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6 February 1980

CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

AID AND TRADE

Note by the Secretaries

1. The Secretary of State for Trade circulated under cover of his letter of 14 January 1980 to the Secretary of State for Foreign and Commonwealth Affairs a note on aid and trade (MISC 17(79)31). Copies of these documents are attached, for discussion in conjunction with the report of the Official Group on Overseas Aid (OD(80) 8).

Signed ROBERT ARMSTRONG
R L WADE-GERY
R M HASTIE-SMITH

Cabinet Office

6 February 1980

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COPY OF A LETTER FROM THE SECRETARY OF STATE FOR TRADE
TO THE FOREIGN AND COMMONWEALTH SECRETARY DATED 14 JANUARY 1980

* * *

AID AND TRADE

In circulating the Aid Policy Review the Cabinet Office referred to the complementary work of the Aid and Trade Working Party and added that it would be submitted to Ministers separately. With this letter I am therefore circulating the Working Party's second report and a further note dealing with the Consensus and Mixed Credit under a covering note which draws all the recommendations together.

Misc 17(79) 31.

The effective operation of the Aid and Trade Provision has been much hampered throughout the past year by disagreement both about the terms on which it could be used and about the volume of finance which should be made available to it. I hope that the present report will at least resolve the first difficulty, and that our discussions about the aid framework will shortly lead to a satisfactory financial provision. If the ATP is to be used effectively in 1980/81 rapid decisions are needed on both these matters, so that officials can get on with the business of selecting the projects which best meet its developmental and commercial/industrial criteria.

I would hope that the present report, which complements the recommendations in the Aid Policy Review for a more commercial

From the Secretary of State

and industrial orientation to the aid programme generally, could be discussed with the main review.

I am copying this letter and its enclosure to all Ministers who received the Aid Policy Review, to Sir Robert Armstrong and to Peter le Cheminant.

* * *

AID AND TRADE

Note by the Department of Trade

1 The Aid and Trade Working Party, an interdepartmental group chaired by the Department of Trade, was set up in 1977 to review the co-ordination of arrangements for dealing quickly with mixed credit offers by our competitors and to consider generally the co-ordination of aid and trade policies. Among the recommendations it made was the establishment of the Aid and Trade Contingency Provision (ATCP). The group was reconstituted in 1979 to examine the operation of the scheme, and its first report was circulated under cover of a letter from the Secretary of State for Trade on 8 June 1979.

2 When Ministers considered the ATCP at the E(EA) meeting on 19 June they noted that the Working Party would in due course be submitting a further report, making recommendations for improvements in the scheme. This report is attached at Annex A.

3 As the report was being prepared during the summer Ministers decided to carry out a wider aid policy review. Since this was bound to have implications for the future of any special Aid and Trade provision, the Working Party's report was held over for further consideration in the light of the review. It was also necessary to discuss further two points not covered conclusively in the report, ie (a) the circumstances in which mixed credit (including the use of the Aid and Trade Provision) could be offered by the UK without undermining the International Consensus on Export Credit, and (b) what might be done to deal adequately with others' mixed credit offers in cases where it was not appropriate to use the Aid and Trade Provision. These points were dealt with in a preliminary way in paragraphs 20-21 and 23-24 of the second Working Party Report (Annex A); but those paragraphs are now to be regarded as overtaken by the note at

Annex B, which sets out the facts on the International Consensus and discusses the relevant considerations. In the light of these we recommend that:-

(i) We should consult with our EEC partners and with the Americans about the control of hard aid loans, lines of credit and mixed credit, and campaign actively, within the Consensus, for prior notification of all soft credit offers with a grant element below 25% (at present, such notification is required only for offers with a grant element below 15%).

(ii) In the light of the results achieved under (i), we should consider further the feasibility of securing international agreement to requiring prior notification for all deals, including hard aid loans, with a grant element between 25% and say 40%.

(iii) We recommend that the Aid and Trade Provision (which is for use where the rest of the aid programme cannot support commercially and industrially desirable export orders) should be available for use to offer mixed credit in markets known to be regular recipients of mixed credit facilities from other countries. In other markets, to secure business of particular importance, we should only make such offers selectively and discreetly. These offers should be confined to the business to be identified under recommendation (vi) below.

(iv) The feasibility, cost and desirability of providing ECGD with resources to match others' offers of mixed credit which either has a grant element of less than 25%, or is in other ways unsuitable for countering through the Aid and Trade Provision, should be urgently considered further.

4 The following further recommendations on the use of the Aid and Trade Provision are drawn from the report at Annex A:-

(v) That aid should not infuture be used in support of firms or undertakings which the DOI consider to have insufficient prospects of viability over the medium/long term.

(vi) That a limited number of developmentally sound and industrially important projects or orders for new equipment be identified in consultation with British industry and given priority to establish them in markets with good commercial prospects.

(vii) That in line with a more selective approach, as an experiment, one or two countries should be chosen as deserving special priority for ATP allocations for commercial reasons, provided that our competitors have already established there either mixed credit or aid on hard terms.

(viii) That the views of Heads of Posts in the relevant markets should be sought in future, and at an early stage, on all ATP proposals, and that new guidance should be issued about this.

(ix) That as much relevant information as possible should be made available to ODA at the earliest possible stage for the minimum test of developmental soundness to be carried out.

(x) That the current limitation of ATP to markets with a gnp per head of $1000 in 1972 should be updated to markets with a gnp per head of $2000 in 1976, but excluding the wealthier oil producing and the Communist developing countries.

(xi) That the normal terms of the aid element in ATP should continue to be grants or Variant 1 loans.

5 In addition we recommend that:-

(xii) While continuing to aim at the maximum gearing in the normal use of the Aid and Trade Provision, we should also be prepared to finance some business 100% from the ATP where we can obtain a firm but informal understanding that this will also secure at least as much additional important commercially-financed business.

6 The proposals for improving the day-to-day administration of the ATP and its financial control (Annex A, paragraph 27) are already being implemented.

7 We invite Ministers to endorse recommendations (i)-(xii) above, which complement the recommendations in the Aid Policy Review in relation to a more commercial and industrial orientation to the use of the aid programme generally.

Department of Trade
December 1979

 ANNEX A

THE AID AND TRADE CONTINGENCY PROVISION 1977-79

Report by the Aid and Trade Working Party

Introduction

1 The Aid Policy Review is examining the policies governing the aid programme in relation to developmental, political and commercial objectives. Within the relationship between aid and trade the Aid and Trade Contingency Provision (ATCP), which dates from 1977, is a relatively new attempt to reconcile developmental and commercial objectives. Among the features which distinguish it from previous policy initiatives in this field are the following:

a it has a separate allocation within the bilateral aid programme

b while, to meet the requirements of the Overseas Aid Act, all projects have to pass a minimum test of developmental soundness it is the industrial and commercial objectives of the scheme which predominate in the selection of projects

c the fund is available to support good projects in any developing country whose GNP per capita was less than $1,000 in 1972; it is not allocated to particular countries in advance d the initiative for proposing projects lies with the Departments of Trade and Industry, and through them with exporters

e the fund can be used in association with commercial credit backed by ECGD, especially when this is necessary in order to match the use of such techniques by our competitors.

2 In essence ATCP provides special foreign exchange support to developing country governments so that they can direct orders to British firms against a background that other donor countries have offered or are offering rival special inducements in support of their companies. Its attraction to recipients is the additionality of the aid offered. It could be seen therefore either as a trade promotion device (which could in its operations also provide developmental benefits) or as an aid device which gives special weight to commercial factors. Operating as it does in the border country between aid and trade the scheme is almost inevitably controversial, and it was in fact already under review following the over-commitment of its resources when the aid policy review provided the opportunity to consider it in a wider context.

Survey of ATCP 1977-1979

3 There is no doubt about the demand for a scheme of this kind among exporters. Although the scheme has only been operating for two years, and applications have had to be actively discouraged since it became over-committed 6 months ago, the volume of business as at 31 August 1979 may be summarized as follows:

Applications considered by the Departments of Trade and Industry	over 200
Applications formally submitted to the Sub-Committee on Aid and Trade of which:	99

Rejected by HMG or withdrawn	29
Under consideration	9
Rejected by recipient Government	26
Accepted by recipient Government	19
Offers outstanding	16
	99

4 The 19 offers actually accepted by recipient Governments have the following expenditure profile:

1978/79	£12.1 million
1979/80	£39.0 million
1980/81	£14.5 million
1981/82	£ 4.7 million
	£70.3 million

The value of exports directly related to this volume of aid is £226 million so that the ratio of exports to the aid element involved has been more than 3:1, which compares very favourably with the corresponding ratios for multilateral aid (approx 1:1) and the remainder of the bilateral aid programme (approx 0.6:1), though these are averages only; some individual multilateral aid uses, for example, yield at least as much as the ATCP.

5 The main reason for this favourable ratio has been the use of mixed credit, either to match equivalent concessional finance by others (i.e. paragraphs 5a(1)-(3)/(4) below) or in a few cases to offer it ourselves (i.e. paragraphs 5a(4)/(5)-(6) below). The position on this is as follows:

	Offers Made	Accepted	ATCP input (£m)
a Mixed Credit Cases			
(1) foreign mixed credit for the business	4	1	4.5
(2) foreign mixed credit currently for the market	17	6	29.9

		Offers Made	Accepted	ATCP input(£m)
(3)	foreign mixed credit previously for the market	5	3	14.2
(4)	foreign aid for the business	4	1	9.6
(5)	foreign aid currently for the market	3	1	3.5
(6)	no evidence of foreign aid or mixed credit	8	3	4.3
b	Aid Cases	16	3	3.3

6 It would be wrong to draw firm conclusions from such a relatively brief experience, but it can be seen that about 70% of the money used on mixed credits has been accepted in markets where there is some history of mixed credits; and the chances of success appear to be slightly better, as one might expect, where our offer leads rather than follows the competition. Aid without commercial credit has been offered mainly for consultancies or exceptionally where ECGD credit is not available.

7 The geographical distribution of ATCP offers has been as follows:

South and South East Asia	:	21 (including 9 in Malaysia); 5 have been accepted
Africa south of Sahara	:	17 (including 7 in Tanzania); 7 have been accepted
Middle East and Mediterranean	:	15 (including 9 in Egypt); 5 have been accepted
Caribbean and Latin America	:	8; 2 have been accepted.

Only 3 offers were made in countries which have no British aid programme at all, but 20 offers were made in countries which normally receive only technical assistance, and many of the other offers were in countries where the British aid programme is small.

8 The distribution of ATCP offers as between sectors as at 31 August 1979 was:

Sector	Aid Offers (£m) Accepted	Outstanding	Rejected
Shipbuilding	18.1		4.1
Process Plant	10.0	1.965	23.1
Power Plant	17.86	33.1	39.458
Railway Equipment	4.938		5.73
Aerospace	4.9		4.3
Construction Industry	2.6		
Vehicles	2.240		
Telecommunications	10.062	3.218	4.00
Others (port complex and transport feasibility study)		33.496	9.586
Total	£70.70m	£71.779m	£90.274m
Value of UK exports expected to arise through above aid offers	£226.544m	£248.400m	£316.91m

Operational Problems

9 Over-commitment of resources has already been mentioned. This is combined with very considerable uncertainty not only about whether offers will be taken up, but about whether they will still be on the original basis, and about the rate at which the money will be spent. All these factors lead to uncertainty and lessen control over spending, and to a need to monitor offers carefully, once made, to watch their progress and their conformity with the schemes as originally put forward. Not only has it upset

expenditure plans, but the bunching of offers last winter and the total embargo which followed must have resulted in a less satisfactory selection of projects than might have occurred if the resources had been more evenly committed. The abrupt changes of policy have also disrupted relations with exporters. What is needed is a system of selection and forecasting which will produce a more even flow of resources while avoiding both over-commitment and the risks of over and under-spending.

10 Another group of problems concerns the speed of decision which is required on ATCP cases. Competitive consideration often requires that a bid be made quickly, but ODA has to be satisfied that a project is developmentally sound. The assessment of developmental value has to show that positive cost/benefit returns are likely, taking into account economic, technical and managerial factors, as well as future uncertainties eg on the price of traded products. The appraisal which this entails may therefore require substantial information and considerable time. If the process is too slow, business may be lost, but if it is rushed ODA are vulnerable on grounds of public accountability under the terms of the Overseas Aid Act. Moreover, their experience is that in practice firms often get led to insist upon early deadlines when the buying government's plans in fact mature at a much slower pace.

11 It has been suggested that the ATCP has been insufficiently discriminating in the selection of markets and industries considered to have the most promising prospects. Certainly hitherto it has operated within present criteria on a first come first served basis with the exports to aid ratio a major consideration, and there has been little conscious direction towards particular markets or industries. However, since our experience now shows that there is an abundance of industrially and commercially acceptable projects in relation to the money that is likely to be available, it is accepted that more stringent industrial and commercial criteria should be applied.

12 Finally there has been concern about the use of mixed credit. It is not to our own national advantage to escalate a credit race by intensifying the competition for soft credit. So long as other donor countries use hard aid loans for domestic industrial purposes in countries where we do not, or are prepared to offer mixed credit to secure orders, we must choose whether we should abandon the field to them, to seek to match them or to take the initiative. They of course face similar issues in countries where the situation is reversed to our advantage. There is a risk that increased use of mixed credit will ultimately be self defeating. It will encourage greater use of the technique by others and intensify competition in financing terms across the board.which would be to our ultimate disadvantage.

DISCUSSION AND RECOMMENDATIONS

Concentration by market and industrial sector

13 Although the Working Party is unanimous in accepting the need for applying selection criteria more stringently, it has not been able to agree on the best method for doing so. ODA consider that Departments should identify a limited number of key markets and target industries in advance and confine the scheme accordingly. This would greatly ease the strain on the administrative and staffing resources of the ODA in assessing developmental values, as well as, in their view, improve the likely immediate commercial returns to the British economy. They believe that defensive action or the support of jumbo projects in other markets would not be justified even on commercial grounds since by definition these would not be likely to lead to any large commercially financed spin-off. Even more fundamental, in an aid programme where financial constraints are extremely tight and giving multilateral assistance through the Community and other channels is inevitable, there is a much stronger need to ration funds available for anything like the ATCP than other Departments have so far accepted.

14 Department of Trade and Department of Industry could not accept such a restrictive approach. The scheme, in its present form, is highly valued by British industry who would like to see a substantial increase in the funds available. The Departments consider that it must retain three essential features: the ability to concentrate on the more promising markets or exports; the facility for the judicious matching of foreign aid assisted competition in any country; and the flexibility to exploit good commercial opportunities worldwide when this is considered important from the commercial and industrial angle. DOI and DOT argue that the ODA proposals would meet only the first of these requirements and that concentration on a few countries would exclude major capital projects, which occur irregularly and infrequently in other areas where our competitors might offer concessional terms (whether financed by aid or some other way) to secure the contract. Exclusion of whole sectors would also be unjustifiable since any valid assessment of competitiveness and growth prospects can only be made at company level and not on a sectoral basis.

15 Nevertheless there is a need for positively directing scarce aid resources and some common ground exists between the above views. It is accepted that ATCP should not in future be used in support of firms or undertakings which DOI considered had insufficient prospects of viability over the medium/longer term. DOI is well used to making assessments of this sort in the context of its finance assistance operations. DOT and DOI could seek to identify, in consultation with industry, those projects or orders for new equipment (eg System X) which it might be particularly important to secure for commercial and industrial reasons and agree that certain negotiations with prospective customers could be conducted on the assumption that ATCP assistance would in principle be available to clinch the deal. Equally a market might be identified from time to time as meriting particular attention, provided that it was a market in which ECGD could prudently offer credit terms, and discussions might be held with British companies and with the development

authorities of the country concerned to determine the projects which might receive assistance. Malaysia might be a good example at the present time, because there is an urgent need to reinforce our traditional presence in the face of powerful attacks from Japanese exporters and others and there are no pressures at present on the availability of ECGD cover; Indonesia and Philippines may also be suitable. However before selecting a market we would have to be satisfied by means of enquiries through ECGD and Posts that the use of mixed credit or tied aid on hard terms was established there so that it could be clearly demonstrated that we were offering only matching facilities unless our national interest strongly justified an initiative. In general we should obviously stay clear of those markets where our competitors are making extensive use of mixed credit or ordinary aid to little commercial advantage. In addition a facility to match aid or officially-assisted competition could be provided by ECGD as suggested in paragraph 29 below.

.16 The gap between some of the departmental views should be noted for discussion during the aid policy review, particularly whether or not ATCP should continue to be available in support of capital goods contracts without geographical restriction. Within the limits of the common ground we recommend

a that ATCP should not in future be used in support of firms or undertakings which the DOI consider had insufficient prospects of viability over the medium/long term

b that a limited number of developmentally sound and industrially important projects or orders for new equipment be identified in consultation with British industry and given ATCP priority to establish them in markets with good commercial prospects

c that in line with a more selective approach as an experiment one or two countries should be chosen as deserving special priority for ATCP allocation for commercial reasons provided that our competitors have already established there either mixed credit or aid on hard terms d that the current limitation to markets with a GNP per head of $1000 in 1972 should be updated to markets with a GNP per head of $2000 in 1976, but excluding the wealthier oil producing and Communist developing countries.

Developmental Soundness and Commercial Deadlines

17 The recommendations at paragraph 16 will ensure that some projects are developed, well in advance of commercial deadlines, in close consultation with ODA, on lines which are developmentally sound from the beginning. Provided the principle of selection is applied staff in ODA will be able to familiarise themselves with the economies and sectors concerned so as to be able to give prompt advice on the developmental quality of the proposals which come forward. But there will still be a need in practice to ensure that all the information they need about the project itself is available early.

18 To meet this requirement, decisions should take due account of the views of Heads of Post (in conjunction where appropriate with ODA Development Divisions) who should be consulted on a more systematic basis than hitherto on all ATCP proposals, regardless of size, at the earliest possible stage. Heads of Post should be provided with the criteria for developmental assessment and guidance on the exact information required for appraisal of proposals on which their views are sought. They can then, with their close knowledge of the country concerned and its development plans, and of the local standing and prospects of the British firm concerned, as well as their appreciation of the competitive situation, offer their considered advice and the supplementary information sought, which would provide the essential material for reaching decisions. But those decisions must rest in London, primarily with ODA, given the terms of the Overseas Aid Act and the likelihood of stiff competition for limited aid resources.

19 However, in some cases there may still be problems in obtaining all the information required by ODA. For example, a

recipient government may be unwilling to provide details on some aspects of a project, such as its financial viability, especially if other countries are willing to provide aid or other concessional credit without those details. Indeed it is the view of some members of the Working Party that ODA apply the minimum test of developmental soundness too rigorously and that there is room for ODA to streamline its procedures consistent with accountability. Against that ODA argue that no two projects are the same and that there is no one minimum test. Each case has to be considered on its merits. They do not consider a proposal in any greater depth than is necessary to establish its economic, technical and managerial credentials. However, in cases where they have doubts ODA must, consistent with their accountability for public funds, try to resolve them, if necessary by seeking additional information; and must reject those proposals on which they are unable satisfactorily to resolve those doubts.

20 The recommendations contained in paragraph 16 will still leave the problem of making a really rapid response within a matter of days in other markets, that is in order to match soft finance where this is in our national interest, from a competitor of which there may well be no hard evidence until shortly before tenders have to be in. Since a proper project appraisal will be impossible in the time available, the use of overseas aid will not be possible, and ECGD, if involved already in considering support for commercial credit, could treat it purely as a matter of commercial financing. In such cases there is a strong case for ECGD being allowed to operate its powers to support unusually concessionary terms where necessary to match others. Such an arrangement should result in a quicker response as well as a neater, more coherent financial package for the project, more readily comprehensible to the recipient. However, ECGD's powers are not as wide as those of ODA - they cannot, for example, give grants except for the purpose of interest relief. They would have to operate through the banks but the Bank of England view is that it is very unlikely that funds in any significant quantity would be available, even with an ECGD guarantee for maturities over 10 years; for maturities over 15 years it

considers that no funds at all would be forthcoming. DOI consider that pension and other institutional funds should be tapped but the Bank of England see no future in this.

21 Matching by ECGD at all levels of grant element would require them to issue more guarantees and expose them to a greater contingent public expenditure liability on that account. More importantly there would be additional public expenditure cost for ECGD in the form of increased interest support and probably refinancing. The interest support costs would run throughout the life of the loan and would be unpredictable because they would depend on market interest rates. Further work would be needed to examine how the increased costs for ECGD could be contained within public expenditure limits. ECGD consider it appropriate to operate only in the non-aid area ie where the grant element of the finance supported is less than 25%, and leave more concessionary official flows to ODA as at present. But for reasons stated above ODA would wish to pass this responsibility for mathcing to ECGD although they would be prepared to continue defensive matching on aid terms in good commercial markets. ECGD estimate that for operating below 25% grant element £5 million per annum would finance the cost of additional interest make-up on a substantial amount of loan principal. If ECGD's powers, at present dormant, introduced to facilitate matching of unusually concessionary foreign terms, were to be activated special financial provision would be required for the purpose. The Treasury however consider that even if matching by ECGD was otherwise feasible the proposals envisaged above would be objectionable on grounds of public expenditure control and of the international reaction to it.

22 Against this background <u>we recommend</u>:

a that the views of Heads of Post in the relevant markets should be sought in future, at an early stage, on all ATCP proposals, and that new guidance should be issued about this

b that as much relevant information as possible should be made available to ODA at the earliest possible stage for the minimum test of developmental soundness to be carried out c that separate consideration should be given to providing ECGD with the resources for defensive matching. This examination should concentrate in particular on the technique that might be used and the manner in which their public expenditure costs might be contained within planned public expenditure limits.

The Use of Mixed Credit and Terms of Aid

23 It is in the UK's interest to strengthen the international consensus on export credits. This is the best defence we have against a credit war, which would favour the strongest economies and the longest pockets. The Americans have been campaigning for prior notification of mixed credits with a grant element of 15-25%/and for ~~banning~~ all mixed credits with a grant element of less than 25% to all but the relatively poorest LDCs. This would hit the French in particular. Mixing aid with credit tends to undermine the Consensus, especially where the grant element of the package is less than 25%, and is a practice we should try to outlaw. But there is no early or realistic prospect of abolishing mixed credit where the total financial package has a grant element of 25% or more which qualifies internationally (provided the money is given primarily for developmental purposes) as aid. While therefore we should not risk undue exposure by using mixed credit in ways which we know are likely to provoke retaliation, a judicious and limited use of such a facility where the aid element can be given reasonable prominence and weight, need not be against our long-term interests. To avoid a general spread of the practice we would need to make it clear internationally that we were only offering mixed credits reluctantly and would be ready to stop doing so if others did too.

24 The extent of the risks attendant on initiation of over 25% grant element packages is of course difficult to quantify. The DOI, as a result of consultations with industry and banks, consider that a carefully planned and concerted bid for a project, involving

a selective use of mixed credit initiation is the only successful means of countering the aggression of other countries, and that a policy of matching only for particular business is unlikely to yield beneficial results. The aid element in most ATCP offers has in nearly all cases taken the form of a grant or interest-free loan (ODA Variant 1). At first sight this might seem to risk undermining the use of harder aid terms in countries where these would normally apply, but since the overall terms of mixed credit package with a grant element of 25% are in any case slightly harder than the hardest or normal ODA country terms (Variant 4 has a grant element of 26.8%), it is difficult for the recipient to argue that the terms for ATCP arereally soft. Moreover it takes a big loan on hard terms to add up to a grant element of 25% so that the use of grants and interest-free loans makes the ATCP go further.

25 We therefore recommend

a that, within the constraints imposed by our membership of the EEC, we should actively campaign to tighten control over mixed credits, in particular for prior notification of mixed credits with grant elements in the range of 15-25%. While we should be ready to match in response to such notifications where this reflects the national interest, we should not ourselves initiate in this range.

b That in markets with good commercial prospects where mixed credit or aid on hard terms tied to particular projects by other countries are already established, or exceptionally where there is no evidence of previous use, we should as well as matching, be ready to make judicious and limited initiative use of mixed credits with a grant element of 25% or more using the ATCP subject to the constraints in para 23 above.

c That in all markets where the grant element of the competition is below 25% we should consider the possibilities of ECGD defensive matching.

d The normal terms of the aid element in ATCP should continue to be grants or Variant 1 loans.

Financial Control

26 This problem was discussed at length in the first 1979 ATWP Report. At its heart is the need to balance the sound management of the limited funds available against a judgement on the proportion of offers likely to be accepted and the phasing of expenditure against them. The aim is to avoid both under and over-spending, and particularly overcommitment. In the light of experience over the first two years of the scheme, we are now better able to judge the level of commitment which may be expected to result in expenditure close to the agreed provision. There are, however, some particular problems. A close watch needs to be kept on very large projects, which could upset the forecasts of expenditure. Also, changes in the nature and size of a project between the original offer and the completion of the commercial negotiations, may require us to insist on some rephasing of expenditure or even the reassessment of developmental soundness. Further difficulties arise when offers are outstanding for six months or more as these act as a log jam on new proposals being considered and problems can arise over the availability of ECGD cover if the amount available for a market has in the meantime been used up by other business. ECGD provide support for business, whether it is supported by aid or not, on a first come first served basis and there is no question of reserving it for mixed credit deals.

27 To cope with these various problems, we recommend

a that SCAT should meet regularly (perhaps every two months) to review the likely flow of expenditure arising from commitments already entered into, to determine in relation to accumulated experience of past offers how much more can reasonably be commited over the next two months, and to discuss which of the projects most likely to come forward should have provisional priority for ATCP.

b in order to reduce the overhang of outstanding commitments, the validity of new ATCP offers should be limited to six months in the first instance.

c that projects whose features and costs significantly change after offers have been made should be reassessed to ensure that they still have a positive developmental value and offers withdrawn if they have not.

d that SCAT should make up an annual report on the working of the ATCP for interdepartmental consideration at an appropriate level.

CONCLUSION

28 After a slow start in 1977/78, a hectic period of hyper-activity and over-commitment in the winter of 1978/79 and now an enforced period of reflection the ATCP requires some adaptation to reduce the administrative and financial problems it has raised. A number of steps need to be taken to minimise the risk of stimulating a credit race and undermining established business, and to improve the project appraisal procedure. The demand from exporters is such that the scheme could absorb considerably more than the 5% of the bilateral aid programme which it has had so far, but there is an important need to institute an approach which will ensure that this part of a constrained aid programme is used to better commercial and industrial advantage.

ANNEX B

The Consensus, Mixed Credit and the ATP

Report by the Aid and Trade Working Party

1 The ATP was originally conceived as a facility reserved for developmentally sound projects of commercial or industrial importance in countries for which no aid allocation was available, or where the allocation was already fully committed; it could be used to provide the aid element in measures to associate aid and commercial credit, whether through mixed credit or in other ways. From the outset the maximum aid element laid down was 50% of the financing (two-thirds if the case was industrial), though 100% could be provided for consultancies. In the event about 70% of the offers made under the ATCP have been of mixed credit. About 70% of the money so used has been accepted in markets where there is some history of mixed credit by the UK. Is this use of mixed credits in our best interests?

2 We and all other major exporting countries have joined in the international Consensus which regulates the terms of export credit in order to prevent the damaging consequences which would flow from widespread cut-throat international competition over export credit terms. The result of such competition would be to determine international competitiveness for export business according to the size of the purses of individual exporting countries. In such a race the UK could not expect to win, and in the course of the race, we should incur large costs to our economic resources and our balance of payments.

3 The Consensus establishes maximum credit periods and minimum interest rates for officially supported export credit. Internationally the concessionality of a credit package is measured by its "grant element". (This is a percentage figure based on the present value of the credit discounted over its repayment period at a 10% per annum discount rate). By this standard a commercial credit on the best terms allowed by the Consensus has a "grant element" of 8.59%. The OECD define aid as official flows to developing countries which are primarily developmental in purpose and have a grant element of at least 25%. The Consensus seeks to restrain mixed credits (ie part commercial, part aid loan or other soft money - such credits do not always qualify as 'aid') below the 25% level by requiring prior notification of packages with a grant element below 15% and prompt notification, after the event, if the grant element is between 15% and 25%. These arrangements give contenders some chance of

matching mixed credit offers by their competitors. There has been general disapproval internationally of the use of mixed credits with the French gathering most of the opprobrium over many years for regularly initiating facilities in the 15-25% grant element range. But criticism is less easy to make stick in situations where the grant element is 25% or more, since such transactions escape the discipline of the Consensus, and may qualify as 'aid'. Indeed the broad concept of linking private with official flows even enjoys some respectability where private finance supported by export credit is linked to international aid funds through arrangements known as co-financing. The prospect of tightening the Consensus to the extent of totally banning the mixed credit technique is considered at best distant, given the entrenched position of the French and their wish, shared by others, to counter hard aid loans by the Japanese.

4 In this situation it is possible to argue that mixed credits are against the interests of the UK. Their effect is to provide longer credit at lower rates of interest than would be available on normal commercial terms. Proliferation of mixed credit would result in the operation of a Gresham's Law whereby bad credit drives out good, eventually undermining the Consensus. On this reading the right way to respond to the competitive situation is to increase our pressure in international policy discussions for the ultimate banning of mixed credit and as a first step towards this for further moves towards outlawing it below 25% grant element. Meanwhile when our exporters are faced by mixed credit offers by others we should vigorously match those offers with a view to demonstrating that mixed credit does not pay. If we want to use aid to support bids for particular export contracts, it may be possible to do this without using mixed credit by financing either part or all of a contract with 100% aid on the informal understanding that the rest of the contract, or other business not formally linked to it, will come to British exporters on normal commercial terms. However the difficulty of arranging such deals should not be underestimated.

5 Alternatively it may be argued that mixed credits with a grant element of 25% and above are not subject to the Consensus, that some of them can be regarded as aid, that there is no distinction so far as the buyer is concerned between such credits and equivalent aid loans, that the grant element is high enough both to avoid contamination of Consensus credit terms and to ensure that the practice cannot become enormously widespread, and that, at the present time at least, the only realistic prospect of extending international action

against mixed credits is to concentrate on the narrower front of credit below 25% where there is most support for making controls more effective. If mixed credits with a grant element of 25% or more are going, on any realistic basis, to continue for some time, we owe it to our exporters to offer them some similar help where this can be justified on developmental grounds (in so far as the ATP is concerned) and to the extent that public spending constraints allow. Under such mixed credit arrangements a given volume of soft finance (aid and officially supported export credit) can cover contracts three or four times the value possible if 100% aid is offered on equivalent loan terms, so that we can get greater commercial benefits for the same public expenditure cost. However, the true cost to the UK economy will be much the same whether the package is made up of 100% aid or a mixture of aid and commercial credit.

6 Having weighed the considerations above, we recommend that

(i) We should consult with our EEC partners and with the Americans about the control of hard aid loans, lines of credit and mixed credit, and campaign actively, within the Consensus, for prior notification of all soft credit offers with a grant element below 25% (at present, such notification is required only for offers with a grant element below 15%).

(ii) In the light of the results achieved under (i), we should consider further the feasibility of securing international agreement to requiring prior notification for all deals including aid loans with a grant element between 25% and say 40%.

(iii) We recommend that the Aid and Trade Provision, (which is for use when the rest of the aid programme cannot support commercially and industrially desirable export orders) should be available for use to offer mixed credit in markets known to be regular recipients of mixed credit facilities from other countries. In other markets, to secure business of particular importance, we should only make such offers selectively and discreetly.

7 This however leaves the problem discussed in paragraphs 20-24 of the second Working Party Report - viz.how to match offers by other countries which cannot appropriately be countered by the Aid and Trade Provision, either because the grant element is under 25%, or because the importing country is not one to which the scheme applies, or because it is impossible to be satisfied, even on the minimum test, that the relevant project is developmentally sound.

8 The Working Party discussed, in this context, the idea that ECGD should have resources available purely for defensive matching in such cases, particularly where the grant element is less than 25%. Because the Aid Policy Review has supervened, it has not been practicable to examine fully the feasibility of setting up such an arrangement and its possible scale and cost, nor how it might be accommodated given decisions on total public expenditure. But we agree that this matter ought to be pursued, and accordingly recommend that:-

(iv) The feasibility, cost and desirability of providing ECGD with resources to match others' offers of mixed credit which either has a grant element of less than 25%, or is in other ways unsuitable for countering through the Aid and Trade Provision, should be urgently considered further.