



Foreign and Commonwealth Office

London SW1A 2AH

27 July 1982

Prime Minister

Content that I should write
to the Chinese Ambassador in the
terms attached?

A.J.C. $\frac{19}{7}$

Dear John,

Chinese Ambassador's Dinner for the Prime Minister: Letter on
Subjects Raised

In your letter of 13 July to John Holmes you described a tete-a-tete conversation the Prime Minister had with the Chinese Ambassador when she dined with him on 12 July. The Ambassador raised three points which the Prime Minister undertook to look into.

- (a) the possibility of a soft loan for China;
- (b) the difficulty of a "tax" imposed on defence sales;
- (c) subjects which the Prime Minister would wish to raise during her visit to Peking in September.

You asked for a draft letter setting out what we were able to say to the Chinese Ambassador on these topics. I attach such a draft, which Sir Antony Acland has suggested would perhaps go better from you than from the Prime Minister herself.

The major question raised by Mr Ke is of course the possibility of a soft loan, proposed by Sir Y K Pao in a number of meetings with Ministers over the last few months. We considered this in March after he had approached Lord Carrington. It was generally concluded that there would be great difficulties whether the money came from Britain or, as Pao has also suggested, Hong Kong. The matter has now been looked at again, in the light of Pao's latest call on the Prime Minister. Our conclusions, with some of the arguments, are contained in an ODA letter you will have received which was commissioned separately and which sets out where we stand on aid to China in more general terms. The conclusions on the soft loan are generally although not entirely negative. In these circumstances we do not think that in replying to the Chinese Ambassador we can go beyond the limited formulation in the attached draft.

/The proposed



/ The proposed reply to the Ambassador on his other two points is self-explanatory. For your own information I attach a background note prepared by the Ministry of Defence on their commercial exploitation levy, the defence sales tax referred to by the Ambassador.

Yours ever,

A handwritten signature in dark ink, appearing to read 'Francis Richards', written in a cursive style.

(F N Richards)
Private Secretary

A J Coles Esq
10 Downing Street

SR 11 (Revised)

DRAFT: minute/letter/teleletter/despatch/note

TYPE: Draft/Final 1+

FROM:

A J Coles Esq

Reference

DEPARTMENT:

TEL. NO:

SECURITY CLASSIFICATION

TO:

Your Reference

- Top Secret
- Secret
- Confidential
- Restricted
- Unclassified

His Excellency Mr Ke Hua
 Ambassador of the People's Republic
 of China
 31 Portland Place
 LONDON WIN 3AG

Copies to:

This letter will do. Clearly we need advice for Trade & will recall with pleasure Mrs J and will

PRIVACY MARKING

SUBJECT:

.....In Confidence

The Prime Minister has asked me to thank you and

CAVEAT.....

~~Madame Chang Ming for your generous hospitality on 12 July. She greatly enjoyed the occasion both as a prelude to her forthcoming visit to China, to which she is keenly looking forward, and as an opportunity to talk with you, see old friends and make some new ones.~~

need someone with Jan write note not

Her Majesty's Ambassador in Beijing has been instructed to convey to your government on his return to Beijing certain views about the question of Hong Kong.

I understand that you asked the Prime Minister about the subjects she hopes to discuss with the Chinese leaders during her visit in September. As she explained, she hopes for an exchange of views on current international and bilateral matters including the future of Hong Kong and our trade relations. As the international situation is changing so rapidly, it is probably best to leave more detailed consideration of the agenda until September, when the matter can again be raised through the diplomatic channel. However, if the Chinese side has any specific proposals to make, we would be happy to consider these at any time.

Enclosures—flag(s).....

I understand that you also raised two particular

questions with the Prime Minister. ~~These have been looked into and she has asked me to write to you to explain the position on each.~~

You asked about the possibility of a 'soft loan' which Sir Y K Pao and others have raised with the British Government. The Government would very much like to increase the British contribution to China's modernisation programmes, but a soft loan poses problems for us at present. Export credits, supported by the Export Credits Guarantee Department (ECGD), are already offered at concessionary rates of interest in accordance with the OECD consensus. Further softening of these could only be financed by an additional claim on public spending and you will know that it is a fundamental principle of the Government's current strategy that public expenditure must be held down. Only in this way can we restore health to the economy, an objective which is not only in our own interests but that of the world economy generally. I regret that this consideration precludes the kind of major new commitment in China that has been envisaged.

I should however add two points which offer some mitigation. First, Britain welcomes the aid programmes which multilateral agencies such as the World Bank and UNIDO are pursuing in co-operation with the Chinese Government. We make major contributions to support these agencies in their work. Second, I do not exclude the possibility of an increase in our programme of technical and cultural exchange with China, which would be a further contribution to the relationship between our two countries.

This would do. - we have a clause which enables us to match other loans - which we are able to do.

/You also

You also enquired about a Government tax in connection with negotiations for the Luda destroyer refit. I believe that you were referring to the commercial exploitation levy which is imposed on sales of equipment where the research and development costs have been borne partly or wholly by public funds. This levy applies to much of the equipment involved in the Luda refit project.

This seems ridiculous if we want the business the more open to be adjusted to take account of the very serious work.

While negotiations on price must remain a matter between your Government and British industry, the British Government are prepared to consider constructively how, in the special circumstances of this project, the levy might be reduced or waived in the interests of securing a settlement satisfactory to both parties.

The Prime Minister is aware of the importance of this contract, not only commercially, but as a milestone in the relations between our two countries in the defence field. She very much hopes that it will soon be successfully concluded.

Thank you again for a memorable evening.



Ministry of Defence Note on Commercial Exploitation Levy -
Project 051

The policy governing the commercial exploitation of equipment developed with HMG funding has been laid down by the House of Commons Committee of Public Accounts. Under this policy sales of such equipment to other countries are liable to a levy, the standard rate for which is 7½% of the sale price.

In the case of Project 051 (refit of two Chinese Luda destroyers), much of the equipment associated with the Sea Dart system is subject to this levy, and prices quoted by British Aerospace include the amount which British Aerospace and their sub-contractors would be required to pay to HMG following successful negotiation of a contract. The other main contractor, Vosper Thornycroft (UK) Ltd is also affected, but only marginally.

The cost of the levy to the Chinese is currently assessed at about £3.5m. We would be prepared, subject to Treasury concurrence, to waive this charge if, as a result, contract prices could be agreed with the Chinese. The gap at present is, however, much wider at some £24.5m of a total quoted by our contractors of £126m.

/The normal



The normal UK practice, where the application of levy is likely to lose UK contracts, is not to grant total waiver but to substitute for the standard rate of levy a profit sharing arrangement under which the return to HMG is dependant on the profit outturn obtained by industry. On this programme UK industry believes it must seek a net return of 10%, a figure with which MOD would not disagree.

We are now seeking to establish that the contractors would accept in principle the profit sharing alternative, after which we would hope to construct a formula which would satisfy their requirements, be acceptable to the Public Accounts Committee, and provide for HMG to share profit, but only if the 10% profit target is exceeded. If this is achieved, it will be possible to reduce the price sought from China by the £3.5m referred to in paragraph 3.

If the contractors refuse to accept profit sharing, the only other course would be abatement or waiver of the levy by the Treasury, but it will be hard to persuade Treasury that industry has played its part in reducing prices if the profit sharing proposals are rejected.