

Passed to
PM Party
2.5.86
AK

cc: [initials]



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 May 1986

Tim Flesher Esq
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LONDON
SW1

Dear Tim

TOKYO ECONOMIC SUMMIT - TIED AID FINANCING

... I attach a copy of a brief which I passed to Charles Powell just before he left with the Prime Minister yesterday. We would like to make one minor change to this, and add one health warning.

The amendment is to the second sentence of the background note: after "UK and many others", insert "(in particular the US)".

The health warning concerns the worked example in paragraph 4 of the background note. This is intended for background, and not for use. (In order to make the example easier to follow, some simplifications have been assumed which would leave the Prime Minister open to the objection that Japanese tied aid finance does not work in this way. We are arming the Chancellor with a slightly more complex example which he may use.)

I should be very grateful if you could pass these points on to Charles in the most appropriate way.

Yours ever,

Tony

A W KUCZYS
Private Secretary

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TOKYO ECONOMIC SUMMIT - TIED AID FINANCING

Objective:

- to join US and others in persuading Japan to accept the proposed new OECD "discipline" package, including novel (but essential) use of "Differentiated Discount Factors".

Line to Take:

- we must bring the escalating credit war among industrial countries under control; it distorts trade and aid and is costly;
- after long discussion we are near to agreement in OECD on a package which makes sense: only Japan and Switzerland are opposing;
- the feature which they oppose (Differentiated Discount Factors) is necessary to replace an artificial method of calculating comparisons which gives unfair advantages to low interest-rate countries;
- it is unseemly for Japan, with its huge current surplus, to insist on retaining an unfair trade advantage.

Background

Tied aid finance is a device for offering cut-price bids for large credit-financed export contracts. UK and many others ^(in particular the US) dislike it but have joined in as the only way of matching the competition (in which Japan and France have tended to set the pace).

2. The attempt to control the process has been built on the principle of distinguishing between aid on the one hand and market trade credit on the other, by establishing a deliberate gap: if

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you depart from market terms in relation to exports to countries for which the agreement allows this at all, then you must offer a package with a minimum "grant element" of X%. (X% is now 25%. The US want a 40% minimum: the Community say 35%. These views could be reconciled in negotiation once the principle is agreed).

3. But to evaluate the "grant element" one must be able to convert different repayment and interest rate schedules (which can readily involve subsidy) and an appropriate discount factor must be adopted. This is the focus of the unresolved argument:

- the present arrangement uses an artificial factor of 10% for all discounting calculations;
- the proposed arrangement would use different discount factors for each creditor country, reflecting market costs of capital in that country.

4. The importance of this for the UK and others can be seen from a simple example. Suppose UK and Japan offer identical bids of £100 million for an engineering project, and each offers to finance 25% - the permitted "minimum grant element" - by free gift of technical assistance, etc. But the remaining 75% is financed on credit which costs 12% in the UK and 7% in Japan. Using the artificial 10% discount factor for both will result in the UK credit element showing an extra cost to the buyer (because $12 > 10$), and the Japanese credit an extra benefit. No problem for Japan, but the UK will have then to produce more aid to get the total "minimum grant element" back to the required 25%. Using Differentiated Discount Factors as we propose, this problem would disappear, because the different market interest rates would be discounted by different factors and yield virtually identical results for Japan and UK.

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