



An important exchange on a subject which is likely to come up at the European Council.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

A. & C. $\frac{26}{3}$

24 March 1982

Michael Scholar, Esq.,
No. 10, Downing Street

Dear Michael,

I do not see the need for a formal guarantee to the Bank now.

HUNGARY

..... | Since the subject of Hungary's current liquidity crisis is, I understand, likely to be raised by the Germans at the European Council, and came up at the Prime Minister's briefing meeting this morning, you may like to see the attached copies of the Governor's letter of 16 March to the Chancellor, and the Chancellor's reply tonight.

Copies of this letter go to Brian Fall (FCO) and David Wright (Cabinet Office).

Yours ever,
J. O. Kerr

J. O. KERR



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 March 1982

The Rt Hon Gordon Richardson, MBE
Bank of England
EC2R 8AH

New Rt. Governor,

HUNGARY

Thank you for your letter of 16 March about the approaches for assistance which have recently been made to you by the Hungarian National Bank. This is obviously an important, and in present circumstances very complex, issue.

While other countries have a greater direct interest than we do, I share your wish that a country which is basically sound economically, and which has moved some way from a rigid command system in the running of its economy, should not be pushed into default simply on liquidity grounds. I agree too that it would be much better not to add to the strains on the international banking system.

If therefore our principal Community partners and other European countries closely affected were ready to join in a BIS operation for short term deposits with Hungary, I would not in principle exclude a guarantee by the Bank to the BIS, and by the Government to the Bank (though there are difficulties, to which I revert in paragraph 9 below, about any government guarantee), at a level in relation to other participants which reflected our economic strength and the degree of our economic interest in Hungary compared with theirs.

I should add at once however that I do not believe that we can get into the lead in this matter. We certainly could not participate, for example, without our major Community partners, who are both stronger economically and nearer to Hungary. Moreover, as you indicated in the penultimate paragraph of your letter, we would have to consider whether such an operation would not be fatally flawed without at least some measure of support from the United States.



I believe that the Germans have legal difficulties about giving a guarantee to the Bundesbank, but that they would like to participate in the BIS operation and are seeking a means of doing so. They have of course much more at stake in Hungary than we have. But I understand that Genscher is likely to raise the question of help to Hungary at the European Council next week.

As regards the United States, it seems to me essential to persuade them to say publicly that whatever their views about credit for the Soviet Union, or even for other members of the Eastern bloc, they have no wish to see normal credit denied to Hungary. So long as the banking system believes that there is a serious risk that the United States will try to get the entire Alliance to deny credit, subsidised or otherwise, to all the satellite countries as well as to the Soviet Union, it will not increase its exposure in Hungary, and will indeed feel bound to try to reduce it. This could mean that credit was withdrawn from Hungary by the banks as fast as European governments extended new credit.

In present circumstances it will not be easy to persuade the Americans to say something explicit enough to reassure the banking system, not least because the Americans will see it as rather difficult to explain a policy of differentiation to their public opinion. I think you will have seen the report that Fekete told the Americans that withdrawals by European-based Soviet banks had contributed substantially to the Hungarian problem. That will not help. However, though I understand the White House has yet to approve this, it looks as if the Americans may be prepared to go along with a first major step towards differentiation by acquiescing in the early admission of Hungary to the IMF, while Polish admission will be delayed. If Hungary can be speedily admitted, that would have some value in beginning to reassure the banks.

On the other hand, it may not be easy for the United States to agree to the large and the early IMF drawing which Hungary will no doubt want. The United States has been arguing for stronger conditionality in the IMF and they will hardly feel able to exempt a Communist country. There is a well established tradition which has been applied to countries like China and Zimbabwe that a decent interval, or period of "familiarisation", must elapse after IMF entry before a country makes a substantial drawing. So it is likely to take some time for Hungary to get access to substantial IMF funds. It follows that we cannot count on an early "take out" for a BIS deposit with Hungary from an IMF drawing. And if we are to be drawn into a rescue operation, it is important to see our way out of it.



The guarantee question is, as I mentioned, far from straightforward. The FCO do not wish to give the guarantee, yet it is very unattractive for the Treasury to enter into what is really a contingent public expenditure obligation. Since we have no specific powers, this would have to be done on the sole authority of the Appropriation Act, with prior notification to Parliament. I cannot see great attraction to Parliament in all this.

My conclusion is that an orderly solution to the Hungarian situation may take time and may have to be the result of a series of efforts over a period. These might have to include substantial retrenchment by the Hungarians themselves; the admission of Hungary to the IMF as soon as that can be arranged; the supply by the Hungarians of full information, on the lines you describe, about their economic situation; a considerable effort to persuade the Americans to differentiate publicly in favour of Hungary on the whole issue of credit to the Eastern bloc; probably an IMF drawing in due course, linked with some understanding with banks which now have exposure in Hungary; and the progressive restoration of banking confidence as a result of all these steps. I think it very likely that the United States will have to be convinced that Hungary will in no sense be a conduit for resources to the Soviet Union and that, as a minimum, the Hungarians will not backtrack on the measure of economic liberalisation they have achieved. US endorsement, or at least benevolent neutrality, will be a sine qua non.

I think we may have to work at a programme on these lines. I am not at present sure whether it will prove practicable to include a BIS operation as part of it. After next week's European Council, we may be clearer not only about the views of our European partners but also about US views on the follow up to the Buckley mission as well as on Hungarian admission to the IMF.

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

Yours sincerely,

John Kew

pp. GEOFFREY HOWE



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Hungary

10 DOWNING STREET

From the Private Secretary

26 March 1982

Hungary

Thank you for your letter of 24 March, to which you attached copies of the Governor's letter of 16 March to the Chancellor and the Chancellor's reply of 24 March. The Prime Minister will find it most useful to have this during the European Council meeting next week. She has commented that if the Bank of England were to give a guarantee to the BIS she does not see the need for a guarantee by HMG to the Bank of England.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office) and David Wright (Cabinet Office).

M. G. SCHOLAR

John Kerr, Esq.,
HM Treasury

SECRET