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cc FCO
PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

21 May 1989

Thank you both for the original paper on Poland and for the expanded version. I am sorry you have not had a prompter response. That does not indicate any lack of interest. We are conducting a major review of policy towards Poland and your ideas are being considered in that context. It is certainly common ground that a medium-term debt restructuring with IMF involvement will be needed and that a vital element in this will be to ensure a radical restructuring of the Polish economy to improve its efficiency. Your ideas have a clear role to play in that.

Equally we think the place to pursue them is in the context of the negotiations with the Paris Club and the IMF later in the year, and see an international meeting in London this month as premature. This is not bureaucratic foot-dragging: its a case of bringing together all the various proposals which are kicking around, e.g. the Brady plan for debt reduction, which have a bearing on your plans.

I hope you will see this as a strong declaration of interest - which it is - even if you feel that we are not pressing on fast enough.

(C. D. POWELL)

Mr. George Soros

KK

cc 8/9

Foreign and Commonwealth Office

London SW1A 2AH

12 May 1989

Dear Charles,

Poland at flap

Thank you for your letter of 2 May enclosing the expanded version of the paper on Poland by George Soros. Whitehall Departments are studying the proposals, as part of a review of our policy towards Poland in response to your letter of 19 April. This exercise is expected to be completed very soon and we may then be able to provide some suggestions of how Soros' ideas could be tailored more closely to Polish realities as we see them.

Mr Soros proposed an international meeting in London later this month preparatory to an unofficial tripartite meeting in Warsaw. We think this would be premature: there are many other proposals under discussion in other fora which have a bearing on his plans, but will take more time to mature. The most important will be the tough negotiations ahead in the IMF and Paris Club. There are other relevant discussions, notably about the Brady Plan for debt reduction. A hastily arranged meeting, which attempted to force the pace of international discussions, could prove counter-productive.

The Foreign Secretary hopes you can convey this negative response to Mr Soros without creating the impression that we are wholly dismissive of his ideas. It is clear to everyone that a medium-term debt restructuring, with IMF involvement, will be needed and that a vital element in this will be to ensure a radical restructuring of the Polish economy to improve its efficiency. The sort of ideas Mr Soros is proposing could have a role to play but they would have to be pursued in the context of the negotiations with the Paris Club and the IMF later the year.

I am copying this letter to Jonathan Taylor (HM Treasury), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

Yours ever,

Richard Gozney

(R H T Gozney)
Private Secretary

C D Powell Esq
PS/10 Downing Street

MJ2 DNM

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 May 1989

POLAND

George Soros has sent me the enclosed expanded version of his paper on Poland. As you will see, he is now anxious to pursue the idea of a preparatory meeting in London prior to an unofficial tripartite meeting in Warsaw. I should be grateful for advice on how to respond to this.

I am copying this letter and enclosure to Jonathan Taylor (HM Treasury), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

Charles Powell

Richard Gozney Esq
Foreign and Commonwealth Office.

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SENDER'S INSTRUCTIONS/MESSAGE:

Dear Mr. Powell:

The following is an expanded version of the Poland Paper.

George Soros

soros fund

A Plan to Solve the Economic Crisis in Poland

(Expanded Version)

A political solution in Poland cannot endure without economic assistance from the West. Indeed, both sides are entering into a social contract in the firm expectation of such assistance.

The fact that the Polish economy is so devastated creates an opportunity. A comprehensive restructuring scheme, which would be otherwise inconceivable because of existing structures and practices, becomes feasible.

There are three major tasks to be accomplished:

a) restructuring of the international debt;
b) monetary stabilization;
c) internal economic reform.

The three tasks can be accomplished more effectively in combination than separately.

The central problem in internal economic reform involves the more effective use of capital. This is the main stumbling block in all reform attempts and it has not been overcome in China, Yugoslavia or Hungary (although the latest moves in Hungary look promising).

The problem is that the interests of capital are not properly represented. Communist systems treat capital as a free good and the function that in a capitalist system is performed by the owner is left unfulfilled. Economic reform has difficulty in dealing with the problem because the owners are missing. Even the managements of so-called independent enterprises are more responsive to political pressures, keeping employees satisfied and making barter deals with third parties, than concerned with maximizing the return on capital.

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The problem could be resolved in conjunction with a debt reorganization scheme. The enterprises owned by the Polish state could be used in a kind of debt:equity conversion scheme. In the first instance they would be put in the hands of an independent Agency which would be charged with the task of selecting and supervising managements; reorganizing state enterprises into joint stock companies; and finding final owners for their capital. As part of the reorganization, the Agency may sell all or part of some companies to investors at home or abroad. When the reorganization is completed, a large part of the foreign debt would be exchanged for debt or equity of the reorganized entities.

<u>The Liquidating Agency</u>

The Agency would be established by agreement between the Polish government and the Paris Club, subject to the approval of the Polish Parliament, so that it would not infringe on Polish sovereignty. Its independence from domestic political pressures would be assured by the fact that the foreign lenders may not accept the eventual exchange offer if they are not satisfied with its work. The Agency may employ foreigners in an advisory capacity. It will have a limited life span, say three to five years. Since only a portion of its assets can be placed into private hands during this period, the Agency will have to make permanent arrangements for performing the ownership function. The creation of a capital market should be an essential part of these arrangements.

<u>Monetary Stabilization</u>

The establishment of the Agency would be combined with a monetary stabilization scheme arranged with the assistance of the IMF. It would take the form of a "big bang" in which price controls and subsidies are removed all at once and the zloty is tied to the ecu at a realistic exchange rate. It may involve giving the Polish National Bank a greater degree of autonomy to assure proper control of the money supply.

Domestic prices of tradeable goods would adjust to international levels with appropriate differentials for consumer goods which would be subject to import duties. Real wages need not fall but there would be a temporary reduction in living standards due to high unemployment caused by tight monetary policy and tough decisions taken by the Agency. But the radical reforms coupled with a settlement of the debt problem should encourage new investment so that both employment and living standards would start to rise rapidly from the initial low point. Special measures would be needed to attract investment to areas of high unemployment or to improve labor mobility. To make the removal of subsidies socially acceptable, pensions and unemployment benefits would be fully indexed to the cost of living. The 80% indexation of wages agreed to in the social contract could also remain in force but, if the stabilization scheme is successful, the cost of living would remain stable after the initial adjustment. The removal of subsidies and the decisions taken by the Agency should swing the state budget into surplus, allowing a reduction in taxation.

International Debt

i) Paris Club

There would be a three-year moratorium on Paris Club debt. After that time, if the Paris Club is satisfied with the performance of the Agency, it would exchange its debt for participating preferred shares or convertible bonds of entities established by the Agency. These entities may be operating companies, or investment companies holding shares in investment companies. The preferred dividend (or, in the case of convertible bonds, the coupon) would be fixed at a low rate, say 3-5%, payable in hard currency, but the lenders may participate in the improved performance of the companies in question. Participating preferred shares may represent a certain percentage (say, 30%) of each company's capital and the lenders may decide in which company they want to hold shares.

ii) Bank Debt

The commercial banks will continue to receive interest; but they will be asked to give a 3-5 year option to the Agency to repurchase the loans at 50% of par; in addition, they will be asked to relend to the Agency half the interest they receive, subject to the same conditions. The Agency will have an incentive to exercise the option as soon as possible because the effective interest rate, calculated on the repurchase price, is very high. It will use any funds raised from the sale of assets for this purpose and, if it makes progress in attracting foreign investors, it should be able to refinance the entire amount quite soon. The bankers will have to be persuaded to accept these terms by the Paris Club governments.

Under this scheme, Poland's interest payments will be reduced by about one billion dollars a year for the next three years. In addition, Poland should receive new credits from the World Bank and the IMF of, say, $700,000 a year. Most importantly, one can expect significant private investment from abroad, not to mention the dollars coming out of Polish mattresses. These factors should be sufficient to create an upward momentum in the economy. After the expiration of the moratorium, interest payments will once again increase to roughly their present level but by that time the economy should be in a better position to cope with it. Moreover, Poland will be meeting its obligations in full, instead of being in default. The debt problem will have been resolved.

Every party will have to make concessions: the Western creditors, the Polish government and the Polish people. Without such concessions there is no way out of the present economic crisis; but, by putting the various elements together, a positive resolution becomes clearly visible. The importance of successful economic reform in Poland can hardly be exaggerated.

I have found considerable interest in this proposal both from the Polish and the Western sides. Both the Polish government and Solidarity have indicated that they would welcome an informal discussion under the aegis of the Stefan Batory Foundation in Warsaw. I suggest a preparatory meeting in London, prior to an unofficial tripartite meeting in Warsaw. The earliest possible date is May 16 in London and May 18 in Warsaw. Your urgent response is requested, via my New York office.

George Soros
May 1, 1989

cc: Ambassador Robert Blackwill, Washington
Dr. Horst Teltschik, Bonn
Mr. Charles Powell, London
M. Hubert Vedrine, Paris
Mr. Gianni de Michelis, Rome
Messrs. Secula and Wroblewski, Warsaw
Mr. Bronislav Geremek, Warsaw