

PRIME MINISTERPOLICY UNIT
27 March 1984EXPORT CREDIT FOR PAKISTAN

In OD tomorrow, the FCO, MoD, and DTI may argue in favour of providing cover for up to 70% of the value of a contract for £220 million for two Type 21 frigates. ECGD would incur a Departmental Maximum Liability (DML) of £217 million.

Given Pakistan's financial position, this proposal comes very close to aid, in military form. Pakistan is a poor risk and currently uses 60% of her aid to pay off external debts. The Arab backers who had originally put up 50% of the earlier order (for two small frigates) have withdrawn their offer, which suggests that the market takes a similar view of Pakistan's credit-worthiness to that taken by ECGD, which had placed a Section 2 Market Limit for Pakistan of £60 million. £55 million of this is already taken up. This order would push our exposure up to several times this prudential limit. ECGD is already making calls of £600 million a year over the next two years.

The prime object of exporting is to get paid, not to win prestige, or cement friendships, important though these can be. Giving military aid in the guise of export credit is of no help to a country in financial difficulties, since defence equipment purchases cannot generate foreign exchange.

Norman Tebbit accepted, in his letter of 7 March, that ECGD have already supported Vosper's export efforts beyond the limits they would consider prudent. And that if a limit on cover to Pakistan was adhered to the Vosper's order would crowd out other business, such as the export of a BL Ital car operation, which is well advanced.

Industrial Issues

It will be argued that the order will assist in the privatisation of Vosper and sustain its Woolston yard at Southampton. There is clearly force in this point, but the market will have to

take a view on whether cover will be forthcoming in the future for similar orders. The question whether it is worth risking these sums to assist the privatisation of Vosper needs to be seen in the wider context of BS privatisation and MoD orders. The three, profitable, dedicated warship yards (Vickers, Vosper and Yarrow) and the unprofitable Swan Hunter are candidates for privatisation. MoD have two Type 22 frigate orders to place very shortly. They propose placing them, not with the warship yards, but with Swan Hunter and Cammell Laird. DTI consider that all three dedicated yards can be privatised without these orders. Vickers (submarine specialists) and the Yarrow yard are full; Vospers badly need work, but could still be saleable on a slimmed down basis. Swan Hunter needs an MoD order to be saleable at all.

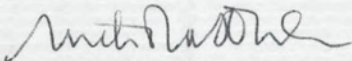
We think that the option of placing one of the Type 22's with Vosper rather than with Cammell Laird, and not providing what amounts to aid to Pakistan, ought to be considered. Cammell Laird, now a heavily loss-making offshore yard, seems an odd choice by the MoD. It has to do with Cammell's submarine background, which MoD think they may wish to call upon in the future. Cammell's bid was lower than Vospers, but we are less impressed than the MoD by this; the bid may be unrealistic, and paid for eventually by the taxpayer.

Could the Pakistan Order be Secured Later?

Another alternative, less immediately helpful to Vosper's Woolston yard, might be to keep the negotiation in play if and until Pakistan's financial position improves. How sure are we that the French and Italians are prepared to provide the necessary credit and in any case, would the Pakistan Navy accept these alternatives? Vosper's offer is lower than its rivals'; Admiral T K Khan, the Pakistan Chief of Naval Staff, is strongly committed to British systems (he attended the RCDS in 1979). Warship design reflects, to a certain extent, naval concepts. It would be worth considering whether, in the event that cover is refused at this juncture the Pakistan Navy might prefer to wait, rather than pay a higher price for less preferred equipment.

Recommendation

There seems to be no point in winning orders for which we seem unlikely to be paid. If Vosper's steel shipbuilding capability at Woolston, with its proven record of warship design and exporting, is worth preserving, ought not a Type 22 contract be awarded to Vospers? Failing that, is there any possibility of securing a Pakistan order when Pakistan's finances improve?


NICHOLAS OWEN


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PRIME MINISTER

c Sir Robert Armstrong

Frigates for Pakistan: Export Credit for
Vosper Thornycroft
(OD(84) 8)

BACKGROUND

1. In early 1982 Ministers agreed that 50 per cent Export Credit Guarantee Department (ECGD) cover should be provided on a contract value of £150 million in support of the potential sale by Vosper Thornycroft of two frigates to the Pakistan Navy; the rest of the credit was to be sought from Arab sources. This would have given ECGD a Departmental Maximum Liability (DML) (i.e. the maximum amount which ECGD might have to pay in terms of principal, agreed increases in the cost of the contract, and interest payments if there were to be a default on the loan) of £110 million. On 24 August 1982 you wrote to President Zia referring to this offer and supporting Vosper's efforts. The value of the contract has now risen to £220 million (as a result of an enhanced specification) and the Arab credit package is no longer available. The Pakistan Navy claims to have a comprehensive French offer for the enlarged contract, including 50 per cent Government backed credit. Vosper have now applied for increased ECGD cover of up to 85 per cent of the contract price of the enlarged order, which would give ECGD a DML of between £27 million and £250 million; they believe this would clinch the decision in their favour.

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2. The Secretary of State for Trade and Industry wrote to the Chief Secretary, Treasury on 7 March about this potential sale, as well as that of patrol craft to Kenya. This letter, and the ensuing correspondence, have been circulated under OD(84) 8. Mr Tebbit drew attention to the importance in

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industrial terms of both orders to Vospers whose immediate export prospects are poor. He believed that providing credit on orders of this kind was essential if warship building capacity was to be sustained. Without such orders, the prospects for privatising Vosper (or the price obtained) would be adversely affected. If the Pakistan order were lost, Vosper's Woolston shipbuilding yard would have to close; this would help to reduce the over-capacity in steel warship building, but it would be preferable for the reduction to occur elsewhere. Mr Tebbit believed that it would be helpful if possible to defer decisions on the Pakistan deal until the Government had decided the detailed approach to warship building privatisation and had discussions with potential purchasers.

3. The Secretary of State for Trade and Industry pointed out that ECGD were concerned that the potential exposure on both orders would be beyond what could be justified by the economic circumstances of the countries, and therefore outside the guidelines agreed by Ministers in 1982. It would also damage the prospects in the markets concerned for other sales requiring credit. Mr Tebbit recommended that support be given for either the Kenya or the Pakistan sale, but not both, and considered that Kenya was marginally the better case.

4. In subsequent Ministerial correspondence, culminating in Mr Turnbull's letter of 19 March to Mr McCarthy in Mr Tebbit's office, it was agreed that the request for export credit support for patrol craft for Kenya should be agreed, but that the question of support for frigates for Pakistan should be considered by OD. In the course of this correspondence, the Chief Secretary, Treasury recorded that his agreement to support for the Kenya deal was conditional upon withdrawal of the existing credit cover for the Pakistan deal, which in any case expires at the end of March.

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5. The Foreign and Commonwealth Secretary, in his minute to the Chief Secretary, Treasury of 15 March, argues that the foreign policy implications are such that an exception should be made to the prudential considerations which would customarily influence decisions on such cases as export credit support for the sale of the frigates to Pakistan. Your own support for Vosper's efforts in your letter to President Zia is an important factor. Although Vosper's are now seeking increased cover, Sir Geoffrey Howe believes that the President will expect the United Kingdom to stand by its support for Vosper. The President recently told Baroness Young that Vosper's bid would have priority once adequate financing had been arranged. The Pakistanis would be surprised and disappointed if we now backed out of the deal. The Foreign and Commonwealth Secretary therefore recommends that the increased cover should be agreed, and if necessary special cover outside the normal limits could be reserved in order to keep the market open to other British exporters.

6. The Lord President of the Council and the Chancellor of the Exchequer will be unable to attend the meeting because of Parliamentary commitments. The Chancellor will be represented by the Chief Secretary. If the Secretary of State for Foreign and Commonwealth Affairs is unable to attend, the Minister of State, Foreign and Commonwealth Office (Baroness Young) will represent him.

HANDLING

7. You should invite the Foreign and Commonwealth Secretary or in his absence the Minister of State, Foreign and Commonwealth Office, to introduce the discussion. If Baroness Young is present, she might also report on her recent discussions with President Zia. The Secretary of State for Trade and Industry, the Defence Secretary and the Chief Secretary, Treasury, should then be invited to comment. Points to establish are -



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- a. Is it possible, as Mr Tebbit has suggested, to defer a decision until the Government has decided the detailed approach to warship privatisation and had discussions with potential purchasers? If so, should the existing level of cover be maintained until final decisions can be made?
- b. If not, does the Committee believe that the potential political damage resulting from a refusal to increase credit cover in this case outweighs the prudential considerations which point to a refusal to increase cover?
- c. If so, should cover be increased outside the normal limits for Pakistan so as to avoid prejudicing British exporters' prospects of obtaining civil orders? Would the additional risk which this course would involve for ECGD be acceptable? (In this connection the Foreign and Commonwealth Secretary has pointed out that it would be wrong to ignore the relatively high economic growth Pakistan has achieved over the last six years.)
- d. If the view is taken that credit cover for the sale should not be increased, should the existing cover be withdrawn when it expires at the end of the month? If the Pakistanis had not by then made their decision, they could be expected to react sharply to withdrawal.

CONCLUSION

8. Subject to the points made in discussion, you could guide the Committee to decide whether a decision on export credit cover in support of the sale of frigates to Pakistan should be taken now or deferred pending decisions on the Government's approach to warship building privatisation,



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in which case the Committee will presumably wish to maintain the existing level of cover after the current offer expires at the end of March and until final decisions are taken. If a decision needs to be taken now, the Committee will need to decide whether -

- i. the export credit cover should be increased, and, if so, whether the increase should be outside the normal guidelines for Pakistan or within them; or
- ii. the cover should be maintained at its current level until Pakistan makes its final choice; or
- iii. the existing cover should be withdrawn when it expires at the end of March.

David Goodall

A D S Goodall

27 March 1984

27 FEB 1984





PRIME MINISTER'S
PERSONAL MESSAGE

SERIAL No. 7164/82

10 DOWNING STREET

Pakistan Military Aid June 1980

THE PRIME MINISTER

24 August, 1982.

MASTED

cc OHS
Subject + Defence

Gen. Z. President

When we met in Pakistan last year, and I still have happy memories of the fascinating day we spent together, we had a brief discussion about the possible supply of British military equipment to Pakistan. At that time you were thinking of buying HMS LONDON for your Navy and I was delighted to hear that the sale and delivery of PNS BABUR, as she is now called, went so smoothly and that the Flagship of the Pakistan Navy remains a British built ship.

I understand that you are now contemplating the purchase of new frigates and that among the suppliers being considered is Vosper Thornycroft Ltd. Their offer, which includes provision for 100% credit financing, is, as I think you will know, backed by the British Government, who have agreed to provide a significant proportion of the credit through the Export Credit Guarantee Department.

There has, of course, been much discussion of the role of frigates as a result of the recent battles in the Falklands and I wanted to let you know that in our considered opinion the Type 21 frigates, which Vosper Thornycroft are offering you, performed magnificently throughout this most successful campaign and fully

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lived up to our expectations. It now has the unique advantage that it has been battle tested in some of the most severe weather conditions in the world and in an adverse air situation. You as a soldier will know better than I how important it is that equipment, which men may have to use in battle, should be tested in this way. The Type 21 has proved itself to be a fine ship of sound design and popular with its crews; mechanically reliable and a stable weapons platform. Of course, no untested ship is ever perfect and if as a result of our experience in the Falklands, some improvements have been found to be desirable, these would, of course, be included in any ships built for Pakistan should you place your order with Vosper Thornycroft. So you would get ships which incorporate the lessons learnt from the most recent and most testing battle experience.

I need not elaborate on the other benefits to the Pakistan Navy of having their ships built in a British shipyard. Co-operation between our two navies has been particularly close since 1947. We share many of the same naval traditions, have common training and operation procedures and, of course, a shared language.

I am confident that if you decide to buy the Vosper Thornycroft frigates they will serve you very well indeed for the tasks which face your country and your Navy.

Warm personal regards.

Yours sincerely

His Excellency General Mohammad Zia-ul-Haq,

Nazimuddin Khan