Reference No P 01561

CONFIDENTIAL

PRIME MINISTER

The Aid and Trade Provision (EX(85)8 and 9)
(Memoranda by the Secretary of State for Trade and Industry and the Foreign and Commonwealth Secretary.

BACKGROUND

1. EX last discussed Aid and Trade Provision (ATP) at its third meeting on 22 May. The Committee were agreed that the present ATP arrangements were working to the disadvantage of UK industry, and that the United Kingdom could not afford to adopt a more reluctant attitude to the provision of mexed credits than other major industrial countries. The Committee invited the Secretary of State for Trade and Industry, in consultation with the Foreign and Commonwealth Secretary, the Chief Secretary, Treasury and the Minister for Overseas Development, to review the operation of the Aid and Trade Provision (ATP) programme and bring agreed proposals for new arrangements before the Committee. EX(85)8 - a memorandum by the Secretary of State for Trade and Industry covering a report by an interdepartmental working party of officials - is the result.

Proposals

2. Mr Tebbit generally endorses the recommendations of the interdepartmental working party which are summarised at the very beginning of their report. Essentially these recommendations propose:

(a) ATP Administration

(i) no set percentage limit on 'initiation' offers;

(ii) no formal per capita income level governing ATP eligibility, but ATP should be used only exceptionally where per capita income is over $3,000 p.a. (1981) and in Communist developing countries;

(iii) richer oil exporting countries to remain ineligible, but China to be eligible;

(iv) ODA appraisals to continue and to be done swiftly;

(v) interdepartmental differences to be put quickly to interested Ministers;

(vi) the Foreign Secretary to put a report to colleagues every two months identifying potential problems.

(b) <u>ATP Offer Methods</u>
Officials to discuss with the financing sector new soft loan mechanisms with care taken in public statements for the time being to avoid raising premature expectations.

(c) <u>ATP Budget and Funding</u>
(i) assuming the new loan mechanism, no budget increase in ATP in the current financial year;

(ii) if ATP provision is to be increased in future years, Ministers could take the decision now (which would pre-empt a proportion of other claims) or in the autumn in the PES round (which would limit ATP offers made in the next few months).

3. In his covering memorandum, Mr Tebbit recommends:

(a) the principle of a new soft loan mechanism should now be agreed (thus helping the Minister for Trade in his visit to Jakarta in the first week of July) and arrangements put in place as soon as possible;

(b) a decision should be taken now to increase the current annual provision of £66 million for ATP to £130 million by 1988/89;

(c) the money should come from the existing aid budget (for which the Foreign Secretary is responsible). The Foreign Secretary's paper explains why he rejects this recommendation.

MAIN ISSUES

4. The main issues are:

(a) the proposals concerning ATP administration;

(b) the principle of a soft loan mechanism;

(c) the need for additional ATP funding, and the source of the funds.

Administration aspects of the ATP

5. This involves four issues:

(i) 'initiations';

(ii) ATP eligibility;

(iii) appraisal of potential ATP-assisted projects; and

(iv) how to keep Ministers well informed.

6. An initiation offer is where the UK makes the first offer of aid for a project. Since October 1984 the UK has had a self-imposed limit on initiations of 45 per cent of total ATP funds (a limit which has now been reached for the 18 month period to March 1986). The purpose of the limit was to tighten controls on mixed credit finance and to ensure funds were available for important matching offers. Officials conclude these concerns can be met by extending the present system of ATP budget management.

7. On eligibility, the OECD Development Assistance Committee (DAC) Guidelines question the case for providing subsidised finance

to stronger developing countries. Officials recommend that, while there should be no formal per capita income level governing ATP eligibility, it should be used only in exceptional circumstances for developing countries with a per capita income above $3,000 p.a. (1981), that richer oil exporting countries would remain ineligible for ATP, and that China be eligible for ATP.

8. The large majority of ODA's project appraisals have been completed speedily. The report stresses the importance of timely appraisal, particularly where matching cases are involved. But the tension between ODA's aid objectives and DTI's objectives in support of UK industry remains, as the Samanala Wewa case on the 26 June agenda illustrates.

9. Officials recommend that arrangements to inform Ministers should be improved with the Foreign Secretary circulating a regular two-monthly report to colleagues, and early warning of potential difficulties given to interested Ministers. This should be of procedural benefit, but will not avoid the need for occasional collective discussion by Ministers of difficult issues.

Principle of a soft-loan mechanism

10. Current ATP offers generally involve an ATP grant from HMG of 25-30 per cent of the project value and a fixed rate loan from a UK bank for some or all of the balance, to be repaid over 5-10 years with the risk and the effective interest rate subsidy covered by Exports Credit Guarantee Department (ECGD). Some countries, including Indonesia and (it now appears) China, prefer instead a single soft loan with a long maturity (up to 25 years) and a grace period before the repayments start. Japan and Germany already offer soft loans on these terms, with a concessionary element equivalent to up to a 40-50 per cent grant. Powers exist for ECGD to make soft loans, but the whole amount of the capital sums lent would fall immediately to be counted as public expenditure instead of only the aid element in present-style mixed credit offers.

11. Mr Tebbit recommends agreement be reached now on the principle of a soft loan mechanism, subject to the resolution of practical issues. Officials have identified two possible soft loan mechanisms - annuities and interest rate top-up (described in detail in Annex 1 of the Working Party's report). Under 'annuities' a grant would be paid to the UK supplier's bank; the interest income this capital sum would generate would then be applied to reduce the interest rate on the long term loan. The public expenditure cost profile would be similar to the present mixed credit mechanism. Under 'interest rate top-up' grants would be paid annually to the UK supplier's bank over the lifetime of the long term loan to meet the costs of the interest rate subsidy. The net present value of the aid element, and so the real burden on the UK economy, implied by the soft loan arrangements would be the same as that in present-style ATP offers, and the UK monetary effects would be broadly similar however the aid was given. But the immediate public expenditure and PSBR costs of the interest rate top-up approach would be markedly lower (since payments would only amount to, say, 10 per cent of project value in the early years, instead of 30 per cent under conventional ATP or 'annuities'). As time passed, however, the annual burden of interest rate subsidies would eventually exceed that of ATP/annuities, given a constant underlying aid volume.

12. Further work would need to be done on both of these mechanisms if the principle of soft loans were agreed. It is not clear whether the capital markets would be ready to provide money with 25 year maturities; the prudential requirements of banking supervision might limit what the banks could do. Parliament would need to be informed if ECGD were to accept risks on repayment periods of up to 25 years as this would be an important change in the use of their powers. Assuming Ministers wish to introduce soft loan mechanisms, the paper proposes that the Government should simply say - if questioned before arrangements have been completed - that it is considering the feasibility of soft loan mechanisms in consultation with the financial community.

The need for additional funding

13. The ATP budget is currently £66 million (10 per cent of UK bilateral aid and 5 per cent of the total aid programme). This budget currently enables UK firms to secure about £250 million a year. The practice of offering mixed credit arrangements seems to have been growing - there was a 50 per cent increase in mixed credit offers in 1984 against 1983 - as competition between industrial country suppliers has intensified for a declining volume of third world orders total OECD expenditure commitments on mixed credit packages fell from $5.7 billion in 1981 to $4 billion in 1984). Because the UK has not hitherto offered soft loan terms, no ATP business has yet been secured in the expanding Chinese and Indonesian markets.

14. The case for additional ATP funds is essentially:

(i) that it directly supports UK industry and employment;

(ii) that by helping UK firms to enter new markets, and prove new capabilities, it helps them to secure further business in these markets, or further orders of particular types, on commercial terms;

(iii) that more funds are needed to break into new markets in the Far East.

Mr Tebbit accordingly proposes that the programme be doubled over the next three years, and suggests that the necessary funds should be diverted from bilateral aid programmes: the argument essentially is that £10 million of ATP can secure £30 million of orders for UK industry, whereas £10 million of tied bilateral aid produces only £10 million of order. The Foreign Secretary's response is that funds cannot be diverted, within the already substantially reduced and steadily shrinking programme of bilateral aid, from the poorest countries who need grants to richer developing countries with the ability to repay loans. Neither Mr Tebbit nor Sir Geoffrey Howe pursue the suggestion made at the last EX meeting that funds should be found for additional ATP out of the Department of Employment's job support programmes: Annex 2 to the Report by officials explains Mr King's rejection of this idea - although there is no exact agreed basis of comparison, it seems clear that the annual cost per UK job secured through ATP is several times that of each job secured through Community and related Porgramme expenditures.

15. In practice the interest rate top-up mechanism (paragraph 11 above) may provide a way out of the immediate public expenditure dilemma. Mr Tebbit already accepts that no additional provision is needed for the current financial year; significant expenditure is most unlikely to be incurred on new ATP offers until 1986/87. Given that the first year public expenditure cost of business secured through interest rate top-up is only a fraction of that secured through conventional ATP annuities, a substantial additional volume of business could be financed within the existing programme if this mechanism is used (this is illustrated in the table in paragraph 2 of the Note of Mechanisms which follows Annex 1 to the officials's report). It may be sufficient to conclude for the time being that the top-up mechanism should be made available - which should enable some additional offers to be made within the existing programme over the next few months while decisions are taken in the context of the 1985 Public Expenditure Round about the future level of the total ATP programme. In that case there would be no immediate need for Ministers to commit themselves on the level of ATP up to 1987/88, despite Mr Tebbit's wish to settle the issue now. It would then be for the DTI, ODA and the Treasury to consider the position in the context of the public expenditure bilaterals; and Ministers may well conclude that they need to reach an understanding not only on the public expenditure numbers but also on the real volume of aid to be provided, and its allocation as between conventional ATP, annuities and interest rate top-up arrangements.

HANDLING

16. You will wish to invite the Secretary of state for Trade and Industry to introduce the report by officials and his recommendations

about it. Thereafter the Foreign and Commonwealth Secretary will wish to state the case against the diversion of bilateral aid, and the Chancellor of the Exchequer will wish to comment on the implications of any introduction of soft loan mechanisms and on the substance and timing of public expenditure decisions. In structuring the discussion it may be sensible to start with the proposed changes in the administrative arrangements for handling ATP decisions; then move on to the soft loan mechanisms; and finally deal with the public expenditure issues.

CONCLUSIONS

17. You will wish to reach conclusions on:

(i) whether or not to approve the proposed changes in the administrative arrangements for taking decisions on ATP proposals;

(ii) whether or not to endorse the principle of introducing soft loan mechanisms as an alternative to the present mixed credit offers, subject to further detailed work on the practicalities; and

(iii) whether there should be any immediate increase in the ATP programme for 1986/87 and subsequent years, or whether this decision should be left to the 1985 Public Expenditure Survey Round.

J B UNWIN

Cabinet Office
25 June 1985