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Prime Minister

MLS 18/12

From the Secretary of State

Michael Scholar Esq
The Private Secretary to
The Prime Minister
10 Downing Street
London SW1

ought CPRS advice

~~by~~ by 4/5 Jan.

15 December 1981

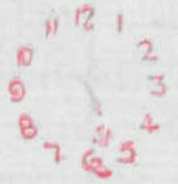
Dear Michael,

OVERSEAS PROJECTS: COMPETITORS' PRACTICES

The first EX meeting, called for an examination of the practices of our main competitors in pursuing overseas projects. Officials in this Department, in consultation with those of other interested Departments, have prepared the attached summaries of how Japan, France, Germany and the USA are structured to tackle this market.

With each having its own distinct combination of industrial structure, financing institutions, domestic market, economic imperatives, traditions of adjustment, and Government involvement, the Secretary of State has concluded that we cannot realistically attempt to duplicate what they do. Especially, there are such glaring differences between the UK and such countries as Japan and France, that it is notfeasible to set overriding priorities for industry. Rather, the approach should be to continue to be guided by the opportunities that the main UK companies want to pursue. This does not preclude drawing their attention to particularly attractive markets which they may have ignored, or types of project that they may not have identified.

The potential market for major projects is immense, if concentrated at present in the developing world, and holds out opportunities for the



From the Secretary of State

full range of manufacturing and services. Our competitors have made a conscious decision to pursue these, and their companies can readily command the range of disciplines and resources necessary to present very attractive packages. If the UK is to sustain its manufacturing base and market position, clearly industry must win its share. More particularly, in the current recession, projects won generate orders, and hence employment, rapidly. Furthermore, when the Government provides support it has the assurance of doing so to the more competitive and combative companies who are prepared to take on the competition in difficult markets.

The main problem is to encourage disparate UK interests to work together to produce the same effective terms that our competitors can achieve through their institutions. Recent successes suggest that we are beginning to put our act together better, though there are still areas where we are seeking improvement.

From an overall trade perspective, the Secretary of State considers that support, through ECGD, the aid programme, or Industry Act, which enables UK companies to match the practices of our competitors is far preferable, and more likely to yield early results, than giving way to the protectionist pressures to ease adjustment for our less competitive industries.

Unless it was particularly wished, the Secretary of State would not suggest an EX meeting on these papers by themselves. Through EX(O) regular reporting of major project opportunities has been set in hand, and arrangements to make the most of senior Ministerial visits. The Secretary of State is however, concerned that the ability to continue support under the aid programme for major project opportunities using ATP will be negligible next year. But this is a matter that he

From the Secretary of State

proposes to raise separately.

Copies of this letter and enclosures go to the Private Secretaries to the members of EX, to the Secretaries of State for Defence Energy, Transport and the Environment, to Sir Robert Armstrong and to Robin Ibbs.

Yours sincerely,

JOHN RHODES
Private Secretary

JAPAN

INDUSTRIAL STRUCTURE

The Japanese industrial structure is characterised by:

(i) large industrial groupings comparable in size with the multinational companies but in most cases with more diverse interests;

(ii) a complex, highly efficient and Government-regulated banking system closely geared to the needs of industry; and

(iii) intense competition between companies and between banks, in a large and demanding home market with a strong preference for Japanese goods.

2 Most of the industrial groupings are involved in overseas projects. There are two kinds. The first are trading houses comprising a central sales and distribution company and major bank with between 20 to 130 associated companies. The second are industrial conglomerates of 20 to 40 mainly manufacturing companies, which may or may not be associated with a particular bank. Both kinds are loose groupings, with substantial overlaps, so that individual companies can independently pursue project opportunities, or join readily in consortium with companies from other industrial groupings, including both manufacturing and trading.

3 To give an indication of the scale of these industrial groupings, Mitsubishi, the largest trading house, had a turnover twice that of Royal Dutch Shell in 1979. Even the major constituent companies of the smaller industrial conglomerates can be larger than their UK counterparts. Matsushita Electrical Industries and Hitachi Ltd both manufacture heavy electrical plant and both have a higher turnover than GEC; the two industrial conglomerates of which they form part have turnovers twice that of GEC.

4 The effectiveness of the Japanese industrial structure may be illustrated by the performance of their firms in the power plant and desalination plant sectors. The Japanese share of the world market for power plant rose from 6% in the late 1960s to 12% by the mid-1970s and has achieved spectacular growth since. In 1979 Japanese companies took 55% of all export orders for turbine generators and 75% for large transformers. The tender for a recent power project in Australia follows a trend of reducing real costs, and could not have covered the cost of the raw materials to UK and other suppliers. Financing proposals are offered at highly attractive terms, including no payments until commissioning, any Yen exchange risk assumed by the bidder, etc. Moreover, Japanese firms can rapidly improve their financial proposals at the crucial point of negotiations.

5 A contract for a £500m desalination plant in Saudi Arabia was let to three Japanese companies. The competing UK company subsequently learnt from one of them that the business has been accepted at a 20% loss. If necessary, even lower prices would have been offered. For a subsequent smaller contract, one of the five Japanese companies involved submitted an equally low bid while the rest submitted bids comparable with those of European firms also pursuing the contract. This is one of a number of instances where the suspicion has arisen that Japanese firms have decided between themselves beforehand which one should win the contract. Historical precedent of Japanese commercial behaviour eg motorbikes, colour TV, ship-building, motor cars, etc suggests no let-up in the Japanese desire to

establish dominant market shares for new areas such as power and desalination plant, telecommunication projects, and future micro-chip production and application.

6 The industrial groupings benefit from economies of scale; extremely efficient and flexible production; large research and development programmes, with in some cases major Government involvement; a facility for cross subsidisation of temporarily unprofitable activities (Mitsubishi, for instance, covers projects and a wide range of manufactures from chemicals to electronics goods); and the resources to diversify rapidly into new and growing markets. Companies tend to have high fixed costs - apart from labour in some instances, major companies often carry the costs of housing, education and travel for their workers, which contribute to a prime objective of long-term profit through maximising market share, rather than immediate maximisation of profit on individual contracts.

7 The banking system ensures that finance is rarely a constraint on the activities of the industrial groupings. The Japanese have a high propensity to save. The banks are in strong competition in on-lending this money. The result is that industry is offered the long-term credit that it needs. Individual companies naturally look first to their main bank for finance but they are free to get the best deal they can from elsewhere in the banking system. With industrialisation being initially financed wholly by bank lending, and with a slower development of a capital market, despite bank equity in individual companies being restricted (10% currently, but due to reduce to 5% by 1986), there is generally a continuing and close working relationship between banks and the major Japanese groups.

To present a balanced picture, two recent developments which have constrained bank lending should be mentioned. First, there has been some crowding out of private sector lending by public sector borrowing to finance large budget deficits. Japanese firms have however been able to assume a higher proportion of self-financing through higher profits generated by a favourable Yen exchange rate. Second, Japanese banks have been restricted since last year to lending a maximum of 20% in relation to their capital to any one major customer. Many major banks have increased their capital or are in the process of doing so to partly overcome this constraint.

GOVERNMENT INVOLVEMENT IN INDUSTRY

8 Lacking any significant natural resources, there is effectively consensus in Japan on the need to maintain industrial pre-eminence above other objectives. Industry is usually capable of doing this unaided but when necessary there is acceptance of central planning to achieve this by, for instance, a rapid transfer of labour and capital from dying to growing industries. The Government role in implementation, usually through MITI, is opaque to outsiders but highly effective.

9 When a promising sector has been identified, the Government adopts an aggressive "infant industry" approach providing research and development funds and cheap finance to assist the sector to rationalise and develop advanced products focused from the outset to gain overseas markets. Intensive competition is promoted in the domestic market to test the results. The overseas market, usually concentrating initially on South East Asia, will then be attacked at price levels designed to establish a large market share, with a subsequent/parallel strategy to penetrate new markets, deploying a wide range of methods including manufacturing investment in developing countries to allow Japanese domestic manufacture to move to products of higher or new

technology, and investment in production facilities in the markets to be attacked.

10 This process is articulated throughout companies/sectors by a style of "consensus" which is unique, but extremely effective, flexible and opaque. It is this consensus approach which clearly distinguishes in kind as well as extent Japanese planning from that employed in Eastern Europe.

EXPORT CREDIT

11 The Export Import Bank (EXIM) and MITI offer the usual range of credit facilities within the consensus and insurance but these are less extensive than those of ECGD. EXIM also offers import development loans at 6-9% interest repayable over 7 to 20 years to countries for the purpose of gaining access to resources which Japan needs. The largest of these was to China (for coal and oil). Aid development loans have a similar purpose and in theory are unrelated to export credit lines so that the consensus does not apply. Japanese producers generally receive a higher than usual proportion of the contracts financed in these ways.

BILATERAL AID

12 The Japanese bilateral aid programme ($2.6 billion in 1978) has been concentrated in the Far East and South East Asia but has been extended to include some Middle East and African countries. Project aid is being progressively untied, though even in these instances a Japanese consultant is often appointed which effectively gives Japanese industry an inside track. In addition to serving developmental purposes in many instances, Japanese aid is also strongly motivated by commercial objectives, and hence political objectives, since the expansion of trade is a pre-eminent objective: a comparison is that 5% of UK aid in 1978 went to countries with per capita incomes exceeding $1,000 compared with 17% for Japan. These recipients included Iraq, Brazil and Algeria. Between them they offer an excellent mix of good commercial markets and the resources Japan needs. Commercial interest is similarly reflected in the sectoral distribution of Japanese aid. 23% was devoted to industry, mining and construction (UK 12%) and 49% for public utilities (UK 22%).

MIXED CREDIT

13 Japan claims to have only recently reintroduced mixed credits and no figures are yet available. The grant element has generally been above 25% and therefore does not require notification under the Consensus before a contract has been awarded. One exception was in 1980 when they put in a £300m bid, with a 16.7% grant element, for a railway electrification contract in Mexico. In this case ECGD had sufficient notification and were able to make a matching offer. In addition, there have been reports from India and Kenya of Japanese lines of mixed credit for telecommunications and other projects. Japanese firms receive assistance with their pre-contractual expenses for projects. There are indications that these are more widely available and more generous than those which UK firms receive. Furthermore the Japanese trading houses have an in-built capacity for counter-trade in what may be quite unrelated commodities, and this also serves to increase their competitiveness.

MARKET AND SECTOR PRIORITIES

14 The Japanese Government periodically publishes the expected sectoral priorities for future investment and trade. But whatever may be the general declared objectives, the harsh reality is very aggressive competition in power generation and desalination, metal and chemical process plant, energy developments, railways, telecommunications and applications of micro electronics. The Japanese are not of course always successful. They failed for instance to obtain a dominant share of the market for earth moving equipment, and an attempt at the civil aircraft market abroad has met with indifferent success. In some markets, eg the Far East and South East Asia (where the industrial groups are frequently well entrenched through manufacturing operations), the Japanese position is so dominant that UK and European producers will often not bother to compete; elsewhere (eg Middle East, Eastern Europe, Latin America), the Japanese effort is well established as a result of policies directed at acquiring energy and raw material supplies. In developed markets such as the EEC and the USA they tend to concentrate on achieving a high market share in a limited number of sectors, essentially - and for obvious reasons - where procurement decisions are in private hands.

(This paper generally reflects the situation in France before this year's election)

Industrial Structure

The distinctive feature of the French technique in pursuit of overseas projects goes back to the essential role played by Government in the creation of French industry in the absence of a fully effective capital market. The French Government sees the country still in the process of this industrial evolution, and accept as their objective the establishment of enterprises capable of taking on the Japanese and Germans. Some of the more pertinent aspects of this approach are:

(a) A consistent pattern of developing policies to maintain key industries, eg nuclear, aerospace, military technology, telecommunications, fast rail, etc, with capture of markets an essential part and with concentration on no more than two companies in each industry.

(b) A strong Government equity stake in banking, insurance and companies themselves: a situation complicated by central controls exercised through the prefectures and through major sectors of the financial system.

(c) A relentless emphasis upon technology acquisition, whether through Government procurement demanding technology-transfer from non-French participants, denial of market access while French products are developed, or insistence upon joint-ventures for technologically oriented inward investment.

(d) Deft use of political leverage and opportunistic drive for particular markets: military sales tactics in the Middle East, South America and South Africa are one illustration. This includes the conclusion of large civil contracts with Iraq when much-needed military deliveries were being negotiated, and the large credits recently offered to Brazil when everyone else is tightening exposure to Brazil is another. A feature of French sales policy, which applies particularly but not exclusively to arms sales, is to emphasise France's independence over the continuance of supply.

2 Of particular interest in the projects industry are 13 consultancy firms, known as SOFRES, which are closely connected with important public sector bodies and cover the main project sectors. This public sector link allows subsidised financing, and the SOFRES admit that, wherever possible they specify French equipment. French private sector consultants also adopt a similar attitude.

3 Another illustration lies in Technip, largely owned by the two state-owned oil companies, and offering design engineering and general contracting for projects overseas. In 1979 they won turnkey contracts worth £108m; as with the SOFRES, post-tax profits are usually less than 1%. They have recently instituted a scheme of free engineering consultancies and claim to have gained a foothold in Brazil by doing this. It has also been reported that the Mitterand Government has it in mind to increase the French bilateral aid programme.

Government Involvement

(a) Subsidised Credit

4 Credit at subsidised rates is pervasive in the French economy. In 1979/80, 44% of all loans and credits were subsidised, with Government or semi-public institutions (regional banks, etc) providing over half this (and this figure has now included tax reliefs or direct Government subsidies as opposed to loans). There has been a steady increase in the proportion of subsidised

loans since 1974 following the introduction of new subsidies to encourage exports or investments. In 1979/80, 78% of loans to exporting companies were subsidised. The value of the subsidised loans was about £5 billion.

(b) Export Credit and Insurance

5 In France there is no single entity which performs the functions of our own ECGD but a similar range of facilities is provided through credit insurers (COFACE) and Government sources (DREE, Banque de France, Trésor). In 1979/80 COFACE report that their facilities alone cost some £400m, about the same as ECGD's: this appears to be a very conservative figure, since cost escalation cover alone cost the French Government about £280m, while ECGD made a profit of about £6m on their cost escalation cover scheme. A recent OECD study of Consensus participants estimated that French interest rate subsidies for 1980 were about £1,000m. This was much the highest figure and was more than double that estimated by OECD for the UK. More generally, although the total value of French and UK exports is broadly comparable, for the two years 1977-78, French officially supported export credits on terms over five years (excluding aircraft and ships) totalled more than twice those of the UK, suggesting a heavy concentration on projects.

6 Some arrangements to act as lender of last resort when French firms have to accept onerous terms seems possible, for example, in September 1980 Plessey lost to Thomson-CSF a £400m contract for an electronics complex in Iraq. A key aspect was a performance bond of some £80m, which Thomson accepted (but which was unacceptable to Plessey) despite Thomson's relatively stretched balance sheet.

(c) Aid and Mixed Credit

7 France's aid total is high: £1.6 billion in 1979 (West German £1.6 billion, UK £1.0 billion), 40% of which went to her overseas territories and departments. Fully tied bilateral aid accounted for £730m of total aid (West Germany £253m. UK £420m), 90% of which went to Francophone countries, largely on grant terms.

8 Besides having a much larger aid budget, the French mixed credit programme is far more extensive than the UK's. French mixed credits notified in 1980 were £1,120m (compared with £580m in 1979). The aid portion of this was £350m compared with only about £70m from the UK. The French are aggressive users of mixed credits and have little hesitation in initiating. It is also difficult to know whether there is a firm French offer to match, since although they may tell the client informally that aid will be provided, the precise terms of mixed packages are rarely notified until after the contract has been won.

9 The covert use of tied aid by the French is made more difficult to combat by their use of established lines of credit to part or wholly finance capital projects. The French typically open a line of credit to finance a project or the purchase of equipment which may be of relatively low cost. The line is then extended or further, major, projects included. During 1980 alone, the French notified us of 12 lines of mixed credit (worth £413m, aid portion £160m) open to 11 countries. By contrast, the UK recently opened its first line of mixed credit, with Malaysia for £77m; the grant element is over 25% and therefore the Consensus does not require its use to be notified before a contract is awarded. One notable recipient of French lines of credit is Brazil. The French have offered in excess of £600m since May 1980 in soft credit with an overall grant element of only about 15.2% which under the Consensus requires notifications as soon as it is offered for a contract. Some of the projects included concern hydro-electric power, railways and airport development. (By contrast, the limit for ECGD's Section 2 account for Brazil has recently been fixed at £1,250m - as a prelude to the signing in October of a Memorandum of Understanding covering large projects in Brazil).

10 In Mexico, the French have recently operated two lines of mixed credit simultaneously, particularly for railway projects. In 1978, they used one to scoop the contracts, in excess of £150m, for the extension of Mexico City Metro. Although this did not fully use up the first line, a second, for £100m, was opened by President Giscard during his visit in March 1979. COFACE did not notify ECGD of this line until September 1979, thus contravening the Consensus. When French and UK firms were bidding for a further £100m contract in early 1980, ECGD had considerable difficulty obtaining an answer from COFACE as to whether one of the lines would be used. In the event, we made a matching offer despite the French prevarication, and COFACE only confirmed later that their first line of mixed credit was being made available.

(d) Pre-contractual Expenses

11 The French have several means of assisting firms with pre-contractual expenses. Although we do not have comprehensive figures, reports from UK firms indicate that they are at least as generous as the Overseas Projects Fund 1981 (budget £m 5.75 pa) and, unlike the Fund, do not require repayment if a contract is won. In addition, we know that project consultants have offered free feasibility studies normally costing up to £50,000.

(e) Ministerial Visits

12 M Giscard's Minister for Foreign Trade generally spent about half the year abroad on trade promotion ventures. Of particular interest is the fact that he prepared the ground for Presidental visits by making a visit to the country about 4 to 6 weeks ahead so as to prepare texts for signature. These texts often included agreements relating to specific projects or framework agreements which are the prelude to specific agreements. While this is impressive itself, it can only be possible if the projects concerned have been earmarked well in advance for final agreement during the Presidential visits. One example of this was the President's visit to Mexico in March 1979 when the line of credit was agreed.

(f) Military Aid

13 The French have a military aid programme which is much more substantial than HMG's and is used very effectively. The French recently used it to pre-empt the Sudanese market with about £15m of free artillery equipment under a line of credit arising from President Giscard's visit there in 1979.

Market Sector Priorities

14 Two main factors determine French priorities: the need to secure raw materials supply, particularly oil, and the pursuit of markets for priority industrial sectors. Once these have been taken into account, the informal control exercised by the Government over major enterprises combined with the freedom of the Government to pick firms from amongst the limited number available in each sector to be flag bearers, enables the French to pursue projects in an impressively single-minded way.

15 Resource diplomacy explains the priority treatment accorded to Mexico, Brazil and the Gulf States. It is in these areas that French tactics have caused most concern to UK firms. The French can also be expected to preserve what they regard as their traditional project markets - the Francophone and Eastern European countries.

16 As regards sectors, it can be expected that projects involving the six priority sectors in the VIII National Plan will be given prominence. These cover aerospace and the full range of information technology. The French

have also been concentrating on railways, non-ferrous plant and, particularly in the Middle East and South America all aspects of power generation.

GERMANY

Germany industry as a whole benefits from low inflation and good labour relations. Despite generous Government aids to R&D, the percentages of GNP devoted by Germany and the UK to investment in both R&D and manufacturing industry generally have been broadly comparable. The crucial difference lies in the relative increase in net output per unit of investment, with Germany's almost twice that of the UK. Between 1973 and 1978, the average annual percentage increase in productivity (volume of output per employee) in manufacturing industry was 2.4% in Germany against 0.8% in the UK. These basic features have underpinned German industry's ability to offer very good value in terms of product technology and price, despite a strong currency for the recent past (in the immediate post-war years by contrast there was a period when the Deutschmark was held down in value) though with an advantage in their interest rates.

2 Germany has a social, rather than a free, market economy. The Government sees its job as maintaining competition and stability within the economy and to assist the structural adjustment of the economy to changing demands. This assistance cost the Federal and Land Governments in excess of £2.5 billion in subsidies to industry in 1978. German industry also benefits from the most effective "non-tarrif barriers" in Europe, DIN standards. Thus the French for example have made several hundred applications in the past few years for particular French standards to be recognised as equivalent to DIN, but so far not even one has been approved. In addition, there are some striking contributory features of industrial structure and the role of Government which should be recognised.

Industrial Structure

3 The large German banks account between them for just 7% of the share capital of all German publicly quoted companies, and yet they are by far the most important controllers of major companies through shareholdings. The banks derive their power by combining shareholdings on their own accounts and holdings on behalf of their clients placed on deposit with the banks and carrying proxy voting powers. The banks are the sole stockbrokers in West Germany and can buy and sell shares on both their own account and on behalf of their clients. Although concern at the level of banks' holdings has increased, they do not publish a full and detailed list of all their holdings, and their shareholding authority when proxy votes are taken into account cannot readily be ascertained. This relationship with companies, begun through the lack of a developed capital market with the growth of German industry restarted after the First World War, remains close: the German "composite" banks thus fulfil within their capabilities the functions of the clearers, merchant banks, and, to a large extent, the institutional shareholdings. By virtue of this multiplicity of interest, major German companies enjoy a consistency and unity of support from the financing sector which enhances their competitive versatility and tolerance of risk.

4 The Federal Government has major shareholdings in a considerable number of assorted types of companies. The State owns, for example, 40% of the holding company Veba AG which is the third largest European company by turnover with interests in chemicals, electricity and transport. A more noteworthy feature, however, is that the Länder have major industrial holdings, some of which are controlled directly and others of which are controlled by the local state banks (Landesbanken). This close involvement of the state at the regional level with banks and companies is a special feature of the German economy, and its significance derives from the strong autonomy of the Länder, who, for example, have effectively unimpeded authority to dispose of 40% of all tax revenues. The Landesbanken typically provide 50% of the commercial finance for overseas projects, eg a recent report instances

a coal gasification plant being built in Mexico, with a total cost of $120m, $100 million of which was put up by the North West Rhine and Westphalia Government, and the remaining $20 million by Lurgi. Combined with the power and shareholder involvement of the banks, the total financing environment provides a highly effective means of promoting economic aims and channelling Government (Federal and Länder) support, adding up to a flexible and opaque structure of assistance to industry. Finally, German industry is well supported by its Chambers of Commerce which help to focus industrial market effort and which benefit from a statutory levy.

5 German project firms, particularly in heavy engineering, are generally bigger than those in the UK. Siemens and AEG-Telefunken (electrical engineering contractors and manufacturers) had 1979 turnovers of £6.7 billion and £3.4 billion compared with GEC's £2.5 billion. German project firms sometimes form part of conglomerates. Thus Mannesman (pipe mills and steel processing firm) includes Demag, and Metallgesellschaft (non-ferrous metal plant) includes Lurgi; their 1979 turnovers were £3.0 billion and £1.9 billion respectively compared with BSC's £1.5 billion and Davy Corporation's £0.6 billion

Government Involvement

(a) Export Credit and Insurance

6 This is made available through two Government-backed private companies (Hermes and AKA) and one public company (KfW). AKA and KfW are both able to provide a limited amount of domestic finance for projects at slightly below market rates. German exporters and their banks carry a higher risk factor than their French, Japanese or UK competitors. In 1980, German officially supported export credits covered only 14% of total exports (UK 35%), but cost $2.5 billion (UK £1.2 billion), implying a much greater concentration than in the UK.

(b) Aid

7 The German aid budget, while lower as a percentage of GNP is substantially larger in money terms than the UK's: in 1979, disbursements were £1.6 billion compared to £1.0 billion for the UK. Government policy is to increase the aid budget at a rate of at least double that of Federal expenditure as a whole in the period to 1983. Germany formally ties a smaller proportion of its aid than its major competitors, but this has to be seen against the fact that specifications in DIN narrow the scope of compliance in favour of German companies. Otherwise, their formal criteria for aid cover the span of developmental and commercial considerations.

8 While political reasons are a major factor in determining the direction of German aid expenditure, the exploitation and safeguarding of raw material supplies is very important. There is also evidence that the Germans systematically subsidise particular industries from their aid programme. For example, projects above a certain size are examined by a group comprising representatives of the industry concerned, including the trade unions, which decides where aid can be used most effectively. Also, in 1976 part of the aid budget was earmarked for purchases from the German shipbuilding industry. In 1978 this was broadened to include measures which are "also of structural, employment generating and conjunctural benefit" to the domestic economy; overseas projects could be included in this. The ceiling for this special allocation was 15% of aid commitments in 1978: about £120 million.

(c) Mixed Credits

9 While German aid disbursements in 1979 were less than twice the UK's, their offers of mixed credits (£260m) amounted to more than three times the

UK's (est. £80m). In 1980, however, the UK for the first time reversed this position with £230m in offers of mixed credit to Germany's £80m. German use of mixed credit seems to be mainly directed towards capital goods sales to developing countries and securing supplies of raw materials. German mixed credits generally have a grant element only marginally above 25%; there is then no Consensus requirement for prior notification. (An example was in 1979 when Siemens won the main Tunis urban railway contract worth some £90m with a financial package with a 24.3% grant element). They usually agree to mixed credits with a 15-25% grant element only in order to match.

10 An unusual source of mixed credit can be made available through the German Bank for Reconstruction and Development (KfW). Normally, KfW provides export credit by borrowing on the capital market and on-lending at fixed commercial rates, without any official subsidy. However, they can blend such borrowing with funds avanced from the European Recovery Plan. This Plan formed part of ths US investment programme after the Second World War and is administered jointly by the Federal Government and the German States. Its annual budget is equivalent to about £50m and it lends at a fixed interest rate of 4.5%.

(d) Military Aid

11 The Germans have been giving considerable military aid to Greece and Turkey for more than 10 years. This recently cost Vickers one substantial tank contract in Greece. Following NATO pressure, Germany made about £150m available to Turkey in 1980 for the purchase of Leopard tanks. For 1981 the budget is about £18m for Greece and £30m for Turkey. Other countries have also received German military aid. In 1979 for example it enabled Lursenwerft to undercut Vospers for the sale of four fast patrol boats in Kuwait.

(e) DEG

12 The German Investment Development Company (DEG) is a Government owned corporation established in 1962 to promote investment by German companies in developing countries. It is similar to the Commonwealth Development Corporation but places a much greater emphasis on industrial projects. In 1978, DEG's new commitments were £28m. This money is being increasingly used to give German industry a larger share of overseas mining projects. One example of their work was the announcement in December 1980 that they would help to set up six joint ventures in the Philippines in areas including engine manufacture, chemical plant, mining and telephone equipment manufacture.

13 In conjunction with this use of the DEG, the Government has further promoted investment in developing countries through a number of substantial tax inventives. These have enabled parent companies in Germany to defer for five years tax on any profits reinvested overseas. DEG money is also being increasingly used to give German industry a larger share of overseas mining projects. There is a special Government subsidy for mining exploration costs of up to about £15m in 1981 which is repayable if the results lead to investment.

Market and Sector Priorities

14 Although Germany has extensive coal deposits, the Government is concerned, like the Japanese and French, to secure supplies of raw materials, including oil. This largely explains the relative concentration of export promotion facilities and aid on South America, the Middle East and the USSR (gas supplies). They also attach priority to Turkey and North Africa.

15 As regards sectors, the Germans concentrate on all aspects of heavy engineering. They are very strong in the supply of railway equipment. The Government believes a growth area of particular significance will be energy saving equipment. There is also evidence that the Government attaches importance to steel plant and power generation projects.

USA

The main characteristics of the US projects industry derive from:

(a) A very large home market, with a disposition to order from domestic industry;

(b) The existence of major contracting enterprises such as Bechtel and Fluor, who by virtue of a strong home base, often working for public utilities in some of the functions carried out by nationalised industries, have developed considerable financial strength;

(c) Large and well-diversified manufacturing companies, with well-established links to the main contractor/management companies;

(d) Apart from such links established through their internal market, in many export markets with a history of UK political involvement, local requirements tend to be couched in specifications favouring US suppliers.

2 The US Government, while formally eschewing specific support to companies for export projects, nonetheless is a past master at using political clout and the leverage of civil/military aid, to establish a presence for US exporters for major projects. In addition, where there have been major and massive federal programmes, whether space, defence or civil (such as the Federal Aviation Authority), their manufacturers inevitably have a major advantage. They are arch lobbyists in fora which are decisive to future international standards eg ICAO (where they have consistently won in competition for adopted designs - most recently for blind landing at Plessey's expense) and NATO.

3 Consequently, where large scale and advanced technology are dominant, US firms are very strong competitors. By value of contracts won by constructing companies in 1979, US firms occupy first, third, fourth and sixth places in the world. The largest, Fluor, won $4.4 billion on this basis compared with the $2.1 billion won by Davy, its main UK rival and fifth in world ranking. An important structural difference is the capability of such US firms to provide the complete range of design, management and finance services required for large projects.

4 The sectors in which the American project industry is especially strong include process plant (especially oil refineries), telecommunications (especially those involving satellites), airports, power generation and railways. The market priorities and performance of US project firms are to a considerable extent influenced by American foreign policy. US firms won substnatial project business in the Middle East (especially Saudi Arabia) in 1979 (at 17% of the total, only slightly less than Japan) but the value of contracts fell by a third in 1980, reflecting in part changes in American foreign policy in the region. Similarly, there are special embargo prohibitions on the sale of high technology to the USSR, Cuba, etc which inhibit their companies from some categories of capital projects. Finally it should be mentioned that the US projects industry is critical of the support it receives from Government and of restrictive legislation. If some of these disincentives to export were removed the industry would become an even more effective competitor.

5 There is a system in the USA under which a domestic manufacturer can establish a wholly owned subsidiary for the exclusive purpose of exporting known as a domestic international sales corporation (DISC). Such corporations enjoy deferral of corporation income tax, and the net effect is to reduce tax on profits by some 25%. In 1978 the Administration announced the intention of phasing out the DISCs system, but this was not accepted by Congress and no further action has been taken. There is evidence that this system is an effective export subsidy, and it continues to be strongly criticised in the GATT by the Community and others on these grounds.

6 US firms in Saudi Arabia benefit considerably from the unique role played by the US Army Corps of Engineers to plan, commission designs, evaluate bids and award construction contracts for armed forces instalment on behalf of the Saudi authorities. Projects completed under the Corps's supervision have cost £470 million, £3,000 million are at the proposal or design stage. The Corps handles this work as the main contractor and receives payment in advance, thus avoiding the cost and risks involved in payment by instalment. Design and engineering work is contracted exclusively to US firms and although construction work is put out to international tender, US firms clearly benefit from the prior involvement of the Corps and US consultants. There are indications that the Corps is establishing a similar position in Oman.

7 The Export Import Bank (EXIM) provides direct financing, normally up to 55% of the contracts but occasionally for 100%, and insurance to the project industry. There is a tendency to deploy extended duration of loans as a mechanism for winning business, but exchange risk and cost escalation cover are not available. The US Government is a strong advocate of the Consensus, and hence adopts an aggressive attitude against mixed credits. The US have declared their intention to match French offers of mixed credit through EXIM long-term soft finance. This helped them win a £30 million locomotive contract in Mexico earlier this year against French, UK and Japanese competition. Although the US maintains a substantial aid programme, its objectives seem to be predominantly political, and the general pattern of bilateral aid is determined by internal US pressures. Financial assistance towards the pre-contractual expenses of US firms is available on lines similar to that provided by DoT.

8 The original Reagan proposals for EXIM implied a 31% reduction in loans for 1982/83. But there have been indications that, in response to strong corporate pressure, this kind of dramatic cut-back may not be implemented. It is moreover, the view of our Embassy in Washington that the original EXIM proposals are more vulnerable to amendment by Congress than most. The industry's export prospects may therefore not be significantly affected. The proposals for the aid programme in 1982/83 on the other hand are for a $200 million increase. As indicated above the US projects industry is unlikely to be a major beneficiary, but there are also indications that the Americans will shift the balance towards more bilateral and less multilateral aid which might work to the advantage of the industry.