P.01548

CONFIDENTIAL

PRIME MINISTER

Fixed Rate Export Finance (FREF) and the Aid and Trade Provision (ATP)

(EX(85)3, 6 and 7)

BACKGROUND

FLAG A

Revised ground rules for the operation of ATP were agreed as recently as last September, and were to be reviewed after two years operation. (The details were set out in the Secretary of State for Trade and Industry's letter of 13 September to the Chief Secretary.) Since then however there have been disagreements over a number of individual aid cases, some of which, for example the 2nd Bosphorus Bridge and the Samanala Wewa power station, have had to come to EX. These have revealed a difference of views on the basic principles underlying ATP and aid for exports generally, and Ministers agreed to bring the broad issues to EX in parallel with the long standing remit to reconsider export promotion services (item 2 on the agenda). The third aspect of the problem the state of the Export Credit Guarantee Department (ECGD)'s finances, is to be discussed separately in July. A detailed Note by Officials on Export Credit policy has been circulated with Mr Tebbit's Private Secretary's letter of 17 May.

FLAG B

Proposals

2. Mr Tebbit argues, in EX(85)3, that both FREF, (which is operated by ECGD), and ATP are essential if our exporters are to compete successfully, and that ATP needs to be made more flexible and the available funds significantly increased if its effectiveness is to be maximised. He therefore proposes:

a. the maintenance of FREF on the present basis;

b. that ATP should be recognised as primarily an instrument of trade rather than aid policy;

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c. the removal of the 45 per cent initiation limit (applied to cases where the United Kingdom is the first to offer mixed credit) and other (unspecified) bureaucratic procedures;

d. a graduated increase in ATP allocation (at present £66 million), to at least double its present level by 1987/88, principally to support business in China, Indonesia and SE Asia;

e. that officials prepare proposals for a loan facility, for cases where importing countries specify soft loans rather than mixed credit.

3. The Minister without Portfolio is concerned that the United Kingdom is losing orders to competitors who offer soft loans over very long periods. Like Mr Tebbit, he argues the need for a significant increase in the ATP budget and for greater flexibility. In particular he proposes moving away from the present system of either 100 per cent aid or a mixture of 25 per cent aid plus export credit towards a combination of grants, low-cost loans, export credit and support for joint ventures in order to be able to compete on the same basis as other countries.

4. The Chief Secretary argues, in EX(85)7, that FREF, which is estimated to cost about £400 million in 1985/86, should be reviewed in time for decisions to be taken in this year's Public Expenditure Survey (PES). He opposes any increase in public expenditure to provide more ATP. He is prepared to accept an increase financed from the Aid Programme, and that new methods of blending ATP grants with ECGD or commercial money should be explored. He suggests that a proportion of ATP be reserved for matching competitors' offers, in order to avoid end-year pressure on the budget of the kind that has happened in the past. He puts forward the following conditions.

a. Use of ATP only in countries which are good credit risks.

b. Honouring of OECD rules.

c. No initiation in countries which are not regular recipients of mixed credit.

d. No public announcements which might undermine our OECD efforts to curb international trading subsidies.

MAIN ISSUES

5. The main issues are as follows.

i. Should FREF be reviewed?

ii. Should a more flexible and aggressive policy be adopted towards the ATP programme?

iii. If so, what detailed changes need to be made and how far should the ATP budget be increased.

FREF

6. The operation of the Fixed Rate Export Finance scheme is explained in Annex A of EX(85)3. The main costs are a result of past decisions, and it will be difficult to reduce them below the predicted level quickly. The cost of future business will depend on the difference between United Kingdom interest rates and those in other countries; there is a predicted net inflow to the Exchequer in 1988/89. Mr Tebbit argues that because the terms are governed by an OECD "Consensus", this acts as a restraint on others, as well as allowing United Kingdom exporters to compete. The Chief Secretary points out that the scheme is indiscriminate, and supports a narrow sector of United Kingdom industry. He suggests a study of reforms, including a more selective approach, in time for decisions during this year's PES.

7. If Ministers decide to study possible improvements to FREF further, it might be convenient for them to be taken alongside the review of ECGD's finances generally which is to be completed by July.

ATP

8. The main argument for a more flexible and aggressive policy towards the ATP programme is that the United Kingdom's restraint in export subsidies in form (trying to preserve the fiction of a genuine aid element provided for developmental reasons combined with commercial credit), in stance (preferring to match rather than initiate), and in amount, results in lost business and reduced jobs. The counter-argument is that it is not in the interests of United Kingom or other industrialised countries to sell our goods and services at uneconomic prices; that the right approach is to get rid of such distortions; and that any attempt by the United Kingdom to increase our subsidies will be self-defeating because our major competitors, with their greater resources, will be able to outbid us.

9. If the Committee concludes that there is a case in principle for a more flexible and aggressive policy, they may well wish for further study of how the various changes proposed would work in practice before reaching final decisions. If so it would be helpful to give some guidance for this work, eg:

i. if the 45 per cent initiation limit is removed, should we nonetheless restrict initiation to an agreed list of countries already receiving mixed credits?

ii. should there be a new loan scheme?

iii. should we stay within the OECD rules? (Mr Tebbit and Lord Young are unclear on this and on how far the rules are actually being broken by other countries)

iv. should ATP, however organised, be confined to countries which are good credit risks?

v. should a proportion of ATP be reserved for matching, or should business be treated on its merits as it arises, perhaps with limited flexibility between years?

vi. should ATP be rationed, to provide end-year flexibility?

The ATP budget

10. Mr Tebbit and Lord Young argue that ATP is good value for money, as compared, for example, to Selective Employment measures. The Chief Secretary disagrees, although he accepts that ATP is more cost effective than some other (unspecified) public expenditure.

11. The decision on expenditure depends in part on whether an aggressive policy is to be adopted. If Ministers ask for further work on the proposed changes in policy, this could be accompanied by more information on the costs of particular changes. It is of course, likely to be very difficult to find extra resources on the scale envisaged by Mr Tebbit and Lord Young, in this year's PES; and it would not be appropriate to enter into commitments now to additional expenditure in 1986-87 and subsequent years, in advance of the Survey.

HANDLING

12. The Committee seem likely to agree that FREF be reviewed, either as part of the forthcoming discussions on ECGD, or separately. The timing of either course will put it in the PES context. The main discussion is thus likely to be on ATP. It may be convenient to separate discussion of the form which ATP should take from the size of the programme.

13. You will wish to invite the Secretary of State for Trade and Industry to introduce his paper, supported by the Minister without Portfolio. The Chief Secretary could then be invited to speak on his paper, putting the case against radical change. Thereafter the Foreign and Commonwealth Secretary and the Minister for Overseas Development will wish to comment on the effect of the present arrangements, and any changes, on the aid programme and on relations with customer and competitor countries

CONCLUSIONS

14. You will wish the Committee to reach conclusions on the following:

i. whether to maintain FREF on the present basis, or to commission a review;

ii. whether, in principle, ATP should be made a more flexible and aggressive instrument of trade policy.

iii. if so, what guidance should be given for further work on:

a. whether to remove the 45 per cent initiation limit and allow greater use of mixed credits;

b. whether to remove other controls so as to allow the United Kingdom to match terms offered by competitors on the same basis;

c. whether officials should prepare proposals for a new loan facility;

d. the size of the ATP Budget.

PG

P L GREGSON

21 May 1985

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D/MIN/AB/3/13

21st May 1985

Dear David,

In Michael Heseltine's absence I have seen your paper 'Aid for Trade' (EX(85)6), which is to be considered tomorrow morning by the Ministerial Committee on Exports.

Though I am not, I understand, eligible to come to EX, I should like to lend strong support to your thesis. It is quite clear from our experience in the MOD in supporting overseas Defence sales that there is a need to be flexible with credit terms. Defence exports, which usually consist of high value items, are as much in the national interest as civil exports, and the arguments in your paragraphs 6 to 9 apply equally to them - more so in some cases, perhaps, since for example:

a. the follow-on orders for spares and support during in-service life often double the original order value, and are normally <u>cash</u> business;

b. where we need to soften credit terms at all, we do not need to do so by much. We do not look for the very soft terms that our competitors offer for civil projects (eg your Annex A).

/ There ...

The Lord Young of Graffham

There is one other aspect of this matter which I hope can be pursued, namely the greater participation by the Banks in extending credit for overseas sales. I believe there is more that they can do on their own; but particularly there would be obvious advantages in using ECGD money to leaven that from the private sector.

I am sending copies of this letter to the members of EX and to Sir Robert Armstrong.

Yours ever

Adam

21 MAY 1985