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Treasury Chambers, Parliament Street, SW1P 3AG

L Appleyard Esq
PS/Foreign Secretary
Foreign and Commonwealth Office
Downing Street
London SW1

17 April 1985

Dear Len

CHIEF SECRETARY'S VISIT TO HUNGARY:
9 - 11 APRIL

The Chief Secretary reported the main points to emerge from his visit to Hungary in his minute of 15 April to the Prime Minister. You may however find it helpful to have the enclosed detailed record of the Chief Secretary's discussions in Hungary.

I am copying this letter to Mark Addison (No. 10), John Mogg and Steve Nicklen (Industry and Trade), Mike Reidy (Energy) and to Phil Compton (Bank of England).

Yours sincerely
Richard Broadbent

R J BROADBENT
Private Secretary

CHIEF SECRETARY TO THE TREASURY

NOTE OF DISCUSSIONS HELD ON 9 AND 10 APRIL DURING THE CHIEF SECRETARY'S VISIT TO HUNGARY

9.00am Tuesday, 9 April:

Mr Peter Veress - Minister for Foreign Trade

After opening courtesies, Mr Veress gave his view of Hungary's latest trade position. Trade with Britain showed modest but steady progress despite fluctuations in the exchange rate. Exports to Britain were higher particularly following the successful Hungary Today Exhibition. Hungarian statistics showed that imports from Britain were also higher but overall the trade gap was smaller and the situation was promising.

2 The strict controls on imports necessary between 1982 and 1984 were being relaxed. Hungary wished to encourage investment and it recognised that this would mean incresing imports of machinery. COMECON as a whole was moving away from central planning of technological development and each country was seeking to specialise in areas where it felt it had particular aptitudes. For Hungary, in addition to agriculture, this meant concentrating on micro-electroncis, robotics, chemicals and pharmaceuticals. Hungary would welcome inward investment in these areas. Mr Veress criticised the provisions of the COCOM agreement which he said created a restrictive atmosphere, diminished confidence and reduced willingness to trade well beyond the areas in which the agreement was meant to apply.

3 **Mr Veress** explained that the recent Party Congress had endorsed the next 5 year plan which provided a framework within which invidual Hungarian corporations could plan and negotiate projects with foreign countries. He hoped

that British companies would seek out opportunities and be persistent in pursuing them. Hungary was bound to remain short of hard currency for the next 5 years and with the best will in the world this could lead to problems in individual cases. Mr Veress hoped that British firms could consider novel means of financing projects such as joint venture companies.

4 In answer to a question from the Chief Secretary, Mr Veress confirmed that the Hungarian Government did not favour counter trade. Nevertheless, given the shortage of hard currency, when a contract went out to competitive tender abroad and similar tenders were received, the possibility of counter trade was likely to be decisive. In these circumstances, it was often the tendering companies rather than Hungary which first raised the possibility. But opportunities for counter trade would not be allowed to override commercial considerations in considering tenders.

5 Discussing general trends in Hungarian industry, Mr Veress identified energy as a major problem. The USSR would remain a major supplier but Hungary would require increasing amounts of foreign currency and export goods to pay for it. For this reason, the next 5 year plan projected an increase in Hungarian coal production. Hungarian steel production was likely to fall, reflecting lower demand and over capacity in the industry. Light industry, particularly textiles and shoes were planned to increase largely with the Russian export market in mind. Chemicals and fertilizer output were other areas where a significant increase in output was planned. In endorsing the next 5 year plan, the Party Congress had emphasised the need for increased efficiency in industrial production.

6 In discussion of relations with the EC, Mr Veress said that Hungary has made its position clear. It was disappointed that the EC was apparently unprepared to pay a tiny economic price to allow Hungary to further its economic development. The Hungarian Government doubted the political will of the EC to reach an agreement. It had formed the impression that whatever approach it adopted, the EC would raise difficulties about Hungary's state industries. Hungary's political situation meant that an agreement had to give substantive advantages to Hungary to make it worth signing. There was no evidence that these advantages would be forthcoming and Hungary was not therefore planning any further initiatives. The Chief Secretary noted Mr Veress' views and suggested that any processs of negotiation was bound to take time and require movement on both sides. With the installation of a new Commission in Brussells an opportunity might exist for Hungary to put forward new ideas.

10.00am Tuesday, 9 April:
State Secretary Banyasz

7 Mr Banyasz began by explaining his position within the Government. He was the Government's chief spokesman with a seat in the Cabinet. He ran a small office (about 60 people) which performed two main functions. First, it informed the people about the activities of Government, the problems they face and how they were trying to tackle them. Second, it appointed editors and oversaw the administration of Hungary's Press, made up of about 1,710 publications of which around half were state owned.

8 Mr Banyasz went on to emphasise that the Hungarian Government believed honesty was the best and only policy in its relations with the Press. Once Editors had been

appointed, they exercised complete editorial freedom. He often met editors and made suggestions as to what they should cover. But the final decision rested with the editors themselves outside particularly sensitive areas (of which he instanced the health of Soviety Leaders).

9 He had recently taken to holding Press Conferences which were an innovation in Hungary. He had held two in recent weeks and planned to hold a third on 16 April, for foreign journalists. These Press conferences were being held in the run up to general elections on 8 June where, for the first time, it would be obligatory to have two or more candidates in each constituency. He thought this was an important step making it easier to unseat incumbants. It was being matched by efforts to increase the role of Parliament by encouraging more discussions and promoting more initiatives from within it.

10 In response to a question from the Chief Secretary, Mr Banyasz agreed that the young tended to be underepresented in these activities. He did not however believe this was due to cynisism. The problem was as much one of limited time and the young particularly had to work hard, often holding two jobs. They preferred to use their spare time for other than political activities. Hungary was largely free of social problems such as drug abuse.

11 Mr Banyasz agreed that there was inevitably a tension between the pursuit of efficiency in the economy and the social goal of equality. He did not however believe the tension was irreconcilible. It was a matter of emphasis, from time to time, and the recent Party Congress had stressed clearly that the first priority at present was efficiency. The resulting inequalities were criticised and at times resented. But a clear concensus remained about the need to pursue efficiency. The Government took steps to ensure that the most disadvantaged sections of the population, such as the aged, were given a measure of protection.

12.00 noon Tuesday, 9 April:
Finance Minister Hetenyi

12 After opening courtesies, Mr Hetenyi described the background to Hungary's budget for the current year which had recently been approved by the Party Congress. The Hungarian economy faced two main problems. First, foreign exchange. Second, the state budget had to generate a surplus because the corporate sector was not generating sufficient to finance investment. This contrasted with the position in the personal sector where considerable surpluses were being generated but there was no effective tax system to allow the Government to take part of the benefit of these.

13 The latest Budget forecast income of £600 billion Forints and expenditure of 603.5 Fts - a deficit of 3.5 Fts or 1/3% of GDP. The State's income was predominately from state owned companies (80 per cent) and only 15 per cent from other corporate bodies and 5 per cent from individuals, including farmers. This reflected a very high tax on profits - 35 per cent nationally plus 15 per cent local taxes plus a tax equivalent to 40 per cent of the wage bill towards the cost of social security provision. There was no personal income tax and a very low sales tax on consumer goods - a maximum of 7 per cent.

14 An important theme of the recent Party Congress had been to improve efficiency through allowing greater incentives to be given to maximise performance. The tax system would need to be brought up to date to match these reforms. In particular, some sort of personal income tax would have to be considered and Mr Hetenyi hoped to raise the proportion of income raised from sales tax over the next three to four years. One innovation it was planned to introduce in the coming year was to separate the State and local Budgets. Of total income of 600 billion Fts, 480 Fts were attributable to national taxes and 520 Fts to local taxes.

15 Another recent innovation had been the authorisation of bonds for state firms and co-operatives. It was possible for an individual to issue a bond but since bonds were guaranteed by the State the bond issue would need a State permit. The bond market was at a very early stage. It was an experiment and further development would depend on how it performed. 700 million Fts worth of bonds were issued in the previous year (compared to 22 billion Fts lent by banks for investment). The State determined the rate of interest on bonds. Bond rates were currently up to 2 per cent higher than the maximum interest rate paid by national savings accounts (9 per cent).

16 Mr Hetenyi also referred to subsidies and price control as another area where he hoped for early developments. 30 per cent of prices were controlled in Hungary compared with nearly a 100 per cent only a few years ago. The Hungarian Government believed that price controls were necessary on the social grounds in some fields, such as housing. But elsewhere it wished to end subsidies and price controls wherever possible.

3.15pm Tuesday, 9 April:
Deputy Prime Minister Marjai

17 Mr Marjai began by discussing the outcome of the recent Party Congress. He went to some lengths to emphasise that the outcome had been as expected. Economic reforms would continue and at about the pace expected. Nevertheless, the next few years would be difficult ones and the Government tended to present the outlook in optimistic light in order to give the people, whose main interest was in their standard of living, a degree of hope. In fact, the Government did

not see any significant improvement in standards of living for 2 - 3 years. And since the Government intended to allow differentials to increase, a significant part of the population would see their position stagnating or even worsening. Such a redistribution was however essential if performance was to improve and efficiency to increase. Any surplus generated by improved performance would have to be used to improve the position of the reserves and to finance essential technological imports. These problems were foreseen in the Plan but popular aspirations made it inevitable that it would be difficult to secure all its goals.

18 The gainers from this policy were the entrepreneurs who were prepared to work long hours or take up new opportunities. There was also a speculative element which was not significant in absolute terms but politically was very sensitive. The policy led to major problems with pensioners, often on fixed incomes, who had been hit very hard. The Government was taking some steps to protect them but the adjustment was inevitably proving painful.

19 Mr Marjai saw a pressing need for a system of personal income taxes in Hungary in the near future.

20 Mr Marjai referred in the search for greater efficiency to the need for Government to withdraw altogether from some areas of commercial life. The Government had threatened for years not to support indefinitely poor performers in industry. Recently it had carried out this threat and ceased to support a number of companies which had subsequently gone bankrupt leaving creditors partically unpaid. This had created considerable comment but the Government intended to persist in its new policy.

21 In discussion of the EC, Mr Marjai emphasised at length the disappointment Hungary felt at the apparent intransigent position of the EC. Detailed preliminary discussions had

led to a statement of the Hungarian position which, taking into account the relative strengths and weaknesses of the Hungarian and EC economies was entirely reasonable. The economic cost to the EC would have been miniscule and the benefits to Hungary no more than their due following Hungary's accession to GATT. Yet the Commission had thrown up endless difficulties, referring to Hungary's position as "maximalist" and suggesting that Hungary's socialist system made any progress difficult. Member States did not do more than mouth Commission arguments and Hungary was bound to conclude that the political will for an agreement did not exist within the EC. Hungary regarded the latest statement of its position as entirely reasonable and did not propose to change it. It was considering whether to make its position and that of the EC public in order to explain within its own country why there had been no progress in the discussions.

5.30pm Tuesday, 9 April:
Mr Timar, President of the National Bank

22 After opening courtesies, Mr Timar gave his views on Hungary's latest financial position.

23 The position in Hungary was much improved since 1982 when the liquidity crisis was at its peak. Although it was not apparent then, 1982 represented the worst point in a situation which was largely due to factors beyond Hungary's control. Hungary was grateful for the understanding shown by British banks during those difficult times. Hungary had been able to conclude acceptance agreements with British banks during 1982 which had proved invaluable.

24 Since 1982, Hungary had joined the IMF and the World Bank. The reserves had been replenished to some extent in 1983 and 1984 and $6.7 billion of foreign debt had been repaid. The aim was to continue repayments of

foreign debt, with a further $3 billion being repaid in the coming year. This target was being stuck to despite the cold winter which had led to increased fuel imports.

25 Mr Timar emphasised that this improvement had only been achieved through drastic measures including severe cut backs in investment and in standards of living. In short the classical recipe had been applied and thus far had produced results. But these cut backs could not be continued indefinitely.

26 For the future, he looked forward to a very slight increase in standards of living and in investment which was essential to underpin further economic growth. The process of economic reform would continue steadily. In the financial field, Hungary was moving towards a two level banking system. About 12 new banks had been founded to provide finance for small and medium sized firms and he wished this process to continue. One possibility in a year or two was to separate credit branches from the National Bank and to move towards more commercial banks which, with greater use of existing banking instruments, would prove more flexible in regrouping capital.

27 Mr Timar said that he would welcome greater activity from British companies in Hungary. In particular he would welcome the import of working capital which joint ventures and other inward investment would bring. He would be prepared to accept equity participation in joint ventures and he gave as one example the Central European Bank in which Hungary held 34 per cent of the equity with 6 foreign holders holding 11 per cent each. The bank was highly profitable and remitted its profits abroad. He acknowledged that this was a special case in that the bank transacted business solely in currency exchange and outside Hungary's borders. Nevertheless there were possibilities to set up equity joint partnerships. Siemens of West Germany

had just started such a venture.

9.00am Wednesday, 10 April:
Party Secretary Szuros

28 Mr Szuros said that the recent Party Congress had endorsed Hungary's foreign policy unchanged. Hungary was a member of the Warsaw Pact Group and it attached great importance to its relations with the Eastern Bloc. But it regarded dialouge with everyone on the basis of mutual respect as important. The open and strategic position of Hungary meant it inevitably attached importance to maintaining dialogue and strengthing peace and security throughout Europe and beyond.

29 Mr Szuros was glad therefore to see the gradual development of Hungary's relations with Britain. He saw no reason why the pace of development could not be accelerated. Hungary was open to further contacts in the political, cultural, and economic fields, particularly the latter which at present was bound to be the priority of the Hungarian Government. The Hungarian Government believed that its trade policy, based upon increasing bilateral and multilateral contacts (including GATT, the IMF and the World Bank) was of mutual benefit to all participants. He emphasised that the situation within Hungary was stable and that contacts made now could be relied upon in the future.

30 The Party Congress had clearlt endorsed the economic reforms being pursued by the Hungarian Government. It was essential to seek great efficiency in the economy since a small country like Hungary could only survive by promoting the international division of labour and then excelling in its chosen field. To take part in this process Hungary would have to become more efficient and the Government's policies were aimed at making the Hungarian economy increasingly able to integrate within an international division of labour. There were some dissenting voices

within the Congress but those opposed were isolated and without support. Overall there was a strong concensus in support of the government's policies.

31 In discussion of Mr Gorbachev's recent speech on economy and foreign relations in Moscow, Mr Szuros emphasised that it was the tone of Mr Gorbachev's statement that was important and that Britain should not respond too hastily to particular proposals. He stressed that a genuine change was underway and that there was more to follow. He referred particularly to the link made by Gorbachev between the poor performance of the Russian economy and foreign affairs, particularly arms control. The USSR was a huge country and not an easy one to change. It was worth taking notice of a new tone in Government since change could be far reaching once underway.

32 Mr Szuros stressed that the Eastern Bloc States were interdependent and were bound to remain so for the forseeable future. Nevertheless, the eastern states wished to work for co-operation not confrontation because of the disastrous consequences which might follow from the latter. The eastern and western countries followed different systems, but neither was particularly right or superior compared to the other. In terms of arms, there was an approximate balance of forces and refinement beyond this was an over elaboration. Hungary subscribed to the proposal that European states without nuclear weapons should not accept nuclear weapons on their soil; and those with nuclear weapons should accept no more. Hungary would also support any proposal for the simultaneous abolition of NATO and the Warsaw Pact.

33 In a brief discussion of relations with the EC Mr Szuros said that it was disappointing that Hungary had been treated as any other country might have been, with no appreciation of the political innovation of its approach to the EC. But he did not believe that Hungary would be rigid on this issue and some change in its position could not be ruled out.

R J Broadbent

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