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OD(80) 28

COPY NO

43

17 March 1980

CABINET
DEFENCE AND OVERSEA POLICY COMMITTEE

AID TO TURKEY

Note by the Secretaries

Attached is a note by Sir Kenneth Berrill, Chairman of the Official Group on Aid to Turkey (MISC 31).

Signed ROBERT ARMSTRONG
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Cabinet Office

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AID TO TURKEYNote by the Chairman of the Official Group MISC 51

INTRODUCTION

1. The United Kingdom Government will need a firm position on the level and type of United Kingdom aid to Turkey for an OECD meeting on 26 March, at which firm 'pledges' of aid will be expected from all participating countries. Herr Matthoefer the German Finance Minister, who is co-ordinating the efforts plans to fly to Ankara on 27 March, and expects to take a complete international package of bilateral aid with him.
2. This report summarises the reasons why Turkey needs aid, the political factors affecting the amount and type of aid that might be offered, and the stance which the United Kingdom might adopt, in relation to that of other countries. It discusses the financial implications of the possible options for the aid programme and asks for Ministerial decisions.

BACKGROUND

3. In May last year Ministers received a report from an Interdepartmental Official Group on Turkey. Most of the background set out in that report still applies. However there is now a new Government which came to power in November 1979, with a centre/right orientation under Mr Demirel.
4. Events in Afghanistan have enhanced the strategic role of Turkey in the Middle East. Turkey is the only Islamic country in Europe, and borders on Iran, Iraq and Syria as well as Russia. It has an important strategic military role, since it controls the Bosphorus and Dardanelles which limit Soviet access to the Mediterranean, and has a large army under NATO command. It also provides bases for intelligence, and air defence.
5. The Turkish economy is in severe difficulties, exacerbated by an acute shortage of foreign exchange. Inflation is running at at least 80 per cent annually; unemployment is about 20 per cent; total external debt is now 15 billion dollars, the bulk of which matures over the next few years; the balance of payments deficit for 1980 is likely to be between 2 billion and 3 billion dollars. Total exports scarcely cover oil imports alone; reserves

have shrunk to 0.6 billion dollars (around one month's imports); there are serious energy and raw material shortages; and many factories are working at under 50 per cent capacity. It seems likely that only the existence of a substantial 'black economy' has prevented more severe social consequences. There is already a high level of political violence. Clearly the risk exists of growing internal dissension, with danger to the stability of this important NATO ally.

THE NEW ECONOMIC PROGRAMME

6. The Demirel Government recently announced a package of economic measures which, if successful, should go some way to reverse the long-standing reliance on the grossly inefficient public sector, and create instead a greater role for market forces. The main elements are -

- a. Improved arrangements for controlling the money supply
- b. Higher interest rates
- c. A devaluation of the Turkish lira vis-a-vis the dollar by 35 per cent, and the limitation of multiple exchange rate practices
- d. More liberal trade and payments regimes
- e. Promotional measures for exports
- f. Promotion of foreign investment in Turkey
- g. The removal of most price controls
- h. More competition for State Economic Enterprises, and large price increases for state traded goods
- i. Arrangements for consolidating Turkey's external non-guaranteed commercial debt.

7. The Official Group believe that the measures represent a start in the right direction. It is encouraging that the Turks are at last trying to do many of the things which the West has been urging on them unsuccessfully for years. But there remain many question marks. Can the extensive public sector be made to pay for itself? Are the rises in prices for agricultural outputs and inputs, eg fertilizers, tolerable? Since exports at present merely offset the cost of oil imports, can the economy be made to turn-round fast enough to keep pace with rising oil prices, let alone improve the non-oil balance of payments? One thing is clear; if the Turkish economy is to avoid further dislocation it must have substantial immediate foreign currency inflows, which will probably have to be highly concessional. The Turks

estimate their balance of payments deficit for the next five years as totalling \$13.5 billion. All the indications are that they will continue to need heavy injections of aid for many years to come. This need would be there no matter what political party or military group was in power.

THE 1980 AID EXERCISE

8. The IMF has put Turkey's unidentified financing needs in 1980 as between \$1.5 billion and \$2.5 billion from Governments and private banks. In the wake of Afghanistan, the Germans have taken on the role of organising the international community, through OECD, to provide the necessary Governmental aid. The German Finance Minister, Herr Matthoefer, has put personal prestige at risk against the success of this exercise. He has made clear his view that in all the circumstances, both international and domestic within Turkey, this year's exercise needs to be bigger, more concessional, and faster disbursing than the one in 1979. The most immediate problem is to get cash into Turkey's hands quickly so that she can increase imports of oil, raw materials, and spare parts; break the bottlenecks in output; and cut the inflationary spiral caused by shortages of goods. Herr Matthoefer recognises that 1980 aid will probably need to be the start of a 4-5 year programme. The OECD will, we understand, be looking to us for a contribution of \$60 million (rather less than a full "formula" share of \$75 million). President Carter has also expressed the hope that the United Kingdom will both 'untie' last year's aid, and contribute generously to this year's exercise with 'untied' aid.

9. There will thus be considerable political pressure for the United Kingdom to match, or improve on last year's offer. Any United Kingdom aid can only be a very marginal contribution to Turkey's needs, but however much aid we give, in view of the wider implications at present for our relations with Germany, it is important that the United Kingdom should not be seen too much to drag its feet or take the lead in opposing German proposals during the negotiations.

POSSIBLE TYPES OF AID

A. Debt Rescheduling

10. The Turks have asked that debt service due for payment between 1 July 1980 and 30 June 1981 (most of which is in respect of guaranteed commercial debt, but partly government-to-government aid debt) should be rescheduled. The Germans propose that at the meeting on 26 March a statement should be made agreeing the need for rescheduling and suggesting a meeting in May or June for detailed negotiation on terms. The United Kingdom will have to respond, but it would be very difficult to oppose such a proposal. Rescheduling Turkey's debts is probably inescapable because it will not be possible for her to meet her debt repayments over the next few years even with a series of very substantial aid packages. The effective choice is between an agreed and orderly rescheduling, and a disorderly accumulation of arrears. The Turks will try to obtain a more generous 1980 agreement than in previous years. They are also expected to seek agreement on ²⁶~~25~~ March that, pending a rescheduling conference, Turkey would cease to make interest and capital payments as they fell due in succeeding months. This would be prejudicial to the later negotiations and it would be preferable simply to leave the Turks where they are now - in default.

B. Bridging Finance

11. The Turkish Central Bank is approaching the Bank for International Settlements (BIS) for a \$500 million short-term facility in advance of untied aid which it hopes will be pledged at the OECD meeting but which may not be received for some months. The BIS may be prepared to arrange a modestly sized short term facility provided a substantial proportion is backed by a number of central banks. The Bank of England would only be willing to participate for a small share, up to the amount of any untied United Kingdom aid which the Government decided to provide (but see Paragraph 18 below).

C. European Community Aid

12. The United Kingdom is committed to a Fourth Financial Protocol of at least as large as the Third (£23 million) as from October 1981, and - if the Turks ratify it - to the supplement to the Second Financial Protocol (cost to the United Kingdom: 41 maa, or £27 million). We are not committed to any further emergency assistance through the Community comparable to last year's

75 maa. but if we blocked a 1980 emergency aid offer from the Community, it would deprive the Turks not only of United Kingdom funds, but also of those of our Community partners. Community aid will be slow disbursing (unless a decision is taken to provide programme aid rather than project aid - and we could make our agreement to any Community package conditional on its not being programme aid), so there would be little, if any, extra cost to the aid programme in 1980/81. But there would be serious implications for later years from any new EC commitment.

D. Military Aid

13. The Turks have proposed the creation in NATO of a \$150 million special fund for the purchase of military equipment. The United Kingdom has no provision for a military programme.

E. Trading Concessions

14. In principle it would be possible to assist the Turkish economy by some lowering of barriers to Turkish exports, eg textiles or agricultural products, or by concessions on immigrant labour. But none of these possibilities would be politically attractive, either to the United Kingdom, or to France, Germany and Italy.

F. ECGD

15. ECGD has been 'off cover' for Turkey since October 1977. There is no prospect of renewing cover given the prospects for the Turkish balance of payments.

G. Bilateral Aid

16. In the 1979 exercise, the bulk of the aid came through bilateral aid commitments, and this pattern will be expected again in 1980. Last year the United Kingdom promised £15 million (\$54 million) in the form of a tied programme loan. This compared with \$200 million for Germany, \$70 million for France, and \$200 million for the United States. In fact, because of a variety of delays, many on the Turkish side, none of this United Kingdom money will have been disbursed during 1979/80, and so most of it is likely to flow during 1980/81. (The Turks would most willingly take all of this £15 million immediately in United Kingdom refined petroleum products if we

would permit our list of tied products to be extended this wide. But officials recommend against this.) As noted earlier, there will be considerable pressure internationally for more rapid disbursement of the previous and the next tranche. But our tying procedures give us a measure of control over the rate of disbursement, which will need to be balanced against the pressures on the aid budget.

THE UNITED KINGDOM AID BUDGET

17. For 1980/81 we are already committed to the 1979 package of firstly the £3.5 million agreed for refinancing aid debt, secondly the carry-over of our bilateral aid commitment (£15 million) and thirdly our share of the EC aid commitment. Present provision for Turkey in the 1980/81 Aid Framework is some £10 million short of the 1979 carry over. The overall contingency provision in the 1980/81 Aid Framework to cover all possible requirements is only £58.5 million. Of this the £10 million is required for Turkey, and potential claims amounting to more than the balance have already been identified, even though the year has not yet commenced. Thus (and the National Contingency Reserve apart) any new commitment to Turkey would severely limit the scope for meeting other claims later in the year on the Aid Budget. In particular there would be little if any scope for implementing the conclusions of the recently conducted Aid Policy Review that more use should be made of the Aid Budget for political purposes or to secure industrially or commercially attractive projects. The only way out of this dilemma would be to tie any new commitments to Turkey very narrowly indeed and to ensure that very little was disbursed

until 1981/82.

OPTIONS

18. Ministers need primarily to decide what shall be the United Kingdom stance at the OECD 'pledging' meeting on 26 March. But United Kingdom attitudes to the total 1980 aid programme for Turkey need to cover seven elements -

- a. Military Aid - officials assume that the United Kingdom will continue to insist that it has no system of military aid.
- b. Trading Concessions - officials assume the United Kingdom (and our partners) will not be prepared to make any concessions.
- c. ECGD cover - officials assume that the United Kingdom will continue to leave Turkey 'off cover'.

d. Debt Rescheduling - officials assume that the United Kingdom will agree to take part in the May meeting which will discuss the Turkish bid for a medium term (5 year) rescheduling exercise on very favourable terms (5 year grace period: 7 year repayment; 2 per cent interest). Officials recommend that the United Kingdom should argue initially against reopening the 1978 and 1979 rescheduling agreement but be prepared to concede if the tide (particularly the Germans) is running against us. At worst, the cost to the aid programme in 1980/81 of an agreement to reschedule would be about £3 million. In considering the 26 March meeting this possible later liability should not be overlooked. ECGD's Trading Fund could require up to an additional £30 million, a charge on the PSBR although not on public expenditure.

e. EEC Aid - officials assume that the United Kingdom will take part in the discussions on a possible 1980 EEC aid package. This, too, will take place after 26 March and again any liabilities will be unknown at that time. But the United Kingdom would find it difficult to frustrate an EEC package by refusing to join it and officials assume that the United Kingdom would take part. Our share of the 1979 effort was £9.5 million, so again in considering our position for 26 March we need to assume a contingent liability for EEC 1980 of something over £10 million.

f. BIS Short Term Facility - the BIS could let the Turks have a short term loan (to be repaid from untied loans when received) to be spent on immediate oil imports. But the Bank of England would only participate if the United Kingdom Government intended to include untied aid in its 26 March package - see g. below.

g. 1980 Bilateral Aid - this is the main subject of the OECD 26 March meeting. For the United Kingdom there are three possible lines of approach -

- i. to regard helping Turkey and not offending the Germans (and Americans) as constituting such a strong case that the United Kingdom will offer in 1980 at least as much bilateral aid in real terms as in 1979 and disburse both it and the 1979 aid more quickly.

(The Turks have claimed that the French will be increasing their bilateral aid from Fr.300 to Fr.400 million and untying two-thirds of it; on the face of it this seems unlikely, although the French have loosened the tying of their 1979 aid.)

ii. To offer the same amount of bilateral aid in money terms as in 1979 but tie it so tightly that we ensure that very little of this new commitment flows in 1980/81. Such a course would create problems for the aid programme in 1981/82 and later when aid is planned to decline sharply in real terms (and the aid for Turkey problem will still be with us).

iii. To say that we cannot afford any bilateral aid contribution in 1980. We will stand by our 1979 commitment and contribute our share to any agreed 1980 EEC programme but our public expenditure position does not enable us to go further.

Officials are agreed that although any contribution the United Kingdom might make to help Turkey could at best be marginal, the balance of argument lay against course (iii) (No 1980 bilateral aid). In particular, with the EEC Budget discussions looming ahead we could not afford to take the risk of damaging our relationship with Germany.

As between course (i) at least as much bilateral aid in real terms as in 1979 and less tying and (ii) the same bilateral aid in nominal terms as in 1979 but tightly tied so as to minimise the flow in 1980, officials were unable to come to a recommendation. Course (i) has political advantages but would create great difficulties for the 1980/81 United Kingdom aid programme. Course (ii) creates difficulties for the United Kingdom aid programme in 1981/82. Priorities in the Aid Programme are very much the concern of the Secretary of State for Foreign and Commonwealth Affairs and he no doubt will give his views to his colleagues on this difficult choice.

14 March 1980