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(2)

CONFIDENTIAL

(1) Prime Minister

To note

MCS 4/11

(2) Mr Coles

PRIME MINISTER

I refer to the Chancellor's minute of 19 October proposing measures to reduce export credit risks and subsidies. I comment also on the question of ECGD exposure worldwide and in Mexico which Cabinet raised last month.

The measures proposed by the Chancellor provide a basis for officials of the Departments concerned to draw up some new operating guidelines. But officials need also be instructed to have regard to broader aspects of the problem because it is essential that we get the right balance between financial prudence and the interests of our exporters at a time of continued recession and difficulty.

First, I would strongly underline what the Chancellor says about export interest rate subsidies and credit risks being different issues. Unless our export interest rates match those of our competitors, we will inevitably lose business in many perfectly creditworthy markets. And a substantial proportion of our exports to riskier markets, being on short-term credit, do not attract interest rate subsidy. As the Chancellor notes, the essential control on interest rate subsidies is the level at which the Consensus rates are set. The last two consensus negotiations, together with favourable movements of commercial rates, have markedly reduced the subsidy burden in respect of all markets. I am reluctant to follow him in seeking to anticipate the next round of negotiations. But I do agree that we should seek to persuade our partners to resist a return to the very high subsidy costs of a year or two ago, especially for exports to the rich countries. The Consensus is of particular importance to the competitive position of United Kingdom project exports and I shall be getting advice from the Overseas Projects Board before the next round of negotiations.

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Secondly, the controls suggested by the Chancellor could be a useful reinforcement to existing mechanisms governing ECGD exposure provided that:-

(i) they are not operated in an unduly rigid fashion;

(ii) they are relaxed as and when circumstances permit; and

(iii) they have regard to the fact that companies cannot swiftly switch from one export market to another - market positions can take much time and money to establish.

I agree, however, that there is a need for prudence in limiting ECGD's credit exposure on markets facing debt service difficulties; and that the country risk should be given more weight in future. I would like official efforts in this direction to be focussed on ECGD's Section 2 (National Interest) operation. I see no cause for breaking the long tradition of relying upon ECGD's statutory Advisory Council's commercial advice in respect of Section 1 operations. I would also hope that any proposed global limit on ECGD's Section 2 exposure - for which I see no strong case - would not be used to force ECGD into an ultra-cautious policy. This would carry the following dangers:-

(a) it would drastically reduce the export opportunities for British exporters (and markets once lost are difficult to recover);

(b) it might in fact lead to more country defaults if it added to the growing crisis of confidence amongst international commercial lenders; and

(c) it could have a long-term effect on the viability of the ECGD scheme by undermining the insurance concept of spead on which it has been built.

Thirdly, I agree that we should have a procedure whereby more of the major projects,for which a competitive financial package has to involve a large amount of subsidy to the customer, should come to Ministers for collective decision. But we should not try to fix some arbitrary limits of acceptability in advance. The various elements in the judgement are too complex for that. And we owe it to our exporters to ensure that such a procedure is operated with the speed required by an intensively competitive market-place.

As to the present position on ECGD's exposure worldwide and in Mexico, I attach two notes summarising the situation. On Mexico, ECGD has already taken steps to avoid adding to its substantial existing exposure for the time being; but I believe that we should avoid any announcement that it is off cover. The situation there could improve fairly rapidly if the present rescue negotiations are carried through successfully; and there is a real risk that an announcement of the withdrawal of ECGD cover would affect the confidence of other lenders.

ECGD's exposure worldwide now totals some £28,600 million. This is reasonably well spread both by markets and by category of export. A large part of it concerns goods sold on cash or short-term credit; and exports to safe, developed markets. Support for exports to the weaker, developing countries is carefully controlled by the ECGD Advisory Council, and by the official Export Guarantees Committee which considers Section 2 applications. It is not possible for ECGD to reduce its exposure quickly since the bulk of its liabilities represent contracts already obtained and in the course of completion. Nothing leads to more ill will than withdrawal of cover from business already being negotiated. But action has already been taken to withdraw cover for future business with a number of countries already experiencing debt service difficulties. The existing procedures for careful scrutiny of the forward country risk, together with the new controls that the Chancellor has proposed, are adequate to ensure that ECGD exposure on highly vulnerable overseas markets does not reach an unacceptable level.

I am sending copies of this minute to the Chancellor, other members of EX, and to Sir Robert Armstrong.

Arthur Cockfield

Department of Trade
1 Victoria Street
London, SW1H OET

LORD COCKFIELD

4 November 1982

MEXICO - ECGD'S POSITION

Mexico is currently the fourth largest market in ECGD's portfolio. Whilst there is no way that the existing exposure can be quickly reduced (as it relates to cover for contracts already signed) action has already been taken to restrict future cover very closely whilst Mexico's debt service problems persist.

Present arrangements for cover

a Short Term credits (up to 180 days)

Cover remains available without formal restriction but ECGD is operating close control over all new applications at present. The volume of this business is not substantial.

b Medium and Long Term credits (normally up to 10 years maximum)

Reduced market limits have now been applied as follows:

Section 1 (commercial account) - £650m

Section 2 (national interest account) - £600m.

The bulk of these limits has already been utilised (only about £75m being uncommitted). Most of this will be needed to support contracts which have already been signed but where the guarantee has yet to be issued, and potential contracts where the negotiations have reached a very advanced stage. However for the time being ECGD is exercising administrative delay in dealing with all new applications for cover.

c Country grading

Mexico has been downgraded from 'B' to 'C' in view of its deteriorating economic outlook (but ECGD's claims experience so far remains good).

Current exposure

ECGD's maximum exposure now totals £1203 million. This relates to firm business where the contracts have been signed and the guarantees issued and includes provisions for future interest payments. Apart from an estimated amount at risk of £28m for Short Term business, the exposure relates to Medium and Long Term credits with payments maturing over the next 20 years.

Specific Cases

i Sunderland Shipbuilders/Trans. Maritima Mexicano (TMM)

This contract valued at £20.8m was signed on 18 June 1982. No ECGD guarantee has as yet been issued but it would be contrary to established practice to refuse to cover a contract signed in all good faith against the Department's indication that cover would be available.

ii Sunderland Shipbuilders/TMM

No contract (potential value £21.5m) has as yet been signed but the builders have reportedly entered into an "agreement to supply" 2 ships of which item i. is the first and this the second. There is no formal ECGD commitment to provide cover for this additional vessel and ECGD does not propose to offer support under current circumstances. (This decision will probably lead to strong protests from the builders).

iii Sicartsa Steel Mill

This is a firm commitment and accounts for approximately £465m of the total exposure of £1203m on Mexico. Following the signing of a Memorandum of Understanding between the Prime Minister and President Portillo, Davy Loewy entered into contracts in February 1982 valued at £350m with a UK content of £200m. This represented Mexico's largest ever export order and will provide 28,000 man years of work for UK industry. Finance is being provided by an ATP grant of £35m and ECGD supported export credits of £197m and Dm 151m at a fixed rate of 7¾% with repayments over 13 years after a 2 year grace period. Loan agreements and ECGD guarantees were signed on 14 April 1982 and, as the contract will take 5 years to complete, final payment will not be due until 2002.

ECGD is legally committed to cover the Davy Loewy contracts and there are no grounds which would allow the Department to withdraw at this stage. Even were the project to be cancelled by the Mexicans there would be termination costs to be funded by loan drawings. In addition ATP funds of £32m have been advanced.

Repayment of principal of the ECGD guaranteed loans is not due to commence until 1989, hopefully well beyond the current period of financial difficulty.

ECGD'S WORLDWIDE EXPOSURE - SEPTEMBER 1982

(Note by Export Credits Guarantee Department)

Introduction

1 This paper reviews ECGD's exposure at the present time and looks in particular at its exposure on vulnerable overseas markets. Like all its counterparts overseas, ECGD is currently passing through a very difficult period in its operations. Because of the world recession major country defaults in addition to the financial difficulties of individual buyers overseas have reached unprecedented levels. Over the last five financial years ECGD has paid claims totalling over £1000 million, against a premium income of about £750 million. Reserves built up in earlier years have thus been sharply reduced. Approximately 65% of claims paid relate to general country problems (delays in transferring foreign exchange etc). ECGD covers about 30% of total British exports but a very much higher proportion of exports of manufactured goods and capital plant which are traditionally sold on Medium and Long Term credit. The Department's business has been based on the concept of spread of risk and covers a wide range of exports to all viable overseas markets. However, because of difficult world trading conditions many important overseas markets are now vulnerable to debt service problems. ECGD's exposure on these is analysed below but it should be noted that ECGD's commitments on an overseas market cannot be reduced quickly as the current amount at risk relates to guarantees issued over recent years insuring contracts at various stages of completion. However the exposure figures, which reflect the maximum amount that the Department has guaranteed including future interest payments, greatly exceed the probable amount of loss that ECGD would suffer if a country defaulted. Even in the unlikely event of a country reneging on its entire existing debt ECGD's liabilities would be reduced by the savings resulting from the stoppage of shipments and drawings under guaranteed credits and the consequential additional reduction in interest payable under the contracts.

Current worldwide exposure

2 The maximum amount ECGD can guarantee is set by Parliament. At present ECGD is authorised to accept liabilities up to a maximum of £30,000 million in sterling and a further SDR 20,000 million in foreign currencies. The actual total amount at risk worldwide is currently estimated at £28,600 million. The comparable figure 3 years ago was £17,000 million. Of the current amount at risk Short Term business (ie where payment is to be made within 180 days) accounts for £4,200 million (£3,900 million). ECGD credit exposure involving repayment terms of 2 years or more is of the order of £24,400 million, (£13,100 million). Of this about 48% is covered under the Section 1 commercial account and 52% under Section 2 national interest account. In general it is the Department's credit exposure - rather than its revolving Short Term business - which is most vulnerable to a deterioration in overseas market conditions. The table at Appendix A shows the 30 largest markets by exposure at the present time. Fortunately this includes many markets where there is no immediate threat of a financial crisis. However, those which might be vulnerable to balance of payments or political difficulties are analysed in more detail below.

Horizon of Risk

3 In accordance with international practice (governed mainly by the OECD Consensus arrangements) the maximum credit periods normally supported range from 5 years for richer markets to 10 years for developing countries. Exceptionally, longer terms can apply in certain sectors (eg nuclear power stations). Allowing for the period between contract and delivery/commissioning therefore the

Department's horizon of risk for major projects can reach 15-20 years. (In the case of the Castle Peak B project in Hong Kong for example, the forward exposure period runs up to the year 2002). Therefore, once ECGD has committed itself to guarantee a contract it is locked in for a long period ahead.

Methods of country assessment

4 Long term forecasting of the sort required is far from an exact science and account has to be taken of political developments as well as economic trends. Appendix B describes the present system of country risk assessment and controls. In assessing market risks the Department has access to international financial statistics and the advice from our embassies abroad. Economic and political developments in all significant markets are kept under continuing review. Decisions on Section 1 cover are taken after consultation with the Advisory Council of businessmen and on the basis of a prudent, commercial view of the overseas risks. Requests for cover on the largest and more marginal risks are directed towards the Section 2 (national interest) account. Here the Export Guarantees Committee of interested Departments (chaired by the Treasury) attempts to balance the UK national interest benefits involved in terms of employment etc against the risk of non-repayment. In recent years greater emphasis seems to have been given by the EGC (and Ministers when agreement at official level is not reached) to the industrial/employment arguments than to the risks involved. Consequentially ECGD's exposure on a number of vulnerable markets is higher than it would have wished.

Spread of risk

5 ECGD's cover is reasonably well spread at the present time. However because of the greater opportunities for exporters of engineering goods and capital plant in developing countries exposure on these is rising. The table at Appendix C shows the present geographical spread of business. Mexico (4.9%) and Latin American countries (7.1%), together with the CMEA bloc (9.3%) account for about 21% of the total exposure, and many of these countries fall into the vulnerable category. Potentially the most dangerous concentration of risk is on Hong Kong/China which already represents 13.5% of the total portfolio (and if the current negotiations on the nuclear power project succeed this figure could be doubled). The table at Appendix D shows exposure in relation to each grade of market. Markets are classified on a 4 grade system (A-D) in accordance with the assessment of their vulnerability to economic/political problems; this increases the premium for cover in the riskier markets, "A" being the lowest and "D" the highest risk category. At present the balance between the exposure on the better (A and B markets) and the riskier C and D markets is satisfactory.

Exposure on vulnerable markets

6 The growing number of developing countries which have run into serious debt service difficulties has meant that ECGD has had to withdraw or severely curtail its cover for many important overseas markets. Appendix E lists those for which credit cover under both Section 1 and Section 2 has been withdrawn in the last year or so and other markets for which no cover is currently available. The amounts at risk shown in all cases are in respect of business underwritten before cover was withdrawn. It is important to bear in mind that although cover may formally have been withdrawn, it is always open for sponsoring Departments to submit a case for supporting a particular contract under the Section 2 national interest arrangements. A measure of cover has, for example, been made available

exceptionally for Ghana and Zambia despite the general non-availability of cover. Countries who have rescheduled their debts (or are about to do so) are listed in Appendix F. It is normal practice to withdraw cover for further business on such markets and this would only be restored when it can be demonstrated that the rescheduling agreement is being honoured and circumstances have improved sufficiently to justify further lending.

7 Because of the Department's adverse experience, cover is therefore not available for countries such as Iran, Poland, Romania, Yugoslavia and Cuba, all of whose economic difficulties are well-known. Nor is it intended to restore cover for Argentina under present circumstances. Other important markets that might run into difficulties are listed in Appendix G. Cover for future business on all of these is being carefully controlled. With the exception of Hong Kong and China, monetary limits (see Appendix B) have been set on the total liability the Department can accept without further review on each of the markets listed under both Section 1 and Section 2. In the case of Hong Kong and China there are no formal Section 2 limits but all project business is considered on a case by case basis in consultation with Whitehall Departments.

No new cover is in practice being given for Mexico at present. Cover is also tightly restricted on Brazil, Egypt, Kenya, GDR and Hungary which seem to be the most vulnerable of the other markets listed. Over a longer term both India and China may present problems if the extend their reliance on official export credit, rather than aid, to finance their major investments.

Conclusions

1 ECGD's worldwide exposure is reasonably well spread:both geographically and between the developed and developing world.

2 Nevertheless ECGD has a high exposure on many major markets that might be vulnerable to a debt crisis over the next few years.

3 No action can be taken to reduce the level of ECGD's existing commitments on these markets but strict limits are being applied to additions to the current exposure.

ECGD
September 1982

ECGD

MARKETS RANKED BY TOTAL AMOUNTS AT RISK <u>OUTSIDE SHORT TERM</u>

Position as at April 1982 (last year's ranking in brackets)

	COUNTRY		GRADE	TOTAL AMOUNT AT RISK £m
1	Hong Kong	(1)	A	2893
2	South Africa	(2)	A	1643
3	USA	(3)	A	1491
4	Mexico	(14)	B	1056
5	Brazil	(4)	C	914
6	Poland	(5)	D	899
7	Nigeria	(12)	C	834
8	Yugoslavia	(8)	D	737
9	USSR	(6)	B	734
10	Iran	(13)	D	592
11	India	(10)	C	585
12	South Korea	(9)	B	557
13	Indonesia	(25)	C	531
14	Iraq	(-)	C	460
15	Egypt	(28)	D	402
16	Romania	(11)	D	400
17	Canada	(22)	A	356
18	Dubai	(7)	B	338
19	Oman	(15)	C	308
20	Algeria	(16)	C	305
21	Argentina	(20)	C	284
22	Kenya	(18)	C	279
23	Greece	(-)	A	277
24	Jordan	(-)	C	274
25	China	(17)	B	210
26	Philippines	(24)	C	208
27	Irish Republic	(23)	A	185
28	Switzerland	(-)	A	179
29	Norway	(21)	A	175
30	Liberia	(26)	C	172

NOTE ON ECGD'S SYSTEM OF COUNTRY ASSESSMENT AND CONTROLS

System of Assessment

1 ECGD makes assessments of the creditworthiness of overseas markets based on all the available information on economic performance (balance of payments, GDP growth, debt service, reserves, etc) and political developments.* ECGD's past experience and commitments are taken into account. In most problem markets limits are set which determine the maximum amount that can be underwritten for that market without further review. These are set after consultation with the Advisory Council of businessmen for Section 1 (commercial account) operations or the inter-Departmental Export Guarantee Committee for Section 2 (national interest) operations. The limits are fixed after taking into account the usual level of demand for cover on the country concerned and represent the maximum amount of exposure for that market. In practice ECGD would not expect to meet claims amounting to the total amount of its exposure even if a country defaulted on all its debts, because many guaranteed contracts would only have been partially completed at the time the default occurred. The table in the Appendix attached gives details of ECGD's current exposure on some of the more vulnerable developing countries.

2 It is important to note that ECGD is not able to take swift evasive action when a debt crisis has become apparent as its commitments run for a long period ahead (allowing for the negotiating, contract completion and credit periods, the Department may need to look 10-20 years ahead). Once a deteriorating trend has been discerned the Department can act to reduce limits or even stop all future cover, but such action is unlikely to affect significantly the amount falling due over the next year or so that might fall for rescheduling if a developing country gets into debt servicing difficulties.

Existing Control Mechanisms

3 The Department's main methods of control over the growth of its liabilities on vulnerable markets are, therefore:-

i country limits applied to the maximum amount at risk on a market (excluding short term business)

and ii a country grading system, which classifies overseas markets in four grades (A to D) in accordance with the assessment of their vulnerability to economic/political problems. This increases the premium charges for medium and long term cover in the riskier markets.

APPENDIX C

ECGD exposure by geographical regions (£m) - Position as at September 1982

	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
Developed countries:						
EC	691.3	5.9	12.1	0.1	703.4	2.9
Rest of Europe	988.2	8.5	197.6	1.6	1,185.8	4.9
North America	1,043.7	8.9	922.8	7.3	1,966.5	8.1
Others	514.3	4.4	131.6	1.0	645.9	2.7
Developing countries:						
CMEA	820.5	7.0	1,456.2	11.4	2,276.7	9.3
Latin America (excluding Mexico)	753.2	6.4	986.9	7.8	1,740.1	7.1
China, Hong Kong	741.8	6.4	2,554.4	20.1	3,296.2	13.5
Sub-Sahara Africa (inc. South Africa)	2,042.9	17.5	2,002.2	15.7	4,045.1	16.6
Asia (excluding China, Hong Kong)	1,381.7	11.8	1,331.4	10.5	2,713.1	11.1
Middle East	1,318.1	11.3	1,519.0	11.9	2,837.1	11.6
of which oil exporters	868.0	7.4	1,075.6	10.0	1,943.6	8.0

The above Amounts at Risk do not add up to the global Amount at Risk as certain markets eg Caribbean are not included in this Appendix.

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APPENDIX D

ECGD exposure by market grades (£m) - Position as at September 1987

Grade	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
A	4,738.5	40.5	4,360.6	34.2	9,099.1	37.2
B	1,688.9	14.5	1,564.7	12.3	3,253.6	13.3
C	4,480.1	38.3	4,226.5	33.2	8,706.6	35.7
D	788.7	6.7	2,578.2	20.3	3,366.9	13.8

S1 = Section 1 Commercial Account

S2 = Section 2 National Interest Account

AAR = Amount at Risk

Grade A = lowest risk/lowest premium grade

Grade D = highest risk/highest premium grade.

The current distribution of markets over the 4 grades is: A 18.7%; B 10.1%; C 44.4%; D 26.8% out of a total of 198 markets for which we currently have amounts at risk or are open for cover.

APPENDIX E

Major markets for which ECGD cover withdrawn during past 2 years (and not reinstated) (£m) - Position as at September 1982

	S1 AAR	S2 AAR	Total AAR
Poland	161.1	715.7	876.8
Yugoslavia	136.2	575.1	711.3
Romania	53.5	340.7	394.2
Argentina	115.9	152.0	267.9
Tanzania	34.3	57.9	92.2
Cuba	46.3	29.0	75.3
Bolivia	11.2	21.4	32.6
Senegal	26.4	-	26.4
Malawi	11.6	9.8	21.4
Costa Rica	2.9	-	2.9
Dominican Republic	0.2	-	0.2

Other major markets for which no ECGD cover currently available

	S1 AAR	S2 AAR	Total AAR
Iran	59.3	106.0	165.3
Zambia	14.0	91.2	105.2
Turkey	19.4	85.7	105.1
Ghana	8.1	37.0	45.1
Zaire	-	36.7	36.7
Sudan	21.1	9.8	30.9

S1 = Section 1 Commercial Account

S2 = Section 2 National Interest Account

AAR = Amount at Risk

APPENDIX F

RESCHEDULING AGREEMENTS - Position as at September 1982

1) Agreements signed

	£m
Ghana	24.79
Guinea	6.34
Indonesia	9.64
Madagascar	2.43
Peru	6.32
Poland	54.4
Sierra Leone	0.73
Sudan	49.5
Togo	21.0
Turkey	56.30
Zaire	33.26

2) Signatures pending

	£m
Liberia	1.8
Senegal	0.78
Sudan	10.25
Turkey	63.7

3) Negotiations pending on new or extending rescheduling.

Central African Republic - Costa Rica - Guyana - Liberia - Madagascar - Nicaragua - Poland - Romania - Senegal - Sierra Leone - Sudan - Togo - Uganda - Vietnam - Zaire.

APPENDIX G

Markets of high exposure/vulnerability for which
ECGD cover currently available (£m) - Position as at September 1982

	Ranking in "top 30" list of markets by exposure	S1	% of total S1 AAR	S2	% of total S2 AAR	Total	% of total AAR
Hong Kong	1	550.2	4.7	2,538.6	20.0	3,088.8	12.7
South Africa	2	841.2	7.2	734.3	5.8	1,575.5	6.5
Mexico	4	693.3	5.9	468.5	3.7	1,161.8	4.8
Brazil	5	283.8	2.4	709.7	5.6	993.5	4.1
Nigeria	7	767.2	6.6	239.8	1.9	1,007.0	4.1
USSR	9	473.3	4.1	337.2	2.7	810.5	3.3
India	11	291.1	2.5	294.3	2.3	585.4	2.4
South Korea	12	184.7	1.6	346.0	2.7	530.7	2.2
Indonesia	13	232.2	2.0	334.0	2.6	566.2	2.3
Iraq	14	438.5	3.8	92.8	0.7	531.3	2.2
Egypt	15	122.2	1.1	274.7	2.2	396.9	1.6
Kenya	22	58.2	0.5	206.1	1.6	264.3	1.1
Jordan	24	253.1	2.2	83.8	0.7	336.9	1.4
China	25	191.6	1.6	15.8	0.1	207.4 *	0.9
GDR	-	38.9	0.3	61.8	0.5	100.7	0.4
Hungary	-	34.9	0.3	0.8	neg	35.7	0.1

S1 = Section 1 Commercial Account

S2 = Section 2 National Interest Account

AAR = Amount at Risk

* NB If UK obtains nuclear plant contract, AAR would increase by £1000-4000m.