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Foreign and Commonwealth Office

London SW1A 2AH

1 July 1980

Prime Minister (2)
mt *mt*
Dear Michael,

Indo/Soviet Arms Deal

Your letter of 3 June asked why, if the Indians are prepared to spend some \$1.6 billion on buying weapons from the Soviet Union (albeit provided by loans on favourable terms), we should continue to provide them with aid on the present scale.

The recent arms deal with the USSR is large. Agha Shahi told us that he felt that the cost of the items being supplied if purchased in the West would be some \$8-10 billion. This is certainly too large a figure, but the Soviet terms are so soft that, in comparison with commercial market terms, the sale amounts almost to a gift. There was thus a strong inducement to the Indians to complete the agreement.

We would normally consider defence expenditure as an argument against a substantial aid programme only if its level was more than could reasonably be justified or if the recipient was regularly accepting subsidised sales to the exclusion of British manufacturers. Neither of these considerations applies to India. At 3.2% of GNP, Indian defence spending is not out of line with comparable developing countries; and India is continuing to maintain a balance between weapons supplied from the Warsaw Pact countries and from the West. We ourselves have sold substantial quantities of armaments to India and are actively seeking opportunities for further contracts.

There are strong commercial considerations in support of the aid programme. Over the last three years we have used aid to support a major effort to interest British industry in India after a period of indifference and neglect. We have had a distinct measure of success. British exports to India at £456 millions for 1979 were 31% up on 1978 (these figures do not include arms sales): more than to the Soviet Union and considerably more than to China. Following the aid policy review we are giving greater weight to British commercial and industrial (as well as political) benefits in allocating aid and India is a strong contender on these grounds. It is a condition of all British aid to India,

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M O'D B Alexander Esq
10 Downing Street

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other than that provided under the RTA (Retrospective Terms Adjustment) Debt Relief Agreement, that it is spent on the purchase of British goods and services, and aid has secured contracts for British supplies which they would not have won otherwise. There are examples of this in the power generation, coal, steel and process plant sectors of the UK economy. The Indian coal mine mechanisation programme is a particularly good example. British firms have won orders for long wall mining equipment which we believe will assist them to establish themselves in the expanding market in India and to win further contracts on commercial terms. We are also hopeful of securing a £1 billion steel plant contract for which the Davy Group is bidding (the Prime Minister recently sent Mrs Gandhi a personal message supporting the Davy bid) and financial support for this is on offer from the aid programme.

In terms both of need - a per capita income average of £75 p/a - and effect use of resources - a consistently high level of actual disbursements - India has for many years been regarded by the principal donors in the West as a suitable recipient of substantial aid. In 1979/80 gross receipts from all Western sources (including the World Bank) amounted to \$1,739 million, of which Britain, the leading bilateral donor, provided 13.8% (£121 million). However, in terms of per capita receipts India, which contains more than half the world's poorest people, receives considerably less from all sources, including Britain, than nearly any other developing country.

There are also political reasons for maintaining a significant level of aid. Indian relations with the United States are poor: an effective bilateral relationship between Britain and India is important to the West, not least in the context of the Soviet invasion of Afghanistan. Our aid programme is seen by Mrs Gandhi's government as one of the touchstones of the Indo/British relationship as a whole. The Indians accept that the overall level of British aid is a matter for the British Government to decide, and have accepted the cuts so far made with good grace. However, they are apprehensive that a further cut in British aid to India would have an adverse effect on other bilateral donors - the Governor of the Indian Reserve Bank recently mentioned Indian concerns to the Chancellor of the Exchequer. Any further reduction in the Indian share of the reduced British bilateral programme would be seen by Mrs Gandhi as discriminating against India and against her government in particular; and as evidence of our downgrading Indo/British relations. It would be contrasted with our increased programme of aid for Pakistan. Cuts in aid to India by other aid donors, many of whom like us face constraints imposed by domestic economic problems, could then be blamed on us.

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In such matters Mrs Gandhi has shown in the past that she is often swayed by her feelings rather than by sound economic and political analysis. One cannot of course quantify the political effect of a further cut in our aid programme. But in present circumstances it would be better to avoid actions which might finally drive her from her position of comparative balance between East and West into a significantly closer connection with the Soviet Union.

Partly because of the political merits of the other competing claims (such as Zimbabwe, Turkey and Pakistan) the India programme has already borne a considerable share of the reduction in our global aid. The £121 m which we expect to spend this year and the £87 million proposed for 1981/82 are respectively 26% and 51% less in real terms than the £135 million provided in 1978/79. These figures cut projected expenditure to little more than inescapable forward commitments. Other considerations aside, Ministers here feel that to go further than is currently proposed in reducing the India aid programme would give rise to serious presentational difficulties and would prejudice our own political and commercial interests.

I attach a breakdown of our present aid programme to India as background to this letter.

yours ever
Roderic Lyne

(R M J Lyne)
Private Secretary

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