



PM/89/063

PRIME MINISTER

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Prime Minister

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CBT

This sets out what we shall be able to offer in Strasbourg. It is a good hand for you to play. The UK initiative to establish a European Development Commission seems a worthwhile idea. On the Bank, there seems

Economic Support for Eastern Europe

not point being isolated. I think we shall have to accept it in principle, & study it to death in the Monetary Committee.

1. In my minute to you of 24 November about help for Poland, I promised to send you views on the wider subject of economic support for Eastern Europe generally, in the context of the forthcoming discussion at the European Council on 8-9 December. You have also asked to be armed for Strasbourg with inter-departmentally agreed options which would enable the UK to make commitments on further aid, either bilaterally or multilaterally, should the need arise in discussion there.

2. There should be a substantive discussion on Eastern Europe, and there is a lot of good material for a powerful declaration by Heads of Government. At the Elysee on 18 November it was agreed that the Commission would report to Strasbourg on the various possible forms of agreement between the Community and individual Eastern European countries. You have already given M. Delors a copy of our "framework" paper on the EC's relations with Eastern Europe. An East-West declaration at Strasbourg is also envisaged, with work in hand among Political Directors on the basis of instructions from Foreign Ministers in Brussels on 27 November. That discussion went well and showed that other member states and the Commission are in general agreement with our approach. The Strasbourg statement

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/should



should therefore be substantive and resonant, encouraging and welcoming political and economic reform, re-affirming basic Western values without triumphalism, suggesting increased political links with Western Europe, and proposing a new overall framework for relations.

3. You stressed at the Heads of Government meeting on 18 November that the Community should decide at Strasbourg further practical measures of help for Eastern Europe. Much of course has already been done, and Section A of the enclosed paper by officials demonstrates the generous response of the Community and the United Kingdom. We should maximise the credit for the effort already made. Other member states will wish to do the same. The paper also brings out the very sizeable further assistance which will be made available to Poland and Hungary, once they have concluded IMF agreements.

4. Officials have also considered what further measures should be supported at Strasbourg, and have examined some of the ideas which have been raised by others. The attached paper was prepared by FCO, including ODA, and Treasury officials. They conclude, and I agree, that we might support the following (as set out in Section B of the paper):

- a) a second tranche of free food for Poland for quick disbursement to the needy;
- b) a Training Foundation for Eastern Europe, which would provide EC help for the establishment of training courses geared to restructuring and privatising East European firms, in industry, commerce, banking and other financial services. It should involve only a modest financial provision which is already available in the 1990 EC budget;



- c) a Euro-Polish bank, operating in the private sector, which would encourage enterprise and would be matched by parallel bodies in other reforming East European countries;
- d) student exchanges and Eastern European involvement in areas covered by existing Community exchange programmes.

Another body?

5. Officials have also considered a possible UK initiative to establish a body, the "European Development Commission" (EDC), which would make available economic advice to East European governments undertaking reforms. These governments have no reliable statistics. They lack accurate cost and pricing mechanisms; at present they do not know what costs and prices are. Their instruments for macroeconomic policy and supply-side reform are defective. The proposed EDC would aim to show the East Europeans how to correct these failings. It would become a specialist source of economic expertise on dismantling command economies and introducing market principles. Advice would cover a range of practical policies, and it would bring together representatives of East and West in a way not possible in the OECD. This could have a useful political impact while providing a real service at little cost to public funds. This policy advice would complement the help with training courses which would be provided by the EC Training Foundation. Our policy of differentiation between Eastern European countries could be maintained, and we would be encouraging the private sector.

6. These ideas, together, form a sound package of practical assistance, and one which would permit us to maintain our role in ensuring the right positive response to the changes in Eastern Europe.



7. The Presidency are determined to force a decision at Strasbourg on the principle of their proposal for a new Development Bank for Eastern Europe. This is considered in Section C of the attached paper, which brings out the serious disadvantages of the proposal. However, you will be able to point out that all member states, including the French, share the common aims on Eastern Europe set out in the preamble to the proposal. We can readily endorse the wish that Eastern European countries move towards our political and economic system; that we should demonstrate our commitment to facilitate ongoing reform, that there is a need for coordinated efforts to help the transition to market-oriented economies; and a need to mobilise appropriate financial resources. But we do not believe that a development bank would be a cost-effective way of proceeding.

8. Most member states will be attracted by the French proposal, and will welcome a Community initiative going beyond the help already offered to Poland and Hungary, to encompass all those countries embarking on reforms. They will argue that the bank would be a useful channel to coordinate Western investment effort along the lines of existing regional banks elsewhere.

9. The French proposal is firmly on the agenda of the European Council, and David Williamson has warned me that he does not believe that it will be possible to secure agreement that the idea should be dropped. If so, the best achievable outcome may be that the proposal should be remitted for careful scrutiny by the Monetary Committee. Our chances of success there - and of bringing out the advantages of the EDC - will be much enhanced if the

/European



European Council Conclusions laid down as the criteria for that scrutiny those identified in the officials' paper: differentiation, complementarity, help for enterprise, cost effectiveness and sound finance. We should look for support for this approach, principally from Chancellor Kohl and Mr Lubbers, although Italy, Portugal and Luxembourg have also shown some hesitation over the French proposals.

10. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Minister of State for Overseas Development, the Governor of the Bank of England and Sir Robin Butler.

A handwritten signature in dark ink, appearing to be 'D. H.' with a stylized flourish.

(DOUGLAS HURD)

Foreign and Commonwealth Office

4 December 1989

AID FOR EASTERN EUROPE

Introduction

1. The 8-9 December Strasbourg European Council will conclude a major declaration on Eastern Europe, including a new overall framework for the Community's relations with it. The message will be substantive, and designed to encourage and aid political and economic reform. The Prime Minister stressed at the Heads of Government meeting on 18 November that the Community should decide at Strasbourg further practical measures of help for Eastern Europe on top of the Council decisions on 27 November on a trade package, economic aid regulation, and EIB guarantees for Poland and Hungary.

2. The Prime Minister has asked to be armed for the Strasbourg European Council with interdepartmentally agreed options which would enable the UK to make commitments on further assistance either bilaterally or multilaterally, should the need arise in discussion there. The Presidency, who have proposed a Regional Development Bank for Eastern Europe, envisage that the substantive new measure for Eastern Europe should be approval in principle of the new bank.

3. This note is in three parts:

a) Section A - a summary of the UK contribution to date, both bilateral and contributions to multilateral efforts, together with an assessment of further multilateral support which will result from the conclusion of IMF agreements,

b) Section B - those elements which we should support/propose at Strasbourg as a positive Community response;

c) Section C - the merits and disadvantages of the French proposal for a Regional Development Bank for Eastern Europe.

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A1. UK CONTRIBUTIONS TO POLAND AND HUNGARY

DECISIONS ALREADY TAKEN

Bilateral

Poland - A "Know-How Fund" of £25 million over 5 years (40 projects under way). This fund has now been doubled to £50 million. In addition we will be financing an agricultural project worth £15 million.

- Contribution of \$100million to the \$1 billion Stabilisation Fund.

Hungary - "Know-How Fund" announced on 12 October, £25 million over 5 years.

Multilateral

European Community

- 100 mecu of free food for Poland (this will certainly be followed by a further tranche in 1990 of about 200 mecu).
- 300 mecu package for Poland/Hungary in 1990 covering agricultural reform, environmental protection and manpower/vocational training.
- EIB lending to Poland and Hungary of 1,000 mecu over 3 years. Some \$200 million is assured to Poland in 1990.
- A substantive package of trade measures including the abolition or suspension of all quantitative restrictions for Hungary and Poland from 1 January 1990, the granting of GSP to both countries, covering inter alia reduced tariffs and levies on certain agricultural products.

Paris Club

- The postponement of certain Polish debts up to early 1990.

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A2. ASSISTANCE WHICH SHOULD FOLLOW THE CONCLUSIONS OF
IMF AGREEMENTS WITH POLAND AND HUNGARY

Poland

- IMF Stand-by Arrangement worth \$700 million.
Intensive negotiations in progress. Agreement hoped for by Christmas.
- IBRD support worth \$300 million.
- Paris Club substantive rescheduling of Polish debts, likely to cover all arrears from 1988 and 89 as well as future maturities at least for 1990 and possibly longer. ECGD could account for about \$200 million of about \$2 billion of interest payments rescheduled for Poland. In addition, the Paris Club will reschedule substantial arrears from 1988 and 89, as well as principal repayments due in 1990.
- A \$500 million bridging facility for Poland, to be funded by the BIS with the support of central banks. The Bank of England will need an indemnity from the Treasury.

The total amount of official international finance for Poland in 1990 seems likely to reach \$5 billion, or about 6% of GDP, including the effects of rescheduling Paris Club interest. Any drawdown of export credits would be additional to this.

The UK will be contributing very substantial financial support for Poland in 1990. This will include our contribution to the Stabilisation Fund, our rescheduling of ECGD's claims in the Paris Club, disbursements from the Know-How Fund and expenditure on the agricultural project. We shall also be contributing directly to food aid and to the EC action plan. The total amount involved is about £250 million. In addition, the UK is of course providing support indirectly through its membership of the major international institutions - the IMF, IBRD and EIB - where it is a major shareholder, and Paris Club rescheduling of arrears and principal. The numbers are as follows:

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New UK financial help for Poland in 1990

	<u>£m</u>	<u>\$m</u>
Stabilisation fund	64	100
Paris Club rescheduling of interest	140	220
Know-How Fund	10	16
Agricultural project	15	19
UK share of EC action plan on agricultural reform, environment and training	<u>30</u>	<u>15</u>
	259	370

Memorandum items

UK share in IFI operations		
IMF	31	49
World Bank	13	21
EIB	24	38
Paris Club rescheduling of principal	112	176
arrears	223	350

Hungary

- Bridging finance from the BIS will only be sought if the timing of payments makes this necessary. Instead Hungary is seeking a balance of payments loan from the EC. Different figures have been mentioned, the range is \$500 million - \$1 billion. Western support depends critically on Hungary reaching agreement on a new programme with the IMF, and this is proving very difficult.

G24 contributions: Also annexed is a summary of current pledges by other G24 countries to Hungary/Poland.

B. PROPOSALS WHICH THE UK CAN ENDORSE

Additional Free Food for Poland

Commission have promised an early proposal for a second tranche of free food, probably at about 200 mecu. We should support, but insist that it be efficiently and directly targetted at the needy.

Training Foundation for Eastern Europe

A Presidency proposal now being developed by the Commission. It responds to precise needs in Poland and Hungary, and would concentrate on management, education and training. Cooperation would be designed to facilitate the transfer and application of know-how and expertise to Eastern European countries. There would be an important role for information and documentation. It would encourage training, both in Eastern Europe and through students/managers/trainees being placed in the EC, and might provide assistance with training equipment and materials in Eastern Europe. A foundation could serve as a clearing house, and bring together existing needs and means of meeting them, both in the member states and through Community programmes. Adequate financing is already available in the Community budget for 1990. The Commission and Germany argue that the European Centre for the Development of Vocational Training, based in Berlin could be adapted for this purpose. We should support the principle of a Foundation, but its location need not be decided in Strasbourg.

Euro-Polish Bank and parallel banks in other reforming East European countries

The Commission are working on ideas to strengthen the banking sector in Poland and to encourage private banks from EC member states to expand their operations there. This

would serve to strengthen the private financial infrastructure in Poland, which is very weak, and matches one of the purposes identified for our own Know-How fund. But the main investment would come from the private banks involved. Similar arrangements could be considered for other reforming East European countries, since strengthening the private sector is an essential element in the transition from state-controlled to market based economies. We should encourage the Commission to work up a proposal.

Youth and Student Exchanges and Eastern European Interest in the Content of Existing Community Programmes

We can welcome the Commission's intention to propose a framework for encouraging student mobility and a scheme to cover reforming Eastern European countries interest in the content covered by existing Community programmes such as ERASMUS.

Additional UK proposal

The above proposals are on the table and can be supported. Officials have also identified a possible UK initiative which at modest cost would make a useful contribution to the reform process in East European countries. It might be called a European Development Commission (EDC). This would be a new pan-European institution which would:

- a) analyse and appraise the economic policies and performance of East European member economies, with particular emphasis on medium term and structural issues; eg policies on labour market, tax, monetary, energy market issues
- b) provide expert advice and technical assistance to these countries, including policy advice;

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- c) serve as a channel for member states and EC contributions for technical assistance funding as appropriate;
- d) liaise with and encourage institutes and academics specialising in the particular problems of state monopolies, and their gradual conversion to Western-style economic systems;
- e) provide a forum for representatives of Eastern European governments to meet their opposite numbers to discuss concrete issues.

Membership would be open to all OECD countries, and all reforming East European countries, including Yugoslavia and the Soviet Union. The EDC should be closely associated with the OECD so that it can draw on its expertise. It would work closely with the IMF and World Bank for countries who are members of these Institutions. The OECD dimension would be very useful (and much more attractive than the moribund Council of Europe Resettlement Fund, advocated by Luxembourg, the membership of which is more disparate, and does not include the United Kingdom. If we were to join, we would be expected to make an accumulative contribution of about \$25 ,million, together with a pledge of a further \$25 million.)

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C. EASTERN EUROPEAN DEVELOPMENT BANK.

The French envisage that this bank would be designed to stimulate and coordinate international aid efforts. It would have a share capital of 10 becu, of which 20% would be called up in four equal tranches. The uncalled capital would be available as security for loans raised by the new bank. The French now accept that participation should be broadened to include not only the member states, the EEC itself, and the EIB, but EFTA and non-Europeans such as the US and Japan. Europeans should hold about 65% of the shares and the EC at least 51%. The bank would cover all Eastern European countries, and the size of capital reflects this. Eastern European countries themselves would also be subscribers. The bank would be targetted at the private sector through a range of interventions; investment loans, technical assistance, etc.

As the Prime Minister said in her letter of 28 November to Chancellor Kohl, there appears to be no shortage of resources available to Poland and Hungary; many existing institutions were already helping; and the proposed bank would be too bureaucratic and would make international coordination more difficult.

A test of whether any new institution is required is whether it, rather than the existing Institutions and Instruments, would add to the efficiency of our response to the new situation in Eastern Europe, and indeed whether a response on the scale proposed is necessary. Any arrangement would also need to permit continued close political control to ensure that the Community can continue to differentiate in favour of reforming countries of Eastern Europe.

The sponsors of the proposed bank argue that it would

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- be a visible sign of Western, particularly EC, support for reform in Eastern Europe,
- coordinate Western investment efforts in Eastern Europe,
- appraise investment projects and ensure conditionality,
- develop expertise in the reform of state trading countries,
- attract additional non-EC support, especially from the US and Japan,
- reduce competition among creditor countries,
- enjoy preferred creditor status,
- be able to deal flexibly among recipient countries, eg countries with high debts such as Poland might receive only technical assistance while more credit-worthy countries would get loans at either market or concessionary rates.

Our own reservations about the proposals include

- there appears to be no shortage of funds becoming available to Poland and Hungary,
- both Poland and Hungary are already overburdened with debt; they need the equity and expertise of the private sector,
- a regional bank with full East European involvement in management, would not easily lend itself to the political direction required by our policy of differentiation,
- existing institutions have both the expertise and the resources for both structural lending and imposing conditionality. The EIB specialises in project loans. The IFC is best placed to catalyse private equity investment,
- these existing institutions are more likely to be able to marshall support from non-European creditors, eg the US and Japan,

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- the new bank would take 18 months to 2 years to create, and longer still to develop expertise,
- it risks being over-bureaucratic and not flexible enough to meet the needs of a growing private sector,
- the scale of the proposed operation is enormous (£7 billion) and the cost of the UK's paid-up share could be about £140 million (assuming the EC had half the shares),
- the narrow spread of the bank's assets in a small number of politically and economically vulnerable countries, including both soft loans and equity investment, would make it an unattractive borrower on international capital markets. The inclusion of Eastern European shareholders would also undermine its creditworthiness, placing an undue burden on Western creditor governments to guarantee its liabilities.
- it might be subject to more pressure to support lending on soft terms to prop up newly democratic but essentially uncreditworthy borrowers.

Although we share the Presidency's general objectives on Eastern Europe, the disadvantages of the proposed bank outweigh its merits.

CONCLUSIONS

- a) At Strasbourg we should seek to obtain maximum credit for the aid which the Community and member states have already provided and that which will be made available when Hungary and Poland conclude agreements with the IMF.
- b) We should advocate and support the existing proposals specified in Section B, and if appropriate, table the proposal for an EDC.
- c) We should continue to adopt a questioning attitude on the need for a European Bank along the lines proposed by France. We should bring out the real disadvantages set out

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in Section C, and seek to avoid any commitment in principle to this proposal. If further consideration is necessary, it should be carried out by experts, notably the Monetary Committee. The disadvantages would be best brought out if the technical study were established according to the following criteria:

- i) application of differentiation, and strict political conditionality in treating East European countries;
- ii) avoidance of duplication with the efforts of existing multilateral institutions, and/or undermining IMF programmes;
- iii) assistance should be targetted at encouraging the private sector, and should primarily draw on the efforts of the Western private sector;
- iv) cost effectiveness of the assistance;
- v) sound financial principles.

In subsequent consideration, it will be important to consider how far we can build on existing institutions, IFC, IBRD and EIB, to provide further help to Eastern Europe. We should be ready to consider creating a new affiliate of the IFC (the private sector arm of the IBRD) to catalyse private sector investment if this would effectively deploy additional resources. We could also consider co-financing by interested creditor governments (or commercial banks) along side the IBRD or EIB for either policy-based loans or specific projects thus securing both conditionality and good project appraisal. The possible role for the EDC would also be relevant.