Part 2

Confidential filing

ECGD

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TRADE

Pt 1 : Jan '80

Pt 2 : June 86

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
11.12.89 CLOSED -							

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PART 2 ends:-

HMG Memo on Future of ECGD (NOV. 89.)

PART 3 begins:-

SSIDTI to CST 11.12.89

Mr Powell

Kenneth Warren asked me to draw your attention to paragraphs 28 & 29.

A Kennon
23/11/89

With the Compliments of

The Clerk of the

Trade and Industry

Committee

01-219 5777

COMMITTEE OFFICE

HOUSE OF COMMONS, SW1A 0AA

CG39

TRADE AND INDUSTRY SELECT COMMITTEE

FUTURE OF ECGD

Memorandum by HM Treasury

This memorandum seeks to respond to the Committee's request for Treasury views about the financial implications of continuing to operate ECGD as at present, or adopting the recommendations contained in the Kemp Report.

Background

2. The Exchequer bears two types of cost from ECGD's operations. First, the public expenditure cost of subsidising the credit terms on which certain exports, insured by ECGD, are sold. Second, the cashflow deficits arising from ECGD's trading activities. The trading activities are the issuing of guarantees to exporters and banks against non-payment by their customers and borrowers respectively. Cash flow deficits from trading arise when the premium and interest income from issuing such guarantees are insufficient to cover the net claims and administration costs arising from those guarantees. The deficits from the trading activities are not classed as public expenditure but the Exchequer has to meet them and they are a call on the PSDR.

Public Expenditure

3. There are two programmes on which public expenditure costs are incurred in respect of exports guaranteed by ECGD. First, under the Fixed Rate Export Finance Scheme (FREF), ECGD makes up the shortfall between the fixed rate of interest charged to customers of UK exports sold on credit terms over 2 years, and the floating rate of interest charged by the banks who provide the finance. The fixed rates charged to customers are regulated by the terms of an international agreement (the "Consensus") to which the UK subscribes. The floating rates charged by the banks reflect an agreement between ECGD and the banks participating in the FREF scheme. The banks receive a floating rate of interest,

which for most currencies is the 3 or 6 month LIBOR rate for the currency in question plus an agreed margin. For sterling loans, (which comprise two-thirds of FREF supported loans) the interest rate paid to the banks has usually exceeded the Consensus rates with the difference made up by the UK taxpayer. Table 1 (Column B) sets out expenditure on this programme since 1979-80.

4. A second source of subsidy paid in respect of exports insured by ECGD arises from the Aid and Trade provision. Although the costs of these subsidies are carried on the Vote of the Overseas Development Administration, they should be included in any assessment of the cost to the taxpayer of ECGD operations, because they are incurred in respect of exports insured by ECGD, which for the most part would not take place without this subsidy. Table 1 (Column C) sets out expenditure on this programme since 1979-80.

5. It can be seen from Table 1, that since 1979-80 the taxpayer has spent an average of £379 million per year on subsidies in respect of exports insured by ECGD.

Trading Activities

6. ECGD has only one statutory objective, to encourage UK exports. However, since its establishment all Governments have required it to break-even on its trading activities taking one year with another. It is clear that in recent years this requirement has not been met. ECGD's last published accounts relate to the 1987-88 financial year, and showed the following position:

(a) On a trading basis, a cumulative deficit of £252 million.

(b) On a cashflow basis, net drawings on the Consolidated Fund of £1,164 million.

7. These deficits have arisen because, since the outset of the debt crisis, ECGD has been paying out more in net claims than it has been receiving in premium income. The resultant cashflow deficits have had to be met from the Consolidated Fund, as ECGD is

financed from Votes. There was another substantial cashflow deficit in 1988-89 pushing up net Consolidated Fund drawings to £1.68 billion and this pattern is expected to continue for some years. The current forecast is for peak drawings of £3.7 billion, which are then expected to fall as recoveries of past claims are made.

8. Because at least some of these claims should eventually be recovered, the cashflow deficits will not necessarily lead to a final loss of the same size. In accordance with commercial accounting practice, ECGD's profit and loss account and balance sheet include a provision against the possibility of losses arising on both claims paid (rescheduled and unrescheduled) and future amounts at risk in problem markets. Provisions are made against all categories of claims and future amounts at risk but the largest are against sovereign exposure. The provision against sovereign exposure is calculated by reference to the Bank of England matrix.

9. ECGD's accounts show sovereign exposure in 1987-88 of £10.4 billion against which a provision of £2.3 billion (22.1 per cent of the exposure) has been made. ECGD's premiums have not been adequate to make these provisions out of reserves and, as a result, ECGD has a deficit on reserves (ie an accumulated loss). If the likelihood of claims on future amounts at risk increased and/or the prospects of recovering past claims was reduced, then ECGD would need to increase provisions against its sovereign debt exposure. To the extent that any increase in provision is not covered by net income on new business, the accumulated loss will worsen.

Kemp Report Recommendations

10. The Kemp Report made two basic recommendations:

(a) The short-term insurance business (Insurance Services Group) should be reconstituted as a PLC, with a political risk reinsurance facility with HMG. Initially the PLC would be 100 per cent Government owned, but with the possibility of introducing private capital at a later date.

(b) The medium-term insurance business (Project Group) should continue to provide its present facilities and should remain a Government Department.

11. The rest of this note considers the financial implications of adopting these recommendations, and of a complete withdrawal of ECGD from these activities, leaving provision to the private sector.

Insurance Services Group

12. Whatever decisions are taken about ISG they will not affect expenditure on FREF or ATP. These subsidies are only paid on goods sold on at least 2 years credit and ISG only provides insurance for goods sold on credit periods of up to 2 years.

13. The insurance of exports sold on short-term credit has not been as liable to sovereign claims as Project exports sold on medium-term credit. Nevertheless heavy claims on one market in the early and mid 1980s led to payments in excess of income and, as a result, the main short-term facility (CST) has made drawings on the Consolidated Fund to finance the payments. The CST trading account, after making the appropriate provision, against all its exposure (including sovereign exposure) currently has positive reserves. This reflects an assumption that some of these past claims, which have now been rescheduled, will be recovered.

14. If ISG was established as a Government owned company, the working assumption is that the residual liabilities in respect of guarantees issued in the past would be accounted for separately from the new business undertaken by the new company. The constitutional and institutional arrangements between ISG and the rest of Government would change but, while the company remained 100 per cent Government owned, the financial realities would remain basically unchanged.

15. HMG would have to capitalise the company at whatever level was deemed appropriate in the light of general requirements governing insurance companies. The initial injection would be public expenditure but, as this would constitute an increase in the Government owned company's liquid assets (which is negative public expenditure) the initial increase would be immediately offset. While the PLC carried out business as a 100 per cent owned Government company, HMG would stand behind it. Net cash generated would add to the company's liquid assets and thus to the PSDR, while any net cash requirement would require a drawing on the Consolidated Fund and thus a reduction in the PSDR. The reinsurance facility would be accounted for separately but this would not alter the underlying financial consequences for HMG.

16. If private capital was introduced the situation would change. The purchasers would acquire for a certain price the business of ISG, including the capital base. The extent to which the price paid exceeded the capital base would comprise the net receipts (after expenses) of the sale.

17. Thereafter, the financial effects on HMG would depend upon whether ISG had, as Kemp recommended, a political risk reinsurance facility with HMG. If it did not, HMG would have no further financial responsibility for ISG. If there was a reinsurance facility, HMG would receive a flow of income from the charge it levied on the new company for providing reinsurance. In return, HMG would be liable to meet claims and losses arising from its share of the reinsured risk. [This could be less than 100 per cent, if reinsurance was shared with the private sector]. How this account would balance out would depend upon the quantity and quality of the reinsured risk and the amount HMG charged ISG in reinsurance premiums.

18. A privatised ISG with a political risk reinsurance facility from HMG would mean fewer contingent liabilities for HMG but also less income to meet any losses that arose on those (reduced) liabilities. The contingent liabilities would be reduced because ISG's guarantees against commercial risk (the bulk of the business) would be provided against its own capital base and

whatever commercial risk reinsurance could be arranged. [There would be no question of HMG reinsuring commercial risk]. It would also be reduced to the extent that political risk reinsurance was available from the private sector and could replace HMG reinsurance. Income would be reduced as HMG lost access to surpluses on the commercial business, which would now belong to the company.

Project Group

19. The public expenditure costs of subsidising credit terms arise on exports guaranteed by the Project Group. The Government is obviously committed to meet the continuing subsidies arising on existing commitments. The future level of expenditure on such subsidies for new business (assuming, for the moment, that the FREF and ATP schemes continue to operate) would depend upon two variables. First, the level of new project exports insured by ECGD. Second, the gap between the floating rates of interest paid to the banks on export finance loans and the fixed (Consensus) interest rates received from the customers, with the UK taxpayer making up the difference.

20. Business levels will reflect a number of factors, including the competitive position of UK companies exporting capital goods and demand for such products in their major markets. Since the debt crisis, the market for such products has fallen compared with the peak in the early 1980's and a recovery to those levels is considered unlikely in the near future.

21. Future expenditure on FREF will also be sensitive to the difference between market interest rates for sterling and dollars (in which most FREF loans are denominated) and Consensus rates. At present Consensus rates are set according to the following formula:

Markets	Repayment periods	
	2-5 Years	Over 5 Years
Category 1 (relatively rich)	Commercial rates	commercial rates
Category 2 (middle income)	SDR + 1.05%	SDR + 1.55%
Category 3 (less developed)	SDR + 0.2%	SDR + 0.2%

Notes to Table

1. Commercial rates are set for each currency separately and (for most currencies) are based on the yield in the secondary market on 5 year Government bonds plus a margin of 1 per cent.

2. The SDR means the average interest rate of US dollars, West German mark, Japanese yen, French franc and sterling, on 5 year Government bonds weighted according to the IMF Special Drawing Right.

3. Countries are obliged to charge for Category 2 and 3 markets at least the 'Consensus" rate or the appropriate commercial rate for the currency in question. Countries may charge higher rates than these if they wish.

22. The determination of the formula for calculating Consensus rates is a matter for international discussion in the OECD Consensus. It is the Government's policy to seek the phasing out of all subsidies on an agreed multilateral basis. In practice this mainly means eliminating the "matrix rates" for Category 2 and Category 3 markets and replacing them by commercial rates, as is the rule for Category 1 markets. Discussions are currently taking place in the OECD Consensus on reforms to the Consensus.

23. Apart from the public expenditure costs of paying FREF and ATP subsidies on new medium-term credits the Exchequer is also liable to meet the cashflow deficits that arise if the guarantees on these credits are called. In line with its standing financial objective, ECGD should attempt to break even on this business.

They make underwriting and pricing judgments designed to achieve break even. However, insuring Project business is inherently risky. This is for three main reasons: the narrowness of the portfolio (a small number of markets and projects); the long horizon of risk (10 year average); and the unpredictability of future events, making it difficult to judge today the "risk" in a particular market in 5 years time. As a result, there will always be a danger that the insurance of such risk (even if undertaken on a cautious pricing and underwriting basis) will lead to eventual losses. For example, since 1980 ECGD's Project Group has generated premium income (net of administrative costs) of £0.9 billion but, to date, has been required to make sovereign debt provisions of £1.9 billion against the liabilities, implying a probable loss of at least £1 billion on the post 1980 business. Any subsequent increase in the size of the sovereign debt provision would increase this loss.

24. The heavy past costs to the Exchequer of ECGD facilities for Project exports have led to an examination of the advantages and disadvantages of withdrawing these facilities and leaving the provision of insurance cover for Project exports to the private sector. This action would involve withdrawing two types of Government support for Project exporters. First, the withdrawal of FREF and ATP subsidies on new business. This would mean that the customers for UK project exporters would not be guaranteed, from HMG sources, the availability of a fixed rate of interest on the loan. The transaction would have to be financed at a market rate of interest. At the moment, there is only a limited supply of fixed rate sterling finance available in the market but this poor supply probably reflects the existence until now of fixed rate finance through the FREF system. The withdrawal of the FREF scheme should lead to an increase in the availability of fixed rate pure cover finance from the market, although this would obviously be at commercial rates of interest.

25. Second, the withdrawal of ECGD's credit insurance guarantees for Project exports would mean leaving it to the private sector to provide insurance cover for such markets. Again, the existence of

ECGD's cover has probably held back the development of private sector facilities and withdrawal of the ECGD scheme should lead to some expansion in private sector facilities.

26. To the extent that the private sector was not able to replace ECGD facilities it is necessary to consider the consequences of the withdrawal of these facilities. These can be considered under two headings: (a) cost, (b) industrial, employment and balance of payments.

(a) Cost

27. The taxpayer would be relieved of the costs of subsidising new Project business by the withdrawal of the FREF and ATP schemes. The savings are difficult to forecast because of the uncertainties surrounding the relevant factors including the level of Project exports, the relationship between UK and world interest rates, and the outcome of international negotiations. If the average of the past 10 years is taken a guide to the future the savings on FREF would be £329 million per year and on ATP £49 million per year. The Exchequer would also be relieved of the risk that guarantees on new business would be called.

(b) Industrial, Employment and Balance of Payments

28. At present around £1.5 billion per year of UK exports are insured by ECGD's Project Group. This is about 2 per cent of total UK exports but about 15 per cent of capital goods exports. Estimating how much of these would be at risk if Project Group facilities were withdrawn is difficult. Conventional analysis, based on elasticities, suggests that, as the subsidy on an average contract is equal to about 7 per cent of the contract value, the business lost in volume terms would be about £50 million. To this would need to be added the £300 million of business supported by tied aid credits, and the possibility that loss of the credit insurance guarantee would mean that no sales at all would be made to certain markets. The total effect on exports from the combined effect of all three measures is hard to measure but it does not follow, as is sometimes claimed, that all such exports would be lost.

29. We cannot assess the loss with any confidence but the maximum possible short term loss would be £1.5 billion per year or 2 per cent of total UK exports. This is almost certainly an overestimate, since it makes the unrealistic assumption that all the exports subsidised would be lost once the subsidy was withdrawn. But this is a static analysis only, based on the first round effect of the withdrawal of subsidies. Whatever the initial loss, it would not affect overall exports, output or employment to the same degree. The is because the case for withdrawal rests on the dynamic effects of the change. Just as the withdrawal of subsidies has an adverse impact upon the recipients of those subsidies, it has a beneficial effect upon the rest of the economy which is relieved of the burden of paying for them. Activity in the sectors losing the subsidies would tend to fall, but activity in the rest of the economy would tend to increase as the Exchequer, relieved of these costs, was in a position either to cut taxes or to increase the PSDR which, other things being equal, would lead to downward pressure on interest rates. The dead weight of the subsidies would be lost. As these benefits work through, the exports and output lost in the subsidised sector would be offset by higher exports and output in the rest of the economy. This transfer of resources from subsidised to unsubsidised activities would (other things being equal) lead to a more efficient employment of these resources and consequent benefits to the supply-side of the economy. After this adjustment had taken place, the distribution of resources would be different and more efficient but there would be no reason to expect any overall loss of output, employment or to the balance of payments.

TABLE 1

PUBLIC EXPENDITURE COST OF ECGD FACILITIES

A	B	C	D
Year	FREF (£m)	ATP (£m)	Total (B+C)
1979-80	219	29	248
1980-81	359	26	385
1981-82	500	53	553
1982-83	546	47	593
1983-84	327	28	355
1984-85	430	59	489
1985-86	385	36	421
1986-87	225	81	306
1987-88	134	48	182
1988-89	151	50	201
1989-90 (estimate)	346	86	432
TOTAL	3622	543	4165
Average	329.27	49.36	378.63

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

21 November 1989

Dear Neil,

KEMP REVIEW OF STATUS OPTIONS FOR ECGD

The Prime Minister has seen your Secretary of State's letter to the Chief Secretary of 31 October, and the subsequent letters from the Secretary of State for Defence, the Foreign Secretary and the Chief Secretary.

As regards the future of the Project Group the Prime Minister has commented that the Government cannot put UK industries at an unfair disadvantage relative to their competitors. She does not therefore consider that the zero option can be accepted. She has however noted that colleagues are considering further ways in which costs and the risks of future losses can be reduced.

I am copying this letter to Steven Catling (Lord President's Office), Stephen Wall (Foreign and Commonwealth Office), Brian Hawtin (Ministry of Defence), Martin Le Jeune (Privy Council Office), Carys Evans (Chief Secretary's Office), Paul Tucker (Bank of England) and Trevor Woolley (Cabinet Office).

Yours,
Paul

Paul Gray

Neil Thornton Esq
Department of Trade and Industry

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PRIME MINISTER

REVIEW OF THE FUTURE OF ECGD

You have been signing quite a few letters recently in response to representations from industrialists on the future of ECGD.

You may therefore like to note the latest position on internal Government discussions on the Review.

Nick Ridley wrote round a couple of weeks back (Flag A) setting out his conclusions following the preparation of a detailed report by officials. In brief these were:

- to press ahead with setting up a new Government company for the ECGD Insurance Services, with the aim of introducing private capital as soon as possible;

- moving to withdraw political risk reinsurance from Insurance Services;

- retaining the ability to underwrite business in the national interest under Insurance Services but using this power prudently;

- on the key issue of the future of the Projects Business, not to take any unilateral action to bring UK support to an end but at the same time to look at the ways in which the private sector could take on the better risk business.

It is the last issue, the future of Project Business, that is the most sensitive. In the work by officials, the Treasury have wanted to keep in play the so-called "zero option". It is that which Mr. Ridley is resisting.

The Defence (Flag B) and Trade and Industry (Flag C) Secretaries have written in to support the continuation of the Project Business. The Policy Unit (Flag D) are of the same mind.

The Chief Secretary (Flag E) has thus far sent only an interim response. He will be replying in more detail now the Autumn Statement is behind us. His interim letter repeats the arguments for the "zero option", but he also hints at the continuation of the Project Business on a somewhat reduced scale.

The next step is for further dicussions between Nick Ridley and Norman Lamont. My impression is that the Treasury recognise that there is no chance of you or other colleagues accepting the zero option. The most likely outcome of the further discussions is therefore for agreement on its continuation, but perhaps with some tightening up of the margin.

Content to note the position reached and to await the outcome of the further discussions?

Yes - we cannot accept the zero option - we cant put our own industries at an unfair disadvantage with their competitors.

MT

BRCG.

PAUL GRAY
17 November 1989

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FCS/89/198

TRADE AND INDUSTRY SECRETARY

Kemp Review: Status of Options for ECGD

1. Thank you for copying to me your letter of 31 October to Norman Lamont. I have now seen Tom King's letter of 7 November and Norman Lamont's of 8 November.

2. I welcome the decision to review ECGD's status particularly in the light of progress towards an open market in the European Community. I agree generally with the recommendations in your letter.

3. The insurance facilities now available from ECGD's Insurance Services Group (ISG) in Cardiff and the export credit arrangements for major projects available from the Project Group in London both remain essential for British exporters' participation in many of the markets which have the greatest future potential for UK trade.

4. The Working Group concludes that Government backing is no longer essential for the bulk of Insurance Services' business, and that Insurance Services would have greater flexibility to meet UK companies' requirements for comprehensive domestic and export insurance packages if it operated outside the framework of Government. In developed country markets, Insurance Services is already in competition with private sector insurers, and within the European Community state backed insurers are increasingly vulnerable to challenge on grounds of unfair competition. I therefore agree that we

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Content to note the position reached and to await the outcome of the further discussions?

Yes - we cannot accept the zero option - we can't put our own industries at an unfair disadvantage with their competitors.

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BRCG.

PAUL GRAY
17 November 1989

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FCS/89/198

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/should

should establish Insurance Services as a Government company with the aim of introducing private capital as soon as possible.

5. It is in UK exporters' interest that ISG should continue providing political risk cover for those markets which require it. I therefore welcome your suggestion that we should initially provide a government-backed reinsurance facility for short-term political risk although I foresee some possible difficulties in not providing this facility to private insurers as well as ISG, since ISG's competitors could legitimately claim they were being unfairly treated. Any such arrangement will need to be carefully scrutinised to ensure that it cannot be attacked as an illegal state aid under the Treaty of Rome. I therefore share your hope that the private sector will soon develop the capacity to provide political risk reinsurance, and agree that we should announce an intention in principle to withdraw the government facility after five years. But we will need to review this when we see whether, and if so how rapidly this action encourages the private market to develop.

6. I agree we should also retain a mechanism for providing insurance for exports in the national interest outside the EC when Insurance Services does not consider the risk appropriate for cover on a commercial basis. There could be compelling political industrial or strategic reasons for the government to carry an insurance risk in particular circumstances, but the facility should obviously be used judiciously.

7. For project business it seems clear that the private sector cannot for the foreseeable future be expected to provide export credit arrangements of the scope now

/available

available from ECGD. I think we must retain a government-backed insurance facility for project business if we are to maintain and improve the performance of British manufacturing industry in risky markets. Withdrawing from these markets will have implications for the prospects of major British contractors more generally. The cost to the taxpayer of export credit would have to be very high to justify embarking on a process of adjustment out of this sector - given the adverse consequences for the short term employment and balance of payments outlook, and the longer term impact on other countries' perceptions of our industrial capability.

8. I recognise that the debt problems faced by many developing countries in the 1980s have led to heavy claims on ECGD some of which may never be recovered. But I do not think we should allow the extraordinary events of the 1980s to distort our view of the prospects for the Project Group meeting its break-even objective in the future. I appreciate too that the cost of providing credit at the "matrix rates" agreed by the OECD concensus is high while UK interest rates remain so far above international levels. But I am concerned about the possible reaction of foreign purchasers if we ask British companies to offer credit to developing countries at full commercial rate when UK interest rates temporarily appear so much less attractive than those available from our competitors. We expect inflation and interest rates to fall, and we are now making good progress towards multilateral agreement to eliminate the subsidy system. We should not by unilateral action now weaken the position of UK companies in markets where they may soon be competitive with unsubsidised finance.

/9.

9. The UK is heavily reliant on the efforts and enterprise of its exporters. To ensure our future as a trading nation our exporters must be prepared to fight the competition worldwide, and not just in OECD markets. I therefore agree that we should end the uncertainty over ECGD's future by making an early public statement as you propose. This should stress the government's commitment to ensuring competitive insurance and export credit facilities for UK exporters, and point out that the services available to exporters will be enhanced rather than curtailed by the steps we are taking towards privatisation of part of ECGD's operations.

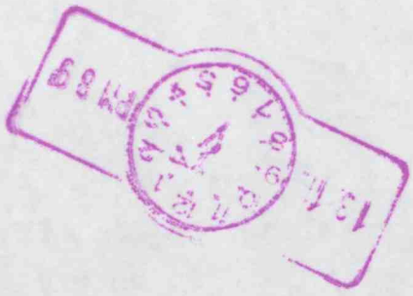
10. I am copying this letter to the Prime Minister, the Lord President, Chief Secretary to the Treasury, Defence Secretary, Minister of State for the Privey Council Office, Governor of the Bank of England and the Cabinet Secretary.

DH

(DOUGLAS HURD)

Foreign and Commonwealth Office
13 November 1989

TLADG : ECGD PT2



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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street SW1P 3AG

The Rt Hon Nicholas Ridley MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

8 November 1989

Dear Nick

KEMP REVIEW OF STATUS OPTIONS FOR ECGD top end

Thank you for your letter of 31 October, enclosing the Working Group report on the Kemp Review.

2. This seems to be a very thorough job, and I join you in thanking those concerned.

3. We must consider these issues against a grave financial background. ECGD will shortly publish accounts showing net drawings on the Consolidated Fund of £1.7 billions and an accumulated loss of £527 million. There is more to come. Claims will continue to arise from the debt crisis for some years to come, and we estimate further net drawings of another £2 billion to take the net drawings to £3.7 billion. Revisions to the provisions, following the new Bank of England matrix, will probably increase the accumulated loss to well over £2 billion. Our major objective in all our consideration should be to avoid any repetition of this disaster.

4. It will need a bit of time to consider the complex issues involved. We need also to consider the related question of a Portfolio Management System for ECGD, on which I understand you will shortly be writing to all interested colleagues. I should like to discuss these two issues together.

5. I shall therefore be replying at length on the Kemp Review a little later in the month, as soon as possible after the Autumn Statement. My initial reactions are these. I agree with your view that our objective should be the earliest possible privatisation of the short term business. I think we shall

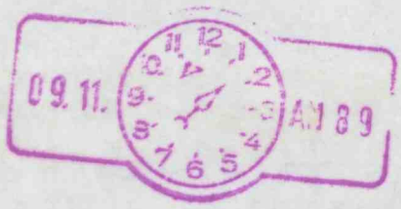
commission work on this very quickly, so that privatisation could take place almost simultaneously with the establishment of the company. I shall want to look more carefully at the case for a reinsurance facility. But I am instinctively against the creation of a residual National Interest facility for high risk business which could all too easily become an easy option for dealing with uncomfortable industrial or political problems while disguising the ultimate cost to the taxpayer.

6. I am less sure than you are that we should retain the Project Group. I think there is a good case for the Zero Option, in view of the enormous losses incurred or impending on past business, the risk of further losses on new business, and the large subsidies paid on almost all this business. If in the end we decide to keep the Project Group in existence on a smaller scale, we would have to take firm action to minimise the risk of future losses and to bring the current subsidy bill to an end. This would be very difficult, and so to my mind the best and simplest course is closure.

7. Pending discussion among Ministers I am sure we should all avoid public comment on these issues, despite the considerable industrial lobbying to which we have both been exposed. Unfortunately the Treasury has been asked to supply a written Memorandum to the Trade and Industry Select Committee, following up David Trefgarne's oral evidence last week. My officials are preparing a purely factual note which they will show to your people before submitting it on 8 November as required.

8. I am copying this interim reply to the Prime Minister, and to Geoffrey Howe, Douglas Hurd, Tom King, Richard Luce, Robin Leigh Pemberton and Sir Robin Butler.

NORMAN LAMONT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B B CC PM

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 32/8S

7th November 1989

Dear Norman

KEMP REVIEW OF STATUS OPTIONS FOR ECGD

Nick Ridley sent me a copy of his letter to you of 31st October in which he sets out his proposals for the future of ECGD following the report of the inter-Departmental Working Group. Like him I am pleased that the Working Group has reported so quickly and I agree that we now need to bring matters to an early conclusion.

I agree totally with Nick's general approach. The status quo for ECGD is not an option open to us. We have to do something to allow the Insurance Services Group to continue to provide the valuable support it does for industry, and its transformation into a joint stock company and the introduction of private capital is clearly the way to go. However, a lot of defence business is with the less developed world and we may well wish from time to time to have the facility to pursue business in the national interest, possibly for strategic or other policy reasons, that a private sector company would not have the ability to handle. I am glad, therefore, that Nick accepts that we should not withdraw from political risk re-insurance until there is adequate private market capacity and that we should retain a capability to underwrite business in the national interest.

The Rt Hon Norman Lamont MP

I accept there is merit in setting a timetable for phasing out our political risk re-insurance involvement. But we should recognise the difficulties this type of insurance poses for the private sector. Three years from the date of privatisation may be a stiff target. We shall need to monitor progress carefully and, as Nick notes, be prepared to modify this timetable if progress is slower than we would hope.

I am particularly glad that Nick has rejected any unilateral withdrawal of ECGD support for project business. The support ECGD can offer both in insurance and interest support is increasingly critical in its own right to the success of major defence export business and the timing could not be worse for any such suggestion. I suspect the Working Group report under-estimates the potential impact any such withdrawal would have on defence exports. Major defence sales are both highly competitive and price sensitive, and the price elasticity assumption used to calculate the potential volume export loss understates the probable impact in the highly specialised, high value defence capital goods sector. Moreover, the high interest rate policies we have adopted, while costly in their short-term effect on the size of the interest make-up subsidy, should produce their own correction over time. I am convinced, as is Nick that we should tackle the subsidy problem multilaterally. We must not put our exporters at a competitive disadvantage. The defence sector has done particularly well in regularly producing a major positive trade balance. We need this to continue.

I am also content with Nick's recommendation for a quick Machinery of Government review of the status of a residual ECGD and with his views on timing. Industry is much exercised over the future of project support and we need to end uncertainty.

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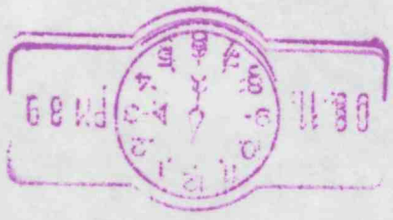
Finally I should like to make one further point. I strongly support the continued need for a National Interest facility for both short and longer term business. A major defence sale can have important repercussions politically and strategically and this may very properly influence our decision to provide ECGD support. Richard Ryder has been suggesting that in such cases and where support is offered which might not be justifiable on narrower grounds of strict financial prudence, then any contingent risk, or by extension, interest subsidy should be borne by the sponsoring Department. This seems to me to be wholly wrong. Having made a decision in the national interest then the consequences should remain with ECGD which has the administrative expertise and whose statutes provide specifically for this kind of responsibility.

I am copying this letter to the Prime Minister, Geoffrey Howe, Douglas Hurd, Nicholas Ridley, Richard Luce, Robin Leigh Pemberton and to Sir Robin Butler.

Tom King



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PAUL GRAY

6 November 1989

THE KEMP REVIEW OF STATUS OPTIONS FOR E C G D

We should welcome the proposals put forward in Mr Ridley's letter of 31 October for early action on the Kemp review.

On the **Insurance Services** side, it is logical not to offer political risk re-insurance to private sector insurers once the Government has given clear and public notice of its intention to phase out its own support of the short-term political risk business. We cannot be sure how quickly the private sector capacity will develop in response but Government disengagement over a five year period or three years from the privatisation of the Insurance Services Group is thought to be a reasonable time scale. Mr Ridley is also right to want to introduce private capital into **ISG** as soon as practically possible; the company will want to know where it stands in planning to meet the competitive challenge posed by the Single Market.

The Treasury has argued against continuing with the present system of **ECGD long-term project business** - the 'Zero Option' - but Mr Ridley says that it would be politically wrong to withdraw unilaterally from it. Industry will certainly welcome reassurance that it will continue to get the same sort of support from ECGD as that available to all our major competitors because there is simply no evidence that the private sector can offer any alternative in this market. Yet its costs can be reduced both by the new portfolio management system to which Mr Ridley refers and arguably by some change in the refinancing methods employed in the FREF programme. Withdrawal of Project support - 'unilateral disarmament' as its critics call it - would put some British defence and engineering businesses at a significant competitive disadvantage at a difficult time; Mr Ridley's political view is surely right.

Howell Harris Hughes

HOWELL HARRIS HUGHES

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the department for Enterprise

The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

The Rt Hon Norman Lamont MP
Chief Secretary to the Treasury
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Date 31 October 1989

Dear Norman

KEMP REVIEW OF STATUS OPTIONS FOR ECGD

David Young and John Major agreed that a Working Group of officials, chaired by ECGD's Chief Executive, Malcolm Stephens, should examine the Kemp Review and consult with interested parties. The Working Group has now completed its deliberations and a copy of its Report is enclosed.

2 The Report is in two parts. The first part examines the case for, and feasibility of, separating the two main ECGD operations and running these as separate businesses. The second part examines the possibility that the UK could unilaterally withdraw its export credit insurance scheme for Project business. This meets your predecessor's request that the Working Group should include the so called Zero Option in its analysis.

3 The Report is a substantial piece of work and I would like to record my thanks to the officials from all the Departments involved.

4 The Report supports the principal Kemp recommendation that the two main ECGD operations (the Insurance Services Group in Cardiff and the Project Group in London) should be run as separate businesses, with the Insurance Services Group reconstituted as a limited Company, permitting the introduction of Private Capital in the future. I fully agree with this recommendation and believe that we should now instruct ECGD officials to proceed as rapidly as possible to take the necessary steps to set up the new Government Company with the aim of introducing private capital as soon as possible thereafter.

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5 There are two other important issues for Insurance Services on which decisions are required. The first is the question of whether Government should provide some measure of political risk reinsurance to Insurance Services, or whether it should withdraw completely.

6 The Report notes that there could be advantages for the Government in seeking to withdraw from political risk reinsurance either immediately or progressively. I note that short term political risk insurance has not to date led to net losses and I am attracted by the idea of taking positive steps to encourage the private reinsurance market to develop capacity for short term politial risk to the maximum extent possible. As a first step, therefore, I suggest that we give clear and public notice of our intention to phase out Government support for short term political risk business and set a firm timetable for doing this.

7 My initial view is that we should aim for Government withdrawal five years from announcements on the Kemp Review or three years from the date of privatisation of the new company, whichever is the earlier. We should, however, recognise that we may need to review this timetable when we have had a chance to see the pace at which capacity in the private market develops. Against this background, I see no purpose in offering political risk reinsurance to private sector insurers, since this appears to run the risk of institutionalising such arrangements.

8 The second issue in relation to Insurance Services concerns whether the Government would wish to retain the ability to underwrite business in the National Interest. Whilst this is only rarely likely to be necessary, it is a useful contingent facility to have and handling it in the way proposed in the Report would avoid the need to reinvent the ECGD Short Term scheme at some future date. Thus my view is that Government should retain this ability but should use it prudently, taking into account the likely cost to the Exchequer when considering the wider political and other benefits of such support.

9 As far as the introduction of private capital is concerned, I believe there are strong arguments that this should be done sooner rather than later. The timing must depend on the speed at which the new company can be set up and established. My view is that Government should make clear at the outset its intention to introduce private capital as soon as is sensible but that the choice of partners should be left until a little later. This does not, of course, mean that we would reject any offers made so far. These could be looked at by ECGD whilst the Company is being set up.

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10 Colleagues will know of the importance that the exporting community attaches to ECGD. I have received strong representations from many interested parties since publication of the Kemp Report and there is clear and widespread support from Industry for the proposal to reconstitute Insurance Services as a Company. I also believe this is in the best interests of UK exporters, other interested parties and ECGD customers and staff. To do otherwise would be to waste a valuable asset and would lose the opportunity to develop a successful financial services industry for the benefit of the UK and to provide the best environment in which to foster UK trade with the minimum of Government intervention.

11 Turning now to ECGD's projects business, the Working Group examined in detail the case for continuing support for UK exporters in this field, or discontinuing this activity completely. I recognise that this is a difficult issue, which partially turns on the extent to which the future costs of the Project Group operation might be felt to outweigh the benefits to the economy as a whole. The costs fall into two categories, support for fixed interest rates and losses which may arise under the insurance scheme.

12 As far as interest rate subsidies are concerned, Ministers have already agreed that the UK objective should be their eventual elimination on a multilateral basis through changes in the OECD Export Credit Consensus. Good progress has been made already. To withdraw support unilaterally now would be politically inept: UK exporters would claim to be at a significant competitive disadvantage at the time of a huge trade deficit. In addition, progress on further reducing interest rate support multilaterally now seems very likely. As you know from our recent exchanges in the context of the PES round, I would rather that we concentrated on this approach.

13 As for insurance for project business, it is generally argued that the private insurance market and banks would not be willing or able to fill the vacuum if ECGD withdrew. I fear it is true that the removal of ECGD from this activity would virtually end the UK's involvement in most project business. The Defence Sector, where ECGD currently covers about 20% of direct exports, would be particularly badly hit. We have received numerous representations from industry and MPs, expressing concern about any withdrawal of ECGD possible support for Project business and pointing to the value to their companies of ECGD support. It is of course not surprising the view of industry is that the benefits of providing support are felt much wider in the economy than the Treasury figures suggest.

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14 I think it is true that early termination of ECGD Project support would have an adverse impact publicly and politically and would be highly controversial. I realise that all this is merely lobbying, but I think the case for termination at the present time of high interest rates and of our balance of payments deficit is inadequate. All the major industrial countries who export major capital goods provide this kind of support and it would, be impossible potentially to justify the UK unilaterally abandoning it.

15 Steps which have been and are being taken to develop a Portfolio Management System for medium and long term political risks (on which I have corresponded with you and shall be writing separately to colleagues) mean that many of the issues of concern to the Treasury are already being addressed. Thus the risk of losses from major country defaults will be reduced, although I recognise they cannot be eliminated and Government will be left with significant contingent liabilities.

16 My conclusion is that unilateral withdrawal by the UK in this sector at the present time would be politically wrong. I would like to take immediate steps to put an end to the current uncertainties in the capital goods and defence sectors by reassuring UK industry that ECGD support for the Project sector, broadly comparable with that available from our major competitors, will continue to be provided by HMG. I have however, asked ECGD to look at ways in which the Private Sector can take on the role of handling the better risk project business.

17 I think it is important that, having agreed to the creation of a Company to handle the short term business we should have a brief and early Machinery of Government Review to decide on the appropriate status for the residual organsation. This review should certainly not rule out the question of Agency or Next Steps Agency status.

18 In summary, I am anxious to put an early end to the uncertainties which have increasingly surrounded ECGD in recent years, and I should therefore be very grateful for the early agreement of colleagues to the approach set out above and in the attached Report. For various reasons, not least to make our intentions quite clear, I believe that we should make a public statement as soon as is possible, setting a timetable to include establishing the company, introducing private capital and phasing out Government support for short term political risk. I see a need to announce this well before the Trade and Industry Select Committee publish their Report on ECGD.

19 Crucial to the timetable of achieving this will, of course, be the question of legislation. My letter of 3 October to the Lord President sought an assurance that ECGD will be allocated

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a slot in the 1990/91 Session. If we are to meet the timetable for phasing out Government involvement in short term political risk insurance, as proposed in paragraph 7 above, we should aim for Royal Assent sufficiently early in the 1990/91 Session so that we can set up the Government Company by the beginning of the financial year 1991/92.

20 The Report represents confidential advice to Ministers and contains commercially sensitive information. Thus I do not think it would be appropriate to publish the Report or to circulate it widely within Departments. However, I would propose to ask ECGD to provide a summary of the Report's main findings and conclusions to ECGD staff as soon as possible.

21 I am copying this letter and attachment to the Prime Minister, Geoffrey Howe, Douglas Hurd, Tom King, Richard Luce, Robin Leigh Pemberton and to Sir Robin Butler.

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CCLO



Treasury Chambers, Parliament Street, SW1P 3AG

NBPM
RHCG
11/8

The Rt Hon Nicholas Ridley MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H OET

11 August 1989

Dear Secretary of State,

ECGD: PROPOSED EXPORT CREDIT AND INVESTMENT GUARANTEES BILL

Your predecessor wrote to mine on ~~20~~ Aar June seeking policy clearance of the measures in this Bill. Treasury and ECGD officials have discussed these proposals in detail and I can now give Treasury clearance for all of them.

I am copying this letter to E(A) colleagues.

Yours sincerely,

P Warlock

NORMAN LAMONT

[Approved by the Chief Secretary and signed in his absence.]

dti

the department for Enterprise

CC/AC

The Rt. Hon. Lord Trefgarne
Minister for Trade

NBPM
CTB
8/8

The Rt Hon Norman Lamont MP
The Chief Secretary
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Your ref
Date 7 August 1989

Dear Norman,

JORDAN: ECGD COVER

WILL REQUEST IF REQUIRED

In ~~Nicholas~~ Ridley's absence, I am responding to your letter of ~~28~~ July.

I am grateful for your agreement that guaranteed advances should be resumed in respect of the majority of contracts under the two defence lines of credit and the Public Security Directorate contract. Subject to consultation with the Embassy in Amman, we will advise the Jordanians and contractors. However, before finally giving them a decision on resumption of guaranteed advances, we will require contractors to establish the banks' position regarding the unguaranteed lending. We need to make it quite clear that there can be no question of ECGD taking over the banks' share of the risk and there would clearly be advantage in obtaining the banks' agreement to resume their lending if ECGD does the same.

I do feel, however, that I have to revert both on the Racal case and the contracts you have suggested should be terminated.

On the Racal case, you have said that the contract should continue provided the banks make available their unguaranteed lending. Whilst I appreciate the desire to ensure that ECGD's liability is kept to the minimum, the fact is that, if the banks refuse to make lending available, then ECGD will have a significant loss under its credit risk cover. ECGD will, already indicated above, do all it can to try to ensure that bank lending is available but it

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The Rt Hon Norman Lamont MP

August 1989

is the ECGD's judgement that any decision in relation to the banks' attitude should be a general one applying to all contracts and not simply to the Racal contract. I hope, therefore, that you can agree that the Racal case can be dealt with on the same basis as all the other cases and that unguaranteed lending should not be a pre-requisite for the resumption of guaranteed lending.

On the Vospers contract, quite apart from the importance that King Hussain attaches to the Patrolboats, and the points made to him by the DTI here I do not share your apparent confidence regarding resale. It would certainly not be easy to find an alternative market for these vessels, and even if it proved possible, the probability is that a new buyer would require considerably different on-board equipment and would also be unwilling to pay the desired price, given the background to the vessels' availability. In addition, given that the Jordanians have already paid over £13 million, including loan drawings of over £11 million, there must be a danger that they would be unwilling to repay this money given that they had received nothing for it. It also has to be noted that ECGD is on risk for a bond in respect of the down-payment of some £2 million. It is our view therefore that this should be allowed to go forward.

Against this background, my firm view is the amounts of money involved in the other three small contracts and the tanks spares contract are so small that it would not be worth the bad feeling that would be produced by us cancelling them. I would therefore urge you to agree that these should proceed.

I am copying this letter to the Prime Minister, John Major, Tom King and Robin Butler.

Yours

David.

LORD TREFGARNE



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the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Peter Wanless Esq
Assistant Private Secretary to
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Date 30 June 1989

Dear Peter

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTACTS

Thank you for your letter of 13 June with the report of the last quarterly EGC review of large potential defence and civil contacts.

We agree that the Jordan tornado aircraft case, for which cover under the special £1bn Arms Account was previously reserved, should now be simply logged as a priority defence project, but that any revival of this sale will have to be considered in the light of circumstances prevailing at the time.

I am copying this letter to Charles Powell (No.10), Ian Woodman (MoD), Richard Gozney (FCO), John Millett (ODA) and Tim Downing (BoE).

Yours ever

Ben Slocock

BEN SLOCOCK
Private Secretary

the Enterprise initiative

TRADE : ECGD PT 2



dti

the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon John Major MP
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Date 20 June 1989

Dear John,

EXPORT CREDITS GUARANTEE DEPARTMENT

PROPOSED EXPORT CREDIT AND INVESTMENT GUARANTEES BILL

1 You will be aware that the Lord President has granted ECGD authority to introduce a Bill to amend the Export Guarantees and Overseas Investment Act 1978 (EGOI). I am writing to clear formally the proposed measures on policy grounds. I attach a schedule listing these.

2 The principal power being sought (Item 1 on the schedule), to which the Chancellor gave his support in a letter to the Lord President on 15 February 1989, will enable ECGD to give guarantees so as to achieve significant public expenditure savings on outstanding loans under the Fixed Rate Export Finance (FREF) scheme. ECGD wish to take advantage of opportunities in the international capital markets to reduce the funding costs incurred in the exercise of its basic statutory functions. Although ECGD were unsuccessful in obtaining legislative time in 1988/89 for this measure the financial markets are expecting ECGD to pursue this course following earlier negotiations with the banks.

3 In addition to the above, ECGD are also seeking a number of minor changes to their powers in order to respond to developments in their business environment. In respect of Item 4 on the schedule - the provision to market ancillary services - it is increasingly the case that multi-national companies look to their insurers to provide more comprehensive support packages and this measure would enable ECGD to meet this demand and at the same time develop its business.

the Enterprise initiative

4 The new power at Item 5 would enable ECGD to deploy its risk assessment and claims resources in support of export credit insurance provided by third party insurers. Closer co-operation could then take place between ECGD and the private sector to their mutual benefit and to the benefit of UK exporters.

5 As you will note the powers sought are not controversial and are designed to enable ECGD to take advantage of the marked changes in the commercial and financial markets since ECGD last sought legislation. I should welcome your endorsement of these measures.

6 I have not of course included any reference to possible legislative implications of decisions we may take on the recent Review of ECGD's status.

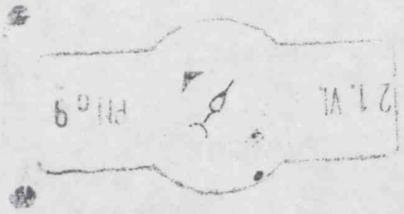
7 I am copying this letter to E(A) members.

SCHEDULE

LEGISLATIVE PROPOSALS

POWER SOUGHT	PURPOSE
1. To empower ECGD to do whatever is appropriate to control/minimise public expenditure and trading losses and to reduce the funding costs of existing commitments, in particular in respect of FREF.	1&2. To take advantage of developments in the capital markets.
2. To pay/supplement fees and commissions and expenses in connection with loans and guarantees.	
3. To give, and receive, reinsurance on a global basis.	3. Present powers restrict ECGD to reinsure only in the circumstances of specific new trans actions. This power would enable reinsurance arrangements to be entered into on a general, non-specific, basis.
4. To market ancillary services.	4. To develop business by presenting a more comprehensive business package.
5. To empower ECGD to enter into contracts to provide a risk assessment and/or claims service in order to facilitate the provision of export credit insurance by UK insurers.	5. To remedy ECGD's lack of powers to deploy its risk assessment and claims resources in support of export credit insurance provided by third party insurers.
6. To give Investment Insurance cover for loan guarantees.	6. To give guarantees in respect of certain loans to overseas Associates of UK companies.
7. To enter into commitments denominated in ECUs and other currency combinations.	7. To introduce more flexible foreign currency financing arrangements.

Trade.



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Treasury Chambers, Parliament Street, SW1P 3AG

Ben Slocock Esq
Private Secretary to the
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

13 June 1989

Dear Ben,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The Interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period October to December 1988. The attached report identifies the potential problem areas and updates the report attached to my letter of 22 December 1988.

Iraq has repaid £66 million in the last few months and the UK continues to be regarded as a preferred creditor. However, overdues on letters of credit have risen steadily so ECGD has doubled premiums on short-term cover to contain exposure.

As the Jordanian Tornado contract has been postponed, EGC recommended that the reservation of cover should be dropped, subject to Ministerial approval, but that it should be logged under the list of priority contracts. If that is agreed no commitment to provide cover could subsequently be claimed and any new request will have to be considered in the light of the circumstances at the time.

The level of cover required under the overdraft facility to accommodate potential defence contracts in Malaysia is unclear. A hydro electric power station will require £350 million of ECGD cover but if this contract goes forward only £100 million will be available under the market limit for the potential defence sales.

There has been no resumption of medium term cover for Nigeria but EGC has recently agreed cover can be offered for sovereign risk up to DML £110 million in respect of the OSO project, subject to specified conditions.

EGC has been asked to consider a contract worth £75 million to supply Armoured Personnel Vehicles (APVs) to the Philippines. It cannot be accommodated within the market limit but Departments are suggesting that there might be a case for cover under the Special Arms Account even though this is a DX market.

In Turkey, a substantial amount of potential business is chasing limited cover so the reservation for the Istanbul Expressway (DML £110 million) has been dropped to enable ECGD to indicate on other prospective business which might stand a better chance of going forward.

The agreed list of priority defence projects for the Supplementary Section 2 account for defence sales is at Annex B.

I am copying this letter to Charles Powell, (No 10) Ian Woodman, (MOD), Richard Goozney (FCO), John Millett (ODA) and T J H Downing (Bank of England).

Yours,

Peter Wanless.

PETER WANLESS
Assistant Private Secretary

ORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts Quarterly Report of Potential Problem cases October - December 1988.

A Cases which were included in the last Quarterly Return

1. Brazil

Ministers agreed to the introduction of DX cover in August 1988 immediately the IMF declared the SBA effective and before a bilateral agreement with ECGD. Discussions with ECGD on the bilateral debt agreement were adjourned in March because it was not possible to reach agreement on the interest rate. EGC has agreed that indications of cover or offers in excess of £5m under the DX facility should be conditioned that effectiveness would depend upon signature of the Brazilian bilateral. The Secretary of State for Trade wrote again to the Prime Minister for agreement to allow cover for the proposed sale by MEL of electronic equipment to the Brazilian Air Force, in the light of the claims of COFACE support for the French competitor. Any cover made available would have to be provided under the Section 2 defence allocation. The Prime Minister has subsequently re-confirmed her earlier decision that cover should not be made available for this business in view of Brazil's debt rescheduling problems.

2. Cameroon

ECGD cover for the United Scientific Holdings (USH) contract to supply Scorpion light armoured vehicles to the Cameroon Government had not been approved by Ministers. Any general resumption of cover on a DX basis will be considered in the light of the outcome of any Paris Club rescheduling, subsequent bilateral and progress under the IMF programme. Departments had agreed previously that no cover could be made available for the Bamenda ring road or 3 towns water project.

3. Jordan

ECGD cover for Jordan has been suspended. Negotiations are under way with the IMF for a standby agreement which will pave the way for a Paris Club rescheduling of official external debts. ECGD is considering what action should be taken under the defence lines of credit on contracts which have not been completed and which have been caught by the suspension of drawings. EGC will be advised

ther in due course. Negotiations on the BAe Tornado contract, for which £480 million had been reserved under the Special Arms Account, had been postponed. EGC agreed to recommend that the reservation of cover should be dropped but that it should be logged under the separate list of priority contracts. The removal of the reservation would be subject to Ministerial endorsement but if that was agreed no commitment to provide cover could subsequently be claimed and the case would have to be examined afresh in the light of the circumstances at the time.

4. Kenya

The market limit continues to be under pressure, with a substantial number of civil contracts for which indications have been given, the majority with ATP (in particular, Nairobi water supply project (£10m), blood plasma processing plant (£23m) and Western Kenya pipeline extension (£66m)). Indications have been given for BAe aircraft and to Marconi for the supply of communications equipment. An indication has also been given for a prospective defence contract (FH70 guns - approximately £15 million). The defence and civil contracts will be competing on a first come, first served basis for the limited cover available.

EGC has agreed a revised Section 2 market limit to £350m.

	£m	
Section 2 Market Limit (Grade c)	350	
Firm Business	204.7	(+96* outside ML)
Offers/Reservations	104.05	
Balance available	41.25	
Indications	305.96	

* cover agreed by Ministers for Vosper Thorneycroft patrol boats outside the market limit.

5. Nigeria

An EGC market review paper had been circulated which recommended that there should be no resumption of Medium Term cover at present but that cover for sovereign risk in respect of the Oso project subject to specified conditions, should be offered for a $100 million loan value (DML £110m). A meeting has been

l d to consider cover for the OSO project in advance of the Prime Minister's meeting with President Babangida in the first week in May. It was agreed that cover could be considered for the OSO project provided certain conditions were met.

6. Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June 1987. MOD continue to consider that this deal might be resurrected and it has therefore been included on the MOD Priority List of prospective contracts. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no presumption that cover at the earlier level of £360 million for new frigates will be available, particularly if in the meantime indications of cover have been given for other business. The Section 2 balance is sufficient for other individual contracts on a first come, first served basis but there could be problems if several of the larger contracts became firm simultaneously. If the frigate deal was resurrected it would be necessary to consider providing cover under the special defence allocation; the country limit would then have to be reviewed with the presumption that a significant reduction would have to be made, thus prejudicing prospects for covering larger civil projects. A market review paper would be circulated to EGC shortly.

	£m	
Section 2 Market Limit (Grade D)	180	
Firm Business	24.25	
Offers/Reservations	52.29	
Balance available	103.46	(as at March 1989)
Indications	1,194.26	(As at May 1989)

7. Turkey

It was not certain that the Istanbul Expressway (DML £110m) would now go forward and the reservation of cover had been dropped. The release of that additional cover taken with expected repayments in the current year enabled ECGD to give indications of cover for potential civil or defence business up to £180 million DML. Cover for the Eagle Fire Control System could now be offered within the market limit and the contract had been removed from the Priority List for cover

t er the Special Arms Account. Cover for Civil business including the Omerli water treatment project (DML about £120m) could now also be made.

	£m
Section 2 Market Limit (Grade C)	750
Firm Business	427.2
Offers/Reservations	176.38
Balance available	146.42*
Indications	908.29

* £28 million would become available in June and further £50 million at the end of 1989.

8. Venezuela

The market limit was currently £200m, with a ceiling of £30m DML on individual contracts. A prospective contract for the sale of BAe Hawk aircraft with an estimated DML of £245m could not be accommodated within the market limit and has therefore been included on the Priority List of contracts for the Special Arms Account. The commercial banks might press Venezuela to restructure its debt in the Paris Club. In the meantime, ECGD is adopting a cautious approach to new commitments and would be consulting the EGC about cover requested by USH for Scorpion light armoured vehicles (DMC £66m) for which a firm contract had been signed.

	£m
Section 2 Market Limit (Grade D)	200
Firm Business	0
Offers/Reservations	38
Balance available	162
Indications	170

9. Zimbabwe

Negotiations continue on the prospective air defence package (radar and Rapier missiles) with a DML of approximately £127 million for which a reservation of cover under the market limit has been made. The prospective contract to provide 5 Hawk aircraft (DML £53 million) would also be competing on a first come first

ved basis for the cover available within the reservation. There is a substantial amount of civil business including two prospective contracts, one with ATP , which might require cover shortly. The balance of cover available is limited but sufficient cover remains currently to accommodate the immediate requirements.

	£m
Section 2 Market Limit (Grade C)	430
Firm Business	153
Offers/Reservations	150
Balance available	127
Indications	487

B. New cases

1. **Philippines**

A balance of some £21 million remained within the DX market limit of £25 million. But the Philippines was in default with the Paris Club and ECGD were applying administrative delay to new applications for cover. The potential GKN contract for APVs, of some £75 million, could not be accommodated within, and would be inappropriate for, the DX market.

	£m	
Section 2 Market Limit (DX)	25*	
Firm Business	3.72	
Offers/Reservations	3.72	
Balance available	21.28	(as at March 1989)
Indications	138.22	(as at May 1989)

* £37 million cover has been made available outside the market limit for the JBE Gas Turbine contract.

Malaysia

ECGD cover of some £350 million would be required for a recently agreed ATP offer of a grant/soft loan of £85 million for the hydroelectric power station project - Pergau. The current market limit was £500 million with a balance of £450 million; if the power station contract went forward only £100 million would be available for the substantial defence contracts which might flow from the recent negotiations between Malaysia and DESO. It was unclear what level of cover would be required for the overdraft facility associated with the defence contracts. DESO and ECGD would advise shortly on the cover required for potential defence contracts and whether, in view of the political commitment, a reservation of cover should be made for the overdraft facility.

3. Iraq

ECGD had been paid some £66 million of maturities falling due in the current calendar year and remained a preferred creditor. Protocol overdues were currently some £22 million but £2.2 million only was overdue for more than 2 months. Although a balance of £60 million remained under the 1988 Protocol, that cover had been allocated to potential business. The 1989 allocation of £340 million had been distributed between the Al Shemal project, £75 million for the pharmaceuticals and £200 million for the GPLOC; no large projects could be accommodated under the GPLOC. Credit for short-term business was available within a market limit of £60 million for 180 days under Section 1 and for £100 million on 360 day credit terms under Section 2. Amounts overdue under short term facilities totalled £23.8m at the beginning of May. As a result ECGD had doubled premiums on short-term cover to contain exposure and had extended the claims waiting period to 15 months. The problems would be kept under constant review.

ANNEX A

PROJECT BUSINESS

	1986/87 £m	1987/88 £m	1988/89 £m
Income	377.88	277.70	269.19
of which premium	98.18	72.50	96.53
Expenditure	634.90	806.70	703.66
of which claims	617.40	791.80	657.10
Net cash flow	(257.02)	(529.00)	(434.46)
Consolidated Fund balance	(96.80)	(664.40)	(1,195.87)
Net cash flow excluding refinancing	(351.02)	(529.00)	(502.75)
Consolidated Fund balance excluding refinancing	(226.54)	(664.40)	(1,267.88)

NOTES

(i) Bracketed figures indicate a deficit or charge.

(ii) Income includes, in addition to premium, moratorium interest from rescheduled sovereign debt.

ANNEX B

PRIORITY DEFENCE PROJECTS

SUPPLEMENTARY SECTION 2 ACCOUNT FOR ARMS SALES

Position as at: 21 April 1989

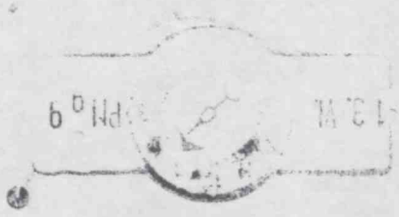
ALLOCATION FOR SUPPLEMENTARY ACCOUNT	£1bn
	DML £m
FIRM BUSINESS:-	NIL
Sub Total	-
RESERVATIONS:-	NIL
Sub Total	-
BALANCE AVAILABLE	£1 bn
INDICATIONS:-	
NONE	

PRIORITY AND LIKELY TIMING OF PROSPECTIVE DEFENCE CONTRACTS

CONTRACT	DATE	DML £m
1. Venezuela - Hawk aircraft	Negotiating	£245m
*2. Jordan - Tornado IDS	?	£480m
3. Pakistan - Type 23s	?	£360m

* EGC recommended that the reservation is dropped, subject to Ministerial endorsement, but that the contract is logged under the list of priority contracts.

TRACE: ECG Pg 2



CEPU

dti

the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London
SW1P 3AG

Department of Trade and Industry

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01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref NP2AAF
Your ref
Date 9 June 1989

NBPM at this stage.

RRCG
9/6

Dear Chief Secretary

THE KEMP REPORT ON THE FUTURE OF ECGD

16 May - at flap

I would like to thank you, and colleagues, for your responses to my letter of 18 May.

I am pleased to note that there was general agreement to the process which I suggested for reaching decisions on this Report. During my absence from the office, Alan Clark was able to agree that publication should go ahead and to the text of the ECGD Press Notice. Formal publication took place on 5 June with press coverage on the following day.

I note your comments, and Geoffrey Howe's, about my proposed timetable. I recognise that I had set a very ambitious target motivated as much by the need to minimise the period of uncertainty for ECGD's customers and staff as by the possibility of using the legislative slot allocated to ECGD. I would therefore still like to suggest that we should aim to reach decisions as quickly as possible but if we find that we do require longer to study the Report than I have suggested then I would be prepared to allow the timetable to be extended slightly.

I also note the emphasis you place on officials studying the "zero option" of discontinuing ECGD's project business altogether. While I have no objection to this, I have to say that I see no serious possibility of our adopting such an option and I would hope that consideration of this did not deflect attention from the other equally radical, but more realistic, options described in the report.

the Enterprise initiative

dti

the department for Enterprise

All interested Departments (HMT, DTI, FCO, MoD, OMCS and the Bank) have expressed an interest in being represented on the working group to be chaired by the ECGD's Chief Executive. I welcome this. Malcolm Stephens will shortly be in touch with his colleagues to arrange the first meeting.

Copies of this letter go to the Prime Minister, Geoffrey Howe, George Younger, Richard Luce, Robin Leigh-Pemberton and Robin Butler.

Yours sincerely

Ian Stoock.

(Approved by the Secretary of State and signed in his absence)

the Enterprise initiative

TRADE: ECGD pt 2.

FCS/89/101

SECRETARY OF STATE FOR TRADE AND INDUSTRY

Review of the Status of ECGD

1. Thank you for copying to me your letter of 16 May to John Major, which seeks colleagues' views on the procedures for handling Mr Kemp's report on the future status of ECGD. I have now seen John Major's reply of 18 May, and the letter from the Prime Minister's Private Secretary of 22 May.

2. I agree that we need to reach decisions on the report's interesting recommendations as quickly as possible. In doing so we should obviously take account of the widest possible range of views from ECGD's customers: I therefore agree that the report should be published, without the commercial-in-confidence annexes. The accompanying press release should make clear that it is an independent report, whose findings are being studied by the Government.

3. In view of the FCO's large interest in export promotion and the importance in the report of judgements about the possible impact of the European Single Market

/on

on credit policy, I should like the FCO to participate in the Working Party. I agree with the Chief Secretary's view that the Working Party will need longer than the month you proposed to reach recommendations on these complicated issues. A mid-October target for officials to report seems more realistic.

4. I am copying this minute to the Prime Minister, John Major, George Younger, Richard Luce, Robin Leigh-Pemberton and to Sir Robin Butler.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
25 May 1989



CONFIDENTIAL AND MANAGEMENT IN CONFIDENCE

CABINET OFFICE
OFFICE of the MINISTER
for the CIVIL SERVICE

The Minister of State
Privy Council Office
The Rt. Hon. Richard Luce MP

Horse Guards Road
London SW1P 3AL
Telephone: 01 -270 5929

C89/2639

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1 Victoria Street
LONDON
SW1H OET

23 May 1989

Dear David,

REVIEW OF THE STATUS OF ECGD

Thank you for sending me a copy of your letter of 16 May to John Major.

A principal interest I have in this, of course, is the Next Steps dimension. I am glad to see that the Review considers the application to ECGD's operations of our policy that to the greatest extent practicable the executive functions of Government should be carried out by Executive Agencies. The Project Manager and I have some reservations about some of the analysis in this area, but I am quite content for the Review to be published as a basis for consultation and consideration, on the understanding that, as you say, this does not imply Government endorsement of the Review's findings or, I would add, necessarily of all the analysis. I agree with John Major that the whole range of options should be examined.

Because of our interest I am glad that OMCS will be represented on the proposed Working Party. I hope also that my officials can be associated with yours and those of ECGD in the preparation of the Press Notice which you propose should accompany publication of the Review, and in the preparation of the sort of briefing which no doubt you will be having ready against the questions that may come on publication.

I am copying this letter to those who had copies of yours.

Yours ever,

RICHARD LUCE

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24. V.

BANK OF ENGLAND

With the Governor's Compliments

Bank of England
London EC2R 8AH

The Governor

23 May 1989

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1-19 Victoria Street
London
SW1H 0ET

Dear David,

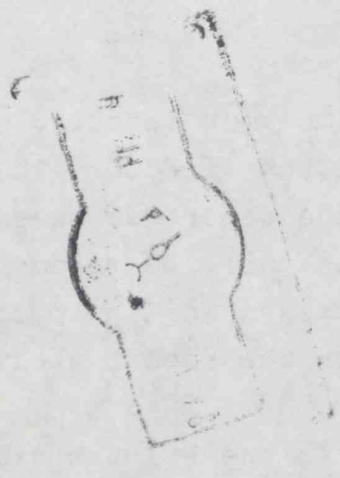
Thank you for copying to me your letter of 16 May to John Major on the Kemp report on the status of ECGD. The procedure which you propose for considering the report seems entirely sensible to me and I confirm that the Bank will be ready to provide a representative on the proposed working party. I also agree that it will be best to publish the report without delay.

I am copying this letter to the Prime Minister, Sir Geoffrey Howe, George Younger, John Major and Robin Butler.

Yours ever

Robin

Trade - ECwD Pt 2.



CONFIDENTIAL AND MANAGEMENT IN CONFIDENCE

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

22 May 1989

Dear Neil,

REVIEW OF THE STATUS OF ECGD

The Prime Minister has seen your Secretary of State's letter of 16 May to the Chief Secretary and the enclosed report of the Review of the Status of ECGD. She has also seen the Chief Secretary's response of 18 May.

The Prime Minister is content with the proposal for early publication of the report, and has noted that the timetable for further work is now under consideration.

I am copying this letter to Carys Evans (Chief Secretary's Office), Stephen Wall (Foreign and Commonwealth Office), Brian Hawtin (Ministry of Defence), John Footman (Bank of England) and Trevor Woolley (Cabinet Office).

Yours,
Paul

(PAUL GRAY)

Neil Thornton, Esq.,
Department of Trade and Industry.

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CONFIDENTIAL

PRIME MINISTER

REVIEW OF THE STATUS OF ECGD

Last August, Lord Young commissioned a study to determine whether changes were needed to ECGD's existing status and organisation.

His letter at Flag A explains that the report has now been completed and proposes:

- immediate publication, making it clear that this does not imply Government endorsement of the report's findings;

- urgent study by an inter-departmental group of the report and the available options, with a view to a report back by late June.

The report itself is at Flag B. I don't suggest you plough through this as it is not an easy read. But you might want to glance at the conclusions and recommendations on pages 153-160 of the first volume. As Lord Young's letter says, there are some fairly radical points here.

The Chief Secretary has now commented (Flag C). He is content with early publication. But he thinks a report back by officials in June is too quick, and suggests a later date of mid-October, thereby foregoing the possibility of legislation in the 1989/90 Session.

You may wish to endorse the proposal of early publication, but simply note that the timetable for further work is now under consideration.

Content to proceed on that basis?

Yes

PAUL GRAY
19 May 1989

EAMAVS

cst.ps/8jm18.5/drft

CONFIDENTIAL AND MANAGEMENT IN CONFIDENCE



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

18th May 1989

Dear David,

THE KEMP REPORT ON THE FUTURE OF ECGD WITH PG/AT?

Thank you for your letter of 16 May, enclosing a copy of the Kemp report.

This report raises important issues, which will need a lot of study. I agree with your procedural suggestion, that it should be remitted for further study to a group of officials under the Chairmanship of ECGD's Chief Executive. The Treasury would be represented by Peter Mountfield. I should like that review to include a wide range of options, including all those listed in the Report (from the "zero option" of discontinuing ECGD's project business altogether, to the other extreme of leaving the whole operation, projects and short-term, in its present form). At the moment I have an open mind as between these different choices, and I am sure that in any public statement we should not prejudge them.

That leads to the question of publication. I entirely agree that it will be right to publish the report in full (less the "Commercial in Confidence" annexes) and as quickly as possible. Otherwise there will be damaging leaks and unnecessary speculation.

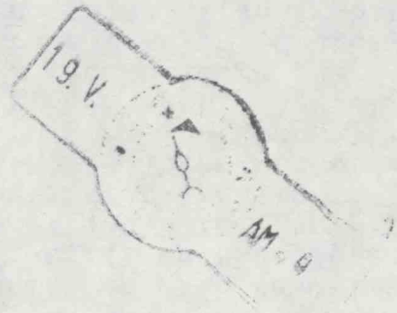
However, I an concerned at the ambitious nature of the the timetable you suggest. I recognise that it is based on the hope of utilising a slot in next year's legislative programme, already reserved for ECGD purposes. However, I suspect that the Lord President would be reluctant to see the proposed ECGD Bill hijacked for these much wider and more conroversial purposes. In

any case, as a practical matter, I think it will take longer than you suggest to reach agreement. Translating that agreement into draft legislation would also take time, and I do not believe a Bill could be ready early in the next session. I propose, therefore, that we let the place in the legislative programme be used for its original purpose (which I wholly support) We should leave longer for the study of options, and should ask officials to report back to us by mid-October, just before the new session opens. Such interim changes as can be agreed immediately can then be introduced in ECGD's 1990 Business Plan, which ministers will be considering in March 1990. I hope, on reflection, that you will feel able to agree.

I am coping this letter to the Prime Minister, Geoffrey Howe, George Younger, Richard Luce, Robin Leigh-Pemberton and to Sir Robin Butler.

Yours ever,

JOHN MAJOR


19. V.

dti

the department for Enterprise

CONFIDENTIAL AND MANAGEMENT IN CONFIDENCE

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

.The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
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Direct line 215 5422
Our ref PS5CLH
Your ref
Date 16 May 1989

Dear John

REVIEW OF THE STATUS OF ECGD

As you are aware, I asked in August last year for a study to be carried out to determine whether any change needed to be made to ECGD's existing status and organisation to enable it better to meet the needs of UK exporters post 1992. I invited Mr R T Kemp, a former ECGD Group Director, to undertake this task. Mr Kemp has now submitted his report to me. A copy is enclosed.

You will see from the report that Mr Kemp has recommended that quite radical changes should be made to both the structure and status of ECGD. In essence, his preferred option is:

(1) that ECGD's Insurance Services Group (dealing with exports sold on short term credit) should be converted into a wholly owned Government company as a first step towards greater co-operation with the private insurance market and a possible eventual privatised shareholding;

(2) this operation should compete with existing private insurers operating in the field of domestic and export credit insurance and that there should be some degree of reinsurance for political risks from HMG, via ECGD;

the Enterprise initiative

(3) that ECGD's Project Group (dealing with capital plant and equipment exports sold on longer term credit) should retain separate Departmental status as much of this business involves difficult national interest judgements and HMG is always likely to have to stand behind the political risks in this area.

Because of the importance of ECGD to the exporting community (and I have been receiving a lot of correspondence from major exporters worried about ECGD's future), these proposals will almost certainly be regarded as controversial and provoke opposition from some quarters who would prefer no changes to be made. I would, therefore, wish to discuss them fully with you and other interested colleagues.

The immediate question is how best to organise consideration of the report so that we can have the benefit of advice from both within and outside Whitehall.

Inevitably, the existence of the report will create a period of uncertainty for ECGD, its customers and staff. I believe it is right that we should try to minimise this period and I, therefore, propose that we set ourselves the target of reaching decisions before the Summer Recess.

In order to achieve this target, and to ensure that we have the benefit of views from a wide range of interests, I suggest that we publish the report in full as soon as possible and announce its existence by means of a press release. In doing so I would make it clear that this is being done to facilitate informed discussion, and does not imply Government endorsement of the Report's findings. This will enable the numerous outside interests (exporters, banks, the insurance market) to continue their inevitable lobbying on a basis which is as fully informed as possible. Such early and full publication (which should, of course, include ECGD's own staff) will also avoid the risk of unfounded rumours or false fears. Until it is published, I should be grateful if circulation of the Report could be kept to the absolute minimum and no comments made to outside parties.

I further propose that we should invite officials - from ECGD, Treasury, DTI, the Bank, and possible FCO, OMCS and MOD - to form a working party under the Chairmanship of ECGD's Chief Executive to review the report and make appropriate recommendations by, say, late June. This report could also take on board the views of outside interests which, as far as possible, should be fielded by ECGD.

dti

the department for Enterprise

I should be grateful for your urgent comments on the procedure proposed so that the necessary arrangements can be put in hand as soon as possible.

I am copying this letter to the Prime Minister, Geoffrey Howe, George Younger, Robin Leigh-Pemberton and Robin Butler.

Yours ever,

Norman

the Enterprise initiative


16. V.

ECPC

MINISTRY OF DEFENCE WHITEHALL LONDON SW1 2HB

MO 32/8L

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

21st February 1989

CDP 2211

Dear John,

ECGD'S TRADING RESULTS: 1987-88

Thank you for copying to me your minute of 9th February to the Prime Minister commenting on the ECGD trading accounts for 1987/88. The continued international debt crisis clearly poses real problems for the management of ECGD finances and I look forward to seeing David Young's proposals in due course. I hope, however, that we shall continue to try to strike a reasonable balance between a proper concern for the totality of ECGD risk and the particular and sometimes broader considerations that often underlie major defence sales. ECGD support has been of great importance in helping achieve our major national successes in defence exporting and I am naturally concerned that this should not be unduly inhibited in any revised arrangements under consideration.

I am copying this letter to the Prime Minister, Geoffrey Howe and David Young and to Sir Robin Butler.

Yours ever,
George

George Younger

The Rt Hon John Major MP

TRADE: LE CAD pt 2

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

10 February 1989

ECGD'S TRADING RESULTS: 1987-88

The Prime Minister was grateful for the Chief Secretary's minute of 9 February. She has noted the ECGD's 1987-88 results, and welcomes the action proposed by the Secretary of State for Trade and Industry for looking at the totality of ECGD's exposure.

I am sending copies of this letter to Neil Thornton (Department of Trade and Industry), Stephen Wall (Foreign and Commonwealth Office) and Brian Hawtin (Ministry of Defence).

(PAUL GRAY)

Miss Carys Evans,
HM Treasury.

cst.ps/1jm9.2/dfts

Prime Minister CC PW.
Content to note and welcome the action proposed at X above? PRC 9/2

FROM: CHIEF SECRETARY
DATE: 9 February 1989

PRIME MINISTER

ECGD'S TRADING RESULTS : 1987-88

I felt I ought to give you early notice that the trading accounts of ECGD for 1987-88 which were laid before the House last week, make sombre reading. The Department recorded a trading loss of £86 million for the year and, more seriously, show negative reserves of £213 million so that it is technically insolvent. Its borrowing from the Consolidated Fund rose to £1164 million at March 1988. Although this does not technically count as public expenditure it has to be financed and limits the Chancellor's room for manoeuvre in future budgets. In the current financial year, ECGD is drawing a further £700 million from the Consolidated Fund to honour its guarantees to exporters. These drawings will continue until at least 1992.

2. The loss reflects the fact that, in spite of the progress that ECGD has made in developing its business, claims by exporters on previous business continue to run well ahead of recoveries and income from current premiums. The deteriorating situation in debtor countries means that ECGD is also having to increase its provisions against future losses in line with the recommendations of accountants Peat Marwick and with best commercial practice. The National Audit Office has this year not qualified the accounts after last year's criticisms.

3. Inevitably, we must expect adverse Press comment when ECGD's Annual Report is published this week. We shall of course need to reassure people that the Government stands fully behind ECGD financially. The results, however, are bound to draw attention to the riskiness of ECGD's business. In plain language, the taxpayer foots the bill if a portion of ECGD's £10 billion of existing claims in riskier markets is not repaid.

4. The figures reflect of course to a large extent the continued impact of the international debt crisis. Many developing countries have made disappointing progress in improving their ability to service overseas borrowing. Even those which have not rescheduled formally are often having to struggle to pay their debts - witness the stream of requests we receive for concessional terms. The global environment for ECGD's business, therefore, remains a highly risky one. We need to take this fully into account in our future decisions if we are to avoid piling up further unacceptable risks at a potentially heavy ultimate cost to the taxpayer.

5. This is an ever present danger with separate ad-hoc decisions about individual cases, as at present. However, David Young will soon be proposing ways of looking at the totality of ECGD's exposure, so as to put these decisions into a wider context. I believe these will be most helpful. Meanwhile I hope colleagues will co-operate in keeping further high-risk additions to ECGD's portfolio to a minimum.

6. I am copying this to David Young, Geoffrey Howe and George Younger.

CEvans

JOHN MAJOR

approved by the Chief Secretary and signed in his absence

Trade - ECAD



cst.ps/15pw22.12

CONFIDENTIAL

cc P.U.

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

CDP
23/12.

Neil Thornton Esq
Private Secretary
to the Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

22 December 1988

Dear Neil,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period July-September 1988. The attached report identified the potential problem areas and updates the report attached to Carys Evans's letter of 22 September.

Since the last report the proposal to provide cover for the United Scientific Holdings contract to supply Scorpion tanks to the Cameroon Government, has been the subject of Ministerial correspondence.

The Chief Secretary has agreed that cover should be extended to Biwater Projects Ltd for the completion of a scheme to provide drinking water in the Niger State. That concession was agreed because of our political commitment to Nigeria and following its agreement with the IMF on a Stand-by Arrangement. Any further ECGD cover for Nigeria will have to be considered in due course against the normal criteria for the resumption of DX cover.

The pressure on the limited balance remaining within the Turkish market limit continues with an indication of cover now required for the Omerli water treatment project and the prospects of a credit package for defence equipment is being considered. A market review will take place early next year.

A reservation of cover has now been made for the prospective air defence package which is being negotiated with the Government of Zimbabwe.

ECG has agreed that ECGD might continue to give indications of cover in respect of contracts on business with Brazil, up to a limit of £5 million only. Any cover for contracts above that limit is conditional upon signature of the bilateral debt agreement. Ministers will consider shortly a proposal by MOD for cover to be offered for the proposed sale of MEL electronic equipment to the Brazilian Air Force, under the defence allocation.

The agreed list of priority defence projects for the supplementary Section 2 account for defence sales is at Annex B. MOD is continuing to discuss with the German banks, cover arrangements for the German share of the Tornado aircraft to Jordan. Attempts are still being made to persuade the Italians to cover their share of the deal. The deadline for making the financing arrangements effective has been extended to 31 January 1989.

I am copying this letter to Charles Powell (No.10), Brian Hawtin (MOD), Lyn Parker (FCO), John Millet (ODA) and T Downing (Bank of England).

Yours sincerely,

Peter Wanless

PETER WANLESS
Assistant Private Secretary

EXPORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts Quarterly Report of Potential Problem cases July - September 1988.

A Cases which were included in the last Quarterly Return

1 Cameroon

United Scientific Holdings (USH) have signed a contract to supply Scorpion light armoured vehicles to the Cameroon Government. ECGD had made clear to USH that there was no cover available. The contract with a DML of £46m, has been included at the top of the MOD priority list of prospective defence contracts for the special defence allocation. The Chief Secretary to the Treasury has proposed that in the circumstances the exposure should be shared equally between ECGD, USH and the Cameroonians, subject to the Cameroonians clearing their arrears of some £15m to ECGD. (Some £7m of the arrears relate to a contract involving a long-standing dispute and ECGD considers that to be in a different category).

In addition to the USH contract there were other potential defence contracts (for which ECGD cover would not be required) and substantial prospective civil contracts with ATP support offered. A recent market review has resulted in a new market limit of £25m with a contract value limit of £5m. But further allocation of cover will depend on the Cameroonians agreeing a satisfactory programme for the clearance of arrears and a review of their progress under the IMF programme, probably in February 1989.

2 Kenya

The market limit continues to be under pressure, with a substantial number of small civil contracts for which indications have been given, the majority with ATP (in particular, Nairobi water supply project (£10m), blood plasma processing plant (£23m) and Western Kenya pipeline extension (£66m)). Indications have been given for BAe aircraft and to Marconi for the supply of

communications equipment. Further indications have been given for prospective defence contracts (Tucano aircraft - approximately £31 million and FH70 guns - approximately £15 million but that contract might not now go forward). The defence and civil contracts will be competing on a first come, first served basis for the limited cover available.

EGC has agreed a revised Section 2 market limit to £350m.

	£m	
Section 2 Market Limit (Grade c)	350	
Firm Business	191	(+103* outside ML)
Offers/Reservations	136	
Balance available	23	
Indications	260	

* Cover agreed by Ministers for Vosper Thorneycroft patrol boats outside market limit.

3 Nigeria

ECGD medium term cover is not appropriate at this stage of Nigeria's attempts to develop a revised recovery programme. The medium term credit package announced in July 1987 is therefore no longer valid. Exceptionally Ministers have agreed the extension of cover to Biwaters for the Niger State Water Project, and the loan agreement has now been signed.

4 Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June 1987. MOD considers that this deal might be resurrected and it has therefore been included on the MOD priority list of prospective contracts. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no

presumption that cover at the earlier level of £360 million for new frigates will be available, particularly if in the meantime indications of cover have been given for other business. The Section 2 balance is sufficient for other individual contracts on a first come, first served basis but there could be problems if several of the larger contracts became firm simultaneously. If the frigate deal was resurrected it would be necessary to consider providing cover under the special defence allocation; the country limit would then have to be reviewed with the presumption that a significant reduction would have to be made, thus prejudicing prospects for covering larger civil projects.

	£m
Section 2 market limit (Grade D)	180
Firm Business	23
Offers/Reservations	73
Balance available	84
Indications	1,100

5 Turkey

A balance of some £158 million remains within the market limit of £750 million but there is a substantial amount of civil business in prospect. It is now clear that the third Bosphorus Bridge project will not go forward for a year or two, but negotiations continue on the contract for the Istanbul Expressway (DML £110m). Marconi and Plessey are competing for a contract for HF radios (DML £88 million). The HF radio defence contract has been included on the list of priority contracts for cover under the special defence allocation, but it would be included under the market limit if sufficient cover was available when an offer had to be made; but that would squeeze out civil projects including the Omerli water treatment project (DML about £120m). The BAe bid for Rapier missiles (DML £100million) has been lost.

	£m
Section 2 Market Limit (Grade C)	750
Firm Business	438
Offers/Reservations	154
Balance available	158
Indications	900

6 Venezuela

EGC recently agreed an increase in the market limit to £200m, with a ceiling of £30m DML on individual contracts. A prospective contract for the sale of BAe Hawk aircraft with an estimated DML of £245m could not be accommodated within the market limit and is therefore included on the list of priority contracts for the special defence allocation; but the contract is no longer imminent.

	£m
Section 2 Market Limit (Grade D)	200
Firm Business	55
Offers/Reservations	22
Balance	123
Indications	200

7 Zimbabwe

Negotiations continue on the prospective air defence package (radar and Rapier missiles) with a DML of approximately £125 million for which a reservation of cover under the market limit has now been made. There would be insufficient cover remaining within the market limit for the prospective Hawk contract (DML about £220m) or the alternative Harrier (DML about £286m) which the Government of Zimbabwe were also considering. There is a substantial amount of civil business including two prospective contracts, one with ATP, which might require cover shortly. The balance of cover available is limited but sufficient cover remains currently to accommodate the immediate requirements. EGC is reviewing the market limit.

	£m	
Section 2 Market Limit (Grade C)	400	(proposed £430)
Firm Business	158	
Offers/Reservations	160	
Balance available	82	
Indications	300	

B New Cases

1 Brazil

Ministers agreed to the introduction of DX cover in August 1988 immediately the IMF declared the SBA effective and before a bilateral agreement with ECGD, because of claims that other export credit agencies were proposing similar action. It subsequently transpired that FRG and the USA did not resume cover and France has now come off cover. The Brazilians are delaying signature of bilateral debt agreements because of a problem with the Brazilian constitution. The Bank of England were also concerned about the economy. EGC has agreed that indications of cover or offers in excess of £5m under the DX facility should be conditioned that effectiveness would depend upon signature of the Brazilian bilateral. The Secretary of State for Defence has written to Ministerial colleagues for agreement to allow cover for the proposed sale by MEL division of Philips Electronics and Associated Industries of electronic equipment to the Brazilian Air Force, to be provided under the Section 2 defence allocation.

ANNEX A

PROJECT BUSINESS

	1986/87 £m	1987/88 £m	1988/89 £m
Income	377.88	278.30	324.32
of which premium	98.18	72.50	134.95
Expenditure	634.90	806.71	680.23
of which claims	617.40	791.80	657.90
Net cash flow	(257.02)	(528.41)	(355.90)
Consolidated Fund balance	(96.80)	(663.81)	(1,114.58)
Net cash flow excluding refinancing	(351.02)	(528.41)	(420.60)
Consolidated Fund balance excluding refinancing	(226.54)	(663.81)	(1,182.89)

NOTES

(i) Bracketed figures indicate a deficit or charge.

(ii) Income includes, in addition to premium, moratorium interest from rescheduled sovereign debt.

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ANNEX B

PRIORITY DEFENCE PROJECTS:

SUPPLEMENTARY SECTION 2 ACCOUNT FOR ARMS SALES

Position as at: 14 November 1988

ALLOCATION FOR SUPPLEMENTARY ACCOUNT	£1bn
	DML £m
FIRM BUSINESS:-	
Sub Total	-
RESERVATIONS:-	
Jordan-Tornado IDS	£480m (maximum authorised by Ministers)
Sub Total	£480m
BALANCE AVAILABLE	£520m
INDICATIONS:-	
None	

PRIORITY AND LIKELY TIMING OF PROSPECTIVE DEFENCE CONTRACTS

CONTRACT		DATE	DML £m
1	Cameroon - Scorpion	Negotiating	£50m
2	Brazil - MEL/Philips	Negotiating	£45m
3	Turkey - HF Radio	Winter 88/9	£88m
4	Venezuela - Hawk	Negotiating	£245m
5	Pakistan - Type 23s	?	£360m

23. XII AM

TRADE: ECCD PR2

cst.ps/2ce/22.9/ec

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CDP
23/9.

Treasury Chambers, Parliament Street, SW1P 3AG

Neil Thornton Esq
Private Secretary to the
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

22 September 1988

Dear Neil,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period April-June 1988. The attached report identified the potential problem areas and updates the report attached to Jill Rutter's letter of 17 June.

Since the last report, the resumption of DX cover for Brazil, with a limit of £250 million, has been announced. The announcement followed signature of a Paris Club multilateral agreement and ratification by the IMF of Brazil's adjustment programme in a Stand-by Agreement. Two new markets have been included in Section B. Ministers are likely to be required shortly to consider cover under the special defence allocation for the sale of Scorpion light armoured vehicles for the Cameroon Government.

At Annex B of the report is the EGC agreed list of priority defence projects for the supplementary Section 2 account for arms sales. Ministers agreed at the meeting on 26 July that the monitoring arrangements for the special defence allocation should include provision for listing contracts logged against the facility and a priority list of prospective defence contracts. The two new prospective contracts for the sale of arms to Cameroon and Venezuela have been included on the priority list.

At the meeting on 26 July, Ministers also agreed that in negotiations with the Jordanians, MOD should limit ECGD credit exposure to as low a level as possible, with an upper fallback limit of £480 million. The Sales Agreement and the Memorandum of Understanding for the Tornado aircraft was signed last week. Discussions on the financing terms, within the maximum approved by Ministers, are continuing.

Officials have corresponded about the proposed MOD Ministerial visit to Egypt and Jordan in particular, which are designed to promote exports. ECGD have made clear that they are not prepared to accept any further exposure on those markets. In other cases it is essential that in preparing Ministerial briefing their advice is sought about the availability of cover. Following the end of the Iran/Iraq conflict Ministers have endorsed the EGC recommendations to marginally increase both the Iranian market limit and the horizon of risk. ECGD will submit a market review of Iraq to EGC shortly. Discussions on the Malaysian defence package are continuing; MOD will report progress in due course.

I am copying this letter to Paul Gray (No.10), Brian Hawtin (Defence), Stephen Wall (FCO), John Millet (ODA) and Trevor Woolley (Cabinet Office) and T Downing (Bank of England).

Yours sincerely,

P. Warless

PP **MISS C EVANS**
Private Secretary

aef2.cj/jones/minute/egc

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EXPORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts Quarterly Report of Potential Problem cases April - June 1988.

A Cases which were included in the last Quarterly Return

1 Kenya

The market limit continues to be under pressure, with a substantial number of small civil contracts for which indications have been given the majority with ATP; indications have been given for BAe aircraft and to Marconi for the supply of communications equipment. Further indications have been given for prospective defence contracts (Tucano aircraft - approximately £31 million and FH70 guns - approximately £15 million although that might not now materialise). The defence and civil contracts will be competing on a first come, first served basis for the limited cover available.

EGC recently agreed the proposal to combine Sections 1 and 2 and the small increase in the revised Section 2 market limit to £350m.

	£m
Section 2 Market Limit (Grade c)	350
Firm Business	208 + 103* (outside ML)
Offers/Reservations	116
Balance available	26
Indications	358

* Cover agreed by Ministers for Vosper Thorneycroft patrol boats outside market limit.

2 Nigeria

DX cover will be considered only if payments under the existing bilateral debt agreement are current, an effective IMF programme and a Paris Club rescheduling agreement are implemented and ECGD are able to negotiate a new bilateral rescheduling agreement. Although there is a substantial amount of prospective defence business, defence sales are not generally eligible for DX cover, and no cover will be available for such business with Nigeria.

3 Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June 1987. MOD consider that this deal might be resurrected and it has therefore been included on the MOD priority list of prospective contracts. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no presumption that cover at the earlier level of £360 million for new frigates will be available, particularly if in the meantime indications of cover have been given for other business. The Section 2 balance is sufficient for other individual contracts on a first come, first served basis but there could be problems if several of the larger contracts became firm simultaneously. If the frigate deal was resurrected it would be necessary to consider providing cover under the special defence allocation; the country limit would then have to be reviewed with the presumption that a significant reduction would have to be made, thus prejudicing prospects for covering larger civil projects.

	£m
Section 2 market limit (Grade D)	180
Firm Business	37
Offers/Reservations	84
Balance available	59
Indications	1112

4 Turkey

A balance of some £140 million remains within the market limit of £750 million with substantial prospective civil business. EGC confirmed recently the market limit of £750m although it was generally accepted that the third Bosphorus Bridge project would not go forward for a year or two. Negotiations continue on the contract for the Istanbul Expressway (DML £110m). UK companies are also competing for two prospective defence contracts (HF radio (DML £88 million) and Rapier missiles (DML £100 million)). Both the defence contracts feature on the list of priority contracts for cover under the special defence allocation.

	£m
Section 2 Market Limit (Grade C)	750
Firm Business	440
Offers/Reservations	168
Balance available	142
Indications	785

5 Zimbabwe

Negotiations continue on the prospective air defence package (radar and Rapier missiles) with a DML of approximately £125 million but there would be insufficient cover for the prospective Hawk contract (DML about £220m). There is a substantial amount of civil business including two prospective contracts, one with ATP, which might require cover shortly. The balance of cover available is limited but sufficient cover remains currently to accommodate the immediate requirements. ECGD will consider reviewing the market limit shortly.

	£m
Section 2 Market Limit (Grade C)	400
Firm Business	194
Offers/Reservations	0
Balance available	206
Indications	285

B New Cases

1 Cameroon

United Scientific Holdings (USH) have signed a contract to supply Scorpion light armoured vehicles to the Cameroon Government. ECGD have made clear to USH that there is no cover available currently. The contract with a DML of £46m, is at the top of the MOD priority list of prospective defence contracts which might be included under the special defence allocation.

ECGD are imposing administrative delay on all applications for medium term cover; a decision on the resumption of cover will be taken when the outcome of the IMF negotiations is clearer and including the question of whether or not they will need to seek a Paris Club rescheduling agreement. In addition to the USH contract there are other potential defence contracts (for which ECGD cover will not be required) and substantial prospective civil contracts with ATP support offered. It might be difficult to find cover for all the larger prospective civil projects, especially if the market limit is constrained in consequence of the use of the special defence allocation for the USH Scorpion sale.

	£m
Section 2 Market Limit (Grade D)	250
Firm Business/Reservations	85
Balance	165
Indications	215

2 Venezuela

EGC recently agreed an increase in the market limit to £200m, with a ceiling of £30m DML on individual contracts. A prospective contract for the sale of BAe Hawk aircraft with an estimated DML

of £245m could not be accommodated within the market limit and is therefore included on the list of priority contracts for the special defence allocation.

	£m
Section 2 Market Limit (Grade D)	200
Firm Business	0
Offers/Reservations	92
Balance	108
Indications	100

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ANNEX A

PROJECT BUSINESS

	1986/87 £m	1987/88 £m	1988/89 £m
Income	377.88	278.30	324.32
of which premium	98.18	72.50	134.95
Expenditure	634.90	806.71	680.23
of which claims	617.40	791.80	657.90
Net cash flow	(257.02)	(528.41)	(355.90)
Consolidated Fund balance	(96.80)	(663.81)	(1,114.58)
Net cash flow excluding refinancing	(351.02)	(528.41)	(420.60)
Consolidated Fund balance excluding refinancing	(226.54)	(663.81)	(1,182.89)

NOTES

(i) Bracketed figures indicate a deficit or charge.

(ii) Income includes, in addition to premium, moratorium interest from rescheduled sovereign debt.

aef2.cj/jones/minute/egc.3

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ANNEX B

PRIORITY DEFENCE PROJECTS:

SUPPLEMENTARY SECTION 2 ACCOUNT FOR ARMS SALES

Position as at: 24 August 1988

ALLOCATION FOR SUPPLEMENTARY ACCOUNT	**£1bn**
	DML £m
FIRM BUSINESS:-	
Sub Total	-
RESERVATIONS:-	
Jordan-Tornado IDS	£480m (maximum authorised by Ministers)
Sub Total	£480m
BALANCE AVAILABLE	£520m
INDICATIONS:-	
None	

PRIORITY AND LIKELY TIMING OF PROSPECTIVE DEFENCE CONTRACTS

	CONTRACT	DATE	DML £m
1	*Cameroon - Scorpion	Negotiating	£50m
2	Turkey - HF Radio	Autumn 88	£88m
3	Venezuela - Hawk	Negotiating	£245m
4	Turkey - Rapier	Winter 88/9	£100m
5	*+Pakistan - Type 23's	?	£360m

* Use of the special defence allocation could prejudice prospects of cover for large potential sales in these markets.

+ ECGD does not accept this as a priority project.

cst.ps/2ce/22.9/ec

TRADE: ECGD PT2

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers Parliament Street SW1P 3AG

Secretary of State for Trade and Industry

Department of Trade and Industry



report attached to Bill Rutter's letter of 17 June

Since the last report, the resumption of DA cover for Brazil,

include provision for libeling contracts lodged against the

and Venezuela have been included on the priority list

010/4210

CGPC

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Treasury Chambers, Parliament Street, SW1P 3AG

Neil Thornton Esq
Private Secretary to the
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

CDP 17/6

17th June 1988

Dear Neil,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period January to March 1988. The attached report identifies the potential problem areas and updates the report attached to my letter of 23 March. – Attys

There have been a number of developments since the last report and there has been Ministerial correspondence on both the Jordanian and Malaysian issues in the last week. The Ministry of Defence's letter of 13 June and the brief for the Prime Minister's discussion with King Hussein, advise the Prime Minister not to enter into detailed discussion on the credit arrangements necessary if the Germans refuse to accept their share of the sale of Tornado aircraft. The extent of ECGD cover will need to be considered further in the light of the German and Italian decisions on support for the deal. The Ministers directly concerned with the Malaysiqan defence package will, as proposed in the letter of 12 June from No. 10, consider the various issues shortly.

I said in my letter of 23 March that Ministers will have to consider any resurrection of ECGD cover for the sale of frigates to Pakistan before negotiations resume. The Treasury has proposed that DX cover for Nigeria should be made available only if payments are current and an IMF programme is implemented.

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It is unlikely that the contract for the third Bosphorus Bridge will be awarded to the UK, but the market limit will come under pressure if competing defence and civil projects go forward. ECGD are preparing a market review which will be considered by EGC shortly. The Zimbabwean market limit is sufficient for the more immediate prospective contracts, but it might come under pressure if more than a limited amount of the prospective business goes forward.

EGC have now considered further the practical arrangements for managing the special Section 2 defence allocation. A report of the points which require further Ministerial consideration will be available shortly.

I am copying this letter to Paul Gray (No.10), Brian Hawtin (Defence), Tony Galsworthy (FCO) , John Millet (ODA) and Trevor Woolley (Cabinet Office) and T Downing (Bank of England).

Yours sincerely

Jill Rutter

for JILL RUTTER
Private Secretary

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EXPORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts
Quarterly Report of Potential Problem Cases January-March 1988

A Cases which were included in the last Quarterly Return

1. Brazil

Westland Helicopters are competing with the French company Aerospatiale for the sale of helicopters to the Brazilian Navy. Discussions on a Paris Club rescheduling will take place when an SBA is agreed but currently no medium/long term ECGD cover is available for this market. When DX cover is introduced defence sales will not qualify for cover. Ministers have, however, agreed to consider offering cover for this prospective contract if there is clear evidence of French competition. French officials continue to maintain that official credit support is not available for the French competitive bid at present. However, their position will change quickly once rescheduling is agreed. France has fewer inhibitions about lending for military purposes. An early submission will be made to Ministers once rescheduling is near. Other prospective contracts which will require ECGD cover when DX cover is available include Rolls Royce Spey Engines and Airbus aircraft.

2. Jordan

Negotiations on the terms of the prospective contract for the sale of Tornados to Jordan and the financing arrangements are nearing completion; cover has been agreed in principle up to a maximum DML of £385 million for this contract under the Section 2 defence allocation. The amount of cover required cannot be determined until the negotiations are finalised and until the Germans reach a decision on the extent of their participation. If the Germans continue to refuse to offer official support the position would have to be considered further. On current assumptions the absence of German and Italian official support might require an increase in ECGD liability up to some £530 million. ECGD are currently reviewing the general cover arrangements for Jordan.

3. Kenya

The market limit is under pressure with a substantial number of small civil contracts for which indications have been given the majority with ATP; indications have been given for BAe aircraft and to Marconi for the supply of communications equipment. Further indications have been given for prospective defence contracts (Tucano aircraft - approximately £31 million and FH70 guns - approximately £15 million). The defence and civil contracts will be competing on a first come, first served basis for the limited cover available.

ECGD will conduct a market review shortly but an increase in the limit is unlikely to be recommended. Some flexibility might be made available by incorporating the Section 1 balance of approximately £50 million into the Section 2 limit.

	£m
Section 2 Market Limit (Grade C)	270
Firm Business	211 + 103* (outside ML)
Offers/Reservations	8
Balance available	51
Indications	293

* Cover agreed by Ministers for Vosper Thorneycroft patrol boats outside market limit.

4. Nigeria

DX cover of £200 million for capital goods and equipment plus additional support for existing projects and for new projects will be made available if payments are current and an IMF programme is implemented. Although there is a substantial amount of prospective defence business, defence sales are not generally eligible for DX cover, and no cover will be available for defence sales to Nigeria.

5. Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June 1987. An increase in the market limit

to £150 million was agreed on the assumption that the proposed sale was unlikely to be resurrected. Pakistan is however still considering whether to purchase UK frigates. A positive decision would lead to proposals to revive the substantial HMG backed credit package but that is unlikely. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no presumption that cover at the earlier level of £360 million for new frigates will be available, particularly if in the meantime indications of cover have been given for other business. Demand for cover has been substantial and the Section 2 balance has been reduced to £46 million. If the frigate deal was resurrected it would be necessary to consider providing cover under the special defence allocation.

	£m
Section 2 market limit (Grade D)	150
Firm Business	46
Offers/Reservations	56
Balance available	46
Indications	935

6. Turkey

A balance of £135 million remains within the market limit of £750 million with substantial prospective civil business. EGC agreed recently to increase the market limit by £150 million to provide cover for the UK bid for the third Bosphorus Bridge and the contract for the Expressway. The contract for the Bridge might not be awarded to the UK but negotiations continue on the Expressway. UK companies are also competing for two prospective defence contracts (HF radios (£80 million) and Rapier missiles (£100 million). ECGD will conduct a further market review shortly.

	£m	
Section 2 Market Limit (Grade C)	750	
Firm Business	467	
Offers/Reservations	148	
Balance available	135	
Indications	632	(including Bosphorus Bridge)

A New cases

1. Zimbabwe

Negotiations continue on the prospective air defence package (radar and Rapier missiles) with a DML of approximately £125 million. There is a substantial amount of civil business including two prospective contracts, one with ATP, which might require cover shortly. The balance of cover available is limited but sufficient cover remains currently to accommodate the immediate requirements. ECGD are reviewing the market limit.

	£m
Section 2 Market Limit (Grade C)	400
Firm business	189
Offers/Reservations	14
Balance available	197
Indications	176

ANNEX

PROJECT BUSINESS

	1986/87 £m	1987/88 £m	1988/89 £m
Income	377.88	155.02	869.7
of which premium	98.18	69.3	103.1
Expenditure	634.90	806.8	778.3
of which claims	617.40	789.9	755.7
Net Cash flow	(257.02)	(651.8)	91.3
Consolidated Fund balance	(96.80)	(785.0)	(754.0)
Net cash flow excluding refinancing	(351.02)	(651.8)	(515.2)
Consolidated Fund balance excluding refinancing	(226.54)	(785.0)	(1,385.1)

NOTES

(i) Bracketed figures indicate a deficit or charge.

(ii) Income includes, in addition to premium, moratorium interest from rescheduled sovereign debt. The large income figure for 1988/89 is attributed to the high level of new refinancing forecast to take place, hence the forecast positive cash flow for the year.



Fade
ECGD pt 2

OIO

cc PC
checked with CDP - not for BOX

D H Twyford
Director
Chairman
Project Group Board

ECGD

CONFIDENTIAL

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3 June 1988

P Mountfield Esq
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CDP
3/6.

Dear Peter,

ECGD VISIT TO TURKEY

1 As you may know, I have just returned from a week's visit to Turkey and the purpose of this letter is to let you have my immediate impressions. The objective of the visit was to make an assessment of the current economic situation and policy and also to try to obtain some indication from the Turkish Administration of their short term priorities in the light of the heavy demand for our cover. The visit came at a useful time as a follow-up to the Prime Minister's visit and also because some clearer idea of the Turkish Government's economic policy is now beginning to emerge. Overall, the visit was reassuring: the Administration appeared to have got a firmer grip on the situation than we had imagined and it would seem that Prime Minister Ozal is throwing his weight behind his more cautious economic advisers. It is also likely that many of the major projects that have been put to us for consideration will now be deferred but we will be left with a problem as to how to handle the defence business which seems likely to go ahead. Derek Coombe is preparing a short paper reviewing the current Section 2 (National Interest) arrangements and we will also be consulting our Advisory Council to see if they have any appetite to increase the rather low Section 1 limit. I do not think that major adjustments are called for but we will be seeking greater flexibility as to how the balance of the £800m medium term limits should be allocated. In particular, it would seem to be unnecessary to reserve too large a proportion of the remaining cover for the potential contract for the third Bosphoros Bridge Project which seems unlikely to come to the UK in the near future.

2 In Ankara we called on a number of the senior officials in the economic departments and we were able to gain a good insight into current thinking on economic policy. The visit was particularly timely as the day before our calls the Prime Minister and the President had reviewed the economic situation with their Chief Advisers. In Istanbul we were able to compare notes with some of the commercial bankers and local contractors and Derek Coombe and also took the opportunity of attending the meeting of the World Economic Forum where the speakers included a number of Ministers - including the Prime Minister and his brother, Mr Yusuf Ozal. At the final social function relating to the conference I was able to have a few words with Prime Minister Ozal in order to try to clarify the situation about which major new projects were likely to go ahead. In both Ankara and Istanbul we were able to meet the rather impressive "two passport technocrats" who have been recruited by Ozal in his policy of reversing the brain-drain now occupy important economic posts. In my view, whilst their presence undoubtedly induces some resentment from those below, they have added very considerably to the intellectual quality of the Administration.

3 **Economic Situation** - It is clear that both the Administration and the commercial sector had grown nervous about developments in the economic field during 1987 and the early part of this year. Our apprehensions about the public sector deficit and the heavy debt burden were fully understood but it seems that nerves are now very much calmer. Even the commercial critics of the Government policy do not seem to be worried about a serious economic crisis this year. Everyone to whom we spoke seemed confident that the external economic front situation was manageable. It seems clear that the Administration will have no serious problem in closing this year's financing gap by further borrowings overseas. Following the success of the German bond issues, it now looks as though Turkey will be turning to the Japanese market in order to raise similar untied finance. The other factor which has induced greater optimism has been the buoyancy of exports during the first quarter which have, again, exceeded expectations. The much more intractable problem seems to be that of reducing the public sector deficit. This is to be tackled at each end. Decisions have been taken to reduce the amount of new public borrowing (and, in particular, the number of new investment projects to be undertaken is to be very severely rationed - see below). Attempts are being made to increase the efficiency of the State Economic Enterprises and also to sell these off to the private sector where feasible. I suspect that these reforms will take some time to produce tangible results and there are obvious limitations on the pace of privatisation due to the thinness of the local capital market. On the income side, the Treasury is to give priority to increasing the tax yield, mainly by closing loopholes and tackling evasion. Whilst those responsible again spoke confidently, I suspect that these reforms will, again, take some time before they are fully effective.

4 **Developments in Economic Policy** - From our discussions with key officials, including the Governor of the Central Bank (Saracoglu) and the Under Secretary at the Treasury (Canevi), we were able to put together a fairly clear picture of the economic policy that is now being put in place to restore the situation following the lapses in 1987 (which were openly blamed on general election indulgence). First of all, growth is to be limited to about 5% for the next two or three years. The main objective is to reduce inflation to the level of about 20% in the foreseeable future (no precise target was quoted). No new investment projects will be undertaken over the next two/three years (with the exception of some defence projects and - possibly - projects financed on the BOT basis). This will effect both the public sector borrowing requirement and the foreign debt situation. These policies will be maintained in the face of the forthcoming municipal elections (largely because the Government sees its political future tied to the level of inflation and does not believe that it can buy itself out of its current unpopularity by greater spending).

5 **Defence Priorities** - Mr Ozal made clear that key defence orders would be exempted from the general embargo on new projects. He confirmed this to me in private when I spoke to him about prospects for British exporters. Mr Erdem (Chairman of Defence Industry Support and Development Fund - DIDA) stated publicly that further contracts would be placed for certain projects but these would normally involve foreign investment and co-production as well as offset. He indicated that now the contract for AP Vehicles had been placed with the USA the next priorities would include a further deal with the USA on missiles and the HF radio contract where the front runners are Marconi and Plessey. Whilst he mentioned a long list of other possibilities, most of these seem likely to be deferred until next year or even later with the possible exception of a contract (in which Pilkington are interested) for the optical equipment relating to the APVs. Altogether he indicated that the total programme might involve an expenditure of some $11bn over the next 10 years, but only a limited number would proceed over the next year or so. The longer term prospects involve a number of interest to UK firms, including fire control equipment, radar, missiles (Rapier), helicopters, etc. But the impression gained was that we would not be asked to give early commitments for these.

6 **Civil Projects** - Mr Yusuf Ozal stated clearly that the ban on new projects for at least two years was to enable them to reduce public expenditure. However, projects already underway would be completed as soon as possible. Unfortunately this clear statement was undermined by the answer that Prime Minister Ozal gave to a question at the World Economic Forum conference. He implied that exceptions might be made for new BOT projects. However, my personal view is that he had in mind the long standing BOT contracts which have been in negotiation for three years or more in the power sector. Mr Canevi had told us quite clearly that whilst new BOT projects would be treated in a similar way to ordinary business, the Government hoped to conclude one of the major contracts for a thermal power station which has been under negotiation for some time, and possibly two or three of the smaller hydro schemes which are also under discussion. This will

be to prove that the BOT concept really worked. Both he and Mr Saracoglu confirmed that in their view BOT would not be appropriate for highway projects such as the Tarmac/Wimpey expressway contract. In the meantime, it was clear from statements emanating from Mayor Dalan that he still had hopes of pursuing both the third Bosphorus Bridge and the related expressway projects. In view of this confusion, I took the opportunity of asking Prime Minister Ozal which projects he thought might go ahead in which UK firms were interested so that I could report this back to our Prime Minister. I asked him whether it was intended to defer the Bosphorus Bridge Project. He hesitated but chose not to answer this question directly. However, he did say that he thought that the expressway project would come to the UK and quite soon and he also confirmed that some defence projects were likely to be placed with the UK firms. My interpretation of this is that either the contract for the third bridge is to be placed with the local Turkish syndicate who are the lowest bidders, or - more likely - that the project is to be placed on the back burner.

7 My general conclusion is that the economic policy is now moving in the right direction but the room for manoeuvre is limited and the situation will have to be monitored very carefully. Nevertheless, the Administration seems to be well aware of the main dangers and if they maintain their resolution in the run up to the municipal elections (the timing of which will be at their option) then the dangers of a serious crisis may be receding. Moreover, even if for domestic reasons one or two exceptions are made, the intention to drastically reduce the number of new projects to be undertaken, will add to external confidence and increase their chances of closing the financing gap. As I have said, we will be putting forward papers to the Export Guarantees Committee reviewing our country arrangements but it would seem that the likely demands to be made on us in the near future are manageable if the special reservation of cover for the third bridge project is allowed to lapse.

Yours sincerely,

Don Twyford

D H TWYFORD

cc Mr C D Powell, PS/Prime Minister, 10 Downing St.
Mr S Ratcliffe, PS/Secretary of State, DTI, 1 Victoria St.
Miss M Davies, PS/Minister for Trade, DTI, 1 Victoria St.
T L A Daunt Esq, CMG, HM Ambassador, Ankara, Turkey
Mr M C S Weston CVO, SED, FCO
Mr T Muir, OT4, DTI, 1 Victoria St.
Mr C C W Adams, PEP, DTI, 1 Victoria St.
Mr N Jaggers, Bank of England
Mr C Henn, DESO, MOD, Main Building, Whitehall
Mr M G Stephens)
Mr D R Coombe) ECGD



3298/21

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GCBQ

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

CDF
24/3

Alison Brimelow
PS/Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H 0ET

23 March 1988

Dear Alison,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTORS

The interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period October-December 1987. The attached report identifies potential problem areas which, with the schedule of project business at Annex, updates the report attached to Zoe Everest-Phillips' letter of 24 December 1987. at flap

There are no new cases in the current report. The additional ECGD cover required for the prospective sale of Tornados to Jordan was agreed in the Chief Secretary's letter of 18 March. ECGD's potential exposure up to a maximum of £380 million will be logged against the Section 2 defence allocation. The Chief Secretary has made clear that there can be no question of including any further substantial defence contracts under the special defence allocation in the current year, without a Ministerial review of the arrangements. The resurrection of any ECGD cover for the sale of frigates to Pakistan, for example, would have to be considered by Ministers before the resumption of negotiations. EGC have agreed an increase in the market limit for Turkey; the £150 million increase, with the balance previously available, should provide sufficient cover the third Bosphorus Bridge and the Expressway, should those two contracts feature in the discussions during the Prime Minister's visit to Turkey in early April.

I am copying this letter to Sir Robin Butler, Charles Powell (No 10), Brian Hawtin (MOD), Tony Galsworthy (FCO), Miles Wickstead (ODA), Stephen Haddrill (Department of Energy) and Kevin Butler at the Bank of England.

Yours sincerely,

Jill Rutter

JILL RUTTER
Private Secretary

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TRADE: ECGD Pt. 2

Attachment to J.M Rutter's letter of 23 March about "Export Credit Cover for prospective Defence and Civil Contracts 'Apologies' CST. Offic

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EXPORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts Quarterly Report of Potential Problem Cases October-December 1987.

A **Cases which were included in the last Quarterly Return**

1. Brazil

Westland Helicopters are competing with the French company Aerospatiale for the sale of helicopters to the Brazilian Navy. Discussions on a Paris Club rescheduling will take place when an SBA is agreed but currently no medium/long term ECGD cover is available for this market. When DX cover is introduced defence sales will not qualify for cover. Ministers have, however, agreed to consider offering cover for this prospective contract if there is clear evidence of French competition. French officials continue to maintain that official credit support is not available for the French competitive bid at present. However, their position will change quickly once rescheduling is agreed. France has fewer inhibitions about lending for military purposes. An early submission will be made to Ministers once rescheduling is near. Other prospective contracts which will require ECGD cover when DX cover is available include Rolls Royce Spey Engines and Airbus aircraft.

2. Jordan

The additional ECGD cover required for further negotiations on the sale of Tornados to Jordan has now been agreed. DESO and ECGD will negotiate on the basis of a 50:50 risk sharing arrangement which would increase the DML to £290 m (or £330 m with capitalisation of interest); agreement has also been given to a 60:40 risk sharing arrangement being offered as an absolute fall-back position. Risk sharing on a 60:40 basis would increase ECGD's DML to £335 m (or £380 m with capitalisation of interest).

3. Kenya

The cover position remains generally unchanged with a substantial number of small civil contracts for which indications have

been given; cover has been reserved for Airbus aircraft and indications have been given for BAe aircraft and to Marconi for the supply of communications equipment. The market limit could come under pressure if large contracts became firm.

ECGD will conduct a market review shortly but an increase in the limit is unlikely to be recommended.

	£m	
Section 2 Market Limit (Grade C)	270	
Firm Business	159 + 103*	(outside ML)
Offers/Reservations	74	
Balance available	37	
Indications	249	

* Cover agreed by Ministers for Vosper Thorneycroft patrol boats outside market limit.

4. Nigeria

DX cover of £200 million for capital goods and equipment plus additional support for existing projects and for new projects will be made available when negotiations on arrears of moratorium interest are concluded. Although there is a substantial amount of prospective defence business, defence sales are not generally eligible for DX cover, and no cover will be available for defence sales to Nigeria.

5. Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June 1987. An increase in the market limit to £150 million was agreed on the assumption that the proposed sale was unlikely to be resurrected. The Ministry of Defence report to the Prime Minister of 24 February suggests that Pakistan is still considering whether to purchase UK frigates. DESO are proposing that the Pakistanis should buy second-hand frigates initially but only on condition that they also undertake to buy new frigates. The report concludes that

a positive decision would lead to proposals to revive the substantial HMG backed credit package. That would be difficult. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no presumption that cover at the earlier level of £360 million for new frigates will be available, particularly if in the meantime indications of cover have been given for other business. Demand for cover has been substantial and the Section 2 balance has been reduced to £56 million. If the frigate deal was resurrected it would be necessary to consider providing cover under the special defence allocation.

	£m
Section 2 market limit (Grade D)	150
Firm Business	35
Offers/Reservations	59
Balance available	56

Indications about £1b.

6. Turkey

A balance of £250 million remains within the market limit of £750 million with substantial prospective civil business. ECGD have carried out a market review and EGC has accepted the recommendation to increase the market limit by £150 m. No 10 has had a number of press enquiries about whether the Prime Minister will be supporting the UK bid for the third Bosphorus Bridge during her visit to Turkey in early April; the UK is also well placed to win the contract for the Expressway and Golden Horn Crossing; there is sufficient cover now available for both contracts.

	£m
Section 2 Market Limit (Grade C)	750
Firm Business	330
Offers/Reservations	170
Balance available	250
Indications	597

A New cases

Nil

ANNEX

PROJECT BUSINESS

	1986/87 £m	1987/88 £m	1988/89 £m
Income	377.88	216.9	837.7
of which premium	98.18	63.9	101.8
Expenditure	634.90	813.2	755.5
of which claims	617.40	794.7	731.9
Net Cash flow	(257.02)	(596.5)	82.2
Consolidated Fund balance	(96.80)	(727.4)	(704.8)
Net cash flow excluding refinancing	(351.02)	(636.9)	(494.4)
Consolidated Fund balance excluding refinancing	(226.54)	(769.5)	(1,351.9)

NOTES

i. Bracketed figures indicate a deficit or charge.

ii. Income includes in addition to premium, moratorium interest from rescheduled sovereign debt. The large income figure for 1988/89 is attributed to the high level of new refinancing forecast to take place, hence the forecast positive cash flow for the year.

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cc PC

Foreign and Commonwealth Office

London SW1A 2AH

21 March 1988

Dear Jill

21/3

Export Credits for Arms Sales

The Foreign Secretary has seen your letters to Richard Wilson of 28 January and 7 March confirming the Chief Secretary's approval of the practical arrangements agreed by officials for the introduction and operation of the new £1 billion special account for arms sales. I have delayed replying until after the EGC discussion. The Foreign Secretary welcomes the agreement and looks forward to ane early Parliamentary statement being made to enable the new facility to enter into force.

The Foreign Secretary accepts the understandings attached by the Chief Secretary to the use of the new facility. He is glad that we have got away from the practice of offsetting against other countries' limits. He accepts that market limits should be reviewed, but attaches particular importance to the terms of your letter to Richard Wilson of 28 January, where you noted that the Chief Secretary "would expect the review to provide some offsetting reduction .... But each case will have to be considered on its merits".

The Foreign Secretary notes that the EGC will recommend when a review of the limit should be carried out. An example of the level at which such a review might be considered was at the end of the first year if significantly ore than one third of the £1 billion had been used at that time. But the Foreign Secretary would not wish that example to be converted into a firm limitation on the use of the new facility. He also attaches importance to the proviso agreed by EGC that indications of cover should be given beyond the upper limit of the facility. Many potential contracts will in practice go elsewhere.

I am copying this letter to Charles Powell, Richard Wilson, Alison Brimelow, Nick Wilson and Brian Hawtin.

Yours ever

(R N Culshaw)
Private Secretary

Jill Rutter
PS/Chief Secretary

TRADE : GCGD PT2

009/4211

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CHIEF SECRETARY TO THE TREASURY

CC/PC

Treasury Chambers, Parliament Street, SW1P 3AG

R T J Wilson Esq
Private Secretary
Cabinet Office
70 Whitehall
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CDS 8/3

7 March 1988

Dear Richard,

EXPORT CREDITS FOR ARMS SALES

I said in my letter of 28 January that the Chief Secretary was reluctantly prepared to approve the introduction of the £1 billion special Section 2 allocation for arms sales subject to an understanding with his colleagues about its utilisation. The conditions which he suggested for the introduction of the new arrangements included acceptance of the presumption that the £1 billion limit would last for 3 years, but that it could be reviewed before the end of that period in exceptional circumstances; the relevant market limit should be reviewed as part of the procedure for allocating contracts against the new account, with the aim of providing an offsetting reduction in overall contingent liabilities; the new arrangement should be monitored as part of the current arrangements for the quarterly review of defence and civil sales. Ministers have not raised further objections to those conditions and officials have agreed within the Export Guarantees Committee the practical arrangements for controlling the special allocation.

The Committee has agreed that there should be no formal point at which the limit will be reviewed, but the utilisation of the allocation will be monitored and a recommendation to carry out a review will be made by EGC to Ministers at the appropriate time in the light of developments. On the presumption that the arrangements will last for 3 years, EGC will, for example, consider whether it would be appropriate to review the arrangements at the end of the first year if significantly more than 1/3 of the £1 billion had been used at that time.

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ECGD will cover arms sales under Sections 1 or 2 whenever practicable. But when there is insufficient cover under the normal arrangements, having regard to any need to maintain the availability of cover for other exports, and there are no grounds for increasing the market limit, the case will be submitted to Ministers by EGC for decision on logging the Departmental Maximum Liability of the particular contract against the £1 billion allocation.

EGC will introduce changes in the quarterly reporting arrangements so that Ministers are better informed about competing defence and civil business in markets where cover is limited, and has agreed to set up an arrangement that will attempt to rank competing defence claims in some order of priority. That should be useful when Ministers have to decide how to deal with a particular arms sale under the special account, if it seems likely that there is more business than the £1 billion limit can accommodate.

The Chief Secretary is satisfied with the practical arrangements agreed in EGC, including the revised quarterly reporting arrangements (though these can of course be reviewed in the light of experience). He is therefore prepared to agree the introduction of the £1 billion allocation for the special arms fund. The new arrangements will become effective from a date to be agreed for the Parliamentary Statement about the new facility which ECGD officials are drafting; the draft Statement will be cleared at official level before being submitted to Ministers for approval.

I am copying this letter to Charles Powell (No. 10), Alison Brimelow(DTI), Lyn Parker (FCO), Nick Wilson (Employment) and Brian Hawtin (MOD).

Yours,

Jill

JILL RUTTER
Private Secretary

TRADG : ECAD 172

016/2986

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Treasury Chambers, Parliament Street, SW1P 3AG

R T J Wilson Esq
Cabinet Office
70 Whitehall
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SW1

28 January 1988

Dear Richard,

EXPORT CREDITS FOR ARMS SALES

The Chief Secretary has seen the comments by DTI, MOD and FCO Ministers on the proposals in Zoe Everest-Phillips' letter of 23 December, including the qualifications which he set out for the introduction of the special Section 2 allocation for arms sales.

The Chief Secretary remains concerned about adding to ECGD's contingent liabilities in this way, particularly given that most of the additional cover provided by this facility is likely to be made available in the riskier markets. ECGD's recently published accounts demonstrate the consequences for the Exchequer of taking on excessive business in such markets in the past. The Department believe that current business is viable. It is important - particularly in view of the continuing cost of earlier decisions - that we do not jeopardise future performance. For that reason he is not prepared to accept an additional £1 billion allocation without an understanding with his colleagues about its expected utilisation.

However, he is prepared to go forward on the basis of a presumption that the limit would last 3 years. Possible claims on it must be monitored quarterly as part of the existing arrangements covering defence sales. This will provide early warning of too rapid a build up of additional contingent liabilities and enable decisions to be taken, rearranging

TRADE : 6CLO PT2

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priorities where necessary, to avoid the agreed total being exhausted. But he would be prepared to agree to a review before the end of 3 years, in exceptional circumstances.

On the question of reviewing market limits, he notes his colleagues' opposition to "automatic" reduction or closing of limits. His view remains that he would expect the review of the appropriate country limit to provide some offsetting reduction in the overall contingent liabilities. But each case will have to be considered on its merits.

The Chief Secretary has also noted the comments on his earlier reference to the interdepartmental group's conclusion that there is no evidence to support the view that arms sales benefit the economy more or impose less risk than civil contracts. He maintains the view that that is an important conclusion on which the report is clear; Departments represented on the Group accepted that there is no intrinsic reason to believe that there are major benefits from arms sales against civil sales. On that basis there are no grounds for any special pleading based solely on the nature of the goods to be covered.

The Chief Secretary has instructed Treasury officials to arrange an early meeting of EGC to consider the detailed procedures for the arms account and to report to him about the practical arrangements. I understand that the Cabinet Office have agreed that this is the right way to take these matters forward.

I am copying this letter to Charles Powell (No. 10), Alison Brimelow (DTI), Ian Andrews (MOD), Robert Culshaw (FCO) and to Nick Wilson (Employment).

Yours,

Jill.

JILL RUTTER
Private Secretary

27 January 1988

ECGD

The Prime Minister was grateful for the material included with your letter to me of 26 January. She has noted the further progress in hand on management reforms and looks forward to seeing the results of the current strategic review.

I am copying this letter to Jill Rutter (HM Treasury).

(PAUL GRAY)

Steven Phillips, Esq.,
Office of the Minister for Trade,
Department of Trade and Industry.

ABG 8/4

27 January 1988

ECGD

The Prime Minister was grateful for the material included with your letter to me of 26 January. She has noted the further progress in hand on management reforms and looks forward to seeing the results of the current strategic review.

I am copying this letter to Jill Rutter (HM Treasury).

(PAUL GRAY)

Steven Phillips, Esq.,
Office of the Minister for Trade,
Department of Trade and Industry.

dti

the department for Enterprise

CC86

The Hon. Alan Clark MP
Minister for Trade

Prime Minister

Further background to today's announcement. Welcome the further progress on management reforms and look forward to seeing the results of the strategic review (X on last page)?

PRCG 26/1

Yes

Paul Gray Esq
Private Secretary to the
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Your ref
Date 26 January 1988

Dear Paul,

ECGD

Flap

The imminent announcement of ECGD's 1986/87 Trading Results offers an appropriate opportunity to provide you with a report on developments in ECGD since Michael Gilbertson wrote to David Norgrove on 9 October 1986 about the Department's 1986 Business Plan. The report is enclosed.

In summary, it notes:

(i) that ECGD's current business is being underwritten on a viable basis;

(ii) that ECGD's coverage of UK exports has fallen to 19.6% of the total, partly as a result of the world-wide decline in orders for capital projects;

(iii) the continuing impact of the world debt crisis on ECGD's overall financial position: the Consolidated Fund Deficit has increased to over £1 billion (though this does not represent a loss since ECGD continues to pay a full rate of interest on it), the general provision against loss on sovereign debt has been raised to £1.1 billion and net reserves have reduced to £201 million;

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the department for Enterprise

Paul Gray Esq January 1988

(vi) that the extent of ECGD's eventual loss on sovereign debt cannot yet be judged but is likely to be well within the amount of the general provision;

(v) the 1987 Business Plan objectives, which are:

- to grow the business by providing a better priced and better quality service to exporters;

- to contain overheads; and

- to minimise loss resulting from the debt crisis;

(vi) that internal management reforms are being pushed through as recommended in the Management Review and the MDRB, in particular a new management information system is being introduced based on commercial management accounting principles; and

(vii) that a long term strategy review is being put to Ministers.

I am copying this letter to Jill Rutter in the Chief Secretary's office.

Yours sincerely

Steven Phillips

STEVEN PHILLIPS
Assistant Private Secretary

ENC

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the department for Enterprise

ECGD 1986/87 RESULTS

The 1986/87 results will show that ECGD recorded a trading surplus of £177.5 million for the year, though this was significantly boosted by moratorium interest due but not necessarily received under Paris Club reschedulings. This is down on the £238.6 million surplus for the previous year, due mainly to a £17 million reduction in premium income, and an increase by £32 million in losses due to exchange rate movements on assets denominated in foreign currency. (The 1985/86 figures also benefited from the writing back of £14 million of loss provisions made in earlier years.) The trading accounts for 1986/87 have been qualified by the NAO in respect of the general provision for loss on sovereign debt. These results continue to indicate that the business ECGD is currently underwriting (and has, indeed, underwritten since the onset of the debt crisis) shows every prospect of being profitable and making a significant contribution to reserves. This is the result of the action taken to increase premiums, tighten up underwriting and curtail or withdraw loss making facilities. For this reason, as well as to avoid pricing ECGD out of the better risk business and reducing the competitiveness of UK exporters, Trade and Treasury Ministers have decided, for the second year running, against any general increase in ECGD's premiums.

The results do, though, show a continuing decline in the level of business insured, down to £13.9 billion (19.6% of UK non-oil exports) against last year's £15.9 billion, and in the number of policyholders, down from 8592 to 7766. This is largely attributable to the dramatic fall-off in orders world-wide for major projects and to more selective underwriting by ECGD.

To a lesser extent, ECGD business has also been affected by UK exporters switching their attention to the EC and North American markets where the need for credit insurance cover is less apparent. Whilst this trend does not mean that ECGD is failing to fulfil its primary objective of encouraging exports, it is essential - if the breakeven objective is to be met - for the business to be as broadly based as possible, with a solid core of good quality risks. Then it will be sufficiently robust to sustain the inevitable losses and to enable ECGD more confidently to support those more marginal risk exports which would not otherwise go forward.

The World Debt Crisis

The 1986/87 financial results show that ECGD has yet to emerge from the shadow cast over its business by the world debt crisis. Two figures point this up: the deficit with the Consolidated Fund rose in the year to £1000.8 million, from £652 million at the start of the year, and the general provision (against loss on the amount owed to ECGD by the debtor countries) was increased to

£1121.9 million, from £582.4 million. The result of this has been to reduce ECGD's net assets to £201.3 million against last year's £563.3 million. But there is a very important point to be made about these figures: neither the deficit nor the general provision should be considered as a loss. Most of ECGD's major sovereign debtors have (as part of wider IMF-approved economic adjustment programmes) either entered into formal debt rescheduling agreements or are confidently expected to do so. These provide for the orderly repayments of debts over periods of up to 10 years and the payment of interest at proper commercial rates in the interim. Whether all of these countries will manage to honour their obligations without defaulting or seeking further relief remains, of course, uncertain. A further rise in the cash deficit over the next year or so must still be anticipated but this now seems unlikely to reach the £3 billion given in the last report. (This reflects the more widespread use of the refinancing technique under which ECGD guarantees new loans to the debtor countries to enable them to avoid defaulting on their old ECGD guaranteed debt.) Thereafter, but subject to the wider uncertainty, ECGD expects to see the deficit reduce as the repayments start to roll back. Meanwhile, ECGD continues to pay a full rate of interest on its borrowings, funded in part by recoveries of past debts from the debtor countries.

However, for ECGD to escape loss-free from this situation is probably impossible. The general provision in ECGD's Accounts was instituted to reflect such a possibility. From a small beginning of only £14 million in 1982/83 the provision has now passed the £1 billion mark. It has never represented ECGD's estimate of the amount of loss it would suffer on its sovereign debt. Rather, it should be regarded as a 'shading over' of ECGD's reserves to demonstrate their vulnerability to further problems on the debt front. The area shaded over has increased significantly as ECGD has revised and refined its methodology for calculating the provision. At the end of the year, the general provision represented 85% of gross reserves, compared with 47% at the start. This change does not reflect an equivalent deterioration in ECGD's view of the prospects for recovering this debt, but is ECGD's response to a new situation created partly by the action of the commercial banks who, with a number of quite different considerations in mind, have embarked on a round of substantial increases in their provisions. The general provision is now set at 17.7% of the sovereign debt. A loss on this scale would be quite unprecedented and is not anticipated by ECGD whose experience over the years has been that debtor countries (outside revolutionary situations) do eventually honour their debt obligations. The past may not hold good for the future but there must be a reasonable expectation that any loss will be contained well within the amount of the general provision. The NAO have qualified ECGD's accounts as to the uncertainty over the adequacy of the provisions and ECGD's accounting treatment of it (which has been accepted by NAO in previous years). The main disagreement

between ECGD and the NAO is over whether the Bank of England guidelines issued to the commercial banks for supervisory purposes should be applied to ECGD. The Department has consistently maintained that the guidelines are only partially relevant to its circumstances.

The 1986/87 Business Plan

Against this background, the main themes in ECGD's 1986/87 Business Plan are:

(a) to maintain and extend ECGD's business - especially in the short term area - not least since this will reduce the impact of overheads on premium rates, etc;

(b) to make current business sufficiently profitable and the risk portfolio sufficiently well spread in order to be better able to withstand any recurrence of the difficulties which have beset the Department in recent years;

(c) to control overheads; and

(d) to do all it can to contain the adverse impact of the debt problem on its finances.

Like its counterparts in the other major exporting countries (who are similarly affected) ECGD's capacity to influence the outcome of the debt crisis is limited, although the Department will do all that it can in the relevant international fora and in bilateral negotiations with the debtor countries to ensure the best possible outcome. The main preoccupation of the Business Plan is, therefore, the need to manage current business in a way which meets the twin objective of encouraging exports and achieving financial breakeven. The Plan recognises that the key to this lies in the retention and growth of good quality business. Not only does this provide the necessary capacity to absorb losses but it provides the solid base from which more marginal exports can be supported which might not otherwise go ahead. But the Department recognises that this growth in business has to be achieved without any parallel increase in overheads, both to maintain the Department's and UK exporters' competitiveness.

The Plan details, therefore, the measures already taken, and planned to be taken, to improve the attractiveness of ECGD's facilities, the speed and quality of its service and to develop new products in order both to increase business and to diversify and improve the quality of its risk portfolio. In pursuit of these objectives the Department has undertaken a major review of its marketing strategy in order to be confident that it is now giving UK exporters what they want at a price they can afford. Already the Insurance Services Group (the non-project side of the business) has introduced new computerised systems which enable it

to process 50% of requests for cover within 24 hours against only 18% a year ago. Customers are also finding ECGD more willing to tailor-make its insurance to their individual requirements. Pricing has become much less standardised and, on the project side, a new premium system will be launched later year which will match premium rates more closely to risk and thus attract more of the better quality business.

These changes in ECGD's outward face are being, and will be, complemented by changes on the inside. Those flowing from the Management Review, which was touched on in the last report, have been reinforced by further management changes. The refinement and enhancement of the business planning process, culminating in the 1987 Plan, was welcomed by both Trade and Treasury Ministers. For 1988 the link between business planning and resource bidding and allocation will be forged even more closely.

The new Chief Executive, Malcolm Stephens, has given added impetus to this process by strengthening the system under which the Plan is monitored and calling for changes in the timetable so that the 1988 Plan will be in place before the start of the Financial Year. He has also undertaken a review of business strategy, which Ministers will be invited to endorse. Given the importance of the strategic issues which this will raise, my Secretary of State will almost certainly wish to report again to the Prime Minister on the outcome of his discussions with the Chief Secretary. Once agreed, this will provide the long term framework within which future annual Business Plans can be written.

TRADG : GC90 PT2



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the department for Enterprise

LCCPC

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
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Your ref
Date 19 January 1988

CDD
25/1

Dear John,

ECGD : CONTROLLING CONTINGENT RISKS MAP.

When I wrote to you on 2 October, I said that I recognised scope for improvement of the existing mechanisms for containing and managing ECGD's exposure to country risk. ECGD officials have been working hard at this in recent months and have now let me have the enclosed progress report, which I am sure you will find of great interest. Together, they form a significant package and an important and useful step forward.

I think the main points to note are the following:

a Action is being taken to develop professional skills especially in the use of modern technology and to allocate resources in closer harmony with business need.

b Interface with other Whitehall Departments and the Bank of England will be improved and given a more structured form.

c A prototype system of computer-based portfolio analysis, broadly on the lines recommended in the

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1985 Management Review, has been developed and is now ready for "testing". However, I must stress that this will not of itself manage the portfolio nor generate a system for doing so. It will not of itself, for example, produce decisions on country limits or large cases. We shall have to continue to work these out by the sweat of our brow making the best use we can of the material available including output from the new computer model, which will be gradually tailored and developed for this purpose.

Progress has been made with all the items in the enclosed programme, although full implementation will inevitably take some time.

Overall, I am hopeful that this, coupled with our recent decision on a new procedure for dealing with large arms cases, will lead to a significant improvement in the arrangements for managing ECGD contingent liability.

I am copying to the recipients of earlier letters on this subject.

ECGD: CONTROLLING CONTINGENT COUNTRY RISKS

Note by ECGD

Role

New definitions have been introduced to make it clear that the International Group of ECGD is responsible for all aspects of policy, assessment work, and Departmental relations, applying to a market generally. This includes being the channel of communication with Whitehall, Overseas Posts, foreign Embassies and international organisations, on such matters.

Resources

2. Resources will be organised to provide a higher level of input for markets of importance and high perceived risk. Expenditure of resources on markets of perceived low risk or where demand for cover and therefore premium income is small will be reduced to a minimum. This principle will be followed through in a variety of ways as explained below.

Staff

3. The staff structure is being reviewed, with assistance from in-house consultants, to produce an overall saving in numbers and cost. Greater use will be made of professional Economist staff at Grade 7 and HEO level.

Training

4. An intensive training programme is being undertaken to improve the competence of existing staff in basic economics and computer techniques. Together with a greater use of Economist staff, this will provide a mix of Departmental and professional expertise in country risk assessment.

Information Technology

5. The use of Information Technology is being developed and expanded rapidly in the following areas:

i retrieval and analysis of data;

ii control of liabilities for country limit purposes;

iii maintenance of basic background material on major markets;

iv spread sheet analysis.

Papers

6. It is intended that this should lead to an improvement in the quality of review papers, including greater use of improved forms of presentation.

Market Gradings

7. The existing system of grading markets for premium purposes is being radically overhauled to provide more refined guidance to the Business Groups. The new system will distinguish between short and medium-term risk and between perceived propensity to different types of loss. This will open the way for the ECGD Business Groups to derive premium rates tailored more accurately for individual cases or areas of business based on the principle of "building blocks".

Market Reviews

8. A structure for routine review of markets based on monitoring key indicators has been developed.

Overseas Visits

9. Country Policy staff will continue to visit overseas markets, but the programme will be made more cost-effective by

i focussing on markets of importance in business terms;

ii drawing up forward plans to ensure as far as possible that markets are not visited more frequently than is really necessary and arranging joint visits with other Groups wherever appropriate;

iii requiring specific objectives for every visit to be agreed in advance with the authorising officer and for reports to be written in relation to these objectives.

Sources

10. Inquiries have established that there is no single source, either in the private sector or within Government, that is able and willing to supply data in the form and over the field that we require. There is, therefore, no practicable alternative to continuing to collect and collate material within ECGD. However, we shall experiment with adding to our normal sources/methods the purchase of information from commercial sources, although it is clear that this can never substitute completely for information from privileged channels. A trial is being made with the purchase of package data in spread sheet form for a group of major markets from the Wharton Institute. Recent initiatives for improving the discussion and exchange of country information with other export credit agencies and the multilateral institutions, eg in the Berne Union and OECD, have proved useful and will be developed further.

Section 1/Section 2 Boundary

11. The Advisory Council will be asked to agree that for the better risk markets generally business (except for specific categories to which special considerations apply such as large arms cases or experimental forms of cover) should normally be

taken under Section 1, eg Section 1 case size limits and divisions based on maximum length of credit will be withdrawn: where the Council is unable to advise that further business should be accepted in the light of the economic assessment of a market, future business would be considered under Section 2. This would mean that the confusion of operating parallel Section 1 and Section 2 limits for the same market will be much reduced.

Delegation

12. Many country policy decisions on markets of low risk are of small significance in business terms. In some cases, the administrative cost of writing and clearing normal review papers is disproportionate when set against our expected premium income. The Advisory Council will be asked to agree that in such cases decisions may be taken at an appropriate official level using a less cumbersome procedure, subject to post facto notification to the Council on a routine basis. This will free official and Council time for more substantial issues.

Portfolio Analysis

13. The Management Review, 1985, recommended that ECGD should examine the feasibility of developing a computer-based system of portfolio management for country risk. A proto-type computer-based system for analysing our portfolio has been developed in collaboration with the Central Statistical Office and given preliminary trials. Using input of:

i forecasts of ECGD exposure;

ii numerical probabilities of loss by market in future years based on a blend of quantitative analysis and subjective adjustment (with assistance from an inter-Departmental 'Committee of Experts');

iii alternative scenarios of prospects for the world economy;

the model produces forecasts of gross loss from transfer claims by markets within defined ranges of probability. We plan to produce 'real life' runs for 43 markets (which together account for 90% of our current portfolio) early in 1988. It is important to note that the programme will not of itself manage our portfolio nor automatically produce guidelines for doing so. Research will continue into extending the use of this model, eg into the possibility of generating useful material based upon the improved understanding of relationships within our portfolio and the ability to carry out simulation studies that the model will provide. In the meantime, output from the portfolio and associated country models will be increasingly used as an additional input for our country review papers.

Internal Management

14. As country policy work now spreads across Division and Group boundaries, a Steering Committee has been set up to agree strategy and trouble-shoot.

Communications

15. It is vital that the Country Policy Branches should maintain a responsive and open attitude to the changing needs of ECGD and in particular the Business Groups. The most effective means for communication, especially new possibilities offered by developments in the IT field, will be a matter of continuing review.

ECGD
January 1988

Foreign and Commonwealth Office

London SW1A 2AH

15 January 1988

Dear Richard,

Export Credits for Arms Sales

The Foreign Secretary has seen Zoe Everest-Phillips' letter of 23 December giving the Chief Secretary's qualified agreement to the proposed supplementary accounting procedure for major arms sales in difficult markets. He has also seen Stephen Ratcliffe's letter of 11 January giving Lord Young's reaction.

My letter of 21 December to Alison Brimelow recorded the Foreign Secretary's welcome to the proposal to establish supplementary accounting for arms sales. He attached no qualifications as he wished to see how the proposed new system worked. It seemed markedly better than existing arrangements. The Foreign Secretary agrees that a ceiling on the supplementary account is necessary to impose a sense of priorities in adding to contingent liabilities. But he is not sure that the £1 billion, tentatively suggested in the Cabinet Office paper as a starting-point, has any objective validity. Accordingly he agrees with Lord Young that it would be best to stick to the original recommendation that a ceiling of £1 billion should be set in the first instance; that commitments against the ceiling should be reviewed quarterly as part of the existing "early warning" for reporting to Ministers on potentially difficult cases; and that the level of the ceiling should be reviewed by Ministers as need arose. He would not accept any presumption that such reviews would necessarily result in an increase of the ceiling. This would depend on the strength of the case for raising it in the light of all relevant factors.

The Foreign Secretary agrees that an allocation under the new system should trigger a review of the relevant market limit. However, he believes that it would be wrong to presume that in each case the review would lead to some reduction in that country limit. It could well; but much would depend upon the circumstances of the particular case and the country concerned.

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The Foreign Secretary also considers that it may be a little misleading to claim that there is no evidence to support the view that arms sales as a whole, whatever their individual size and importance, benefit the economy more or impose less risk than civil contracts. The Cabinet Office paper says only that very little evidence existed to support the arguments which had been deployed on either side and that it would require a major exercise to gather such evidence; even so a firm conclusion might not emerge.

I am copying this letter to the Private Secretaries to the Prime Minister, the Defence Secretary, the Secretary of State for Trade and Industry and the Secretary of State for Employment.

Yours ever

(R N Culshaw)
Private Secretary

Richard Wilson Esq
Cabinet Office

Trade ECGD. Pr 2

CSPC

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
XXXXXXX 01-218 2111/3
Telephone 01-~~218 7822~~

MO 32/8V

13th January 1988

CDP 14/1

Dear Richard,

EXPORT CREDIT FOR ARMS SALES

My Secretary of State has seen the report from the inter-departmental group attached to your letter of 11th December. He has also seen the reported reactions from his colleagues, in particular the observations of the Chief Secretary set out in Zoe Everest-Phillips' letter to you of 23rd December.

Mr Younger is broadly content with the analysis in the report, and the actions it proposes. He noted in particular the conclusion that on a comparative basis arms sales were no less beneficial to the economy than exports of civil equipments; but that their size makes them particularly attractive economically, although that brings the problems to which special consideration has to be given.

Clearly it is sensible in setting up a special account to place some initial indicative figure on its size. But Mr Younger would not wish the £1Bn mentioned by the Committee to become an inflexible ceiling for a three year period as suggested by the Chief Secretary. Rather, as the report suggests, the figure of £1Bn should be reviewed as the need arises, perhaps when 75% has been committed. Mr Younger is also concerned that the proposal to insert a degree of automaticity into the review of country limits triggered by the use of the special account could undermine the operation of the scheme. A reduction of the country limits might indeed prove prudent but that should be determined in the light of circumstances at the time.

While the backstop of such a special account will be valuable and helpful, Mr Younger is concerned that its existence should not cause it to be used whenever there is some problem with an arms sale in relation to existing country limits. As the report points out difficult cases have represented only a very small proportion of the total number, and Mr Younger would not wish the existence of the new account to cause that to rise. In each case of difficulty it will be essential to examine first all possible ways of accommodating the sale within existing arrangements, for example by a marginal extension to existing country limits which cannot by

Richard Wilson Esq
Cabinet Office

their nature be based on exact calculation, or through a greater degree of involvement by the private sector, both industry and the banks.

Mr Younger has noted the suggestion that a statement should be made to Parliament. If such an announcement proves necessary, it will need to be carefully worded in order not to set off an undesirable reaction by our main competitors; he would be grateful therefore if Ministry of Defence officials could be consulted at the drafting stage.

If colleagues accept the proposals from the interdepartmental committee, Mr Younger is firmly of the opinion that those large defence contracts for which cover over and above the market limit has already been agreed should not be debited against the special account.

I am sending copies of this letter to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Secretaries of State for Employment and for Trade and Industry and to the Chief Secretary.

Yours sincerely

(I C F ANDREWS)
Private Secretary

Richard Wilson Esq
Cabinet Office

TRADG : ECGD 9R

DEPARTMENT OF TRADE AND INDUSTRY
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PS/ *Secretary of State for Trade and Industry*

CONFIDENTIAL

11 January 1988

Richard Wilson Esq
Cabinet Office
70 Whitehall
London SW1

Dear Richard,

EXPORT CREDITS FOR ARMS SALES

My Secretary of State has seen Zoe Everest-Phillips' letter of 23 December 1987 containing the Chief Secretary's agreement to the proposed procedure for accommodating major arms sales in difficult markets.

The Treasury's letter contains two qualifications: that the proposed overall limit of £1 billion should not be reviewed for at least 3 years, and that the review of the appropriate market limit (triggered by a decision to support a special arms case) should aim to secure some reduction in that limit, though not necessarily pound for pound.

The purpose of setting a limit is so that Ministers can review the circumstances if that limit is reached. We do not think it is possible to predict the rate of utilisation of the new facility; nor do we think it would be sensible to rule out an increase for such a long period ahead. My Secretary of State would, therefore, wish to stick to the original recommendation which was that a ceiling of £1 billion should be set in the first instance and that commitments against this ceiling should be reviewed quarterly as part of the existing 'early warning' for reporting to Ministers on potentially difficult cases. As the Report indicated, Ministers would have an opportunity to develop priorities between conflicting claims on a limited volume of cover and the level of the ceiling would be reviewed by Ministers as need arose.

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On the Chief Secretary's second qualification, my Secretary of State stands by what he said in his letter of 18 December. He remains of the view that it is very important that there should be no question of any "automatic" reduction or closing of normal country limits.

Subject to the views of the Secretary of State for Defence, and other Ministers who may wish to comment further, my Secretary of State suggests we set the new procedure in place and see how things go. I understand that a meeting of the Export Guarantees Committee is being called to discuss the detailed arrangements and any potential cases for inclusion in the facility. The Jordan contract which has already been the subject of Ministerial correspondence is the only current case although there may be some advantage in reviewing others that may be expected to crop up in the near future. ECGD officials are also working on a suitable Parliamentary statement which they will be discussing in draft with Treasury officials before putting to Ministers.

I am copying this letter to the Private Secretaries to the Prime Minister, the Foreign & Commonwealth Secretary, the Chief Secretary, the Secretary of State for Defence and the Secretary of State for Employment.

Yours sincerely

Steph Ratcliffe

STEPHEN RATCLIFFE
Private Secretary

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TRADE: ECGD R2



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Treasury Chambers, Parliament Street, SW1P 3AG

Dr Timothy Walker
Private Secretary to the Secretary of State
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

CDI
30/xii

24th December 1987

Dear Dr Walker,

EXPORT CREDIT FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The interdepartmental Export Guarantees Committee (EGC) reviewed recently the quarterly reports of large prospective defence and civil contracts for the period July - September 1987. The attached reported of the review provides early warning of potential problem cases which, with the schedule of project business at Annex, updates the report attached to Jill Rutter's letter of 23 September.

The position on the 4 cases which were included in the last quarterly return and which are updated in part A of the attached report, remains substantially the same. A market review of Pakistan has been completed and a review of Turkey will be carried out early in the new year. The 5 new cases in part B do not raise immediate difficulties but are included in the summary report as potential problems. MOD are preparing separate reports for EGC up-dating the information available on the negotiations on the sale of Tornados to Jordan and aircraft and defence equipment to Zimbabwe.

I am copying this letter to the Private Secretary to the Prime Minister, the Private Secretaries to the Secretaries of State for Defence, Foreign Affairs, Overseas Development, Energy, Sir Robert Armstrong, and Mr K Y Butler at the Bank of England.

Yours sincerely,

Zoë Everest-Phillips

ZOE EVEREST-PHILLIPS
Assistant Private Secretar

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EXPORT GUARANTEES COMMITTEE

Export Credit Cover for Prospective Defence and Civil Contracts Quarterly Report of Potential Problem Cases July-September 1987

A CASES WHICH WERE INCLUDED IN THE LAST QUARTERLY RETURN

1. Brazil

Westland Helicopters are competing with the French company Aerospatiale for the sale of helicopters to the Brazilian Navy. No medium/long term ECGD cover is available for this market in the absence of agreement with the IMF and a Paris Club settlement. Ministers have agreed to consider offering cover for this prospective contract if there is clear evidence of French competition. French officials continue to maintain that official credit support is not available for the French competitive bid.

Other prospective contracts which will require ECGD cover when DX cover is available include Rolls Royce Spey Engines and Airbus aircraft.

2. Kenya

The cover position remains generally unchanged with a substantial number of small civil contracts for which indications have been given; cover has been reserved for Airbus aircraft and indications have been given for BAe aircraft and to Marconi for the supply of communications equipment. The market limit could come under pressure if large contracts became firm shortly.

ECGD, DTI and MOD will consider the potential cases which might go forward and the availability of cover before preparing the briefing for the Prime Minister's visit to Kenya early in the new year.

	£m
Section 2 Market Limit (Grade C)	270
Firm Business	157 + 103* (outside market limit)
Offers/Reservations	82
Balance available	31
Indications	279

*Cover agreed by Ministers for Vosper Thorneycroft patrol boats outside market limit.

3. Pakistan

The cover reserved for the frigate sale to the Pakistan Navy expired at the end of June. An increase in the market limit to £150m was agreed on the assumption that the proposed sale was unlikely to be resurrected. The Ministry of Defence report to the Prime Minister of 25 November suggests that a decision by the Pakistanis to purchase UK frigates is still awaited. It concludes that a positive decision would lead to proposals to revive the substantial HMG backed credit package. That would be difficult. The Chief Secretary to the Treasury has made it clear that if the Pakistan Government raise again the prospect of buying frigates there should be no presumption that cover at the earlier level of £360m will be available, particularly if in the meantime indications of cover have been given for other business.

	£m
Section 2 market Limit (Grade D)	150
Firm Business	35
Offers/Reservations	14
Balance available	101
Indications	631

4. Turkey

An increase in the market limit to £660 was agreed by Ministers recently to include an allocation of £200m cover for the GKN Warrior project. Indications of cover continue to be given on a first come, first served basis but the market limit is now virtually exhausted.

EGC will review the market in the light of a paper by ECGD early in the new year, when the timing and content of the austerity measures to be introduced by the re-elected Mr Ozal should be clearer.

	£m
Section 2 Market Limit (Grade C)	660
Firm Business	338
Offers/Reservations	317
Balance available	5
Indications	1bn

B. NEW CASES

5. Greece

The Prime Minister was briefed to encourage Mr Papendreou to buy both Tornado and British built frigates in the margins of the European Council on 4/5 December. There is insufficient ECGD cover available to accommodate both contracts within the market limit and there is a substantial amount of prospective civil business. In the unlikely event that both the frigate and aircraft contracts were awarded to the UK some £500m to £600m ECGD cover might be required; the Section 2 balance is £510; indications of cover for civil business is about £1.5b.

The Greek market limit has not been reviewed recently but the Treasury and the Bank of England believe there is insufficient evidence at present to

justify any increase, especially since the Minister of National Economy has resigned in public protest against Mr Papendreou's budget.

	£m
Section 2 Market Limit (Grade B)	600
Firm Business	-
Reservations	90
Balance available	510
Indications	2200

6. Hungary

The Hungarian state airline (Malev) proposes to buy either four Airbus aircraft or five BAe 146 aircraft. In either case it would be difficult to accommodate the exposure involved unless cover was provided on a leasing/asset based financing basis which the Hungarians are reluctant to consider.

	£m
Section 2 Market Limit (Grade C)	75
Firm Business	2
Offer/Reservations	-
Balance available	73
Indications	130

7. Jordan

Ministers agreed recently that the market limit for Jordan could be increased by £150m to provide cover for the purchase of Tornado aircraft if offsetting savings could be found from other markets. Officials are discussing this matter.

8. Nigeria

DX cover of £200m for capital goods and equipment plus additional support for existing projects and for new projects has been offered to Nigeria, but cover will not be available until Nigeria clears the substantial arrears of moratorium interest due under the bilateral agreement and agreement is

reached on the administrative arrangements for the line of credit under the bilateral agreement. Although there is a substantial amount of prospective defence business, defence sales are not generally eligible for DX cover. The question of credit will need careful consideration by Departments before the Prime Minister's visit to Nigeria in early January.

9. Zimbabwe

There have been no developments on the proposal to sell fighter aircraft to Zimbabwe. MOD are currently discussing with the Zimbabweans the aircraft sale and the separate contract for the sale of radar and defence missiles. The original estimate was that the aircraft would require some £150m cover and the defence package a further £100m, but recent reports imply that the Zimbabweans are unlikely to be able to spend that amount on defence equipment. There is no commitment to provide ECGD cover.

	£m
Section 2 Market Limit (Grade C)	400
Firm Business	187
Offers/Reservations	39
Balance	174
Indications	340

ANNEX

PROJECT BUSINESS

	1986/87 £M	1987/88 £M	1988/89 £M
Income	377.88	220.01	862.88
of which premium	98.18	50.59	53.83
Expenditure	634.90	789.17	646.86
of which claims	617.40	770.67	573.84
Net cash flow	(257.02)	(569.16)	216.02
Consolidated Fund balance	(96.80)	(698.80)	(534.17)
Net cash flow excluding refinancing	(351.02)	(681.81)	(522.31)
Consolidated Fund balance excluding refinancing	(226.54)	(908.35)	(1430.66)

NOTES

i. Bracketed figures indicate a deficit or charge.

ii. Income includes in addition to premium, moratorium interest from rescheduled soverign debt. The large income figure for 1988/89 is attributed to the high level of new refinancing forecast to take place, hence the forecast positive cash flow for the year.

009/4206

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Richard Wilson Esq
Private Secretary
Cabinet Office
70 Whitehall
London
SW1

23rd December 1987

Dear Mr Wilson,

EXPORT CREDIT FOR ARMS SALES

The Chief Secretary has seen the report of the interdepartmental group which considered the export credit arrangements for arms sales, which was attached to your letter of 11 December to Alison Brimelow. This is a very difficult area, which has caused Ministers much trouble in the past. The Chief Secretary is therefore grateful for the comprehensive report of the interdepartmental study and the contributions made by the Departmental representatives including, in particular, the Cabinet Office chairmanship.

The Chief Secretary agrees with the recommendation of the interdepartmental group that the second option offers the most acceptable solution. This provides for the introduction of a procedure under which major arms sales which cannot be accommodated within country limits are scored under a supplementary Section 2 account for arms sales. He does so with reluctance, because his overriding concern is to contain ECGD's contingent liability in risky markets. He accepts that the special circumstances of arms exports have often led Ministers to increase those risks, in a somewhat random fashion, in response to political and industrial pressures. He is therefore anxious to improve the disciplines governing such sales, and to introduce an element of choosing between competing priorities. He had hoped that something on the lines of the first option (a pooling system) would provide this. But he recognises the practical problems which have arisen in offsetting increases in one market to accommodate large arms sales by reductions in other comparable markets; as a result of the crude nature of ECGD's present market limits as a risk management tool. Accordingly, he is prepared to support option two as the best system available in the circumstances.

The Chief Secretary's agreement to the new proposal is subject to the following two conditions. First, the overall limit should be set at £1 billion (departmental maximum liability). In his

view this is the maximum amount which Ministers should be prepared to add to ECGD's contingent liabilities for this purpose and the addition should if possible be kept even lower. Ministers will therefore need to reach a view about relative priorities. As the report suggests, the existing review arrangements should be used - he believes, rigorously - to help Ministers keep a running check on commitments against this limit, and to enforce choices between competing projects if there is any danger of the limit being exceeded. There should be no presumption that the limit will be increased, and it should not be reviewed for at least three years. At the start of the new arrangements, those recent large defence contracts for which ECGD cover has been made available beyond the market limit on an exceptional basis should be considered for inclusion under the scheme. Secondly, the review of the appropriate country market limit, which will form part of the procedure for reallocating contracts to the supplementary account, should aim to secure some reduction in that limit to contain ECGD's contingent liability, though not necessarily pound for pound.

On other aspects of the report, the Chief Secretary endorses the Group's conclusion that there is no evidence to support the view that arms sales as a whole, whatever their individual size and importance, benefit the economy more or impose less risk than civil contracts. This is an important conclusion, and he hopes his colleagues will not use such arguments in support of arms sales in future. He also agrees that there are advantages in the UK seeking in include credit arrangements for arms sales within an international OECD agreement in order to contain credit competition.

If other Ministers also accept the proposals in the paper, Treasury officials will arrange a meeting of EGC shortly to consider those potential arms contracts which might be allocated against the new supplementary account and make recommendations to Ministers. ECGD will want to consider how the UK should initiate discussion about the introduction of an international argeement to constrain competition on arms sales.

I am copying this letter to the Private Secretaries to the Prime Minister, the Foreign & Commonwealth Secretary, the Secretaries of State for Defence, Employment and Trade and Industry.

Yours sincerely,

Zoë Everett

ZOË EVEREST-PHILLIPS
Assistant Private Secretary

TRADE: EGGD: PT2



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CDP
22/12.

R T J Wilson Esq
Cabinet Office
70 Whitehall
London
SW1A 2AS

21st December 1987

Dear Richard,

EXPORT CREDIT FOR ARMS SALES

My Secretary of State has seen the Cabinet Office study of the export credit arrangements for arms sales you circulated on 11 December.

He is content with the recommendations of the report.

I am copying this to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chief Secretary, the Secretary of State for Defence and the Secretary of State for Trade and Industry.

Yours sincerely

Peter Baldwinson

Peter Baldwinson
Private Secretary

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TRADE: ECSO Pt 2

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

21 December 1987

CDP 21/12

Dear Alison

Export Credit for Arms Sales

The Foreign Secretary welcomes the Cabinet Office study of export credit arrangements circulated with Richard Wilson's letter of 11 December. He is glad to endorse the proposal to establish supplementary accounting for arms sales.

I am copying this letter to Charles Powell, Jill Rutter, John Howe, John Turner, and Richard Wilson.

Yours ever

Adam Culshaw

(R N Culshaw)
Private Secretary

Miss Alison Brimelow
Department of Trade and Industry

CONFIDENTIAL

cc PC

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PS/ *Secretary of State for Trade and Industry*

CONFIDENTIAL

18 December 1987

R T J Wilson Esq
Cabinet Office
70 Whitehall
LONDON
SW1A 2AS

Dear Richard,

EDP 18/XII

EXPORT CREDIT FOR ARMS SALES

Thank you for your letter dated 11 December enclosing the report of the officials' Working Group.

My Secretary of State welcomes this report as representing a significant step forward. He strongly endorses the proposal for revised methods of both approving and accounting for large arms exports in difficult markets contained in paragraph 17-25 of the report, and agrees that we should put these in place as soon as possible. This should provide us with a much improved means of supporting desirable export business, whilst at the same time exercising a prudent degree of control of the risks. The detailed proposals in relation to ECGD's accounts and its financial objective will also provide appropriate protection for ECGD's Accounting Officer.

My Secretary of State also endorses the suggestion that we begin discussions with overseas partners, starting in the Community, to explore the scope for international agreement to regulate export credit terms for arms business although he doubts whether early results can be achieved. Treasury and ECGD officials can discuss how best to take this further although we should all recognise that this is fraught with practical difficulties.

Paragraph 19 of the report notes that, where Ministers decided that a particular arms contract should be supported under the new arrangements, the liabilities would not be taken under ECGD's normal country limits but would immediately trigger a review of the appropriate country limits. Whilst this is clearly right, it is equally important that ECGD should preserve the ability to support

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normal business with the country concerned and thus my Secretary of State feels it is very important that there should be no question of any "automatic" reduction or closing of normal country limits. It would make little sense for routine business to be crowded out by a single large export order which was being supported for wider political reasons.

The next step would be for a suitable statement to be made to the House. Treasury officials will no doubt be in touch with ECGD to work up a suitable draft and to finalise other follow up matters from the report.

I am sending copies of this letter to Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chief Secretary, the Secretary of State for Defence and the Secretary of State for Employment.

Yours sincerely

Stephen Ratcliffe

STEPHEN RATCLIFFE
Private Secretary

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TRADE ECGD: Pt 2.

CONFIDENTIAL

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bc. P.C.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 December, 1987.

EXPORT CREDIT FOR ARMS SALES

The Prime Minister has seen the Cabinet Office study of the export credit arrangements for arms sales circulated under cover of Richard Wilson's letter of 11 December. Subject to the views of colleagues, she is content with the recommendations of the report by officials.

I am sending copies of this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Chief Secretary, the Secretaries of State for Defence and Employment, and to Richard Wilson (Cabinet Office).

(C.D. Powell)

Miss Alison Brimelow,
Department of Trade and Industry.

CONFIDENTIAL

(1) 32

PRIME MINISTER

EXPORT CREDIT FOR ARMS SALES

You will recall that an official group was set up to try to find a way to deal with the perennial problems over credit for major arms sales.

The group has now reported with two principal conclusions:

- a pooling system, under which an extension of one country's limit to accommodate a major arms contract would be offset by reductions in the limits of other comparable countries in order to contain ECGD's overall exposure, is not manageable. It means that supporting a high-risk contract in one market would deny support to desirable business in a second;

- a more practical step would be to set up a special procedure involving supplementary accounting for major arms sales. It would mean that when Ministers decided to support a major arms contract, they would notify the ECGD Accounting Officer of that decision. A separate ceiling of £1 billion annually would be placed on such business, to control ECGD's overall exposure. This would enable Ministers to see how ECGD's cumulative liabilities on cases of this sort were building up. Overall ECGD's break-even target would remain.

There is interdepartmental agreement at official level on this new procedure. Content, subject to the views of colleagues?

CDP

(C.D. POWELL)
14 December 1987
DA1ABV

CONFIDENTIAL

CABINET OFFICE

70 Whitehall London SW1A 2AS Telephone 01-233

CDP

P 02958

Miss Alison Brimelow
Private Secretary
Secretary of State for Trade and Industry 11 December 1987

Dear Alison,

EXPORT CREDIT FOR ARMS SALES

Earlier this year Ministers asked the Cabinet Office to undertake a study of the export credit arrangements for arms sales. An interdepartmental group was set up under Cabinet Office chairmanship with representatives from all the interested Departments. I attach the agreed report of this group.

THE PROBLEM

From time to time Ministers are faced with major arms sales which require a much larger amount of guaranteed export credit than can be accommodated within the country limits used to control the Export Credit Guarantee Department's (ECGD's) exposure. The precise requirement often becomes clear only at a late stage. Such cases often raise sensitive foreign policy and defence issues, and the UK exporter may be seeking concessions on export credit to counter the defence aid or special arrngements offered by foreign Governments.

It is unavoidable that such cases should usually come to Ministers for decision but the basis on which decisions have to be reached is often unsatisfactory. Ministers find themselves asked to decide at short notice whether to refuse credit with the likely outcome that negotiations will break down and sales be lost with all the foreign policy and defence considerations which may flow from that; or to extend credit beyond the normal limits with all the risks which that entails. ECGD's weak balance sheet, resulting from the international debt crisis, may be unable to absorb the risks associated with the guarantees; ECGD's Accounting Officer may be put in a difficult position on sales which are of doubtful commercial viability; and the cumulative effect of such cases may be an unacceptable contingent liability on the Exchequer.

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We have therefore considered what can be done to help with these problems and to provide a more systematic assessment of the individual and cumulative impact of major arms contracts on the Exchequer.

POSSIBLE SOLUTIONS

It would be possible to have special, less restrictive export credit arrangements for arms sales compared with civil sales. We do not recommend this. Advantages claimed for arms sales have included particularly beneficial employment effects, a large proportion of high technology work, less risk than civil sales in the same market and a higher level of follow-on sales for cash. But all these claims have been challenged. We have found no evidence to suggest that in economic terms arms sales are intrinsically more (or less) beneficial than civil sales: much depends on the circumstances of each case. All Departments represented on the group accept this.

One option would be to set up a pooling system, under which an extension of one country limit to accommodate a major arms contract would be offset by reductions in the limits of other comparable countries, to contain ECGD's overall exposure. However ECGD doubt whether this approach would be manageable in practice. It would also mean that supporting a high-risk contract in one market could deny support to desirable business in a second, unconnected country.

A second option would be to have a special procedure involving supplementary accounting for major arms sales where these could not be accommodated within country limits. This is the approach we recommend. In practical terms what it would mean is that where Ministers decided that such a contract should be supported, they would notify the ECGD Accounting Officer specifically of that decision. A separate ceiling, of perhaps £1 billion initially, could be placed on the cumulative level of such business to control ECGD's overall exposure. Ministers would know, when cases came forward for decision, how the cumulative pattern of ECGD liabilities on cases of this sort was building up. The outturn of all such business would be recorded separately in the ECGD's Trading Accounts. ECGD's financial target would need to recognise the existence of these cases but its break-even objective would remain. If major arms sales covered by the special procedure caused ECGD to fail to meet the objective, this would also be noted. Whenever a major arms sale was approved on this basis, a review of the relevant country limit would automatically be triggered.

CONCLUSION

All members of the Group are agreed that a supplementary accounting procedure for major arms contracts would be workable, and would help to deal with the disadvantages of the present system. I recommend that it should now be put in place.

I am sending copies of this letter and the report to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chief Secretary, the Secretary of State for Defence and the Secretary of State for Employment.

Yours sincerely,

Richard Wilson

R T J WILSON

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EXPORT CREDIT FOR ARMS SALES

REPORT OF AN INTERDEPARTMENTAL COMMITTEE CONVENED BY THE CABINET OFFICE

Introduction

1. This report has been prepared by an interdepartmental group convened to consider problems in the handling of major arms exports under the existing export credit guarantee arrangements. The Cabinet Office chaired the group. The following departments were represented: the No 10 Policy Unit, the Foreign and Commonwealth Office, the Treasury, the Ministry of Defence, the Department of Employment, the Department of Trade and Industry and the Export Credits Guarantee Department.

Background

2. Ministers have recently had to become involved in several cases of large arms sales to foreign Governments. Examples are the sale of Tornado aircraft to Saudi Arabia, the possible sale of Type 23 frigates to Pakistan, of Warrior armoured personnel carriers to Turkey, of fighter aircraft to Zimbabwe and of Tornados to Jordan. These and a number of other similar cases have required difficult decisions about the guarantee of export credit by ECGD. Such sales often require a much larger amount of guaranteed export credit than can be accommodated within the system of country limits which is used to control ECGD's exposure. The precise requirement for guaranteed credit often becomes clear only during the last stage of negotiations. As a result, Ministers have often been faced with the need to decide at short notice whether to extend credit beyond the normal prudential limits, or to refuse credit with the possible outcome that negotiations break down with all the diplomatic, strategic or commercial repercussions which that may entail.

3. This state of affairs has understandably led Ministers to question whether the present arrangements for export credit guarantees on major arms sales are the best which can be devised. In Ministerial correspondence over the last 18 months various issues have been raised:

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i Whether the existing system for controlling ECGD's exposure to the risk of default is preventing desirable arms exports. It has been suggested that there might be special features of arms sales which justify less restrictive arrangements for export credit guarantees.

ii Whether ad hoc decisions to extend country limits or to grant guarantees outside those limits to cater for major arms sales are placing unacceptable contingent liabilities on the Exchequer and undermining the break-even objective for which the ECGD's Chief Executive is accountable.

iii Whether the reservation of large amounts of export credit within the relevant country limits is crowding out desirable civil export sales, which might be more likely than arms sales to come to fruition.

The concern over the relative merits of arms and civil sales and their interaction within the existing country limits led the then Chief Secretary, Treasury to suggest an interdepartmental study of this narrow area in a letter of 9 December 1986. But in his reply of 11 May 1987 the Defence Secretary suggested a broader study of the export credit arrangements for arms sales, which was accepted by the Chief Secretary in a further letter of 18 May. The Cabinet Office was subsequently asked to convene an interdepartmental Group to undertake this study.

Relative Merits of Arms and Civil Export Sales

4. A number of different arguments have been put for and against the view that arms sales have special features which make them preferable to civil sales. Some of these arguments are economic. Others relate to the benefits of sales to the United Kingdom's own defence programme. Yet others are concerned with the implications of arms sales for foreign policy.

5. The main economic arguments which have been cited in favour of arms sales are as follows -

i That the employment implications of arms sales are particularly beneficial, because the jobs generated tend to be concentrated in run-down inner city areas and in depressed regions, and to be more skilled than those associated with civil exports.

ii That arms contracts involve a large proportion of high technology work, with high added value and a technological spin-off for both defence and civil industries.

iii That the credit granted on arms sales is a better risk than that granted on civil sales, because sales are made almost exclusively to foreign Governments rather than to the private sector, and because those Governments may honour their commitments on arms sales in some cases where they default on other borrowing.

iv That major arms contracts generate a higher than average level of follow-on sales of spares, ammunition etc for cash.

6. All these arguments for the comparative benefit of arms sales over civil sales have however been challenged, on the following grounds -

i Although some prominent arms manufacturers are located in economically depressed areas, there is no firm evidence that the employment generated by arms contracts - taking into account the full impact resulting from sub-contracting etc - is concentrated in these areas, or has a higher skill content than that generated by corresponding civil sales. Nor is there any firm evidence that arms sales result in substantial technological spin-off.

ii The evidence that arms sales are a better credit risk is not conclusive. Security considerations may lead Governments to allocate limited foreign exchange to payments for arms purchases. Some limited examples can be cited where Governments have continued to pay loan charges associated with arms supplies for rather longer than those on other debt. But

where countries have suspended or rescheduled debt payments in the Paris Club across the board, debt arising from arms sales has almost always been included, and indeed creditors usually insist that it should be.

iii Many civil sales also generate follow-on business for cash, for spares, feedstocks etc.

iv. Civil sales, unlike arms sales, often make a positive contribution to the economy of the purchasing country, and improve its ability to meet its debt commitments.

7. The Group has considered these economic arguments for and against the view that arms sales are to be preferred to civil sales. Very little evidence exists to support the arguments which have been deployed on either side. To gather such evidence would require a major study, almost certainly involving the collection of new information about the economic impact of arms and civil sales over a long period. But even if such an exercise were undertaken, the Group doubts that a firm conclusion would emerge. All Departments represented on the Group accept, after considering the conflicting arguments which have been put forward, that there is no intrinsic reason to believe that there are major differences in economic terms between arms sales taken as a whole and civil sales taken as a whole. Both types of exports have a valuable contribution to make to the UK economy, provided of course that payment is eventually forthcoming. Individual contracts of either sort may have special benefits, but there is no reason to expect such benefits to arise more often, or less often, in the case of arms sales. There is no escaping the need to consider individual arms contracts on their merits.

Special Features of Major Arms Sales

8. Nevertheless the Group is agreed that major arms sales are particularly likely to raise issues which require Ministerial involvement, because of the following special features -

i The UK is well placed to win such business, both because of the high reputation of its own armed forces and arms industry, and because key competitors in the civil market (for example, Japan and West Germany) generally choose not to compete in most defence markets.

ii Contracts involving the supply of warships, aircraft, armoured fighting vehicles, etc, to poorer countries are often very large in relation to the ECGD's country limits.

iii Such contracts often raise sensitive foreign policy issues. UK willingness to offer financial support for defence exports can significantly affect our political relations with the countries concerned, and such sales may enhance our own interests directly, for example by precluding the sale of Soviet equipment with its associated "advisers".

iv UK arms exporters often compete with those from other exporting countries which have defence aid programmes or special arrangements for supporting credit on defence sales. There are no such measures in the UK. The lack of such arrangements tends to put UK exporters at a competitive disadvantage, and they often seek concessions over export credit as the only way available to the Government to counter this disadvantage.

It is important to stress that current arrangements handle the vast bulk of cases satisfactorily and thus these special features attach to only a small proportion of arms contracts: probably no more than about one per cent of total contracts by number, although of course a higher proportion by value. Some civil sales can also give rise to similar issues: for example airbus sales and the supply of integrated projects such as power stations, airports and processing plant. But they are disproportionately likely to arise on major arms contracts, which account for most of the cases which Ministers have had to consider in recent years.

Present procedure for dealing with major arms exports

9. We have gone on to consider whether, in the light of these conclusions, any improvements can be made in the present arrangements for dealing with major arms export cases. Some features of the present procedures have given rise to difficulty:

a. Credit for arms export sales is subject to the same procedures and requirements as credit for civil sales, including in particular the system of country limits. There is of course a strong case for the view that this is right. Since all such credits are ultimately at the risk of the Exchequer, it makes sense to look at HMG's exposure in each market as a whole, including defence and civil business. But in practice the very large size of some of the arms sales contracts has put this system under considerable pressure. Since the amounts of money involved are sometimes very large in relation to the country limits, a substantial number of cases have had to be referred to Ministers ad hoc, for them to consider whether the limit could be exceeded to accommodate credit for the particular sale in question. These cases often have to be referred to Ministers at short notice as negotiations proceed. There is also a risk that these procedures will lead to piecemeal decision-making, and that the cumulative effect of ad hoc decisions to extend credit guarantees on large individual arms sales will be an unacceptable overall contingent liability for the Exchequer.

b. ECGD have a statutory duty to encourage trade with other countries but are required to operate credit insurance at no net cost to public funds. Ministers have assured the House of Commons that the Department will be left to operate credit insurance in accordance with its 'normal judgements' and that where the Government decide that it is necessary to instruct ECGD to go beyond this, a statement will be made to the House. In practice, Ministers may decide that, perhaps for reasons of defence or foreign policy, guarantees should be given on arms sales contracts where repayment prospects are very doubtful, even where the result is to exceed the country limit. This can place the ECGD Accounting Officer in a difficult position.

10. These problems are the greater because ECGD's general financial situation is not such that it can absorb large arms contracts in difficult markets without jeopardising its general aim of operating the scheme at no net cost to public funds. Because of the continuing debt crisis it has made heavy payments under its guarantees over the last few years and now has a cumulative notional deficit with the Consolidated Fund of £1.3bn. It also has significant contingent liabilities on guaranteed refinancing loans to debtor countries. This cash outflow is not a loss. The expectation is that most of the sovereign debt will be repaid in time although as a matter of accounting prudence a cumulative general provision has been set aside in ECGD's accounts of £1.1bn against the possibility that not all of the debt (including interest) will be recovered. ECGD continues to pay a full commercial rate of interest on its borrowing from the Consolidated Fund and is aiming for a gradual improvement in its outturn in future years. It can therefore still be said to be meeting its broad break-even objective, taking one year with another (and it must be remembered that for at least 60 of its 68 years it produced healthy cash surpluses). But the overall effect of the debt crisis upon ECGD is that it has a weak Balance Sheet. Whilst it has reserves of £1.3bn (including the general provision), virtually all of these are illiquid and take the form of future payments due from debtor countries. Its current exposure to problem countries amounts to almost £7bn.

<u>An international agreement</u>

11. Some of these problems could in principle be reduced by an international agreement regulating export credit terms for arms business, just as the OECD Consensus regulates the terms on civil business. The best way of achieving such an agreement would be to extend the present Consensus into the field of arms exports, by means of a 'Sector Agreement' like those which already apply to aircraft and nuclear power stations. There is no Community mandate for this at present. Objections would centre on the lack of an existing appropriate forum; national sovereignty on defence-related issues; the political nature of the arms business; security considerations inhibiting exchange of information; and differences in national arrangements which sometimes take an 'aid'

rather than 'export credit' character. And an agreement would not deal with the availability of cover in high risk markets, which is the source of most of these problems and the principal concern of this report. Nevertheless, international agreement on credit terms (such as interest rates, credit length etc) could help to regulate international credit competition, and be in line with the UK's general approach in the export credit area. We could therefore begin discussions with overseas partners, starting in the Community. If we began these discussions and, as is to be expected, they ran into obstruction, we could consider applying political pressure at the time of the next OECD Ministerial Meeting in May 1988. It is clear however that even if the negotiations could be got off the ground they would take a long time to produce results. We therefore have to look elsewhere for a solution to our problems, at least in the short or medium term.

Possible new Arrangements to deal with Major Arms Exports

12. The Group has therefore considered whether we could make changes in our own procedures which would ease some of these problems. The Group is agreed that Ministers will inevitably become involved with very large arms contracts which raise major issues of the sort discussed above. It is also important not to prejudge the outcome of existing work to improve the management of ECGD's exposure, through a possible "portfolio" approach to credit risks. It may however be possible to devise new arrangements, or modifications to the existing arrangements, which could provide a more orderly way of considering major arms export contracts, and a more systematic method for assessing their likely impact on the Exchequer, both individually and cumulatively.

A pooling system

13. The first possibility considered by the Group was a pooling system under which an extension of the credit guarantee limit for one country would lead to offsetting reductions elsewhere, to contain ECGD's overall exposure. ECGD is already developing an improved system of country risk analysis for early trial which may eventually lead to improved arrangements for managing country risk giving more weight to the need for a balanced portfolio. The Treasury has proposed an interim arrangement, which would not

affect the development of the longer-term system. Such an arrangement would build on work already done in improving the analysis of country risk. The Treasury argue that it should be possible for part, at least, of this analytical work to be used to devise a more coherent set of country limits grouping countries by degree of risk in broad-brush bands: for example, those similarly affected by changes in key economic factors. Once this had been done, a Ministerial decision to accept an exceptional risk (one taking ECGD's exposure beyond this 'acceptance limit') could be offset by a reduction in the market limit for another market in the same group. Ministers have already taken ad hoc decisions of this kind in two successive cases in Jordan. This system could be further developed, by providing that the new-style country limits could be exceeded by fixed margins (say 10% for Category B markets and 5% for Category C markets) without the need to refer to Ministers, provided such excesses were contained within an overall ceiling of (say) £0.5bn, and were offset by reductions within the same market category.

14. On the other hand, the scope for this procedure is limited until a decision is taken on whether the market limit system can be changed along the lines suggested. There are also more general arguments against it. ECGD country limits can never be the final word as to how much business can prudentially be taken on; they are not firm ceilings or 'business budgets'. Moreover, the economic fortunes of overseas markets fluctuate once risks have been assumed and this restricts the extent to which ECGD's portfolio can be 'manageable' in practice. Whilst Ministers may decide in a particular case that they are prepared, for reasons of defence policy or other national interest considerations, to authorise taking a higher degree of risk than would otherwise be acceptable, it is questionable whether, as a consequence, other desirable business in a different market (which in its own terms is an acceptable risk) should be denied support. This depends on whether Ministers wish in effect to put an upper limit on the overall risk which ECGD should accept, irrespective of the quality of the risk.

Supplementary accounting for arms sales

15. In view of these problems, the Group went on to consider another option, under which changes would be made in ECGD's accounting arrangements to take account of the special nature of major arms sales.

16. ECGD gives its guarantee under either Section 1 of the Export Guarantees Act 1978 (where the business presents a reasonable commercial risk) or Section 2 (where the business is deemed supportable in the UK national interest).(1) Market limits for Section 1 (commercial account) business are set by ECGD's Advisory Council comprising senior representatives from industry and City. Country limits for Section 2 (the national interest account) are recommended by ECGD and considered by the Treasury-chaired Export Guarantees Committee (EGC) subject to Ministerial approval in difficult cases. There are normally no limits for low risk countries (Category A); limits for Category B and Category C are determined by perceptions of risk. Category D markets are mainly those which have recently rescheduled and where no cover or only limited cover is available. There is a special category (DX) of the Sub-D markets cases where, nevertheless, Ministers have agreed that assistance may be available for exports specifically aimed at improving a debtor country's economic position. Ministers agreed a year or so ago that this facility should not generally be available for arms sales.

17. Under the option now proposed there would be a special procedure to deal with exceptional cases where Ministers wished to support a particular arms sale which could not be accommodated within existing ECGD Country Limits.

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(1) Arms sales also attract interest subsidies at the rates provided for civilian business under the OECD Consensus. These are not contingent costs, like those arising from the guarantees but actual costs adding to public expenditure over the life of the loans, their size depending on the difference between commercial interest rates and the fixed interest rates charged to the overseas buyer.

18. The 'trigger' in such cases would be a view recorded at EGC that a case needed to be referred to Ministers, for example because officials in the interested Departments believed a particular sale involved exceptional risks. If Ministers, for broader strategic reasons, then decided to support the sale, the Chief Executive of ECGD would be notified specifically by the Minister for Trade (in consultation with his colleagues) to this effect. This would be necessary in order to protect the Chief Executive in his capacity as Accounting Officer in the particular case.

19. Where Ministers decided that such a case should be under-written, the liabilities would not be taken under ECGD's normal country limits but would immediately trigger a review of the appropriate Country Limit.

20. Additional premiums would normally be charged to exporters to reflect the perceived exceptional risks from large cases in difficult markets.

21. These procedures would be strengthened if Ministers agreed in advance to place a ceiling on the cumulative level of such 'exceptional' cases, of, perhaps, £1bn in the first instance. Commitments against this ceiling would be reviewed quarterly as part of the existing 'early warning' for reporting to Ministers on potentially difficult cases. This would give Ministers an opportunity to develop priorities between conflicting claims on a limited volume of cover for such large cases in difficult markets. The level of the ceiling would be reviewed by Ministers as need arose.

22. The Trading Results of such operations could be brought specifically to Parliament's notice in a supplementary note in ECGD's Trading Account. This would give the outturn of the 'exceptional' large arms transactions undertaken in excess of normal country limits and show both the annual premium income receivable and net losses (or profits) for the year so that after a number of years it would be possible to measure the outturn.

These cases would still form part of the Section 2 ('national interest') account.

23. Ministerial decisions to support these special cases would need to be consistent with Section 2's broad break-even objective. But by definition, cases proposed for this treatment would be those in which the risks involved were greater than usual; the contract values would be large in relation to the market limits for the countries concerned; and the markets themselves risky. Thus, although the expected outturn of each individual project would be positive, the dispersion of risk would unbalance ECGD's book. ECGD's new financial target would need to recognise the existence of such cases. The target would not be softer as a result. But if ECGD failed to meet the target due to the outturn on these large arms sales, the Foreword to the Accounts would explain that this was due to cases underwritten under Ministerial direction. This would provide ECGD's Accounting Officer with suitable protection against criticism by the PAC.

24. If after a number of years' experience it became clear that the cumulative result of such special cases created undue losses, Ministers would need to reconsider the policy. Options would then include cross-subsidising from normal business (thereby requiring exporters in other sectors to pay more to cover losses on special arms cases) and a capital reconstruction. But the object of the review procedures described in para 21 above would be to avoid this developing.

25. These new arrangements would not require legislation; but a statement should be made to Parliament at the time they were established. The statement would bring out the way in which such business would appear in the Accounts, the fact that case decisions would be taken by Ministers, and how ECGD's financial objectives would be affected. It would need to deal with potential criticism that the Government was providing a subsidy or aid for defence sales (contrary to its long standing policy) and that it represented an expansion of UK support or preferential

treatment for arms sales. This would be especially important if the UK were to press for an international agreement to rationalise competitive terms on defence sales.

26. All members of the Group are agreed that a change along these lines would be workable and would help to deal with the disadvantages of the present arrangements.

Summary and Conclusion

27. The Group concluded:

a. There is no reason to expect arms exports as a whole to have more benefits or fewer benefits than civil exports as a whole. Each contract has to be considered on its merits.

b. Major arms contracts are particularly likely to require Ministerial decision because they are often very large in relation to ECGD country limits and can have important foreign policy implications.

c. Present arrangements for considering such contracts have not worked satisfactorily. Cases have often had to be referred to Ministers at short notice. There is a risk of piecemeal decision-making leading to the growth of an unacceptably high total of contingent liabilities for the Exchequer. The ECGD Accounting Officer can be put in a difficult position when Ministers approve projects of doubtful viability for wider reasons of defence or foreign policy. ECGD's already substantial exposure to problem countries increases its difficulty.

d. An international agreement regulating export credit terms for arms sales could in principle reduce these problems. But if it could be negotiated at all it would take a long time to produce results.

e. One option considered by the Group was a pooling system under which an extension of the credit guarantee limit for one country would lead to offsetting reductions elsewhere, to contain ECGD's overall exposure. But it is doubtful whether this would be manageable. It would mean that if Ministers decided to accept a higher degree of risk in one country, we would have to deny support to business which could be desirable in another country which had no connection with the first.

f. The Group therefore considered another option to create a special procedure to deal with exceptional arms sales. Such sales would not be covered under ECGD's normal country limits, and Ministers would notify the ECGD Accounting Officer specially of any decision to support them. ECGD's financial target would need to recognise the existence of these sales but its break-even objective would remain. The total amount of such business would be brought specifically to Parliament's notice in a supplementary note in ECGD's Trading Accounts, and its outturn identified separately. If it caused ECGD to fail to meet their financial target, this would also be noted. A ceiling of, say, £1bn could be put on the total level of such exceptional cases. All members of the Group agreed that a change along these lines would be workable and help to deal with the disadvantages of the present arrangements.

Cabinet Office
11 December 1987



ccfc

16pm

FCS/87/212

CHIEF SECRETARY

ECGD Controlling Contingent Risks

I have seen your letter last month to David Young and his reply.

This is a difficult but important area. I agree with much of what you say. The present piecemeal arrangements are not satisfactory. Of course we cannot allow a limitless accumulation of contingent risk: something needs to be done to put sensible constraints on the system. But you are right, too, to say that because ECGD is in the risk business, we should not take too rigorous a view of its liabilities. In particular, from my own point of view, we must clearly retain the necessary latitude to undertake Section 2 business which we consider essential for our foreign policy and other wider national interests. I confess to sharing David Young's scepticism about too mechanical a transfer of cover between countries.

However, these issues are now being intensively considered between our officials. The Cabinet Office's study of defence relative to civilian sales should, I understand, be ready by end of October, and will contain suggestions for improving the coherence, clarity and discipline of the existing system. I suggest that we should reserve our substantive judgements until we see their recommendations.

I am copying this minute to the recipients of yours.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

12 October 1987

pp (Approved by the foreign Secretary & signed in his absence)

TRADG : GCGD PT2



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Secretary of State for Trade and Industry

02 October 1987

The Rt Hon John Major MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

CDP 2/2

Dear John,

ECGD : CONTROLLING CONTINGENT RISKS

Thank you for your letter received on 25 September about the difficulties of controlling ECGD's exposure to foreign exchange risks. As you say, it did not prove possible to discuss this when we met to consider ECGD's Running Costs although we can certainly pick it up in the meeting you propose on ECGD's business strategy. Your letter sets the scene for such a discussion and perhaps I could be permitted to make one or two observations.

First and foremost, as you recognise, ECGD is in the business of taking on contingent risks. Indeed, the very purpose of ECGD is to provide a Government scheme to support British exporters through periods when no commercial insurer in the private sector could operate. Otherwise, why not leave it to the private sector? It should also be remembered that, apart from a brief period in the 1950s, ECGD produced profits and cash surpluses until only 4 years ago when it was adversely affected by the longest and deepest worldwide recession of this century. Without ECGD to support British exporters throughout the last 4-5 years there is little doubt that a number of major exporting companies would no longer be in business. ECGD's record does not compare badly with other export credit agencies, some of which are less cautious than we are in taking on new business.

The second point I should like to make is that whilst ECGD is currently running a significant cash deficit, it is premature to regard this as a "loss". For the most part, the payments made by ECGD as a consequence of foreign exchange difficulties by debtor

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countries have been the subject of rescheduling agreements in the Paris Club and those debtors have entered into formal agreements to repay over a period time at a commercial rate of interest. Moreover, ECGD is servicing its notional deficit with the Consolidated Fund by paying a commercial rate of interest. I accept that not all of these sums may be fully recoverable in the event; and in recognition of this, ECGD has made prudent provision in its Trading Accounts. It has now built up progressively over the last 4 years a general reserve of £1122 million which is sufficient to cover the total default on moratorium interest across the full range of debtor countries or the complete failure by any one of the top four debtors. The inherent nature of the risks insured by ECGD, involving horizons of up to 15 years or even longer in developing countries, is such that the financial outturn is highly imponderable and will never be subject to accurate evaluation by actuarial, economic, statistical or any other techniques. To believe otherwise is simply wishful thinking. Moreover, the risks cannot be divided into finite categories of "acceptable" and "unacceptable". Although we set country limits, we cannot pretend that they are scientifically accurate assessments of the amount of risk it is reasonable to take. Risk evaluations fall in a continuing spectrum from the perceived "very good" to the perceived "very poor" and it seems perfectly reasonable for Ministers to decide in some cases that they are prepared, for reasons of defence policy or other national interest considerations, to authorise taking a higher degree of risk than would otherwise be acceptable.

That said, I am far from complacent, and I recognise that there may be scope for improvement of the existing mechanisms for containing and managing ECGD's exposure to country risk. But whatever methods we employ, there will always be cases where ECGD is under strong pressure (sometimes supported by Ministers of interested Departments) to support business for reasons of international competition, or for other policy reasons, where the risks are reckoned to be at the margin of acceptability in underwriting terms. Since there are no corresponding pressures in the other direction, this results in a continuing bias towards taking on speculative risks. It is difficult to see how this can be avoided in a Government scheme. The Treasury has a clear role at the heart of these discussions on difficult cases in that Treasury consent is required under ECGD's statute, a role that is exercised through the Export Guarantees Committee which is chaired by a Treasury representative. At the extreme, no "hard case" backed by the Minister of any Department can be allowed without the consent of a Treasury Minister.

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I agree, however, that recent history invites a review of the existing machinery for deciding just how much risk ECGD should take in difficult markets, or groups of markets. In this regard, there are currently two exercises which I hope will take us further forward. First, the Cabinet Office is working on draft proposals in relation to large defence contracts in difficult countries and I hope that they will be able to report to us soon. Second, ECGD have been working hard on improvements in the analysis of country risk and are now almost ready to give these a practical trial. If successful, this may point to improved methods of managing the portfolio as a whole but this latter exercise raises a number of difficult technical and managerial questions and I, frankly, do not expect early results. Nevertheless it remains a high priority task for the Department and I am anxious that they should get on with it. Meanwhile, I do not favour the kind of interim proposals that have been put forward by the Treasury whereby marginal risks in one country are offset by reductions in the availability of ECGD cover in another. Such an approach has a superficial attraction but it is not, to my mind, an effective method of managing ECGD's business.

I suggest we consider this further when we review ECGD's progress on a portfolio management system and take account of the Cabinet Office study at the forthcoming meeting on ECGD's business strategy.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, George Younger, Cecil Parkinson, Nicholas Ridley, Paul Channon and Robert Armstrong.

Yours

David

LORD YOUNG OF GRAFFHAM

DW4CNC

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TRADE - ECGD . Pr 2

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CDP 24/9

Treasury Chambers, Parliament Street, SW1P 3AG

Dr Timothy Walker
Private Secretary to the
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

23 September 1987

Dear Timothy,

EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS

The interdepartmental Export Guarantees Committee (EGC) met last week for the quarterly review of large prospective defence and civil contracts, in markets where ECGD cover is limited. In the past the Chief Secretary has written to his colleagues when the quarterly review identified difficult problems on the horizon. For the future it has been agreed that there should be a regular, standard report of difficult cases on the lines of that now circulated for ATP cases. I enclose the first such report which identifies 4 potential problem areas.

Three of these (Brazil, Turkey and Pakistan) have already been the subject of Ministerial correspondence. There is no immediate problem on the availability of cover for Kenya but EGC will have to watch developments carefully. A market review of Pakistan will be available shortly. The Turkish market will be reviewed as soon as the results of the election are known.

Of the other cases mentioned in the Chief Secretary's letter of 30 June, after the last quarterly meeting, I understand that an MOD team are discussing with the Zimbabweans their likely air defence requirements, as instructed by OD Committee, but there have been no recent developments. The possible sale of Tornado aircraft to Jordan is to be discussed on 29 September; if that contract goes forward it will, of course, replace the prospective Warrior contract mentioned in the earlier letter.

Attached, as an Annex to the report, is a schedule setting out details of ECGD's project business. This will be updated as appropriate and circulated with the quarterly report. It might be particularly helpful when it is necessary to take decisions on difficult cases, to have a broad indication of the cost of supporting project business.

I am copying this letter to David Norgrove (No.10), John Howe (MOD), Tony Galsworthy (FCO), Martin Dinham (ODA), Stephen Haddrill (Energy), Trevor Woolley (Cabinet Office) and Kevin Butler (Bank of England).

Yours,

JILL RUTTER
Private Secretary

5324/8vj

EXPORT GUARANTEES COMMITTEE
EXPORT CREDIT COVER FOR PROSPECTIVE DEFENCE AND CIVIL CONTRACTS
QUARTERLY REPORT OF POTENTIAL PROBLEM CASES APRIL-JUNE 1987

BRAZIL

Westland Helicopters are competing for the prospective contract for the sale of Lynx helicopters to the Brazilian Navy. ECGD cover of £85m would be required by Westlands. In the absence of agreement with the IMF and a Paris Club settlement, DX cover is not available for Brazil. Ministers have agreed to consider extending cover for this prospective contract if there is clear evidence of French competition with support from the official credit agency. Despite earlier circumstantial evidence French officials have confirmed that credit support is not being offered for Aerospatiale's competitive bid, and have undertaken to inform UK officials of any proposal to offer official support.

The Brazilian Navy continue to express a preference for Lynx helicopters but claim that there is strong French competition supported by COFACE. They were again unable, however, to provide evidence of COFACE support at a recent meeting with the Minister for Trade. A final decision is unlikely before the end of the year.

Other prospective contracts which will require ECGD cover when DX cover is available include Rolls Royce Spey Engines and Airbus aircraft.

KENYA

Limited cover available. Cover has been given to Vosper Thornycroft for a project to extend the naval base; an indication of cover has been offered to Marconi for the supply of communications equipment. There are a substantial number of small civil contracts for which indications have been given; cover has been reserved for one Airbus aircraft and indications of cover have been given for BAe aircraft. However, problems could arise if any sizeable contracts became firm over the next few months.

	£m	
Market limit (Grade C)	270	
Firm business	130	(In addition £103m cover has been given for patrol boats outside ML)
Reservations	112	
Balance available	28	
Indications	360	

PAKISTAN

The £360m credit reserved for the Yarrow Shipbuilders long-standing bid to sell 3 frigates to the Pakistan Navy expired at the end of June. There continues to be a strong preference by the Navy for the Yarrow frigates; the Pakistan Government have not yet made a final decision. ECGD are currently conducting a market review and will be recommending a realistic market limit in order to deal with the increasing enquiries for cover for civil business and a potential Airbus contract.

If the frigate deal was resurrected, any further offer of credit would have to be considered bearing in mind the market limit and the demand for cover for civil business.

	£m
Market limit (Grade D)	75
Firm business	35
Reservations	14
Balance available	26

TURKEY

Ministers agreed in June to a temporary increase in the Section 2 market limit to £660m, to enable an allocation of £200m cover to be made available to the GKN Warrior project. Indications of cover on a first come, first served basis for other business continue to be given, but the agreement of EGC is required before further cover is reserved for cases which are in the final stages of negotiation. Treasury Ministers took the line that the market limit should be reviewed when there was evidence of positive economic adjustment measures or after a general election. That line was not fully accepted by departmental Ministers.

Other credit agencies remain open for medium/long term cover but subject to certain restrictions. ECGD's position in the league table of commitments by export credit agencies has slipped back to ninth place. They are concerned about existing indications of cover given on some £1b project business with only a minimal unallocated cover remaining available within the market limit.

However the general election is now likely to take place on 1 November and although ECGD had proposed in a recent market review paper an increase in the market limit to £800m, EGC agreed to await the outcome of the election before processing the review; no large contracts are likely to be placed before the election which will have important implications for future Turkish economic policy.

		£m
Market limit (Grade C)		660
Firm business		232
Reservations		394
Balance available		34
Indications	(approximately)	1000

5324/17

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ANNEX

General: PROJECT BUSINESS

	1985/86	1986/87	1987/88 (latest forecast)
Project business issued	2,726	3,058	2,173
Premium received on project business	95.2	98.2	66.1
*Net claims paid on project business	(337.0)	(377.8)	10.8
**Consolidated Fund balance for project business	156.9	(96.8)	65.2

* value of claims paid, less recoveries, during the year concerned. The figure relates to business insured in previous years and does not therefore indicate likely experience on new business.

** ECGD's total Consolidated Fund balance in respect of project business (ie excluding business, underwritten by the Comprehensive Group). A deficit does not indicate a net loss; claims paid following Paris Club rescheduling arrangements should in many cases lead to full recovery.



007/4210

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CCBG

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

CDP

September 1987

Dear David,

ECGD: CONTROLLING CONTINGENT RISKS

Since moving into this job, I have been struck by the contrast between the way we approach decisions involving immediate public expenditure, and decisions which involve contingent risks to the Exchequer. In the first case, there is a clear discipline applied, by common consent. Public expenditure totals are set in advance, and decisions are taken within that agreed framework. A Minister advocating additional expenditure has to choose between that and other desirable expenditure in his field. If, exceptionally, he makes a claim on the central Reserve, he knows that there is a finite sum available for that purpose, and that he is competing with the claims of other Ministers. By contrast, no such disciplines apply to contingent risks. Following the disaster of the International Tin Council, the Prime Minister wrote (22 May 1986) to all Ministers in charge of Departments, urging them to take a much closer grip. And contingent liabilities are now routinely reviewed as part of the Public Expenditure Survey. By far the largest stock of such contingent liabilities are those undertaken by ECGD in the normal course of its business. I am becoming increasingly concerned at adding to that burden without full recognition of the implications. Under our present arrangements, individual submissions come forward in a piece-meal way, without any consistent attempt to evaluate the risks or to judge one case against another.

Of course I accept that, since ECGD is in the risk business, with the objective of promoting British exports, we should not take too rigorous a view of its liabilities. We cannot hope to "win them all", and the price of continued support is losses in a few markets. I am, however, concerned at the scale of these potential risks.

I understand that ECGD now insures just under 20% of non-oil UK exports, down from a peak of 35% seven years ago. Its total amount at risk is some £25bn, of which £15bn is on the 'national interest' Section 2 account, which is a direct concern to Ministers. Of that £25bn, about £7.3bn is in the most risky (category D) markets, mainly those which have already rescheduled part of their debt; £5.7bn in category C markets where there is a high degree of risk, £3.4bn in category B and, more cheerfully, £8.4bn in category A markets, where there is less need for rigorous controls. In addition, ECGD holds claims totalling £1bn on countries which have already rescheduled.

Since the debt crisis of 1982, ECGD has had to make massive payments to its policy holders (sometimes because of default by individual buyers, but mainly because its customer countries have had to reschedule their debts). It has exhausted its cash holdings, and has 'borrowed' £1.2bn so far from the Exchequer. ECGD forecast last year that, if countries go on rescheduling, as seems likely, this financing requirement could peak at about £3.2bn - a figure which was used in evidence to the PAC. On current policy, much of this will be refinanced in the City, rather than rescheduled by ECGD, thus bringing the maximum Exchequer borrowing down to £1.7bn (on the latest forecast). But of course the contingent risks of all this refinancing would remain with ECGD. Realistically, we cannot expect to recover all the LDC debt which is currently on their books.

These deficits are the cumulative result of past decisions which this government and its predecessors has taken in previous years. The most prominent cases are of course excessive lending to Poland in the late 1970s, and to Latin America in that period and the early 1980s; continued lending to Nigeria after the oil price collapsed in 1982; and, more recently, to Egypt, long after the writing was on the wall there. There have also been a number of individual cases e.g. our agreement - now withdrawn - to provide cover to Pakistan for frigates in excess of what we considered prudent. If this had gone sour it would have wiped out ECGD's entire premium income (not just its profit) for a year.

Much has already been done to avoid repeating past errors. ECGD have told us that they believe new business to be profitable. Preliminary results for short-term business undertaken in the last two years seems to confirm this. But it will not be possible to judge the success of current underwriting of medium and long-term, and especially of project business, for some years ahead yet. It includes some rather doubtful cases.

Profitability certainly cannot be sustained, if we continue to add contingent liabilities in uncreditworthy markets without the most careful consideration. Recent cases which have crossed my desk since I arrived here include the GKN Warrior contract in Turkey (£200m against a current market limit of £600m, of which only £140m was available); Westland helicopters for Brazil (£85m: no cover available. This is the subject of separate Ministerial correspondence); Zimbabwe aircraft deal (discussed at OD recently: £150m, against a free balance of £192m within a country limit of £400m); Tornados for Jordan (£50m addition to the country limit which we are due to discuss with the Prime Minister on 29 September); and possibly Warriors for Jordan (still in the pipeline, I understand. A possible order of £250m, on top of the Tornado Order. Clearly we can't do both).

These cases illustrate the problem outlined above. The Jordan case is particularly interesting. When my predecessor considered additional cover at an earlier date he suggested that, if Ministers wished to increase ECGD's exposure in Jordan, they should make a corresponding reduction in the market limit for some other country of roughly the same risk category. Although this was reluctantly conceded for that particular case, both your predecessor and the then Defence Secretary made it clear that they did not regard it as a precedent for the future. I have however suggested, in my letter of 10 September to the Prime Minister, that we might need to repeat this procedure. Without some such arrangement for this and other cases, I do not see how we can hope to keep ECGD's contingent liabilities within reasonable bounds. As you said in your recent interview in the Financial Times, there is "no point in encouraging ECGD to make cover available for uncreditworthy countries that are not going to repay their loans". I am sure that is right.

I had hoped we should have a chance to discuss some of these problems in the context of ECGD's business plan, which Alan Clark sent me on 30 June. However, I fear there was not time to fit in a meeting before the recess. As I said at our bilateral on 16 September, I hope we can fit this in later in the year, when ECGD's business strategy

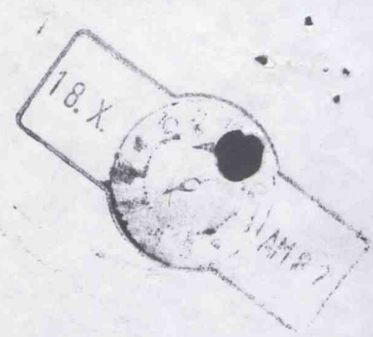
document is ready. Meanwhile, I know that ECGD's Chief Executive is working on proposals for a revised approach to country limits, following discussion with Treasury and FCO officials recently, and the Cabinet Office, following a separate remit suggested by my predecessor, are producing a paper on arrangements for handling arms sales, which are a particular source of difficulty.

The point of this letter, therefore, is to set out the kind of problems we face, and to suggest that until new procedures can be devised which we can all accept, we should be particularly careful in adding further to ECGD's exposure in dangerous markets.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, George Younger, Cecil Parkinson, Nicholas Ridley, Paul Channon and to Sir Robert Armstrong.

Yours Ever,
John

JOHN MAJOR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(Switchboard) 01-215 7877

From the Minister for Trade

Rt Hon John Major MP
Chief Secretary
Treasury
Parliament Street
LONDON
SW1P 3AG

3 August 1987

ECGD 3/8.

Dear John

ECGD COVER FOR BRAZIL/WESTLAND

Thank you for your letter of ~~27~~ July. I understand the reasons why you would not wish to agree cover for the Westland sale now, whilst no progress has been made in the negotiations with the Paris Club. However, I regret that you are not prepared to consider in advance the question of whether such support might be given when ECGD is in a position to resume medium term cover. I would certainly wish us to consider this matter again at that time as I believe there are strong industrial and commercial reasons for an exception being made to our normal (DX) rules.

I agree with the point made by Tim Eggar in his letter of 20 July to you that there is a danger that we will be too late and Westland will find themselves pre-empted by the French. I also share his suspicions that the French may be playing a double game. Although they have recently agreed to join the Paris Club ban on new credits to Brazil we know that COFACE-backed credits have been concluded (one with Petrobras having just been signed). So far there is no evidence of a firm COFACE offer for helicopters, but I believe that Aerospatiale (Government owned) have given fairly clear indications to the Brazilian Navy that a COFACE-guaranteed credit will be available.

We shall certainly be under fierce attack from Westland (and British exporters generally) if the French break the common line and win this contract. Therefore I am sure that it is right to try to get as unequivocal assurances as we can from the French Government that they will adhere to the Paris Club ban. Whilst our Ambassador can give supporting fire in Paris, I agree with him that this is best done at Ministerial level. As these matters fall under the Finance Ministry in France it would be appropriate for this to be done by the Treasury.

Rt Hon John Major MP

August 1987

It is important that we close any loopholes and I should be grateful if it could be arranged to follow-up the Chancellor's discussion with M. Balladur with a letter* asking the French to confirm that:-

1 There is no existing credit facility that could be used to finance the sale of helicopters;

2 Aerospatiale have told the Brazilians that COFACE-backed credits will not be available until progress is made in the Paris Club negotiations; and

3 The French will consult us in advance before they make an offer of support for this business.

We would, of course, have to give them similar undertakings.

On this basis I think we can leave matters as they are but I would wish us to discuss urgently if the French response is unsatisfactory.

I am copying this letter to David Trefgarne, Tim Eggar, Sir Robert Armstrong and Charles Powell at No 10.

* I attach importance to this letter - soon as possible!

ALAN CLARK

999-49

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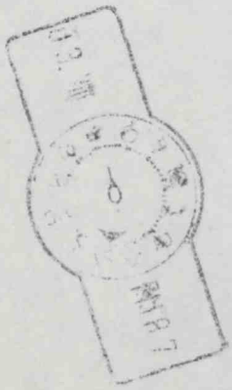

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Hon Alan Clark MP
Minister for Trade
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H 3EB

CDG 28/7.

27th July 1987

Dear Alan,

BRAZIL: COVER FOR WESTLAND HELICOPTERS

Thank you for your letter of 13 July, in which you sought my agreement to an interim strategy which includes exerting diplomatic pressure on the French to defer support for the sale of helicopters to Brazil, and which will commit ECGD to provide export credit cover of £85 million to Westlands when DX cover is available. I have also seen Tim Eggar's letter of 20 July and David Trefgarne's letter of 21 July.

Whilst I agree with your proposal to exert diplomatic pressure on the French, I am afraid that I cannot agree that we should inform either Westland or the Brazilian Government that ECGD cover will be available once DX cover is agreed after a rescheduling agreement.

In his letter of 18 May John MacGregor said that before considering further the proposal to extend cover to Westland, we would need clear evidence of French competition with export credit cover. There is no evidence that Aerospatiale will be supported by COFACE. You confirm in your letter that French officials have said that no formal commitment has been given. My officials report that at the Paris Club meeting last week, the French agreed in principle to support the line advocated by the Americans, who are strongly opposed to extending export credit cover to Brazil. All other major creditors are off cover but the French might insist on honouring existing commitments; it remains to be seen whether the helicopter deal falls to be regarded as eligible for cover. It would be inappropriate in the meantime for the UK to breach the common line between credit agencies on cover for Brazil.

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ECGD
PT 2

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In the circumstances, I strongly support your proposal to exert diplomatic pressure on the French to refuse support for Aerospatiale. Despite the scepticism of the Post about the effectiveness of diplomatic pressures, to which Tim Eggar refers, I hope that he will instruct the Post to make the appropriate representations. Nigel Lawson is being asked to pursue a similar line in his discussions with Mr Ballandur, the French Finance Minister, on 31 July.

I remain concerned that the Brazilians continue to maintain that they do not intend to seek an IMF programme. Their recent announcement of measures designed to restore the economy and strengthen the external account, do not at first sight appear to provide a basis for a standby agreement; the Paris Club has reaffirmed its refusal to consider further rescheduling without an IMF SBA. The position might be clearer by the September meeting of the Paris Club and I suggest that we review the position after that meeting.

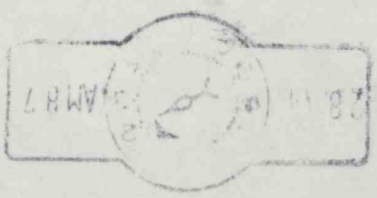
The earlier offer to consider further the question of ECGD cover if there is clear evidence of French credit cover for the Naval helicopter contract will, of course, apply in the interim period. But I would need to be convinced that there are exceptional reasons for extending cover to Westlands for the sale of helicopters to Brazil.

I hope that you can agree to maintain a prudent approach to this issue until Brazil's position in respect of the IMF and Paris Club is clearer.

I am copying this letter to David Trefgarne, Tim Eggar, Sir Robert Armstrong and Charles Powell at No. 10.

Yours Ever,
John

JOHN MAJOR



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MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 6/13V

22 July 1987

CDP
22/7

Dear John,

EXPORT CREDIT FOR ARMS SALES

You wrote to me on 30th June about a number of arms export cases which had been identified at the last EGC meeting. I wrote to you on 8th July about Pakistan, and you will have Alan Clark's further letter to you on Brazil on which David Trefgarne is commenting on my behalf.

In addition to these two matters you mentioned the problems you foresaw about further sales to Jordan. We are indeed well aware of how difficult is would be to provide significant further credit cover there. We (and GKN) regard the Warrior prospect as relatively long term and the Jordanian Commander-in-Chief recently confirmed that he does too. GKN know that they have no authority to indicate that ECGD cover would be available and, in the last resort, it may well be feasible to find some other way of financing the sale. But if we are to hold off our international

The Rt Hon John Major MP

competitors (principally the USSR and Brazil, though the USA may yet re-enter this market), we must keep up the level of activity. One possible alternative source of finance would involve the Jordanians taking components from Turkish production and assembling the vehicles themselves in which case the benefit to Britain would be largely in licence fees and the supply of specialist equipments and sub-assemblies. Nor should the possibility that the Jordanians may be able to persuade one of their richer Arab friends to assist be excluded.

I note what you say about Ecuador and Nigeria, and we appreciate the credit position for these countries. But Nigeria in particular remains an important market in the longer term and, as I said in my letter to John MacGregor of 4th September last year, we must not get the reputation of being fair weather friends only. The defence market is not one where companies can move in and out according to the financial strength of the customer at the time. By our own behaviour we should not encourage companies to think in this way and continue what has been one of the weaknesses of British overseas marketing.

I too am glad to see that initial work is now underway towards setting up the inter-departmental study I agreed with John MacGregor. When this has got a little further we shall need to approve the terms of reference and the procedure to be adopted in its work.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, David Young and Sir Robert Armstrong.

Yours ever,

George

George Younger

TRADE

ECG

PT 2



CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

20 July 1987

From the Parliamentary Under Secretary of State

Dear John,

ECGD COVER FOR BRAZIL/WESTLAND

I have seen a copy of Alan Clark's letter to you of 13 July about Westland's bid to secure the contract to supply helicopters to the Brazilian Navy.

I am sure that Alan Clark is right that the financial terms will be crucial in determining who gets this contract. While we should not lightly set aside the normal DX criteria I believe that the national interest arguments are sufficiently strong in this case for us to do so. Creditor solidarity is an important part of our policy, but it is pretty clear that our efforts at the Paris Club to persuade the French to take a tougher line towards Brazil have not been successful. When it suits their commercial interests to provide cover, as for Aerospatiale's bid for the helicopters, they are likely to do so.

While I do not dissent from the proposed interim strategy set out by Alan Clark, I wonder how long we can safely rest on it. The very earliest Brazil can reach an accord with the Paris Club will be late September. If our information is right, and a decision on the contract will be taken in August/September, then we could well be faced with a situation where we know that the French have made a firm offer, not conditional on a Paris Club rescheduling. We would then have to consider whether to match it, which I am sure we should; but we would have to move very quickly.

These concerns are shared by our Posts at Brasilia (telno 225) and Paris (telno 703); copies of these telegrams are attached. As HM Ambassador, Brasilia, points out, the /decision

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1P 3AG

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The Rt Hon John Major MP 20 July 1987

decision at the end of the day is whether or not we are prepared to match the French. If so, we would do well to make this clear soon to the Brazilians. I share the scepticism of our Posts on the value and effectiveness of lobbying the French.

I am copying this letter to Alan Clark, David Trefgarne, Sir Robert Armstrong and Charles Powell at No 10.

Yours ever,

Tim Eggar

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FM BRASILIA
TO DESKBY 200900Z FCO
TELNO 225
OF 172045Z JULY 87
INFO PRIORITY PARIS, RIO DE JANEIRO

YOUR TELNO 226: BRAZIL/WESTLAND

1. WHILE I WELCOME THE GENERAL THRUST OF THE MINISTER FOR TRADE'S LETTER TO THE TREASURY, AND THE FACT THAT MINISTERS ARE CONSIDERING SUPPORTING THIS FROM THE FCO, I SHARE THE DOUBTS EXPRESSED IN PARIS TELEGRAM NO 703 AS TO THE EFFICACY OF DIPLOMATIC PRESSURE ON THE FRENCH.

2. WE UNDERSTAND (AND HAVE REPORTED EXTENSIVELY ON OUR SOURCES) THAT THE FRENCH HAVE ALREADY COMMITTED THEMSELVES TO GIVE OFFICIAL CREDIT SUPPORT TO AEROSPATIALE WITH NO CONDITIONS ABOUT A PARIS CLUB SETTLEMENT. THEY HAVE INVESTED A GREAT DEAL IN THIS CONTRACT ALREADY AND APPEAR DETERMINED TO GO FOR IT REGARDLESS OF QUESTIONS OF SOLIDARITY WITH THEIR EC PARTNERS OVER CREDIT FOR BRAZIL. I ALSO SEE A REAL RISK THAT IF WE APPROACH THE FRENCH ON THE LINES SUGGESTED, THEY WILL TELL THIS SWIFTLY TO THE BRAZILIANS WHO WILL INTERPRET IT AS (''FURTHER'') EVIDENCE THAT THE UK IS HARDER ON THEM THAN ARE OTHER EUROPEAN CREDITORS. THIS COULD BE DAMAGING BOTH IN THE WESTLAND CONTEXT AND MORE WIDELY.

3. WOULD IT NOT BE POSSIBLE FOR ME TO BE AUTHORISED TO INFORM THE BRAZILIAN GOVERNMENT IN CONFIDENCE THAT ECGD COVER WOULD BECOME AVAILABLE FOR THIS CONTRACT AFTER THE CONCLUSION OF A NEW PARIS CLUB SETTLEMENT (IE AS PROPOSED IN POINT IV OF THE MINISTER'S LETTER, BUT WITHOUT MY MAKING REFERENCE TO THE FRENCH)?

4. EVEN MORE LIKELY TO BE EFFECTIVE WOULD BE AN INSTRUCTION TO ME TO SAY UNCONDITIONALLY THAT WE WOULD MATCH ANY FRENCH OFFICIAL CREDIT. I REALISE THAT THIS WOULD BE LIKELY TO RUN INTO OBJECTION FROM THE TREASURY, BUT SUGGEST THAT ALL DEPARTMENTS CONCERNED SHOULD THINK THROUGH NOW WHETHER WE ARE LIKELY TO BE PREPARED TO MATCH THE FRENCH IN ANY EVENT AT THE END OF THE DAY, BECAUSE IF WE ARE SO PREPARED THE SOONER WE SAY SO TO THE BRAZILIANS THE BETTER WESTLANDS' CHANCES WILL BE.

URE
BSLNAN 2604

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SAMD
ERD
DEF D
MR FEARN

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GRS 120

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FM PARIS
TO IMMEDIATE FCO
TELNO 703
OF 171343Z JUL 87
INFO PRIORITY BRASILIA, RIO DE JANEIRO

YOUR TELNO 236 TO BRASILIA : BRAZIL/WESTLAND

1. ALTHOUGH WE SHOULD NOT DISAGREE WITH THE INTERIM STRATEGY OUTLINED IN TELEGRAM UNDER REFERENCE, WE DOUBT THAT LOCAL DIPLOMATIC PRESSURE ON FRANCE WILL BEAR MUCH FRUIT. WE JUDGE THAT THE MATTER WILL NEED TO BE RAISED AT MINISTERIAL LEVEL.

2. WE SHOULD WARN ALSO THAT IT IS VERY DIFFICULT TO KEEP CAREFUL WATCH ON FRENCH INTENTIONS. THEY ARE INEVITABLY VERY SECRETIVE ABOUT THEIR CREDIT ARRANGEMENTS AND WE SHOULD NOT EXPECT TO BE ABLE TO ANTICIPATE THEIR DECISIONS.

FERGUSSON

YYYY

PCLNAN 0179

LIMITED

SAMD
ERD
DEF D.
MR FEARN

CONFIDENTIAL

TRADG: GCGD PTZ



Foreign and Commonwealth Office

London SW1A 2AH

15 July 1987

From the Secretary of State

Dear John

I was pleased to see from your letter to George Younger of 30 June that the interdepartmental Export Guarantees Committee are now providing a note of difficult cases for circulation to interested Ministers.

I was particularly interested in your comments on Westland's hopes of winning the Brazilian helicopter contract. I find difficulty with your argument that the provision of cover would reduce pressure on the Brazilians to put their economy in order. I share your view on the clear need for the Brazilians to make early progress. But if the Brazilians are determined to purchase helicopters anyhow (of which there is abundant evidence), they are surely not susceptible to pressure (and how is the choice of a British or French seller relevant?). On the other hand, while the deal is of minor significance when set against Brazil's financing needs, it is of considerable importance to Westland. The Brazilians would personally think that we, not they, will be the losers if we maintain our present attitude. So I hope we shall be able to look at this again.

The Rt Hon John Major MP

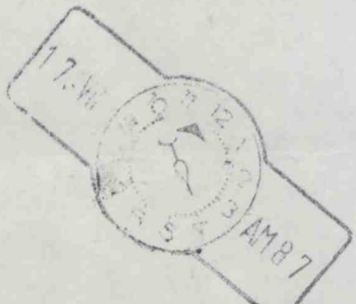
In his letter of 6 July to you, David Young proposed that, in order to accommodate the Warrior and other large contracts in Turkey, ECGD's cover should be increased to £800 million. I have seen your reply of 8 July. But I continue to believe that we should make the £200 million cover available outside the Section 2 market limit. As I said in my letter of 29 June, I would not wish to put at risk prospects for British companies bidding for civil contracts. To have to withdraw support on these so soon after the successful visit of the Turkish Foreign Minister would send quite the wrong signal; Mr Halefogulu, who welcomed the previous increase of ECGD cover, said that he would be happy to see greater involvement of British companies in Turkey. The recent JIC report suggests that given appropriate policies Turkey's long term prospects could be good although short term problems remain. Now that the prospects of an election this year have receded, we expect that Ozal will announce some restrictive measures in the next month. His previous track record supports the view that he will take the necessary steps.

In these circumstances, I am sure that David Young is right to propose the increased cover. I am pleased to hear, however, that officials will be meeting very soon to discuss the whole issue of ECGD cover for defence sales. It is important that we should try to find a more satisfactory way of dealing with these questions.

I am copying this letter to the Prime Minister, George Younger, David Young and to Sir Robert Armstrong.

GEOFFREY HOWE

TRADG : ECOD PT2



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From the Minister for Trade

Rt Hon John Major MP
Chief Secretary to the Treasury
Treasury
Parliament Street
LONDON
SW1P 3AG

13 July 1987

Await Treasury reply
ap

Dear John

ECGD COVER FOR BRAZIL/WESTLAND

WILL REQUEST IF REQUIRED

You will be aware from my letter of 21 May to David Trefgarne of Westland's concern at their chances of securing the important contract for the sale of helicopters to Brazil in the absence of ECGD cover for this market. I attach a copy of the brief prepared by Westland before the election which summarises their case.

They are hoping to secure a contract of about £80 million for the upgrading of the Westland helicopters already operated by the Brazilian Navy and the sale of six additional Lynx helicopters. As you know, ECGD cover for medium-term credits was withdrawn when Brazil sought a rescheduling of its debts. The Paris Club agreement is not operative as the Brazilian Government is failing to honour interest payments due under it. They have in the past year or so been unwilling to return to the negotiating table - but there are signs that they are becoming more amenable. Under these circumstances I have been taking the line with Westland that I cannot give them a commitment to provide ECGD support at the present time as this would undermine the prospects of achieving an early Paris Club settlement. However I have said that I would re-consider this in the event of the resumption of ECGD cover, or if there were clear evidence that the French Govenrment were giving official (COFACE) support to a credit offer from Aerospatiale, who are the main competitors.

I would wish to maintain this position as ECGD has unrecovered claims totalling about £200 million and we do not want to give the wrong signal to the new economic team in Brasilia. Unfortunately the French do not seem to be so circumspect and I fear that they will take this opportunity to take over Westland's position in this market with the commercial consequences set out in their note. As

999-3

Rt Hon John Major MP July 1987

usual with defence sales, it is difficult to establish the facts regarding the French position. However, it is clear that Aerospatiale have offered the Brazilian Navy a very attractive commercial and financial package, together with a broad hint that the credit terms (allegedly up to 10 years at 8.25%) will be supported by COFACE. French officials have also told us that although no formal commitment has yet been given it is probably that support will eventually be provided. It is also evident that the French - unlike ourselves - are not withholding COFACE credit offers to Brazil nor do they restrict such new credits to exports contributing to the economic recovery of the debtor country (thus ruling out military sales).

All of this places us in a difficult predicament. We would much prefer not to be faced with this decision at the present time. There is still a chance that the Brazilian Government may decide to postpone this purchase but at present the information is that the decision will be taken in August/September and that the financial terms will be crucial. If French Government backing were to be provided, we would be subject to heavy criticism because of the commercial and employment consequences for Westland. (I understand that the contract would generate an estimated 516 man years of work for Westland themselves and a further 714 man years for UK sub-contractors.)

Under these circumstances I would propose the following interim strategy:-

i we should exert diplomatic pressure on the French to refuse support for Aerospatiale until Paris Club negotiations have resumed;

ii we should agree that when ECGD is able to resume cover, in addition to providing a measure of normal DX cover, we should offer special cover to Westland for this order outside of the agreed DX limit, (in the event we would defend that exception on the grounds of Westland's needs and French competition);

iii we should advise Westland that when ECGD cover is restored we would be prepared to provide ECGD support for an amount of £85 million, (representing the maximum liability on a 75% credit repayable over five years from delivery at the current OECD Consensus rate of 8.25%); and

iv our Ambassador in Brasilia should be authorised to inform the Brazilian Government in confidence that such ECGD cover would be provided but emphasising that (like the French offer) it will only become available after the conclusion of a new Paris Club settlement.

999-49

Rt Hon John Major MP

July 1987

I hope very much that you can agree to the above proposal: I should be very willing to discuss it with you but Westland are seeking an early clarification of our position.

I am copying this letter to David Trefgarne, Tim Eggar, Sir Robert Armstrong, and Charles Powell at No 10.

ALAN CLARK

ENC



013/2986

CONFIDENTIAL

cc PC

CDP 1/7

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon George Younger TD MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
SW1A 2HB

Dear George,

30th June 1987

EXPORT CREDIT COVER FOR PROSPECTIVE ARMS AND CIVIL CONTRACTS

The Interdepartmental Export Guarantees Committee (EGC) met last week for the normal quarterly review of large prospective contracts, both military and civil, in markets where ECGD cover is limited. The Committee's discussion identified a number of markets where problems seem likely to arise.

Four of the most difficult cases are already before us, including the Warrior sale and other large contracts in Turkey and the possible military aircraft sale to Zimbabwe, or have been the subject of earlier exchanges. In this last category is the Pakistan Frigates contract. I understand that the Pakistan Government are likely to want a further extension of time for the exceptionally generous credit offer we have made. If such an extension is inevitable, it should clearly be for the shortest possible period of time and clearly presented to the Pakistan Government as final. There is increasing pressure for decisions on civil contracts, including a power station where a decision will be needed before the end of this year.

Another case which Ministers have considered already is Brazil where Westlands are still pressing for cover for a helicopter contract for the Brazilian Navy. They have been told by Trade Ministers that we would reconsider our decision not to provide cover if firm evidence were produced of competition with official export credit cover. Brazil, is of course a market on which no medium or long term cover is presently available and, where, if we were to restore cover it would normally be under "DX rules" i.e. for goods which



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would support the Brazilian Government's adjustment efforts. I would be most reluctant to agree to anything which would reduce the pressure on the Brazilians to put their economy in order.

The major new problem identified by the Committee is on Jordan. After a major defence package in 1985, a further £40 million of cover was agreed earlier this year for defence sales. Since it took exposure on Jordan above the level we considered prudent this additional cover was only agreed on the basis of an offsetting reduction in available cover for a similarly risky market. No new cover is now available for Jordan. However, your officials report that there is high level interest on the Jordanian side in Warrior tanks, which GKN are planning to trial next month. The deal could be worth £250 million and is attractive from a political point of view. There can however be no expectation that UK export credit will be available. If you judge ECGD cover would be required, Ministers will need to be consulted before any indications are given to the Jordanians either by your own staff or by GKN.

In addition to these major cases the Committee identified a number of other markets, including Ecuador and Nigeria where there were prospective defence sales but where no ECGD cover was available, either because the Department is completely off cover or is providing only DX cover.

Finally, this review and the large number of current cases point up yet again the difficulties that arise over export credit in the arms sales field. My predecessor agreed with you just before the Election that officials should report to us on the economic advantages and disadvantages of supporting arms sales. I am pleased to hear that the Cabinet Office is organising informal discussions about ways of dealing with such cases.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, David Young, and Sir Robert Armstrong.

Yours Ever,
John

JOHN MAJOR

FCS/87/057

CHIEF SECRETARY TO THE TREASURY

Jordan : Export Credit Cover

1. Your letter of 24 February to Paul Channon agreed an increase in the Jordan country limit to accommodate the Aqaba II project and the additional defence package.

2. I have no objection to Paul Channon's decision to reduce the Section II limit for Algeria by an equivalent amount, on the strict understanding that this does not create a precedent. (It would also seem unnecessary in view of the proposed reduction in cover for Tunisia which we recently agreed.) As I said in my minute of 18 February, it would be wrong to preempt the conclusions of the Portfolio Risk Management System. I shall expect foreign policy considerations to be given proper weighting in whatever system is eventually adopted.

3. I am copying this minute to the recipients of yours.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

8 March 1987

TRAD6 : GCGD PTZ



024/2984

CONFIDENTIAL

CDP 9/3

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

6th March 1987

Dear Paul,

JORDAN: EXPORT CREDIT COVER

Thank you for your letter of 27 February.

I am content with your offer to cut back the Algerian limit by £70 million to enable the two Jordan projects to go ahead. I understand your officials will be in touch with mine about where the reductions will be made, given the limited room for manoeuvre created by the two Memoranda of Understanding and the Financial Protocol with the Algerian Government.

I also note what you say about avoiding decisions on a similar basis in advance of the portfolio management system being in operation. However I understand that a full system is unlikely to be in place for some 2 to 2½ years but that it may prove possible to set an interim system in place as part of the 1987 Business Plan. I would welcome that and look forward to discussing it when the Plan comes forward in June. In the meantime the best way of avoiding the need for ad hoc cut backs is obviously for us to stick within the market limits agreed interdepartmentally. But where this proves impossible, in order to accommodate exceptional cases, I do not think that we can entirely rule out this approach as a means of keeping ECGD's overall contingent liabilities to acceptable levels.

I am copying this letter to the Prime Minister, other members of EX, to George Younger and Sir Robert Armstrong.

Yours ever,

JOHN MacGREGOR

TRADG : ECGD PT2



DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
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(Switchboard) 01-215 7877

Secretary of State for Trade and Industry

27 February 1987

The Rt Hon John MacGregor OBE, MP
Chief Secretary of the Treasury
Treasury Chambers
Parliament Street
London SW1H 0ET

CDP
27/2

Dear John.

JORDAN: EXPORT CREDIT COVER

Thank you for your letter of 24 February on this subject. I am disappointed that in view of the comments from other colleagues, you have not been able to make a more positive response to the proposal in my letter of 13 February, especially taking into account our close relationship with Jordan and its clean payments record.

I am now under considerable pressure from British exporters competing for the Aqaba II project as they are naturally reluctant to incur further expenditure in preparing their tenders without some assurance of ECGD support. I also know from George Younger's letter than an urgent decision is needed on whether ECGD support can be given to the additional defence package under negotiation. For these reasons - and on the clear understanding that this would not be regarded as a precedent - I am accepting your offer to find some offsetting limitations on ECGD's potential exposure in other marginal markets in order to allow support to be given for this business. I am, therefore, instructing ECGD to offer support for both the Aqaba II project (£35m) and for the latest defence package (£36m). In both cases ECGD cover will be given on a risk-sharing (60:40) basis with the private sector and would be taken outside of the existing £500m. Section 2 limit.

JG3AOY

To compensate for this I have also asked ECGD to reduce the Section 2 limit for Algeria by an equivalent amount. Algeria has been selected as this is another hydro-carbon-dependent developing country with potential debt service problems in which defence sales are prominent. I assume this is acceptable to you and others.

I note what you say about the need to establish an effective system of controlling the balance of ECGD's Section 2 portfolio. However, I would be most unhappy at any attempt to apply the offsetting principle to ECGD's Section 2 business before we have a portfolio management system in operation. Also it is important that such a system should not provide an unreasonable restraint on ECGD's ability to support export business on a competitive basis.

Equally important, we must recognise the realities of the market. Companies have to expend substantial funds, resources and time in pursuing these opportunities, and cannot be expected to adopt the consistent and focused approach of their competitors if we are vacillating, or arbitrarily changing, in our readiness to provide ECGD cover. In this case, in the absence of a firm indication from us, Foster Wheeler decided to source their bid for the boiler from Spain, where they could get a more rapid decision.

I do not consider it sensible to tackle this question in an ad hoc and arbitrary fashion. ECGD country limits are not and should be regarded as "cash limits" in normal competitive terms. They should be seen in the context of the realities of companies actually trying to secure business in difficult or fluctuating markets. I am therefore strongly opposed to any further decisions of this kind before Departments generally have had time to consider a comprehensive scheme which will enable British exporters to focus their efforts to derive the maximum benefit from the availability of ECGD cover on marginally creditworthy markets, whilst avoiding unduly hazardous and unacceptable risks.

I am copying this letter to other members of EX and to George Younger and Sir Robert Armstrong.

JG3AOY

PAUL CHANNON

TRADE

ECG

PT 2

CONFIDENTIAL

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CCPC HMT
CO FCO
DN
MOD
DM

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

26 February 1987

Dear Tim,

JORDAN: EXPORT CREDIT COVER

The Prime Minister has been following the exchange of correspondence about export credit cover for Jordan, to which the most recent contribution is the Chief Secretary's letter of 24 February to your Secretary of State. The Prime Minister thinks that the Chief Secretary is right: we should allow the two projects in Jordan to go ahead, but the increase in ECGD's contingent liabilities should be offset by an equivalent cutback in potential exposure on one or more similarly risky markets. She would like to see recommendations on this latter point.

I am copying this letter to the Private Secretaries to members of EX, to the Private Secretaries to the Defence Secretary and the Energy Secretary and to Sir Robert Armstrong.

yours ever,

Charles Powell

Tim Walker Esq
Department of Trade and Industry

CONFIDENTIAL

6

PRIME MINISTER

EXPORT CREDIT: COVER FOR JORDAN

There have been considerable exchanges between colleagues about export credit for Jordan, in particular for some further defence sales and the Aqaba power station, both of which would require an increase in the Section 2 Market Limit. The Chief Secretary is prepared to agree to this but is asking for the consequent increase in ECGD's contingent liabilities to be offset by an equivalent cutback in potential exposure on one or more similarly risky markets.

This seems a fair proposition. We need to support Jordan, and the Jordanians have been good and reliable payers. It makes sense to give them priority over some other markets.

Agree that I should record your support for the Chief Secretary's proposition.

CDP

C. D. POWELL

25 February 1987

Yes

SLHAHQ

007/1285

CONFIDENTIAL

scr

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

24th February 1987

Dear Paul,

JORDAN: EXPORT CREDIT COVER

Thank you for your letter of 13 February. I have also seen the letters from Geoffrey Howe, George Younger and Alistair Goodlad.

I note that you agree that the prospects for the Jordanian economy would not warrant any increase in the Section 2 Market Limit. Nevertheless, you and others argue strongly in favour of the Aqaba project going ahead, in particular, as the first co-financing project with the World Bank. George Younger and Geoffrey Howe feel that there are equally strong political arguments in favour of letting the additional defence package go ahead.

I accept that there are real arguments for enabling these two projects to go ahead. However, we cannot ignore the implications of such a decision for the extent of ECGD's contingent liabilities. You will recall that the recent assessment of contingent liabilities which departments carried out at the Prime Minister's request showed that these were heavily dominated by ECGD liabilities. The distribution of these liabilities, especially when taken together with the quality of the Department's sovereign debt exposure, must be of real concern to us. Thus, although I am prepared to accept that the two Jordanian projects should go ahead, I must continue to ask that the increase in ECGD's contingent liabilities be offset by an equivalent cutback in potential exposure on one or more similarly risky markets. If you see insurmountable difficulties with my earlier suggestion of Turkey, I would be happy for my officials to discuss with yours an alternative package of markets in the same broad risk category e.g. Cyprus or Tunisia.

TRADE: ECGD

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I should also say that I very much hope that ECGD's study of a more sophisticated portfolio risk management system can be brought to an early conclusion and a robust system brought into operation. The development of such an approach was recommended in the Management Review and endorsed by Ministers over a year and a half ago as a means of improving the control of country risk in the interest of preventing an unacceptable build up of risks to the Exchequer.

Finally, I am slightly concerned at your comment that we should take a longer term and geographically wider view of prospects for follow-on business. When in judging how best to deploy ATP funds, we look at the possibility of specific follow-on business that a project might generate, I think we are right not to confine our views solely to the recipient country. But clearly it would not be sensible to take too wide and general a view or there would soon cease to be any meaning in the follow-on business criterion.

I am copying this letter to members of EX, George Younger, Peter Walker and Sir Robert Armstrong.

Yours ever,

JOHN MacGREGOR



cc PC

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ
Direct Line 01-211 3390
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PARLIAMENTARY UNDER
SECRETARY OF STATE

The Rt Hon John MacGregor OBE MP
Chief Secretary
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

Await Chief Secretary's reply

19 February 1987

Dear John.

JORDAN: EXPORT CREDIT COVER

I have seen Paul Channon's letter of 13 February pressing the case for ECGD cover for the NEI bids for the Aqaba 2 power station. I have a particular interest because I led an Energy Sector Trade Mission to Jordan last October which devoted considerable effort to preparing the way for sympathetic consideration by the Jordanians of a UK bid for the project.

As Paul Channon says, there are strong commercial and industrial reasons for supporting this business. With the highly depressed state of the world market for power equipment, we have been urging British manufacturers to make every effort to exploit the few export orders, important though these are. The electricity supply industry in this country has been running at a historically low level of investment and this has created great difficulty for equipment manufacturers. We must have a strong private manufacturing sector capable of meeting the need for new generating capacity which is in prospect. One way we can help preserve this is to do all we can to facilitate exports.

It was with these considerations in mind that in my discussions with Jordanian Ministers last autumn, I stressed UK industry's ability and enthusiasm to contribute to the development of Jordan's electricity sector. Aqaba 2 is central to Jordan's energy strategy and the Jordanian Government attach great importance to it. It is by far the largest single energy project envisaged in Jordan and will be for many years an excellent advertisement for the capabilities of those supplying its equipment. The NEI Group have long recognised this and have devoted much effort to preparation of the way for successful bids. They and the other business representatives in my party emphasised to the Jordanians their determination to submit competitive bids supported by suitably attractive financial offers.

I believe that we left the Jordanians favourably impressed with UK abilities and determination in this respect and in the frame of

mind to look sympathetically at an NEI bid provided it is competitive. However, that is vitally dependent on the promise of ECGD support as proposed by Paul Channon. Absence of this will effectively preclude NEI bidding for the boiler package thus negating both the Company's and our own efforts to ensure that the maximum amount of work arising from the Aqaba project goes to British industry.

I therefore firmly endorse Paul Channon's view that this case should be considered on its merits and that ECGD cover should be given exceptionally outside the Section 2 limit, should UK firms win this business.

I am copying this letter to members of EX, George Younger and Sir Robert Armstrong,

Yours ever,

Alastair.

ALASTAIR GOODLAD

TRADE

ECGD

PT2



FCS/87/043

CHIEF SECRETARY TO THE TREASURY

Jordan : Export Credit Cover

1. Your letter of 6 February sought views on proposals for an increase in ECGD cover for Jordan.

2. Jordan's continued stability is a major British interest and support for King Hussein is a cornerstone of our Middle East policy. We must demonstrate our commitment in meeting the King's requests for practical help at a time when he is feeling exposed as a result of stagnation in the peace process, worsening of the Iran/Iraq conflict and disillusionment with US policies. In view of the confidence and trust which he places in his personal relationship with the Prime Minister, any impression that we had let him down or reneged on previous undertakings for specific projects would be damaging.

3. The Jordanian Commander-in-Chief, General Bin Shaker, asked the Defence Secretary during his visit to Jordan in November 1986 for additional support. Although the Defence Secretary gave no binding commitment, failure to proceed now with these additions to the defence package would be taken as a personal affront by King Hussein who has described our defence relations as 'solidly founded on friendship and trust'.

/ Withdrawal

Withdrawal would also, as you recognise, let in our competitors who envy our exceptionally close ties with the Jordanian armed forces and would like to dislodge us from our privileged position.

4. The Jordanians have also been assured of our interest in the Aqaba II project, notably by Alistair Goodlad during his visit to Jordan in October 1986. Failure to provide cover would effectively rule out British participation in this project - to the bitter disappointment of Crown Prince Hassan, who takes a close personal interest in economic and development matters. Aqaba II is a good revenue-generating project, and is the responsibility of the Jordan Electricity Authority, which has an excellent record. Apart from the intrinsic merits of this project it would be the first of a series of co-financing arrangements proposed under a new agreement with the World Bank. It is important that this should go ahead if the agreement is to succeed, as we hope, in opening up new commercial opportunities for British companies; and such arrangements will reduce our exposure to risk.

5. There are some troubling signs for the Jordanian economy, but I doubt whether it is fair to say that the overall outlook has worsened. Remittances have held up; reserves rose in 1986; and more Arab aid may be forthcoming in 1987 than last year. I note too that Jordan's repayment record and reputation for sound economic management remain intact.

/ 6.

6. I am convinced that these political and developmental arguments are so strong that we should in the national interest agree exceptionally to increase Section 2 cover for Jordan to allow these two projects to proceed.

7. I cannot accept your proposal for an offsetting reduction. It would be wrong in this way to pre-empt the conclusions of the Portfolio Risk Management exercise. I also consider the choice of Turkey as a candidate for an off-setting cut in market limits misplaced, in the light of ECGD's current review of medium term cover for that market, which is to be considered shortly by EGC. As I said in my minute of 5 February to Nigel Lawson on the Ankara natural gas project, we cannot afford to neglect the medium to long term prospects for UK exporters in this large and expanding market.

8. I am copying this minute to the recipients of yours.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
18 February 1987



TRADE

ECO

PT 2

CUFC

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

MO 11/10/4L

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

February 1987

Dear John,

JORDAN: EXPORT CREDIT COVER

In your letter of 6th February to Paul Channon you explained your reservations about the extending the existing credit limit for Jordan in the light of new requirements. One of these is a £40 million extension of the 1985 Defence Package, which the Jordanians raised with me during my visit in November.

The Jordanians have identified a firm requirement for additional defence equipment and because of the success of our original package, want to buy from us. The British exporters are already identified and the contracts are certain to be placed with our firms. If we decline to make the necessary credit available the Jordanians will inevitably turn elsewhere - to France or the Soviet Union, who are undoubtedly willing to supply the equipment Jordan wants on attractive terms. The risk of rescheduling and of our own creditor position will thus not be significantly improved, but we shall have lost good business and forfeited Jordanian goodwill.

The Rt Hon John MacGregor OBE MP

I know Jordan is in a difficult position. But so do the Jordanians. They have a good record and have shown themselves responsible managers. There is evidence that the new package Jordan is seeking has been carefully thought through and that their financiers have taken full account of their ability to make the necessary repayments before submitting the request formally to us. That the banks have agreed to take a greater share of the risk on this second tranche is a clear indication that the City remains confident in Jordan; and we should not discount the support available from other Arab States. The recent Saudi gift of $500 million to help Egypt pay off the worst of its arrears of military debt indicates that financial aid is likely to be forthcoming should the situation become dire.

This new request does not fall within the context of our correspondence about promotion of defence exports; rather it was an unsolicited response to the success of the original package (and a consequence of the unhelpful attitude of the Congress towards the supply of military equipment to Israel's neighbours). During my short time in Jordan it was made very clear to me by the King and senior members of the Jordanian Government how much they appreciated the support we have given them through the 1985 package and their pleasure at the thickening of our bilateral relationship that has resulted. Indeed, King Hussein said that our relationship had never been better and was solidly founded on friendship and trust. If we turn down the new Jordanian request it will undo much

of this good at a time when the Jordanian relationship with the United States is strained, and force them into the hands of the French or Russians whose growing influence in Jordan we have been trying so hard to stem. But equally important, it will seriously damage Jordan confidence in Britain as a reliable ally during these difficult times in the Middle East.

I therefore wish to press the case for accommodation of the additional £40 million of defence equipment in - or outside - the ECGD market limit for Jordan. The political case for this is far stronger than for the the Aqaba 2 Power Station business and the economic case at least as good. I am also anxious that we agree ECGD cover (subject to risk sharing with the banks) for the full list of Jordanian requirements. Anything less would send the wrong signal to the Jordanians and could harm the prospect of a future (Saudi financed) Tornado sale.

In your letter you suggest that any extension of the Jordanian country limit should be compensated for by cuts elsewhere. This follows one of the ideas in the ECGD Management Review last year. While I should be happy to join in any consideration of the handling of these wider portfolio relationships if you felt that to be helpful, such a policy needs to be carefully structured (for instance in relation to Turkey, where there are important defence considerations), and needs to be considered in a longer timescale than is now available.

I am sending copies of this letter to members of EX and to Sir Robert Armstrong.

Yours ever,

George

George Younger



TRADE: ECGD pt 2

CC PC

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
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13 February 1987

The Rt Hon John MacGregor OBE MP
Chief Secretary of the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1

BF // Please await
Chief Sec's reply
CDS
13/2

Dear John.

BUYER CREDIT COVER : JORDAN & TURKEY

Thank you for your letter of 6 February concerning the difficulty we face over demands for ECGD cover for business in Jordan and the attached explanatory note.

In general I agree that the prospects for the Jordanian economy would not justify a further general increase in the ECGD Section 2 limit of £500m. As this limit is currently exhausted this would mean that until the economic outlook has improved normal ECGD cover would not be available expect to the extent that payments are received for business already guaranteed.

There are, as your note explains, two significant pieces of business that would be affected by a complete withdrawal of Section 2 cover : the NEI bids for the Aqaba 2 power station and a further defence package of £36 million. On the latter I see no case for special treatment. Defence sales have already taken the lion's share of the Section 2 limit (£300m out of the total of £500m) and they will not make any direct contribution to the Jordanian economy. George Younger might wish to explore the degree to which these sales might proceed on a reduced scale without ECGD cover.

In my view the Aqaba power station falls into a different category where cover might be considered exceptionally outside the Section 2 limit on the principle adopted in other difficult markets. Here the UK is being asked to participate in a co-financing project with the World Bank. Indeed it is the first coming under our recent co-financing agreement with the World Bank. It would be damaging

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to our attempts to get co-financing projects off the ground if we had to pull-out at this stage. The project is an important one for the Jordanian economy and I believe that we should continue the policy proposed in other high risk markets of providing selective support for key projects where the financing is being shared with the World Bank on a co-financing basis. We are, as you know, following this route on (DX) cover for markets where guaranteed debt has been rescheduled and it would therefore, in my view, be even more appropriate here as Jordan has a clean payments record.

There are in addition, very strong commercial and industrial reasons for supporting this business. NEI expect to bid for the turbines, boilers and switchgear for the project (value £66m). Indeed, this is exactly the sort of project for which we have encouraged NEI to bid since this does not involve turnkey responsibility, as on Rihand : and they have been cultivating the Jordanians for almost two years. They will need to show themselves price competitive if they are to win this order and if successful it will be a very valuable reference in the international power market. As you know we have deliberately sought to minimise ECGD exposure on this project by indicating a willingness to cover a UK content of only about £35 million compared with the total UK interest of over twice that figure, in the hope of using World Bank funds if necessary to meet the difference, thus obtaining extra leverage out of our limited ECGD cover.

For these reasons I consider that there is a very strong case for agreeing that ECGD cover up to £35m should be given exceptionally outside of the Section 2 limit should UK firms win this business. I believe that this case should be considered on its merits and we should not pursue your proposal for finding offsetting reductions in cover elsewhere. This whole question is, of course, still being considered as part of ECGD's overall Portfolio Risk Management exercise but balancing cover in this way is a complex exercise requiring analysis of risk correlation between markets, and the impact on trade and premium earnings. I think it would be unwise to pre-judge the results of this exercise and we obviously could not accept the arbitrary selection of Turkey as a counter-weight for this purpose without much greater study.

Demand for cover on Turkey is, as you know, very great and ECGD is being accused of being over timid. Consequently ECGD is in the final stages of a comprehensive market review which will shortly be put to the Export Guarantees Committee for consideration.

Finally I am grateful to you for agreeing in your separate letter of 6 February to my proposals on the Ankara Natural Gas Conversion Project. You can be reassured that this represents careful

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targetting of a soft loan. It was only after considerable debate that we decided a soft loan was necessary. In general I accept the desirability of a satisfactory mix of ATP and non-ATP business in individual markets. Cases such as Ankara Gas in very tight limit markets will continue to be exceptional. However, I am surprised at your comments on the absence of follow-on business opportunities, as I believe we have to take a longer term and geographically wider view than appears to be envisaged in your letter.

I should be grateful for any early decision on the Aqaba case as we need to advise UK firms whether or not to go to the expense of preparing their bids very shortly.

I am copying this letter to members of EX, George Younger, Peter Walker and Sir Robert Armstrong.

PAUL CHANNON

DW4BZJ

TRADE ! ECFD : PE 2



006/2985

CONFIDENTIAL

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1H OET

6 February 1987

Dear Paul,

JORDAN: EXPORT CREDIT COVER

Officials have considered in the Exports Guarantees Committee (EGC) the current market limit for Jordan and the extent to which prospective business can be accommodated within the limited cover now remaining on this market. Cover within the Section 2 market limit is effectively exhausted but ECGD cover is being sought for further credit to enable the Jordanians to purchase additional defence equipment and for a prospective contract for the Aqaba 2 Power Station project. A decision is needed on Aqaba before the end of the month. An explanatory note by the Treasury on the various issues is attached.

You will recall that we agreed reluctantly in mid-1985 to an increase in the market limit for Jordan to include the sale of defence equipment and services under the Memorandum of Understanding signed in June 1985. ECGD's maximum liability of some £330 million for defence sales formed a substantial part of the market limit of £500 million. The Jordanians are now seeking further credit of some £40 million for defence equipment for which ECGD cover of £36 million will be required.

ECGD cover is also being sought for the Aqaba 2 Power Station project. The project would qualify for ATP support and has been accepted by the World Bank for potential UK co-financing. The ECGD cover required is about £30 million.

The balance of some £37 million under the Section 2 Market Limit until very recently available has now been allocated to contracts won by GEC Marconi and Ransome and Rapier, together with a

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£15 million reservation of cover for a 6th Airbus aircraft for Jordanian airlines. Cover under Section 2 is now exhausted.

As I noted in my letter of 9 December 1986 to George Younger about export credit for arms sales, Ministers have endorsed the policy which requires ECGD to take a more rigorous line in setting and observing country limits. The market limit for Jordan was increased in 1985 to provide cover for defence sales. In agreeing to that increase Peter Rees made clear our concern about the Jordanian economy and the risk of increasing ECGD's liability in that market. Those concerns were outweighed by the political pressures for a concession on the defence package in advance of King Hussein's visit to the UK. Since then the outlook for the Jordanian economy has worsened, given its dependence on continuing Arab support.Our view is that ECGD's exposure on this market is higher than would normally be appropriate. There is certainly no economic justification for increasing it.

The arguments which have been put forward for extending the market limit to include the defence package and the Aqaba project once more reflect the need for us to continue to maintain good bilateral relations with the Jordanians. I obviously support that objective and I am aware that if we withhold further support for defence equipment the Jordanians might turn elsewhere for the additional equipment. I am not convinced, however, that we should further increase the market limit and ECGD's exposure contrary to our judgement of the Jordanian economy and our agreed approach towards controlling the risks to the Exchequer. There is no evidence that if we adopt this firm line it will affect our relations with the Jordanians in a way which would be contrary to the national interest.

In the circumstances I do not think we should increase the market limit for Jordan. However if colleagues feel that it is absolutely necessary to do so in the national interest, then we must take steps to offset elsewhere these additional liabilities so that they do not add unnecessarily to the Exchequer's overall contingent liabilities.

I would therefore be prepared to agree cover for Jordan in excess of the present market limit if this is offset by a decrease in market limits of the same magnitude in other risky markets. My preference would be to reduce the market limit for Turkey (where we have considerable exposure but which is regarded as even riskier than Jordon). Some £30 million would remain after my agreement to allow the Ankara ATP case to go ahead on an exceptional basis. This would be sufficient to cover the Aqaba project. Any further addition for Jordan would have to be matched by a corresponding reduction in the limit on another appropriate market.

I am copying this letter to members of EX, George Younger, and Sir Robert Armstrong.

Yours ever,

JOHN MacGREGOR

JORDAN : SECTION 2 MARKET LIMIT

NOTE BY THE TREASURY

Introduction

1. ECGD Section 2 cover for Jordan is approaching the Market Limit of £500 million. Some £400 million cover has been utilised and about £66 million cover has been offered for various contracts; a balance of some £37 million remains which has been allocated to 3 contracts. A summary table is at Annex A.

2. Two major pieces of prospective business currently require ECGD cover which cannot be accommodated within the Market Limit:

(a) support for UK companies competing for part of the Aqaba 2 Power Station which will require ECGD cover of some £30 million; and,

(b) a further defence package of some £36 million.

3. At a meeting of the Exports Guarantees Committee on 30 January the Treasury took the view that an increase in the Market Limit could not be justified. Whilst agreeing that an increase in the limit could not be justified on economic grounds,

(i) ECGD were prepared to offer cover for the Aqaba 2 Power Station project if an increase in the Market Limit could be agreed; DTI also supported that project, for which aid has been agreed;

(ii) the Ministry of Defence also wanted to meet the Jordanian request to provide further defence equipment.

Market Limit

4. The Section 2 Market Limit was increased in 1985 to £500 million - beyond the level considered appropriate on the basis

of Jordan's economic performance - to provide a substantial reservation (some £300 million) for defence contracts, following the successful conclusion of negotiations with the Jordanians in mid-1985. The limited amount of cover remaining available for civil contracts has been spun out taking some of the risk on Section 1 and, whenever practicable, by a measure of risk-sharing with the private sector. Even so, the available cover has now been exhausted.

5. There are no grounds for increasing the current Market Limit of £500 million. ECGD's exposure currently exceeds that of any other credit insurer. The Bank of England advise that although the Jordanian economy is being carefully managed and their repayment record is acceptable, the economy is weakening steadily and is highly vulnerable because of its dependence on Arab aid. The economy will come under increasing pressure over the next few years, with increasing pressure on the balance of payments deficit, increasing external debt and reductions in the foreign exchange reserves. In these circumstances the Committee felt that the current ECGD Market Limit was beyond the prudent level and, that there were no economic grounds for increasing it.

Aqaba 2 Power Station

6. A number of UK companies are competing for a total potential business of about £107 million which includes a number of separate packages for a coal/oil fired power station at Aqaba. The inter-departmental committee, chaired by the Department of Trade and Industry (SCAT), considered this project for ATP support, and concluded that it should be granted aid if ECGD could provide cover.

7. ATP support is normally available only where sufficient cover remains within the Market Limit to ensure that business on normal terms is not squeezed out. ECGD agreement in principle was given some time ago when sufficient cover was available. The current restriction on the Market Limit has reduced the potential business which might otherwise be available for UK competition. There are no other prospective contracts in Jordan

for which UK companies might compete.

8. DTI emphasise the industrial and commercial benefits for the UK power engineering industry of securing part of this business for which UK companies are competitive on both price and technology. There would be prospects of follow-on business in other markets if the Aqaba contract was secured. The World Bank has confirmed its acceptance of this project for potential UK co-financing; DTI consider that this first agreement with the World Bank on co-financing could, if taken forward, lead to further co-operation on future projects.

Defence package

9. When the Secretary of State for Defence visited Jordan in November 1986 he was invited to consider allowing the Jordanians additional credit of up to about £36 million to buy further defence equipment. MOD regard this as an extension of the 1985 agreement which had a contract value of some £270 million and an ECGD liability of £333 million (the difference being accounted for by the additional cover provided by ECGD of the interest on the loan). The Jordanians have identified the military equipment which they would like to buy; the list includes a BAe air combat simulator. This is the first potential sale of BAe's highly sophisticated simulator and its sale to the Jordanian Air Force would benefit substantially BAe's marketing prospects.

10. MOD have succeeded in reducing ECGD's liability for this additional package by encouraging the commercial banks who are funding the present loan, to accept a higher risk-sharing arrangement than they carry under the current loan.

11. MOD have also put forward political arguments for conceding an increase in the Market Limit to enable the defence package to go ahead. The UK Government has a good bilateral relationship with the Jordanian Government, including close relationship at the highest level with King Hussein, which it is important to maintain. The Foreign Office confirm this, especially in relation to the crucial role played by the Jordanians in the

Arab/Israli dispute. FCO would support any measures to strengthen the existing relationship but accept the need to weigh economic constraints against political advantages. They are seeking further advice from the Post. Both MOD and the FCO advise that the Jordanians will turn either to the USSR or to France for the additional military equipment if they are refused UK credit. That prospect influenced significantly the earlier decision to increase the extent of the earlier loan substantially above what was justified on economic grounds.

12. MOD confirm that there are no other substantial defence contracts on the horizon. The Jordanians fully recognise their vulnerable economic position and have reduced their demands to a minimum. Possible orders for Tornado aircraft or Warrior tanks would be significantly above the level of cover which might be provided by ECGD, and Jordan would clearly have to seek alternative finance, probably by pursuing with the Saudis the earlier negotiations for support.

ECGD's current exposure

13. There is no scope for making room within the market limit for either contract. Jordanian repayments of existing loans are expected to be in the region of £15 million to £20 million per annum over the next few years. This level of repayments will have a minimal effect on ECGD's exposure. Risk-sharing has been introduced to the maximum extent possible.

14. Of the remaining cover, some £15 million is reserved for the UK contribution of the purchase by Alia, the Jordanian airline, of the 6th Airbus A310 aircraft; both our German and French partners have indicated their willingness to support the purchase of the additional aircraft. It would be difficult to withdraw this at this stage. The Jordanians were initially expecting to buy 12 aircraft and might, in the current year, seek support for the remaining 6 Airbus A 320s for delivery in 1990-91; this would require ECGD cover of some £50 million. It would be contrary to normal practice and impracticable in these cases where contracts have been signed to withdraw the indications of cover already given (on a risk-sharing basis)

for the GEC Marconi contract with the Jordanian Public Security Department for the supply of a command control centre (the C31 project) and for the Ransome and Rapier contract (before risk-sharing was imposed).

Conclusion

15. The Export Guarantees Committee generally agreed that the current Market Limit for Jordan is at an appropriate level and that in the circumstances, there are no economic grounds for increasing ECGD's potential liability. The Committee recognised that the Aqaba project is particularly attractive in view of the proposed co-financing arrangement with the World Bank, but the Treasury did not consider that the arguments in favour of the project justify an increase in the Market Limit.

16. The Committee did not feel that the offers of cover for the GEC Marconi and Ransome and Rapier contracts should be withdrawn, nor that cover for the Aqaba project should be provided by withdrawing support for the 6th Airbus aircraft, though no further cover for additional Airbus aircraft should be made available. As for the defence package, the Chief Secretary had made clear in his letter of 9 December 1986 the Treasury's concern about arms exports being pursued without sufficient regard to the availability of export credit cover. The short term prospects of further arms deals with Jordan should be considered in the context of the Chief Secretary's letter, to which neither MOD nor DTI Ministers had yet replied.

17. The Treasury concluded that, on balance, the Market Limit should not be extended further to include either the Aqaba project or the defence package.

HM TREASURY
2 February 1987

ANNEX

JORDAN SECTION 2 COVER

	£M
MARKET LIMIT	500
GUARANTEES ISSUED	396.4
OFFERS MADE	66.25
BALANCE REMAINING	37.35

ALLOCATIONS:

UK CONTRIBUTION FOR THE PURCHASE OF THE 6TH AIRBUS AIRCRAFT	15.0
GEC MARCONI CONTRACT (C31 PROJECT)	19.4
RANSOME AND RAPIER CONTRACT (WALKING DRAGLINES)	3.0
	37.40

OUTSIDE MARKET LIMIT:

AQABA 2 POWER STATION	30
DEFENCE PACKAGE	36


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PM 8 7

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 October 1986

Dear Mike,

ECGD: 1986 BUSINESS PLAN

The Prime Minister was grateful for the report on ECGD's financial position set out in your letter to me of 9 October. She has welcomed the progress ECGD is making towards implementing the results of the Management Review. She will wish to stay in touch with ECGD's position.

I am copying this letter to Jill Rutter (Chief Secretary's Office).

Yours,

David

DAVID NORGROVE

Michael Gilbertson, Esq.,
Department of Trade and Industry

CONFIDENTIAL

Prime Minister 2

DRN 24/10.

MR NORGROVE

20 October 1986

EXPORT CREDITS GUARANTEE DEPARTMENT

ECGD continues to be plagued by the overhang of a vast amount of past business underwritten in respect of countries with payment difficulties. Brazil, Mexico, Nigeria, Egypt and Poland are examples. If low oil prices continue, other countries may join the list of problem countries.

In the last few years, ECGD has set aside some provisions for losses on sovereign debt; one suspects that these are at a lower level than commercial banks consider prudent in respect of similar risks. It is likely that the PSBR will be called upon for substantial amounts for some years in respect of sterling paid out and replaced in ECGD's accounts by sovereign debt. DTI suggests between £300 million and £500 million in each of the next 3 years and smaller amounts thereafter, but this depends on many factors outside the UK's control, including particularly oil prices. The forecast cash deficit is £3,000 million by the end of 1991, but the pessimistic estimate is over £6,000 million. So it will be seen that the risk of overshoot may be substantial, depending on the ability of countries to meet their debts and the extent of debt rescheduling.

The new business plan is to be welcomed as it records progress in the work outlined in the Management Review. Better risk assessment is an essential step to better

management of the risks taken on by ECGD. If it is to recover its market share of British exports, it needs to charge rates fully reflecting the lower risks in Europe and the higher risks in some other parts of the world.

We recommend:

1. Welcoming the progress that ECGD is making towards the implementation of the Management Review.

2. Asking for regular updating on the cash flow position and the effect on the PSBR.

David Hobson

DAVID HOBSON

CC(85)

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422

PS/ *Secretary of State for Trade and Industry*

CONFIDENTIAL

9 October 1986

David Norgrove Esq
Private Secretary to the Prime Minister
10 Downing Street
London
SW1

Dear David,

ECGD: 1986 BUSINESS PLAN

The Prime Minister asked to be kept informed of developments at flap PT1 following my letter of 21st March reporting the ECGD's financial prospects and the implementation of the Management Review. Now that the Chief Secretary and the Minister for Trade have approved the Department's Business Plan for 1986 and the Trading Accounts for the last financial year have been completed, this is an appropriate time to bring you up to date.

CURRENT TRADING POSITION

Overall, there are signs of improvement in ECGD's financial position although future prospects are still heavily dependent upon developments in the world debt crisis and the future of some of ECGD's more significant debtor countries, notably Poland and Nigeria. The Department's Trading Accounts for the year ended 31 March 1986 show an improved outturn - a trading surplus for the year of £226m compared with £83m last year. Even after increasing the general provision (against the possibility of default on sovereign debt) by £170m, there was still an increase in reserves of £56m. This indicates that business taken on by the Department during the last two to three years should be profitable. As a consequence of increased premiums and tighter underwriting, the Department has built up a surplus on current business to provide a reasonable cushion against losses due to unexpected future events. In consequence, it has been agreed that there should be no general increase in premium rates this year. Some small loss making facilities are being kept under review and action has been, or will be, taken to stem further losses.

DW5AXT

1786 1986 BOARD OF TRADE BICENTENARY

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CASH FLOW

Last year's Business Plan contained a base forecast of a cumulative cash deficit of £2 billion by the end of the decade; but I indicated in my letter of 21st March that developments in the world debt problem suggested that the "pessimistic" forecast of £4 billion was likely to be nearer the mark. The revised "base case" in this year's Business Plan predicts that the cash deficit will peak at around £3 billion in 1990 (although more recent work has brought this down to £2.6 billion). These figures would give rise to a call on the PSBR of between £300 million and £500 million in each of the next three years and smaller amounts thereafter. The PSBR figures at the time of the budget made allowance for these changes.

These latest cash forecasts are broadly consistent with the IMF's latest world economic outlook. There are, of course, considerable uncertainties bearing in mind that more than half of ECGD's £30 billion portfolio is in problem markets (eg Nigeria, Poland, Mexico, Brazil). A more pessimistic forecast, assuming that a number of oil dependent markets enter the debt queue, could raise the cumulative deficit to over £6 billion with the annual call on PSBR rising to between £750 million and £1 billion. The eventual outturn is extremely difficult to predict. Moreover, there is very little that ECGD can do to control the deficit, apart from refinancing where appropriate the underlying debt by guaranteeing new loans from the banks rather than borrowing from the Exchequer, since future cash outflows will relate largely to past commitments.

Thus much depends upon how those countries with debt problems, actual or threatened, fare over the next few years. The level of world growth, real interest rates, and oil prices will be the main determining factors.

The assumption is that debtor countries will repay the bulk of their debts and this is reflected in the size of ECGD's reserves.

1986 BUSINESS PLAN

Despite the reasonably good trading position, particularly on current business, the Plan draws attention to the risks. These are chiefly the possibility of a continuing loss of good quality business (there has been a gradual worsening of the quality of ECGD's risk portfolio over the last few years) and the danger that ECGD's exposure might once again become unduly concentrated in high risk markets. The Plan proposes positive action to reduce these risks through a new marketing initiative aimed at achieving a

DW5AXT

better spread of business, a more flexible approach to premium charging and underwriting and the adoption of new techniques for risk assessment and management. The Plan sets targets and objectives for these changes to be introduced as rapidly as possible and progress will be monitored.

THE MANAGEMENT REVIEW AND RUNNING COSTS

The business planning process now follows the lines recommended by the Management Review and the Department has made good progress on the wider organisational and operational changes that were proposed As a consequence, there are now much clearer lines of responsibility and more accountability through the setting of business objectives. A Management Board has been created which will be the top level decision-taking and policy-making body, subject to Ministerial direction. It will also monitor performance and, as far as is possible, take corrective action if the Department is off course. At working level, operational objectives are being set and a new management information system is being developed to provide line managers with the necessary information to enable them to monitor performance against plan. Work is also in hand to integrate the process for controlling running costs with the Business Plan; in this connection, the Department's Action Plan on the Multi Departmental Review of Budgeting will provide a timely impetus to devolved budgeting along the lines envisaged by the Management Review.

CONCLUSIONS

Overall, ECGD is faring reasonably well given the difficult trading conditions it has faced over the last few years. Its balance sheet continues to be weak. It currently has reserves of £456m after setting aside a cumulative general provision of some £582m against the possibility that a full recovery might not be made from the problem debtors, but the reserves themselves are all in the form of recoverable sovereign debt. Thus, ECGD's future prosperity is still heavily dependent upon the ability of debtor countries to repay their debt including interest. Much effort is being made to attract good quality new business to aid ECGD's financial recovery and the Department's core insurance business in the short term field is performing well (although they are currently insuring a declining proportion of UK exports due largely to shift in the pattern of UK export trade).

DW5AXT

In summary,

1 The moves to tighten underwriting and risk management reported in my last letter have been carried further forward and the underlying trading position continues to improve.

2 ECGD's cash position is slightly better than was forecast in the Spring (though worse than forecast in the previous Autumn) and will continue to be dominated by the repercussions of the world debt problem in relation to past business. The amounts are substantial and forecasting continues to be subject to very wide margins of error.

3 The Department is well advanced in implementing the Management Review and this work has now been subsumed in the Business Planning process.

I am copying this letter to Jill Rutter in the Chief Secretary's office.

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

DW5AXT

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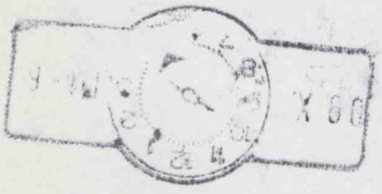
TRADE: ECAD, PTR



MM

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434
My ref: R/PSO/15049/86

Your ref:

DN.

Mark Addison Esq
PS/Prime Minister
10 Downing St
London
SW1

9 June 1986

NBPM.

Dear Mark,

CONTINGENT LIABILITIES

FILE WITH DRN

My Secretary of State has received a copy of the Prime Minister's minute of 23 May about contingent liabilities.

I confirm that he has made arrangements for a comprehensive review of the Department's contingent liabilities, and will ensure that a report is made to the Treasury.

Yours sincerely,

RUY.

R U YOUNG
Private Secretary

TRADE

ECG

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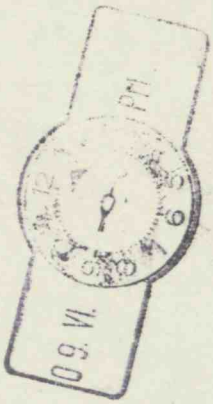

PART ONE ends:-

PM to MINISTERS (MB/86) 23/5

PART TWO begins:-

DOE to MGA 9/6/86



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