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Arrived too late NBPM at this stage. CDP. 22/5

PRIME MINISTER

SUPPORT FOR EXPORTS

I have reviewed our schemes for supporting exporters, and my conclusions are set out in the two papers I have circulated to the EX Committee. But I would stress:

(a) The future costs of Fixed Rate Export Finance through ECGD are much reduced, and we should retain this facility.

(b) On aid, our competitors exploit the system to their own commercial advantage. We by contrast observe the international rules meticulously, and throw in one or two more self-imposed constraints for good measure. Our purist approach, correct though it may be in theory, is losing business for British companies. Recent cases like the Bosphorus bridge and Bangkok buses show this all too clearly. Unless we wake up, we shall not exploit the goodwill of the Hong Kong Agreement and your visit to South East Asia, as well as other opportunities which will come up in the more credit-worthy developing countries.

999-49

(c) At the same time we must not weaken support for our smaller and new exporters: we are increasingly selective and testing value for money, but these companies have scope to expand market share as well.

(d) The US, French and Germans also run assistance schemes for military sales. This is one of our most important export areas, with proven long-term follow-on benefits. We should be looking at what more we can do to match the support which other Governments give.

2 I am sending copies of this minute to members of EX and to Sir Robert Armstrong and Michael Heseltine.

NT

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21 May 1985

Department of Trade and Industry

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PS *Secretary of State for Trade and Industry*

17 May 1985

Mark Addison Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Mark,

The attached note by officials on Export Credit policy, and cross-referenced to in our Cabinet Committee Memorandum, was put to Ministers for information and endorsement in March this year.

2 It should be included in the Prime Minister's briefing for next Wednesday's meeting.

3 Copies of this letter go to the Private Secretaries of the members of EX and to Sir Robert Armstrong.

Yours sincerely,

Robert Coll

ROBERT COLL
Private Secretary

991-1

EXPORT CREDIT POLICY

Note by Officials

The main objective of UK policy in international export credit discussions is to phase out export subsidies progressively, on a multilateral basis. Officials have recently reviewed where and how progress might be made towards achieving this objective over the next 2 years in order to exploit the opportunities offered by major international meetings, eg within the framework of the EC (since export credits are an area of Community competence) at the OECD, at other Ministerial and official meetings and in bilateral contacts. This note sets out the objectives which officials propose to pursue.

Long Term Objectives

2. Ministers' objective of phasing out subsidy can only be met over the longer term by securing a closer alignment of the interest rates in each currency permitted by the OECD Export Credit Consensus ("the Consensus") to market rates in that currency, coupled with free and equal access to the main trading currencies. In addition, trade distortions caused by the practice of using tied bilateral aid either in association with official export credits or in the form of straight aid loans on relatively hard terms must continue to be attacked by pressing for OECD agreement on more effective control over their use, leading to their elimination in areas where they distort trade competition.

3. The substantial recent and projected expenditure on these programmes, shown in the 1985 Public Expenditure White Paper, is:-

£ million	81-82	82-83	83-84	84-85	85-86	86-87	87-88
ECGD interest support costs	587	539	330	441	200	70	-50
Aid and Trade provision	54	47	28	66	66	66	66

Changes in the Consensus since 1983 have substantially reduced the scope for interest rate subsidies on new business, as long as sterling and US dollar interest rates remain about (or below) the international average. But the predominance of pre-1983 business during the forecast period means that the figures above for the cost of interest support depend critically on assumptions about relative interest rates. (On current assumptions, the provisions for 1985-86 will be substantially exceeded). In view of this, the effect of the further improvements which we hope to achieve will only be very gradual.

Tied concessional finance

4. The blending of by aid donors of aid funds with commercial funds including export credit (in the UK normally from the use of the Aid and Trade Provision as part of a mixed credit) takes a variety of forms internationally with a range of levels of grant elements above the minimum 20% allowed under OECD rules. This can cause trade distortion and divert aid from its proper use. Moreover, the trend is for the diversity and scale of such activities to increase, and for developing countries to use their purchasing power to demand such financing. OECD concern over the past 2-3 years has resulted in good statistical information recording, after the event, individual tied concessional financing transactions. In this situation, the essential steps towards improved control are greater "transparency", so that all countries' practices are equally disclosed, preferably in advance of financial offers being made, and "discipline" to control the scale and purposes for which they are used.

5. (a) Transparency could be improved by making the notification procedure prior to any financial offer more efficient, by achieving a more comprehensive definition of tied concessional finance and by instituting "face to face" consultation, ie early meetings on particularly difficult cases, if possible prior to any financial offer being made, in the hope of agreeing a common line. The aim is to make it less attractive for a country to offer tied concessional finance by giving competitors a greater chance to match.

(b) Discipline would be achieved by raising the minimum grant element within a coherent internationally agreed framework, so as to make tied concessional finance more costly without merely diverting further aid funds towards richer countries and trade distorting activities. These steps could include an overall increase and differentiation by recipient country. Agreement in the OECD Development Aid Committee on measures to ensure that aid is used effectively, eg by fostering international competitive bidding procedures, would also assist in eliminating trade distorting uses of aid funds.

International progress

6. Despite the 1984 OECD Ministerial remit to work for improvements, in both transparency and discipline, France and Italy have opposed any new measures to increase discipline. A hard-won EC mandate to improve transparency alone, notably to bring Japanese, German and Austrian practices within the net, was opposed by Japan, and did not go far enough to meet the US at the December 1984 Consensus meetings, when they insisted on an increase in discipline through a higher minimum grant element for all tied concessional finance in addition to improved transparency. Since then, we have sought to persuade the US to accept the EC proposal and bring pressure on Japan to do so as well. The US have indicated that they would be disposed to follow this course, in return for a significant EC move on discipline. We are pressing for the latter within an EC context, but the chances of achieving this are slim, not least because the US Administration have now apparently decided, because of budgetary considerations, not to institute a system of matching, despite Congressional and business pressure for them to do so. This will mean that the major providers of tied concessional finance will feel less vulnerable to US counter-measures.

Interest Rate Support Costs

7. The changes in the Consensus in 1983 ended the era of uncontrolled interest rate subsidy, and the extent of this is now controlled by the system of automatic changes in the

Consensus matrix to bring these into line with average commercial market rates. At present, Consensus rates for "poor" markets are determined by the weighted cost of medium term Government bond yields in SDR currencies. These are adjusted every six months, according to the formula agreed in October 1983. Intermediate and rich markets pay approximately 1.1% and 2.2% more respectively. The current matrix of rates is:

	up to 5 years	Over 5 years
"Poor" markets	9.85%	9.85%
"Intermediate" markets	10.7%	11.2%
"Rich" markets	12.0%	12.25%

Credit insurance agencies may not offer rates lower than this matrix except for low interest rate currencies, as described below.

Differentiated Rate System (DRS)

8. Further reductions in interest rate support would be achieved if the system applied at present to low interest rate currencies (eg the yen) were extended to all currencies. The present Consensus allows countries with commercial rates of interest below the matrix to apply such lower rates to export financing. At first sight this may seem to give exporters using these currencies an unfair advantage, but, over time, currencies with low interest rates tend to appreciate in value against other currencies thereby offsetting the apparent advantage, although, in the short term, the offset will not be exact. A Differentiated Rate System (DRS), with Consensus rates for all currencies tied to current commercial rates, would put all countries on the same footing except to the extent that purchasers chose to focus more on the nominal interest rate than on the likelihood of exchange rate changes.

9. Experience suggests that many purchasers will for a variety of reasons, one being that borrowing unsubsidised high interest rate currencies has the effect of accelerating the repayment schedule of the loan, place more emphasis on the nominal interest rate; but there are other reasons why the UK might wish to support a DRS. If, over the medium term, UK interest rates remain broadly in line with average world interest rates (and thus in line with export credit interest rates) the scope for UK subsidies is limited. Countries with high interest rates are however permitted to subsidise more heavily to UK exporters' relative disadvantage. Provided there is free access to low interest rate currencies (imperfections exist under the present arrangements, and these may be exacerbated if further currencies are used), de facto abolition of all subsidies would leave the UK in little worse position than at present vis-a-vis countries with low interest rates, and would improve our competitive position against currencies with higher interest rates than ours. However for the time being France and Italy are strongly opposed to further constraints on their ability to offer subsidies and too great an insistence by the UK on a full DRS might therefore jeopardise the Consensus. But recent developments in the financial markets, particularly the growth of interest rate and currency swaps allowing the crystalisation of the subsidy and its transfer from one currency into another (eg Yen at a subsidised rate of 6% pa rather than the commercial rate of 7.7%), may lead to new pressures for the adoption of a DRS.

<u>Maintenance of the Consensus</u>

10. The UK is restrained from pressing more quickly for the abolition of export subsidies by the concern that France and Italy might block the EC's continued adherence to the Consensus, thus endangering its existence. Officials believe that the following advantages of the Consensus make it worth preserving:-

(i) unregulated subsidy offers, which would place the strongest economies at an advantage, are avoided;

(ii) buyers expect, and will accept, less generous credit terms than in an unregulated situtation;

(iii) subsidy costs are reduced;

(iv) tensions in international trade and political relationships are eased;

(v) a breach of the GATT anti-subsidy code is avoided.

As a result, gradual measures give the greatest chance of achieving, and the best means of approaching, the ultimate objective of the elimination of export credit subsidies.

PRIORITY OBJECTIVES

11. In accordance with this approach, officials have identified the following objectives which offer the best chance of progress in the short term:

(i) Tied Concessional Finance As detailed above, officials are seeking to build on the existing EC mandate on transparency with measures on discipline acceptable to the US as a first step towards phasing out trade-distorting practices altogether. Japanese acceptance of the EC transparency proposals will be crucial. Moreover there is a risk that the gap between any new EC proposals on discipline (which, because of the position of France and Italy are likely to be modest) and over-ambitious US demands may prevent early progress.

(ii) Sector Agreements The negotiation of separate agreements on credit terms for the following sectors to which the Consensus does not yet apply:

a. Agriculture The US has been unwilling to discuss limitations on all agricultural export credits until the EC has agreed to discuss major changes to the Common Agricultural Policy. Talks on the latter will begin shortly in GATT. Many EC countries have expressed reluctance in their turn to concede to the Americans on mixed credits until the latter have agreed to an agricultural sector discussion. Officials will try to resist such linkage, and have pressed the US at least to take part in export credit negotiations.

b. <u>Aircraft</u> A sector agreement on aircraft would represent an improvement on the present situation, but radical changes are unlikely to be negotiable. Negotiations have just begun, with the EC position based on a mandate agreed by ECOFIN last December. Separate negotiations are being held for large commercial aircraft and for other aircraft. Progress on smaller aircraft is likely to be very slow, but for larger aircraft it is possible that agreement between the EC and the US (the only prducers) could be achieved more quickly, but on a relatively unsatisfactory basis in terms of subsidy cost.

c. <u>Nuclear Power Stations</u> An agreement concluded last August is now effective, but contentious details are still being discussed.

d. <u>Ships</u> Ministers have agreed that the UK should press to move negotiations for ships over 100 grt from the industry group to the export credits group within the OECD. This could eventually lead to the present exceptionally favourable and heavily subsidised terms for export credits for ships being brought into line with the overall Consensus.

(iii) <u>Consensus Participation</u> In order to minimise wasteful international competition in export credits, officials have suggested to EC member states that the Commission should propose at the next Consensus talks that a number of non-OECD exporting countries (Brazil, Israel, Mexico, South Africa and South Korea) be invited to join the Consensus. This proposal, at least for some of the countries suggested, is likely to be sympathetically considered by EC member states and by other OECD countries, although the reaction of the proposed countries themselves is uncertain.

(iv) Interest rate commitments Commitments to a particular interest rate issued by an Export Credit Agency are normally held for 6 months. Matrix rates are reviewed half yearly. Exporters benefit by applying for commitments at the end of a half yearly period if rates are expected to rise; yet exporters expect to benefit immediately should rates fall. Officials intend to argue that forward interest rate commitments should be replaced by a system where the applicable interest rate is that prevailing at date of contract signature. This change would reduce exporters' ability to exploit fluctuating rates to the detriment of the Exchequer. The proposal would reduce subsidy costs, and improve transparency, since all competitors would be committed to current rates of interest.

(v) DRS for "rich" markets It may be possible to establish a DRS for sales to OECD countries, where current matrix rates involve little or no subsidy in sterling and US dollars (the main currencies used by ECGD), even though a more wide-ranging DRS is not currently feasible. Officials consider that this may be negotiable, probably on the basis of using agreed Commercial Interest Reference Rates for each currency, in return for the extension of the current limit on the credit term from 5 years (exceptionally 8½ years) to, perhaps, 10 years. Although the direct savings in the cost of interest support would, under current assumptions, be very small, this would restrict the use of subsidy by countries with high interest rate currencies, particularly France and Italy, and would also be a first step towards a wider DRS. However if other countries with export banks (notably Canada, Sweden and Norway) are not to benefit more because of their ability to fund themselves in a range of currencies at the finest rates, it is proposed that an initiative on this should be deferred until the Bank of England and the Treasury have completed their enquiry into the scope for a UK export bank.

Tactics

12. If Ministers agree, Officials would decide their tactics in the light of these priorities for the regular meetings in Brussels and Paris and would hope to be able to advance discussion of short term priorities at the March meeting of the OECD Consensus Group and in other bilateral contacts. Inevitably, our EC and OECD partners will be seeking balancing concessions across this whole field, and we shall need to be able to respond flexibly within this pattern of objectives. Ministers would be consulted as necessary in the light of the outcome of these negotiations before the OECD Ministerial meeting in April.

13 March 1985

TRADE: Non tariff barriers: Pt 4.
(attachment to DTI to MEA 17/5).

17 MAY 1985