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(2)

Prime Minister

A v. useful summary of Poland's (enormous) difficulties.

Dear Michael

POLISH DEBT

The OD meeting on 15 April will consider this problem and decide whether the UK can sign the draft agreement reached in Paris last week. I attach a note by the Treasury and FCO officials who attended last week's meeting. It describes the agreement. The Chancellor has not yet had time to read this but has asked me to circulate it. It comes very close to the pattern predicted in the Chancellor's minute to the Prime Minister of 3 April. It ends by listing five questions for Ministerial decision. The Chancellor will make firm proposals to his colleagues on each of these at the meeting.

I am sending copies of this minute and the attachment to John Halliday (Home Office) Michael Collon (Lord Chancellor's Department) Roderic Lyne and Stephen Gomersall (FCO) David Hayhoe (Chancellor of the Duchy of Lancaster) Jim Bukcley (CSD) Brian Norbury (MOD) and Stuart Hampson (Department of Trade).

Yours ever,

Peter

P.S. JENKINS
Private Secretary

Poland

Poland

NOTE BY OFFICIALS

POLISH DEBT AND RELATED MATTERS

1. Polish debt to Western creditors now amounts to about $27 billion. It has built up steeply in the last 5 years. The reasons for this have included:-

   a. The modernisation programme, relying heavily on imports of Western technology.

   b. Continued shortfall in industrial production during this buildup period.

   c. A conscious decision to maintain and improve the domestic standard of living.

   d. A run of very bad harvests leading to greatly increased imports of food.

2. By the end of 1980, debt service (repayment and interest) was running at something like 100% of Poland's export earnings.

3. Western Governments have been uneasily conscious of the problem for over a year. Last autumn the French Government (apparently acting at the request of Poland) took the initiative in calling a meeting of creditors, and proposed a programme of debt relief. Negotiations have continued at an increasing pace since then. The UK line has been approved by Ministers at a number of points, most recently by OD on 12 February (OD(81)2nd Meeting).

4. The 15 largest <u>Western creditor</u> Governments appointed a task force of five to prepare a debt settlement agreement with Poland. The members were the US, FRG, France, Austria and the UK. That task force held three meetings and has now made recommendations to a full meeting of the creditors held in Paris on 9 and 10 April. The creditors in turn have endorsed the proposals (with some minor reservations) and agreed to recommend them to Governments for approval. Subject to this the intention is to conclude the agreement at a final meeting in Paris on 27 April.

5. In the last few weeks, as the political situation in Poland has deteriorated, the Polish side have become increasingly desperate and have now agreed to almost all the Western terms. At the same time it is clear that the Polish Government may be unable to deliver the programme of economic reform which is essential if Poland is to correct her balance of payments deficit. Any agreement at this stage is an act of faith. Moreover it has to be in a form which can be abruptly terminated if there is a Russian takeover or a repressive régime in Poland. This is well recognised on both sides.

6. In a normal debt rescheduling operation the creditor countries would have the support of the IMF and there would be an agreed programme of economic stabilisation. Although Poland has made the first tentative moves towards rejoining the IMF, there is no such IMF support at the moment. The agreement therefore has elements both of a standard debt rescheduling and of am IMF agreement.

7. The present draft agreement consists of an Agreed Minute to be signed by representatives of both Governments, to which would be annexed a document describing the Polish recovery programme. This in effect takes the place of an IMF-type letter of intent. It contains figures which are treated in the agreement as firm targets for the rest of 1981, and indications of intention for later years.

8. The main features of the agreement are:-

a. Relief of a high percentage (80%) of principal and interest of officially-guaranteed debt falling due in the last eight months of 1981.

b. Agreement in principle to consider extending this treatment to maturities in 1982 and 1983 if Poland meets its self-imposed targets. (It is tacitly accepted that similar arrangements will probably be needed in 1984 and 1985).

c. A grace period of four years with repayment spread over a further four years. (The creditors are prepared to fall back on 4½ + 4½ if necessary).

d. Commercial rates of interest during the period of postponement.

e. Provision for regular review by a group of creditor countries before each extension.

f. Comparable treatment to be given to other creditors; this includes the USSR as well as private banks.

g. A break clause which would suspend the agreement if the USSR invades or the Polish government resorts to force (although these events are not stated explicitly). (This is politically important. But even in this worst case, we would still eventually have to do something about accumulated past debt).

h. Creditors will be free to choose whether to reschedule or refinance debts due to them. (The Chancellor of the Exchequer, Secretary of State for Trade and Lord Privy Seal are in separate correspondence about the choice of method).

i. Financial credits granted before 1981 will probably be rescheduled along with other debts, though France and Germany are holding out for better treatment against US opposition.

j. Conversely, credits made available by UK and others as part of the bridging operation in early 1981 will probably be deducted from the amount of new relief which we are asked to give.

k. The agreement makes no provision for new credit - see paragraph 13 below.

9. Our assessment of this agreement is as follows. We do not think we can push the Polish side any further. The "recovery programme" is now more realistic than the plans we were shown at the end of last year. Its performance is clearly subject to continuing political stability. But on that assumption we think it has a reasonable chance of success. The main problem remains the length of time before the Polish current account can be

restored to surplus and the accumulated debt reduced. It does not seem realistic to expect this before 1986 or 1987. This explains the very long "consolidation period", with a 4 year grace period and debt repayments spread over 8 years. It also explains the high proportion of debt to be consolidated. It is important to avoid a bunching of maturities in the later 1980s. This would merely lead to a repetition of the problem we now face.

10. But debt relief on this scale will not solve the Polish problem. We estimate that it will improve the Polish current account by about $2.8 billion in 1981. A parallel operation by the banks involving 80% of capital but no relief of interest would yield an additional $2.5 billion in 1981. That still leaves a gap of $5.4 billion even on the somewhat optimistic Polish projections.

11. This means that the Poles must look to the Russians to bridge at least part of the gap. The document attached to the draft agreement assumes that the USSR will provide credit of some $1.5 billion in hard currency in 1980 and 1981 and tolerate a trade deficit for at least the next five years between Poland and the rest of the Eastern Bloc. Further details are promised in the final version and the US team will not sign without these.

12. There will still be a financing gap which cannot easily be closed in the short term either by increasing exports or reducing imports. Poland has to import food to avoid social unrest, and raw materials in order to produce export goods. This gap will have to be covered by fresh credits from Western banks and possibly Western Governments. As noted above, this is left over for subsequent bilateral negotiation. Few banks will be prepared to increase their exposure to Poland without Government guarantee (though this attitude might change if the IMF were to take a part). New Government guarantees pose a problem for the UK. Ministers decided to minimise our official exposure in Poland. They approved a total of only £40 million new credit for 1981 from the UK. Of this all but £8 million has already been allocated.

13. But the Polish side tried hard to get large new credits written into the agreement. The UK and US representatives resisted this. The matter is left for separate negotiations. Meanwhile,

the French chairman, on behalf of his Government, has made a written démarche, urging all participants to consider Poland's needs for new credit urgently and sympathetically. He argues that it is unrealistic to expect Poland to repay her debts without further credits. The French intend to call a separate meeting of potential "donors", possibly on 28 April immediately after the final meeting of creditors. Ministers may wish to consider how we should respond. It will be difficult to refuse to attend. But our present performance on new credit (unlike debt relief) now falls well short of other creditor-countries ($71 million promised in 1981, compared with $554 million for France, $310 million for Germany and $530 million for USA - which however is unlikely to improve on this). The Poles have circulated a list of requests which seeks another $150 million from the UK, and another $60 million from France, $100 million from FRG and $200 million from USA. For comparison, on a trade-weighted basis the UK might be asked to provide about $450 million in all. However other countries have a much bigger political interest in Poland. The UK has no great interest in protecting its trading position in Poland since payment for our exports will be so long delayed. Our primary aim so far has been to secure repayment of our existing credits.

14. There is a similar problem over <u>short-term credit</u>. The normal practice when a country's debts are rescheduled is to withdraw all short term ECGD cover immediately. It is normally reinstated once it is clear that a stabilisation programme is being implemented and progress being made in repaying outstanding debt. In the case of Poland there is normally about £10 million outstanding in short-term cover at any one time. The Poles sought a clause in the agreement which would have ensured the continued provision of new credit. This was refused. In the exceptional circumstances of Poland it may be necessary to continue leaving these facilities open; this will depend on Ministers' attitude to the provision of new credit generally.

15. New credit will also be needed for <u>agricultural sales</u> under the terms of the second package approved by the EC Agricultural Council. This is included in the estimate of takeup of the £40 million referred to above, and has been approved by Ministers in separate correspondence.

16. During the negotiations Poland asked for new concessions on access to markets to be included in the agreement. They have a case. To repay existing debt they need to expand exports quickly. The immediate problem is production. But in 1982 and later they will run into marketing difficulties. As this is primarily an EC matter (for at least four major creditors) it was left for separate negotiations. No decisions are needed now.

17. Outside the current negotiations we have learned that Poland has put out feelers to the IMF which may result in her rejoining the Fund. Privately, the Poles have confirmed that there are unlikely to be any Russian objections. Officials regard this as a useful step, and our delegation to the IMF have been told not to obstruct any such developments. But membership of the Fund would take some months to negotiate and could not be concluded in time to make any difference to the size of the problem in 1981 and probably not in 1982. Meanwhile it may be possible to associate Fund observers in some way with the monitoring process and thus to ensure a progressive tightening-up of conditionality in a way which is politically more neutral than similar action by Western creditor Governments.

18. The issues for Ministerial decision at this stage are:-

i. Should the UK sign the debt relief agreement as it now stands?

ii. Should we then reschedule or refinance?

iii. Should the UK attend any meeting about the provision of new credit?

iv. If so, are Ministers prepared to increase the £40 million already approved for the rest of 1981, and by how much?

v. Do Ministers wish to maintain short-term cover of approximately £10 million at any one time?

vi. Should any statement be made to Parliament?