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SUBJECT cc MASTER

10 DOWNING STREET

From the Private Secretary 23 June 1986

Dear Colin,

SOUTH AFRICA

The Prime Minister held a further meeting of Ministers this morning to consider the draft OD paper circulated by your Secretary of State on Sunday evening. The Lord President, the Foreign Secretary, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, Sir Robert Armstrong and Sir Percy Cradock were present.

The Prime Minister expressed serious concern at the disclosure to the press over the weekend of details of the group's last meeting, the fact of the current meeting and of the planned meeting of OD, and of the possibility of a visit by the Foreign Secretary to South Africa.

The Prime Minister said that she had that morning spoken to Chancellor Kohl by telephone about South Africa. She had found him firm in his opposition to economic sanctions and strongly in favour of a diplomatic initiative by the Community with the South African Government. It was also clear that the United States was anxious to work for the maximum coordination between the main industrialised countries and hoped that the European Community would avoid precipitate action. It seemed that the United States Administration was willing to hold the line against measures which would damage the South African economy if other Allies were equally resolute. Against this background, the paper circulated by the Foreign Secretary was not in its present form an adequate basis for determining the Government's position at the European Council and subsequently. It did not attempt to define the purpose of measures which the Community might take. It risked elevating the ANC to a position where they appeared to be the only black group relevant to a dialogue with the South African Government. It took no account of the risk of a moderate backlash in South Africa which would arise if the international community failed to give any credit for the reform measures which had been taken, even though they were clearly not enough. It offered no real assessment of the likelihood of South African retaliation for economic measures taken by the Community. These might extend to takeover of Western assets, repudiation of debts, and restrictions on the export of strategic minerals. It gave the impression that the mainspring of our policy should be to go along with the crowd rather than to give a lead in what we thought was right. Since it appeared that Germany and the United States at least shared our reservations about economic measures, this was too defeatist an attitude. In her view, our aim at the European Council should be to avoid any decision on concrete measures while time was given for consultations with other members of the Economic Summit Seven and for exploratory discussions with the South African Government.

The Foreign Secretary said that it was massively beyond Britain's capacity to affect what happened in South Africa. We should not therefore cast ourselves in the role of architect of the future. We had tried for years to promote change in South Africa by dialogue without any real response. The recent emergency measures in South Africa made it all the harder for moderate blacks to come forward to take part in negotiations. The prospects were for a recurrence of this cycle of repression. At the time the Eminent Persons Group had been established, we had given a commitment to consider further measures if it should fail. We were under a similar obligation in the Community. There was a plain necessity for us to take some action soon. He agreed that we should give a lead rather than simply follow. In the light of experience one was bound to be sceptical of how long both Germany and the United Staes would stand firm against measures. He agreed that it would be worth exploring the possibility of support at the European Council for a diplomatic initiative, although he thought that the odds against success were slender, in the light of the South African Government's rejection of the Eminent Persons Group's proposals. It would be prudent therefore to consider what measures we would be ready to adopt if necessary and on what timescale. The Presidency had circulated various proposals. It was virtually impossible to find a measure with no costs to us or with no effect on blacks in South Africa as well as on the South African Government. But we were likely to find ourselves faced with the prospect of a consensus at the Council for restrictive measures. If we were to stand out alone against them, the difficulties of the Government's position both politically in this country and in the Commonwealth would be greatly increased. One possiblity to be considered was that measures should be adopted conditionally, to be implemented only after the results of a mission to South Africa had been assessed.

In discussion it was suggested that the domestic pressure on the Government to take measures would in all likelihood increase. Mr. Waite's return from South Africa would probably add to this. The Government were unlikely to win the moral argument without adopting some measures. In political terms there might be a majority against economic measures within the Conservative party but there was probably a majority for them in the House of Commons as a whole. While the long-term prospects in South Africa were a legitimate concern, the United Kingdom's capacity to influence them was limited. Priority had to be given to the tactical handling of the problem of sanctions in Parliament, in the European Community and in the Commonwealth.

In considering possible economic measures there was a difficult balance to be struck. We needed to be able to show that any measures would be effective in promoting change in South Africa. At the same time, they should do the least possible damage to our own economic interests and keep to a minimum the risk of retaliation. It was also important that the United Kingdom should not seem to bear an unfair share of the burden imposed by economic measures. We should be ready if necessary to propose specific measures which would be difficult for others to accept, as a way of deflecting calls for action in areas difficult for us. But we had to take account, too, of the danger that the United Kingdom would be identified as the main obstacle to sanctions or as responsible for restricting their scope. This would not only be damaging politically but could risk retaliation against our very considerable economic interests elsewhere in Africa. The aim should be to go to the Commonwealth meeting in early August with a limited package of measures which could credibly be represented as the most that could be negotiated between the European Community and the Economic Summit fewer countries.

As regards specific measures by the Community it was noted that:

(i) other member states should be challenged to take action where the United Kingdom had already done so;

(ii) a ban on the import of fruit, vegetables and wine from South Africa enjoyed wide support in the Community. But it would be particularly damaging to rural blacks. In the Trade and Industry Secretary's view, it would also carry the highest risk of retaliation by South Africa. The presumption should be that we would oppose it;

(iii) there were significant objections to a ban on the import of coal (which would cost the jobs of 15,000 black mineworkers and put at risk our exports of mining equipment) and steel (which would be a breach of GATT). But the risk of retaliation on these items was probably less;

(iv) we should propose the addition of a ban on imports of uranium since this would be difficult for France and Germany and might therefore deter them from pressing for a ban on fruit and vegetables.

The Prime Minister said that the matter would need to be considered by OD on 24 June. The draft paper should be rewritten to make it less defensive and to make clear that our preferred outcome at the European Council was to defer decisions on negative measures to give time for consultations with other major industrialised countries and for a mission to visit South Africa and report. A fuller study of the scope for retaliation by the South African Government was also needed.

I am copying this letter to Joan MacNaughton (Lord President's Office), Rachel Lomax (H M Treasury), John Mogg (Department of Trade and Industry), Andrew Lansley (Chancellor of the Duchy of Lancaster), Murdo Maclean (Chief Whip's Office), Michael Stark (Cabinet Office) and Sir Percy Cradock.

yours ever,

Charles Powell

Colin Budd, Esq.,
Foreign and Commonwealth Office

POSSIBLE FURTHER MEASURES AGAINST SOUTH AFRICA:
THE SCOPE FOR SOUTH AFRICAN RETALIATION

South African retaliation to new measures would depend on many factors including the severity of those measures and the number of countries applying them. Minor measures might evoke no retaliation.

2. There has been no retaliation against the measures by the Commonwealth and the EC last Autumn. But a recent trade embargo by Sweden has been met by the introduction of a licensing requirement on South African imports from Sweden. It is not yet clear how far the South Africans intend to use this actually to frustrate Swedish imports.

3. If South Africa went for retaliation in areas other than the measures imposed on her, she would consider the following areas.

TRADE RETALIATION

4. South Africa needs to maximise her foreign exchange earnings and to maintain her standing as a reliable source of supply. But it is impossible to judge whether the South African Government in their present mood might cross the threshold from recrimination into the area of deliberate or even disproportionate punitive retaliation. Such retaliation would be likely to be selected: the Front Line States (because of their vulnerability) and the United Kingdom (for similar reasons and because we may be perceived as having a leading role in both the Commonwealth and the EC) could be targets. In certain circumstances South African retaliation in the trade field could be legal as counterrailing action under the GATT.

5. Measures which had a significant trade impact, selectively or otherwise, could provoke a combination of several forms of retaliation:

(a) Import restrictions

(i) Licensing requirements

(ii) Tariff increases

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(iii) Quota restrictions (or total bans)

(b) Export restrictions (notably on strategic minerals).

Import Restrictions

6. Trade between the United Kingdom and South Africa is almost in balance (1985 UK exports £1,010m; imports £990m.) but nearly 25 per cent of UK imports are accounted for by diamonds which are largely re-exported. South Africa could re-direct this trade elsewhere, eg through Israel.

7. In applying any import restrictions against the United Kingdom, South Africa might act selectively, seeking to damage particular industrial sectors whilst minimising impact on the domestic market. Leading contenders for this kind of action could be spirits and wines (in 1985 Scotch exports totalled £36m. representing our sixth largest market worldwide) and mining equipment (in 1985 UK exports £16m.). Other luxury consumer goods (eg leather and clothing) are perhaps more likely targets than the capital goods field where long-term import substitution policies have already restricted imports to requirements which South Africa is unable technically to meet from domestic sources. In most of the categories named, the UK is a major or the leading supplier and would be more vulnerable to retaliation than other trading partners. Escalation to the point of a total import ban is unlikely; if it happened it would have severe impact, particularly in the UK engineering industry; 120,000 jobs may be involved in exports to South Africa.

Export Restrictions

8. The most likely area for restricting South African exports and the most damaging to the UK economy would be strategic minerals. The UK relies entirely on South Africa for chemical chrome and substantially for chrome ore which is vital to the production of special steels and alloys needed, for example, in the aerospace and nuclear industries. South Africa is an important source of other key minerals of which manganese and

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vanadium are the most important. The Soviet Union is the major alternative source of these minerals. Producers outside the Eastern bloc and South Africa account for 28% of world output of all grades of chrome, 41% of manganese and about 20% of vanadium. Zimbabwe is a major alternative source of chrome but her exports depend almost totally on transport through South Africa.

9. In the event of a cessation of South African supplies, it is difficult to envisage Western industrial demand being met from the alternative sources available, and intense competition for the remaining supplies would drive up prices.

10. A distinction needs to be drawn between manganese, where production from alternative sources could be increased in the short term, and chrome and vanadium, where the problems for increased supply are long term. The UK's stockpile of chemical grade chrome stands at about 14 months' supply.

11. Other export restrictions could be damaging to particular industries; for instance breakfast cereal is dependent on a particular type of South African maize.

<u>Front Line States</u> (FLS)

12. The FLS are especially vulnerable to South African trade retaliation in three areas:

a. Frustration of import/export trade with South Africa. For Zimbabwe, Malawi and Mozambique, South Africa represents an important market for agricultural and other products as well as the usual source of many imports vital to the functioning of their economies. Transport systems in the region also continue to depend heavily on South African technical and other services.

b. Loss of invisible earnings following repatriation of migrant workers and denial of South African tourism etc.

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c. Denial of access to South African transportation and port facilities vital for FLS exports. Alternative railways and ports in Tanzania and Mozambique are inadequate. (UK exports to the FLS could be similarly frustrated by South Africa).

St Helena and Dependencies

13. If the South Africans frustrated the shipping services between St Helena and Tristan da Cunha, the effects on the island would be severe. The provision of alternative shipping services could cost the UK £5m. per annum. Ascension Island, given its air links, would be almost immune to the effects of such a move.

WITHDRAWAL OF SOUTH AFRICAN INVESTMENT OVERSEAS

14. The value of South African investments in the UK is estimated to have been approximately £0.6 billion at the end of 1983. Were these to be liquidated there could be some (probably in most cases very marginal) effect on share prices and there could be an effect on employment from the withdrawal of any direct investment. To the extent that the proceeds were switched out of sterling, rather than held as eg sterling bank deposits, the net effect would be to weaken sterling very slightly.

WITHDRAWL OF GOLD TRADE FROM LONDON

15. The London Gold Market (LGM) represents an important source of direct and indirect invisible earnings for the UK economy. Any interruption in the supply of gold reaching London would be significant. South Africa (as in 1968) could switch most of her primary marketing to Switzerland. Although the LGM would continue to be involved as secondary intermediaries, the switch of primary markets would damage total business in London. One of London's current principal strengths is the readily available physical supply of gold (mostly held in the Bank of England). Any reduction in this stock (as occurred in 1968) will quickly disrupt the market and de-stabilise the price in the short term. One of the side-effects would be to boost the attractiveness of gold produced by the USSR.

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16. By virtue of accounting for some 60 per cent of gold output from market economies, South Africa theoretically could restrict supply to the world market, aiming to destabilise the market or even influence the price. For a number of reasons this action is unlikely:

a. gold is critically important to the South African economy accounting for 40-50 per cent of foreign earnings, 10 per cent of tax revenue and 8.5 per cent of gross domestic product;

b. despite South Africa's share of world production, annual output represents only about 0.75 per cent of the estimated worldwide stock of gold; and

c. temporarily restricting supply and driving up the price would bring marginal suppliers to the market. The supply position would also be influenced by greater recovery of scrap gold.

WITHDRAWAL OF SOUTH AFRICAN FUNDS FROM LONDON

17. Deposit liabilities of banks in the UK to South Africa are modest ($1.4 bn. at end-March 1986, of which 40 per cent are denominated in sterling). Although the withdrawal of these balances would marginally reduce the City's invisible earnings, such action would pose no direct threat to the United Kingdom.

RESTRICTIONS ON PERSONAL REMITTANCES; OR CORPORATE INTEREST PROFITS AND DIVIDEND PAYMENTS

18. Restrictions on personal remittances by foreigners in South Africa seem unlikely to have significant economic effects. Interference with IPD flows would be more serious - UK invisible earnings were of the order of £1.4 bn. in 1984, before the imposition of exchange controls in South Africa. They are probably much lower now.

19. The cost of loss of these would comprise two elements -

a. direct loss of income to United Kingdom entities;

b. the impact on sterling of the effect on the balance of payments. This is difficult to assess given the range of other factors likely to be at work, but would on balance be expected to weaken sterling slightly.

It would seem unlikely that the South Africans would want to resort to this weapon except in extremis. Their aim would be to retain investors' support as far as they could, and action of this type could only damage it further.

RESTRICTIONS ON DEBT SERVICING PAYMENTS/REPUDIATION OF DEBT

20. London is heavily exposed to South Africa as a financial centre. Of particular significance is the exposure of British-owned and other international banks on a consolidated basis (including the operations of branches, subsidiaries and certain affiliates worldwide). South Africa needs the co-operation of the banks, so major retaliation against them may not be likely in response to minor sanctions in the near term.

21. British owned and United States registered banks are each estimated to have claims of roughly equal size at just over $4 bn. at end-June 1985 on a consolidated vasis, or about 25 per cent of the total claims of banks in the BIS reporting area. (Latest data show that claims of US registered banks fell from $3.9bn. at end-June 1985 to $3.2bn. at end-December 1985). Nearly two-thirds of South African borrowing from BIS area banks is due for repayment within one year and for United States banks the proportion is even higher (80 per cent). Just over half of British-owned banks' claims ($2.3bn) is due for repayment within six months.

22. Following the withdrawal of credit lines by certain US banks last summer, the South African authorities imposed a moratorium on capital repayments covering 60 per cent of external debt. An interim agreement between South Africa and the creditor banks has been worked our providing for the repayment of 5 per cent of debts due up to 30 June 1987. Certain categories of debt remain outside the standstill, most significantly debts guaranteed by overseas export credit agencies. A full moratorium affecting all bank lending would be serious for certain British banks.

23. The British groups most affected would be Barclays and Standard Chartered. In 1985, Barclay's profits attributable to South Africa were over 10 per cent of total group pre-tax profits and the equivalent figure for Standard Chartered is significantly higher. More important, however, than the risk to profits is the possible impact of a full debt moratorium on certain British banks' capital. At end-December 1985 seven major British banks had, on a consolidated basis, exposure to South African borrowers of over 10 per cent of the capital base.

24. Barclays and Standard Chartered each have a major stake in an associate bank in South Africa. These two associates account together for half of the Republic's domestic banking. Barclays and Standard Chartered are therefore vulnerable to any threat of nationalisation of their shareholding without compensation. The capital loss of the investment in their associates would, however, be minor compared with the need to write-off or provide against potential write-off of their loans to the two associate banks.

25. In the case of Barclays and Standard Chartered there is an additional dimension in that their associates have, in their own names, borrowed substantial sums estimated at US $3 bn. in the international markets. If extreme circumstances prevailed and these associates were prevented not only from repaying immediately but also servicing the debt, their creditor banks might well look to their bank shareholders to honour the obligations in question. The indications are that Barclays and Standard Chartered may well take the view that, given force majeure, they would not feel obliged to stand totally behind the obligations of their associates in South Africa. Indeed, they have indicated for quite some time that the market should judge those associates as separate entities. They believe that the market has effectively endorsed their position by demanding a significantly higher interest rate from the associates than from the parent groups.

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EXPROPRIATION OF UK ASSETS

26. UK assets in South Africa, in the form of direct and portfolio investment, are valued at about £5 bn. Their expropriation would be very much a last resort for South Africa.

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