

CONFIDENTIAL

SUBJECT *cc* MASTER

Filed on YUGOSLAVIA

Relations Jan 80



hli

vc/DAS

bc PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 March 1988

Dear Lynn,

PRIME MINISTER'S MEETING WITH MR. DJURANOVIC

The Prime Minister had a talk this morning with Mr. Vesselin Djuranovic, Member of the Yugoslav Presidency, before her lunch in his honour. Mr. Djuranovic was accompanied by the Yugoslav Ambassador. HM Ambassador, Belgrade, was also present.

Welcoming Mr. Djuranovic, the Prime Minister said that she would be interested to hear about Yugoslav's economic problems and negotiations with the IMF. She would also welcome an account of Mr. Gorbachev's recent visit to Yugoslavia. Mr. Djuranovic said he would be happy to discuss both points. He would note straight away that relations between Yugoslavia and the United Kingdom were in very good shape.

Yugoslav Economy

The Prime Minister said that Yugoslavia clearly faced very serious economic problems, particularly inflation and the level of indebtedness. The pressing need was to agree a standby arrangement with the IMF. While this would certainly require difficult decisions, the nettle had to be grasped. Speaking frankly, she was not clear whether the problem was that the Yugoslav government did not know what needed to be done; or whether it was simply unwilling to do it.

Mr. Djuranovic said that one of the main objectives of his visit to Britain was to present the situation realistically. Yugoslavia had been pursuing a long-term economic stabilisation programme with the objective of maintaining a high rate of economic growth and of servicing and repaying Yugoslavia's debt promptly. However, experience of the last three years had shown that it was virtually impossible for Yugoslavia to achieve these objectives. They now faced stagnation in growth, while an unacceptably high proportion of foreign exchange had to be devoted to paying off debt. Indeed, last year there had been a negative rate of growth while 40 per cent of foreign exchange had gone to payment of debt interest. The Government now realised that

CONFIDENTIAL

EC

the original objectives had been unrealistic. Moreover, Yugoslavia had made another fundamental misjudgement in believing that they did not need to reach a further agreement with the IMF. Unfortunately the whole question of relations with the IMF had become politicised or, more accurately, ideologised in Yugoslavia. People had thought they could do without the IMF. Now they recognised that they could not.

Mr. Djuranovic continued that Yugoslavia had as a result set itself some clear objectives: to seek a new standby arrangement with the IMF, to keep its debt service ratio to 25 per cent, to try to contain its debts at the present level until 1995 and to strengthen its foreign exchange reserves. Negotiations with the IMF were at present in progress covering three main issues. The first was price liberalisation, import liberalisation and establishment of a foreign exchange market. The Yugoslav government was in favour of all three and differed with the IMF only on the speed with which they could be put into practice. The IMF wanted to see them introduced straightaway: the Yugoslav government thought they should be introduced more gradually. The second issue was the target rate of inflation. The IMF had proposed reducing it to 50/60 per cent by the end of 1988. In the government's view this was unrealistic and it now seemed likely the IMF would agree that any rate below 100 per cent would be satisfactory. If prices and imports were liberalised there was bound to be a considerable degree of inflation. The third was devaluation of the dinar. The Yugoslav government was prepared to contemplate that, but differed with the IMF on the scale of devaluation.

The Prime Minister said there were broadly two approaches to IMF requirements. You could accept them but say that they should be applied over an extended period of three or four years. Or you could decide to take harsh measures straightaway. It was really a question of psychology. People often understood better the need for harsh measures in the short term with the prospect of some relief thereafter, to extending the agony. Mr. Djuranovic should take heart from the successes which had been achieved, for instance, in Israel.

Mr. Djuranovic agreed with the Prime Minister's comments. But some account had to be taken of Yugoslavia's structure. It was a multi-national community which meant that there were many different interests to be reconciled. Decisions which could be taken quite straightforwardly in some countries required careful negotiation and balancing of interests in Yugoslavia or they would be destabilising. It was difficult therefore to bring about the transformation of the economy which was required. But there were no basic differences with the IMF. Their disagreements concerned not whether Yugoslavia should take action, but how much and how fast. Yugoslavia desperately needed the support of the IMF and of other governments.

The Prime Minister said that once agreement had been reached with the IMF on a standby arrangement, the doors would

be unlocked to a good deal of extra help, for instance with the rescheduling of Yugoslavia's debts. The future of Yugoslavia was a matter of great concern to all of us. We were aware of the country's diversity and the risk that this could be exploited to cause instability. Her advice to Mr. Djuranovic was to bring negotiations with the IMF to a speedy conclusion and make a major effort to explain the outcome to the Yugoslav people.

Mr. Djuranovic said that political considerations had also to be taken into account. Yugoslavia was having to steer a very difficult course. They did not want centralisation or repression. But equally there was a risk that decentralisation would unleash centrifugal tendencies. A constitutional amendment would be introduced this year to strengthen the Federal Government, with the aim of making Yugoslavia more stable. These efforts were intended to parallel the economic measures which he had described.

The Prime Minister said that it seemed to her that Mr. Djuranovic had made a very full and basically correct analysis of Yugoslavia's problems. That in itself was a major step towards a solution. As soon as there was agreement with the IMF, we would do what we could to help. She urged Mr. Djuranovic to cheer up: while Yugoslavia's problems were considerable, they were far from insuperable and the long-term prospects were good.

United Kingdom/Yugoslavian Economic Co-operation

Mr. Djuranovic said that economic co-operation between Britain and Yugoslavia was developing successfully but not all the possibilities had been tapped. The main problems arose because of Yugoslavia's economic difficulties. But on the British side, there was a particular problem over ECGD which was withholding credit for exports to Yugoslavia. While he understood the reasons for this, he thought that we were being too inflexible. For instance, both France and Germany had agreed to export credit for the sale of Airbus to Yugoslavia but the United Kingdom had refused. Yet this was quite clearly an economically viable project.

The Prime Minister explained that, when countries were experiencing economic difficulties and had failed to reach agreement with the IMF, we had no alternative but to limit ECGD support. She was not aware of the specific case of the Airbus and would look into it. But the key was for Yugoslavia to take the right long-term action to get its economy into order, and then all sorts of other things would become possible.

British Claims

The Prime Minister raised the matter of Yugoslavia's failure to settle British claims following the mid-air collision between British and Yugoslav aircraft over Zagreb in 1976. We understood that Yugoslavia might encounter difficulties in actually paying claims. But what hurt us was her refusal to acknowledge liability. It was a matter of

grave concern that a claim remained unsettled after twelve years. She understood that negotiations might be possible. If not, it threatened to become a major political problem. She hoped very much that Mr. Djuranovic would consider how a solution might be found.

Mr. Djuranovic said that Yugoslavia had never denied the humanitarian aspect. Various ideas, such as indemnity, could be discussed once the legal processes had been concluded. The Yugoslavian Government would be willing to enter into discussions at that point.

European Community/Yugoslavia

Mr. Djuranovic said that there had been good progress in Yugoslavia's relations with the European Community last year with the conclusion of new Trade and Financial Protocols. The joint Working Group which had been set up would meet in April. Yugoslavia was looking for increased support in two areas: more favourable trade access to the Community market and help for Yugoslavia to adjust to trading with the Community once the internal market had been completed. It was necessary to remember that the Community and Yugoslavia were not on an equal footing. Yugoslavia's special status as a European developing country had been recognised. Yugoslavia desperately needed to be able to earn more foreign exchange.

The Prime Minister said that the future of Yugoslavia mattered a great deal to the European Community. But many of the products Yugoslavia wanted to export caused difficulty. Completion of the internal market should be a stimulus to the Community's external trade as well, from which Yugoslavia should be able to benefit. But she came back to the point that the first and most crucial step was to put the economy in order and not run away from difficult decisions.

Conclusion

The Prime Minister again urged Mr. Djuranovic to cheer up. Britain was a great supporter of Yugoslavia, indeed his country had no greater well-wisher than Britain. Mr. Djuranovic recalled the help that Yugoslavia had received from Britain in the Second World War. He hoped the same spirit could be re-created now.

The Prime Minister does not recall anything of great moment emerging in their talks over lunch. The Foreign Secretary would have filled you in on his own conversation with Mr. Djuranovic.

The Prime Minister would like to know the position on the sale of Airbus to Yugoslavia (which was not covered in her brief). She may wish to write to Mr. Djuranovic on the subject.

CONFIDENTIAL

5

I am copying this letter to Alex Allan (HM Treasury), Stephen Ratcliffe (Department of Trade and Industry), Brian Hawtin (Ministry of Defence) and Trevor Woolley (Cabinet Office).

yours sincerely,
Charles Powell

C D POWELL

Lyn Parker, Esq.
Foreign and Commonwealth Office

CONFIDENTIAL