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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

POLAND: ECONOMIC ASSISTANCE

Note by the Chairman of the Official Group
on Economic Assistance to Poland

1. Last February the Defence and Oversea Policy Committee took a number of key decisions on economic assistance to Poland, mainly relating to 1981 (OD(81) 2nd Meeting). Further decisions, also relating to 1981, were taken by the Committee in April, May and September (OD(81) 8th, 9th and 16th Meetings). It was recognised that difficult decisions on 1982 would be necessary in due course.
2. The background to these, and the actual choices which now need to be made, are described in the attached report by Treasury and Foreign and Commonwealth Office officials. This has been prepared in the light of negotiations involving (in various combinations) Western creditor Governments and banks and the Polish authorities; and after discussions in the Official Group on Economic Assistance to Poland, at which other interested Departments were represented. The essential points are as follows.
3. Poland's financial situation is even worse than expected. She has not met the economic targets written into her 1981 debt rescheduling agreement with Western Governments. Industrial performance is abysmal. The agricultural picture is less grim following a good harvest; but there are serious distribution failures.
4. It is not clear that Poland will get through to the end of 1981 without having to declare a moratorium on her debts or being formally declared to be in default. No international action to avert this seems possible or is recommended. If it happens it will overtake the decisions which we need to make now.

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5. There is serious anxiety about the credit-worthiness of other Eastern European countries. The combined effects of a Polish default and other failures could prove difficult for the Western banking system. Officials are examining this urgently and will report later in the month.
6. Ministers need to decide by 18 November whether the United Kingdom should participate in a Western rescheduling operation for official debt in 1982, on broadly the 1981 pattern. Officials recommend that this should be done, though without the United Kingdom taking the lead; and that (as set out in paragraph 8 of their report) the terms should be somewhat softer than in 1981. Export Credits Guarantee Department (ECGD) funds will suffer, thus adding to the Public Sector Borrowing Requirement; but there is no immediate public expenditure effect, and no realistic alternative.
7. The Government should, through the Bank of England, continue to maintain close contact with British banks involved in the Polish problem. But we should not support American ideas of putting pressure on the banks to soften the terms of their 1982 rescheduling of non-official debt.
8. Ministers need to decide, preferably by 18 November and certainly before the proposed creditors' meeting in mid-December, on the level of any new British credit for Poland in 1982, under three headings.
 - a. Should we proceed with the Ursus project for tractor production? If so, ECGD would guarantee loans under an existing line of credit for approximately £30 million in 1982. The project is an important one, and no public expenditure would be involved unless Poland defaults; but the risk of default is of course considerable.
 - b. Food aid Should we earmark up to £20 million of public expenditure in 1982 for loans to finance the export of British food from European Community stockpiles?
 - c. Industrial credit Should we earmark up to £40 million of public expenditure for loans to finance British industrial exports?

9. ECGD are no longer able to arrange the provision of either food aid or industrial credit, even under a Ministerial directive. Ministers need to decide, therefore, whether the cost of going down either of these routes should be a net addition to public expenditure or should be found from within existing Foreign and Commonwealth Office programmes.

10. The Foreign and Commonwealth Secretary will be circulating recommendations on the issues for decision listed in paragraphs 6, 8 and 9 above.

Cabinet Office
6 November 1981

Signed R L WADE-GERY

POLISH ECONOMIC SITUATION

Note by Treasury and Foreign and Commonwealth Office Officials

Introduction

A wide range of issues about Poland is coming to the boil. Ministerial decisions are needed on some of them in the next two weeks.

2. As Ministers know, the Polish economic situation has been deteriorating sharply since before the emergence of Solidarity in summer 1980. The need for some external economic assistance became apparent in the autumn of 1980. The main Western creditors agreed in April 1981 to reschedule all debts due to them in 1981. At the same time they agreed in principle to mount a similar operation in 1982. The international meeting to consider the next phase of this takes place in Paris on 18-20 November. This determines the immediate timetable. All such international discussion presupposes no Soviet or internal clampdown in Poland.

Background

3. Decisions on Poland cannot be taken in isolation. Most of the Eastern European countries face serious economic problems of one kind or another. Romania (already in the International Monetary Fund (IMF)) faces a serious liquidity problem. Yugoslavia (also in the IMF) has difficulty in raising new money. Hungary, with a smaller gap, is about to join the IMF. We believe both Czechoslovakia and the GDR are facing balance of payments problems. The USSR, following a poor harvest, faces a hard-currency shortfall, has run down its Western assets sharply and may have to increase its borrowing substantially. The cumulative burdens of its own problems, a rising defence programme, support for Third World clients and - in the longer term - declining oil output, mean that the USSR's ability to help Poland may be restricted, though such help is not impossible. But there is now a risk that the problems of Poland,

followed by Romania, could bring about a rapid erosion of western banking confidence in Eastern Europe which could have quite severe implications for the world banking system. No decisions are needed about this immediately. Officials are preparing a paper which will be brought to Ministers in the next few weeks. But this background should be borne in mind in reaching Ministerial decisions about Poland.

Economic Performance in 1981

4. The 1980 strikes precipitated a decline which has continued in the first nine months of 1981. Industrial output in this period was 13.4 per cent down on the same period in 1980. The decline affected all sectors but was particularly marked in coal (output was down 19 per cent). Coal output is crucial because it supplies 80 per cent of total energy consumption and is the largest single export earner (10 per cent of total in 1980). Total exports of coal are down 60 per cent over 1981 as a whole, depriving Poland of \$0.5 billion in foreign exchange. But the loss also affects household consumption (causing public discontent) and industrial output. The total effect on export potential must be far more than the \$1 billion direct effect. Industrial output is falling for other reasons too - industrial unrest, shortages of imported raw materials and semi-finished goods. The only bright spot is the good harvest of 1981, especially of grain and potatoes. This reduces the import requirement next year. But meat supplies are down steeply. (We believe that while there has been a reduction in food supplies compared with previous years, there is at the moment no risk of serious malnutrition or starvation. But there is considerable maldistribution, a flourishing black market, and local shortages in the cities.) For 1981 as a whole, Poland's economy has failed to meet her self-imposed recovery targets incorporated in the first rescheduling agreement.

1981 financing gap

5. Although the immediate operational decision concerns the rescheduling of debts in 1982, there is also a serious problem in 1981. This may even overtake the 1982 rescheduling agreement. Even after generous

rescheduling terms for 1981 offered by Western Governments, significant help from the East and an agreement provisionally reached with the Western banks, Poland still faces a financing gap of \$1.1 billion in the rest of this calendar year. This gap is wider than even Polish forecasts indicated in September (when it was put at \$0.7 billion). The largest single element is a payment of about \$0.5 billion arrears of interest due to Western commercial banks and payable on final signature of the 1981 rescheduling agreement with them provisionally set for 10 December. At present Poland has no reserves and no immediate prospect of raising the additional funds needed to make this payment. There are five possibilities -

a. The banks will themselves lend Poland the money with which to make these interest payments. The United States Government hope very much that the banks will do this, but we assess the chances as remote. Treasury and Bank of England officials are prepared to explain the situation to the British banks, but in their view it would be wrong to put pressure on the banks to act in this way.

b. The banks could roll over the payments due on 10 December or simply defer signature (on the ground that the promised necessary information about the Polish economic situation is not yet available). But this would simply compound the problems of 1982, although it would buy a little time. Once again the situation could be explained to the British banks, but any external pressure would be counter-productive.

c. Poland could turn to the other Comecon countries for help. This seems unlikely to be forthcoming. The other Eastern European countries have problems of their own. The Soviet Union shows no signs of being ready to help this time (as it did at the beginning of 1981) and also has its own problems (see paragraph 3 above).

d. Poland could turn to the West for help. It has already asked for short-term deposits of \$100 million from each of the five largest creditors. At one time the French Government suggested - as an alternative to this - a syndicated loan of \$500 million through the Bank for International Settlements. Both proposals have fallen on deaf ears. We judge there is little chance of concerted Western support, unless the United States Government suddenly decides on political grounds that the time has come to mount a major rescue operation. Alternatively, banking problems may require concerted action by Western governments to shore up banking confidence in Eastern Europe generally. There is no sign of either development at present.

e. Poland could declare a moratorium; or one or more banks might declare a de jure default. (A technical default already exists). In that event all Polish assets overseas would be liable to seizure; any further economic assistance already promised would lapse pending a political decision; and Poland would be forced to trade on a "cash only" basis until normal relations could be restored. This would not provoke serious economic hardship in Poland, whose Trade Account is forecast to be in balance next year, but there would inevitably be a very untidy interregnum. We do not think that the consequences for British banks would be serious. The effects of this situation are examined in more detail in Appendix A. We do not consider that Western governments can do anything at present to prevent a default or moratorium in 1981.

The problems in 1982

6. An immediate moratorium would of course mean that all bets were off. Assuming that Poland somehow gets round this corner, the next problem is the financing gap for 1982. Poland has provided the international Creditors' Group with a recovery programme (now being put into effect, without much support from Solidarity) and a series of forecasts and targets for 1982 and later. These show external debt continuing to rise until 1987. For 1982, even with the Trade Account in rough balance, and with

a repetition of the rescheduling agreements of 1981, Poland estimates the financing gap at \$4.3 billion. The United States Government has suggested that it could be much lower, at \$2.6 billion, but we do not believe this figure and have asked the United States side to substantiate it. Against this the most generous estimate of the funds likely to be available, including support from the IMF and very large agricultural credits from the USA comes to \$2.3 billion and could well be considerably less. The next paragraphs examine the ways in which the remaining gap might be covered.

1982: rescheduling of official debt

7. Western Governments are committed only to consider favourably a repetition of the 1981 operation. The conditions of the April agreement have not been met. Polish economic performance falls far short of the targets set then. Comparable agreements have not been reached with the Eastern Bloc, with other creditors or with the banks. Nevertheless we see little practical alternative to a further rescheduling of official debt in 1982. An orderly rescheduling is preferable to an uncontrolled default. The only issues concern the terms. Poland has asked the United Kingdom (and presumably the other creditors) for softer terms. It would like 100 per cent of the debt rescheduled rather than 90 per cent (giving Poland an extra \$250 million); a consolidation period of ten years with a five year grace period instead of eight years with four years grace; and concessional rather than commercial rates of interest (with a further saving in 1982 and later). It would also like an agreement for the whole of 1982, but the United States Government seems likely to insist on staging with a review after the first six months. They may also insist that the agreement should not be signed until the 1981 bank rescheduling has been settled.

8. Our view is that we should be prepared to soften the rescheduling terms provided that there is a consensus among the creditors to do so. We suggest as a maximum 95 per cent, ten years to repay including a five year grace period, and sub-commercial rates of interest left, as before, for bilateral agreement. We doubt whether any meaningful new conditions can be attached to this rescheduling.

1982: bank rescheduling

9. In addition Poland might seek to persuade the banks to accept softer terms in 1982. For example rescheduling of 50 per cent of interest falling due in that year would provide about an additional \$750 million. The United States Government apparently believe this is feasible. They argue that Governments should not provide extra help merely to bail out the banks. We see the force of this argument. But we do not think it would be possible to persuade the banks who would resist it strongly. Some of them would have to provide immediately for a potential loss (offset against tax liabilities). One or two banks (not in Britain) might run into serious difficulty. It would also create a very dangerous precedent for rescheduling agreements with ldc's. In any case there is nothing Western Governments can do beyond exhortation to bring about such softer terms. Moreover such action would merely pile up a bigger problem of debt service in later years.

1982: new credits

10. The central Polish forecast is of a trade balance in 1982 so that the provision of additional guaranteed export credit is basically an indirect means of financing their debt service. Poland has tabled demands on its creditors totalling \$4.3 billion, including \$340 million from the United Kingdom. Ministers have already made clear to a visiting Polish delegation that this is much too optimistic. However, the Polish demand has to be taken seriously. It is likely to be considered at a creditors' meeting in December along with similar requests to other Governments. The request to the United Kingdom falls under three main heads -

a. The URSUS project. This is a new tractor plant being built in Poland by Massey Ferguson. The details are at Appendix B. There is £200 million of "new money" still to be provided under the existing agreement, of which about £30 million would fall in 1982. There is already a considerable commitment to provide these funds. This project, in which we have already invested £140 million, is regarded by the Poles as symbolic of Western and particularly British support for their plans of economic recovery.

It will be difficult to withdraw from the project, although delays in payment (now made good) provide an escape route. But the size of the additional risk to be undertaken deserves further Ministerial consideration. If it were decided to continue, ECGD would provide guarantees under existing lines of credit. No new public expenditure would be involved, unless Poland were eventually to default.

b. Agricultural credits. During 1981 Poland has benefited from subsidised sales of food from Community stockpiles, with credit provided by the producing countries. The United Kingdom has sold approximately £50 million in this way. Poland would no doubt like to buy more food this way next year, although the requirement will be smaller because of this year's harvest. The Commission might well wish to off-load further stockpiles, but the French and German Governments are unenthusiastic. If a further Community package were proposed we might wish to provide up to say £20 million for this purpose. However, this is not at present a high priority to Poland.

c. Industrial goods. Poland's main need is for raw materials and intermediate products and spare parts to keep its economy going and in particular to generate fresh exports. It is, however, very difficult to establish a direct link between further credit for Polish imports, and additional exports to benefit the Polish Current Account. If we could find such a link and tie credits to export-producing sales, our security would be greater. Some additional provision - perhaps up to £40 million - under this head may be judged necessary.

Additional credits under b and c would be new money. ECGD cannot properly go on providing guarantees for bank lending in the usual way. In that case, any new advances (apart from URSUS) would have to be government-to-government loans and would be government expenditure on an Foreign and Commonwealth Office (FCO) Vote. Treasury Ministers have maintained (at MISC 62) that any such loans would have to be found out of whatever total Cabinet may agree for FCO and ODA programmes next

year. The Foreign and Commonwealth Secretary argues that they should be an additional bid. MISC 62 left the issue for OD to decide: but it must be settled one way or the other before Cabinet resumes its discussion of public expenditure later this month.

Other measures to bridge the gap in 1982

11. The remaining measures are not within the direct control of United Kingdom or Western Governments. They include -

a. Increased help from other creditors. We shall continue to urge Poland to seek comparable help from those other creditors, including the USSR, other COMECON countries, OPEC and Third World trading partners. But it would be unrealistic to expect any significant relief from these sources, except perhaps the USSR.

b. IMF. The likely Hungarian decision to apply for membership of the IMF with apparent Russian acquiescence has removed the main inhibition to Polish entry. Informal talks with the Fund are now taking place. They are unlikely to reach fruition before summer 1982. On the most optimistic assumptions Poland could not do more than borrow its first credit tranche (25 per cent of quota) and perhaps half of its entitlement under the Compensatory Financing Facility during 1982. At best these might yield up to \$0.5 billion and perhaps significantly less. But Polish membership would greatly improve western monitoring of the Polish economy.

c. Polish Trade Account. In the absence of further help Poland will have either to default or to cut its import bill to match available resources (and to put even more effort into improving its export performance). The creditors have asked Poland to prepare contingency plans for a much lower level of imports next year. These have not so far been presented - perhaps because of domestic political difficulties. The

Polish negotiators have argued, with some justification, that any major cuts in imports would have serious domestic political consequences, and would further reduce their capacity to export. It would be unrealistic to look for any substantial trade surplus in 1982. But some creditors might well seek to make some cutbacks in imports a condition of further aid. The United Kingdom may need to decide whether to support any such moves.

LIKELIHOOD AND IMPLICATION OF A POLISH DEFAULT OR MORATORIUM

(Note by Foreign and Commonwealth Office and Export Credits Guarantee Department)

Default

1. At present the Poles are de facto in default. They are in arrears on their debt service payments (currently at least \$500 million of interest to the private banks alone) but their creditors have decided, for the time being at least, that the formal declaration of a default would not be in their best interests. If the arrears continue, it is conceivable that a creditor or creditors may formally declare a default, and that this might lead other creditors to trigger cross default clauses. Litigation to enforce debt repayments could then follow.
2. Whether or not litigation is initiated will depend on creditors' assessments of the likely costs and of the benefits that might be obtained through the seizure of Polish assets in the United Kingdom. Litigation is likely to be long and expensive. A creditor would first have to establish in a United Kingdom court the extent of the debt. This would allow them to seize the assets of the legal entity against which they had obtained judgment. They would not, however, be able to argue that all Polish economic entities were part of the Polish State, so that they would stand to gain only if the particular entity concerned had assets in the United Kingdom. Polish assets abroad are currently small, and the Poles would attempt to reduce them further if a default were called. While in theory creditors would be able to seize Polish-owned assets arriving in the United Kingdom after a default, Polish exporters could easily get round this by including in contracts provisions under which the title to the export passed to the purchaser before the goods entered the United Kingdom. Alternatively, Poland could use third countries as intermediaries.
3. ECGD who, by reason of their guarantees, have the right to control litigation in relation to all debts rescheduled under the terms of the Agreed Minute of 27 April have decided that litigation would not be in their overall interest. So far as private creditors are concerned, there is always the possibility that action could be brought for political reasons in order to discredit a Communist State, but in general it seems unlikely that businessmen would regard litigation as worthwhile. Commercial banks have also so far refrained from taking action.

(Indeed, on one occasion pressure was brought to bear on small creditors to avoid the triggering of a default). The taking of legal action against Poland could affect the long-term prospects of doing business with Eastern Europe as a whole, and the fact that nothing has so far been done in 1981 tends to support the judgment that banks do not see it as in their best interests to call a default. However, a particular risk is that a large bank whose exposure is small might decide to break ranks. Some of the bigger United States banks have notoriously itchy feet and there is a distinct difference in approach between United States and European banks. Moreover, the date for signature of the Poles of the agreement with the private banks in December may prove to be a watershed. If the agreement is not signed, it is conceivable that the banks might call a default for fear of setting a dangerous precedent for other countries.

Moratorium

4. In March the Poles warned banks that they could not service all their private debts although, in the event, they continued to service some of them. An option for the Poles would be for them to declare a formal moratorium on their private or official debts or both. A moratorium has been used in the past by a debtor country to force creditors to negotiate rescheduling of debts. The Poles have recently indicated that they are considering this possibility, but such a course would have serious drawbacks. A moratorium on private debt would not greatly alter the present situation where arrears are already building up. A moratorium of official debt would cut the Poles off from Western export credits, ensuring that trade had to be conducted on a cash basis.

IMPLICATIONS OF A FORMAL DEFAULT OR MORATORIUM

Banking Consequences

5. At end-1980 British-owned banks had unguaranteed claims on Poland of \$563 million, or just over half percent of their total international lending of around \$100 billion. In the event of a default or moratorium, the extent to which banks had to write off their exposure to Poland as losses would depend on the view taken by their managements (and auditors) of the prevailing conditions. The chances of their having to write off all their exposure are increasing as Poland's financial position deteriorates. However, no British bank is so exposed that it would

face unmanageable difficulties even in these circumstances. Indeed, British banks' exposure in Poland represents only 4 per cent of their capital and reserves.

6. A formal Polish default or moratorium would raise doubts about a number of less creditworthy countries. Banks would look more closely at their limits for lending to a number of middle income developing countries, but there is no reason in principle why their credit standing should be called in question. For Eastern bloc countries however, the evident failure of the Russian umbrella to protect Poland from default would be a significant new element. The country in the most difficult position is Romania. Its debt position is by no means so desperate as that in Poland (its debt service ratio is 46 per cent, well below Poland's which is in excess of 100 per cent), and its membership (alone among these countries) of the IMF is a positive factor. Nevertheless, Romania is already experiencing problems in attracting new credit and rolling over existing debts. Other East European countries are also beginning to have similar difficulties.

7. More generally, banks might need to raise their spreads in order to recover their losses in Poland. This would adversely affect other countries, particularly the larger debtors such as Brazil and the poorer countries which cannot afford any increase in the cost of servicing their debts.

8. Nevertheless, banking confidence is delicate and unpredictable. If a Polish default were a messy affair and were soon to be followed by a major debt failure elsewhere, the international banking system would be put under a good deal of strain. Similarly, given the present uneasy state of international financial markets, a Polish default alone could be enough to damage confidence further. There is no evidence that the majority of banks have yet made firm provision against potential losses in Poland although this is apparently under consideration.

ECCD

9. If a moratorium on official debt were declared, ECCD short-term cover would cease immediately and no further lines of credit would be concluded. We would

expect other credit insurance agencies to act similarly. The declaration of a moratorium on official debt would rend the existing debt restructuring arrangements invalid.

10. ECGD would incur claims arising on the full amount of maturities and not just on the 90 per cent subject to rescheduling. The combined effect of such claims would be a total payment of about £70 million in calendar year 1981 (as compared with an estimated £53 million under the debt restructuring agreement). The further claims payable by ECGD from the beginning of 1982 up to the end of 1985 would be in the region of £450 million.

11. The effect of this on ECGD's trading accounts would be very serious. If the Poles were to introduce a complete moratorium, its cash balances with the Consolidated Fund (CF) at the end of 1985 would be £680 million lower than they would have been if no claims at all on Poland had been paid. This figure derives from:

- (a) the cash impact of claims payments;
- (b) the loss of interest income (estimated at £160 million) due to the CF balances being run down; and
- (c) the Poles not paying any interest on their debts.

12. If a default were declared by a private creditor, claims would be made on ECGD guaranteed debt. But it would be for ECGD to decide whether to trigger cross default clauses (which are only contained in their 1981 Agreements) and pursue their own action against the Poles. There would be no obvious benefit to ECGD in activating such clauses.

Trade

13. In theory, and probably in practice (see paragraph 2 above), the Poles would be able to use their export earnings to finance new imports. Polish hard currency trade is now in balance and is planned to be in balance in 1982. Poland could therefore finance her planned imports with export earnings. There might be some disruption in the early weeks and months following a formal default/moratorium and Western exporters might stop shipments until the situation

clarified. Following that period the Poles would have to pay cash for imports. In such circumstances they might be obliged to pay cash in advance. There would thus be a difficult transition period before they generated export receipts to pay in advance for their imports.

Polish Economy

14. The effects of a default or moratorium on the Polish economy are difficult to predict. The Poles would probably suffer a short term decline in industrial output due to shortages of imported raw materials and semi-manufactures. But the disruption would probably last no more than a few weeks or months depending on the Poles' ability to organise their trade and on the level of stocks at the time of the formal default/moratorium. Thereafter, depending crucially on the degree of economic and political cohesion following a default/moratorium, imports and industrial production would be in a position to recover. Depending on the level of imports permitted by the various constraints, industrial production might well suffer a long-term reduction from its pre-crisis levels but would not necessarily be lower than its present level.

IMF Membership and Assistance

15. A moratorium or default would not seriously affect any Polish application for IMF membership. The Fund is open to requests from sovereign countries; the process usually takes several months and it could fail only in the unlikely event that the existing membership objected. The Poles would have to find their initial subscription in reserve assets (25 per cent of a quota of, say, \$1,800 million^{*}) but they could probably make early arrangements to borrow it back unconditionally as their reserve tranche.

16. There is a possibility that Poland could draw a further 25 per cent of quota under First Credit Tranche arrangements even if they were in default. But more extensive borrowing from the Fund's ordinary credit resources (eg up to the current maximum of 450 per cent of quota spread over three years) could present problems. Assuming that the Poles were able to supply the Fund Staff with the information necessary to construct an upper credit tranche programme, two important requirements would need to be met. First, the IMF would need to base

* or about \$910m.

its lending on a viable adjustment programme offering some certainty that it would be repaid within normal time periods (3-5 years for a standby, and within 10 years on more extended facilities); in practice, this would probably mean that the Fund would wish to see the results of international action to sort out the default/moratorium before considering whether to risk its own resources. Secondly, the Poles would have to convince the Fund that they could implement the programme, despite the cuts in consumption and other unpopular measures that would certainly be needed. The programme would be monitored at regular intervals and the Poles would be required to meet the targets set before making planned drawings. These two requirements would clearly pose considerable difficulties for the Poles if they were to seek credit beyond the initial drawings. However, a default or moratorium would not, of itself, rule out access to IMF funds.

URSUS

1. The URSUS project involves the construction of a tractor and engine production facility and ancillary plants for the production of Massey Ferguson Perkins (MFP) type tractors and engines. Begun in 1974, the project has been partly financed by three ECGD guaranteed lines of credit with a total value of some £275 million. To date some £140 million has been drawn down of which £21 million has been repaid.
2. The project is a least 3 years behind schedule and some £135 million remains undrawn under the credit lines; of this total £30 million would be spent in 1982 and the balance in the period to mid 1985. Massey's management contract has expired but an extension was signed on 17 October. The Poles have requested the revision of the terms of the credit lines to permit continued access to funds and the rearrangement of their repayment terms to reflect the project's revised estimated completion date - 1985. Because of the delay the original foreign exchange costs of the project are estimated to have increased by some £60 million; the Poles have indicated that this will be made good by purchases from CMEA sources.
3. Towards the end of last year, Ministers agreed that we should maintain support for this project. ECGD accordingly agreed to defer the due dates for certain principal repayments, and in April 1981 notified the Polish authorities of revised access and repayment schedules to which they were prepared to agree on condition that the Poles decided to continue with the project for completion by the end of 1985. On 15 July Mr Parkinson wrote to the Poles, broadly confirming United Kingdom commitment to the project, subject to these conditions.
4. The Poles have since told us that such a decision was taken by the Council of Ministers on 12 July 1981. Although initially reluctant to let us have sight of what they regard as a confidential internal document covering the whole Polish tractor industry they have now provided us with a translation of excerpts relating to the URSUS project. This appears to be the best evidence that can be obtained as to their intention to carry the project to completion and of the financial provisions made to that end.

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5. Our assessment of the Polish situation, and in particular of Polish ability to service debt in the future, has changed considerably for the worse since Ministers took the decision to maintain support for the URSUS project. Against the assessment earlier in this paper, to increase our exposure on Poland by some £200 million (£135 million for additional principal, plus £65 million for interest) is a most unattractive proposition, and judged simply from the standpoint of financial prudence, there are strong arguments for withdrawing from further support for URSUS if we are able to do so.

6. The Poles have remedied earlier defaults as interest payments under the credit agreements (ie they have made the 10 per cent payments due under the Rescheduling Agreement); with ECGD's consent payments of principal amounts due in 1981 (£16 million) have not been made pending implementation of the agreement reached in principle to rephase repayments. There are, therefore, no legal grounds on which to terminate the credit agreements. Withdrawal could, however, be achieved by our refusal to modify the terms of the agreements. In respect of the bulk of the funds available the terms currently applicable permit further orders to be placed only up to the end of 1981. The agreement reached in principle envisaged the extension of the ordering periods under the loans to be extended, the longest extension, relating to the supply of CKD components, being to 30 June 1985. Inaction on our part would allow the loans simply to expire so far as further access is concerned; repayment of moneys already drawn would fall under the general rescheduling arrangements.

7. Withdrawal in this way would not only avoid the increase of our exposure by the £200 million already mentioned (less the amount needed to cover incompleated orders and termination of existing contracts) but would also save £13 million of interest support on a net present value basis. On the other hand, it would undoubtedly be seen by the Poles as Her Majesty's Government's going back on its given word, and might be taken internationally as such a serious demonstration of lack of confidence in Polish prospects as to have significant repercussions on the attitude

of other creditors. It can also be argued that the URSUS project, if completed successfully, will make a major beneficial contribution to Polish agriculture and thus to Polish economic recovery. British support for the MFP/URSUS project is regarded by the Poles as a symbol of the totality of United Kingdom financial assistance to Poland.

8. The arguments for continuing support are of a political and intangible character, against the concrete financial arguments for withdrawal. Regarding the matter solely from the standpoint of safeguarding its own accounts, ECGD would recommend withdrawal, which would be consistent with the recommendation not to assume further new liabilities. It is for Ministers to say whether the national interest justifies maintaining support for URSUS, when balanced against the high cost risk of doing so.