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Mr Potter OTH

9 January 1986

I shd be grateful
for your comments
please ack

[Signature]

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R E Adams Esq
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Dear Bob

[Handwritten initials]

SAUDI ARABIA - MILITARY AIRCRAFT FOR OIL ARRANGEMENTS
(ECGD's letter of 8 January)

I am writing to confirm the comments that Charles Dudeney gave you over the telephone.

1 The proposal that ECGD guarantee a Saudi Government overdraft of £3 bn plus interest for the purchase of Tornado aircraft raises so many difficult issues that it seems imperative that the matter be considered by a full EGC.

Economic Considerations

2 ECGD's proposal seems to contain a 'Catch-22' element. If the economy is as healthy as the ECGD paper suggests then there should be no difficulty for the Saudis in financing a mismatch of the magnitude suggested; if they cannot finance it then there are real grounds for misgivings about their creditworthiness for an exposure of this size. If the oil proceeds fall short of the levels assumed then ECGD's total exposure could be considerably greater than the paper suggests.

3 It is difficult to obtain reliable data on Saudi Arabia (in itself a reason for some caution). ECGD suggest that the current account deficit was of the order of \$13 bn in 1984, and that "reserves" (ie official external assets?) were \$90-100 bn in mid-1985. The latest OECD Outlook, in contrast, doubled the former and halved the latter figure. Our own projections for the current account deficit and usable assets are nearer those of the OECD than ECGD (last year's Cabinet Office paper offered few crumbs of comfort).

4 These differences are rather critical. At the extreme Saudi Arabia could not long finance current account deficits of \$25-30 bn with liquid assets of only \$45-50 bn. ECGD's projections seem to be based on highly optimistic assumptions about the oil price, viz \$25 pb rather than the \$18 pb used in the EGC paper on Iraq. They do not seem to have considered the probability of a fall in price, which is likely to result from

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Saudi's unwillingness to compensate for other OPEC countries' over-production when demand for oil drops in the spring. It might also be prudent to consider the implications of a sharp fall in the price, to an extreme of say, \$10 pb - although it is unlikely that such a level would be other than temporary.

5 If oil revenues fall far short of ECGD's projections this would not only erode the oil security for the overdraft; it would also make it very difficult for the Saudi Government to honour its unconditional payment obligation. Moreover, such a decline in revenue would require even more massive retrenchment than already seems necessary. Payment for military hardware might attract a much lower priority in any sharp cutback in imports; and if the burden of adjustment fell entirely on non-military imports there might be implications for the stability of the regime.

6 All in all, therefore, it is not entirely surprising, given the economic background, that ECGD do not realistically expect other export credit agencies to be prepared to share such a risky exposure - presumably the exemption of arms sales from the Consensus means that we cannot invoke the Reciprocal Agreement against the Germans and Italians. However, the Germans and Italians could justifiably be pressed to take their share of the risk - should it be decided that the proposal is in fact worthy of support. As a general principle, it is unacceptable that the Germans refuse to cover their share of Tornado sales to non-NATO countries. This question arose in the context of the Omani sale and we advised then that the Germans be challenged on this point.

Other Issues

7 Apart from the difficult economic background to the proposal, there are a number of other factors that need careful consideration:

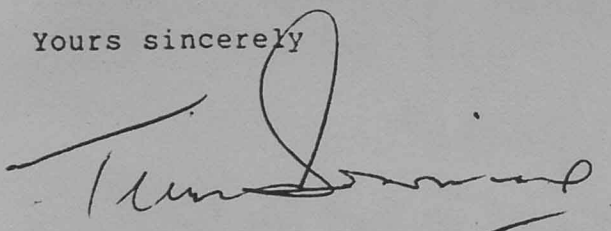
- (a) A substantial element of the total exposure envisaged seems likely to represent interest, a fortiori on the lower revenue prospects that the Saudi authorities may face. Will they be willing or able to pay interest in defiance of Sharia law? SAMA seems legally precluded from so doing. This is an area where the post may be able to advise. (Incidentally, what legal regime would govern the contract?) Otherwise, one of the few comforting aspects of this proposal is that IMU would not be involved (presumably?).
- (b) We note that ECGD's Advisory Council has not yet proposed downgrading Saudi Arabia to C, notwithstanding the economic prospects and ECGD's claims' record, although this would have a dramatic effect on the 60:40 ratio of A/B to C/D business were cover to be conceded. At very least, however, it would seem sensible to confirm the downgrading of Saudi from A to B, in order to increase ECGD's potential premium. But there seems no justification for taking on a commitment of £5 bn or more on premiums that do not adequately reflect the risk.
- (c) ECGD argue that their guarantee applies only to the overdraft facility and not to the export or oil lifting contracts. But the reality is that, because of the fragility of Saudi Arabia's financial position and its vulnerability as a one-product economy, ECGD are effectively guaranteeing some combination of oil price and volume that would generate

sufficient revenue to allow the overdraft to be cleared. If the oil price weakens sharply, as many foresee, then it seems inconceivable that resources could be diverted from other more essential imports to finance arms purchases; rather, payment for arms would seem more likely to be withheld in favour of essential imports necessary to support the survival of the regime.

8 Clearly, a decision involving a potential exposure by ECGD of £5 bn or more deserves much greater consideration than has been possible in the short time available; for the proposal seems to involve a massive increase in ECGD's exposure with no increase in exports beyond those already covered by last year's agreement. An additional question is under what form of cover ECGD would propose to take on this commitment. It would not appear to meet any of the standard criteria and there may therefore be a questionmark over their ability to give cover of this kind - although I would not wish to argue generally against ECGD's exploring innovative techniques to support UK exports.

I am copying this letter to Martyn Baker (DTI), Len Davidson (MoD), Reg Ludford (ODA), Peter Sullivan (FCO) and Peter Henley (ECGD).

Yours sincerely



T J H Downing