

Chapter 2: Competitiveness Framework

Section A: Factors Influencing Export Finance

Introduction

This chapter describes the international framework in which official export credit agencies (ECAs) operate. In particular, the multilateral “rules of engagement” governing official ECA activity, market trends, and alternative financing sources together form a dynamic environment that affects how ECAs provide value to their respective exporting communities.

The Playing Field

Historically, the competitive playing field for ECAs has been viewed primarily in financial terms and within the confines of the OECD. Recently, however, ECAs are being pressured to encompass “corporate and social responsibility” (“CSR”) concerns, which include public policy issues such as the environment, thereby adding this dimension to the competitive calculus. A new emerging influence is the higher degree of interest and potential involvement by international financial organizations, namely the IMF and the World Trade Organization. In addition, the promulgation of expanded regulations governing the international banking community known as Basel II and the potential impact these rules could have on the export credit world is briefly discussed. Accordingly, this section outlines the international parameters that deal with official export credit competition, starting with the OECD Arrangement for Officially Supported Export Credits (“the Arrangement”), the World Trade Organization (WTO), the international financial institutions (IFIs; multilateral development banks and the IMF), and Basel II.

OECD: The U.S. government is a Participant to the OECD Arrangement for Officially Supported Export Credits, or the “Arrangement.” While not a formal legal agreement, the Arrangement, which was first implemented roughly 25 years ago, is a set of guidelines developed, agreed to and adopted by the members of the OECD. Specifically, the Arrangement defines the disciplines, principles and procedures by which member ECAs are to provide export credit support with the express purpose of ensuring a level playing field and to minimize government subsidies so that purchase decisions can be made on the basis of market factors such as price, quality, and service. The Arrangement contains provisions for standard export credits to include minimum interest rates, maximum repayment terms, and a risk differentiated exposure fee system for sovereign risk. In addition, special provisions exist for project finance and tied aid, as well as sector agreements for civil aircraft, ships, and nuclear power. The Arrangement has also been incorporated into European Union law and is referred to in the World Trade Organization’s (WTO) Agreement on Subsidies and Countervailing Measures (ASCM), and in this regard provides a “safe haven” from WTO suits for ECAs that follow the interest rate provisions of the Arrangement.

During 2003, the Participants to the Arrangement and the OECD Secretariat undertook a revision of the Arrangement, driven by concerns that the Arrangement could be viewed by the WTO and non-Participants to the Arrangement as discriminatory against non-Participants,

lacking transparency and access to non-Participants, and possibly WTO inconsistent. A revised Arrangement was agreed to at the end of 2003 and was implemented on January 1, 2004. The outcome of this process yielded a document, processes and procedures that are more transparent and accessible to non-Participants and provides for mechanisms to share information more freely with non-Participants on standard export credits.

As the centerpiece of the official ECA world since 1978, the Arrangement has addressed issues as they have arisen, focusing on building and fleshing out a framework within which governments could find mutual benefit in constraining themselves from competing on the basis of subsidies. The U.S. exporting community has benefited regularly and significantly from the repeated expansions of the Arrangement disciplines and today sees a financing playing field that is almost totally level. The main recurring issues relate to resolving whether two practices now defined outside Arrangement disciplines (market windows and untied aid) actually have field-tilting implications and, if so, finding a way to impose the right amount and scope of discipline.

World Trade Organization (WTO): The WTO is a forum for governments to negotiate trade agreements and settle trade disputes. A major focus of the current (Doha) round of negotiations is to ensure that developing countries are not disadvantaged because of their economic status. A component of this issue is export credit subsidies – where a few developing countries that are not members of the OECD have alleged that the OECD Arrangement provides advantages to OECD members at the expense of non-OECD members. As the Doha Round continues into 2005, the issues related to export credits are likely to remain on the radar screen and have the potential to influence the way official export credit rules are established and the parameters within which official export credits are provided.

IFIs: A recently emerging trend that is likely to affect ECAs is the heightened interest by the IMF in the role that other internationally focused organizations (e.g., ECAs, multilateral development banks, and private lenders) might play during a financial crisis. IFIs perceive that there is a role that ECAs could play to ensure the financing for import of critical commodities/inputs to support export-led recoveries in these struggling economies. The IFIs' current focus is on ECAs providing short-term trade finance; however many of the official ECAs have privatized their short-term programs and therefore would have very little to offer unless they were to create a national interest account specifically for this purpose. Ex-Im Bank is one of the few G-7 ECAs that offers an official short-term program with the others being EDC/Canada and NEXI/Japan. Given the profit-making objective of many of the European ECAs, the budgetary constraints that many are feeling, and the associated higher risk of loss in providing financing support to high-risk markets, these ECAs are not inclined to step in during times of financial crisis.

Basel II: A final but potentially significant factor in the importance and roles that ECAs play going forward is Basel II. Basel II refers to the international regulatory standards applicable to the international financial community designed to maintain stable economic and financial markets. The Basel II standards have not yet been finalized and while it is not clear when they will be finalized or when they will actually go into effect, the new requirements are likely to impact if and how the international financial community (e.g., private lenders, insurers, and ECAs) will provide export credit support in the years ahead. To the extent that Basel II provides advantageous (low) capital reserve requirements to official ECAs as compared to their

private counterparts as either lenders, guarantors or insurers (which is a very high and distinct probability), the need and demand for official ECA support is likely to increase somewhat modestly.

Summary: ECAs are dealing with the issues surrounding their appropriate roles in a somewhat volatile and unpredictable environment. Specifically, virtually each and every ECA is trying to redefine its niche based upon its collective government's reading of the tea leaves within the context of its own objectives. With the WTO and OECD Arrangement adding further restrictions to minimize export credit subsidies, ECAs can be expected to look for unregulated, market-like niches in which to gain a competitive advantage.

Long-Term Export Financing Trends

Another critical dimension to be considered in an evaluation of Ex-Im Bank's performance is that the role ECAs have played over the recent past has changed fairly dramatically. In particular, official ECA support for medium- and long-term export credits has been steadily declining as a share of national exports and current activity is more concentrated in the medium term. The many reasons for this decline are discussed below, but simply put, the primary reason is that the private sector has been expanding its capacity and reach very rapidly.

Several long-run trends were identified in last year's Report that seem to be continuing to influence the decline in official ECA support. First, the international bond and syndicated loan market for emerging market borrowers has dramatically increased in the past few years, with borrowers and lenders better prepared and more mature, the net effect being a smoother, more stable environment. Another growing trend is the availability of local currency financing on reasonable terms. This activity is most notable in Asia, and to a lesser extent, Eastern Europe and the former Soviet Union. Consequently, the need for ECA support has been minimized, particularly for sovereign and top tier corporates operating in these markets. However, ECAs are more necessary in situations characterized by:

- Sub-sovereign borrowers;
- Second tier borrowers;
- Less sophisticated, higher risk countries (e.g., Sub-Saharan Africa);
- Multi-billion dollar, controversial and/or "political" transactions that provide greater risk;
- Non-structured medium-term export finance transactions with non-investment grade borrowers; and
- Small business exporters.

As the data in the **Figure 2** demonstrate, G-7 ECA support in the medium- and long-term areas increased in 2003 from a six-year low in 2002. Ex-Im Bank was one of the ECAs that increased its activity, with Japan demonstrating the largest increase. While there are a myriad of factors that have contributed to the volatile nature of ECA support over the last six years, 2003 seems to be a return to more normal levels from a low point reached in 2002, which was most likely caused by a combination of events including a recoil from 9/11, SARs, and the overall world economic malaise.

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

	1998	1999	2000	2001	2002	2003**
Canada	4.5	3.7	4.7	4.8	4.2	4.2
France	8.4	5.5	4.5	6.1	5.3	5.5
Germany	8.3	6.7	10.3	5.7	5.9	5.7
Italy	0.8	1.6	3.3	1.9	1.8	3.3
Japan	9.0	8.1	10.8	9.2	5.7	11.5
U.K.	3.3	5.2	5.8	3.1	4.7	1.8
U.S.	6.6	9.4	9.6	6.8	7.7	8.5
Total G-7	40.8	40.1	49.1	37.6	35.3	40.5
U.S. % G-7	16.1%	23.4%	19.6%	18.1%	21.8%	21.0%

*Source: OECD data (1998-2002 revised from last year's report) and Ex-Im Bank's Annual Report.

**Preliminary results.

Trends in 2003: Focus Group Discussions

This section summarizes the views on export finance shared by the lenders and exporters who attended the four focus group discussions held in connection with this Report.

The overall perception regarding the international marketplace is that term financing risks for the most part have generally improved. However, it was noted that export trade has not fully recovered since September 11 with some countries slower to take on capital investments than others. Moreover, the concentrated competitiveness and limited potential for any one national competitor to dominate in these markets has led some exporters to stretch slightly but cautiously into riskier markets that they might not otherwise seek simply because of the need to generate more business. Further, the larger deals (in dollar terms) are fewer in number, thereby creating a strong sense of urgency to provide every advantage possible. Moreover, globalization continues its trend upward, predominantly driven by a strong and immediate corporate need to survive through lower cost supply chains.

Within the banking industry, the movement toward consolidation, combined with thin profit margins in the area of long-term export finance, seems to have contributed to a smaller population of traditional commercial banks of all sizes able and willing to engage in export credit financing. Ex-Im Bank's 100% guarantee is cited as a factor in some commercial banks' unwillingness to focus on the long-term structured finance segment, as spreads are exceptionally thin. Many lenders who remain in the marketplace have changed fundamental direction and focus, giving heightened attention to the middle market (including the high end of the SME segment). Accordingly, the attractiveness of medium-term finance has gained in importance because:

- The more volatile nature of the buyers (less well known, smaller, in moderate risk markets) allows for more flexible and higher pricing;
- Relationships with U.S. suppliers who are not global provide a more stable customer base with a higher ROI on resources;
- The volume of transactions is much greater (especially in Latin America); and
- Foreign ECA competition for these transactions is thinner and less likely to present a competitive threat (since foreign ECAs tend to be more risk averse).

However, several "old time" export credit lenders have simply closed their export finance divisions altogether, while others have cut their resources down to the essential minimums.

Both exporters and lenders explained that their perception is that the European G-7 ECAs, as well as several mid-sized Scandinavian ECAs, have developed closely coordinated strategies and partnerships with their respective governments, industry, labor and NGOs in the area of export development, including export finance. This team approach seems to be reflected in a common and unified objective to ensure strong and continued national export growth. This approach appears to be different from how the U.S. government and the private sector interact and work toward a common goal. To be fair, the U.S. exporting community recognizes that Ex-Im Bank can only do its part with regard to export finance in trying to bring cohesion to the export development arena. Within this scope, however, they would like to see Ex-Im Bank work more quickly to resolve unusual policy, program and operational issues that affect export transactions and their competitiveness, acknowledging that oftentimes, these unique issues are not within Ex-Im Bank's control alone.

On balance, Ex-Im Bank is viewed as a critical and essential partner to the U.S. exporting community, especially in the higher risk, longer term, large multi-million (or billion) dollar transactions, and to support the SMEs (small and medium sized enterprises). But, in the highly dynamic and sometimes extremely volatile world market of today, ECAs, including Ex-Im Bank, are considered less nimble than they need to be to maximize their utility to the exporting community.

