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② Prime Minister ②

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

FOREIGN SECRETARY

*[Handwritten signature]*

**POLISH DEBT**

... I attach a note on Poland which has been prepared by my officials in consultation with other departments and the Bank of England. It reports on the state of negotiations with Poland on debt rescheduling and new credits and sets out our current approach and the risks that approach entails. There is broad agreement between Departments on this approach.

2. Officials' judgement, which I accept, is that we should maintain pressure on the Poles to sign the generous 1982-84 rescheduling agreement and withhold any new credit until after signature. After signature we can look at new credit but I doubt whether more than a token amount of short term credit would be appropriate. Other creditor governments, including the Germans, are taking a similar line. We should not however deceive ourselves about the risks inherent in this approach. Without the promise of substantial new credits the financial attraction of de facto default for the Poles is considerable. Quite how such a default would come about cannot be foreseen at this stage but, on the basis of advice from the Bank, I judge its impact on UK banks and the banking system generally to be serious but containable, provided that Polish default was in isolation. Its impact on ECGD's finances would also be severe, although we have already taken it into account for PSBR purposes.

3. The conclusion I draw from this is that we should hold onto our present strategy. For us to make concessions on new credit in the absence of substantially improved prospects for the Polish economy would increase the sums at risk without bringing nearer a solution to Poland's difficulties. In presenting our case to the Poles, we should continue to emphasise our goodwill and the purely financial considerations underlying our decisions. In the longer term, we must hope that IMF involvement will be a catalyst for much needed reforms but these are at present a long way off.

discussed in  
para 9 onwards  
in attached note





4. I do not think it is necessary for Ministers to meet to review the position. There is close agreement between Departments on the general approach, while you, Paul Channon and I have all spoken on similar lines in recent foreign contacts. But I am circulating the note now so that Ministers know of the line the UK will take (and the risks it runs) at the bilateral and multilateral meetings on 13 and 17 May.

I am copying this letter to the Prime Minister, to Norman Tebbit, and to the Governor.

*Nigel Lawson*

N.L.

10 May 1985

*(Approved by the Chancellor &  
signed in his absence)*



## CONFIDENTIAL

## POLISH DEBT

## NOTE BY TREASURY OFFICIALS

This note sets out the current state of play on rescheduling Poland's officially guaranteed debt and considers the implications of our current approach. It recommends that despite the risks of default by Poland and the consequences of that for the commercial banks and ECGD, we should hold to that approach.

State of play and current approach

2. Since the Poles initialled in January 1985 a rescheduling agreement covering 1982-84 maturities and of resumed payment of arrears under the 1981 agreements, we have been participating in a further round of multilateral discussion with the Poles, within the Paris Club, on the rescheduling of 1985 maturities (these will continue on 17 May), and are shortly to begin bilateral talks on the 1982-84 agreement (on 13-14 May). The approach adopted to date - reflected in this agenda of talks - has been that the UK is willing to sign the initialled draft agreement rescheduling maturities falling due in the 1982-84 period as soon as the Poles are ready; that we are similarly prepared to negotiate both on the bilateral agreement covering 1982-84 and on rescheduling terms for 1985 maturities (multilaterally and bilaterally); though none of these agreements can proceed to signature before the 1982-84 text has been finally signed. That in turn requires payment of 50% of outstanding arrears under the 1981 agreement.

3. The factor inhibiting further movement is the Polish demand for promises of new credit before they sign the 1982-84 agreement. They have lobbied all their main creditors with substantial quantified demands, amounting for the UK



to \$250 million in 1985 and \$240 million in 1986. The Foreign Secretary was pressed on this point during his recent visit to Poland and it will most likely be raised again during the visit of Lord Jellicoe, as Chairman of the BOTB, next month.

4. The UK line on new credits has been clear. We have said that we could not consider them until Poland has signed the 1982-84 agreement, started to develop a track record in honouring it (by which we have in mind the payment, due on signature, of the remaining 50% of arrears outstanding under the 1981 rescheduling), and good progress has been made towards the 1985 agreement. At that point we would be prepared to look at the case for new credits but only a small move (say £20m) on short term cover is likely to be justified. In practice this may enable the PVC plant to be finished, but most certainly this would not extend to completing the URSUS tractor project. (Both projects were caught by the imposition of sanctions.)

#### Other creditors' views

5. Other official creditors appear inclined to do the same, though exceptions may emerge. The Germans have already appeared to go further, in that Bangemann seems to have made a commitment but the Germans are unlikely to do more than we are prepared to contemplate ie about DM100 million of short term cover. The Americans are likely to be even tougher.

#### Polish reaction

6. Poland's financial prospects are grim, though the speed with which they will get into payment difficulties is inevitably unclear. They may be able to muddle through into 1986: But at some stage our calculations suggest that the Poles will be unable or unwilling to honour their commitments without substantial new credit or further debt relief.

7. This does not mean that we should relax our position on new credits. Until we can be certain they would be used to increase foreign currency earning capacity, it makes little



sense to give the Poles new credits, particularly medium or long term, when we have such serious doubts about their ultimate ability to repay. We do need however to take full account of the likely consequences of a breakdown in the rescheduling process. Judgements on this depend on the form of the breakdown if it occurs.

8. The least bad outcome in the short term from the UK Government's point of view would be for Poland to sign the 1982-84 agreement on present terms, to bring their arrears on the 1981 rescheduling up to date, and to sign a generous 1985 agreement giving virtually total relief on the current year. That at least would bring some small net flow back of funds to the UK. Our tactics in the Paris Club are directed to, and justified by, this end, but this will only provide a short term solution and further problems are likely to emerge in 1986. An alternative perhaps more likely outcome is that the Poles will refuse to sign up 1982-84 on present terms and continue a de facto moratorium on official debts, though fall short of repudiation of them. If they take this course and hence in effect receive 100% debt relief from their official creditors, Poland is likely to be able to continue to service its commercial banking debt at least for the time being. A further alternative - between these two - would be to recognise the financial pressure on the Poles to default but to forestall any such action by reopening agreements already reached and providing more generous terms. This would provide the official creditors with the leverage to ensure that commercial banks took their share of the burden of Poland's non-payment. Such an approach was briefly touched upon at last month's Paris Club; but the French Chairman deliberately steered the meeting towards a less generous and more conventional settlement. As a tactical move, this was probably wise.

#### Possible consequences of Polish default

9. In judging whether we can accept the type of breakdown in the process of rescheduling Poland's official debts that our position on new credits could well precipitate, we need



to consider the likely consequences for the banking system and ECGD. At present the banks' debts are being serviced and can probably continue to be. How they react to events in the official sphere is likely to depend on the manner of the breakdown. If there is no outright repudiation of debt and the Poles play for time, (continuing to pretend to want to service their debt if only new credits were made available), we would expect the banks to be fairly relaxed, provided no Government called a default. The banks may even as a last resort be prepared to provide some credit if it became necessary to keep their own rescheduling agreements viable, though they are most unlikely to consider spontaneous new lending.

10. If the Poles were to repudiate their debt or if some official creditors formally called Poland in default, both of which seem unlikely, so that the default became de jure and not simply de facto, the situation would be more uncertain. The declaration of a default could trigger cross-default clauses in the banks' documentation, though it would not do so automatically - banks representing the larger share of the debt would need to be in favour. The banks might well in such an event be forced to write off the balance of their loans to Poland not already provided.

11. Though this would be unwelcome to British-owned banks, the Bank of England judge it would in isolation be containable. Provisioning policy varies from institution to institution but the banks have on the whole already gone a long way towards providing against the debt and we judge that losses arising from such write-offs would dent their profits but not seriously damage their financial health. A similar judgement probably applies to the banking sectors of other creditors though we are checking this with other G5 creditors.

12. If the problems were confined to Poland, we can be reasonably confident that the impact on the banks of an overt default and consequent write off would be manageable. But although Poland may now widely be regarded as *sui generis*,



it cannot be ruled out that any actual declaration of default could have serious repercussions for some other East European countries and lead to damaging uncertainty among the bankers about the extent of Western Governments' commitment in respect of major debtors elsewhere. This suggests that in handling the situation official creditors should keep in mind the desirability of, so far as possible, avoiding such a formal declaration and generally reassuring banking sentiment.

13. We must recognise, however, that it is unlikely for our reaction to Polish default to go unnoticed by other major debtor countries. If Poland is not called into default by its official creditors there is the serious risk that other countries will decide to honour their payments to banks but not to governments. This has to be balanced against the greater risks involved in calling Poland into default, without actually being able to bring any sanctions to bear. Our line therefore must be to proceed with caution.

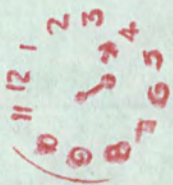
14. It must also be recognised that a de jure Polish default would have very serious consequences for ECGD. The effect on the PSBR has largely been anticipated, but we would have to look again at the treatment of their finances in public expenditure terms and the presentation of their accounts.

#### Conclusion

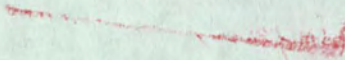
15. Nevertheless the conclusion we draw is that we should hold to our existing strategy. To do so risks, in the unlikely event of Poland being called in default, a write off of debt, but the impact on the banking system should be manageable provided that the default did not trigger or coincide with difficulties with other major debt countries, while the impact on ECGD would have to be faced when we see the circumstances in which default occurs. For us to make concessions on new credit in the absence of substantially improved prospects for the Polish economy would increase the sums at risk, without bringing nearer a solution to Poland's difficulties.



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