CONFIDENTIAL

4 November 1983

MR TURNBULL

cc Mr Mount

Prime Minister

Agree scheme should be ended?

AT 4/11

COST ESCALATION SCHEME

This scheme should be terminated. MT

In 1980, the then Minister for Trade argued for an extension of this scheme of one year "on a clear understanding that no further extension will be made once that year has expired". He argued that the scheme could not be abandoned at that time, when it was most needed (the Pound was high, so was inflation) but that an indefinite extension of the scheme could not be contemplated because it was "fundamental to our strategy that firms should not be protected against the consequences of their own cost increases". Three years later, inflation is under control, the scheme is hardly used and would scarcely be missed. What better opportunity could there possibly be to wind up a subsidy? Yet Mr Channon is arguing that the scheme should be retained because it costs us nothing, and be made permanent in the next substantive ECGD Bill. We have, then, a set of arguments for perpetual subsidy: if a subsidy scheme is relied upon heavily, we cannot abandon industry in its hour of need; if it is not used, it costs us nothing.

If inflation rises in the future, GEC and others will certainly exploit the scheme because it allows them to play it to their advantage. But do they need it? The paper implies that the capital goods industry has special needs. This argument is based on a misunderstanding. First, any industry which is exposed to international competition is vulnerable to cost escalation, whether or not this escalation is foreseen, and whether or not contracts involve fixed prices.

Second, the capital goods industry, which accounts for perhaps 1 per cent of GDP, already receives favoured treatment. A study by Treasury economists last year indicated that, on average, capital projects receive subsidies in the form of interest rate credit and ATP, equivalent to 30-70 per cent of the UK content. The Castle Peak power station, for example, received a subsidy of 42 per cent; the Sicartsa project received a subsidy of 65 per cent - considerably higher than the Polish ship contract (subsidy of 34 per cent). It is understandable that lumpy and visible export contracts should attract particular attention - they are reported in the media, whereas routine sales of, say, overcoats

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are not - but there is no economic justification for subsidising them. We would be better off if we concentrated instead on winning business which yielded the country a better return.

Mr Channon's note mentions the international criticism which this scheme has attracted. With France - a notorious subsidiser - we are alone in providing this kind of cover, a fact which is bound to continue to be resented, and criticised. Why incur this criticism for so little commercial advantage?

The scheme is also a poor advertisement for the Government's economic policies. We have always argued that industry would be one of the main beneficiaries of sound economic policies, which stabilise the value for money and enable planning to be conducted with greater confidence. Why, then, maintain an insurance arrangement which caters for situations in which these policies will either change or go wrong? This is surely an opportunity to wind up a subsidy, which imposes contingent risks on the Exchequer, citing, as the explanation, the benefits of sound economic management. We recommend that no further extension be granted.

NICHOLAS OWEN

Trade: ECGD Jan '80

File

B/c: Mr Owen

RO

10 DOWNING STREET

From the Private Secretary

7 November, 1983

COST ESCALATION SCHEME

The Prime Minister has seen your Minister's letter to the Chief Secretary of 2 November recommending continuation of the Cost Escalation Scheme for a further year with a view to making the powers permanent in the next substantive ECGD Bill. The Prime Minister feels that this scheme has served its purpose but that the time is now right to wind it up.

I am sending a copy of this letter to the Private Secretaries to the Members of E(A), and to Brian Fall (Foreign and Commonwealth Office), Richard Mottram (Ministry of Defence), David Heyhoe (Lord Privy Seal's Office), Robert Lowson (Ministry of Agriculture, Fisheries and Food) and Richard Hatfield (Cabinet Office).

(A. Turnbull)

J. Rees, Esq.,
Department of Trade and Industry

JC

C.NO.

Prime Minister ②

I have minuted out recording that you too take view at X.

AT 9/11

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP
Department of Trade and Industry
1 Victoria Street
LONDON
SW1H OET

MT

8 November 1983

Dear Minister

COST ESCALATION SCHEME

Thank you for your letter of 2 November in which you proposed to extend the cost escalation cover scheme for a further year, with a view to putting it on a permanent basis as suggested by the CBI, at the next legislative opportunity.

I see considerable objections to a permanent scheme of this kind. It was explicitly introduced as a temporary facility and has so been defended on each extension. It is unlikely to be in the long term interest of the UK economy to provide a scheme incorporating subsidies which protects a particular export sector from market forces. Moreover extension on a permanent basis would be likely to revive international hostility which the recent infraction proceedings threatened by the Commission show is only just below the surface.

When I announced the temporary extension of the scheme last year, X I expressed the hope that our success in reducing inflation would lead to a position in which the scheme could be allowed to lapse. In my view that time has now come. Our policies have successfully reduced inflation below the level at which the scheme is operative. Equally important, they have succeeded in reducing contractors' expectation so that applications for cover have virtually ceased. Continuation of the scheme would be entirely inconsistent with our objective of price stability. Withdrawal in these circumstances would be unlikely to inhibit contractors in bidding for overseas contracts.

Moreover, the benefits from the scheme are confined to a limited sector of the capital goods industry - the same sector who already benefit from interest support subsidies. It is difficult to defend a privileged position for this sector of the economy and its protection from market forces. Other sectors have to take equally long term decisions without the benefit of a Government provided hedge against inflation.

I accept that the scheme at present costs nothing and that any premium on new guarantees would serve to reduce - marginally - the substantial net cost to the Exchequer incurred so far. But that is not a strong argument for continuing - or making permanent - a scheme which was expected to make losses and, being open-ended, could impose significant further costs in the future. Any suggestion that the scheme should be put on a permanent basis seems likely to give rise to pressures to make it more generous. We have also agreed to make any extended scheme available to sub-contractors in other EC countries. We do not expect this to give rise to costs in the short term but it effectively puts the UK Exchequer at risk in relation to other countries' future inflation.

For all these reasons, I believe it would be wrong to renew the Scheme.

I am copying my letter to the recipients of yours.

Yours sincerely

J.A. Grieve

f.. PETER REES

[Approved by the Chief Secretary]

TRADE: ECGD, Jan 80.

V892

BF with Treasury response AT 3/11

ECNO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5144
SWITCHBOARD 01-215 7877

From the Minister for Trade

Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London SW1

2 November 1983

Dear Peter.

COST ESCALATION SCHEME

A year ago you were involved in the considerations leading up to the annual renewal of this Scheme and it now falls to me to clear the Government's position on renewal.

A full review of the financial position and prospects of the scheme have been circulated at official level, and the various policy options examined. In practice the only options available to us without new legislation are to let the powers lapse or renew them by statutory order for a further period of 12 months.

Earlier this year the CBI wrote to the Secretary of State on behalf of British industry urging that the Scheme should be kept in being and that it should also be made permanent. This latter action would need a change in legislation, and I would propose to note this request sympathetically for action when ECGD need new powers, which is likely to be in the year 1984/85.

The CBI pointed out that given the substantial sums involved, the submission of bids on fixed-price contracts, desired by many buyers, depends on reasonable certainty that unforeseen increases in future UK costs will not undermine a contract's profitability and jeopardise the jobs which depend on it. Not only this, but UK exporters are in some cases also having to accept buyers' conditions that on non fixed-price contracts only a small addition will be permitted for cost increases over the contract life, which be as long as five or six years. As exporters start looking at projects with construction periods stretching into the early 1990s, industry needs to have the necessary reassurance to encourage them in this field. Past experience has shown that it is the number of bids submitted backed by the Scheme, rather than the number of policies actually issued, which give the best index of the value of the facility. Although guarantees already given will probably produce a loss to the Exchequer of about £85M (which there is no realistic hope of recovering), on current Treasury estimates of inflation there will be no cost to the Government in allowing this Scheme to continue apart from the cost of 5 staff administering existing guarantees. Although very few applications are currently being received, premium earned on new cases would serve to reduce the cost to the Government of the Scheme so far; we also understand that cover is likely to be wanted for the Guangdong Power Station in China, if this project materializes.

It seems to me that if we can keep a Scheme going which costs us nothing and which may help to make the heavy end of British industry more willing to bid for large overseas contracts, then it is to the advantage of the UK economy as a whole to do so. Although Cost Escalation Cover has in the past attracted strong criticism in GATT and other international fora as an unacceptable form of export subsidy, there has been little active discussion of the subject for the past 3 years or so. My conclusion is therefore that our preferred course should be to renew the Scheme on its present basis for a further year, with a view to making the powers permanent in the next substantive ECGD bill.

If you and other colleagues to whom I am copying agree, I should like to make an early announcement of our intention to seek Parliamentary approval for a renewal of the existing powers for one year from 26 March 1984.

I am copying this to members of E(A), Geoffrey Howe, Michael Heseltine, John Biffen, Michael Jopling and to Sir Robert Armstrong.

Yours,

Paul

PAUL CHANNON

Trade Jan 80

ECGD

NBPM AT 7/12

Foreign and Commonwealth Office

London SW1A 2AH

cc NO

From The Minister of State

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London W1

6 December 1983

Dear Peter,

COST ESCALATION SCHEME

1. I refer to Paul Channon's letter of 2 November to you about the renewal of this Scheme.

2. In his letter of 5 January, Douglas Hurd supported the Scheme's renewal for 1983/84, but made the point that it has faced international criticism. I see that the UK has now told the EC Commission that if agreement is obtained for an extension of the Scheme beyond 26 March 1984, the benefit of the Scheme will be made available on equal terms to sub-contracts with companies in other EC Member States. This commitment is likely to increase the complexity and potential cost of operating the Scheme, with no additional benefit to UK exports.

3. A decision to end our Scheme would be welcomed by most of our EC and Consensus partners; therefore, in view of the current low level of inflation and the corresponding lack of demand for cover, I believe that ECGD's powers to provide Cost Escalation Cover should be allowed to lapse when they expire next March.

4. I am copying this to the recipients of Paul Channon's letter.

Yours ever,

Malcolm

Malcolm Rifkind

Trade ECGD Jan 80

NBPM
AT 17/11

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 32/3

16th November 1983

Dear Paul

COST ESCALATION SCHEME

Thank you for sending me a copy of your letter of 2nd November to the Chief Secretary about the renewal of this scheme. I have since seen his response, and also the Prime Minister's comments.

As I said when this matter was last considered in January this year, very little use has been made of the scheme to support defence sales. Moreover, our continued success in restraining inflation removes the need for the scheme in the immediate future and should give industry the confidence it requires to bid for long term contracts. It therefore seems more difficult to justify retention of the scheme at the present time, and I would be content to see it lapse. However, I would hope that it could be reintroduced without undue difficulty if economic conditions outside our control, such as another major oil crisis, made this necessary to safeguard both civil and defence exporters from a dramatic increase in inflation.

Copies of this letter go to the recipients of yours.

Yours ever
Michael

Michael Heseltine

The Rt Hon Paul Channon MP

Trade
Jun '80
Cost Escalation.

From: THE PRIVATE SECRETARY

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

NBPM
AT
14/11

Callum McCarthy Esq
PS/The Rt Hon Paul Channon MP
Department of Trade and Industry
1-19 Victoria Street
London SW1H OET

14 November 1983

Dear Mr McCarthy

COST ESCALATION SCHEME

Mr Prior has seen Mr Channon's letter of 2 November to Mr Rees. He fully agrees with the course Mr Channon proposes. While there has not been a high take up of this particular form of guarantee in Northern Ireland it is of great benefit to exporters seeking major overseas contracts.

I am copying this letter to the Private Secretaries to the Chairman and Members of E(A) to Brian Fell (FCO), Richard Mottram (MOD), David Heyhoe (Lord Privy Seal's Office), Robert Lowson (MAFF) and Richard Hatfield (Cabinet Office).

Yours sincerely

for D A HILL

CAM

TRADE: Cost escalation cover scheme: Jan 80