest receipts	151	84	153	180	165	177	180	190
B216	Other services & income receipts	176	158	162	190	201	225	310	300
B250	Services & income payments	-3314	-3415	-3475	-3329	-3192	-3417	-3680	-3830
B252	Imports of services	-354	-247	-449	-436	-424	-436	-495	-540
B254	Interest payments	-2843	-3031	-2889	-2729	-2609	-2734	-2920	-2990
B256	Other services & income payments	-117	-137	-137	-164	-159	-247	-265	-300
B280	Private transfers, net	331	318	375	462	764	944	1100	1000
B300	Current Account Balance	-3035	-2272	-1412	-774	-618	-665	-780	-1240
B400	External financing, net		2272	1412	774	618	665	780	1240
B410	Non-debt-creating flows, net		0	0	0	0	0	0	0
B420	Borrowing from official creditors, net		277	748	898	-754	1616	5112	1375
B421	IMF		0	0	0	0	0	0	0
B422	Multilateral organizations (CMEA)		-139	96	495	-132	-74	-40	-50
B423	Other official creditors		417	652	403	-622	1690	5152	1425
B430	Borrowing from private creditors, net		-183	-393	-32	-203	-52	-482	-325
B431	Commercial banks (London Club)		-438	-232	-17	-472	392	-87	-125
B432	Nonbank creditors		256	-161	-16	269	-444	-395	-200
B450	Interest arrears		1000	1100	1400	300	1100	-3300	0
B460	Resident lending abroad, net		-1	-5	-85	13	-211	-250	-200
B480	Errors and omissions		1547	81	-1067	1026	239	0	0
B500	Change in reserves (- = increase)		-369	-119	-340	236	173	-300	390

e = estimate, f = forecast



CODE	EXTERNAL LIABILITIES & ASSETS	1981	1982	1983	1984	1985	1986	1987e	1988f
=====									
EXTERNAL LIABILITIES (\$ million)									
-----									
D100	Convertible Currency External Debt	26000	26500	26400	26900	29555	33528	39398	40104
		=====	=====	=====	=====	=====	=====	=====	=====
D102	Total debt % GDP	48.3	40.5	34.9	35.5	41.9	45.4	58.8	63.8
D104	Total debt % exports goods & services	480.2	545.5	501.6	474.7	539.7	589.6	634.4	607.6
D110	Medium/Long term debt	24306	23572	22435	21480	23938	28836		
D111	Short term debt	1094	1328	1265	1320	1217	1392		
D112	Interest arrears	600	1600	2700	4100	4400	3300	0	0
-----									
By creditor:									
D200	Official creditors	14194	15225	15978	17057	18865	21878	27042	28117
		-----	-----	-----	-----	-----	-----	-----	-----
D210	IMF	0	0	0	0	0	0	0	0
D220	Multilateral organizations (CMEA)	2191	1943	1921	2273	2437	2641	2935	2845
D230	Other official (Paris Club)	12003	13282	14057	14784	16428	19237	24107	25272
D237	o/w Interest arrears	0	1600	2700	4100	4400	3300	0	0
D300	Private creditors	11806	11275	10422	9843	10690	11650	12356	11987
		-----	-----	-----	-----	-----	-----	-----	-----
D310	Commercial banks	8901	8200	7633	7216	7514	8617	9409	9250
D311	Commercial banks % change	-12.7	-7.9	-6.9	-5.5	4.1	14.7	9.2	-1.7
D312	Medium/Long term	7207	6872	6368	5896	6297	7225		
D313	Short term	1094	1328	1265	1320	1217	1392		
D314	Interest arrears	600	0	0	0	0	0	0	0
D320	Nonbank creditors	2905	3075	2789	2627	3176	3033	2947	2737
-----									
EXTERNAL ASSETS (\$ million)									
-----									
A500	Official reserves (excluding gold)	278	649	765	1106	870	698	1000	610
A505	Reserves % imports goods & services	3.1	8.4	10.4	15.2	12.0	9.1	11.7	6.5
A510	Gold value (market prices)	187	215	180	146	154	185	231	
A520	Gold (million ounces)	0.470	0.471	0.472	0.472	0.472	0.472	0.472	
A600	Domestic banks' foreign assets	131	187	235	355	485	677		
A700	Deposits in BIS banks	757	965	1244	1547	1595	1721		
A900	Potential IMF credits	0	0	0	0	0	0	2200	2300

=====

e = estimate, f = forecast

CODE DEBT SERVICE PAYMENTS (\$ million)	1981	1982	1983	1984	1985	1986	1987e	1988f
P100 Interest payments	2843	3031	2889	2729	2609	2734	2920	2990
P200 Amortization payments	1397	368	508	364	756	715	975	720
P300 Debt service % exports goods & services	73.9	66.6	60.9	51.2	57.6	56.6	58.1	52.3
P310 Interest % exports goods & services	49.5	59.4	51.8	45.2	44.7	44.9	43.6	42.2
P320 Amortization % exports goods & services	24.3	7.2	9.1	6.0	12.9	11.7	14.6	10.2
P500 Average external interest rate	10.9	11.4	10.9	10.1	8.8	8.2	7.4	7.5
P510 Average real external interest rate	38.5	23.0	17.9	8.4	5.8	5.6	2.7	4.2

e = estimate, f = forecast

CODE GOVERNMENT & MONETARY SECTORS	1981	1982	1983	1984	1985	1986	1987e	1988f
=====								
GOVERNMENT SECTOR (zloty billion)								
.....								
G200 General government borrowing	314	163	142	192	121	144	300	
G202 General government borrowing % GDP	11.4	2.9	2.1	2.2	1.2	1.1	1.7	
G210 General government revenue	1149	2405	2708	3403	4224	5171	6000	
G211 General government revenue % change	-5.4	109.3	12.6	25.7	24.1	22.4	16.0	
G212 General government revenue % GDP	41.7	43.4	39.1	39.7	40.7	39.9	34.4	
G220 General government expenditure	1463	2568	2850	3595	4345	5315	6300	
G221 General government expenditure % change	17.7	75.5	11.0	26.1	20.9	22.3	18.5	
G222 General government expenditure % GDP	53.1	46.3	41.2	41.9	41.9	41.0	36.1	
.....								
MONETARY SECTOR (zloty billion)								
.....								
M100 Domestic credit	3377	4177	4630	5146	6233	7802	10600	
M101 Domestic credit % change	21.2	23.7	10.8	11.1	21.1	25.2	35.9	
M110 Claims on state budget	-97	161	184	236	472	921	2350	
M120 Claims on rest of domestic economy	3474	4016	4446	4910	5761	6881	8250	
M200 Net foreign assets	-143	-166	-200	-252	-247	-133	300	
M300 Other liabilities	1271	1852	1963	2368	3244	5284	10000	
M400 Money (M1)	1116	1590	1752	2020	2456	2989	3900	
M401 M1 % change	22.6	42.5	10.2	15.3	21.6	21.7	30.5	
M500 Money + quasi-money (M2)	1917	2660	3045	3595	4465	5607	7500	
M501 M2 % change	24.2	38.8	14.5	18.1	24.2	25.6	33.8	
M511 M2 velocity % change	-11.7	45.2	9.1	4.9	-2.7	-0.5	0.6	
.....								
M700 Short-term interest rate	4.0	6.0	6.0	6.0	6.0	6.0	6.0	
M710 Real short-term interest rate								
.....								
M800 Consumer price % change	19.4	103.7	25.5	15.4	14.6	14.7	27.0	40.0
=====								

e = estimate, f = forecast

CODE	STRUCTURAL FACTORS	1981	1982	1983	1984	1985	1986
=====							
MERCHANDISE TRADE							
.....							
F100	Merchandise exports (\$ million)	10464	10457	11000	11800	10912	11558
	Export composition % total:						
F110	Machinery & transport exports		47.2	43.8	38.5	41.5	36.3
F112	Coal exports		12.9	13.4	14.2	13.7	11.7
	Export destination % total:						
F120	Convertible currency area	47.5	43.4	43.7	45.1	46.9	46.0
F122	Non-convertible currency area	52.5	56.6	56.3	54.9	53.1	54.0
F130	Exports % GDP	19.4	16.0	14.5	15.6	15.5	15.6
.....							
F150	Merchandise imports (\$ million)	12564	10654	10582	10962	10436	10914
	Import composition % total:						
F160	Energy imports		21.2	25.4	22.6	21.6	20.2
F162	Machinery & transport imports		23.7	24.7	27.1	29.8	31.6
	Import origin % total:						
F170	Convertible currency area	46.1	40.1	36.8	36.0	38.6	39.2
F172	Non-convertible currency area	53.9	59.9	63.2	64.0	61.4	60.8
F180	Imports % GDP	23.3	16.3	14.0	14.5	14.8	14.8
.....							
REAL GDP ORIGIN: 1980 = 100							
.....							
F210	Industry (49.4% GDP)	86.0	82.6	87.3	92.1	95.7	99.9
F220	Agriculture (18.2% GDP)	102.0	108.1	114.4	120.8	121.0	128.1
F230	Construction (10.7% GDP)	76.0	69.9	75.3	81.4	84.9	88.4
F240	Transport/Communication (21.7% GDP)	100.0	100.0	110.0	120.5	125.4	131.3
.....							
POPULATION AND EMPLOYMENT							
.....							
F500	Population (million)	35.90	36.23	36.57	36.91	37.20	37.46
F501	Population % change	0.9	0.9	0.9	0.9	0.8	0.7
F511	Per capita GDP % change	-10.8	-5.6	4.6	4.7	2.8	4.4
.....							
F520	Employment (million)	17.42	17.00	16.95	17.00	17.14	17.23
F521	Employment % change	0.6	-2.4	-0.3	0.3	0.8	0.5

=====

e = estimate, f = forecast

BY BAG

CONFIDENTIAL

FM EAST BERLIN

TO FCO TELNO 001 SAVING OF 18 MARCH 1988

INFO SAVING TO BONN, MOSCOW, BMG BERLIN, PARIS, WASHINGTON,  
UKMIS CSCE VIENNA, DEPT OF TRADE AND INDUSTRY

## MR MELLOR'S VISIT TO EAST BERLIN, 15-16 MARCH

## SUMMARY

1. GDR views expressed to Mr Mellor in a full one-and-a-half days in East Berlin were familiar but with some marginal softening and improvements. GDR stressed their anxiety to see progress through compromises at CSCE Vienna, laid modest claim to an independent role in the Warsaw Pact, looked forward to a continuation of their own dialogue policy in Western Europe, praised our bilateral relations and accepted our list of humanitarian cases. They were less disputatious than usual when Mr Mellor confronted them with some home truths on denuclearisation and human rights, and listened with unaffected interest to his views on the Gulf and Arab/Israel problems.

2. Mr Mellor met Church representatives and also gave a substantial Press Conference, which was mostly well reported. GDR were, as in the Leipzig leg, conscientious hosts and contributed to a very good visit.

## DETAIL

3. Talks with GDR fell into four sections, of which that with Professor Schmidt (B. below) was distinctly promising. None were bad.

A. Minister Oskar Fischer

In a useful 40-minute talk with Foreign Minister Fischer, Mr Mellor stressed HMG's desire to see active progress in the disarmament

/field

field, which meant especially something substantial on conventional disarmament, to bring more mutual confidence. This was essential for ratification of an eventual START agreement. Fischer was inclined to re-state a number of Warsaw Pact platitudes such as "no compensation" for INF weapons removed but he was generally responsive and assured Mr Mellor that GDR had no intention of keeping quiet within its alliance on matters which vitally concerned the future of the GDR. The fact that some weapons systems did not stand under GDR control did not mean that GDR could not speak firmly to its allies about them. Fischer agreed that the Stockholm Agreement and particularly the implementation of inspection and verification processes were a landmark. Fischer agreed in principle, but was not particularly clear about the order of events at the next stage of the disarmament process.

B. Professor Max Schmidt

Professor Max Schmidt (Head of the IPW think-tank and of GDR Round Table team at Wilton Park) was much clearer about timetables. He said he could perfectly appreciate our argument that conventional disarmament was of first priority for us, and specifically confirmed that it would be unreasonable and unrealistic for Warsaw Pact to adopt the attitude that nuclear weapons must go before others. He also believed that a compromise on dual capables must be achievable. He agreed with Mr Mellor that one must not attempt, at the beginning of mandate negotiations, to make too rigid definitions on which substantive negotiations might later get stuck. Mr Mellor made the point strongly that it would be no use the GDR imagining that they could play on West German sensitivities about short-range weapons in the hopes of wringing something more out of them when those politicians advocating weakness on short-range weapons were in fact becoming more isolated. Schmidt seemed to assent to the point of view that one should not waste valuable time in such vain hopes. Schmidt also appreciated Mr Mellor's point that an eventual START treaty would not get easy ratification by Congress unless substantial progress on conventional disarmament was already visible. He suggested that the Warsaw Pact side would come up with fresh initiatives after a START treaty, when the experts had necessary time available.

C. Deputy Minister Nier

C. Deputy Minister Nier

(i) Bilateral. Nothing very important emerged on bilateral issues, which were generally treated in a satisfactory manner. In particular Nier confirmed that GDR wished to see consolidation and improvement of our trading relationships, and realised the importance they have for the overall political relationship. He welcomed the fact that Dr Beil will be coming to UK again in October. Mr Mellor made the point that the visit of Mr Moynihan over Easter would give the opportunity to discuss in more detail environmental matters, as well as sporting ones. It is clear that Deputy Minister Reichelt intends to take up questions of environmental collaboration with Mr Moynihan. Nier seemed genuinely to welcome the satisfactory development of the Round Table. He professed to be surprised by a newspaper report mentioning our seven outstanding humanitarian cases, claiming that GDR only knew of two. But he accepted our up-to-date list. Nier replied in now-classic terms to Mr Mellor's references to human rights in their broader sense, claiming that GDR took human rights very seriously, and saw them in their entirety, including social and economic aspects, unemployment etc. He felt that the press had made a targetted campaign against the GDR. Nier also mentioned the problem of visas for GDR Embassy and businessmen in London, of which the Department are well aware. Mr Mellor said we hoped to give him good news soon.

(ii) East-West and International. Mr Mellor hoped 1988 could turn out as well as 1987. While HMG were hopeful of keeping up the impetus after INF, we remained rather disappointed at progress in CSCE. We had also hoped to see a more definite swing of the Soviet economy away from large-scale arms production. Nier replied claiming that GDR was optimistic in principle but as disappointed as we were at CSCE. Countries like UK and GDR must not underestimate their role within their Alliances, and he restated GDR's claim to have kept East/West dialogue alive in 1983/4. GDR would pursue its dialogue policy, and the upgrading of its relations with Western Europe, especially the FRG (but giving no obvious hint that Honecker should be invited to UK). Nier perfunctorily welcomed changes in the USSR, with whom GDR exchanged experiences and information from their "objectively very different" position.

/GDR

GDR would seek "normalisation" both of Comecon/EC relations and of GDR/EC relations. Nier made a plea that negotiations at CSCE Vienna should get away from bargaining chips and take a broad view of issues which were susceptible to consensus (CONSENSUSFAHIG). In reply Mr Mellor stressed the need for the East to do some more hard thinking on human rights, and also work for a better framework in which to raise particular cases; many practical results could be achieved without shaking whole political systems. We should avoid sterile arguments, but nevertheless recognise that the Vienna conference could hardly come to a close without major progress on Basket Three. On military matters in Vienna, Nier complained that he did not yet see much evidence there of the rather positive exchange between yourself and Marshal Akromeeyev about dual-capables. As to human rights, one only had to look back to Madrid to see how far we had come; but the West must not delude itself: GDR would refuse anything in Basket Three which threatened socialism. Nier put in a standard plug for the Moscow Conference, but did not press it against Mr Mellor's arguments. Nor did he dispute Mr Mellor's suggestion that our differences on dual-capables could be as much in form as in substance and that the essential was to prevent attempts to use dual-capables to bring in by the back door questions of nuclear disarmament. Finally, Mr Mellor gave Nier some up-to-date views on Iran/Iraq and on the Israeli/Arab question, which were listened to with great attention.

4. Mr Mellor also had a useful and relatively optimistic account of the state of play between Church and State from Stolpe, Konsistorialpräsident, which we have reported separately.

#### COMMENT

5. This was a very useful and comprehensive visit. I was very pleased with it, as, I think, was Mr Mellor too. GDR were impressed that he devoted five full days, and referred to this flattering assiduity several times. We covered all the subjects, economic (in Leipzig) and political, that we wanted. The forthcoming and relatively uninhibited remarks of Professor Max Schmidt may indicate

/more



more effort on GDR side in the next few months to contribute positively and seriously to the East/West debate. GDR took most of Mr Mellor's frankly-stated arguments with attentiveness and a minimum of contentiousness. The occasional misreporting by Neues Deutschland, which was in any case corrected, does not detract from this.

EVERARD

*EUROPEAN POLITICAL*

*W E D*

CONFIDENTIAL



*pmg*

✓  
24/3

CH/EXCHEQUER	
R	24 MAR 1988
ACTION	EST
COPIES TO	Sir G. LITTLER
	Mr LANKESTER
	Mr A.J.C. EDWARDS
	Mr H.P. EVANS
	Mr MOUNTFIELD

*for info*

10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

23 March 1988

✓  
✓

*Dear Lynn,*

PRIME MINISTER'S MEETING WITH MR. DJURANOVIC

The Prime Minister had a talk this morning with Mr. Vesselin Djuranovic, Member of the Yugoslav Presidency, before her lunch in his honour. Mr. Djuranovic was accompanied by the Yugoslav Ambassador. HM Ambassador, Belgrade, was also present.

Welcoming Mr. Djuranovic, the Prime Minister said that she would be interested to hear about Yugoslav's economic problems and negotiations with the IMF. She would also welcome an account of Mr. Gorbachev's recent visit to Yugoslavia. Mr. Djuranovic said he would be happy to discuss both points. He would note straight away that relations between Yugoslavia and the United Kingdom were in very good shape.

Yugoslav Economy

The Prime Minister said that Yugoslavia clearly faced very serious economic problems, particularly inflation and the level of indebtedness. The pressing need was to agree a standby arrangement with the IMF. While this would certainly require difficult decisions, the nettle had to be grasped. Speaking frankly, she was not clear whether the problem was that the Yugoslav government did not know what needed to be done; or whether it was simply unwilling to do it.

Mr. Djuranovic said that one of the main objectives of his visit to Britain was to present the situation realistically. Yugoslavia had been pursuing a long-term economic stabilisation programme with the objective of maintaining a high rate of economic growth and of servicing and repaying Yugoslavia's debt promptly. However, experience of the last three years had shown that it was virtually impossible for Yugoslavia to achieve these objectives. They now faced stagnation in growth, while an unacceptably high proportion of foreign exchange had to be devoted to paying off debt. Indeed, last year there had been a negative rate of growth while 40 per cent of foreign exchange had gone to payment of debt interest. The Government now realised that

CONFIDENTIAL

the original objectives had been unrealistic. Moreover, Yugoslavia had made another fundamental misjudgement in believing that they did not need to reach a further agreement with the IMF. Unfortunately the whole question of relations with the IMF had become politicised or, more accurately, ideologised in Yugoslavia. People had thought they could do without the IMF. Now they recognised that they could not.

Mr. Djuranovic continued that Yugoslavia had as a result set itself some clear objectives: to seek a new standby arrangement with the IMF, to keep its debt service ratio to 25 per cent, to try to contain its debts at the present level until 1995 and to strengthen its foreign exchange reserves. Negotiations with the IMF were at present in progress covering three main issues. The first was price liberalisation, import liberalisation and establishment of a foreign exchange market. The Yugoslav government was in favour of all three and differed with the IMF only on the speed with which they could be put into practice. The IMF wanted to see them introduced straightaway: the Yugoslav government thought they should be introduced more gradually. The second issue was the target rate of inflation. The IMF had proposed reducing it to 50/60 per cent by the end of 1988. In the government's view this was unrealistic and it now seemed likely the IMF would agree that any rate below 100 per cent would be satisfactory. If prices and imports were liberalised there was bound to be a considerable degree of inflation. The third was devaluation of the dinar. The Yugoslav government was prepared to contemplate that, but differed with the IMF on the scale of devaluation.

The Prime Minister said there were broadly two approaches to IMF requirements. You could accept them but say that they should be applied over an extended period of three or four years. Or you could decide to take harsh measures straightaway. It was really a question of psychology. People often understood better the need for harsh measures in the short term with the prospect of some relief thereafter, to extending the agony. Mr. Djuranovic should take heart from the successes which had been achieved, for instance, in Israel.

Mr. Djuranovic agreed with the Prime Minister's comments. But some account had to be taken of Yugoslavia's structure. It was a multi-national community which meant that there were many different interests to be reconciled. Decisions which could be taken quite straightforwardly in some countries required careful negotiation and balancing of interests in Yugoslavia or they would be destabilising. It was difficult therefore to bring about the transformation of the economy which was required. But there were no basic differences with the IMF. Their disagreements concerned not whether Yugoslavia should take action, but how much and how fast. Yugoslavia desperately needed the support of the IMF and of other governments.

The Prime Minister said that once agreement had been reached with the IMF on a standby arrangement, the doors would

be unlocked to a good deal of extra help, for instance with the rescheduling of Yugoslavia's debts. The future of Yugoslavia was a matter of great concern to all of us. We were aware of the country's diversity and the risk that this could be exploited to cause instability. Her advice to Mr. Djuranovic was to bring negotiations with the IMF to a speedy conclusion and make a major effort to explain the outcome to the Yugoslav people.

Mr. Djuranovic said that political considerations had also to be taken into account. Yugoslavia was having to steer a very difficult course. They did not want centralisation or repression. But equally there was a risk that decentralisation would unleash centrifugal tendencies. A constitutional amendment would be introduced this year to strengthen the Federal Government, with the aim of making Yugoslavia more stable. These efforts were intended to parallel the economic measures which he had described.

The Prime Minister said that it seemed to her that Mr. Djuranovic had made a very full and basically correct analysis of Yugoslavia's problems. That in itself was a major step towards a solution. As soon as there was agreement with the IMF, we would do what we could to help. She urged Mr. Djuranovic to cheer up: while Yugoslavia's problems were considerable, they were far from insuperable and the long-term prospects were good.

#### United Kingdom/Yugoslavian Economic Co-operation

Mr. Djuranovic said that economic co-operation between Britain and Yugoslavia was developing successfully but not all the possibilities had been tapped. The main problems arose because of Yugoslavia's economic difficulties. But on the British side, there was a particular problem over ECGD which was withholding credit for exports to Yugoslavia. While he understood the reasons for this, he thought that we were being too inflexible. For instance, both France and Germany had agreed to export credit for the sale of Airbus to Yugoslavia but the United Kingdom had refused. Yet this was quite clearly an economically viable project.

The Prime Minister explained that, when countries were experiencing economic difficulties and had failed to reach agreement with the IMF, we had no alternative but to limit ECGD support. She was not aware of the specific case of the Airbus and would look into it. But the key was for Yugoslavia to take the right long-term action to get its economy into order, and then all sorts of other things would become possible.

#### British Claims

The Prime Minister raised the matter of Yugoslavia's failure to settle British claims following the mid-air collision between British and Yugoslav aircraft over Zagreb in 1976. We understood that Yugoslavia might encounter difficulties in actually paying claims. But what hurt us was her refusal to acknowledge liability. It was a matter of

grave concern that a claim remained unsettled after twelve years. She understood that negotiations might be possible. If not, it threatened to become a major political problem. She hoped very much that Mr. Djuranovic would consider how a solution might be found.

Mr. Djuranovic said that Yugoslavia had never denied the humanitarian aspect. Various ideas, such as indemnity, could be discussed once the legal processes had been concluded. The Yugoslavian Government would be willing to enter into discussions at that point.

#### European Community/Yugoslavia

Mr. Djuranovic said that there had been good progress in Yugoslavia's relations with the European Community last year with the conclusion of new Trade and Financial Protocols. The joint Working Group which had been set up would meet in April. Yugoslavia was looking for increased support in two areas: more favourable trade access to the Community market and help for Yugoslavia to adjust to trading with the Community once the internal market had been completed. It was necessary to remember that the Community and Yugoslavia were not on an equal footing. Yugoslavia's special status as a European developing country had been recognised. Yugoslavia desperately needed to be able to earn more foreign exchange.

The Prime Minister said that the future of Yugoslavia mattered a great deal to the European Community. But many of the products Yugoslavia wanted to export caused difficulty. Completion of the internal market should be a stimulus to the Community's external trade as well, from which Yugoslavia should be able to benefit. But she came back to the point that the first and most crucial step was to put the economy in order and not run away from difficult decisions.

#### Conclusion

The Prime Minister again urged Mr. Djuranovic to cheer up. Britain was a great supporter of Yugoslavia, indeed his country had no greater well-wisher than Britain. Mr. Djuranovic recalled the help that Yugoslavia had received from Britain in the Second World War. He hoped the same spirit could be re-created now.

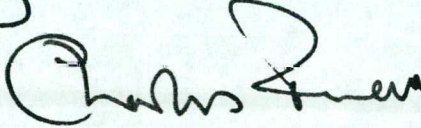
The Prime Minister does not recall anything of great moment emerging in their talks over lunch. The Foreign Secretary would have filled you in on his own conversation with Mr. Djuranovic.

The Prime Minister would like to know the position on the sale of Airbus to Yugoslavia (which was not covered in her brief). She may wish to write to Mr. Djuranovic on the subject.

CONFIDENTIAL

5

I am copying this letter to Alex Allan (HM Treasury), Stephen Ratcliffe (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

Yours sincerely,  


C D POWELL

Lyn Parker, Esq.  
Foreign and Commonwealth Office

CONFIDENTIAL

BF to JMG 11/4

FROM: P MOUNTFIELD

DATE: 8 April 1988

ECONOMIC SECRETARY

cc PS/Chancellor  
Sir P Middleton  
Sir G Littler  
Mr Evans  
Mr Bottrill  
Mrs Thomson

## VISIT OF POLISH DEPUTY PRIME MINISTER

Mr Sadowski, Deputy Prime Minister and President of the Economic Planning Commission PEC, is visiting London on 29 April on his way to Washington for talks with the IMF. He will be having a meeting with Mr Mellor in the morning. FCO have asked if you would be prepared to see him as well. I understand there is a spot in your diary that day at 4.00pm.

2. I strongly recommend that you should see him. Negotiations between Poland and the IMF and with her creditors are now moving into an interesting phase. A fund mission is in Warsaw at present, and on its return will be reporting the outline of a possible standby agreement. We guess that Sadowski's visit is an attempt to persuade the fund management to accept his terms. (The essential issue is the speed of the adjustment versus domestic political pressures). He will also be lobbying for support from supposedly friendly creditor governments: among whom, I fear, he numbers the UK. But the US government, again for domestic political reasons (the large Polish vote in Chicago) is opposed to any early agreement with the IMF, certainly before the presidential elections.

3. A meeting with Sadowski at this present stage would give us a chance to inject a note of realism into Polish expectations. I therefore think we should take the chance.

4. I would be available to support you, if you wished, at a meeting. Fuller briefing can be provided nearer the time, when we have had a report from the returning IMF mission.

RM

P MOUNTFIELD



FROM: G R WESTHEAD  
DATE: 11 April 1988

A handwritten signature in dark ink, appearing to be "G R Westhead".

MR MOUNTFIELD

cc PS/Chancellor  
PS/Sir P Middleton  
Sir G Littler  
Mr Evans  
Mr Bottrill  
Mr Thompson

**VISIT OF POLISH DEPUTY PRIME MINISTER**

The Economic Secretary has seen and was grateful for your minute of 8 April. He is content to see the Polish Deputy Prime Minister, Mr Sadowski during his visit to London on 29 April. We will reserve 4.00pm on that day as a firm booking.

2. The Economic Secretary would be grateful for briefing and official support for this occasion, including a pre-meeting at 3.45pm.

3. It would be useful if briefing could reach this office by close of play on Friday 26 April.

A handwritten signature in dark ink, reading "Guy Westhead".

GUY WESTHEAD  
Assistant Private Secretary



13 APR 1988

The Rt. Hon. Lord Young of Graffham  
Secretary of State for Trade and Industry

C D Powell Esq  
Private Secretary to the  
Prime Minister  
10 Downing Street  
LONDON  
SW1A 2AA

12/4

CH/EXCHEQUER	
REC.	12 APR 1988
ADJ.	[REDACTED]
COPIES TO	

Department of  
Trade and Industry

1-19 Victoria Street  
London SW1H 0ET

Switchboard  
01-215 7877

Telex 8811074/5 DTHQ G  
Fax 01-222 2629

Direct line 215 5422  
Our ref PS1AOW  
Your ref  
Date 11 April 1988

CHIEF SECRETARY	
REC.	14 APR 1988
TO	MR P. DAVIS
	Mr EST, Mr Anson, Sir G. Lither
	Mr Lancaster Mr Menck, Mr Bingham Mr Moore
	Mr Mansfield Mr Turnbull,
	Mrs Brown Mr Call.

Dear Charles,

**YUGOSLAVIA : ADRIA AIRWAYS**

In your letter of 23 March to Lyn Parker, reporting the Prime Minister's meeting on that day with Mr Djuranovic, you noted the question he raised about ECGD cover for a potential Airbus aircraft sale to Adria Airways. The PM expressed interest and indicated that she might wish to write to Mr Djuranovic on the subject. The position is as follows:

1. In July 1984 Adria Airways signed a purchase agreement with Airbus Industrie for five A320 aircraft, together with spare parts and spare engines for delivery beginning in the first half of 1989 and ending in 1991. Adria was therefore a launch customer for the A320, against strong US competition: the USA have in fact supplied most of Adria's existing fleet. Originally the French and Germans (like ECGD) refused cover for the transaction. However, upon learning that the Americans were prepared to give further cover, they offered to cover 3 aircraft.

2. ECGD recognised that Adria is an important case and that a move to cover should be made in advance of any decisions to resume medium term cover generally for Yugoslavia. Accordingly, ECGD aimed to persuade Adria to do the deal on a leasing basis, which should enable the Department to give cover under asset based financing arrangements - by taking into account the value of the asset and the fact that the lessor would be able to repossess the aircraft in the event of default - thus producing a much reduced country limit exposure: £9m against a figure of £40m for full cover.

3. After some argument, Adria eventually agreed to consider a leasing agreement. Progress on this however will depend not only on the signing of the next multilateral debt rescheduling agreement by the Paris Club (which, of course, depends upon an IMF Standby arrangement being in place) but also acceptance by the Paris Club that leasing transactions will continue to be excluded from debt rescheduling agreements. To date the latter point has not been decided by the Paris Club. At the last meeting the agenda was not completed and it will therefore appear on the agenda of the next meeting which takes place on 18 April. However, this initiative has enabled the UK to make a more positive commitment to our Airbus partners and Adria and should enable discussions on the financing arrangements to continue.

A draft letter is enclosed for the PM to send to Mr Djuranovic explaining that all depends on an IMF Standby agreement being agreed.

As further background, I should add that, while ECGD has taken a generally more restrictive attitude towards the resumption of medium/long term cover for Yugoslavia than the other European export credit agencies, its high existing exposure (of some £450m resulting from the generous support given for Yugoslav development projects before Paris Club debt restructurings began in 1983) is the highest of all apart from the US Eximbank's. Cover even on the limited scale required for an asset based financing arrangement will have to be given under the DX criteria. This should be possible in time provided that a successful economic adjustment programme is at last put in place, as evidenced by an IMF Standby arrangement. To relax on this point now would, of course, give the wrong signals to the Yugoslavs at a critical point when we are all trying to get them to accept a tough IMF programme which stands a chance of bringing their economy, and foreign debt position under control.

Copies of this letter and enclosure are going to Lyn Parker (FCO), Alex Allen (HM Treasury) and Trevor Woolley (Cabinet Office).

*Yours ever*  
*Step Ratcliffe*

STEPHEN RATCLIFFE  
Private Secretary

**DRAFT LETTER FOR PRIME MINISTER**

**His Excellency Mr Veselin Djuranovic,  
Presidency of the Socialist Federal Republic  
of Yugoslavia**

It was a great pleasure for me to meet you in London on 23 March and be able to discuss matters of mutual interest, especially to hear at first hand of your Government's determination to tackle Yugoslavia's present economic problems.

One particular point you raised which I promised to inquire into concerned the sale of Airbus aircraft to Adria Airways. I am told that ECGD and the other export credit agencies involved are examining the possibility of providing support for a leasing arrangement. This would be subject to the reasonable condition that the current negotiations with the IMF on an economic adjustment programme and the subsequent debt restructuring negotiations with the Paris Club of creditor countries are concluded satisfactorily. It would also be subject to agreement among creditor agencies that such leasing arrangements would be excluded from any future debt reschedulings.

Although I understand that delivery of the first Airbus aircraft is not scheduled until next year, Airbus Industrie will obviously want to be sure that cover is available from the export credit agencies. I am told that the partners in the Airbus Consortium and indeed Adria Airways were prepared to accept the leasing arrangement proposed.

As we noted during our meeting, a great deal depends upon the first step of reaching a satisfactory agreement with the IMF on appropriate economic adjustment measures, which should lead to the negotiation with your major creditor countries of a

realistic debt restructuring plan that Yugoslavia can cope with: this is clearly a matter of great mutual concern since, amongst the export credit agencies, the ECGD has one of the highest exposures on Yugoslavia, deriving from past support given to your country.

As always, we in the United Kingdom want to extend all the friendship and support we can to Yugoslavia and I look forward to a successful outcome to all the matters we have discussed, not least the supply in due course of Airbus aircraft to Adria Airways.

DC1.T4

EXCHEQUER  
14 APR 1988  
Mr MOUNTFIELD  
EST  
Sir G. LITTLER  
Mr LANKESTER  
Mr A. J. C. EDWARDS  
Mr H. P. EVANS

✓  
14/4



Page

10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

13 April 1988

YUGOSLAVIA

I enclose a copy of a letter to the Prime Minister from Mr. Djuranovic, Member of the Presidency of the Socialist Federal Republic of Yugoslavia.

I am copying this letter and enclosure to Alex Allan (Treasury).

C. D. Powell

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



EMBASSY OF THE SOCIALIST FEDERAL  
REPUBLIC OF YUGOSLAVIA

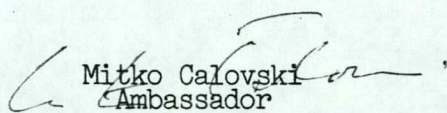
5 LEXHAM GARDENS,  
LONDON, W8 5JU.  
Tel: 01-370 6105

London, 13 April 1988

Dear Madam Prime Minister,

I was asked by H.E. Mr. Veselin Djuranovic,  
Member of the Presidency of the SFR of Yugoslavia, to  
present to you his personal letter.

Please accept, Madam Prime Minister, the  
expressions of my highest consideration and profound  
personal respect.

  
Mitko Calovski  
Ambassador

The Rt Hon Margaret Thatcher, MP  
Prime Minister of the United Kingdom  
of Great Britain and Northern Ireland  
10 Downing Street  
London SW1

Predsedništvo  
Socijalističke Federativne Republike Jugoslavije

Beograd

11. april 1988.

Gospodjo Predsedniče Vlade,

Dozvolite mi da Vam, po povratku u zemlju, još jednom zahvalim na gostoprimstvu i prijateljskoj atmosferi kojom smo bili okruženi tokom nedavne posete Vašoj zemlji. Uverili smo se i ovog puta da su koreni prijateljstva između naših naroda duboki, a osnove saradnje između naših zemalja čvrste.

Razgovori koje smo vodili o najvažnijim pitanjima naših bilateralnih odnosa i međunarodne situacije, verujem da će te se sa mnom složiti, bili su i ovog puta sadržajni i zaista korisni. O sadržaju naših razgovora upoznao sam Predsedništvo SFRJ koje je visoko ocenilo otvorenost i duh prijateljstva u kome su oni vodjeni, kao i razumevanje koje ste Vi pokazali za rešavanje problema i potreba daljeg privrednog razvoja naše zemlje.

U toku je donošenje značajnih odluka koje treba da podstaknu oživljavanje naše privrede i otvore put bržem razvoju. Uvereni smo da ćemo, osloncem na sopstvene snage i kreativnost naših ljudi, za koju ste i Vi našli reči ohrabrenja, uz saradnju i podršku naših partnera i prijatelja iz inostranstva u tome i uspeti. Očekujemo da će saradnja između naših dveju zemalja, za koju smo zajednički

konstatovali da je u usponu, imati i dalje značajno mesto u ovim našim naporima.

Verujem da ćete se složiti sa mnom u korisnost kontinuiteta političkog dijaloga između naših dveju zemalja. Zato sa zadovoljstvom očekujemo da ćete biti u mogućnosti da u dogledno vreme, svakako kada Vam Vaše obaveze dozvole, dodjete u posetu našoj zemlji. To će biti i prilika da Vam uzvratimo toplo gostoprimstvo koje ste nama ukazali.

Primate i ovog puta izraze mog poštovanja,

iskreno Vaš

*Veselin Djuranović*

Veselin Djuranović

Gospodja  
Margaret Tačer  
Predsednik Vlade



PRESIDENCY OF THE SOCIALIST  
FEDERAL REPUBLIC OF YUGOSLAVIA  
B E L G R A D E

Belgrade, 11 April 1988

Dear Madam Prime Minister,

May I thank you once again, upon my return home, for the hospitality accorded to me and the friendly atmosphere I and my associates enjoyed during our recent visit to your country. I returned to Yugoslavia convinced once again that the roots of friendship between our nations are deep and that the foundations upon which the cooperation between our countries is based are firm and lasting indeed.

I trust that you share my belief that the talks we had on the major issues of our bilateral relations as well as on the international situation were, also on this occasion, meaningful and truly useful. I have reported the substance of our talks to the Presidency of the SFR of Yugoslavia, who have highly appreciated and assessed the frankness and openness as well as the spirit of friendship in which they were conducted, and the understanding that you demonstrated for solving the problems we face and the needs associated with the further economic development of our country.

We are in process of arriving at important decisions designed to give an impetus to the recovery of our economy and to pave the way for a faster development. We are confident that we shall succeed in this, by

The Rt. Hon. Margeret Thatcher, M.P.  
Prime Minister  
10 Downing Street

drawing upon our own resources and upon the creativity of our people, for which you personally found words of encouragement, as well as through the cooperation and support of our foreign friends and partners. We expect that the cooperation between our two countries, which we both noted was on the rise, shall continue to play an important role in these efforts of ours.

I believe that you share my view on the usefulness of the continued political dialogue between our two countries. We are, therefore, looking forward to your visit to our country at your earliest convenience, of course in the context of your busy schedule. This would also make it possible to reciprocate to you the warm hospitality that you have so kindly accorded to me.

I avail myself of this opportunity to renew to you, dear Madam Prime Minister, the assurances of my highest consideration.

Sincerely yours,  
(Sgd.) Veselin Djuranović



10 DOWNING STREET  
LONDON SW1A 2AA

THE PRIME MINISTER

✓ 15/4

CH/EXCHEQUER	
REC.	15 APR 1988
ACTION	Mr MOUNTFIELD
COPIES TO	EST. SIR G. LITTLER
	Mr LANKESTER
	Mr A.J.C. EDWARDS
	Mr H.P. EVANS

14 April 1988

Y  
Yon Excellency

It was a great pleasure for me to meet you in London on 23 March and be able to discuss matters of mutual interest, especially to hear at first hand of your Government's determination to tackle Yugoslavia's present economic problems.

One particular point you raised which I promised to enquire into concerned the sale of Airbus aircraft to Adria Airways. I am told that ECGD and the other export credit agencies involved are examining the possibility of providing support for a leasing arrangement. This would be subject to the reasonable condition that the current negotiations with the IMF on an economic adjustment programme and the subsequent debt restructuring negotiations with the Paris Club of creditor countries are concluded satisfactorily. It would also be subject to agreement among creditor agencies that such leasing arrangements would be excluded from any future debt reschedulings.

Although I understand that delivery of the first Airbus aircraft is not scheduled until next year, Airbus Industrie will obviously want to be sure that cover is available from the export credit agencies. I am told that the partners in the Airbus Consortium and indeed Adria Airways were prepared to accept the leasing arrangement proposed.

As we noted during our meeting, a great deal depends upon the first step of reaching a satisfactory agreement with the IMF on appropriate economic adjustment measures, which should lead to the negotiation with your major creditor countries of a realistic debt restructuring plan that Yugoslavia can cope with: this is clearly a matter of great mutual concern since, amongst the export credit agencies, the ECGD has one of the highest exposures on Yugoslavia, deriving from past support given to your country.

As always, we in the United Kingdom want to extend all the friendship and support we can to Yugoslavia and I look forward to a successful outcome to all the matters we have discussed not least the supply in due course of Airbus aircraft to Adria Airways.

Yours sincerely

Margaret Thatcher

His Excellency Mr. Veselin Djuranovic



FROM: P J WALES  
DATE: 25 April 1988

MR MOUNTFIELD

cc PS/Chancellor <sup>2</sup>  
PS/Sir P Middleton  
Sir G Littler  
Mr Evans  
Mr Bottrill  
Mr Thompson

VISIT OF POLISH DEPUTY PRIME MINISTER

As I mentioned to your Secretary earlier today, the Polish Embassy telephoned to say that the Polish Deputy Prime Minister Mr Sadowski will now be unable to see the Economic Secretary this coming Friday 29 April. This is due to important commitments that he must take up within the Embassy.

A handwritten signature in black ink, appearing to read "Peter Wales".

P J WALES  
Diary Secretary

RESTRICTED

137120  
MDHIAN 7361

*mp*

RESTRICTED

FM WARSAW

TO IMMEDIATE FCO

TELNO 190

OF 271055Z APRIL 88

INFO ROUTINE EAST EUROPEAN POSTS, MOSCOW, UKDEL NATO, WASHINGTON  
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON

POLAND : ECONOMIC RESULTS FIRST QUARTER 1988

SUMMARY

1. SOME ENCOURAGING RESULTS FOR THE FIRST QUARTER. BUT WAGE AND PRICE RISES SIGNIFICANTLY ABOVE PLANNED TARGETS, AND WAGE INCREASES OUTSTRIP PRICES. AUTHORITIES CONCERNED. DECISION ON SPECIAL POWERS FOR GOVERNMENT TO BE TAKEN SOON. CURRENT INDUSTRIAL UNREST WILL PLAY A ROLE.

DETAIL

2. PROFESSOR SADOWSKI, VICE-PREMIER RESPONSIBLE FOR THE ECONOMIC REFORM, IS TO CALL ON MINISTERS ON 29 APRIL BEFORE FLYING TO WASHINGTON FOR TALKS WITH IMF AND US GOVERNMENT. FOLLOWING SUMMARY AND ANALYSIS OF RECENT ECONOMIC PERFORMANCE MAY BE USEFUL BACKGROUND.

3. FIRST QUARTER RESULTS: OUT-TURN FOR JANUARY-MARCH SHOWS THAT BASIC INDICATORS FOR MAIN SECTORS OF THE ECONOMY WERE HIGHER THAN IN SAME PERIOD OF 1987. JANUARY AND FEBRUARY PROVED GOOD MONTHS OWING TO FAVOURABLE WEATHER AND BECAUSE FOR SAME PERIOD IN 1987 PRODUCTION AND FOREIGN TRADE WERE UNUSUALLY LOW. GROWTH SLOWED IN MARCH. FOLLOWING ARE MAIN POINTS (UNLESS OTHERWISE STATED PERCENTAGES ARE INCREASES/DECREASES COMPARED WITH JANUARY-MARCH 1987) :

(A) INDUSTRY

SOLD PRODUCTION OF SOCIALISED (IE STATE-OWNED) INDUSTRY:  
+ 7.6% OF WHICH MINING: +2.7% AND MANUFACTURING: +8%.  
25.4 - 25.7% OF CENTRAL ANNUAL PLAN (CAP) COMPLETED.

(B) AGRICULTURE

CENTRAL PROCUREMENT OF FATSTOCK: -2.4%

PROCUREMENT OF BEEF ON THE HOOF: +0.5%  
MILK PROCUREMENT: +4.3%  
FERTILIZER SALES, JULY '87-MAR'88: -4.7%

(C) CONSTRUCTION

PRODUCTION OF ENTERPRISES IN CONSTRUCTION AND BUILDING SECTOR: +21.4%. THIS REPRESENTS 21.2% OF CAP FORECAST.  
HOUSING CONSTRUCTION INDUSTRY: +13.5%. 13.8% OF ANNUAL LOCAL HOUSING TARGETS ACHIEVED.

(D) TRANSPORT

GOODS CARRIED BY SOCIALISED TRANSPORT ENTERPRISES: +16.2%.

(E) FOREIGN TRADE

IMPORTS EXPORTS

WITH ZONE I (NON-CONVERTIBLE CURRENCIES).....	(PERCENTAGES)	
	+11.6	+9.5
WITH ZONE II (CONVERTIBLE CURRENCIES..)	+13.3	+15.1
BALANCE OF TRADE DEFICIT WITH ZONE I: -31.1M ROUBLES (JAN-V '87 : -91M ROUBLES)		
BALANCE OF TRADE SURPLUS WITH ZONE II: +277.3M DOLLARS (JAN-MAR '87 : +201M DOLLARS)		

21.3% OF CAP ACHIEVED FOR ZONE I EXPORTS.  
22.5% FOR ZONE I IMPORTS.  
24.4% OF CAP ACHIEVED FOR ZONE II EXPORTS.  
24.6% FOR ZONE II IMPORTS.

(F) AVERAGE MONTHLY WAGE

AVERAGE MONTHLY WAGE IN THE 5 BASIC SOCIALISED ECONOMIC SECTORS (INDUSTRY, CONSTRUCTION, TRANSPORT, COMMUNICATIONS AND TRADE): +45.9%  
AVERAGE MONTHLY WAGE FIGURE DOES NOT INCLUDE WAGE PAYMENTS FROM ENTERPRISES' RETAINED PROFITS. A DEPUTY FINANCE MINISTER HAS SAID PUBLICLY THAT WAGE RISES INCLUDING THOSE PAID FROM RETAINED PROFITS AMOUNTED TO 59%.  
AVERAGE PENSIONS: +44.2%

(G) INCOMES AND EXPENDITURES

INCOMES: +60%

EXPENDITURE: +52.9%

(H) PRICES

RETAIL PRICES OF CONSUMER GOODS AND SERVICES: C. +45%  
(+37% IF ALCOHOL AND TOBACCO ARE EXCLUDED). OF THESE:  
OVERALL RETAIL PRICES OF GOODS IN SOCIALISED SECTOR: +43%  
RETAIL PRICES OF GOODS IN NON-SOCIALISED SECTOR: +62%.  
PRICES OF FOOD: +46% OF WHICH +42% IN SOCIALISED SECTOR  
AND +66% IN NON-SOCIALISED SECTOR.

COMMENT

4. THESE RESULTS ARE IMPORTANT AS COVERING FIRST QUARTER SINCE INITIATION OF 'SECOND STAGE' OF ECONOMIC REFORM, AND REFLECTING FIRST EFFECTS OF PRICE INCREASES INTRODUCED ON 1 FEBRUARY. GENERAL JARUZELSKI ANNOUNCED IN MARCH (MY TELNO 128) THAT OUTCOME OF FIRST QUARTER WOULD DETERMINE WHETHER GOVERNMENT WOULD GIVE SPECIAL POWERS TO SADOWSKI TO SPEED INTRODUCTION OF REFORM.

5. FIGURES ARE A MIXED BAG. OUTPUT FIGURES FOR THIS QUARTER, USUALLY THE MOST DIFFICULT FOR THIS YEAR, ARE GOOD, WITH ABOVE-AVERAGE FULFILLMENT OF PLAN TARGETS. FOREIGN TRADE RESULTS ARE ESPECIALLY ENCOURAGING. BUT THE AUTHORITIES ACKNOWLEDGE SPECIAL FACTORS: MILD WINTER, COMPARATIVELY POOR PERFORMANCE IN 1987. THE 1988 PLAN ITSELF IS NOT AMBITIOUS (AIMING AT ANNUAL GROWTH OF 3.2-3.8% AGAINST ACTUAL ANNUAL GROWTH OF 5% IN 1983-86). OUTPUT STILL REMAINS WELL BELOW 1978 LEVEL. EVEN SO THE AUTHORITIES SEEM PLEASED.

6. MOST WORRYING AREA IS PRICES AND INCOMES. AT 45% RETAIL PRICE INCREASES EXCEEDED 1988 TARGET OF 36%. INCOMES HAVE OUTSTRIPPED EVEN THESE INCREASES.

7. SADOWSKI HAS ALWAYS JUSTIFIABLY ARGUED THAT PRICE AND WAGE REFORM IS ONLY PART OF THE REFORM POLICY AND THAT OBSERVERS SHOULD SHOULD CONCENTRATE ON ESSENTIAL STRUCTURAL CHANGES AND NEW ECONOMIC MECHANISMS BEING INTRODUCED. IN A STATEMENT TO THE SEJM (PARLIAMENT)'S ECONOMIC REFORM COMMISSION ON 23 APRIL HE SAID THAT FIRST QUARTER RESULTS REVEALED NO DIRECT THREAT TO ECONOMIC POLICY BUT ADDED THAT THE 'PRESENT SITUATION IS NOT FAVOURABLE.' PRICE GROWTH SHOULD EXCEED INCOME GROWTH BY 6-7% IN ORDER FOR ECONOMY TO APPROACH EQUILIBRIUM (AN INTERESTING AND RARE ADMISSION



RESTRICTED

137120  
MDHIAN 7361

THAT REDUCED CONSUMPTION IS AMONG OBJECTIVES OF PRICES AND INCOMES POLICY AS WELL AS THE PRIMARY GOAL OF RATIONALISING THE WHOLE PRICE STRUCTURE). THE CURRENT TREND COULD HOWEVER REVERSE ITSELF.

7. LATTER POINT IS OBVIOUSLY RIGHT . THE REFORM IS STILL IN ITS INFANCY. SADOWSKI HOPES THAT FIRST QUARTER PRICE AND WAGE INCREASES WILL PROVE TO HAVE BEEN A ONCE-FOR-ALL PHENOMENON, ANYWAY AT SUCH STEEP RATES, RATHER THAN INDICATING A SECULAR TREND. THERE HAVE BEEN SOME POSITIVE DEVELOPEMENTS RECENTLY INCLUDING PROGRESS ON CREATION OF COMMERCIAL BANKING SYSTEM AND IMPORTANT DECISIONS TO ABANDON SOME MAJOR INVESTMENTS IN TRADITIONAL HEAVY INDUSTRIES, DIRECTING RESOURCES THUS SAVED TO INVESTMENTS MORE LIKELY TO PROMOTE REFORM. THESE SHOW THAT SADOWSKI ENJOYS JARUZELSKI'S SUPPORT AND CAN WIN DIFFICULT POLITICAL BATTLES. BUT FOR THE POLITICAL MANAGEMENT OF THE COUNTRY, PRICES AND INCOMES REMAIN THE NUMBER ONE ISSUE. THERE IS AMPLE EVIDENCE OF CONTINUING PRESSURE FOR SUBSTANTIAL WAGE INCREASES. THIS WILL BE FUELLED FURTHER BY THE 1 APRIL INCREASES IN ENERGY PRICES AND RENTS. THIS WEEK'S STRICK IN BYDGOSZCZ AND NOWA HUTA (REPORTED SEPARATELY) CONFRONT THE GOVERNMENT WITH A VERY DIFFICULT CHALLENGE. THE EXAMPLE OF SUCCESS OF THE BYDGOSZCZ STRIKERS WILL NOT BE LOST ON OTHERS.

BARDER

YYYY

DISTRIBUTION

154

MAIN 153

MONETARY

EED

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN



Foreign and Commonwealth Office

*Php*

CONFIDENTIAL

London SW1A 2AH

CH/EXCHEQUER	
REC.	29 APR 1988
ACTION	Mr BOTTRILL
COPIES TO	CST, PMG, EST, Mr ANSON, Mr H.P. EVANS, Mr MOUNTFIELD, Mr ROSSON, Mr BURGNER

29 April 1988

✓  
29/4

*Dear Charles*

Visit of Hungarian Prime Minister

Mr Karoly Grosz, the Hungarian Prime Minister, is to call on the Prime Minister at 1630 on Thursday 5 May. He will be accompanied by the Hungarian Ambassador, Dr Domokos; a Deputy Foreign Minister, Mr Kovacs; and an interpreter, Mr Szombati. Personality notes, and Mr Grosz's programme, are enclosed. Our Ambassador in Budapest, Mr Appleyard, will also be present. The Prime Minister is to give a dinner for Mr Grosz later that evening.

The Prime Minister invited Mr Grosz's predecessor, Mr Lazar, to visit Britain during her visit to Budapest in February 1984. Mr Grosz himself was due to come to London last summer, as Budapest Party Secretary. On becoming Prime Minister, he made clear that one of his first priorities was to visit Britain. He has expressed admiration for the way the British economy has been turned round, and has said he wants in particular to discuss the relevance of British experience for Hungary.

In the formal talks, the Prime Minister may wish to concentrate on bilateral subjects; Hungarian economic restructuring and relations with the IMF, and Britain's economic experience; EC/Hungary; and East/West relations including the impact of Gorbachev on Soviet relations with Eastern Europe. The Hungarians have agreed with this broad agenda. Among bilateral subjects, they have said that Mr Grosz will want to discuss trade and economic cooperation; the high level of British visa fees; cooperation in English language teaching in Hungary; and our refusal to allow the remains of General Meszaros to be transferred to Hungary from Herefordshire. The Hungarian Ambassador has said that Mr Grosz will also hope to discuss, perhaps over dinner, more sensitive political questions relevant to Hungary's future, including relations between Government and Parliament. Mr Grosz may also refer to the recent influx of refugees into Hungary from Romania, and ask for the British Government's moral support. The Prime Minister may wish to express sympathy at the practical difficulties. If the financial aspect is raised, she may wish to say that any such support would have to come through the UNHCR.

CONFIDENTIAL



Mr Grosz will no doubt invite the Prime Minister to pay a further visit to Hungary. The Prime Minister may wish to accept in principle. But we see no need for any further visit in present circumstances.

Mr Grosz may also mention a possible invitation to HM the Queen to visit Hungary. The Prime Minister might wish to take note, making the point that the Queen's programme of overseas visits is heavy, and is usually decided years in advance, but saying that any invitation would of course be considered in the normal way.

#### Hungary Internal

Mr Kadar has become the main obstacle to faster change. His potential successors, of whom Mr Grosz is a front-runner, are jockeying for position. Mr Grosz undoubtedly sees his visit to London as helpful in this context. He also hopes to use it to gain support for his programme of political and economic reform.

A special Party Conference is to be held in Budapest on 20 May to discuss future reforms. During 1987, legislation was introduced on enterprise bankruptcies (the first in Eastern Europe), and on banking reform, allowing the creation of potentially independent commercial banks. This has been followed, from 1 January 1988, by the introduction of VAT, and personal income tax. Mr Grosz wishes to take further similar measures to improve productivity and remove economic distortions, even if this means higher unemployment and inflation. Naturally, this approach is arousing opposition.

Mr Grosz's government is also pursuing political reform. Exit visas were for instance abolished on 1 January 1988 (although those with a criminal record still have difficulty getting passports). The Hungarian Parliament (in which Mr Grosz is a polished performer) has begun to see some real debate, and voting is not always unanimous. But it is not clear whether Mr Grosz is able or wishes to extend political reform. Four Party members have recently been expelled, including a prominent liberal MP, ostensibly for indiscipline but in fact for flirting with concepts of liberal democracy. Mr Grosz is having to tread a fine line between old-style conservatives, grouped around Mr Kadar, and liberals who wish to move towards stronger parliamentary control over the executive, if not towards a multi-party system.

#### Hungary/IMF

Hungary's foreign debt has been climbing rapidly, and now stands at some \$18 bn (gross). It has so far avoided rescheduling, and there is no sign that it wishes to go down that road. The current account deficit in 1987, at \$850m, was



an improvement on 1986 (\$1.4 bn). Hungary can still raise new money on international markets. But banking confidence has become more fragile. It is vital to reduce dependence on foreign loans. This in turn requires radical restructuring of industry, even though this may carry serious social costs in the short term.

A tough IMF Standby programme has been largely agreed, although not yet endorsed by the Executive Board (because of an unresolved problem over Hungarian actions on interest rates).

The Prime Minister may wish to welcome the programme as further evidence of Hungary's commitment to restructure its economy. She may wish to say that, subject to a detailed examination of its terms, the UK hopes and expects to be able to support it.

#### EC/Hungary

The Community is negotiating a trade and economic cooperation agreement with Hungary. The main element is a Community commitment to abolish a large number of quantitative restrictions (QRs) on Hungarian exports to the EC by 1998. In return, the Community is seeking counter-concessions from the Hungarians, including improved procedures for the issuing of import licences, increased quotas on EC exports of consumer goods, and better access for EC businessmen to the Hungarian market.

The Prime Minister may wish to reaffirm the strong political importance the UK attaches to early and successful conclusion of the negotiations. She will however also wish to urge Mr Grosz not to underestimate the far-reaching nature of the agreement and the importance we - and our Community partners - attach to ensuring that the text contains adequate safeguard provisions to protect particularly sensitive products from market disruption following liberalisation.

#### Bilateral Relations

These have continued to make real progress since the Prime Minister's visit in 1984 and Mr Kadar's visit to London in 1985. Among the Warsaw Pact countries, Hungary is responding best to our policy of increased contact. Many genuinely useful professional contacts now take place independently of either Government (eg a symposium last month on criminal policy, initiated by Mr Alex Carlile QC MP). Hungary's human rights record is not unblemished. But it is better than any other in the Warsaw Pact. There are no bilateral personal cases, or other major bilateral political problems.

CONFIDENTIAL



The Prime Minister may wish to be aware that the Foreign Secretary plans to tell Mr Grosz, earlier in the day, that a special scholarship is being created, funded jointly by the Foreign and Commonwealth Office and Shell, to be called the "Count Szechenyi Scholarship", for a Hungarian to study at a British University; and that an agreement will be signed during the visit, with MAFF, on agricultural exchanges. The Hungarians have proposed an agreement on building and construction. The Department of the Environment are studying a Hungarian draft. If Mr Grosz raises this, the Prime Minister could say that it is being carefully considered. We would wish to be clear that an agreement would help to increase trade.

The Prime Minister may wish to pay tribute to the treatment being given to British children in Budapest at the Peto Institute for Conductive Education (mainly cerebral palsy). Several hundred British children have attended the Institute. The DHSS are about to send a team to Budapest, partly to study the Peto method. The Hungarian Minister of Health, Mrs Csehak, has been invited to visit Britain later this year. Mr Nicholas Scott, DHSS, intends to visit Hungary in September. The Hungarians wish to establish a special annexe to the Institute, for treatment of non-Hungarian children. Mr Grosz may mention this, and suggest that HMG might contribute. The Prime Minister may wish to say that we shall be glad to continue and perhaps expand the expert exchanges with the Peto Institute currently carried out under the bilateral UK/Hungarian Health Cooperation Agreement. But she will wish to avoid any financial commitment in relation to the proposed international annexe.

On commercial relations, UK exports have remained steady in recent years at around £100m. In 1986 and 1987 we were in 7th position among OECD suppliers to Hungary. Over 60% of Hungary's trade is with the West. Given its size and present economic difficulties, Hungary is unlikely ever to become a major market for the UK. But there are no difficulties over credit: there is room for further business with ECGD under both Section 1 and Section 2. There are opportunities for British companies in the modernisation and restructuring of Hungarian industry, especially in transport (where the Hungarian Minister of Transport, Dr Toth, has just paid a useful visit to London, and has a particularly good relationship with Mr David Mitchell); metallurgy; energy production and conservation; chemicals and agriculture. The Prime Minister may wish to refer to a visit to Hungary last month by an industrial delegation led by Lord Jellicoe; and to commend in particular British Aerospace's latest proposals for leasing of the 146, which include imaginative ideas on industrial cooperation and counter-purchase, and also take account of the Hungarian shortage of hard currency. Nothing would give UK/Hungarian trade a better stimulus than this deal.

CONFIDENTIAL



Mr Grosz for his part may raise three bilateral issues:

(i) Visa fees. The Hungarians have complained repeatedly about delays caused by our visa procedures, and about the level of fees (a short-visit visa for a Hungarian costs more than 30% of the average monthly salary). Our procedures have recently been improved and speeded up. The Foreign Secretary wrote to the Hungarian Foreign Minister on 4 April to say that we had made special arrangements for senior officials and businessmen, and other improvements. This was well received. But Mr Grosz is likely to mention our visa fees. The Prime Minister may wish to say that the fee is a standard charge for visitors from all countries. There is no likelihood of any reduction, because we aim to recover the cost of our visa system through these receipts.

(ii) English language teaching (ELT). The Hungarians are pushing hard for more ELT for special (especially scientific and technological) purposes. The British Council have sent an independent consultant to Budapest to report on opportunities and needs. The consultant's review, presented in October 1987, is still being studied by both sides. Under the Anglo-Hungarian Cultural Exchange Programme, ELT is already the British Council's most important activity in Hungary. There are five British teachers in place. British specialists run summer schools in Hungary. And Hungarian teachers of English attend training courses run by British teachers in the UK and Hungary. The British Council also provide various consultancies and supply teaching materials etc. The Prime Minister may wish to point to this impressive range of activity, and take note without commitment of any request Mr Grosz may make for it to be extended.

(iii) Remains of General Meszaros. The Hungarian authorities have several times asked us to authorise transfer of the remains of General Meszaros, a leader of Kossuth's 1848 rebellion, from Titley Cemetery in Herefordshire to Hungary. Their most recent request was in January 1988, when they presented a petition signed by 18 Hungarian citizens who claim to be General Meszaros' closest surviving relatives. A Miss Szabo, who lives in New York and owns the grave at Titley, also claims (with apparent justification) to be the nearest relative. She opposes any transfer of the remains (as does for instance the Hungarian Freedom Fighters' Association in Great Britain). Ministers recently decided that there was no basis to change their earlier view that, in these circumstances, the remains should not be moved. The Hungarians have been so informed. Mr Grosz may question this decision. The Prime Minister may wish to say that we cannot return the remains if there is significant opposition on the part of the family.

CONFIDENTIAL



I am sending copies of this letter to the Private Secretaries to the Chancellor of the Exchequer, Secretaries of State for Trade and Industry, Social Services, Education and Science, and the Environment, and to the Head of the OD Secretariat.

*Yours ever*

A handwritten signature in dark ink, appearing to read 'R N Culshaw', with a stylized flourish at the end.

(R N Culshaw)  
Private Secretary

C D Powell Esq  
10 Downing Street

CONFIDENTIAL

CONFIDENTIAL

145576  
MDHIAN 7646

CONFIDENTIAL  
FM BUDAPEST  
TO DESKBY 290930Z FCO  
TELNO 192  
OF 290800Z APRIL 88  
INFO PRIORITY UKDEL,IMF/IBRD

GROSZ VISIT: IMF

SUMMARY

1. IMF TEAM HOPEFUL OF REACHING AGREEMENT ON LETTER OF INTENT BEFORE GROSZ'S DEPARTURE FOR BRITAIN. TEAM SATISFIED WITH IMPROVED PERFORMANCE OF HUNGARIAN ECONOMY. IMF WOULD LIKE MINISTERS TO MENTION TO GROSZ THE IMPACT OF TAX REFORMS ON THE PRIVATE SECTOR AND THE IMPORTANCE OF IMPORT LICENCING.

DETAIL

2. DE FONTENAY (HEAD OF IMF TEAM) CALLED ON ME YESTERDAY EVENING TO GIVE A BRIEFING ON THE CURRENT NEGOTIATIONS. HE PROPOSED TWO POINTS WHICH HE WOULD LIKE THE MINISTERS TO RAISE WITH GROSZ DURING HIS VISIT AT THE REQUEST OF THE IMF.

BACKGROUND

3. THE IMF TEAM IS HERE TO CONCLUDE A SUPPLEMENTARY ANNEX TO THE HUNGARIAN LETTER OF INTENT WHICH WOULD ENABLE THE HUNGARIAN APPLICATION TO BE PUT BEFORE THE IMF EXECUTIVE BOARD IN MAY. THERE ARE TWO REMAINING TECHNICAL POINTS OF DISAGREEMENT: DEVALUATION AND DOMESTIC INTEREST RATES.

GROSZ VISIT ISSUES

4. THE TWO QUESTIONS THAT THE IMF WOULD LIKE MINISTERS TO RAISE WITH GROSZ CONCERN THE IMPACT OF TAX REFORMS IN THE PRIVATE SECTOR AND IMPORT LIBERALISATION. FIRST, THE CURRENT TAX REFORMS INCLUDE AN ENTREPRENEURIAL TAX WHICH MAINLY BEARS DOWN ON PRIVATE SECTOR AND COOPERATIVE ENTERPRISES. THIS IS CAUSING SIGNIFICANT PROBLEMS FOR PRIVATE SECTOR COMPANIES. IT RUNS COUNTER TO THE INTENDED EFFECT OF THE TAX REFORM PROGRAMME AND GROSZ'S OWN APPROACH. THE TAX REFORMS ARE CURRENTLY UNDER REVIEW, INCLUDING THE ENTREPRENEURIAL TAX. THE IMF WOULD LIKE MINISTERS TO REAFFIRM THE IMPORTANCE OF INCENTIVES FOR PRIVATE SECTOR AND COOPERATIVE ENTERPRISES AS A BASIS FOR LONG-TERM GROWTH, AND TO ENCOURAGE GROSZ TO FOCUS ON THIS ASPECT IN THE REVIEW. SECOND, THE IMF IS WORRIED THAT THE GOVERNMENT WILL BE TEMPTED TO BE MORE RESTRICTIVE ON IMPORT LICENCES FOR BALANCE OF PAYMENT



CONFIDENTIAL

145576  
MDHIAN 7646

REASONS, LEADING TO SIGNIFICANT DISTORTIONS OF THE ECONOMY. THEY WOULD LIKE MINISTERS TO EMPHASISE THE IMPORTANCE OF MAINTAINING A SENSIBLE POLICY OF IMPORT LIBERALISATION.

POINTS OF DIFFERENCE

5. IN THE PREVIOUS ROUND OF DISCUSSIONS THE IMF INSISTED ON A 5 PER CENT DEVALUATION IN THE FIRST HALF OF 1988. THE HUNGARIANS REFUSED BUT HAVE NOW INDICATED THAT THEY WOULD ACCEPT A DEVALUATION IN JULY. ON DOMESTIC INTEREST RATES, THE IMF HAVE BEEN CONCERNED AT THE DIMINISHING SAVINGS RATIO AND THE MASSIVE SIBSIDISING ELEMENT INVOLVED IN PREFERENTIAL MORTGAGE RATES THROUGH THE SAVINGS BANK (OTP). AS A COUNTERPART FOR DELAYED DEVALUATION, THE IMF ARE ASKING FOR SIGNIFICANT INCREASES IN DOMESTIC LENDING RATES. DE FONTENAY THOUGHT THERE WAS A GOOD CHANCE THAT A COMPROMISE WOULD BE REACHED. I SAID WE HAD INDICATIONS THAT THE HUNGARIANS WERE KEEN TO REACH AGREEMENT BEFORE GROSZ'S VISIT. DE FONTENAY AGREED THAT THIS FITTED IN WITH CURRENT ESTIMATES, SINCE THE TEAM WAS EXPECTED TO LEAVE HERE NEXT TUESDAY.

ECONOMIC PERFORMANCE

6. IN GENERAL, DE FONTENAY COMMENTED, THE IMF WAS SATISFIED WITH THE PRESENT PERFORMANCE OF THE HUNGARIAN ECONOMY. THERE HAD BEEN A SIGNIFICANT IMPROVEMENT IN THE FOREIGN TRADE AND BALANCE OF PAYMENTS SITUATION, PRICES WERE STILL ON TRACK AND THE BUDGET DEFICIT LOOKED TO BE ON TARGET. THERE ARE STILL SOME WORRIES ABOUT DOMESTIC MONETARY AGGREGATES BUT THESE ALSO INVOLVED DIFFICULT DEFINITIONAL PROBLEMS. THE IMF HAD CONCLUDED THAT GROSZ WAS THE BEST PRIME MINISTER HUNGARY WAS LIKELY TO HAVE AND WAS KEEN TO SUPPORT HIS REFORMS.

7. FCO PLEASE PASS FIGGIS (EED), BATT (HMT), RICHARDSON (ERD), JAGGERS (BOE).

APPLEYARD

YYYY

CONFIDENTIAL

145576  
MDHIAN 7646

DISTRIBUTION

155

MAIN 154

MONETARY  
EED

ERD

[-]

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

RESTRICTED

153724  
MDHIAN 7962

RESTRICTED  
FM BUDAPEST  
TO IMMEDIATE FCO  
TELNO 204  
OF 031015Z MAY 88  
INFO IMMEDIATE UKDEL IMF/IBRD



OUR TELNO 192 : BROSZ VISIT : IMF

1. BEFORE HIS DEPARTURE EARLY THIS MORNING, DE FONTENAY INFORMED US THAT AGREEMENT HAD NOW BEEN REACHED BETWEEN HUNGARY AND THE IMF CONCERNING THE SBA.

2. FCO PLEASE PASS TO FIGGIS (EED), RICHARDSON (ERD), BATT (HMT), JAGGERS (B OF E) AND GEORGE (DTI).

HARBORNE

YYYY

DISTRIBUTION

155

MAIN 154

MONETARY  
EED

ERD

[-]

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

RESTRICTED

154426  
MDHIAN 7998

RESTRICTED  
FM BUDAPEST  
TO DESKBY 031500Z MAY FCO  
TELNO 206  
OF 031350Z MAY 88  
INFO IMMEDIATE UKDEL IMF/IBRD

OUR TELNOS 192 AND 204 : GROSZ VISIT : IMF

1. JANUARY (FIRST SECRETARY, COMMERCIAL) HAS NOW BEEN ABLE TO SPEAK TO BAKO (MANAGING DIRECTOR, MNB) WHO HEADED HUNGARY'S NEGOTIATING TEAM. BAKO CONFIRMED THAT AGREEMENT HAD BEEN REACHED ON THE SBA. THE SOLE POINT AT ISSUE DURING THE MOST RECENT PHASE OF NEGOTIATIONS HAD BEEN THE IMF'S CONCERN THAT HUNGARY SHOULD TAKE MEASURES TO INCREASE THE HOUSEHOLD SAVINGS RATIO. CONSEQUENTLY, THE ORIGINAL LETTER OF INTENT REMAINS INTACT, AND A DRAFT ANNEX HAS BEEN SUBMITTED TO THE IMF SETTING OUT IN DETAIL ADDITIONAL MEASURES TO ENCOURAGE SAVINGS. THE HUNGARIANS WERE CONFIDENT THAT THE ANNEX WOULD RECEIVE THE APPROVAL OF THE MANAGING DIRECTOR OF THE FUND BY THE END OF THIS WEEK. EXCHANGE RATE POLICY HAD NOT FIGURED IN THE LATEST ROUND OF DISCUSSIONS.

2. BAKO THEN MENTIONED THAT THE IMF TEAM HAD COMPILED A SUPPLEMENTARY PAPER OUTLINING RECENT ECONOMIC DEVELOPMENTS IN HUNGARY WHICH WOULD BE SUBMITTED TO THE BOARD OF MANAGEMENT ON DE FONTENAY'S RETURN TO WASHINGTON. HE WAS CONFIDENT THAT THE BOARD WOULD FORMALISE ITS AGREEMENT TO THE SBA BY 17 MAY.

COMMENT

3. THESE DEVELOPMENTS NOTWITHSTANDING , MINISTERS SHOULD STILL BE BRIEFED TO MAKE THE POINTS ON THE ENTERPRISE TAX AND ON IMPORT POLICY SET OUT IN PARAR 4 OF OUR FIRST TUR.

4. FCO PLEASE ADVANCE TO FIGGIS (EED), RICHARDSON (ERD), BATT (HMT), JAGGERS (B OF E) AND GEORGE (OT3/5, DTI).

HARBORNE

YYYY

RESTRICTED

154426  
MDHIAN 7998

DISTRIBUTION

155

MAIN 154

MONETARY  
EED

ERD

[-]

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

FROM: A BOTTRILL

DATE: 4 MAY 1988

PS/CHANCELLOR

cc: Chief Secretary  
 Paymaster General  
 Economic Secretary  
 Mr Anson  
 Mr H P Evans  
 Mr Mountfield  
 Mr Robson  
 Mr Burgner  
 Mr Batt

*Ch. Content for me  
 to write as proposed?  
 2/ 4/5  
 OK -*

**VISIT OF HUNGARIAN PRIME MINISTER - THURSDAY 5 MAY**

If relations with the IMF are raised, the Prime Minister will need to know that the Hungarians have agreed a programme with the IMF (Budapest telegram No 204 of 3 May.) The programme is expected to be put to the IMF Executive Board in the middle of this month.

2. We do not yet have the details but understand that further action on devaluation has been postponed for the time being and what is called 'compensatory action' has been taken on interest rates.

3. Hungary has so far avoided rescheduling both with the banks and with the Paris Club. Meticulous implementation of the terms of the stand-by arrangement will be necessary if Hungary is to continue to service foreign debt and maintain the ability to borrow new money.

4. A draft letter to No 10 is attached.

*AS/BW*

A BOTTRILL

**DRAFT LETTER**

C D Powell Esq  
10 Downing Street  
London SW1A 2AA

**VISIT OF HUNGARIAN PRIME MINISTER**

If Mr Grosz raises relations with the IMF, the Prime Minister should know that the Hungarians are reported to have agreed a programme with the IMF. (Budapest telegram No 204 of 3 May.) We do not have details but understand that further devaluation has been postponed although 'compensatory action' has been taken on interest rates.

2. Hungary has so far avoided rescheduling with both the bank and the London Club but will need to implement meticulously the terms of the IMF stand-by arrangement if it is to continue to service foreign debt and maintain the ability to borrow new money.

3. Copies go to the private secretaries of the Secretaries of State for Foreign Affairs, Trade and Industry, Social Services, Education and Science and the Environment.



10 DOWNING STREET  
LONDON SW1A 2AA

CH/EXCHEQUER	
REC.	06 MAY 1988
ACTION	Mr BOTTRILL
COPIES TO	CST, PMG, EST, Mr ANSON, Mr H.P. EVANS, Mr MOUNTFIELD, Mr ROBSON, Mr BURGNER

✓  
6/5

From the Private Secretary

5 May 1988

Dear dyn,

PRIME MINISTER'S MEETING WITH THE HUNGARIAN  
PRIME MINISTER

The Prime Minister had a talk this evening with the Hungarian Prime Minister. Mr Grosz was accompanied by Mr Kovacs, the Deputy Foreign Minister and the Hungarian Ambassador. HM Ambassador, Budapest was also present.

Introduction

The Prime Minister recalled her visit to Hungary in 1984 which had made a deep impression on her. She asked that her regards be conveyed to Mr Kadar. Mr Grosz thanked the Prime Minister for inviting him to the United Kingdom. Her visit to Hungary was remembered with great pleasure. She was a very popular person there. Indeed the visit had been a milestone in relations between Britain and Hungary. Now it was his good fortune to be the first Hungarian Prime Minister to visit the United Kingdom since the Second World War. He brought greetings from Mr Kadar and also from Mr Ryzkhov who had recently been in Budapest and had told him at length about her visit to the Soviet Union.

Economic and Political Reforms in Hungary

The Prime Minister said that there was a great air of change in East/West relations. It was an exciting moment to be in government but placed a heavy responsibility on leaders to give a lead and convince their people of what needed to be done. We were following very closely what was happening in Hungary. She was pleased to hear that agreement had just been reached with the IMF. The fact was that the measures needed to get the economy right would impose some hardship in the short term, while the benefits would take longer to work through. It was essential not to waver.

Mr Grosz said that Communist societies faced serious psychological and ideological problems. They had all made the mistake of relegating the individual and putting too much emphasis on uniformity. Hungary was perhaps ahead of other Communist societies in beginning to break away from this. They had learned the lessons of 1956 when the ruling party had



completely lost the support of the population. It was greatly to Mr Kadar's credit that the situation had changed since then. He had seen the need for Hungary to implement socialism flexibly and in keeping with its own traditions. This had given the country a period of rapid development. But that momentum was now exhausted. New ways had to be found to free people's energies and make the economy more dynamic.

Mr Grosz continued that the immediate task was to reform the structure of Hungary's economy. He had studied the Prime Minister's speeches and had learned greatly from them. But not all her solutions could be adopted in Hungary, where the state owned 95 per cent of the means of production and the private sector only 5 per cent (although that 5 per cent produced 20 per cent of the national income). Hungary was working out a new strategy which would give the private sector a greater share in the economy and provide those working for the state with more incentives. The latter was an essential ingredient. For instance they were experimenting with issuing shares to employees in large firms. The response had been good, with some 25-30 per cent of employees subscribing. To date only those actually working in a particular firm were allowed to acquire shares in it. But a Bill was now in preparation which would allow anyone to acquire shares. The aim was to obtain access to a mix of state, private and foreign capital. There was also a particular need to achieve a better distribution of resources. At present the state took too much and left too little to individual enterprises. He would like to see market forces playing a bigger role. It was no secret that such proposals were causing some heart-searching within the Hungarian Party and Government because they marked a significant breach with long standing policies and traditions. He hoped that such reforms would lead to a qualitative change in people's lives in Hungary, above all by reducing the role of the state.

The Prime Minister welcomed the changes that were taking place. The great scourge of the twentieth century was the notion that Government's created wealth. It would be important to change people's psychology so that they did not automatically look to Government for their standard of living and also to establish a clear link between effort and reward. Small business had a particular role to play in Hungary's development. Mr Grosz said that the price of the changes he had described was a significant increase in Hungary's indebtedness. His priority was to obtain sufficient resources to enable him to carry through the major adjustments which he envisaged. Hungary would need help from outside, for instance in the form of joint ventures. These could help introduce new ways of thinking as well as bring additional resources. He had been encouraged by his discussion on this with the CBI. Joint ventures could also provide training in management which was particularly necessary. To sum up, he wanted to swing the gates wide open on Hungary's politics and economy and introduce more modern thinking.

East/West relations

The Prime Minister referred to the changes which Mr Gorbachev was making in the Soviet Union. In essence he understood that seventy years of Communism had failed to produce the increase in living standards and the quality of life which was needed and that in consequence the Soviet Union was falling ever further behind western societies. Its position as a super-power was owed exclusively to its military strength. She believed that Gorbachev was determined to see these changes through even though he was encountering very substantial difficulties. Mr Grosz agreed. There were great constraints in the Soviet Union. Hungary was more fortunate, being such a small society by comparison. Both Gorbachev and Ryzkhov had plenty of courage and resolve. But Ryzkhov had recently told him that they were encountering even greater difficulties than they had expected. Apparently the real problem was not so much the resistance of the bureaucracy as the fact that the great mass of ordinary people found it hard to comprehend the changes which were being made. The rigid system which had been imposed in the Soviet Union for so long meant that there was just not the necessary degree of political awareness. The Prime Minister agreed that the problem was basically one of psychology and communication. The fault of Communist societies was that they discouraged leadership. People waited to be told what to do. Even though a very different atmosphere now was evident in the Soviet Union, it would be a long time before the results of Mr Gorbachev's reforms came through.

The Prime Minister continued that glasnost and perestroika offered new opportunities for Eastern Europe. They enlarged individual freedom and once that process started it would be difficult to halt it. It was one of those moments in history when there was a chance to take a major step forward. Equally it was important to manage change and not to go too fast. This was where relations between countries on either side of the East/West divide, such as Britain and Hungary, could help by giving support and encouragement.

Mr Grosz agreed with the Prime Minister's analysis. He emphasised the great differences between conditions in the Soviet Union and those in Eastern European countries. The Soviet Union was much less developed. He believed that it would now focus much more on its internal problems rather than its world role. As the Prime Minister had said, this should create opportunities for East European countries. But then they faced many problems too. For instance things were bad in Romania. The Prime Minister asked whether Mr Grosz expected the Romanian regime to last. Mr Grosz thought that it would. People did not like the present leadership but tolerated it. Moreover there was a fairly broad band of people in Romanian who to be frank had been corrupted and had a vested interest in the present regime. While he would not give much for Ceausescu's long term prospects, he would probably survive for the time being.

Mr Grosz continued that the main problem in Poland was

the state of the economy. Political tensions there stemmed from economic difficulties and the huge debts which Poland had amassed. The Prime Minister said she could not see how Poland would get out of its difficulties. The Poles did not seem to understand the need for sustained sacrifices if they were ever to cure their economy. The decision to hold a referendum, in effect on the question whether there should be price rises, had shown very erratic political judgment on the part of the Polish leadership. The outcome had been perfectly predictable. Mr Grosz said that he had recently asked General Jaruzelski why he had held the referendum. Jaruzelski had said that people had to be given the choice whether to carry out reforms rapidly with a heavier burden in the short term, or spread them out over a longer period so that the burdens were rather less. Characteristically the Polish people had opted for rapid reform with lesser burdens which was the one option not on offer. He thought that Jaruzelski wanted gradual reform. There was tremendous unrest below the surface and the leadership had to proceed cautiously. The problem with Solidarity was that they had no real alternative concept. The Prime Minister agreed that Solidarity had not known how to use freedom when they had won it. Mr Grosz commented that Solidarity's performance also showed how much easier it was to be in opposition than in Government.

The Prime Minister said that the situation in Yugoslavia was almost as difficult. She had seen Mr. Djuranovic recently, and found him very depressed about the prospects. How did Mr. Grosz see the situation in Bulgaria? Mr. Grosz said that the Bulgarians had produced a number of quite clever ideas, but had failed to put them into practice. They were confused by Gorbachev's policies and rather fearful of them. They were therefore stuck with half solutions.

#### EC/Hungary

Mr. Grosz referred to Hungary's disappointment at the lack of progress in its negotiations for a Trade and Economic Cooperation Agreement with the European Community. The Prime Minister said that the United Kingdom was keen to see the negotiations brought to a successful conclusion. We were being as helpful as we could. The problem was that some European Community Member States wanted to keep their quantitative restrictions. Mr. Grosz said that the fact of the quantitative restrictions was not a real problem. The difficulty was that the Hungarians still did not know what products those restrictions would apply to. The Community had failed to hand over a list. In any case, the amount of trade involved was not very large, which made him inclined to think that the difficulties on the European Community side were political in origin. Hungary was knocking on the door, but there was no answer. The Prime Minister said that she fully understood Hungary's frustration with the lack of progress. We would knock on the door as well. She would pursue the matter with Chancellor Kohl and if necessary raise it at the European Council in Hanover. It was absurd that the negotiations had dragged on so long without a result, although the Hungarians should not underestimate the importance and

difficulty of an agreement, and the need for proper safeguard provisions. Mr. Kovacs interjected that the United Kingdom was insisting on a super-safeguard clause, going well beyond normal GATT safeguards, which would be activated in the event of a sudden surge of imports of sensitive products. Mr. Grosz added that he doubted the need for this since Hungary was not exporting any products to the Community which were likely to create turmoil. The Prime Minister retorted that if there was no problem, then the safeguard provisions should not cause any difficulty. The fact was they were necessary to reassure some of the Mediterranean countries. She repeated that the United Kingdom would do its best to bring the negotiations to an early and successful conclusion.

### Visits

Mr. Grosz invited the Prime Minister to pay a further visit to Hungary. She really would be very welcome. The Prime Minister said that she would like to come again, although this time in the summer. Mr. Grosz then handed over a letter of invitation to The Queen to visit Hungary at a convenient date. I have written separately about this.

### Television

The Prime Minister said that she would be giving an interview to Hungarian Television straight after the meeting. She asked whether there were any particular points which Mr. Grosz would wish her to make. Mr. Grosz said it would be helpful if the Prime Minister could express her interest in and support for Hungary's reforms, and repeat what she had said to him about the EC/Hungary Agreement. The transcript of the subsequent interview will be available to you.

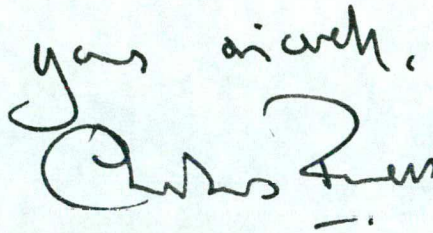
### Speeches

The texts of the prepared speeches by the Prime Minister and Mr. Grosz were circulated at the dinner (I enclose a copy of Mr Grosz' text). However, both of them in the event made entirely different speeches off the cuff. Since we had no recording equipment to hand, they are lost for ever. But they were very good.

Finally, I should say that my bland bureaucratic prose does not do justice to what was a lively and stimulating exchange, nor to Mr. Grosz's evident enthusiasm for change and reform. He came across as impressively self-assured and determined to press ahead, although often sombre about the scale of the difficulties facing Hungary.

We shall need to follow up the point on EC/Hungary. I think the Prime Minister would wish to send an early message to Chancellor Kohl urging fresh efforts to complete the negotiations during the German Presidency, and giving notice that she would otherwise expect to raise the matter at the Hanover European Council.

I am sending copies of this letter to Alex Allan (HM Treasury), Stephen Ratcliffe (Department of Trade and Industry), and Trevor Woolley (Cabinet Office).

Yours sincerely,  


C.D. Powell

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.

**CONFIDENTIAL**

cc: Chief Secretary  
 Paymaster General  
 Economic Secretary  
 Mr Anson  
 Mr H P Evans  
 Mr Mountfield  
 Mr Bottrill  
 Mr Robson  
 Mr Burgner  
 Mr Batt

Treasury Chambers, Parliament Street, SW1P 3JZ  
 01-270 3000

5 May 1988

C D Powell, Esq  
 No.10 Downing Street  
 London SW1A 2AA

A handwritten signature in blue ink, appearing to be 'JMG'.

*Dear Charles*

**VISIT OF HUNGARIAN PRIME MINISTER**

If Mr Grosz raises relations with the IMF, the Prime Minister should know that the Hungarians are reported to have agreed a programme with the IMF (Budapest telegram No 204 on 3 May.) We do not have details but understand that further devaluation has been postponed although 'compensatory action' has been taken on interest rates.

Hungary has so far avoided rescheduling with both the banks and the Paris Club but will need to implement meticulously the terms of the IMF stand-by arrangement if it is to continue to service foreign debt and maintain the ability to borrow new money.

Copies go to the private secretaries of the Secretaries of State for Foreign Affairs, Trade and Industry, Social Services, Education and Science and the Environment.

*Yours sincerely*

A handwritten signature in blue ink, appearing to be 'J M G Taylor'.

J M G TAYLOR  
 Private Secretary

**CONFIDENTIAL**



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	-7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST. SIR P. MIDDLETON SIR G. LITTLE, SIR T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H. P. EVANS.

3 November 1988

PRIME MINISTER'S MEETING WITH CARDINAL GLEMP

The Prime Minister had a talk on the first evening of her visit to Poland with Cardinal Glemp at the Archbishop's Palace in Warsaw. Cardinal Glemp was accompanied by Bishop Dabrowski. H.M. Ambassador, Warsaw was also present.

The Prime Minister began by saying that Poland was very special, it could not be compared to any other country. She was very pleased to be paying a visit and would welcome the Cardinal's advice on how she should deal with the very tricky issues posed by the present situation in Poland. Cardinal Glemp referred to the very warm feelings in Poland towards Britain. There were many Polish families living there as well as memories of the War. After the War, the Church in Poland had been forced to come to terms with a different reality, that of Communism. The Church did not belong to any political group. It had to support the interests of the entire Polish nation. Its most important task was to cultivate moral attitudes, particularly a sense of good and evil. The Communist system had done much damage in this respect. It had torn down Christianity and put nothing in its place. It was left to the Church to preserve and develop fundamental values such as respect for human dignity.

The Prime Minister said that she understood the very important role played by the Church. She also appreciated that Poland had to sort out its own problems. The main problem seemed to her the absence of any mechanism through which to do so. The crucial difference between the western democracies and Communist systems was the absence of any act of political consent in the latter. Although Solidarity was referred to as a trade union, its main function was in fact to express different political views to those of the Government because no other channels for this existed. Cardinal Glemp agreed that it was important to sort out what Solidarity stood for. He believed that its aspirations were positive and in "this evil system" they strove for good. Certainly they were more than just a trade union. Unfortunately they were also full of people who pursued their own private goals. There were great difficulties in the way of dialogue between them and the Government. But he hoped that reason would prevail.

CONFIDENTIAL

The Prime Minister said that she realised she was treading on eggshells by paying her visit to Poland at such a difficult time. There was no way she could let down the hopes of people who wanted greater freedom and human rights. Equally there was no way she could interfere in Poland's internal affairs. All she could do was draw on our own experience in Britain and on the Christian faith. Clearly, there was a very deep wish among people in Poland to have a bigger say in how their lives were run, with more freedom of expression. She hoped that by seeing Solidarity she would at least encourage them not to lose heart. At the same time, she could understand their pessimism: it was hard to detect a real will on the part of the Polish Government to find a way through in the proposed Round Table discussions.

Cardinal Glemp said that these were indeed very difficult and complex problems. In the situation which the Prime Minister described, the Church was an independent force. It sought to diminish emotions and tensions. Sometimes it sympathised with one side, sometimes with the other. It remained neutral in the sense of not engaging in political struggle. But in his personal view, there were good prospects for achieving some progress in the present situation. He believed the Prime Minister's visit could be very helpful in this respect. It would encourage those who believed in freedom and it would help the Polish Government over its sense of isolation. He believed the Polish people would respond well to the sign of friendship which the Prime Minister's visit represented.

The Prime Minister said she well understood the sensitivity of the situation. The message which she would seek to convey was that you could not have successful economic change without giving people more personal liberty. Cardinal Glemp said there had been some progress both in the direction of more personal freedom and more economic freedom. But Poland had to learn how to proceed democratically. Extremists on both sides did not want this. Nonetheless he hoped for developments in a positive direction. The risk he saw in the present situation was that a Round Table dialogue could divide the opposition, with some accusing others and collaborating with the Government or becoming its instrument. It would be wrong to be entirely cynical about the Polish Government or believe that it could not genuinely work for the good of the nation. The Prime Minister said she remained convinced that the nub of the problem was the lack of any mechanism for real debate or transfer of power by democratic means. Cardinal Glemp interjected that the Prime Minister was absolutely right. The Prime Minister continued that this meant that it was very difficult to get from the present system to something better, and comparatively little that any outside country could do to help. We could offer practical assistance such as management training and greater exchanges between teachers and students. Once there had been successful economic and political reform, the West would be ready to provide financial help. But her greatest concern of all remained to show that we were not letting down people who had fought courageously for freedom under very difficult conditions. She would try to steer her way through these conflicting demands.

The meeting ended with some discussion of Cardinal Glemp's forthcoming visit to Australia and New Zealand. The Prime Minister referred to the advice she had received from the Pope before visiting Poland for which she was very grateful.

CONFIDENTIAL



CONFIDENTIAL

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

C.D. POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.

CONFIDENTIAL

CONFIDENTIAL



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	-7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST, SIR P. MIDDLETON, SIR G. LITTLE, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EVANS.

3 November 1988

*Handwritten notes:*  
Heavy going but to be aware before PEM material AA

PRIME MINISTER'S MEETING WITH THE POLISH PRIME MINISTER

WEDNESDAY 2 NOVEMBER

The Prime Minister had a talk with the Polish Prime Minister shortly after her arrival in Warsaw on the evening of 2 November. Mr. Rakowski was accompanied by the Polish Foreign Minister and other officials. H.M. Ambassador Warsaw was also present.

Mr. Rakowski welcomed the Prime Minister. Her visit was seen in Poland as a very important development. He believed their talks would be productive. He found in life that one either took to someone straightaway or did not. He already felt all the barriers fall away with the Prime Minister. He approached the meeting with due humility. Mrs. Thatcher had been Prime Minister of a very important country for nearly ten years. He had been Prime Minister of Poland for a matter of weeks. Indeed, this was his first encounter in that capacity with a foreign Prime Minister.

Mr. Rakowski continued that he would like to use the time to tell the Prime Minister something about the new government and its policies. There had been interesting developments in Poland since the dramatic events of 1980. The high emotions of that time had given way to a calmer approach. Passions had cooled and people were now more objective. Ideology had its place. But the main issue was Poland, its present and its future. There had to be genuine national reconciliation. He believed this was now closer than three years ago. The other main task was to deal with the effects of the economic and political crisis and invigorate the economy. The round table discussions which he had proposed could help achieve both these objectives. But it did not matter so much who sat round the table as what was on the table in every home in Poland. In saying that, he was not disparaging the usefulness of a discussion with the various political forces to find a platform for reconciliation. Indeed, he would be putting out a statement later in the evening saying that he remained committed to round table discussions and listing what should be discussed in them. The list would include development of a trade union movement which would draw on the experience of all the different forms of trade unionism which had emerged in Poland in recent years. That must, of course, include Solidarity.

CONFIDENTIAL

Mr. Rakowski continued that, nonetheless, the most important task was the economy. There had been a great deal of talk about economic reform. But no-one had actually done much. The essence was to revitalise the economy, to put things which had been stood on their heads back on their feet. After the war Poland had adopted the Stalinist concept of socialism which gave a dominant role in every area to the State. His approach was very different. He wanted the State to disturb people as little as possible. He was glad to see from the Prime Minister's interview with Polityka that she agreed. People had come to depend on the State for everything. Managers were comfortable with the system which told them what to do. By rationalising, you eliminated people's sense of security. The first task was to change people's mind-set, to persuade them to take risks. It was also necessary to break up monopolies, to establish hundreds of thousands of small businesses and to convert a part of the defence industry to civilian purposes. He was under no illusions; all this would take a generation to achieve.

Mr. Rakowski continued that the latest step in this process was the decision to close the Lenin shipyard in Gdansk. Father Jankowski had said that he could not understand how a Marxist could close down the Lenin Shipyard. That was a typical Polish approach. The Poles were very fond of debating. Every Pole in the country had his own plan for reform of the economy. As a consequence, it was difficult to achieve consensus. The fact was that closure of the Shipyard should have been done years ago. Production was down and there were other shipyards which worked better. The decision had not been directed against Solidarity. It was not a political decision. Even if the shipyard was closed, its name and its association with Solidarity would remain a part of Poland's history. He had been pleasantly surprised by Mr. Walesa's response. He had expected Mr. Walesa to call a strike. Instead, his approach had been to say that the Lenin shipyard was not an inefficient plant and that the workforce should demonstrate that by now working well. It was the first time for many years that he had heard anyone in Poland speak of working well. It would soon become apparent that closure of the Lenin shipyard was only the first step. Closure of one of the biggest steel mills in the country would be announced very shortly. There was no way the Polish economy could be healthy when huge subsidies were needed for the main industries. Loss-making enterprises simply had to be closed or the Polish economy would perish. He wanted to make clear that he was absolutely committed to rationalisation as the only way to extricate Poland from a crisis. Poland's great weakness historically had been lack of consistency. He was determined to change that.

The Prime Minister commented that the Polish government had embarked on the most difficult task of all, that of going from a centralised economy to a system based on private enterprise and competition. Mr. Rakowski had described the aim but had given no indication as to how he actually proposed to get from one to the other. At least there was some experience of private enterprise in the agricultural sector. It was not just a matter of changing economic policies. There had to be personal, political and spiritual change. Under Communism, people were like birds in a cage: once you opened the door, they were afraid to go out. The vital task facing the Polish government was to take the Polish

people with them in making changes; and the problem there was the lack of any political mechanism for consulting them and allowing them to express their views. This was what she meant in saying that economic reform could only work if accompanied by political reform. She thought that Mr. Gorbachev understood this in the Soviet Union, at least up to a point.

The Prime Minister continued that the difficulties facing the Polish government were immense and would probably get worse before they got better. She had been faced with difficult decisions, although on a smaller scale, in 1979, but had persevered. The great difference between her situation then and Mr. Rakowski's now was that she had been democratically elected to carry out change and twice subsequently re-elected. She had been able to convince people of the need for change and reform. The Polish government must consult its people and obtain their willing consent to reform. It did not matter what shape the table was, but they must sit at it with Solidarity and other opposition groups and explain and persuade. Indeed such a process of consultation should go on all over the country. They must also work out how they proposed to achieve the objectives that Mr. Rakowski had described to her. She was in the habit of saying to people: do not tell me what to do, tell me how to do it. That would be good advice for Mr. Rakowski to follow too.

The discussion had to conclude at this point so that the Prime Minister could leave for her meeting with Cardinal Glemp.

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

(CHARLES POWELL)

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	-7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST, SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EVANS.
4 November 1988	

Dear Lynn,

PRIME MINISTER'S MEETING WITH THE  
POLISH PRIME MINISTER IN WARSAW ON THURSDAY 3 NOVEMBER

The Prime Minister had a further meeting with the Polish Prime Minister in Warsaw on the morning of 3 November. Mr. Rakowski was accompanied by Mr. Olechowski, Foreign Minister, Mr. Wojtik, Secretary of State for Foreign and Economic Co-operation, Mr. Gertych, Polish Ambassador in London and Mr. Duchowski of the Polish Ministry of Foreign Affairs. H.M. Ambassador, Warsaw was also present.

Mr. Rakowski asked whether there were any points the Prime Minister wished to raise as a result of their discussion the previous evening. The Prime Minister said that one point had arisen during her subsequent discussion with Independents about agriculture, and that was the degree of state control over agriculture. Far from being genuinely private, it seemed there were rigid controls over both inputs and the sale of products. Mr. Rakowski said that agriculture had distinctive characteristics in Poland which marked it out from other socialist countries. It was not collectivised. Instead there were an enormous number of small farms below five hectares, and at least one million farmers were also in industry. To make farming profitable, these small farms had to be restructured into larger units. But the economic conditions had to be right and that meant it would be a very slow process. Mr. Rakowski continued that the Government recognised the key importance of agriculture. Steps had already been taken to guarantee farmers their rights of ownership. This had already produced results. Indeed over the last eight years agriculture had been the only sector of the Polish economy which had steadily improved, with increased investment in farm buildings and machinery. There were indeed controls over the procurement of agricultural produce for sale. But as from 1 January 1989 this monopoly would be lifted. The Government had also decided on measures to close the gap between rural incomes and those of workers in cities. These steps would lead to enormous change in conditions in the Polish countryside.

The Prime Minister said that, all the same, there seemed to be no incentive for people to work their land more efficiently, particularly if there was a rigid state control over inputs such as the purchase of machinery and fertilisers. Mr. Rakowski gave a detailed account of the experience of his cousin, who now

farmed the family's land of some sixty hectares. He had two tractors, a Fiat car, a colour television and a suite of Yugoslav furniture. He had recently added an annex to the house with central heating. It had taken him ten years - only ten years - to make it. His main complaints were the poor quality of machinery available and the lack of spare parts. His relative success was not uncharacteristic. The number of tractors had more than doubled over the last seven years and a great deal of progress had been made. Of course Polish agriculture was still far behind that of Western Europe. But it could not be changed at a stroke. The Prime Minister said that the answer lay in prices. If the price was right, the farmer would produce for the market. Mr. Rakowski conceded this: there had been a free market in fruit, vegetables and flowers for years and it worked perfectly well. His aim was to extend the free market to all agricultural produce and leave supply and demand to determine the price. Agriculture must be the priority. One consequence of this was the need to persuade the heavy industry barons to expand production of tractors, machinery and fertilisers to meet farmers' needs. Unfortunately, there was still a lot of old fashioned thinking in Poland which said that the economy would be strong only if heavy industry was strong.

Mr. Rakowski said that he would like to take up something which the Prime Minister had said the day before. She had asked how the Polish Government could achieve its objectives if it did not have the support of the people. Certainly they did not have total support. Equally he hoped the Prime Minister did not believe the caricature whereby the unfortunate, lonely government was on one side and the people of Poland on the other. If that was true, his government would last no time at all. In reality, the economic record of the last few years, including payment of some \$12 billion of interest on foreign debt, showed that people were working. The Government were conducting intensive polling to track the national mood. He had been pleased to receive a poll the previous evening which showed that his approval rating as Prime Minister had gone up from 37 to 53 per cent in recent weeks. That showed a healthy basis of support. It depended very largely on a single factor, namely the belief that he was committed to improve economic conditions. The Prime Minister said that she did not want to disappoint Mr. Rakowski but she was not very impressed by the polls. If he was taking the really difficult decisions, then his popularity would be plummeting. The changes needed for the long-term produced short-term hardships. In her own case in the United Kingdom, the most difficult years had been between 1979 and 1981. The polls had been frightful. But she had ignored them and pressed on with the right policies, and they had begun to pay off after three or four years. The only poll she minded about was the one which took place every five years in a general election.

The Prime Minister said that she would like to hear more about the Government's plans for economic reform. Mr. Rakowski said the Government needed time. There were many difficulties in the economy. For instance there was a shortage of labour. There were also absurdities in social policy, such as 3-year maternity leave for women and early retirement at 43 for miners. All these problems had to be tackled. He knew full well that he would face strikes and demonstrations if he persisted with rationalisation. But there was no alternative. He thought

there were lessons to be learnt from the trade union reforms in the United Kingdom. The Prime Minister cautioned Mr. Rakowski to remember that there was a crucial difference between the British and Polish situation: in Britain trade union members had an alternative outlet for political activity, in Poland they did not.

The Prime Minister said there were a number of practical issues which she would like to mention briefly. We were ready to help with management training if the Polish Government would find that helpful. The offer did not imply any criticism but was intended to be helpful. Mr. Rakowski - who appeared not to understand the Prime Minister's offer - said that many Polish managers were receiving training in the West and learning to be independent. The Prime Minister continued that we would also like to see more exchanges of teachers and pupils to spread contacts between Britain and Poland more widely. In the same spirit, we would be taking steps to speed up the system of issuing visas. Mr. Rakowski welcomed these two proposals. For his part, he would welcome a stronger British presence in Poland. There were historic links. But English was rapidly being replaced by German, and German industry enjoyed a considerably better reputation in Poland. The most useful way in which Britain could help Poland was over her foreign debt. This was a noose round Poland's neck and restricted the options for economic reform. He hoped the Prime Minister would use her prestige to establish a favourable climate for Poland in the Paris Club and at the IMF. Poland desperately needed some breathing space. The Prime Minister said that agreement with the IMF was the vital step which would unlock a great deal of other help.

The Prime Minister urged Mr. Rakowski to cheer up. She had faced many difficulties in the first years of her first term of office but had come through them. We wanted Poland to make the necessary breakthrough. Mr. Rakowski said that he was optimistic. He believed that the round table dialogue would take place despite all the difficulties. He also had tremendous faith in the Polish people. Poland would get through.

Over lunch later, both Mr. Rakowski and Mr. Olechowski pressed the Prime Minister hard for help over rescheduling of Poland's debt. The Prime Minister insisted that agreement on the IMF was the essential first step. That would unlock many doors. There was also some further discussions of the prospects for the round table. Mr. Rakowski claimed that the Government had sent Mr. Walesa various concrete proposals for the agenda. They awaited a reply. He added that the Government were ready for power-sharing. The Prime Minister said that she did not think power-sharing the right concept. The key question was whether the Government and party were prepared to relinquish their power over large areas of national life and restore them to the people.

I am copying this letter to Alex Allan (H M Treasury), Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Neil Thornton (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

*yes dear,*  
*C.D. Powell*  
C.D. POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	- 7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EVANS.
4 November 1988	

*Dear Mrs,*

PRIME MINISTER'S MEETING WITH POLISH INDEPENDENTS  
WEDNESDAY 2 NOVEMBER

The Prime Minister met a number of members of independent organisations on the first evening of her visit to Poland, at the Ambassador's Residence in Warsaw. Those present were Professor Dzielski, Mr. Paszynski, Professor Trzeciakowski, Professor Bender, Mr. Janowski and Professor Findeisen.

The Prime Minister said how interested she was to have the opportunity to meet her guests and wanted to hear from them about development in Poland and the prospects. Mr. Gorbachev had realised that a centralised economy did not work. But it was very difficult to move from a centrally planned system to a freer one.

Professor Trzeciakowski said the Party would never accept this change. Reform meant de-politicisation of the economy in which 900,000 jobs for Party members would be lost. It would be very difficult to convince people to give up this privilege. It might be easier to convince the Army and police who did not share these vested interests. The decision on the Lenin Shipyard revealed the essence of the problem. The hardliners were not prepared to leave the field to economists who wished to de-politicise the economy. It was essential to find a compromise with the military.

Professor Dzielski said he represented a group of conservative anti-Communists, who had been inspired by the Prime Minister and President Reagan. They were not in the main body of the Polish opposition but were trying to develop a constructive anti-Communism. For them, it was not important who governed, but that changes occurred. Their approach was "soft confrontation", forcing change but leaving the authorities a way to escape. Economic freedoms came before political freedoms. The military and police were interested in economic freedoms which might save them from the consequences of economic collapse. The opposition should understand the right of the authorities to survive. The Prime Minister commented that an opposition could only become the government if it was united. She agreed that government should withdraw from many areas of decision-taking. In a sophisticated society this required a majority of people to believe the time was right for this change.



Professor Findeisen described the situation of young people who saw no prospects. Mr. Gorbachev could involve Soviet youth, but it was much harder in Poland. Many of their brightest young people were emigrating. Political freedoms were essential to give young people the chance to take part in public life. At present they were blocked by the nomenklatura which required political approval for appointments from the lowest level upwards. If nothing changed, Poland would lose its young people twice over: both those who emigrated and those who wished to do so. The Prime Minister commented that it was important to change the system altogether not simply to create conditions in which young people could replace older ones within the existing system.

Professor Bender said Poland did not have a real political or economic life. Within the establishment, there was no real political opposition, as he well knew from his role as an independent Catholic Deputy in the Sejm.

Mr. Janowski stressed the importance of agriculture as the foundation on which a free enterprise economy could be built. For the first time since the War, the Polish Government had acknowledged agriculture as posing the most important tasks for the economy. But there was a chance that the authorities were merely using agriculture, not addressing the real problems which were causing food shortages. Eighty per cent of expenditure on agriculture went to the State sector which occupied twenty per cent of the land, and of three million private farmers half had neither horse nor tractor. Many of those who had tractors, could not get the equipment or spare parts for them. The fact that agriculture functioned at all was due to the resolve of the farming community, the toughest class in Poland. The authorities had to give political and economic guarantees if agriculture were really to develop. The Prime Minister said she could not see why guarantees were necessary to those who owned their land. Mr. Janowski said that might apply in Britain, but not in Poland, where farmers were uncertain that tomorrow the land would still be theirs. The authorities controlled so much, from the price of produce to the distribution of tractors. In practice there were limits on ownership.

Mr. Paszynski described the position of the private sector which had survived the latest economic crisis in a better condition than the State sector. It could be seen everywhere outside of the heavy industries, for example in light industry and food processing. Professor Bender said that the best examples of private enterprise were the production of flowers and vegetables. Professor Trzeciakowski said that even these sectors were subject to influence by the State which controlled the supply of fertilisers.

The Prime Minister asked how the process of change could be set in hand. She could not accept that change was impossible. After years of being told that socialism was inevitable, it was now clear that it was the death of socialism that was inevitable. Professor Trzeciakowski said the number one problem was the political one. He himself had refused the post of Vice-Premier in Mr. Rakowski's new government. The younger generation was fed up with the non-violent approach of Solidarity. People were deeply disillusioned about the round table talks after the purely

political decision to liquidate the Lenin Shipyard. It had killed the round table. He and his colleagues had been preparing proposals for reform of the economy including privatisation, de-monopolisation and changes of priorities. But the Party hardliners had won. The Prime Minister said that she understood exactly why Professor Trzeciakowski had refused the post of Vice Premier. She believed firmly in peaceful change and the importance of winning the intellectual arguments.

Professor Trzeciakowski said there were one or two bright spots, such as the Church Agricultural Foundation. Professor Findeisen said that institutions such as this gave young people hope. But it was difficult to have hopes in a society where, for example, boy scouts could not go to church in their uniforms. The Prime Minister said this was absurd. She exhorted her Polish guests to keep hope alive.

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry), Shirley Stagg (Ministry of Agriculture, Fisheries and Food) and Trevor Woolley (Cabinet Office).

*you already.*  
*Charles Powell*

(CHARLES POWELL)

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.

CONFIDENTIAL



✓  
7/11

CH/EXCHEQUER	
REC.	- 7 NOV 1988
ACTION	Mr BOTTRILL
COPY TO	EST, Sir P. MIDDLETON, Sir G. LITTLE, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H. P. EVANS.
4 November 1988	

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

Dear Lynn,

PRIME MINISTER'S MEETING WITH GENERAL JARUZELSKI

The Prime Minister had a meeting with General Jaruzelski this afternoon lasting some three hours. General Jaruzelski was accompanied by the Polish Foreign Minister, the Polish Ambassador in London and two other officials. H.M. Ambassador, Warsaw was also present.

The Prime Minister opened by saying that she was very grateful to General Jaruzelski for letting her see and hear such a wide variety of people. She had long wanted to come to Poland. Her visit was taking place at a very difficult juncture for the country. But it also came at a very exciting moment in East/West relations. She admired what Mr. Gorbachev was doing in the Soviet Union. The Prime Minister continued that she had held two meetings with Mr. Rakowski in which they had talked very freely. The Polish Government clearly faced considerable problems with the economy, but that was always true when you embarked on major change. People had high expectations and wanted immediate results.

General Jaruzelski then spoke for the next one and three quarter hours. He was very pleased the Prime Minister had come to Poland. It could prove to be an historic visit, matching those of General de Gaulle and Chancellor Brandt in their time, given the current state of East/West relations and the prominent role played by the Prime Minister. But the outcome of the visit should serve the interests of both countries. Poland had strong links with the Soviet Union. The reasons for these was not so much ideological or political as reasons of state. For centuries, Poland had been sandwiched between more powerful countries to the East and to the West. She had at last found a home within secure borders, which were guaranteed by Soviet power. He personally enjoyed very close relations with the Soviet leaders, especially Mr. Gorbachev, who, incidentally, always spoke of the Prime Minister with the greatest respect and sympathy.

General Jaruzelski continued that Poland had embarked on a process of reform and renewal well ahead of most other Socialist countries, but was now part of a broader current of reform sweeping Eastern Europe and the Soviet Union. In

this context, Poland also wished to expand her relations with Western countries. She now enjoyed good relations with Italy and Austria. Relations with the United States were also improving, though not yet enough. Polish/German relations were of particular importance, but still well below the level Poland desired. It would soon be the 50th Anniversary of the beginning of the Second World War. He hoped it could be an occasion to close that particular chapter. Germany was a particularly important trading partner for Poland, with two-way trade at least three times as great as with the United Kingdom.

Turning to international issues, General Jaruzelski said that Poland had a particular interest in arms control. The Polish Government hoped the Vienna talks could be brought to a conclusion in November. That would require agreement to hold follow-up meetings on human rights in Paris, Copenhagen and eventually Moscow. He was in no doubt that human rights could usefully be discussed in Moscow without any inhibitions. He regretted that some of the proposals put forward by the United Kingdom in Vienna had not been taken up, for instance those on school exchanges. In the field of conventional arms control, the key was to find ways to make both the Warsaw Pact and NATO countries feel more secure. Parity alone was not the answer. More emphasis should be put on removing the capacity for surprise attack and on giving the forces of both Alliances a purely defensive posture. This should be reflected in the deployment of forces and in their training. The plan which he had put forward for greater stability in Central Europe had many of these elements. He would readily admit that the Eastern countries had been unforthcoming on some of these issues over the years. For instance, they had not been ready to accept reductions in conventional forces, had rejected extension of the area to be covered by such reductions to the Urals and had been unco-operative about verification. All these obstacles were now being removed. But the most important task of all was to create confidence. On this, he supported Mr. Gorbachev's proposal for a European Reykjavik. He would also favour more extensive bilateral meetings to discuss security issues. For instance, there might be a meeting of British and Polish defence experts. Such talks could help create greater clarity about differing doctrines of defence and a better understanding of the respective strengths of opposing military forces. Some countries put the emphasis on ground forces, others gave more weight to air forces. Some had conscript armies, others had professional forces. All these factors needed to be balanced out.

General Jaruzelski continued that bilateral relations also needed new stimulus. Contacts had been rebuilt after the painful collapse of the early 1980s. He was grateful to the Prime Minister for having seen the former Polish Foreign Minister when he visited the United Kingdom. The Polish Minister of Education had just paid a successful visit to Britain and had returned keen to promote exchanges of teachers and students. He was sorry that we had responded negatively to Polish ideas for training managers (sic).

Economic co-operation was also important. The Prime Minister might look a bit suspicious at the mention of this and think that Poland was sticking out a hand. He could understand that she would wish to take both political and economic considerations into account in responding to a request for help in this area. But he hoped she would also take a long-term view.

General Jaruzelski said that he would like to explain the present situation in Poland against the background of the country's history. One had to understand how much tragedy Poland had gone through to appreciate how much she now valued her independence. For instance, forty per cent of Poland's industrial assets had been lost in World War Two and over six million people killed. Since the War, they had embarked on the huge task of rebuilding the country. There was no doubt that administrative rigours had been imposed to achieve this, which had reached the point of terror. Moreover, Poland had been slow to accept modern ideas. By making the state responsible for distributing and allocating everything, the system had discouraged people from making any effort or showing any initiative. He recalled some words the Prime Minister had spoken in 1979 to the effect that she could not promise anything to anyone except that everyone would be rewarded for more effort. That was the direction Poland now wanted to go. The imposition of martial law had been a step backwards but necessary in the circumstances. Subsequently Poland had not reached all its targets. To some extent this was the fault of Western sanctions. But the Poles had also been responsible for their own errors and inconsistencies. They had been too sluggish in trying to reform the economy. This was not to say that the period 1982/7 had been wasted. National income had increased by 5 per cent a year and large sums had been paid in interest on Poland's foreign debts. All this was despite a reduction of working time of some 18 per cent. At the same time some absurd social provisions had been introduced under pressure from the trade unions, such as three-year maternity leave and early retirement for miners. There were problems with inflation and with housing. There had also been a miscalculation over the pace of price reform. It was now clear that this had to be spread over a longer timescale. Despite these difficulties Poland was now entering a more radical stage of reform and would be bold in its search for ways to increase efficiency and initiative. He very much hoped Mr. Rakowski would stick to his commitment to introduce greater economic efficiency.

General Jaruzelski said that economic reform must be matched by political progress. The Government had embarked on a process of renewal and democratisation. In many respects Poland was advanced in its democracy. There was a constitutional tribunal which could overrule government decisions. There was a Parliamentary ombudsman. There was extensive democracy in the workplace. There was also the issue of the round table. He would prefer to discuss that in greater detail the following day, after the Prime Minister's visit to Gdansk, so that she would have an overall picture. He hoped that she would then share her

thoughts with him. For the time being, he would say only that the round table was not a tactical move. It went back to a proposal which he himself had originally made in 1981 but Solidarity had turned down at the time. The Polish Government was prepared to sit and discuss any topic. For instance they would talk about political and constitutional matters and how to find a place for opposition in the political system. They would discuss ways to get politics out of the trade unions and the trade unions out of politics. In this context, he had been much impressed by the trade union reforms carried through in the United Kingdom. The Government would also discuss economic reform. But the round table would lead nowhere if Solidarity always stuck to its maximalist demands. He had often urged Walesa to free himself from adventurism. But the truth was the extremists in Solidarity now had more influence than Walesa himself. Despite all this, he believed that a solution would eventually be reached. Indeed, it was vital for Poland that it should be. But it must not be an artificial agreement which simply created new problems.

General Jaruzelski continued that he did not want to impose any particular view of the Polish situation on the Prime Minister. He knew that she was listening to the views of others too. Solidarity tended to be idealistic about its own role and gave the impression that all good was on its side. But he also had to think of the interests of the Polish State. Poland's history meant that the interests of the State had to take priority. He knew that the Prime Minister had firm views on all these matters including human rights. Indeed, he had read the speech which she intended to make at dinner and had redrafted his own in consequence. But equally he was confident that she would arrive at an objective view of the situation in Poland. He hoped that she would be able to use her immense prestige to help Poland secure assistance in overcoming its economic problems and in establishing better bilateral economic co-operation. There had been some unhappy experiences in this latter field over the URSUS tractor factory and a PVC plant, on both of which Poland has suffered heavy losses.

General Jaruzelski apologised for speaking at such length. But he had wanted to explain the situation to the Prime Minister as fully as possible. She enjoyed great prestige and great affection in Poland and he believed her visit could have very great importance for the country. He wanted to emphasise once more that his commitment to democracy was not a tactical matter. Poland had found to its cost that failure to implement democratic rules ended in disaster. But democracy like the universal values represented in the Helsinki Accords, had to be adapted to the specific conditions of Poland.

The Prime Minister thanked General Jaruzelski for his very full account of developments in Poland and on the world scene. She would start by commenting on the international aspects. We shared the wish for an early end to the Vienna talks, but were sceptical whether a human rights conference in Moscow would be appropriate. While there had been

progress in the Soviet Union in implementing the Helsinki Accords, it was not yet sufficient to warrant agreement to a conference in Moscow. Conventional stability talks were important, but would only succeed if there was much greater frankness on the part of the Warsaw Pact about the strength and deployment of their forces than had been the case in the MBFR talks. Geographical differences also had to be taken into account, in particular the vast hinterland for reinforcement enjoyed by the Warsaw Pact, while NATO's reinforcements had to come across the Atlantic and the Channel. We attached very great importance to negotiations on chemical weapons which had proliferated alarmingly. The Warsaw Pact enjoyed a heavy preponderance in these weapons. The main guarantee of Europe's security would remain the nuclear deterrent: she saw no scope for further reductions in nuclear weapons in Europe at this stage.

The Prime Minister continued that she would like next to address some of the broader political and economic issues raised by General Jaruzelski. It was quite evident that the centrally-planned economies had failed, most of all because of their inability to respond to change. Marx had assumed that people would conform to economic laws. But human beings simply were not like that. If you denied them the right to take their own decisions, they would not act responsibly. It simply was not possible for any Government to arrogate to itself the power to plan an economic system from the centre. Socialism with its system of controls just did not work. Mr. Gorbachev had come to realise this in the Soviet Union. Of course there were people who were comfortable with socialism because it relieved them of the need to take decisions for themselves and gave great power to corporate bodies such as trade unions. She had set out to change all that in Britain in 1979, by abolishing controls, privatising state-owned companies, spreading ownership among people, giving incentives to greater effort by reducing the tax burden, and leaving managers to take their own decisions. The result had been a tremendous shake out and the difficulties had been much quicker to emerge than the positive results. It took time for people to get used once more to taking responsibility. But greater freedom had worked and enterprise had come back. That was why the British economy was now successful. The key was to give responsibility back to individual people.

The Prime Minister continued that the same thinking had inspired the Government's trade union reforms. The purpose of these had been to give individual trade unionists more power at the expense of union bosses. They were able to decide for themselves whether their interests would really be served by going on strike. This greater freedom for individual trade union members had been an essential part of Britain's economic recovery. She noted in parentheses that General Jaruzelski had said in his interview with The Guardian that Britain's trade unions were not truly independent because they were controlled by the Labour Party. Actually it was the other way round. But there was another aspect, which was a crucial difference between Britain and Poland: people in Britain did not have to rely

on trade unions to express their political views. They were able to decide whether or not to support the Government's policies in free elections. If they did not like those policies, they could change the Government. In Poland, trade unions, including Solidarity, seemed to be the only means of political expression for people who opposed the Government. While that lasted, she did not see how economic reform could succeed because people would use strikes as a political weapon in default of any other means of pursuing their political objectives.

The Prime Minister continued that she was very grateful to General Jaruzelski for enabling her to meet representatives of every shade of opinion in Poland. She had not come to create problems or to interfere in Poland's business. She could only say what had worked for Britain. But she welcomed the Polish Government's decision to offer round table talks with other groups. It was always best to talk and discuss and she hoped that Solidarity would accept the invitation. When she had visited Father Popieluszko's church earlier in the day, she had felt the power of the Solidarity movement. As a politician, her instinct told her that power could not be denied. As an organisation, Solidarity was outside her experience but it obviously had a cohesion and a strength which meant it must be given a role. She would let General Jaruzelski have further reflections after she had met the Solidarity leadership the following day. She could assure him she would be as supportive of dialogue in talking to them as she was in talking to the Polish Government. She held to the maxim that an empty chair does not talk. There was another point. She had heard Mr. Rakowski say that he was willing to discuss power sharing. With respect, that would not deal with the real problem. It was not a question of sharing power but of taking powers away from government and giving them back to ordinary people to exercise for themselves. General Jaruzelski wanted to go in the same direction as Mr. Gorbachev but had the advantage in Poland of people who could remember what a free enterprise economy was like and who had experience of owning their own land. That was a great blessing. She had seen for herself the tremendous achievements of the Polish people in re-constructing Warsaw after the terrible damage done during the Second World War. A nation which had the spirit to do that must be able to overcome present problems. We wanted to see Poland succeed.

The Prime Minister said that she would also comment on bilateral relations. Poland had a special place for Britain. For us it was different to other East European countries. It was partly history, in particular the experiences of the Second World War. It was partly the fact that we had a large number of Polish people who were excellent members of the community and also very good Conservatives (General Jaruzelski permitted himself a wintry smile). She was sorry to learn that our relations were now less substantial than those of Germany. There was a certain irony in that in the light of history. As to economic help, once Poland was able to reach agreement with the IMF, that



would unlock the door to further financial assistance, including re-scheduling of debts. We would be ready in principle to use our influence helpfully with the IMF provided we could be sure that economic reform would be durable, and for that further political reform was essential. There seemed to have been some misunderstanding about help with management training: we were very ready to offer such help and the details could be discussed. There were also other practical steps which could be taken in our relations. She had described these to Mr. Rakowski.

General Jaruzelski thanked the Prime Minister for her remarks. He had been fascinated by what she said. He would make a few brief comments. First, it was important to remember that the East needed a sense of security no less than the West. The Soviet Union and Eastern Europe had suffered terribly in World War Two and this had made a deep psychological impact. While the West tended to talk in terms of the map which showed Western Europe as a relatively small appendage to the great land mass of the Soviet Union, the Soviet Union itself tended to look at the globe and feel itself surrounded. Secondly, he disliked the emphasis which the Prime Minister put on deterrence because it pre-supposed that the other side was a potential aggressor. It was time to give up the philosophy of enmity. We were doomed to live alongside each other and should concentrate more on common problems such as ecology rather than the military threat. Thirdly, it could not be said that Communism was a social system which had failed. There was its role in achieving victory in the war against Hitler. There was the Soviet presence in space. There was its outstanding record in basic science. In retrospect, it was a great pity that Lennin's new Economic Policy had not been continued: if it had been, the Soviet Union would have been much more advanced now. Lastly, one should never forget that societies and economies moved in cycles. Capitalism was certainly resurgent at the moment but had not always been so. The role of individual leaders had great importance. If it had not been for the Prime Minister's strength of character and determination, Britain might well still be languishing.

Summing up their discussion, he would like to say that he had found it refreshing and helpful. He thought Poland could learn a lot from the United Kingdom's experience. He wished the Prime Minister well for her visit to Gdansk. There might be attempts to exploit it. He recalled her undertaking in her letter to him not to add further complications to Poland's existing difficulties.

I am copying this letter to Alex Allan (H.M. Treasury), Neil Thornton (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and to Trevor Woolley (Cabinet Office).

*your diary,*  
  
CHARLES POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

✓  
7/11

CH/EXCHEQUER	
REC.	- 7 NOV 1938
ACTION	Mr BOTTRILL
COPIES TO	EST, Sir P. MIDDLETON, Sir E. LITTLE, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H. P. EVANS.

4 November 1988

Dear Lynn,

PRIME MINISTER'S MEETING WITH MEMBERS OF THE CONSULTATIVE COUNCIL

The Prime Minister met members of the Consultative Council at the Sejm in Warsaw on 3 November. Thirteen members of the Council were present (out of a total of nearly sixty) but only seven of these spoke. The Prime Minister was greeted by Professor Secomski who invited Professor Legatowicz, a Catholic, to introduce the Council.

Professor Legatowicz said the Consultative Council was an unconventional institution, composed of people invited personally by General Jaruzelski. It was intended to broaden the base of the advice available to the General. Among its members were many people who had not previously taken any part in public life. Two-thirds of members did not belong to any political party. The Council was very broadly based therefore, although it was true that at the time of its formation some people had refused to join it. The Council held only plenary meetings, at which there were no taboo subjects, and no constraints of time. The purpose of their meetings was to present General Jaruzelski with their views and the views of those whom they represented. The General always sat through meetings. Members could be confident that points raised would get a response. Finally, Professor Legatowicz said that it had been clear from the start that the Council was not a closed body. There had been no changes yet, although there was a suggestion that the Council could be transformed into a Council of National Reconciliation. But this lay in the future and awaited a broader national consensus. Professor Secomski added that the Council had been important in opening up the political process in Poland. Its role now was to broaden the dialogue and try to draw in Solidarity, representatives of the official unions, and the church.

The Prime Minister asked on what subjects the Council had given advice, and why. Professor Skubiszewski said that meetings were concerned with three types of subjects: those proposed by General Jaruzelski, those of specific interest to members, and those put forward in correspondence between members and the public. The advantage of the Council was that views could be expressed direct to General Jaruzelski and through him to the Government. The Council had discussed various social problems: economic reform, the environment, emigration of young people, and would soon discuss international problems. Professor Secomski commented that subjects were usually general in nature.

Professor Maciszewski said that the Council's decisions were taken by consensus. Perhaps this was an excess of democracy, but Poland had not had enough democracy in the past. Moreover, he was one of only two Communist Party members of the group meeting the Prime Minister. The others belonged to the "constructive opposition" or even to the opposition unqualified by an adjective. Professor Szczepanski said the Council mostly composed of Professors, preoccupied by analysis of facts. The information they provided to General Jaruzelski was factual and was therefore sometimes unpleasant for him. Professor Gleysztor said another quality of the Council was that its proceedings were published in 40,000 copies without any censorship. Professor Sila-Nowicki said he viewed the Council as a platform for free expression, and a reflection of the greatly increased freedom of speech in Poland. The Prime Minister commented that she found the Council easier to understand described in this way than as a platform for tendering advice. The meeting then broke up as the Prime Minister had to leave for her meeting with General Jaruzelski.

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

*Yours sincerely,*  
*Charles Powell*

C. D. POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	- 7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EDANS.
4 November 1988	

PRIME MINISTER'S MEETING WITH MEMBERS OF  
WALESA'S BRAINS TRUST

The Prime Minister met members of Walesa's Brains Trust in the Ambassador's Residence in Warsaw on 3 November. The members of Walesa's Brains Trust present were Professor Andrzej Stelmachowski, Mr. Jan Josef Lipski, Mr. Marcin Krol, Mrs. Janina Zakrzewska, Mr. Jacek Czaputowicz and Mr. Stefan Bratkowski.

The Prime Minister began by saying how glad she was to be in Poland, and how grateful she was that so many people had given up time to see her. She had only ever known a system of freedom under the rule of law impartially applied. She was therefore very interested in how Poland might make the transition to such a system. She had met already people who said the round table process was dead. How did her guests today see the prospects? It seemed to her to be not so much a question of seeking power-sharing as limiting the power of government.

Professor Stelmachowski said that Poland enjoyed today the best international climate since the war, which offered the potential to enlarge the area of freedom. The opposition did not want to share power. Society was pulverised. It was important to start at the bottom, and the first requirement was for freedom of association. The problem was that the authorities feared the emergence of an organisation as powerful as Solidarity had been in 1980. Therefore a trade union must be only a trade union. It could only be this if there was real freedom of association for others. Of course the government required certain guarantees. But society was pluralistic and its structures must be pluralistic. The government still believed that economic reform could be introduced without society's support. This was a mistake and could lead to conflict. In Professor Stelmachowski's view the spirit of the time was one of conciliation.

Mr. Bratkowski was unhappy about the term opposition, since he regarded himself as simply fighting for the rights of citizenship. The country was in a mess. The economy, as the Prime Minister knew, was appallingly run. He cited the example of the Lenin Shipyard in Gdansk which was forty-fifth in the list of five hundred largest enterprises in Poland, exporting 75 per cent of its production. The fact that it suffered from a negative added value arose purely because of a false exchange rate implied

in calculating the value of the rouble against the dollar. Mr. Krol, endorsing this, said the opposition could not share power, and propositions so far made by the authorities had been totally false. If, like him, you had been anti-socialist all your life you could not participate in a Communist system. The purpose of the round table talks had been to create the possibility of sharing power. The opposition were ready to accept responsibility. But co-optation into the system was totally undemocratic. It was true that there had been some liberalisation in the last seven years, in allowing wider expression of views. But this did not amount to democracy. Indeed, he had not observed a single real step towards democratisation. Structural changes were essential and the authorities must give up a large share of their power, especially in the economy.

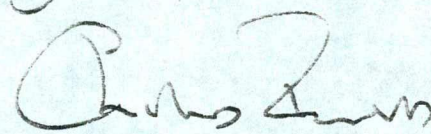
Mr. Czaputowicz wished to talk about Europe. On the one hand Western Europe was aiming at integration, and on the other there were the beginnings of integration in Eastern Europe. This had been clear from Gorbachev's visit to Poland earlier this year. For example, he wanted to create 200 joint Polish-Soviet enterprises, an extremely dangerous prospect for Poland. The need was to overcome the divisions in Europe not to promote them. On another point, Mr. Czaputowicz criticised the decision by the Presidents of West European Parliaments to accept the invitation from the President of the Polish Parliament to participate in a conference in Warsaw in November. It implied that East European Parliaments were similar to those in the West. This was simply not the case. Lastly, Mr. Czaputowicz said that young people were very radical. There had been a change of mood recently, exemplified by the current boycott of military training classes in universities.

Mr. Lipski confirmed that the opposition did not wish to take over power. But without social control, no reform was possible. This was particularly true in a system where political criteria always had priority. The Lenin Shipyard decision exemplified this. The Prime Minister asked what Mr. Lipski meant by social control. He replied that a parliamentary system would serve this purpose. But in Poland what was called a Parliament was not a Parliament at all. It could become a more useful instrument of control if reformed so that candidates could be put forward by genuine organisations. Lastly Mr Lipski asked what means should be employed to carry out economic reform. Experience to date showed the capacity of the present system for wasting everything. Only far-reaching democratisation could ensure economic reform. In this context he attached great importance to effective social insurance to avoid social conflict at times of economic hardship.

Finally, Mrs. Zakrzewska spoke, as a representative of the Polish Helsinki Committee. She recalled the Prime Minister's opening words about the freedom under the rule of law impartially applied. The Helsinki Committee had been founded in 1982 but it was important to understand why it continued to operate after the lifting of martial law. This was because Poles did not enjoy freedom under the rule of law. It was true that there were greater areas of freedom now. But these were not based on law. Rather, they were arbitrarily assigned and could be as easily withdrawn. Her Committee's struggle was for a law equal for all citizens and a law which would be obeyed.

At this point the meeting had, unfortunately, to be broken off as the Prime Minister was already late for her next appointment, a meeting with the Consultative Council.

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

Yours sincerely,  


(CHARLES POWELL)

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



✓  
7/11

CH/EXCHEQUER	
REC.	-7 NOV 1988
ATTN	Mr BOTTRILL
CHIEF	EST. P. MIDDLETON
	Sr G. LITTLER,
	Sr T. BURNS,
	Mr LANKESTER,
	Mr MOUNTFIELD,
	Mr H.P. EVANS.

10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

5 November 1988

Dear Lynn,

PRIME MINISTER'S MEETING WITH GENERAL JARUZELSKI  
IN WARSAW ON 4 NOVEMBER

The Prime Minister had a final round of talks with General Jaruzelski after returning to Warsaw from Gdansk on 4 November. General Jaruzelski was again accompanied by the Polish Foreign Minister and officials.

General Jaruzelski began by saying that people in Gdansk had been most impressed by the Prime Minister's visit. He was grateful to her for agreeing to lay a wreath at the monument at Westerplatte. Next year would be the 50th anniversary of the outbreak of the Second World War and he wondered whether it might not be an idea to mark it in some special way, perhaps a conference or a seminar. He would like to hear the Prime Minister's impressions from her visit.

The Prime Minister said that she had found her visit to Gdansk moving. She had learned so much and understood so much. She was grateful to General Jaruzelski for putting no obstacle in her way. She had much appreciated his decision to join her in laying a wreath at Westerplatte. She had been greatly impressed by the old town of Gdansk. It was almost impossible to conceive how people had summoned up the courage and spirit to reconstruct it from the terrible devastation of the Second World War. The people of Gdansk had given her a very warm reception as she walked through the old quarter to the City Hall.

The Prime Minister continued that she had subsequently gone to meet Mr Walesa and other Solidarity leaders. There had been huge crowds but they were very orderly, peaceful and cheerful and made up of people of all ages. She had talked at length to Mr Walesa and his advisers. If she had to sum up what they had said, the strongest emotion that came through was their resentment that Solidarity was illegal. They had considerable achievements to their credit. They wanted to take part in the life of the country and in restoring Poland's economy. They were willing to talk. But they did not like the notion that the invitation to attend round table discussions was a favour or privilege which could be withdrawn

at any moment at the Government's whim. They wanted to be treated as a legal organisation which had a right to be consulted. They had talked a great deal about a plural society and political system. They recognised this was only a long term aim and she had encouraged them to focus on immediate steps. She had also posed the question, what was the alternative to dialogue. Solidarity were fairly upset about the timing and manner of the decision to close the Lenin shipyard in Gdansk. They recognised that there were considerable problems with the yard and in her view might have accepted closure had the matter been handled differently. As it was, they were convinced that the decision was a political one. She had found it difficult to draw them out on a specific agenda for round table talks. Her understanding was that they would meet later in the day to decide how to reply to the Government's latest invitation to talks. She felt they wanted to talk but needed an assurance that the talks would be genuine and in good faith and that they would be treated fairly. In short they would probably say yes but attach riders to their acceptance. She had not found Walesa or the others bitter although they claimed to have been let down by the Government many times in the past. She had been impressed by their commitment to peaceful discussion and their moderation.

General Jaruzelski said that, before dealing with these points, he would like to revert to one of the broader issues he had raised with the Prime Minister the previous day. He had read her Bruges speech and found it impressive. He had been particularly interested by her insistence that Europe extended beyond the bounds of the European Community. He would like to see Britain and Poland play a role in bridging the gap between the two parts of Europe. He hoped that relations could develop in that direction as a result of her visit. He could declare with great sincerity that this was Poland's intention.

Turning to Poland's domestic affairs, he could acknowledge that the Prime Minister had an interest in Poland's stability. He also wanted Poland to be a stable country and a constructive element in Europe. He wanted to accomplish the reforms which he and Prime Minister Rakowski had outlined, drawing on Britain's experience as well. He was convinced this was the only way for Poland and did not want more disappointments. He was 65, he had covered a long hard road and was now nearer the other side. He had no desire for more honours or decorations. His only objective was the good of Poland. If he talked about reconciliation, it was because he saw it as the most important objective. But Poland's affairs were very complex and the difficulties would only be solved if all sections of society were willing to act responsibly. There were certain realities which could not be denied. Solidarity had been a legal organisation, indeed it had virtually ruled Poland. But it had wanted to be the only ruler. It had sought a monopoly of power. To be made a legal organisation once more, it must demonstrate responsibility. Poland had to restore its economy. That would mean redundancies, tough measures to curb inflation and so on. But



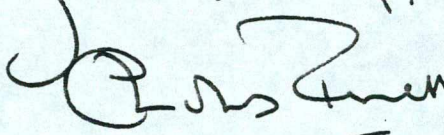
there was no indication that Solidarity was willing to call on people to tighten their belts and work. Solidarity went far beyond the normal concept of a trade union. It had its own political goals. The Government were ready to discuss a model for de-politicised trade unions in Poland, in which a major role would of course be played by Solidarity. But he wondered whether Solidarity itself would be satisfied with this, given its political ambitions. He agreed with the Pope who had said that Solidarity should be treated as an idea. One possible course might be to form a new body which embraced Solidarity's ideas and included Walesa himself, but not all those associated with him. General Jaruzelski continued that Poland's recovery was gravely hampered by strikes. These were organised by a very small minority of workers. They imposed their views by pressure, picketing and even by violence. The same people who had cheered the Prime Minister earlier in the day at Gdansk had a short while previously carried banners reading "hang the Communists". If this continued, Poland would descend once more into anarchy. This was one reason why the Government insisted that the Solidarity delegation at round table talks should not include the extreme element.

General Jaruzelski said that the Prime Minister had referred to the closure of the Lenin shipyard. Contrary to Solidarity's assertion this had not been a political decision. Other closures would follow, indeed closure of a major steel works in Poznan was imminent. He had talked to a number of workers from the Lenin shipyards that morning in Gdansk. They had told him that the decision to close the yard was painful but not unexpected. Indeed it had been a surprise to them that the yard had been kept open so long. This suggested that Solidarity were misrepresenting the views of the people who actually worked in the yard. He hoped they were not using the decision to close it as a pretext for blocking the round table talks. The Prime Minister should not be misled into thinking that Solidarity had universal support in Poland. No doubt she had been impressed by large crowds which had turned out to welcome her in Gdansk. But then one million people had gone on to the streets for Mr Gorbachev. Opinion polls indicated that support for the Polish Government had risen sharply. He wanted to reassure the Prime Minister once more that he was sincere in seeking a platform for reconciliation. Changes would be made both in the Party and the Government, and the more calm there was, the further he would be able to go. He wanted to have round table talks. But their purpose must be to reach conclusions on the basis of discussion. Solidarity wanted agreement on the results before the discussion started. Poland could only advance by consensus. In spite of all, he was optimistic. He would follow the Prime Minister's example and keep his nerve through difficult times.

The Prime Minister said that she had fought strikes and insisted that people must be able to go to work even during a strike. She knew what it was like to restructure an economy. She had respect for what General Jaruzelski was trying to achieve. She had told him frankly how the prospects seemed to her, based on the discussions she had held and her own experience. Only he could decide what to do. But her views

had been offered in friendship and from a desire to see Poland restored. She could only say that she did not believe that Solidarity could be ignored, indeed that an attempt to ignore them would court disaster. She agreed with General Jaruzelski on the need to work to overcome divisions in Europe. She would consider on her return how this might be taken further and how Britain should respond on other matters which General Jaruzelski had raised with her, including the idea of an event to mark the 50th anniversary of the start of the last War. General Jaruzelski said that the Prime Minister's visit had created a bridgehead for future results. He had a better understanding of her policies and objectives. That had been valuable, indeed inspiring. He hoped she would be ready to use her great influence for Poland's benefit.

I am copying this letter to Alex Allan (HM Treasury), Neil Thornton (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

*Yours sincerely,*  


Charles Powell

Lyn Parker Esq  
Foreign and Commonwealth Office.

CONFIDENTIAL



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

7/11

CH/ES CHEQUER	
DES.	- 7 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR L ANKESTER, 5 November 1988 MR MOUNTFIELD, MR H.P. EVANS

Dear Sir,

PRIME MINISTER'S MEETING WITH SOLIDARITY LEADERS IN  
GDANSK ON 4 NOVEMBER

The Prime Minister met leaders of the Solidarity movement in Gdansk on 4 November. The first part of the meeting was with Mr. Lech Walesa, Professor Geremek and Dr. Onyszkiewicz. The discussion subsequently continued over lunch with other senior Solidarity advisers as well as Father Jankowski and the Bishop of Gdansk.

The Prime Minister opened the discussion by saying she would like to hear Mr. Walesa's view of the situation in Poland. These matters were always more complicated than they seemed from outside. In her talks with the Polish Government, she had said that Solidarity was more than a trade union, it was an expression of opinion and opposition in a country where there was no other means of expressing political views. It was a great movement which could not be ignored or denied. Whether legal or not, it was a fact of life.

Mr. Walesa said that he was glad the Prime Minister understood Solidarity's struggle. Solidarity would prefer to be just an ordinary trade union. But in the Polish system it had to take up wider economic and political issues which could not be aired in any other way. Solidarity knew perfectly well that it could not fight the present Government or replace it. There were clear limits on how far it could go. Its most important demand was for equality before the law. Solidarity wanted to be a legal organisation which would be consulted as of right rather than being invited to take part in round table talks as some sort of favour. Such favours could always be withdrawn when it no longer suited the Government. Solidarity had been tricked by the Government too many times in the past. The only real solution was for the Government to give them the freedom which would enable them to start to work with will, conviction and commitment to rebuild Poland. He wanted to add that Poland was worth helping and should be helped. The main effort must come from the Polish people themselves but they needed the assistance of other governments as well.

The Prime Minister said that she understood that

Solidarity wanted to talk to the Government but on the basis that it was a legal movement with a right to be consulted. She wondered how they intended to respond to the Government's recent invitation to round table discussions. Mr. Walesa said that the present system was rotten. It had made Poland bankrupt and this in turn was slowing down the economic progress of Europe. You could not have a society based on coercion. Solidarity's fight was for freedom in economic, social and political matters. This was the challenge of the era. Mr. Gorbachev could not be another Stalin even if he wished to be. The question was whether greater freedom came through evolution, as Solidarity wanted, or revolution. Revolution brought only painful losses and at the end of the day one still had to find solutions. The Communist system was finished. The only question was how to get out of it. Solidarity believed that economic reform was the best way forward. Solutions to other problems would emerge as a result of that. They knew that economic reform required difficult decisions including the closure of firms making a loss. But such decisions must be reached on the basis of genuine economic criteria. The closure of the Lenin shipyards could have been accepted in due course, but there was no justification for selecting it to be the first industrial enterprise to be closed. Even the management did not believe that closure was justified.

The Prime Minister said she understood Solidarity's desire for greater fairness. The crucial question was how to get from where they were now to where they wanted to be. All sides in Poland talked of reconciliation. There must be a way forward. When there were differences, it was best to get together to discuss them. If she understood correctly, Solidarity were prepared to talk if their legitimacy was recognised. Mr. Walesa said that they were not even that ambitious at the first stage. All they asked was that the agreed objective of talks should be pluralism, not socialist pluralism but just pluralism. Discussions could then concentrate on how to bring it about. Provided Solidarity knew that the goal was pluralism, other things could be decided later. But they would not be bought off. The Prime Minister said that Mr. Rakowski had spoken of power sharing. She had replied that it was more important to limit the powers of government and give them back to people.

The Prime Minister continued that she had tried to put herself in Mr. Walesa's position and asked how she would avoid being wrong-footed. What would people say if he refused the Government's invitation to talk? She could understand that he would want some assurances as a basis for talks, but it was important always to underline Solidarity's willingness to talk. Solidarity should also prepare a detailed agenda and supporting papers, so that there were concrete proposals on the table.

Mr. Walesa said that with hindsight, Solidarity had lost in 1980. The Communist system always needed a scapegoat. As long as Solidarity was fighting, it could be tolerated. But once it started putting forward a positive programme it began to be a real threat to the Communist

Party. The Government's approach to the round table discussions was to get Solidarity to turn out its pockets in advance. It also wanted to put limits on what could be discussed and who could represent Solidarity. Neither of these demands were acceptable. But solutions had to be found. His response to the Government would be to say that Solidarity wanted round table talks, but the Government should not do things in the way they announced the closure of the Lenin shipyard. He knew that difficult decisions had to be faced and they could be accepted if based on genuine economic criteria. The Prime Minister asked how Solidarity could get its points across to the Government. Mr. Walesa pointed to the ceiling and said that all its meetings were bugged so there was no problem.

The discussion continued over lunch when Mr. Walesa was joined by representatives of the Solidarity leadership and its senior advisers. Mr. Walesa said that Solidarity believed Poland should be ready to try all the various possible remedies for its economic problems which had already been proved in the West. But they wanted Poles to be treated on an equal footing with other European countries. They were not interested in receiving gifts.

Professor Geremek then invited Mr. Mazowiecki to comment on the philosophy of the round table discussions. Mr. Mazowiecki said that the round table proposal was a direct result of social pressure. During the last forty years, all change in Poland had arisen from social pressures. Solidarity did not wish to say no all the time. Their long term goal was a fully independent Poland, with a place in the European community of nations. But they were prepared to go slowly. The round table proposal had seemed at first a chance of escape from the stalemate of recent years. After Mr. Walesa's meeting on 16 September with General Kieszczak, Solidarity had received the impression that for the first time the authorities recognised that appearances would not do. However, since then, there had been an unbroken attack on Solidarity in the press and the media. Solidarity thought somebody had been trying to undermine the talks. Then had come the provocative decision on the Lenin Shipyard in Gdansk. This was taken on political grounds and undermined the credibility of the authorities' declared readiness for further reforms. Now was a very difficult moment. But Solidarity knew it must not respond in a confrontational way. They were ready to talk about most things, but not the future of Solidarity itself.

The Prime Minister asked if Solidarity's view was that the round table was only a ploy. She wondered what people in Poland would think if Mr. Walesa accepted the latest offer to attend the round table, or conversely declined it. Mr. Walesa said that Solidarity's experience was discouraging. Talks with the authorities on the Church Agricultural Foundation had lasted over five years and produced no real result. The authorities wanted talks with no concluding point. Solidarity recognised the need for compromise. But the terms had to be right and they could

CONFIDENTIAL

- 4 -

not ignore possible reactions among their supporters. The Prime Minister asked what the alternative to talks would be. Mr. Walesa replied that Solidarity did not wish to humiliate the Government, and were ready to offer face-saving formulations. There must be compromise, otherwise society would "switch on the afterburners". They did not want anarchy. Indeed, if the Government reached the point of collapse, he would even join the Communist Party himself to shore it up! He admitted that in some areas the authorities had recently begun to move in the right direction. But they only moved under pressure. Solidarity could not wait for two hundred years.

The Prime Minister said that she understood Solidarity's desire for pluralism. She came from a pluralist society. But Solidarity could not achieve this in the short term. However, Solidarity could not be ignored or rejected. They had done so much. Her anxiety was that Solidarity should never put themselves in the wrong and so damage their reputation. The next step needed very careful thought. That response to the Polish Government should be very skilfully drafted. Mr. Walesa said that the lunch in which the Prime Minister was participating was in itself a great help. When the Prime Minister had left, he would write to General Kiszczak confirming Solidarity's readiness to begin talks in a climate of hope and goodwill. Solidarity wanted the round table and wanted to create a climate of goodwill and hope. He added that he would not accept interference by the authorities in Solidarity's delegation. He had yet to discuss with his colleagues the terms of his reply, but he believed his voice would carry some weight in their discussions. Solidarity would get the Government to the table. The only question was when. The Prime Minister commented that Solidarity had a very strong hand to play. They had the conviction and knew in which direction they wished to go. It was worthwhile taking small steps.

Mr. Walesa said that Solidarity could not and would not try to change the Government. But they had to force the authorities to take them seriously and start talks. Mr. Merkel said that Solidarity's number one problem was obtaining legalisation as a trade union. The Prime Minister said that, legal or not, they had been asked to go to the round table. This was a paradox. It was also paradoxical that the authorities had provided transport and security for her meeting with Mr. Walesa. Dr. Onyszkiewicz said this was true, but Solidarity required legalisation because only when they were a legally existing union could they be sure of the right to talk to the Government, so obliging the authorities to take account of their views for the longer term. Solidarity's current invitation to the round table was made to look like a privilege. The Prime Minister said that the invitation to the round table was more than that. It acknowledged that Solidarity was a force which could not be ignored. Mr. Walesa commented that the authorities were prepared to talk to Solidarity but at the same time wished to reduce their power and their credibility.

Professor Geremek said that Solidarity had put four points to the round table: legalisation of Solidarity, the reduction of the nomenklatura system in the economy, a new law on freedom of association, and a genuinely independent judiciary. The Prime Minister, noting these, asked whether an independent judiciary could not naturally evolve through the courage of individual judges, prepared to stand up for the rule of law. Mr. Mazowiecki explained the difficulty in Poland where judges who did not toe the line were removed or did not receive sensitive cases to handle. Mr. Walesa said that the longer the system lasted the more corrupt it became. Higher civilisations should develop more freedom. Poland was being offered materialism, but there was nothing of any material worth on offer. The problem was how to escape from this situation in a peaceful way. The major task was to achieve pluralism.

The Prime Minister then asked Mr. Walesa what he would like her to say to General Jaruzelski when she saw him later that day, and to the press. She suggested that she should say she had a most interesting meeting with the Solidarity leadership, and been impressed by the enormous crowds of people who had gathered. Solidarity was a great power in the land and could not be ignored. They had a good deal of sympathy with the democratic political system from which she came and which provided an outlet for an opposition to make its views known. She would say that Solidarity felt deeply that their position was not properly recognised. They knew the direction in which they wanted to go, by clear, steady steps in an evolutionary way, but steps which acknowledged their importance. It was for Solidarity to decide how to reply to the invitation to enter the round table talks. But it was clear that Solidarity needed an assurance that any talks would take place in good faith and would be genuine.

Professor Geremek said that the Prime Minister's summary was excellent. But he asked her to add legalisation of Solidarity as an essential requirement. De facto recognition was not enough. Legalisation opened up the possibility of further evolution and gave a guarantee that they would not be cheated again. The Prime Minister noted this. She would also say publicly that when she had agreed to visit Poland she had explained to the Polish authorities that there were certain things she had wished to do. The fact that she had been allowed to do them all was a step forward.

Dr. Kurakowska said that the strength of Solidarity was partly because it had played a major role in changing the way Polish people thought. Before Solidarity, there was no real attempt to think independently. But now people were thinking more and more independently. She hoped that the fight for the right to free association would be won.

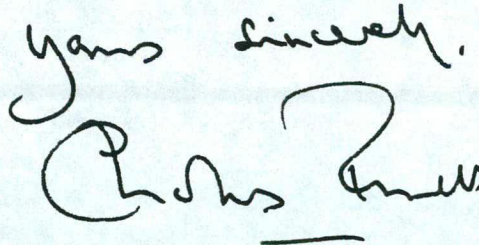
At this point Mr. Walesa made a short speech of thanks to the Prime Minister, to which the Prime Minister replied. Mr. Walesa, Father Jankowski and others then presented the

CONFIDENTIAL

- 6 -

Prime Minister with gifts and the party left to visit St. Brygida's Church before leaving Gdansk.

I am copying this letter to Alex Allan (H.M. Treasury), Neil Thornton (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and to Trevor Woolley (Cabinet Office).

Yours sincerely,  


CHARLES POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.



CONFIDENTIAL



✓ 7/11

CH/EXCHEQUER	
REC.	- 7 NOV 1988
NAME	Mr BOTTRILL
ADDRESSES TO	EST. SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EVANS.
6 November 1988	

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER'S VISIT TO POLAND

As you will see from my records of the Prime Minister's talks in Poland, there are a number of points which need to be followed up:

- General Jaruzelski's suggestion of bilateral talks between defence experts;
- his proposal for bilateral discussions on wider East/West issues;
- the possibility of an event to mark the fiftieth anniversary of the beginning of the Second World War. This would have to be looked at very carefully to prevent it becoming just a propaganda occasion;
- the Prime Minister's undertaking, repeated on Polish television, that we would take action to reduce delays and ease restrictions on visas for Poles;
- her references to willingness to increase exchanges of teachers and schoolchildren;
- our offer of help with managerial training;
- how we should respond to General Jaruzelski's request that we use our influence to help Poland's negotiations with the IMF and the Paris Club (largely covered by the Prime Minister's speech in Poland);
- a possible visit by General Jaruzelski.

I think the Prime Minister would welcome advice on how these issues are to be taken forward.

I am copying this letter to Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry), Tom Jeffery (Department of Education and Science) and to Trevor Woolley (Cabinet Office).

CHARLES POWELL

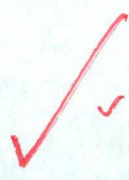
Lyn Parker, Esq.,  
Foreign and Commonwealth Office.

CONFIDENTIAL

RESTRICTED

134064  
MDLIAN 3174

RESTRICTED  
FM TOKYO  
TO PRIORITY FCO  
TELNO 988  
OF 1007337 NOVEMBER 88  
INFO ROUTINE WASHINGTON



YOUR TELNO 315 TO AMMAN: JAPANESE REACTIONS TO THE US PRESIDENTIAL ELECTIONS

SUMMARY

1. THE JAPANESE WELCOME FOR BUSH'S ELECTION IS TINGED WITH CONCERN THAT JAPAN WILL COME UNDER RENEWED PRESSURE TO REDUCE THE BILATERAL TRADE DEFICIT AND TO ASSUME GREATER DEFENCE RESPONSIBILITIES.

DETAIL

2. JAPANESE GOVERNMENT, PART AND BUSINESS LEADERS HAVE WELCOMED BUSH'S ELECTION. IN HIS MESSAGE OF CONGRATULATIONS, PRIME MINISTER TAKESHITA LOOKED FORWARD TO CONTINUING TO WORK CLOSELY WITH THE NEW ADMINISTRATION. THE JAPANESE PRESS NOTE TAKESHITA'S PREVIOUS CONTACTS WITH BUSH AND HIS CLOSE LINKS FROM HIS DAYS AS MINISTER OF FINANCE WITH THE SECRETARY OF STATE DESIGNATE BAKER. TAKESHITA APPARENTLY PLANS HIS FIRST MEETING WITH BUSH AS PRESIDENT NEXT SPRING FOREIGN MINISTER UNO IS HOPING TO MEET BUSH BEFORE ATTENDING THE URUGUAY ROUND MINISTERIAL MEETING IN MONTREAL IN DECEMBER.

3. THE CHIEF CABINET SECRETARY, OBUCHI, IN AN OFFICIAL STATEMENT ON BEHALF OF THE GOVERNMENT, SAID ON 9 NOVEMBER THAT THE JAPANESE GOVERNMENT WERE CONVINCED THAT UNDER BUSH THE JAPAN/US RELATIONSHIP WOULD FURTHER STRENGTHEN AND DEVELOP. JAPAN'S FRIENDLY AND COOPERATIVE RELATIONSHIP WITH THE US WOULD REMAIN THE PIVOT OF HER FOREIGN RELATIONS AND NATIONAL SECURITY. JAPAN WOULD SEEK TO MANAGE HER BILATERAL RELATIONS WITH THE US IN A SPIRIT OF 'COOPERATION AND JOINT ENDEAVOUR.'

4. UNDERLYING THESE FINE SENTIMENTS LIES BARELY CONCEALED CONCERN, WIDELY SHARED BY THE BUSINESS COMMUNITY, THAT THE EXPECTED SLOWING DOWN OF THE US ECONOMY, THE INTRACTABLE DEFICITS AND THE GREATER STRENGTH OF THE DEMOCRATS IN CONGRESS WILL FORCE BUSH TO ADOPT A TOUGHER APPROACH TO JAPAN THAN REAGAN. NEITHER JAPANESE GOVERNMENT SPOKESMEN NOR THE MEDIA EXPECT ANY FUNDAMENTAL CHANGE IN US POLITY TOWARDS JAPAN. BUT THEY ANTICIPATE RENEWED PRESSURE ON MARKET ACCESS ISSUES. JAPANESE OPINION LEADERS BELIEVE THAT BUSH IS LESS

RESTRICTED

134064  
MDLIAN 3174

IDEOLOGICALLY COMMITTED TO FREE TRADE THAN HIS PREDECESSOR, ALTHOUGH THEY SEE HIM AS PREFERABLE TO DUKAKIS AND BENTSEN. THERE IS APPREHENSION LEST BUSH'S PRAGMATISM WILL LEAD HIM TOWARDS CREEPING PROTECTIONISM. THE JAPANESE SEE WHAT USE HIS ADMINISTRATION MAKES OF SUPER ARTICLE 301 OF THE TRADE ACT AS A LITMUS TEST OF HIS COMMITMENT TO FREE TRADE. THERE IS CONSIDERABLE SCEPTICISM THAT BUSH'S COMMITMENT TO A FLEXIBLE FREEZE ON FEDERAL SPENDING WILL BE SUFFICIENT TO REDUCE THE BUDGET DEFICIT, AND THEREFORE A BELIEF THAT JAPANESE INVESTMENT WILL CONTINUE TO HAVE AN IMPORTANT ROLE TO PLAY.

5. THE JAPANESE MEDIA CONCLUDE THAT BUSH'S ELECTION SIGNIFIES THAT AMERICAN VOTERS HAVE OPTED FOR STABILITY OVER NEW POLICIES. THE CONTINUED PURSUIT OF PEACE AND PROSPERITY HAS PROVIDED AN EFFECTIVE ELECTORAL SLOGAN. BUT JAPANESE EDITORIALISTS ARGUE THAT THE NEW ADMINISTRATION MUST FACE UP TO THE REALITY OF THE RELATIVE DECLINE IN AMERICA'S POLITICAL AND ECONOMIC STANDING IN THE WORLD. INEVITABLY, THIS WILL LEAD THE AMERICANS TO CALL ON THEIR ALLIES, INCLUDING JAPAN, FOR GREATER BURDEN SHARING. JAPANESE COMMENTATORS EXPECT BUSH TO PRESS JAPAN TO MAKE A GREATER CONTRIBUTION TO THE COST OF US FORCES IN JAPAN AND TO INCREASE HER ODA RATHER THAN TO RAISE SIGNIFICANTLY HER OWN DEFENCE EXPENDITURE. MOST JAPANESE COMMENTATORS REGARD THIS AS A SOURCE OF POTENTIAL FRICTION BETWEEN JAPAN AND THE US. BUT ECHOING THE CABINET SECRETARY'S STATEMENT, MURATA THE ADMINISTRATIVE VICE MINISTER AT THE MFA URGES IN AN INTERVIEW THAT JAPAN AND THE US SHOULD SEIZE THIS AS AN OPPORTUNITY TO WORK TOGETHER TO SHARE RESPONSIBILITIES.

WHITEHEAD

YYYY

DISTRIBUTION

420

MAIN 420

FCO WHITEHALL  
NAD [-]

FED

NNNN

RESTRICTED

*[Handwritten signature]*

134147  
MDHIAN 1219

*Ch. All overseas posts have been asked to report on local reactions to Bush's victory. I am sparing you most of the telgrams, which report predictable reactions - i.e. v. warm welcomes from the West + allies, lukewarm from most non-aligned, conventionally warm from the Soviets, + hostile from one or two mavericks (eg. Nicaragua). But these two telg. are worth a read.*

RESTRICTED

FM PEKING

TO IMMEDIATE FCO

TELNO 1842

OF 110333Z NOVEMBER 88

INFO IMMEDIATE WASHINGTON

INFO PRIORITY MOSCOW, BONN, PARIS, UKDEL NATO, HONG KONG, TOKYO

CHINESE REACTIONS TO US ELECTION RESULT.

SUMMARY:

1. MORE THAN CONVENTIONALLY WARM WELCOME FOR BUSH.

DETAIL:

2. THE CHINESE MFA SPOKESMAN SAID ON 9 NOVEMBER: "WE WISH TO EXTEND OUR WARM CONGRATULATIONS TO BUSH ON HIS ELECTION. WE SINCERELY HOPE THAT DURING HIS TERM OF OFFICE AS PRESIDENT OF THE UNITED STATES THE FRIENDLY RELATIONS AND COOPERATION BETWEEN CHINA AND THE US WILL FURTHER DEVELOP IN A STABLE AND HEALTHY MANNER ON THE BASIS OF THE PRINCIPLES CONTAINED IN THE THREE SINO-US JOINT COMMUNIQUESES." THE ENGLISH-LANGUAGE "CHINA DAILY" PRINTED A COMMENTARY ON 10 NOVEMBER NOTING THAT BUSH HAD ONCE HEADED THE US'S DIPLOMATIC REPRESENTATION (LIAISON OFFICE) IN PEKING, AND WISHING HIM SUCCESS IN IMPROVING SINO-US RELTIONS. PARTICULAR STRESS WAS PLACED ON THE NEED TO IMPROVE THE US'S POSITION ON NORTH-SOUTH ECONOMIC ISSUES.

3. THE CHINESE WELCOME SEEMS GENUINE. DENG INDICATED TO CARLUCCI DURING THE LATTER'S RECENT VISIT THAT HE WOULD BE GLAD TO SEE BUSH WIN. THE CHINESE LIKE CONTINUITY, PARTICULARLY WHEN THE GENERAL TREND IS MOVING THIER WAY. ON BALANCE THE REAGANITE LINE DOES SUIT THEM, COMBINING SUFFICIENT STRENGTH TO KEEP THE RUSSIANS AT BAY WITH WILLINGNESS FOR MORE PEACEFUL COOPERATION AND REGIONAL SETTLEMENTS. THE ONLY DANGER, THAT PEKING MIGHT BE LEFT BEHIND IN THE GENERAL RAPPROCHEMENT, IS BEING COUNTERED BY THE MOVE TO SINO-SOVIET NORMALISATION.

4. FOR REASONS OF BALANCE AS WELL AS SELF-INTEREST, HOWEVER, THE CHINESE WILL CONTINUE TO PRESS THE US HARD ON SOME ISSUES. THEY WILL WANT TO SEE HOW MUCH THEY CAN GET OUT OF AN UNTRIED PRESIDENT AND A HONEYMOON PERIOD. THE TRADE POLICY QUESTION MENTIONED ABOVE IS ONE EXAMPLE. ANOTHER IS TAIWAN, WHERE THE AMERICANS HAVE DETECTED SOME

RESTRICTED

134147  
MDHIAN 1219

SIGNS OF INCREASED PRC STRIDENCY LATELY.

DONALD

YYYY

DISTRIBUTION

420

MAIN 420

FCO WHITEHALL  
NAD [-]

FED

NNNN

*[Handwritten signature]*  
*(in G.P. (Hunt))*

CH/EXCHEQUER	
REC.	23 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST Sir P. MIDDLETON Sir G. LITTLE, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H.P. EVANS, Mr WAUER



10 DOWNING STREET

Attached letter should have  
been sent with Charles Powell's  
letter of today, to Neil  
Thomson, DTI: Yugoslavia:  
ECCD Cover for the Purchase  
of Airbus.  
Apologies for omission

Duty Clerk.

23.11.88.

Veselin Djuranović  
Member of the Presidency  
of the Socialist Federal  
Republic of Yugoslavia

Belgrade, 31 October 1988

Dear Madam Prime Minister,

I vividly remember my visit to London last March and the meaningful talks I had the honour to have with you.

The immediate reason for my addressing you in this way is the specific issue that I brought up then, which was also the subject of your kind letter of 14 April, related to the ECGD guarantees for the purchase of Airbus planes by the Yugoslav company Adria Airways. I would like to thank you for the forthcoming approach in your letter. However, Adria Airways has decided to purchase, rather than lease, these aircraft and, as I have been informed, already has been assured of the readiness of the German and French counterparts of ECGD, HERMES and COFACE, to guarantee their share of the loan for that purpose. The question was again raised by Adria Airways in their direct contacts with ECGD, and the matter was also discussed at the Anglo-Yugoslav Trade Council meeting held in Belgrade, on 11 October. The Yugoslav side, however, in the subsequent talks with ECGD, noted with regret that it was not possible to come to an

The Rt Hon Margaret Thatcher, MP  
Prime Minister of the United Kingdom of  
Great Britain and Northern Ireland  
L o n d o n

understanding with them so that they would guarantee their share of the loan, instead of leasing, which unfortunately calls the whole project into question.

Bearing in mind the understanding and readiness expressed by you to lend your friendly support to my country, may I kindly ask you to take a renewed interest in this matter. The more so, since we view the purchase of these planes, as I believe you will agree, as an important part not only of the Anglo-Yugoslav economic co-operation, but also of Yugoslavia's economic co-operation with West-European countries.

In the meantime, after my talks with you, dear Madam Prime Minister, Yugoslavia has, as I believe you have been informed, successfully negotiated an IMF agreement on an economic adjustment programme, as well as an agreement with the Paris Club.

Furthermore, there are very important activities now under way in Yugoslavia related to the introduction of economic and political reform.

Major constitutional changes are expected to be adopted by the end of November. Consistent with these changes a reform of the economic system will also be carried out by the end of the year. In this way, the necessary constitutional framework and foundations will be created for a free play of market forces, for deregulation, recognition of diverse types of ownership, for joint ventures and investments of foreign partners, etc. All these changes should make it possible for the Yugoslav economy to become more efficient and more widely integrated into the world economy.

I am sure you realize that we are aware of the complexities of the process involved and of the hardships we shall have to surmount, as well as of our determination to put these reforms in place, wherein we expect your continuous understanding and support.



Needless to say, with these changes in place opportunities will be expanded for further promotion of economic co-operation between the SFR of Yugoslavia and the United Kingdom.

In concluding, I wish to reiterate, dear Madam Prime Minister, our interest in the comprehensive development of Yugoslav-British relations to which you personally have always given full attention.

Yours sincerely,

(Sgd.) Veselin Djuranović




10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	23 NOV 1988
ACTION	Mr BOTTRILL
COPIES TO	EST. SIR P. MIDDLETON, SIR G. LITTLER, SIR T. BURNS, MR LANKESTER, MR MOUNTFIELD, MR H.P. EVANS, MR WALLER

✓  
23/11

23 November 1988

BF ~~3/11~~ 2/12 8/12

## YUGOSLAVIA: ECGD COVER FOR THE PURCHASE OF AIRBUS

The Yugoslav Ambassador called on me this morning to hand over the enclosed message to the Prime Minister from Mr. Djuranovic, dealing with the question of ECGD cover for the purchase of airbus. As you will see, the message says that Adria Airways have now decided to purchase rather than lease Airbus. It also says that HERMES and COFACE have both agreed to guarantee their share of the loan. It seeks the Prime Minister's support for ECGD also to extend a guarantee. The Ambassador added that this is a matter of great importance for the Yugoslav government. They hoped for the Prime Minister's sympathetic support in the light of her talks with Mr. Djuranovic in the Spring. Since then, they had successfully completed negotiations with the IMF on an economic adjustment programme. Externally, the Yugoslav economy was performing very strongly although there were still internal difficulties. He could add that the Prime Minister's remarks to Mr. Djuranovic at their meeting had carried great weight in Yugoslavia and had been instrumental in unblocking internal obstacles to an IMF Agreement. He emphasised his Government's hope for an early reply to the message: the message was dated 31 October but this had been his first opportunity to deliver it.

I said that I was unaware of the exact position over Airbus. I would bring the message to the Prime Minister's attention and seek advice. We would reply as soon as possible.

The Ambassador added a few general remarks about the situation in Yugoslavia. His Government were committed to far-reaching economic and political reform which would take the Communist Party out of government and the economy. While recent street disturbances were unfortunate, they were not a matter for serious concern. The Yugoslav leadership was united in its determination to maintain the present constitutional order, once the agreed constitutional amendments which were finalised at the end of this month. The Ambassador spoke of his satisfaction at the state of our bilateral relations, including our trade. He claimed that

Yugoslavia was attempting to make the NAM more realistic. He referred to the recent discussion of an EC/Yugoslavia political dialogue by EC Foreign Ministers. In all these matters the Yugoslav Government needed the sympathy and support of the United Kingdom. In the light of Mr. Djuranovic's talk with the Prime Minister, they believed that this would be forthcoming.

I said that the Prime Minister followed developments in Yugoslavia very closely, inevitably with some concern but also with great sympathy. She had been pleased by the conclusion of an arrangement with the IMF. In response to the Ambassador's question, I made a few brief comments about the Prime Minister's visit to Washington and her views on East/West relations.

I think the Prime Minister will want to reply as soon as possible to Mr. Djuranovic's message. I should be grateful for advice and a draft reply by 30 November if at all possible.

I am copying this letter and enclosure to Alex Allan (HM Treasury), Lyn Parker (Foreign and Commonwealth Office) and Trevor Woolley (Cabinet Office).

(C.D. POWELL)

Neil Thornton, Esq.,  
Department of Trade and Industry.

# dti

the department for Enterprise

bf 8/2

The Rt. Hon. Lord Young of Graffham  
Secretary of State for Trade and Industry

C D Powell Esq  
Private Secretary to the  
Prime Minister  
10 Downing Street  
LONDON  
SW1A 2AA

CH/EXCHEQUER	
REC.	-2 DEC 1988
ACTION	Mr Bottmill
COPIES TO	EST GIR P. Middleton GIR G Litter GIR T Burns MR Lankester MR Mountfield MR H.P. Evans MR Waller

Department of  
Trade and Industry

1-19 Victoria Street  
London SW1H 0ET

Switchboard  
01-215 7877

Telex 8811074/5 DTHQ G  
Fax 01-222 2629

Direct line 215 5422  
Our ref JW4ABY  
Your ref  
Date 1 December 1988

Dear Charles

**YUGOSLAVIA: ECGD COVER FOR THE PURCHASE OF AIRBUS**

Your letter of 23 November attached a copy of a letter from Mr Djuranovic, in which he again raised the question of ECGD support for the UK share of the sale of Airbus aircraft to Yugoslavia.

The difficulties over extending cover for this case stem from the fact that prospects for the Yugoslavia economy are bleak. For example, inflation in October of this year was running at 236% per year. The current account has improved but the programme agreed with the IMF, when it approved a one year SBA for Yugoslavia for SDR306m (cf230m) last June, may well lead to increased imports in the short term. The austerity programme may bring with it strikes and, possibly, civil disorder. The conclusion must be that it is too early to say whether the current IMF programme will be fully adopted and whether it will have the desired effects. In the past Yugoslav economic performance has continued to deteriorate despite successive IMF programmes.

Stephen Ratcliffe's letter of 11 April 1988 set out the criteria which had to be met for ECGD to provide support for the UK share of this transaction. One of the criteria was that the deal should be transacted on a leasing basis, as this would have enabled ECGD to provide cover under its new asset-based financing arrangements take into account the value of the asset and the relative ease with which it could be repossessed following a payment default. This would reduce

the  
Enterprise



the department for Enterprise

the country payment risk which in turn would lead to a significant reduction in ECGD's market limit exposure. It was also essential to this arrangement that the Paris Club should confirm that leasing deals should continue to be excluded from Paris Club Reschedulings; such confirmation has since been obtained.

Although ECGD had been informed that Adria was prepared to accept a leasing arrangement it later transpired that this was not the case. Despite strenuous efforts on the part of ECGD and our Embassy in Belgrade to persuade Adria to finance this deal through a lease, we now know that the Adria Board is not prepared to contemplate anything other than an outright sale. Adria finds leasing unacceptable because it wants to retain ownership of the aircraft and because of a possible problem over costs in relation to import duty. Its attitude is unreasonable but it will not budge.

The contract is of considerable importance for Anglo-Yugoslav relations. The Yugoslavs see it as a test of our commitment to helping them take the painful reform measures associated with the IMF programme, which HMG had encouraged them to adopt. ECGD has, therefore, been actively pursuing with other Departments and the Airbus partner governments alternative methods of structuring a sale which would give us comparable security to a lease. The essential ingredients are that the transaction must if possible avoid any future debt rescheduling and must enable the aircraft to be repossessed in the event of a default for any reason by Adria. In an attempt to achieve this we have agreed with our French and German counterparts:

- (a) that the transaction should be structured as follows:
  - i a first rank mortgage should be provided as security for the loan;
  - ii the mortgage should contain a clause to the effect that any debt rescheduling which applies to the Airbus contract will constitute an act of default entitling the mortgages to foreclose the mortgage.
- (b) to foreclose the mortgage in the event of debt rescheduling unless there was unanimous agreement against this.

The French and the Germans have also agreed not to extend the cut-off date of 31 December 1982 under the present Paris Club



the department for Enterprise

Agreement. Only the contracts concluded before the cut-off date would be included in any Paris Club debt rescheduling. This should provide an additional safeguard for this transaction.

The Export Guarantee Committee (EGC) has now agreed that ECGD can provide cover on this basis. The way is thus now open for us to make an offer to Adria.

The arrangements for cover I have outlined represent the absolute maximum risk which ECGD feel they can undertake at the present time in view of Yugoslavia's continued economic problems. EGC has recently agreed that the time is still not ripe for any general resumption of longer term cover.

A draft letter is enclosed for the Prime Minister to send to Mr Djuranovic. This letter and the attached draft have been cleared with officials from H.M. Treasury and FCO.

I am copying this letter to Alex Allan (H.M. Treasury), Lyn Parker (Foreign and Commonwealth Office) and Trevor Woolley (Cabinet Office).

*Yours*

*Jeremy Godfrey*

JEREMY GODFREY  
Private Secretary

DRAFT LETTER FOR PRIME MINISTER

His Excellency Mr Veselin Djuranovic  
Presidency of the Socialist Federal Republic  
of Yugoslavia

I was disappointed to read in your letter of 31 October that the sale of Airbus aircraft to Adria Airways has again run into problems. I had hoped that my letter of 14 April contained a formula which would have enabled the project to proceed and it is indeed unfortunate that Adria has in the event not been able to accept a leasing structure, particularly as this is now an established and acceptable financial vehicle for most of the largest airlines in the world.

However, we appreciate the importance of this project to both our countries. Consequently we have been vigorously pursuing with our Airbus partner governments structural alternatives based on a sale which would provide acceptable security for the lenders.

I am very pleased to tell you that a solution has now been found which, I hope, meets both the airline's wish for an outright sale and our own objectives. Briefly, it is proposed that the sale transaction should be financed on the basis of a loan secured by a mortgage (full details will be communicated to the commercial parties soon) but the intention is that the mortgage should be enforceable in a way that would prevent the debt being caught up in any future debt reschedulings - although it is our expectation that you would not seek to move the cut-off date of 31.12.82 agreed with the Paris Club.

I hope that we can now look forward to the successful conclusion of the purchase of Airbus aircraft by Adria.

I shall, as always, follow with great interest developments on all fronts in your country. As you will know, my Government and I welcomed the successful negotiation of the agreement with the IMF earlier this year as well as the agreement with the Paris Club. We continue to believe that, although painful, the economic adjustment programme on which you have embarked remains the best hope for achieving economic stabilisation and progress in your country, and we wish you well in implementing it.





CH/EXCHEQUER	
REC.	- 5 DEC 1988
ACTION:	Mr BOTTRILL
COPIES TO	EST, Sir P. MIDDLETON, Sir G. LITTLER, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, Mr H.P. EVANS.

✓  
5/12

Foreign and Commonwealth Office

London SW1A 2AH

RESTRICTED

5 December 1988

Dear Charles,

Prime Minister's Visit to Poland: Follow-Up

Thank you for your letter of 6 November. You may like to know what progress we are making in following up the points you raised.

- (i) We are planning political consultations in London in January or February, with the Polish Vice-Minister of Foreign Affairs, Kulski. We see them as the major feature in the follow-up to the Prime Minister's visit, and they will cover the whole range of bilateral and international issues and set the framework for subsequent talks on specific areas.
- (ii) Political/military talks are planned for April or May 1989. These should meet General Jaruzelski's suggestion of bilateral talks between defence experts. Our team will include FCO and MOD representatives.
- (iii) We intend to propose talks between policy planners, if possible in the first half of 1989, at which to discuss in greater depth some of the issues covered during the political consultations.
- (iv) The Poles proposed talks on UN issues earlier this year. Because UN subjects are not normally covered during political consultations, we are inviting the Polish experts concerned to London in July or September.
- (v) Event to mark the anniversary of the Second World War. The Poles have proposed informally that a Royal Navy warship should visit Westerplatte on the fiftieth anniversary of the outbreak of war, 1 September 1989. The main problem with this is that the anniversary celebrations might well be an occasion for anti-German rhetoric. We know that the West Germans are nervous about the anniversary. Moreover, the Polish version of the beginning of the Second World War glosses over the Nazi-Soviet Pact. We have already told the Poles informally that we have difficulty with these dates.

/When

RESTRICTED



RESTRICTED

When they put the proposal formally, we intend to suggest instead that the Dartmouth Training Squadron visit Poland during their deployment in the Baltic in May-June next year. (The Poles have also proposed informally that their flagship, the Warszawa, should visit London in May with the Chief of Naval Staff. We have told them we will accept this). Meanwhile, we are investigating the possibilities for some joint commemoration of the outbreak of war which would avoid the propaganda pitfalls.

(vi) Visas. It is unfortunate that a 15% increase in Polish visa applications, coupled with difficulties in recruiting staff in Warsaw earlier this year, caused delays in issuing visas. Priority was however maintained for business and official travellers and the overall position has now improved. Modifications to procedures have been introduced. A new direct high-speed communications facility is now working smoothly after early technical difficulties. A pilot computer project is under way. Temporary extra staff are in place. Further staff reinforcements are being planned for next year to cope with the further substantial increase in applications we can expect in the light of the liberalisation of Polish passport regulations, and the customary summer surge. All this should result in a speedier service across the board in 1989. There are no unusual requirements in relation to private visit applications from Poland. Clearly however there will still be security considerations which have to be taken into account.

(vii) Exchanges of teachers and schoolchildren. This is for the DES, but we will encourage such exchanges as a way of increasing contacts outside the framework of government.

(viii) Management training. On 8 November Mr Waldegrave outlined to the visiting Polish Minister of Culture, Mr Krawczuk, the offer which was set out in the Prime Minister's brief. Mr Krawczuk promised to pass this on to Mr Rakowski on his return to Warsaw. Professor Michael Thomas of the University of Strathclyde, whom the British Council chose to conduct a consultancy report on the shape of the eventual programme, has already made a visit to Poland and will be returning for a more detailed study-tour in January.

/(ix)

RESTRICTED



RESTRICTED

(ix) IMF and Paris Club. We propose to stress in our bilateral dealings with the Poles that the onus will be on them to convince the IMF mission during technical negotiations, and subsequently the IMF Board, that they are serious about implementing the economic and political reforms necessary to meet IMF performance targets. Creditors will need to be satisfied that the programme is being adhered to, and that Poland is in a position to service further debt, before they could consider providing new credits. We can play a part by convincing the US and others that the success of an IMF programme in the Polish situation must depend on political as well as economic liberalisation.

General Jaruzelski's request for our assistance within the Paris Club does not arise until Poland comes to the Club for rescheduling, when we shall be ready, and shall urge others, to go on rescheduling to the extent necessary to meet genuine Polish needs within Paris Club terms.

(x) Return visits. The Prime Minister has already invited Jaruzelski to visit London if his travels bring him near the UK. The Poles are likely to pursue this suggestion energetically, and we assume the Prime Minister would be content to see him in London some time in 1989. We are unclear about the Prime Minister's intentions with respect to Rakowski. No invitation was issued to him either during the visit or in the Prime Minister's thank-you letter. The Polish Ambassador maintains however that the Prime Minister sent a message containing an invitation as she left Warsaw on her flight home. We are not aware of such a message, and would be grateful to know whether anything was in fact said.

If you are content with the above, we will ask Mr Barrett to seek an early call on the Polish Foreign Minister to propose dates for the political consultations and outline an programme of further bilateral contacts

I am copying this letter to Alex Allan (HM Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry), Tom Jeffery (Department of Education and Science) and to Trevor Woolley (Cabinet Office).

*long over*, *L Parker*

(L Parker)  
Private Secretary

C D Powell Esq  
10 Downing Street

CH/EXCHEQUER	
REC.	-6 DEC 1988
ACTION	Mr BOTTRILL
COPIES TO	EST. Sir P. MIDDLETON, Sir G. LITTLE, Sir T. BURNS, Mr LANKESTER, Mr MOUNTFIELD, From the Private Secretary Mr H. P. EVANS.



10 DOWNING STREET  
LONDON SW1A 2AA

*[Handwritten signature]*

5 December 1988

*Dear Sir,*

PRIME MINISTER'S VISIT TO POLAND: FOLLOW-UP

Thank you for your letter of 5 December about action to follow up the Prime Minister's visit to Poland. I have discussed this with the Prime Minister who has three comments:

- The Prime Minister thinks we are wrong to refuse to be associated with the 50th Anniversary of the outbreak of the Second World War and would like this reconsidered. She does not think German nervousness about the occasion sufficient reason to dismiss the Polish invitation.
- You say that the action being taken on visas "should" result in a speedier service in 1989. The Prime Minister has commented that it is "must" not "should". In the light of the advice from the Home Office before her visit, she gave the clearest possible assurance that there would be a significant improvement in the processing of visa applications and that must be honoured.
- The Prime Minister has belatedly confessed that she did issue an oral invitation to Mr Rakowski at the foot of the aircraft steps immediately before departure. I am afraid this is the first I have heard of it. But it remains the case that she would prefer to see General Jaruzelski come here before Mr Rakowski.

Otherwise, the Prime Minister is content with what is proposed in your letter.

I am copying this letter to Alex Allan (HM Treasury), Brian Hawtin (Ministry of Defence), Neil Thornton (Department of Trade and Industry), Tom Jeffery (Department of Education and Science) and to Trevor Woolley (Cabinet Office).

*Yours sincerely,*  
*[Handwritten signature]*  
C. D. POWELL

Lyn Parker, Esq.  
Foreign and Commonwealth Office



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

CH/EXCHEQUER	
REC.	- 5 DEC 1988
ACTION	Mr BITTRILL
COPIES TO	EST SIR P. MIDDLETON SIR G. LITTLER SIR T. BURNS Mr LANKESTER Mr MOUNTFIELD Mr H.P. EVANS Mr WALLER

5 December 1988

*[Handwritten signature]*

YUGOSLAVIA: ECGM COVER FOR THE PURCHASE OF AIRBUS

The Prime Minister has signed the reply to Mr. Djuranovic's recent letter about the sale of Airbus to Adria Airways. I enclose a copy. I am sending the original to Lyn Parker in the FCO, and suggest that the text be telegraphed to Belgrade for delivery as soon as possible.

I am copying this letter to Lyn Parker (Foreign and Commonwealth Office), Alex Allan (H.M. Treasury) and Trevor Woolley (Cabinet Office).

C. D. POWELL

Jeremy Godfrey, Esq.,  
Department of Trade and Industry.



## 10 DOWNING STREET

THE PRIME MINISTER

5 December 1988

*Dear Mr. Djindjic,*

I was disappointed to read in your letter of 31 October that the sale of Airbus aircraft to Adria Airways has again run into problems. I had hoped that my letter of 14 April contained a formula which would have enabled the project to proceed and it is indeed unfortunate that Adria has in the event not been able to accept a leasing structure, particularly as this is now an established and acceptable financial vehicle for most of the largest airlines in the world.

However, we appreciate the importance of this project to both our countries. Consequently we have been vigorously pursuing with our Airbus partner governments structural alternatives based on a sale which would provide acceptable security for the lenders.

I am very pleased to tell you that a solution has now been found which, I hope, meets both the airline's wish for an outright sale and our own objectives. Briefly, it is proposed that the sale transaction should be financed on the basis of a loan secured by a mortgage (full details will be communicated to the commercial parties soon) but the intention is that the mortgage should be enforceable in a way that would prevent the debt being caught up in any future debt reschedulings - although it is our expectation that you would not seek to move the cut-off date of 31.12.82 agreed with the Paris Club.

I hope that we can now look forward to the successful conclusion of the purchase of Airbus aircraft by Adria.

I shall, as always, follow with great interest developments on all fronts in your country. As you will know, we welcomed the successful negotiation of the agreement with the IMF earlier this year as well as the agreement with the Paris Club. We continue to believe that, although painful, the economic adjustment programme on which you have embarked remains the best hope for achieving economic stabilisation and progress in your country, and we wish you well in implementing it.

Yours sincerely

Nagendra Shastri

His Excellency Mr Veselin Djuranovic