United States General Accounting Office

GAO

Testimony

For Release On
Delivery
Expected At
9:30 a.m. EDT
Tuesday
May 16, 1989

EXPORT CREDITS:

The Effectiveness of the 1987 Agreement To Control The Use Of Tied Aid Credits Under The Arrangement On Guidelines For Officially Supported Export Credits

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Before the
Subcommittee on International Development, Finance, Trade and Monetary Policy
House Committee on Banking, Finance and Urban Affairs

138630

GAO/T-NSIAD-89-33

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

I am happy to be here today to discuss with you our review of the 1987 agreement between industrialized countries to control the use of tied aid credits, a form of subsidized export financing. Our review was undertaken at the request of your Subcommittee.

This agreement is the latest in a series of improvements of the Arrangement on Guidelines For Officially Supported Export Credits. The Arrangement is followed by 22 of the 24 developed nations that belong to the Organization for Economic Cooperation and Development (OECD). The Arrangement was adopted by these countries in 1978 in an attempt to neutralize export financing as a competitive factor in international trade.

During our review, we looked at how the agreement is working and whether there are indications that it is discouraging the use of tied aid credits. We examined at the Export-Import Bank over 1400 notifications of concessionary financing offers originating from 16 countries between 1987 and the first 9 months of 1988. The largest number of offers, or about 60 percent, were sent by the United Kingdom, Germany, the Netherlands, Italy, and Spain. These notifications are an indication of the potential contract value of tied aid credit offers and do not represent completed transactions.

We also solicited the views of U.S exporters who believe they are adversely affected by the use of tied aid credits by foreign competitors. We talked with officials of the U.S. agencies involved in this issue as well as officials of the OECD in Paris. We also interviewed representatives of 25 private sector corporations and industries affected by foreign tied aid credits.

REDUCING COMPETITION IN CONCESSIONAL EXPORT FINANCING THROUGH THE ARRANGEMENT

Major OECD countries use tied aid credits to carry out their aid programs. Tied aid credit is the practice of providing subsidized export credits linked to the purchase of exports from the donor country. A consequence of this approach to development assistance is that it tends to blur the distinction between development aid and commercial trade.

The aid programs of many OECD countries focus primarily on major infrastructure projects. Such projects tend to involve the purchase of high value capital equipment in industrial sectors, such as telecommunications, rail transportation, power generation, earth moving, and computers. U.S. exporters in industries in which competitors offer substantial tied aid packages are at a disadvantage. The U.S. government does not support U.S. exports with a comparable tied aid credit program, therefore, U.S. exporters cannot match the concessional tied aid financing packages offered by foreign competitors. Further, once a country has made initial sales of infrastructure equipment, it tends to have an advantage in selling parts and services needed to sustain this equipment.

The United States largely abandoned capital projects in 1973 in favor of more basic human needs in areas such as agriculture, health, nutrition, and education in order to serve the most urgent developing country needs. This emphasis on basic human needs does not lend itself to the support of high value infrastructure equipment exports.

The general policy of the U.S. government is that it is not in the export subsidy business. The major exceptions to this policy are agriculture and military exports. The U.S. government believes that other countries have often used development aid funds to provide subsidized financing for exports which should have competed on a commercial basis. In fact, the level of aid in some cases was so low as to make it difficult to distinguish between the aid and an aggressively financed commercial sale. The U.S. government has responded to the tied aid credit problem by seeking to get rid of, or at least reduce, the use of export credit subsidies through negotiation of international agreements.

U.S. government efforts in the middle 1970s resulted in the Arrangement on Guidelines for Officially Supported Export Credits which became effective on April 1, 1978. It was the start of a process to raise interest rates on government-provided export credits to market levels. The Arrangement specified a matrix of minimum interest rates and maximum repayment periods for most categories of exports sold with government provided credit of 2-year terms or longer. Importing countries were classified into three categories: (1) relatively rich, (2) intermediate, and (3) relatively poor. The poorer the importing country, the lower the permissible interest rate and the longer the permissible credit period. However, the Arrangement allowed for exceptions for tied aid transactions with a certain minimum amount of grant element, originally set at 15 percent.[1]

In another initiative, the United States and 29 other countries, including all OECD members, entered into the International Agreement on Trade-Distorting Subsidies under the auspices of the General Agreement on Tariffs and Trade. The Subsidies Agreement, effective January 1, 1980, required greater member restraint in using export subsidies. Among other things, it prohibited the use of government-subsidized export credits to gain a trade advantage but provided an exception for export credit practices that were in conformity with the OECD Arrangement. Thus, export credit subsidies that violate the terms of the Arrangement would also presumably violate the Subsidies Agreement, making available related remedies.

In 1982 the Arrangement was strengthened when the participants agreed not to extend tied aid financing that had a grant element of less than 20 percent. The aim was to further separate true

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[1]The grant element in a loan is defined as the difference between the original face value of the loan and the discounted present value of the debt service (computed using a 10 percent annual discount rate). The grant element is typically expressed as a percentage of the original loan.

commercial export credits, which have no grant element, from true development aid, which they believed should generally have a relatively high grant element. The thought behind raising the grant element for tied aid credits was that a higher grant element would make less likely that such credits be extended for the purpose of improving the competitive position of a commercial transaction.

In October 1983, the OECD countries also agreed to automatically revise minimum allowed interest rates every 6 months to reflect changes in market rates. However, progress in reducing or eliminating interest subsidies in official export financing was accompanied by a reported increase in the use of tied aid credit, i.e., concessionary financing in the form of a package of development aid and export credits. The United States was concerned about this because it did not have a comparable program. The U.S. response was to press for even higher minimums for grant elements to make the practice even more expensive.

The United States argued that the tied aid credit practice should be limited or even eliminated. This argument was made, however, at a time when the economic circumstances of many developing countries were deteriorating. Many debt burdened countries curtailed their imports of manufactured goods from OECD countries. This caused a concentration of competitive activities in a relatively small group of financially sound countries. According to the U.S. Export-

Import Bank, whenever OECD countries suffered a downturn in their economies, they used tied aid credit offers to stimulate exports to developing countries. Furthermore, aid recipient countries demanded and received soft financing as a condition for participating in major projects, and these markets became known as "spoiled." For U.S. exporters, this meant, in some cases, that they were shut out of the market.

The U.S. government introduced proposals to the OECD countries in 1983, 1984, and 1985 to raise the grant aid element to make mixed credits and other forms of tied aid more costly to the country offering it. These proposals led to an agreement to exclude tied aid credits from the aircraft and nuclear power sectors.

In April 1985, the OECD countries agreed to two changes in the Arrangement regarding tied aid. The minimum grant element for tied aid credits was increased from 20 to 25 percent, and a required 20 working-day prior notification of the intent to offer tied aid or a mixed credit with a grant element below 50 percent was adopted.

In 1986, the European Community countries adopted a negotiating approach which included (1) raising the minimum grant element for tied aid and mixed credits to most countries from 25 to 30 percent by July of that year and to 35 percent one year later, (2) raising the minimum grant element to 50 percent for a small number of least developed countries, and (3) banning tied aid financing to the richest developing countries; however, agreement on the three changes was conditioned on reaching agreement to also change the method of calculating the grant element. Instead of using a standard 10-percent discount rate to compute the value of the aid component, each country would have a different rate based on its government's cost of borrowing funds in the capital market.

Several countries with market interest rates lower than 10 percent opposed the European negotiating position, because the cost of a tied aid offer conforming to the Arrangement would be more expensive under these new rules. According to the Eximbank, it was recognized, for example, that applying a discount rate of 7.5 percent or less to a country's tied aid offers, would make it more costly to reach a minimum grant element level of 35 percent than to reach a level as high as 50 percent under the original method using a 10 percent discount factor. The United States favored the proposed changes but stressed the need for a minimum grant element level higher than 35 percent.

The War Chest

In October 1986, the Congress authorized a 2-year, $300-million War Chest in Eximbank to strengthen the U.S. negotiating leverage with OECD countries. The Congress made available $100 million of the War Chest for fiscal year 1987 and $110 million for fiscal year 1988.

For fiscal year 1987, the War Chest was used to target countries which impeded the OECD negotiations. The U.S. strategy was one of attempting to spoil a market or transaction of particular importance to the French or the Japanese, the two countries who did not want to agree to a new tied aid agreement. The United States would "overmatch" or outbid these countries (which had already offered a tied aid credit) by offering higher levels of concessionality. In November 1986, Eximbank announced two highly concessional lines of credit, funded from the War Chest, of $100 million each to Indonesia and Thailand, two countries where U.S. high technology export sales had been lost because of foreign government concessionary financing arrangements.

According to the Treasury Department, this aggressive policy had a major impact on the OECD negotiations and contributed to reaching the March 1987 agreement described below to increase discipline over tied aid credit practices. By March 1987, all of the governments participating in the OECD Arrangement agreed to accept a two-step proposal which would raise the minimum grant element level to 30 percent on July 15, 1987, and to 35 percent on July 15, 1988; make changes in the calculation of the grant element on those two dates so that by July 15, 1988, market rates would become the dominant factor in calculating the discount rate for each currency.

The successful negotiation of the tied aid credit agreement in March 1987 changed the operating environment significantly. While the War Chest, according to the Treasury Department, was still needed, its role had changed. It was no longer needed as a weapon targeted at countries which impeded negotiations. The new agreement was viewed as removing the rationale for using the War Chest to "spoil" certain markets or transactions.

However, Treasury believed it was still needed in fiscal year 1988 because of (1) the relatively long period before the agreement would be fully implemented, and (2) a grandfathering provision in the agreement which allowed non-conforming tied aid credits as late as July 1990. In this environment, it was felt that the War Chest needed to be transformed into an aggressive mechanism to encourage early and full implementation of the tied aid credit agreement. Eximbank used only $7.6 million of the available $110 million in fiscal year 1988 to ensure implementation of the new agreement.

NO INDICATION OF DECLINING TIED AID OFFERS

The effect of the March 1987 agreement on tied aid credit offers is being studied by the U.S. government and the OECD. Preliminary information obtained from OECD officials in December 1988 indicated that the bulk of the offers since July 1988 were around a 35 percent level of concessionality, rather than the 25 or 30 percent levels of preceding years. However, the preliminary data also seem to indicate that tied aid credit offers have actually increased.

The increased grant element in offers indicates that the United States has had some success in making such transactions more costly to the donor country and sharpening the distinction between aid and commercial export financing. However, the increased level of tied aid offers reported under the notification system offers little support to the U.S. expectation that higher minimum grant requirements would lead to a reduction in such practices.

The increase in reported tied aid offers may be a reflection of several possible alternative circumstances. First, it may only reflect greater adherence to the agreement's reporting requirements. Second, it may reflect donor countries' continued willingness to subsidize exports even with the more costly requirements of the agreement. Finally, the increased volume of offers may reflect reduced market opportunities in which tied aid offers compete. That is, according to OECD officials, member countries may be flooding the market with offers in hopes of connecting with the fewer procurement opportunities available in cash-short developing countries. In recent years, many countries have extended offers that greatly exceed the value of funds eventually committed.

According to OECD officials, when the agreement is completely implemented, it is likely to sharply increase the costs to participant governments of extending tied aid credits. This is believed to be true for all participants because the increase in the minimum permissible concessionality level will increase the proportion of aid credits or grants that enter into the "mix" of these credits. This effect will be even greater for those participants that use currencies whose differentiated discount rates are well below the old standard discount rate of 10 percent. As noted earlier, under the 1987 agreement, each currency has its own discount rate based on the OECD Commercial Interest Reference Rate for that currency.

The continued use of subsidized export financing even with the higher grant element is not surprising given the view of some OECD countries that tied aid credits are a basic and integral part of national export trade philosophy. It is likely, therefore, that some OECD countries will continue to offer concessionary financing, particularly in such industry sectors as power generation, extractive equipment, telecommunications, transportation, computers, and perhaps a few others. These sectors are viewed as offering opportunities to establish and expand market shares in a number of low and middle income developing countries and also providing a preferred position for sales of parts and services to support the original infrastructure facilities and equipment.

EXPORTERS STRESS NEED FOR U.S. MIXED CREDIT PROGRAM TO MEET FOREIGN COMPETITION

We interviewed a mix of small, medium and large U.S. exporters that believed foreign tied aid credit competition had cost them sales. Their consensus was that the government is largely responsible for their lack of competitiveness in certain markets because it does not have a tied aid credit program.

Most exporters supported the concept of the War Chest for use in selectively targeting a few donor countries prone to engage in predatory financing practices. They also believed that it was a useful negotiating tool to enforce greater discipline and transparency in offering tied aid credits under the OECD Arrangement. The exporters believed, however, that the United States needs to have a continuous and predictable tied aid credit program which U.S. companies can count on in planning their exporting strategy to compete in overseas markets. This need seems to be greatest in the five industry sectors which account for about 85 percent of tied aid support for capital projects. The sectors are power generation, extractive industries (mining and earth moving), telecommunications, transportation (locomotives and signaling equipment), and computers. The April 1989 Eximbank report estimated that annual export sales in these industries of between $425 and $785 million may have been lost because of tied aid credits between 1985 and 1988.

U.S. exporters we interviewed also stated that they had lost sales because of other countries' tied aid credit programs. However, not all losses could be documented. Some claims are largely of an anecdotal nature, that is, company officials account for lost sales from foreign tied credit offers either as a result of discussions held with the potential buyers or through information obtained from third parties. In other examples, it is not uncommon for an official government ministry to notify a U.S. exporter that it lost a sales contract because of concessional financing offered by another supplier, but the details of the transaction are not always revealed. This seems to be particularly true in some of the low and middle income developing countries, such as China, India, Indonesia, and Thailand, where concessional financing packages are expected and received. Often this expectation is made clear at the time of the requests for bids.

The extent to which U.S. commercial interests are harmed cannot be estimated by looking only at specific cases of lost sales. After a few rejected bids, U.S companies sometimes get discouraged and do not respond to requests for proposals. Companies cite the high cost of preparing bids as a reason for not competing if there is little expectation of being considered without a tied aid credit offer. In other cases, word is passed that exporters need not bid unless they plan to offer tied aid credits as part of the package. Additionally, some developed countries offer a developing country a line of credit which can be used for any number of projects included in a "shopping list". In some cases, this leads to a closed market for exporters of other countries because the bidding is by invitation only. Hence, in these circumstances, potential export sales are lost because U.S. exporters do not even make it to the starting gate.

In the absence of a U.S. tied aid credit program, some U.S. companies successfully compete with and overcome foreign offers of concessional financing to developing countries by sourcing both the product and the financing outside the United States. In the electric power generation and transmission, telecommunications, and locomotive industry sectors, U.S. companies with wholly or partially owned subsidiaries in Canada have been able to use these subsidiaries to fill sales orders and to obtain concessional financing packages from the Canadian government. U.S.-owned subsidiaries have benefited from Canada's Export Development Corporation, which has emphasized tied aid credit support for Canada's electrical and electronic products, transportation equipment, and power generation and transmission equipment.

There are obvious benefits in increased revenues to the corporations from this kind of operation. However, they are troubling because they lead to shifting production to, or siting new production facilities in, countries where a favorable tied aid credit program exists. This situation has an even greater long run impact when the initial sales lead to significant follow-on sales. This would be true in industries such as radio communications and railway signalling equipment, where large follow-on sales are common.

FURTHER AGREEMENTS NOT LIKELY SOON

The 1987 agreement, which was the sixth in a series to strengthen the Arrangement, did not fully achieve the U.S. objective of raising the concessionality level in tied aid credits to 50 percent. The 1987 agreement was largely a compromise package that has not satisfied every country. According to an OECD official, participants, such as the United States, that feel that tied aid credits distort trade competition and divert aid have not succeeded in completely separating export financing from aid. On the other hand, frequent users of tied aid credits have had to accept the higher cost of an increased grant element and, therefore, their use is more of a burden. However, there is no firm evidence yet that the 1987 agreement is leading to a reduction in tied aid use.

OECD and U.S. government officials believe that there is little prospect of an early resumption of negotiations to seek further discipline in the export credit arena. They note that the full impact of the 1987 agreement has not yet been determined and that many of the agreement countries believe that it represents an appropriate degree of transparency and discipline which was reached after some 10 years of extensive, often difficult negotiations. Some of these countries, particularly those whose aid programs focus on infrastructure projects, consider tied aid credits as an integral part of their trade philosophy and are likely to resist further constraint on the practice.

If the United States is to successfully pursue further negotiations on this issue, it must find a way to motivate other countries to return to the negotiating table. An obvious way would be to resume the tactics which helped to bring about the 1987 agreement, that is, to reactivate a large War Chest to provide a means to counter tied aid credit offers by offending countries in selected markets.

Mr. Chairman, this concludes my prepared statement. I will be happy to respond to any questions you may have.