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Prime Minister

A cautionary note on the French proposal for an investment bank for East Europe. You won't want to shoot President Mitterrand's horse from under him: but we can examine it to death. CDP 17/xi

Treasury Chambers, Parliament Street SW1P 3AG

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17 November 1989

Dear Charles

EASTERN EUROPEAN INVESTMENT BANK

The French proposal for an investment bank will be discussed in Paris tomorrow. This was discussed by the Monetary Committee earlier this week and I have been asked to send you a copy of the report by the Chairman (Sarcinelli). This sets out useful principles to guide us in applying our very positive stance on Eastern Europe. The report notes that the French proposal will require detailed and careful examination, which will be conducted by the Monetary Committee.

2. In the absence of the Chancellor and the Chief Secretary I have been asked to record our strong reservations about the French proposal. I have discussed these with the Chief Secretary who is concerned that they should be included in the Prime Minister's briefing on this proposal. He believes that while our general stance on Eastern Europe must of course remain very positive, this particular proposal is very dubious, and our approach should be correspondingly cautious.

3. First, the scale of proposed multilateral and bilateral activity is already substantial. As an illustration of the extent of help already planned for Poland, officials have calculated that for 1990 it is of the same order of magnitude (some 3 per cent of Polish GDP) as was Marshall Aid of annual benefit to the UK in the 1948-51 period.

4. Second, the new French proposal would add another, and probably unnecessary, element to the work of the IMF, the IBRD, the IFC and the European Investment Bank in this area, as well as the Community itself. This new institution would represent public money channelled into private sector investment in Poland. The result would be that Poland, having privatised its own industry, would simply find this owned by Western Governments. Our objective should be to promote private sector investment, which can bring with it Western managerial skills, access to Western

technology, and the spur of the profit motive. By contrast, heavy public sector involvement in Eastern Europe's industry could lead to an inefficient use of resources, compared to resources flowing from the West's private sector; and of course the public sector would crowd out the private sector.

5. Third, the scale of the operation proposed (10 billion ecu, £7 billion) is enormous. If it were confined to European countries alone, our paid up share would be about £270 million, and our contingent liabilities (which could well be called upon) a great deal higher. The constraints on investment in Poland and Hungary are not lack of funds from overseas, but the right conditions in these countries - which we can help to put right through technical assistance, increased involvement of the private sector, and advice (and loans) from existing lending institutions. Finding the right projects to invest in, rather than any shortage of investment funds, is likely to be the problem for some time.

6. We now have a preliminary assessment from the Fund Staff that financing an IMF programme would not cause major problems in 1990. So there is no need to rush into creating a new institution.

7. The Chief Secretary feels therefore that there is a strong case for caution in responding to this proposal at the Paris Summit. The Prime Minister's response might be that it is an interesting idea which will require a good deal of detailed work, avoiding any final commitment.

8. I am sending a copy of this letter to Stephen Wall, Brian Hawtin and Trevor Woolley.

Yours

Carys Evans

MISS C EVANS
Private Secretary

TO ALL MEMBERS OF THE MONETARY COMMITTEE

THERE FOLLOWS THE TEXT OF THE REPORT OF THE CHAIRMAN AFTER THE COMMITTEE'S DISCUSSION OF 15 NOVEMBER. THIS REPORT CORRESPONDS TO A MANDATE GIVEN BY MINISTERS ON 13 NOVEMBER ON A PROPOSAL BY PRESIDENT DELORS. YOU ARE KINDLY ASKED TO HAND THIS REPORT TO YOUR MINISTER AS PART OF THE PREPARATION FOR THE DISCUSSION TO BE HELD BY HEADS OF STATE OR GOVERNMENT ON SATURDAY.

A. KEES
COMEU B

BRUSSELS, 16 NOVEMBER 1989

REPORT TO FINANCE MINISTERS
BY THE CHAIRMAN OF THE MONETARY COMMITTEE
ON ASSISTANCE TO EASTERN EUROPE

IN RESPONDING TO THE REQUEST FROM THE COUNCIL FOR A ''BALANCE SHEET'' OF THE FORMS OF ASSISTANCE BEING UNDERTAKEN FOR EASTERN EUROPE, THE MONETARY COMMITTEE BRIEFLY REVIEWED THE ECONOMIC AND FINANCIAL SITUATION OF POLAND, HUNGARY AND THE GERMAN DEMOCRATIC REPUBLIC ON THE BASIS OF ANALYTICAL PAPERS PRESENTED BY COMMISSION STAFF, TAKING DUE NOTE OF THE DIFFERENCES AMONG THESE COUNTRIES. IT ASSESSED IN PARTICULAR THE PROPOSALS FOR FINANCIAL ASSISTANCE, WHETHER IN THE NAME OF THE COMMUNITY OR OF THE MEMBER STATES, MAINLY TO FACILITATE MACROECONOMIC AND STRUCTURAL ADJUSTMENT. THE COMMITTEE KEPT IN MIND THAT MANY OF THE PROBLEMS DISCUSSED ARE SHARED BY OTHER COUNTRIES OF EASTERN EUROPE, INCLUDING YUGOSLAVIA, WHICH HAS CLOSE LINKS WITH THE COMMUNITY.

ECONOMIC BACKGROUND

1. THERE ARE FUNDAMENTAL DIFFERENCES AMONG THE THREE COUNTRIES.

IN POLAND OUTPUT PER HEAD IS NOW LOWER THAN IT WAS IN 1980 AND THE POPULATION SUFFER FROM SEVERE SHORTAGES, NOT LEAST FOOD SHORTAGES, WHILE INFLATION HAS ACCELERATED AT LEAST TO 600 0/0 P.A. THE NEED FOR MACROECONOMIC ADJUSTMENT IS EVIDENT. ON EXTERNAL ACCOUNT THE CURRENT BALANCE HAS DETERIORATED THIS YEAR TO SOME USD 2 BN AND, GIVEN THE NEED FOR DEBT REPAYMENT, THE OVERALL DEFICIT WILL TURN OUT AT USD 3.8 BN. THE COUNTRY'S TOTAL EXTERNAL DEBT IS USD 39 BN, SOME 60 0/0 OF GDP, OF WHICH USD 26 BN IS TO PARIS CLUB COUNTRIES, PREDOMINANTLY IN EUROPE. IN HUNGARY RECENT GROWTH PERFORMANCE HAS ALSO BEEN BAD BUT, GIVEN THE BETTER STARTING POSITION, LIVING STANDARDS ARE HIGHER THAN IN POLAND., NEVERTHELESS THERE IS A DANGER OF A FURTHER AND UNCONTROLLED SLIDE. INFLATION HAS THUS FAR BEEN KEPT TO 20 0/0 P.A. THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS IS HOWEVER NOW MOVING RAPIDLY INTO DEFICIT, PARTLY BECAUSE OF HUNGARIAN TOURIST EXPENDITURE, AND THIS COULD REACH USD 0.5 BN THIS YEAR. THE COUNTRY'S EXTERNAL DEBT WAS USD 17 BN AT THE END OF 1988. FOR THE MOMENT HUNGARY RETAINS ITS ACCESS TO THE MARKETS, BUT WILL FACE ACUTE PROBLEMS IN ITS OVERALL BALANCE OF PAYMENTS IN THE EARLY PART OF 1990. UNLIKE THE OTHER TWO COUNTRIES, THE GERMAN DEMOCRATIC REPUBLIC HAS NOT YET EMBARKED ON ECONOMIC REFORM. THE COUNTRY BENEFITS FROM CLOSE LINKS WITH THE COMMUNITY THROUGH THE FEDERAL REPUBLIC AND ITS EXTERNAL DEBT IS MANAGEABLE, BEING USD 20 BN GROSS BUT ONLY USD 11 BN NET.

2. THESE COUNTRIES ALL FACE A NEED FOR HEAVY INVESTMENT IN VIEW OF THEIR AGEING AND ILL-PLANNED CAPITAL STOCK. TO THE EXTENT THAT THEY MOVE TOWARDS THE MARKET ECONOMY THEY FACE DIFFICULT PROBLEMS OF STRUCTURAL CHANGE. THEY ALSO, TO DIFFERING DEGREES, HAVE TO MAKE MACRO-ECONOMIC ADJUSTMENTS. IN POLAND THERE IS IN ADDITION AN IMMEDIATE AND PRESSING NEED FOR BASIC SUPPLIES. THE MEASURES ENVISAGED TO HELP THEM THEREFORE HAVE MANY ASPECTS : MEETING IMMEDIATE NEEDS, TRANSITIONAL FINANCE FOR MACROECONOMIC AND STRUCTURAL ADJUSTMENT AND THE ENCOURAGEMENT OF LONG-TERM CAPITAL INFLOWS.

ACTIONS ENVISAGED

3. MEASURES ALREADY ANNOUNCED TO ASSIST POLAND AND HUNGARY INCLUDE FOOD AID AND ASSISTANCE TO INVESTMENT, TO VOCATIONAL TRAINING AND TO BETTER ENVIRONMENTAL PROGRAMMES. AMOUNTS COMMITTED AS LOANS OR GRANTS UNDER THESE HEADINGS BY G24 COUNTRIES AMOUNT TO SOME ECU 2 BN. IN ADDITION THE EIB AND THE WORLD BANK ARE EACH COMMITTED TO PROGRAMMES OF ECU 1 BN, AND ADDITIONAL EXPORT CREDITS HAVE BEEN ANNOUNCED, FOR USD 1.35 BN. THE COMMUNITY IS IMPROVING THE TWO COUNTRIES' ACCESS TO ITS MARKETS, TO SOME EXTENT UNDER THE GENERAL SYSTEM OF PREFERENCES, AND HAS STARTED NEGOTIATIONS FOR A NEW DEAL ON TEXTILES. FURTHER, THE FEDERAL REPUBLIC OF GERMANY HAS RECENTLY ANNOUNCED A WILLINGNESS TO MAKE SUBSTANTIAL FUNDS AVAILABLE FOR ASSISTANCE TO POLAND. THE MONETARY COMMITTEE FELT, HOWEVER, THAT IT SHOULD CONCENTRATE ITS OWN DISCUSSION ON CERTAIN IMPORTANT PROPOSALS TO GRANT FINANCE IN SUPPORT OF MACROECONOMIC OR STRUCTURAL ADJUSTMENT.

GENERAL PRINCIPLES FOR FINANCIAL ASSISTANCE

4. GIVEN THE POLITICAL IMPERATIVE FOR THE COMMUNITY TO RESPOND TO THE DRAMATIC CHANGES OCCURRING IN EASTERN EUROPE, THE COMMITTEE HAS ASKED ITSELF WHAT CONSIDERATIONS MUST BE TAKEN INTO ACCOUNT TO ENSURE THAT FINANCIAL INITIATIVES UNDERTAKEN IN THIS PART OF EUROPE ARE SUCCESSFUL. THEY ARE,

- ANY REQUEST FOR FINANCE MUST BE ACCOMPANIED BY CORRESPONDING ADJUSTMENT EFFORTS, WHETHER MACROECONOMIC OR STRUCTURAL.,

- IMF CONDITIONALITY SHOULD NOT BE WEAKENED., THE COMMUNITY'S ACTIONS MUST REMAIN CONSISTENT WITH ATTITUDES TAKEN BY MEMBER STATES IN THE FUND.,

- THERE SHOULD BE NO WEAKENING OF THE RULES WHICH WE APPLY TO ALL HEAVILY INDEBTED COUNTRIES.,

- ACTION BY THE COMMUNITY SHOULD NOT INVOLVE CHANGING THE NATURE OF EXISTING COMMUNITY INSTRUMENTS., WE SHOULD AVOID ANY CROWDING-OUT OF ASSISTANCE TO MEMBER STATES.,

- FINANCIAL ASSISTANCE FROM WESTERN COUNTRIES SHOULD NOT SIMPLY LEAD TO A BAILING-OUT OF THE COMMERCIAL BANKS.,

- ASSISTANCE MUST BE RELATED TO SPECIFIC AND PRESSING ECONOMIC NEED., WE MUST NOT CREATE ANY PRECEDENT FOR EASY ACCESS TO ASSISTANCE BY EVERY CENTRAL OR EASTERN EUROPEAN COUNTRY.

FINANCIAL ASSISTANCE FOR POLAND

5. IN SEPTEMBER OF THIS YEAR POLAND ASKED FOR A USD 1 BN STABILIZATION LOAN TO BUILD UP INTERNATIONAL RESERVES AND ENABLE THE ZLOTY TO BE MADE CONVERTIBLE WITH A SINGLE EXCHANGE RATE. THE USA RESPONDED WITH A PLAN FOR GRANTS BY SEVERAL COUNTRIES TOTALLING THAT AMOUNT TO FORM A STABILIZATION FUND.

6. THE STABILIZATION FUND PROPOSAL HAS TO BE SEEN AS PART OF AN OVERALL PROGRAMME. POLAND IS AT PRESENT NEGOTIATING WITH THE IMF FOR A STANDBY OF USD 575 MN TO HELP MEET POLAND'S IMMEDIATE CASH NEEDS. MORE IMPORTANT, THIS NEGOTIATION WILL RESULT IN THE AGREEMENT OF A MACRO-ECONOMIC ADJUSTMENT PROGRAMME. WHEN THAT PROGRAMME IS IN PLACE, THERE WILL IN ALL PROBABILITY BE A PARIS CLUB RESCHEDULING. IN THAT CONTEXT THE STABILIZATION FUND MAY BECOME A KEY PART OF THE OVERALL PACKAGE BECAUSE OF THE NEED FOR A CURRENCY REFORM, THE RESPONSIBILITY FOR WHICH LIES WITH THE POLISH AUTHORITIES AND THE IMF. ONCE NEGOTIATIONS WITH THE IMF HAVE ADVANCED SUFFICIENTLY TO SHOW WHETHER SUCH A FUND IS NEEDED AND TO GIVE AN IDEA OF ITS SIZE, THE FOLLOWING CONSIDERATIONS SHOULD DETERMINE THE POSITION OF THE MEMBER STATES. IF NEEDED,

. IT SHOULD BE SET UP VERY QUICKLY (AND MANY MEMBER STATES HAVE THE NECESSARY ENABLING LEGISLATION).,

. THE EUROPEAN SHARE IN IT SHOULD IN PRINCIPLE INCLUDE CONTRIBUTIONS FROM ALL MEMBER STATES AND THE COMMUNITY SHOULD HAVE AN IMPORTANT WEIGHT.,

. ITS UTILIZATION SHOULD BE IN THE HANDS OF A TRUSTEE CHOSEN BY AGREEMENT BETWEEN THE POLISH AUTHORITIES AND THE COUNTRIES CONTRIBUTING TO THE FUND.

7. SOME MEMBERS OF THE MONETARY COMMITTEE DID NOT FEEL ABLE TO COMMIT THEMSELVES TO THE PRINCIPLE OF A STABILIZATION FUND BEFORE THE OUTLINE OF THE ADJUSTMENT PROGRAMME AND THE DEBT RESCHEDULING IS KNOWN. MOST MEMBERS EMPHASIZED, HOWEVER, THAT POLAND SHOULD BE GIVEN SUBSTANTIAL ASSISTANCE, RAPIDLY DISBURSABLE AND HIGHLY CONCESSIONAL, EVEN IF IT DOES NOT TAKE THIS PRECISE FORM.

8. AS REGARDS THE FINANCIAL ASSISTANCE OF USD 500 MN, REPORTEDLY REQUESTED BY THE POLISH AUTHORITIES IN SEPTEMBER, TO BRIDGE THE FINANCIAL GAP FORECAST FOR THE FOURTH QUARTER OF 1989, MOST MEMBERS WERE NOT AWARE OF IT. WITH REFERENCE TO A POSSIBLE BRIDGING LOAN TO ADVANCE IMF DISBURSEMENTS AND TO BE REPAID WHEN THE IMF MONEY BECOMES AVAILABLE, MANY MEMBERS EXPRESSED THE VIEW THAT IT WOULD NOT BE POSSIBLE TO SAY ANYTHING BEFORE THE TERMS AND CONDITIONS OF THE IMF PROGRAMME BECOME KNOWN.

FINANCIAL ASSISTANCE FOR HUNGARY

9. IN SEPTEMBER MINISTER MAYSTADT PROPOSED THAT THE COMMUNITY SHOULD INVESTIGATE WHETHER IT WOULD BE POSSIBLE AND OPPORTUNE TO GRANT A COMMUNITY LOAN TO HUNGARY WITHIN THE FRAMEWORK OF THE MEDIUM-TERM FINANCIAL ASSISTANCE AVAILABLE TO MEMBER STATES. HOWEVER, MOST MEMBERS OF THE COMMITTEE EXPRESSED CONSIDERABLE CAUTION, SINCE THIS PROPOSAL MIGHT BE DIFFICULT TO RECONCILE WITH THE PRINCIPLES SET OUT IN PARAGRAPH 4 ABOVE. OTHERS ARGUED THAT FINANCIAL ASSISTANCE TO HUNGARY SHOULD TAKE THE FORM OF A STRUCTURAL ADJUSTMENT LOAN., THIS IDEA MERITS FURTHER EXAMINATION IN ALL ITS RAMIFICATIONS, BUT IT MUST NOT LEAD TO A BAIL-OUT OF THE COMMERCIAL BANKS. IT WOULD HAVE TO BE IMPLEMENTED IN A WAY WHICH IS CONSISTENT WITH THE POLICY OF THE IMF.

10. THE HUNGARIAN AUTHORITIES HAVE REQUESTED A SHORT-TERM LOAN OR STANDBY FROM THE EUROPEAN COMMUNITY IN ORDER TO COVER WHAT THEY CONSIDER IS A TEMPORARY PROBLEM IN THEIR BALANCE OF PAYMENTS IN THE EARLY MONTHS OF 1990. HOWEVER, THE GENERAL OPINION IN THE MONETARY COMMITTEE WAS THAT FOR VARIOUS REASONS THERE IS A DANGER OF A RAPID DETERIORATION OF THE COUNTRY'S EXTERNAL FINANCIAL POSITION. SHORT-TERM ASSISTANCE THEREFORE DOES NOT SEEM THE APPROPRIATE SOLUTION, PARTICULARLY AS INFORMAL DISCUSSIONS ARE TAKING PLACE WITH THE IMF AND THE PRESSURE TO REACH SOME UNDERSTANDING WITH THE FUND SHOULD NOT BE REDUCED.

A PROPOSAL FOR A NEW FINANCIAL INSTITUTION

11. THE RAPID CHANGES OCCURRING IN EASTERN EUROPE AND THE NEEDS WHICH THESE COUNTRIES WILL FACE OVER THE NEXT FEW YEARS HAVE LED THE FRENCH MEMBERS OF OUR COMMITTEE TO PRESENT A PROPOSAL WORKED OUT IN SOME DETAIL FOR A EUROPEAN BANK DEVOTED TO ECONOMIC ADVANCE IN THE EASTERN PART OF OUR CONTINENT. IF THERE WERE AGREEMENT ON THIS PROPOSAL THE BANK COULD BE SET UP RELATIVELY QUICKLY., THE PROPOSAL DOES NOT IMPLY ANY DELAY IN THE CONSIDERATION OF SUCH IDEAS AS THE POLISH STABILIZATION FUND OR A STRUCTURAL ADJUSTMENT LOAN FOR HUNGARY - IN FACT THESE COULD BE SUBSUMED INTO THE FUNCTIONS OF THE BANK AT A LATER STAGE.

THE EXISTING REGIONAL DEVELOPMENT BANKS PROVIDE A MODEL TO SOME EXTENT, BUT THE NEW BANK WOULD BE DEVOTED TO THE RECONSTRUCTION OF OLD ECONOMIES RATHER THAN TO THE DEVELOPMENT OF NEW ONES. IT WOULD BE ABLE TO OPERATE ON BOTH CONCESSIONAL AND NON-CONCESSIONAL TERMS AND MIGHT ALSO BE GIVEN A ROLE IN THE MANAGEMENT OF GRANTS AND THE ASSOCIATED COUNTERPART FUNDS. SHAREHOLDING WOULD BE OPEN TO ANY EUROPEAN COUNTRY AS WELL AS

TO THE EUROPEAN INVESTMENT BANK AND TO THE COMMUNITY IN ITS OWN RIGHT, BUT THE COMMUNITY AND ITS MEMBERS WOULD BE ASSURED OF A MAJORITY. THIS WOULD ENSURE THAT THE RECONSTRUCTION PROCESS IS FIRMLY ROOTED IN EUROPE. THE CREATION OF A NEW INSTITUTION ALONGSIDE THE EIB IS CONSIDERED BY THE FRENCH MEMBERS TO BE NECESSARY IN ORDER TO PRESERVE THE PRESENT SPECIALIZATION OF THE EIB, WHICH IS GENERALLY THOUGHT TO BE EXTREMELY VALUABLE.

THIS RADICALLY NEW PROPOSAL PRESENTED TO THE MONETARY COMMITTEE TOGETHER WITH OTHER ALTERNATIVES DESERVES DETAILED AND CAREFUL EXAMINATION, AND THIS WILL BE CONDUCTED IN THE COMMITTEE IN THE NEAR FUTURE.

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