Ch. V Economic Philosophy and Competitiveness
Section A: Trade-related Tied and Untied Aid

INTRODUCTION

Tied aid has been a competitive issue for U.S. exporters (and the U.S. government) since the mid-1970s. At the core of the issue is a fundamental philosophical difference between the economic and aid philosophies of the United States and those of some of our major developed country competitors. Over thirty years ago, the United States concluded that it is bad economic and public policy to blend commercial and developmental objectives by using tied aid credits for capital goods. To bridge the fundamental differences between U.S. views and those of other governments, who believed that tied aid support for major infrastructure projects represented good development policy, the United States used the OECD to negotiate disciplines for the use of tied aid financing.

Accordingly, all Ex-Im Bank tied aid activity over the past two decades (from the mid-1980s War Chest to the current Tied Aid Credit Fund, or TACF) has been used strategically as leverage to create multilateral tied aid rules or enforce the letter (and counter any abuses in the spirit) of the rules.

The OECD tied aid rules have been instrumental in reducing tied aid by over half between 1993 and 2002, to an average of less than $4 billion annually (despite a massive increase in Japanese tied aid from 1998 to 2001). In fact, total tied aid in 2002 fell to its lowest level on record: $2.6 billion, an over 70% reduction from the level before the implementation of the tied aid rules (see **Figure 22**).

Nevertheless, many foreign tied aid programs are likely to continue, and many projects supported by these programs contain a significant portion of capital goods that may have commercial implications. As a result, some U.S. exporters that encounter such financing perceive themselves as uncompetitive, because Ex-Im Bank is generally unable to match tied aid offers for capital goods exports to developmentally-focused projects for which foreign tied aid is permissible.

DEFINITION OF THE VARIOUS TYPES OF AID

Official Development Assistance (ODA), or aid, is concessional financial support of which at least 25% is intended to carry no repayment obligations (i.e., contains 25% concessionality or grant element), and the vast majority of it (over 80%) is 100% pure grant. Aid from a donor government to a recipient developing country government normally supports either "general" uses (e.g., balance of payments support) or the purchase of goods and/or services (local, donor country and/or third country) necessary for the completion of an action or specific project. The latter (with the exception of some local purchases) is trade-related aid.

Trade-related aid may be either "tied" or "untied" to procurement from the donor country and can be provided in two forms: grants[5] or credits. However, because grants do not involve significant repayment obligations, they are not viewed as trade-distorting aid (see below) and are not subject to OECD requirements (other than notification).

Tied aid credits refer to financing that is developmental (not commercially viable projects or exports) and contractually conditioned upon the purchase of some or all of the goods and/or services from suppliers in the donor country or a limited number of countries. This type of aid falls within the OECD Arrangement rules. Using the Arrangement's financial measurement methodology, tied aid to developing countries must be at least 35% concessional, and tied aid to least developed countries must be at least 50% concessional.

Untied aid credits refer to financing that is **not** contractually conditioned upon the purchase of goods and/or services from any particular country. This aid currently falls under the OECD Development Assistance Committee (DAC) rules, which differ from the OECD Arrangement rules in that the DAC provides virtually no restrictions on untied aid use. Therefore, there is a "gray zone" between these two differing definitions (forms) of aid. The resulting ambiguity has often been used to advantage foreign untied aid donors.[6]

Trade-distorting aid refers to aid credits for which the motivation is largely (or significantly) connected to promoting the sale of goods from the donor government's country. Because tied aid credits by their nature can be trade distorting, strict OECD rules discipline their use. For example, it would be considered trade distorting to provide tied aid credits for projects that can service *commercial* term financing, including standard export credit financing. As a result, the Arrangement prohibits tied aid credits for such projects. The Arrangement also prohibits tied aid to countries with a per capita income level above $2,975, because they are considered to have ready access to market financing and official export credits for all types of projects.

By definition, untied aid should be non-trade-distorting, because it should be equally accessible by exporters from all countries. However, through influence exerted indirectly (e.g., through special procedures, required designs and specifications, promises of additional aid, political pressures, gratitude shown by the recipient, etc.), untied aid can become effectively tied while it escapes the Arrangement rules for tied aid. All such aid that is effectively tied must be considered trade distorting. No OECD Arrangement rules currently discipline the use of untied aid except those requiring confidential notification, although the U.S. has proposed such rules. The general lack of Arrangement rules governing the use of untied aid also provides the donor the ability to use very low rates of concessionality with its untied aid, thereby actually encouraging the use of untied aid for inexpensive trade promotion and distortion.

[5] Credits with a concessionality level of 80% or more are viewed as grants and are not considered trade distorting.

[6] DAC rules were developed decades ago. Currently, the DAC is discussing whether to accept a U.S. proposal to modify the DAC methodology for calculating grant element levels. The nominal level of grant element that qualifies as Official Development Assistance (ODA) must be 25%. However, current DAC methodology allows the real level of concessionality to be much lower than 25% (e.g., untied aid credits have been notified with as low as 9% real concessionality and theoretically could provide only 4% real concessionality).

U.S. GOVERNMENT AND EX-IM BANK POLICY

The United States favors aid that represents *bona fide* development assistance. The United States seeks to reduce (and hopefully eliminate) aid that is trade distorting. The U.S. position on this topic is driven by two long-standing objectives for aid:

- Minimize trade-distorting aid because it disadvantages U.S. exporters, i.e., redirects business away from U.S. and other suppliers whose products are superior in quality and price.
- Minimize trade-distorting aid because it is a misallocation of both international and developing country resources. Furthermore, it results in higher contract prices, a capital-intensive development bias, skewed technology choices and an increased debt burden.

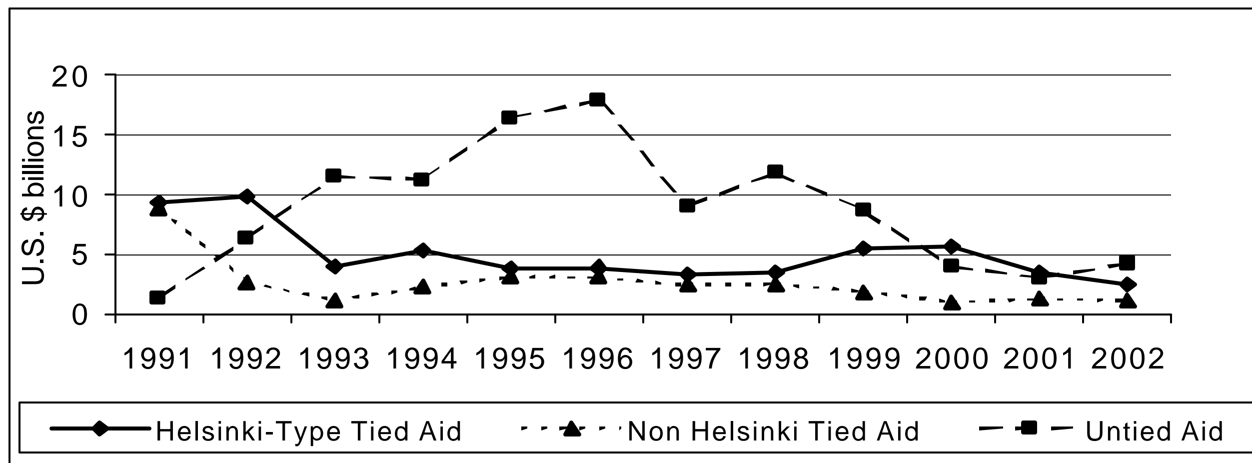
Consistent with long-standing U.S. export financing policy, Ex-Im Bank does not initiate tied aid. Instead, Ex-Im Bank and the U.S. Treasury Department work together to determine whether to match a foreign tied aid offer. The determination to match is made on the basis of largely objective criteria used to determine whether a tied aid match provides negotiating leverage for introducing new disciplines or is useful for enforcement of existing disciplines. The United States considers that tied aid used within the rules to gain a longer-term advantage for sales on market terms violates the spirit of the tied aid rules and should be matched.

ACTIVITY

Implementation of the 1991 OECD Helsinki Package of tied aid rules has greatly reduced the systematic use of trade-distorting tied aid (see **Figure 22**). In 2002, the total volume of tied aid credits reached a record low of $2.6 billion, which is less than one-fourth of the pre-Helsinki volume in 1991. The data support the success of the Helsinki disciplines in containing tied aid to a much smaller scale and to cases least likely to involve trade distortions.

However, the data (**Figures 22** and **23**) coupled with the belief by some governments that tied aid is a legitimate development tool also suggests that there is little chance that tied aid will be totally eliminated. In fact, tied aid that does not distort trade is acceptable development financing. The United States, however, believes that aid programs driven by commercial objectives undermine basic U.S. development goals, because such programs generate high levels of debt and debt service while not directly addressing basic poverty issues. Other governments have refined their approach to tied aid within the Helsinki disciplines and continue to allocate scarce resources to support their exporters where permitted. In fact, the number of Helsinki compliant tied aid offers notified has grown slightly since the start of Helsinki. Reflecting the sophistication of foreign countries' tied aid programs, 2002 marked the first year since 1992 that every notification was deemed compliant with the tied aid rules.

Figure 22: Aid Credit Volume by Type



“Helsinki-type” tied aid is subject to three principal disciplines: (1) no tied aid for commercially viable projects; (2) minimum 35% concessionality; and (3) country limitation (no country recipients with a per capita income above $2,995, but the figure may change annually as it is based on annual World Bank data; see **Appendix G, Annex 1**). OECD Participants determine commercial viability based on the nature of the project, a feasibility study presented by the donor, and, if needed, a “consultations” meeting held to discuss the commercial viability of the project if the feasibility study suggests commercial viability based on cash flows.

“Non-Helsinki-type” tied aid includes: stand-alone *de minimis* projects (valued at less than approximately $2.6 million), grants or near-grants (at least 80% concessionality) and partial grants (at least 50% concessionality) offered to the poorest countries (the UN declared Least Developed Countries, or LDCs). These types of aid are normally not considered to have serious trade-distorting effects and, therefore, are exempt from the Helsinki rules regarding commercial viability and the consultations process (although all tied aid is subject to notification requirements, and *de minimis* tied aid still has to meet minimum concessionality and per capita income requirements).

Figure 23: Notifications of Helsinki Tied Aid and Consultations Group Examinations

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Total
# Of notifications	137	151	273	226	212	195	191	213	182	155	166	2,101
# Of projects examined by Consultations Group	39	25	31	14	4	2	5	2	4	2	1	129
# Of projects deemed non-compliant with Helsinki rules (i.e., com'ly viable)	16	12	21	4	3	2	5	1	4	1	0	69*

*Of the 69 "non-compliant" cases (i.e., cases deemed commercially viable by the OECD Consultations Group), 19 were abandoned and 33 proceeded within Arrangement procedures or on commercial terms. The disposition of several cases is presently unknown.

Reflecting the twin factors of increasingly compliant tied aid offers from other ECAs and the continued absence of new tied aid negotiations, use of the TACF has been fairly minimal over the last five years. This lack of U.S. tied aid activity can be attributed to the fact that Ex-Im Bank's matching approach is generally used to either match (to deter) non-compliant foreign tied aid offers, which have been reduced to zero at present, or to create negotiating leverage to establish new disciplines (see **Appendix G, Figures G4** and **G5**). The FY2002 budget process rescinded more TACF resources in one year than Ex-Im Bank used in the previous five years combined. [Note: During 2002 there were no new tied aid authorizations. However, there were two amendments to existing tied aid authorizations that utilized $13.7 million ($7.0 million for Indonesia and $6.7 million for Morocco).]

For the past few years, the focus of U.S. concern has shifted to untied aid flows. The concern began in the middle of the past decade when Japanese untied aid peaked at over $10 billion per year, and there were a few clear episodes of effective (*de facto*) tying. Since that time the United States has been trying to get at least some (or comparable) tied aid disciplines applied to untied aid. However, these discussions have not produced any agreement because of the lack of consensus by the EU and Japan. The United States continues to believe that undisciplined untied aid remains a threat to the tied aid rules, because it provides all aid donors both the opportunity and incentive to shift tied aid to untied aid in order to circumvent the tied aid disciplines and distort trade.

EXPORTER AND BANKER VIEWS

Once the lightening rod for exporter and banker comments on Ex-Im Bank competitiveness, tied aid has garnered fewer comments over the past few years, and 2002 was no exception. Of the total survey respondents, less than half provided comments on tied aid. Only one third of the banks and two thirds of the exporters that responded assessed tied aid. None of the respondents cited untied aid.

The bankers generally did not consider tied aid to be a problem "except [when offered] by Scandinavian countries." However, two thirds of the exporter respondents indicated that they were dissatisfied with the overall competitiveness of Ex-Im Bank's tied aid policy. Echoing the views of other respondents one exporter said, "Ex-Im Bank can only react, not initiate tied aid." Another exporter expressed frustration by saying, "It is difficult to obtain tied aid support from the U.S.G…our perception is that Ex-Im Bank would not match any tied aid transactions and even if there is an intention for the Bank to do so, the process is lengthy involving other U.S.G. organizations such as OMB and U.S. Treasury." On balance, the exporting community commentary indicates that U.S. tied aid policy is perceived to be less competitive than that of its foreign counterparts.

CONCLUSION

In sum, several of the G-7 OECD Members have aid programs that initiate tied aid and operate within the international disciplines that were set forth in the OECD tied aid rules. The TACF (jointly overseen by Treasury and Ex-Im Bank) is clearly focusing its use on matching only those cases that leverage ongoing negotiations, enforce current disciplines or threaten to distort commercially based competition in the future. Moreover, the competitive environment today is one in which volumes of both tied and untied aid have dropped dramatically over the past decade, almost all foreign aid offers comply with negotiated disciplines and have a developmental cast, and no new tied aid negotiations are ongoing or imminent. As a result, there are very few (and in some years, no) final authorizations of the TACF (although two to three cases per year do meet the current criteria and are offered support from the TACF). The success of the tied aid rules and diminished need for use of TACF to match foreign offers is consistent with overarching U.S. trade policy (although unsatisfactory from the view of some exporters). One partial answer for exporters may turn out to be the pilot mixed credit initiative that Ex-Im Bank and USAID are seeking to implement during 2003 (see **Appendix J**).

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Section B: Market Windows

BACKGROUND

In the sections that follow, the concept of market windows will be defined, and the prime market windows players will be identified, their activity quantified and the competitiveness implications estimated. Contractors hired by the Department of Commerce and Ex-Im Bank, on behalf of the Trade Promotion Coordinating Committee, have prepared a report on the effects of market windows on U.S. economic activity and exports. The results suggest a picture that is fuzzy with the colors tending to gray. In fact, most observers of market windows would find comfort in Churchill's 1950s depiction of Russia: "it is a riddle wrapped in a mystery inside an enigma."

While the clarity of the picture on these aspects is slowly getting better, it is still difficult to conclude anything more than that market windows are *probably* a competitive financing issue *of some degree* to at least *a few* U.S. exporters and producers. More importantly, even if continuing research were to enable a conclusion that market windows were *surely* a significant competitive threat to *most* U.S. capital goods exporters (by no means a foregone conclusion), there would remain a major obstacle to any Ex-Im Bank or U.S. government response.

That obstacle was succinctly pointed out by Representative Jim Leach at a 2000 conference celebrating Ex-Im Bank's 65th birthday: to paraphrase, "watch out where you're going with this market window issue; we don't want another Fannie Mae." That is, the essence of market windows (private entities with a public purpose) is basically an oxymoron in the philosophical framework of the U.S. economic system. The grand experiment to date with such entities (i.e., the Government Sponsored Enterprises, or GSEs, of Fannie Mae and Freddie Mac) is now generally considered by public policy professionals to have worked too well.

The TPCC-mandated market window study highlighted the critical need for much greater transparency for market window institutions in order to ever resolve the appropriate relationship with OECD export credit disciplines. The U.S. government will continue to push in international fora for such transparency, and Ex-Im Bank will continue to explore and investigate the nature and extent of any case specific impacts.

Future editions of this report will provide updates on progress with transparency and clarification of competitive impact.

INTRODUCTION

A market window refers to a type of lending activity – typically by a government owned or directed financial institution – that provides medium- to long-term credits to foreign buyers for purchases of capital equipment and services but claims exemption from the OECD Arrangement disciplines because the support is on "market" terms (e.g., priced on a market basis and break

even financially). However, as a result of their direct or indirect relationship with national governments, such institutions derive certain benefits that purely private sector institutions do not, such as tax exemptions and equity capital provided from government budgets. In addition, the term "market window" indicates that such activity may take place within an institution that also provides lending through an "official window" on Arrangement terms. Reflecting this added context, while market window credits may not be programmatically tied to domestic content, they usually involve domestic content or are linked to some form of national interest.

Market window programs have existed for decades, but they became prominent in the world of official export credit over the last decade as OECD agreements on export credit support became fairly codified, leveling the playing field. It is now frequently the case that the key to a particular export deal is an exporter's ability to find some financing institution that can fill holes in the overall financing package (e.g., cash payment), do something special (e.g., lengthen repayment terms), or accept a level of risk that standard official ECAs or the private markets will not take.

The issue of market windows has proven very challenging in the OECD negotiating context, primarily because of the unwillingness of the two major institutions, Canada's EDC and Germany's KfW, to provide any transparency to their market window business (e.g., either to clearly delineate market window activity in annual reports or to apply Arrangement disciplines to this activity). Unlike tied aid, therefore, there is no requirement for EDC and KfW to notify market window activity or even respond to an Ex-Im Bank inquiry. This lack of transparency has made the issue very difficult to address. It has also made it difficult to clearly define and quantify the extent of the problem. Compounding the problem within the OECD was a recent WTO panel finding, in a long-running aircraft dispute between Canada and Brazil, that market window programs are not *per se* prohibited export subsidies. Rather, the determination of a prohibited subsidy would have to be made on a transactional basis – a challenging proposition when the terms of specific transactions are rarely publicly available.

Ex-Im Bank Policy and Practice

Ex-Im Bank does not operate a market window. Rather, all of Ex-Im Bank's medium- and long-term transactions comply with the terms and conditions of the Arrangement. In its re-authorization in 2002, however, Ex-Im Bank was given permission by the Congress to match the terms and conditions offered by market windows, regardless of whether such terms are consistent with the Arrangement. Matching is permissible even in the case that a market window institution does not provide sufficient transparency for Ex-Im Bank to assess the terms and conditions of a transaction. The intent of this new ability is to advance negotiations on market windows within the OECD and to level the playing field for U.S. exporters.

G-7 ECAs' Policies and Practices

Only two of the G-7 countries provide market window support: Canada through EDC and Germany through KfW. It is important to note that there are several others in smaller European countries and that JBIC could become a major player anytime it chooses.

EDC

Export Development Canada (EDC) is a Canadian crown corporation that operates on private commercial bank principles (i.e., seeks to maximize profits) while providing export credits for Canadian exporters. The majority of EDC's business is in high-income countries (i.e., the United States and Western Europe) and highly concentrated in the few sectors where Canada has world-class companies: about 78% of EDC's 2001 medium- and long-term business was in the telecom (30%; e.g., Nortel), aerospace/transportation (28%; e.g., Bombardier) and mining (19%) sectors.

The general rule of thumb over the last several years has been that 90% of EDC's medium- and long-term export credit business has been done under its market window. However, in any year the ratio may vary. Applying the general ratio to EDC's medium- and long-term activity over the last five years yields the following (**Figure 24**):

Figure 24: EDC Medium- and Long-Term Activity 1997-2002 ($Bn)

	1998	1999	2000	2001	2002
MLT export credits	4.5	4.1	5.2	5.5	5.0
Market window	4.1	3.7	4.7	5.0	4.5
Official window	0.5	0.4	0.5	0.6	0.5

KfW

Kreditanstalt für Wiederaufbau (KfW) is a financial institution that is currently owned by the German government (80%) and the federal states (20%). KfW exists to promote the growth of the German economy in a variety of ways. These include primarily domestic investment, export finance and foreign development assistance. Anywhere from 10% to 25% of KfW's annual activity falls under the category "export credits and project finance." This category is broader than just export credits, as it includes corporate and investment finance. "Corporate and investment finance" includes foreign direct investment and investment support, such as that provided by OPIC in the United States. In 2002, corporate and investment finance comprised about 43% of the "export credit and project finance" activity.

The other 57% of the export and project finance business is export credit support. KfW's export credit support is provided both through its market window and its official window. The market window support (roughly 60%-70% of the export credits) is considered to be on market terms and exempt from OECD rules, while the official window support is on OECD Arrangement terms (and mostly covered by Hermes insurance). Applying a market window figure of 65% to KfW's export credit activity (approximately 60% of export and project finance activity) over the last five years yields the following (**Figure 25**):

Figure 25: KfW Export Credit and Market Window Activity 1997-2002 ($Bn)

	1998	1999	2000	2001	2002
Export credit support	3.8	4.9	6.1	5.6	3.9
Market window	2.5	3.2	4.0	3.7	2.5

Of all of KfW's export and project finance support in 2002, 64% went to Europe, including Central and Eastern Europe. After that, 19% went to Latin America, 11% to North America and 6% to Asia.

In response to a competitiveness challenge and investigation by the European Commission, Germany in 2002 came to an agreement with the Commission to radically restructure KfW's export credit activities. As a result of this agreement, the bulk of KfW's export credit business will be transferred to a separate, but wholly owned, bank subsidiary that will not receive any government privileges. The business that remains under KfW's control will be subject to certain restrictions, such as KfW's participation in a syndicate. This change is expected to be in effect by 2005.

SUMMARY DATA

Combining the two estimates for EDC and KfW yields an average total market window volume in the neighborhood of $7.0 billion per year over the last five years (see **Figure 26**). The majority (at least two-thirds to three-fourths of this activity) is in the United States and Western Europe, largely supporting Bombardier and Airbus aircraft. In such situations, there is no official ECA competition (and for the EDC regional jets, no U.S. product competition). However, there is a segment of some $1 to $2 billion per year in market window activity in middle to upper tier LDCs (especially in project finance). Excluding any Boeing impact for the Airbus sales into the United States, this volume estimate is the market window area of potentially greatest impact on Ex-Im Bank competitiveness as measured in this report.

Figure 26: Market Window Activity 1998-2002 (U.S.$ BN)

	1998	1999	2000	2001	2002
EDC	4.1	3.7	4.7	5.0	4.5
KfW	2.5	3.2	4.0	3.7	2.5
Total	6.6	6.9	8.7	8.7	7.0

EXPORTER AND BANKER VIEWS

Banks had no view on the extent and scope of the impact of market windows on U.S. exports.

Exporters have not spoken up recently on the general theme of market windows, but they have had positive things to say about both EDC and KfW. In general, exporters are impressed with EDC's customer service. U.S. exporters benefit from this aspect of EDC by having dedicated customer service representatives. EDC is seen as wanting to be an exporter's financier of choice and is willing to negotiate on foreign content, i.e., support U.S. exports. Exporters value KfW's ability to provide 100% financing on a transaction, which reduces documentation and processing. In addition, exporters cited longer terms than available under the Arrangement as an appealing aspect of KfW. KfW is also seen as very competitive on project finance because of its market window business. As a result of KfW's business practices, Germany is gaining a foothold in China, Central and Eastern Europe and Russia.

CONCLUSION

Due to a lack of data and transparency, it is challenging to determine the impact of market windows on Ex-Im Bank and U.S. exporter competitiveness. Nevertheless, if there are market window cases with competitive implications, the 2002 addition of the capacity to match a potentially trade-distorting market window offer would seem to put Ex-Im Bank into C territory on the grading scale.

Ch. V Economic Philosophy and Competitiveness
Section C: U.S. Philosophy and Ex-Im Bank Competitiveness

Ex-Im Bank's competitiveness in the area of tied and untied aid falls short compared to its G-7 counterparts. Regarding untied aid, the U.S. government has been concerned about the potential for trade distortion that undisciplined untied aid represents. Accordingly, the U.S. government has been trying to get at least some (or comparable) tied aid disciplines applied to untied aid. However, these discussions have not produced any agreement because of the lack of consensus by the EU and Japan.

With regard to market windows, Ex-Im Bank's competitiveness appears to be fairly low, based on the best available data, with respect to the only two market windows among the G-7 (Canada and Germany, also the only major market windows in the OECD). Identifying and quantifying, much less matching, market windows is a shadow boxing exercise due to the absence of hard data and factual information.

Figure 27: Grading of Ex-Im Bank's Competitiveness in U.S. Philosophical Framework

Program	Ex-Im Bank has program (Y/N)	Grade
Tied/Untied Aid	Y	B
Market Windows	N*	C
Total Average Grade		B-

*However, in its 2002 Charter reauthorization, Ex-Im Bank was granted authority to match market window transactions.