

BANK OF ENGLAND
LONDON EC2R 8AH

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
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Mr Carey
C.J. F. EST,
Sir A. Watt,
Sir K. Coates,
Mr Little,
Mr Lavelle,
Mr Hawtin,
Miss Baker.

My dear Geoffrey.

HUNGARY

As I promised when we spoke briefly on Friday, I am writing to set down in greater detail the approach that has been made to the Bank of England and certain other central banks by the Hungarian National Bank ("HNB") seeking assistance in the economic predicament in which Hungary finds itself.

The Hungarians view the matter as one of considerable urgency. Dr M Timar, the President of HNB, came to see me on 4 March. In the same week Janos Fekete, his First Deputy President, had been to see Karl-Otto Pöhl and Chancellor Schmidt, as well as Fritz Leutwiler, in his capacity both as President of the Swiss National Bank and as President of the BIS. Fekete himself was in Basle at the time of the Central Bank Governors' meeting at the beginning of last week, and spoke again to Pöhl, Leutwiler and myself, as well as making his preoccupations more widely known. It seems clear that all these representations have been made on the highest political authority.

Briefly, over the last six months short-term bank deposits placed with the Hungarians have fallen by over \$1/2 bn, apparently with some considerable acceleration in the last three weeks. Two of the worst offenders have been OPEC countries whose foreign exchange

positions have come under some strain, but there have been other withdrawals spread fairly evenly amongst the major western countries. In addition, the Hungarians judge that their prospects for longer-term borrowing are poor for the moment and make it unlikely that they will be able to raise the \$600 mn or so they need in order to refinance their medium and long-term debt maturities falling due this year. They have also not been helped by the fall in the gold price, since they have borrowed from the BIS and perhaps some other banks against gold, more of which may have to be pledged to maintain a given amount of credits.

Their concern about their liquidity situation is compounded by the fear that it might adversely affect the processing of their application to join the IMF and hence be aggravated all the more. Conversely, if their IMF application went through smoothly, they believe that that very fact and the prospect of putting in place some kind of standby later in the year would materially assist them. Even so, the application (which the US government currently still seems minded to support) can hardly have been formally approved earlier than mid-May at best, and a further delay of several months would be inevitable before any standby could be put in place. They thus foresee a very difficult period, and the purpose of the meetings I have mentioned above has been to canvass the possibilities of help. They describe their need as for standby facilities of some \$500 mn, to be repaid by borrowing from the IMF once they are in a position to do so. They think they might need to draw down a certain amount over the next two months, but that, depending on the response of commercial banks, the rest might be unnecessary.

I view this situation with great concern for two main reasons. The first is the very real danger that if Hungary - whose sensible economic policies have hitherto inspired a special confidence amongst the generality of Western bankers - had to request a rescheduling operation, this would intensify the attitude of extreme caution being taken by Western banks towards Eastern European countries generally. As a result, not only would the risks of Yugoslavia having to seek this course (which are already high) become much greater, but East Germany and Czechoslovakia might

soon find themselves in the same boat. If the Eastern European dominoes collectively fall, then the task of containing the problems of heavy indebtedness elsewhere in the world will be seriously aggravated.

The second reason for my concern is a political one. Hungary's progress over the past decade in developing what they call a socialist market economy has undoubtedly proved an exemplar and lesson to many of the other East Europeans, and can be pointed to as one of the most positive results of the West's policy of détente. If we believe, as I do, that social and economic change in Eastern Europe can only be brought about by such evolutionary development, it would be a great setback if the Hungarians were seen to fail simply because of an unwillingness on the part of the West to extend assistance to tide them over a period of difficulty. This could only give comfort to the political and economic forces in Eastern Europe which are trying to distance CMEA from the West and turn it in on itself. It is, of course, fundamental to this view that the Hungarian economy is basically sound in a way in which the Polish economy is not.

Against the background of this concern, clearly the most effective support would come from renewed deposits from the banking system. If the banks saw that official help was forthcoming for Hungary they would certainly be influenced by that and could very well modify their behaviour accordingly. That behaviour must, however, depend on their own judgment and it would be quite wrong in my view for me to put any form of direct pressure on British banks to lend money against their judgment.

The question, therefore, is whether any kind of official assistance should be given in spite of the obvious risks in doing so. These are such that I could not conscientiously recommend that the Bank of England should put up a loan on its own responsibility. An international operation has more attractions. The BIS would be the obvious body through which such an operation should be mounted, because it is an institution whose main links are with European central banks, including most of the Eastern bloc countries, and of

which Hungary itself is a shareholder. But there too the BIS would face great difficulties because they have reached the limit of what they can do for Hungary, including lending against gold, on normal prudent considerations. The only way the BIS could extend a further credit to the HNB would be with the backing of member central banks. Since, however, most, if not all, of these would not in these circumstances lend in their own name, they could only guarantee the BIS with the backing of their governments; that in turn would of course in each case entail a major political decision.

Economic and political reasons against taking such a step are not hard to find. The support might not be enough to restore banks' confidence enough to lend to Hungary; political developments might supervene to thwart Hungary's entry to the IMF or to jeopardise her access to Fund facilities. Here the US position is critical. Although a BIS loan could be mounted without US support, we and others would no doubt be reluctant to proceed if we thought that US policy was moving more firmly in the direction of economic ostracism of the CMEA countries. On the other hand, if the US Administration could be prevailed upon to state that they differentiated in policy terms between CMEA countries, there might be considerable improvement in international banking confidence even without a BIS initiative. Leaving this possibility on one side, however, all the European governments likely to be involved are suffering from budgetary constraints that may make them reluctant to undertake additional loan guarantee commitments. In any event, we would clearly need to press the Hungarians for much more detailed figures of their debt repayment schedule and for indications of what adjustment measures to promote exports and reduce imports they have in mind, in order to assess the risks of helping them.

But the prior question must be whether HMG is inclined in principle to share my view of the potential gravity of the situation and would

be prepared seriously to consider guaranteeing a portion of a BIS credit in favour of Hungary if other Western governments can be induced to do the same.

I am copying this letter to the Foreign Secretary and to Sir Robert Armstrong.

Yours ever

Gordon.

be prepared seriously to consider transferring a portion of a 115
credit in favour of Hungary if other Western governments can be
induced to do the same.

I am copying this letter to the Foreign Secretary and to
Sir Robert Woodhouse.

11-5 MAR 1982



John King

London