Ch. II Competitiveness Framework
Section A: Factors Influencing Export Finance

THE PLAYING FIELD

This chapter examines the context within which the developed country official ECAs operate by addressing the multilateral rules governing official export finance, long-term trends affecting financing sources and more recent market developments.

The U.S. government is a Participant to the Arrangement on Guidelines for Officially Supported Export Credits, or the "Arrangement." Housed within, but not a formal act of, the Organization for Economic Cooperation and Development (OECD), these guidelines set the disciplines for official export finance and serve as the basis upon which member governments cooperate to minimize the use of government subsidies in export finance. A "gentleman's agreement," the Arrangement has been incorporated into European Union law and is referred to in the World Trade Organization's (WTO) Agreement on Subsidies and Countervailing Measures; if a WTO member country adheres to the interest rate (and related) rules of the Arrangement, its official export credits will not be considered prohibited subsidies[1]. Since the inception of the Arrangement twenty-five years ago, Participants have established disciplines related to market oriented interest rates, a harmonized risk differentiated fee regime, the use of tied aid and limitations on the length of repayment terms for officially supported credits, in addition to special sector agreements on ships, large commercial aircraft and nuclear power.

The U.S. exporting community has clearly benefited from Arrangement rules. The financing rules have succeeded greatly in leveling the competitive playing field, directing competition to the quality and price of the product and not the nature of the official financing package. However, while the multilateral export credit regime has increasingly codified the financing elements of official export credit support, that success has highlighted a fairly significant disparity in the application of public policy goals to official export credits.

Numerous sources have raised the profile of public policy issues within the ECA world, from the environment to the IMF's Highly Indebted Poor Country (HIPC) initiative, including local and international pressure from non-governmental organizations and international events such as the 2002 United Nations World Summit for Sustainable Development. The different missions and places of ECAs within governments (see Chapter 2, Section B) have led to vastly differing responses to such pressures from civil society. On one end of the spectrum, some ECAs, such as Ex-Im Bank, work under numerous statutory public mandates, and some ECAs, such as ECGD, are tied with inter-ministerial consultation on public issues. Conversely, other ECAs operate within governmental systems that more rigidly compartmentalize responsibilities. These ECAs provide export credit support in ways that could contradict or undermine goals supported by their own national governments in other fora. In other words, the multilateral export credit regime

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[1] The Arrangement has come under increased scrutiny by the WTO over the past several years in the ongoing Brazil-Canada aircraft disputes and in the Doha Round of the WTO. This has led the Participants to the Arrangement to undertake a redrafting of the Arrangement. See **Appendix E** for more information.

currently disciplines the financing elements of ECA support and assures a fairly level playing field. However, the absence of comparable weighting and less attention to public issues by guardian authorities tilts the playing field against those ECAs with public policy constraints

LONG-TERM EXPORT FINANCING TRENDS

Another important context for any evaluation of Ex-Im Bank's (or any ECA's) performance is that the stated role of ECAs has changed dramatically over the last couple of decades. As seen in **Figure 2**, official G-7 ECA activity is generally declining, and ECA financing of total national exports has dropped from 15%-20% to 3%-5% over the past two decades. Today, ECAs cede deals to the private market much more often than to each other.

Four key trends have been observed in the nature of export finance. The first major trend has been an increase in local import financing. As large banks' appetite for cross-border risk has declined with crises such as Latin America in the 1980s and Asia in the 1990s, local banking capacities in emerging markets have gradually expanded. The entrance of multinational banks has advanced this trend into emerging markets. With localization of banking markets, and globalization of banks, many traditional ECA markets have been wiped out, with China the most notable example.

A second key trend has been increased privatization in emerging markets. The sell-off of state enterprises in major utilities and infrastructure to private entities has resulted in an increased flow of foreign direct investment, displacing the need for traditional export credits as a source of capital for investment. Privatization has also expanded local capital markets by, for example, parceling out purchasing decisions in small enough chunks for local finance to digest.

Third, new players have entered the export finance market. Major exporters have established their own finance entities, while capital market participants have used structured finance approaches to mitigate the risks of lucrative projects in many markets. In addition, multilateral development banks have created programs to lend directly to private sector borrowers in emerging economies, while the private political risk insurance market has expanded. All of these players have reduced the need for ECA financing.

Fourth, the core ECA markets have stagnated. From the 1950s to the 1980s, as one group of core buyers graduated from needing ECA support, a new group would usually arise. In the 1990s, however, this pattern deteriorated, with the same group of countries remaining as the core ECA buyers but demand decreasing due to the aforementioned three factors.

This shift from being a core player to being a critical yet marginal player (e.g., in riskier markets or cases) has considerable impact on the operational effectiveness and efficiency of any ECA committed to being both a lender of last resort and a rule abiding member of the international community (e.g., OECD and WTO). In effect, the basic question facing ECAs today is how, within specific national policies and institutions, to structure programs and staff to both fulfill national missions and international responsibilities. For Ex-Im Bank, the pressing issue is how to be competitive (with the bulk of demand increasingly in riskier situations) and break even over the longer term (both institutionally and case-by-case). The variety of responses to this question across ECAs is one of the major competitive issues today and will likely be an ever more challenging factor in the competitive landscape in the years ahead.

TRENDS IN 2002: FOCUS GROUP DISCUSSIONS

This section summarizes the views shared by U.S. exporters and bankers at the focus group meetings on export finance trends.

The focus group members collectively painted a picture of a politically and economically volatile, somewhat unpredictable international marketplace undergoing considerable changes. If the U.S. export finance community is to compete, these trends will likely dictate changes in their strategies and business models. Globally, focus group participants explained that Ex-Im Bank financing continues to play an important role in supporting U.S. exports, especially for longer term, large amounts and in higher risk markets. In other words, ECAs generally are still viewed as the most reliable risk management tool available for the riskiest and most expensive transactions and projects. However, in less extreme circumstances, the risks associated with many of the emerging markets are increasingly considered acceptable to private sector financial intermediaries due to the development and implementation of more sound legal, accounting and financial systems.

In addition to private sector finance, an ever broadening menu of financing options exists for the U.S. exporting community, including multilateral development banks, such as the EBRD and the World Bank's IFC, and other ECAs, via market windows, untied aid and, to some extent, co-financing. These options reflect the trend toward greater globalization that continues to permeate virtually every industrial sector in the capital goods arena, with significant impact on the U.S. exporting community's strategic decisions. The exporters explained (with the lenders confirming) that the production of goods and services has shifted from a supply chain supported predominantly by U.S. components and semi-finished goods to processes characterized by vertical specialization. This involves the fragmentation of the production process over national boundaries and can take the form of: (1) a supply chain that is increasingly reliant on foreign parts that are incorporated or assembled here in the United States; (2) a supply chain that includes U.S. content but is produced offshore; or (3) sourcing that occurs entirely outside of the United States (primarily through a number of offshore production facilities of multinationals).

The exporters are regularly faced with decisions regarding sourcing options in the near term, in addition to the longer term issue of whether, where and when production locations should be established. In any event, many large U.S. multinationals, including the larger engineering and design companies, as well as a growing number of medium-sized corporations, have sourcing capabilities outside of the United States that they utilize when production and cost efficiencies dictate. Products that were formerly made domestically are now more an amalgamation of components from multiple sources, many of which are outside U.S. boundaries either because the United States no longer has a comparative advantage or the parts are simply no longer manufactured domestically. Hence, the multinationals have the ability to source either from the

United States a product that has relatively less U.S. content or to source from offshore production facilities with or without U.S. content.

Given the changes in production and sourcing options, financing options are being developed that align more closely with the newer business models. The major ECAs appear to be adapting to the more globalized approach to production and sourcing, accommodating exporter needs with relatively greater flexibility in foreign content support and the implementation of insurance co-financing structures (with the exception of ECGD) with other government and private sector export credit insurers. EDC is the most notable example in terms of foreign content flexibility, while the other ECAs have focused on their co-financing capabilities. The U.S. exporting community noted that the absence of co-financing agreements forged between Ex-Im Bank and other ECAs, combined with a less flexible foreign content approach, is undermining their ability to compete from the United States.

Overall, the exporting community considers Ex-Im Bank an essential partner in its competitive pursuit of global market share. However, as the pace of globalization continues to change the international landscape, U.S. businesses are changing their models in order to adapt and compete on the basis of price, quality and service. The new business models which U.S. corporations are being forced to adopt are characterized by multiple sourcing options and therefore require that export finance support be similarly aligned.

The convergence of an uncertain political and economic landscape, the materialization of more attractive emerging markets, and the globalization of production have together yielded an international marketplace in which official ECAs must redefine their role so as not to be marginalized. This redefinition is leading to a metamorphosis that began to emerge in the 1990s, with 2002 revealing ECA strategies characterized by the development of "precision-point" program features, such as local currency financing, designed to exploit untapped areas of opportunity.

SUMMARY DATA

This data was accumulated from a variety of public sources. Moreover, the individual ECA data probably contain transactions outside the definition of "official" export credit (e.g., market window financing).

A review of G-7 medium- and long-term export credit volumes from 1995 to 2002 suggests a slight recovery from 2001, when support dropped to its lowest level during the seven-year time period. The 2002 upturn of 3% still does not bring the G-7 activity up to the recent historical average of approximately $45 billion.

In any event, ECAs still play an important role, and, as the data indicate, Ex-Im Bank is solidly and consistently one of the top players in medium- and long-term support. It should be noted however, that aircraft plays an increasing role in ECA activity. For example, in 2002, 45% (or $3.8 billion) of Ex-Im Bank activity was attributable to large aircraft transactions alone. Support for aircraft was also a significant factor in the business activity levels for Coface, Hermes and ECGD. In fact, aircraft was probably 33% of all G-7 activity in 2002.

Figure 2: G-7 New Medium- and Long-Term Official Export Credit Volumes ($Bn)

	1995	1996	1997	1998	1999	2000	2001	2002*
Canada	1.9	2.8	5.1	4.5	4.1	5.2	5.5	5.0
France	10.5	6.6	6.6	8.4	5.4	4.5	4.1	6.4
Germany	9.8	13.6	11.3	8.3	6.7	9.8	5.7	5.4
Italy	3.3	1.2	1.7	1.0	1.6	2.6	0.7	2.5
Japan	13.7	10.2	11.3	11.9	14.9	18.5	16.1	12.0
U.K.	3.5	2.5	3.8	3.2	5.1	5.8	2.3	3.3
U.S.	7.8	8.0	9.4	6.6	9.4	9.6	6.8	7.7
Total G-7	50.5	44.9	49.2	43.9	47.2	56.0	41.2	42.3
U.S. % G-7	15.3%	17.8%	19.1%	15.0%	19.8%	17.2%	16.5%	18.2%

**Preliminary results*

Ch. II Competitiveness Framework
Section B: ECAs' Mission and Place in Government

THE CHANGING ROLE OF EXPORT CREDIT AGENCIES

An export credit agency's mission and its place in government determines its business strategies and practices and the extent to which public policies play an important role in its overall business model. Moreover, an ECA's ability to adapt to changing market circumstances is also heavily influenced by its relationship with its national government and the public goals set for it by its government and specific guardian authorities. While the OECD Arrangement codifies many of the terms that apply to official export credit support, individual ECAs have significantly varying degrees of freedom from broader considerations in pursuing their strategies to support domestic exports.

The next section analyzes Ex-Im Bank's mission and role in government and the resultant impact of this broader context on Ex-Im Bank's ability to respond to market pressures. Following the analysis of Ex-Im Bank is an overview of the context in which other G-7 ECAs operate.

EX-IM BANK'S MISSION AND PLACE IN GOVERNMENT

Ex-Im Bank is the official U.S. government export credit agency. Ex-Im Bank's mission and the parameters within which it is required to operate are codified in its Congressionally approved Charter (Export-Import Bank Act of 1945, as amended), which was most recently renewed during the summer of 2002 with the next expiry date of September 30, 2006.

Ex-Im Bank's core mandate is to provide export financing that is competitive with the official support offered by other governments. The public policy goal of this mandate is to enable market forces such as price, quality and service to drive the purchase decision, not government intervention or temporarily exaggerated perceptions of risk. This mandate effectively directs Ex-Im Bank to fill market gaps that the private sector is not willing or able to meet, namely competitive financing (e.g., interest rates and repayment terms) and the ability to assume reasonable risks that the private sector is unable to cover at a moment in time. Within this broad mandate, Congress has also mandated that Ex-Im Bank follow additional directives. The more significant mandates include:

- Ex-Im Bank should supplement, not compete with, the private sector.
- Decisions on transactions should be based solely on commercial and financial considerations, i.e., the finding of a reasonable assurance of repayment, with the exception of:
    - Environment;
    - Adverse economic impact on the U.S. economy; and
    - Various statutory and executive branch parameters.

All of these requirements have a public policy basis and tend to reflect the views of Ex-Im Bank stakeholders, such as NGOs, other U.S. government agencies, labor and financial intermediaries. Hence, Ex-Im Bank is required to strike a fine balance among multiple, sometimes competing, goals and objectives. At the same time, Ex-Im Bank is expected to provide the U.S. exporting community with financing that is competitive with officially supported offers made by our foreign government counterparts – counterparts that most often have fewer public policy constraints to evaluate when deciding whether to provide financing support. Thus, the formula with which to compare Ex-Im Bank's competitiveness against our major ECA counterparts is neither simple nor direct, including both quantitative and qualitative components, as embodied in public policy considerations.

THE MISSION AND PLACE IN GOVERNMENT OF OTHER G-7 ECAS

Each of Ex-Im Bank's G-7 ECA counterparts operates with unique goals and supporting strategies; hence, there is a spectrum of strategies and operating styles. Nevertheless, there are several broad motivational themes with which each ECA can be associated that helps in understanding the differences in levels of activity, products and focus.

Lender of Last Resort: Perhaps the only other G-7 ECA that compares similarly to Ex-Im Bank, in that its primary role is as a lender of last resort, is ECGD of the UK. ECAs with this focus tend to encourage the active participation of the private sector and step in only when taxpayer dollars are needed to meet market gaps. Moreover, lenders of last resort tend to assume a relatively higher level of responsibility for public policy goals as directed by their guardian authorities.

Private Sector Participant: The European ECAs, most notably Coface and Hermes (but also SACE), take on a private sector demeanor due largely to the fact that they are private entities that handle the medium- and long-term book of business on behalf of their respective governments. Driven largely by profit, the controls placed on and the risk profiles of their portfolios tend to be more restrictive (with country exposure limits), resulting in moderate risk-taking. Operationally, many of the European ECAs behave as private sector companies by taking advantage of the efficiencies associated with their private sector side. Finally, the assumption of public policy goals tends to carry less weight for these ECAs because of their narrow focus.

Banker for the Country: For various reasons the Canadian and Japanese ECAs tend to see themselves as the only international bank of any scale in their respective countries. This larger role in the implementation of national trade policy tends to be reflected in broader missions (e.g., national content on specific sales is less important) and more expansive responsibilities.