Part 3: Trade-Related Aid

INTRODUCTION

Definitions

Trade-related aid credits are concessional financial support from a donor country to a recipient country for the purposes of importing equipment necessary for a development project. Trade-related aid may be provided in two forms: tied and untied aid. Both forms can advance the recipient country's developmental goals, yet both, if undisciplined, can be highly trade-distorting.

Tied aid refers to government-to-government concessional financing of public sector capital projects in developing countries that is conditioned upon the purchase of equipment from suppliers in the donor country. Tied aid provided on generous terms to certain public sector projects can facilitate the development objectives of recipient countries; however, tied aid is trade-distorting if offered with the intention of subsidizing a domestic exporter to win a competition for an otherwise commercial project. The United States does not oppose tied aid flows that represent *bona fide* development assistance, even if some capital goods are included. Rather, the United States seeks to reduce (and hopefully eliminate) tied aid that is trade-distorting. The U.S. position on this topic is driven by two long-standing objectives for trade-related aid:

- Minimize trade-distorting tied aid because it disadvantages U.S. exporters, i.e., redirects business away from U.S. suppliers whose products are superior in quality and price.
- Minimize trade-distorting tied 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, and skewed technology choices.

The potential for tied aid to distort trade is most serious in cases where a donor government offers to provide relatively low concessionality[1] tied aid financing for projects that have the potential to borrow and repay on commercial terms, including standard official export credit terms, i.e., are commercially viable. Under these circumstances, a donor government's tied aid offer represents an attempt to "buy" a sale for its national exporters through the provision of subsidy to a recipient country.

Untied aid is the provision of concessional financing for public projects in developing countries that is not contractually tied to exports from the donor country. Provided in a fully transparent, open and objective manner, untied aid allows recipient countries to purchase the best products

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[1] The term "concessionality" refers to the total value of the subsidy being provided by the donor to the recipient country for any one project or purchase. For example, if a country receives a grant of $100 million for a $100 million project, the concessionality of this aid would be 100%, whereas a grant of $35 million combined with a traditional export credit for the remaining $65 million would have a concessionality of 35%.

available on generous financing terms. Of growing concern, however, is untied aid that is *de facto* tied and therefore trade-distorting, i.e., linked in a variety of informal ways to donor country suppliers. Some such informal linkages are: technical design compatible only with, or most conveniently with, donor country equipment; non-transparent bidding procedures; or quiet political pressure on the procurement decisions.

Context

The U.S. government actively participates in ongoing OECD negotiations that aim to discipline trade-related aid practices. In 1991, this work yielded the "Helsinki Package", which limits the provision of tied aid to "non-commercially viable" projects in lower income countries. OECD negotiations in the mid-1980's ensured that such aid must have a minimum 35% concessionality. Following aggressive implementation of the Helsinki tied aid rules, the systematic use of tied aid for export promotion has now been greatly reduced.

On the premise that untied aid should provide no competitive advantage, such aid has had no disciplines attached to it. However, over the past decade there has been considerable anecdotal evidence that untied aid is often linked to the donor country exporters *de facto*. Hence, negotiations as to whether, and if so how, to discipline untied aid have been a major focus of U.S. government efforts at the OECD during the last three years.

To complement the Helsinki Package, in 1992 Congress renamed the War Chest within Ex-Im Bank to the Tied Aid Capital Projects Fund (TACPF) and expanded its mandate to match tied aid that met the Helsinki rules when such action is in the trade or economic interests of the United States. However, reflecting the long-standing, bi-partisan U.S. position that the provision of trade-distorting tied aid subsidies is inherently bad economic policy, Ex-Im Bank does not use the TACPF to initiate tied aid. Whether to use the TACPF to leverage OECD negotiations for disciplines on untied aid is today one of the prime U.S. trade policy issues.

This chapter will:

- evaluate trends in trade-related aid financing worldwide;
- review areas of concern to U.S. exporters confronting foreign trade-related aid; and
- summarize export community views on the competitiveness of the TACPF.

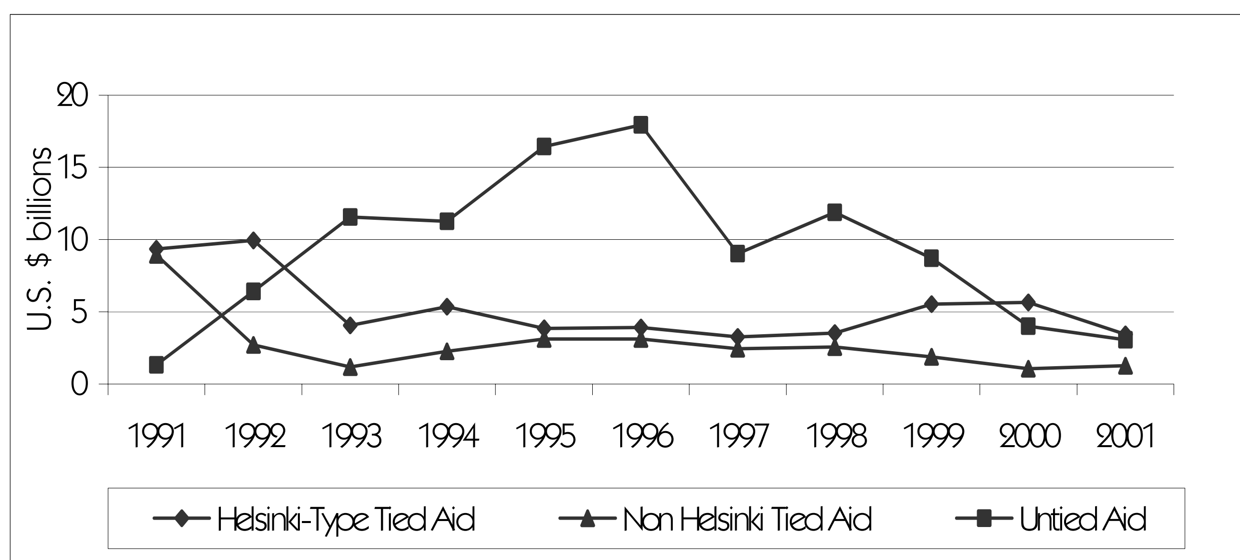
A more detailed discussion of the tied and untied aid negotiations and the use of the TACPF are found in **Appendix H**, which contains the Annual Report to Congress on tied aid use.

EVALUATION OF OBJECTIVE DATA

Trends in Trade-Related Aid Financing

This section reports on trade-related aid offers by foreign countries and examines the trends in those offers. **Figure 12** summarizes the trends by OECD agreement status.

Figure 12: 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). Commercial viability is an important element of the tied aid rules, as concessional funding for commercially viable projects is considered the most potentially trade-distorting type of aid.

These disciplines are "enforced" through the OECD Tied Aid Consultations Group process (the Group is a working group of the Participants to the Arrangement). This process consists of a requirement that all proposed Helsinki-type aid credits be notified before being committed and, if challenged by a member, must have their commercial non-viability proven. The two key tests to determine commercial viability are: 1) whether the project is financially viable (able to support at least standard official export credit terms); and 2) whether financing would actually be available for the project on those same terms or market terms. Without a majority of the Group's support for a conclusion on commercial non-viability, the project is considered ineligible for tied aid and tied aid financing is expected to be withdrawn.

"Non-Helsinki-type" tied aid includes: stand-alone *de minimis* projects (under 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 LLDCs). These types of aid are normally considered to not 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).

While untied trade-related aid must be prior-notified under the OECD Arrangement, just like its tied aid counterpart, it is exempt from the other disciplines which pertain to tied aid. For example, untied aid credits need only have a minimum "grant element" level of 25% as

measured by the OECD Development Assistance Committee (DAC). This is equivalent to only 12-17% concessionality as measured by the tied aid rules. Furthermore, even this small real resource transfer is required, only if the donor wishes to count the untied aid as official development assistance (ODA) under the DAC rules. Therefore, the current lack of international disciplines for untied aid allows it to be used to provide a miniscule level of aid resource transfers, and such small subsidies potentially generate the most serious trade distortions. Commercial viability and country eligibility rules do not apply either. Untied aid is free to crowd out market term financing for commercially viable projects, and projects in wealthier developing countries with access to market-term financing. Moreover, untied aid credits are not subject to the OECD challenge and consultations process, although the United States has challenged, ex post, some untied aid offers as being *de facto* tied.

The year 2001 was remarkable in that the total volume of aid credits notified, at $7.7 billion, was the lowest notified since the implementation of the Helsinki Package in 1992. Tied aid volume was $3.4 billion, or only 40% of the pre-Helsinki level in 1991. Moreover, tied aid offered by all donors except Japan (which represents 95% of all tied aid offered before the Helsinki agreement), has declined from $9 billion in 1991 to only $1.5 billion last year. This is an 83% reduction in the national tied aid programs for which the tied aid rules were developed. This dramatic reduction in tied aid activity indicates that the Helsinki rules and their ongoing implementation have significantly disciplined the provision of aid credits, both reducing the overall volume of these credits and redirecting their use away from certain countries and sectors, as indicated in **Appendix H**, that can bear market or Arrangement terms. The tied aid that remains is concentrated in *bona fide* development sectors that are appropriate to receive aid, such as roads, water, health, education, etc.

The steep decline in total aid activity also resulted largely from changes in untied aid activity. Untied aid showed dramatic growth from 1992 through 1996, after which annual volumes began to decline. Since the implementation of the Helsinki rules in 1992, untied aid volumes rose from approximately $1.3 billion to nearly $13 billion in 1996. Subsequently, untied aid activity has fallen precipitously to only $3 billion in 2001; and it appears that a significant amount of the reduction in untied aid since 1998 (about $8 billion) has been shifted to tied aid, now making Japan the largest tied aid donor by far.

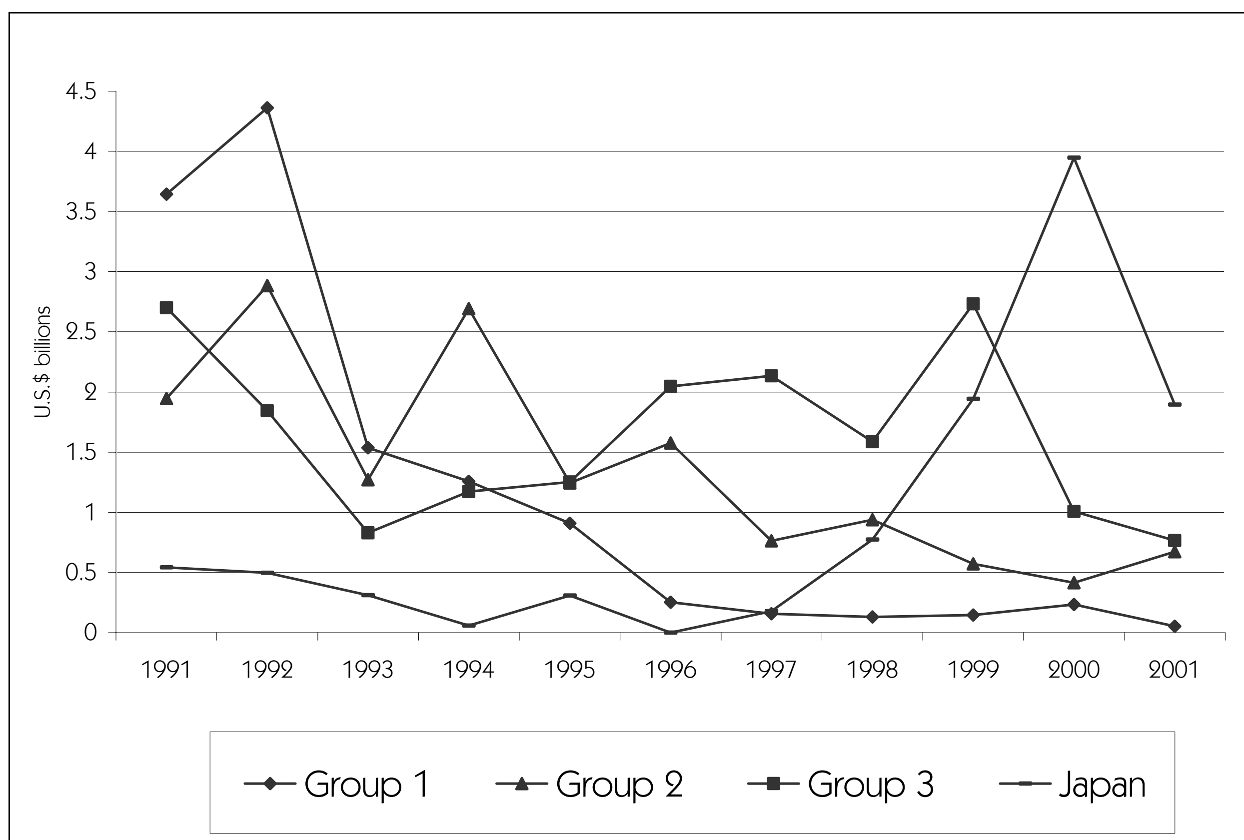
The annual volume of non-Helsinki-type tied aid has remained more or less constant since the implementation of the 1992 agreement, ranging from a high of $3.1 billion in 1995 to a low of $1 billion in 2000. Calendar Year2001 saw a slight increase to $1.3 billion.

Donor Countries

When viewed in the aggregate, the above numbers clearly indicate that the Helsinki disciplines have greatly reduced tied aid trade distortions in volume as well as sector and country terms, and helped optimize the allocation of scarce aid resources. That reduction is an unambiguous and major benefit to U.S. exporters. Cumulatively, since 1993, the Helsinki rules have reduced trade-distorting aid by about $50 billion, and, as a result, it is estimated that U.S. capital goods exports financed on market related terms are $1 billion higher each year then they would have been without these rules.

However, these overall trends mask widely varying profiles of tied aid volumes among groups of countries. As indicated below, post-1995 data shows four distinct trends among tied aid donors (see **Figure 13**). First, there is a group of countries that have taken the Helsinki rules as a signal to significantly reduce (if not cease altogether) the provision of tied aid credits. Second, a few countries have, since Helsinki's implementation, gradually reduced their previously heavy reliance on tied aid, although they continue to offer significant amounts of tied aid. Third, there is one group of smaller countries for which the Helsinki disciplines have had a bigger impact on reallocating the sectoral and country focus of tied aid then in reducing tied aid volumes. Within this group, individual countries' tied aid notifications tend to fluctuate over time without any continuing downward trend. This group is a mixture of countries that traditionally have been among the largest aid donors as a share of their GNP and those that have a stronger export promotion history. Finally Japanese tied aid activity has dramatically increased since 1998 on an order of magnitude not ever witnessed for any other country; while Japanese tied aid activity halved in 2001, it still dominates the OECD in terms of tied aid credit support.

Figure 13: Trends in Tied Aid Activity by Donor



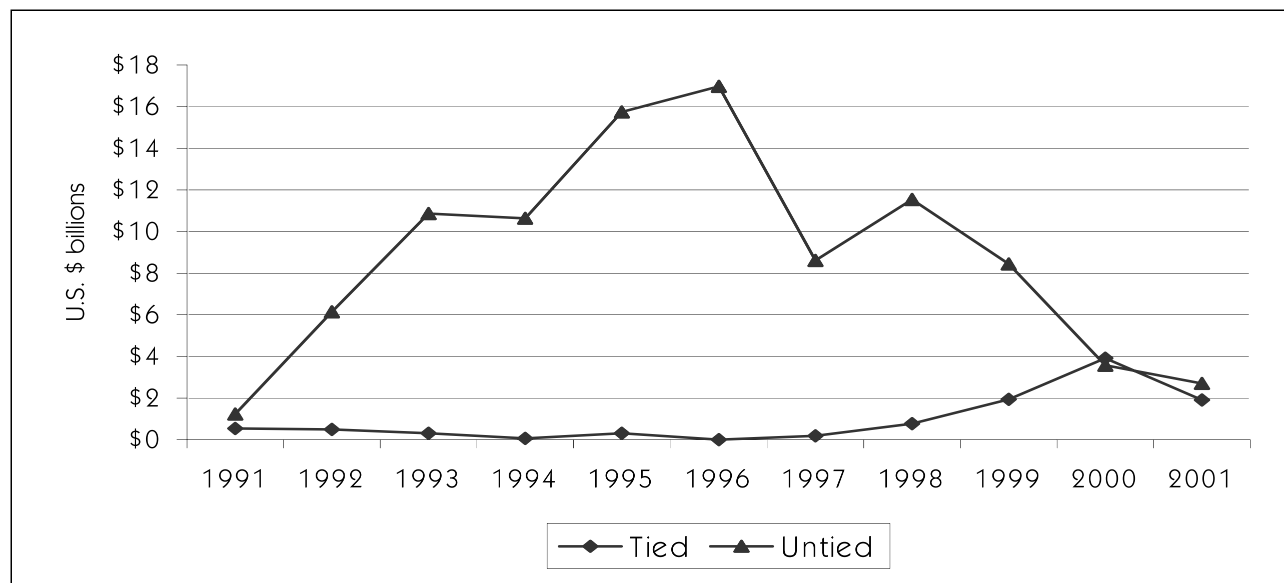
Group 1 consists of countries (Australia, Canada, Italy, Sweden, Switzerland, U.K., U.S.) that were players in the pre-Helsinki and immediate post-Helsinki periods and have now significantly scaled down their tied aid programs, notifying very few tied aid transactions per year (see **Figure 13**). Group 1's average tied aid volume in the 1992-1996 period was 46% of the 1991 level, while the 1997-2001 period's average decreased to 4% of 1991's level.

Group 2, France and Germany, has slowly but steadily decreased tied aid activity in the post-Helsinki period. While Group 2's 1992-1996 average tied aid volume was roughly equal to 1991 activity, in the 1997-2001 period that average dropped to 35%. Of some concern in 2001, however, is that this group was the only one to increase its tied aid activity, up 62% from 2000 to a total of $672 million (though only 35% of 1991 activity).

There are several smaller countries (Spain, Austria, Belgium, Denmark, Netherlands) in Group 3 that have clearly not committed to the volume reductions in tied aid activity in the post-Helsinki era on par with others. Despite reallocating the project and country focus of its aid to conform to the tied aid rules, Spain remains by far the most aggressive user of tied aid in the group with respect to volume. Spanish tied aid averaged $740 million annually (60% of its 1991 level) with a surge in its tied aid volume in 1999 almost equaling that of 1991 [change in dollar/SRD rate makes 1991 larger in dollar terms]. In addition to being the leading provider of tied aid from 1992 to 1999 ($6.5 billion), Spain has been the second largest tied aid player after Japan since the implementation of the Helsinki package, with 18% of the total notified volume. From 1992 to 1996, Group 3's average tied aid volumes were 47% of the 1991 level. During the 1997-2001 period, the average volume was 61% of 1991's activity.

Finally, Japan stands alone as dominating aid finance in the post-Helsinki era. By 2000, the volume of Japanese tied aid jumped from an annual average of slightly over $200 million between 1992-1997, to $4 billion in 2000 – 70% of all OECD tied aid. In 2001, Japanese tied aid activity dropped by half to about $1.9 billion; nonetheless, Japanese activity comprised 55% of the total tied aid in 2001, with France a distant second at 17%. From 1992 to 1997, Japan's average tied aid activity was 40% of its low 1991 level and reached zero in 1996. Remarkably, during the period from 1998 to 2001, Japanese tied aid financing soared to average over 400% of its pre-Helsinki total. In contrast, over this same period, all other donors together reduced tied aid to less than 20% of their collective pre-Helsinki total.

Figure 14: Japanese Aid



Japan's Intention with Aid

Japan averaged $10 billion in untied support during the 1993-1996 period, with a drop to just under $3 billion in 2001 (see **Figure 14**)[2]. Japanese aid in the first years of the 21st century is under immense budget pressure, the impact of which is as yet undeterminable regarding volume and distribution.

Irrespective of the trends and shifts in Japanese aid, its total volume continues to dwarf all other players. More importantly, during 2001, the Japanese took several actions that raise critical questions regarding the use of its tied aid program and its support of the Helsinki disciplines. First, Japan committed untied aid to a project despite an on-going examination of the project's tying status by the OECD, which shortly thereafter led the Participants to conclude that the project was *de facto* tied aid and ineligible for tied aid. Japan also used a seldom-invoked OECD derogation procedure in order to use tied aid for a related project determined to be ineligible for tied aid. Finally, Japan converted several tied aid projects to untied aid projects after they were determined to be ineligible for tied aid by the OECD.

De Facto Tied Untied Aid

Of great concern is the view by many exporters that Japanese untied aid is *de facto* tied, i.e., untied aid provided in such a fashion that it is, in reality, tied. Illustrating this concern are three transactions referred to in the preceding section that Japan converted from tied to untied aid in 2001.
In 2000, Japan notified tied aid for three power projects in China that the United States, based on previous case-by-case experience, believed could be considered commercially viable and therefore not eligible for tied aid. Following normal procedures, the United States challenged these Japanese projects in the Consultations Group, in early 2001. After reviewing the cases, the Consultations Group considered the transactions commercially viable and ineligible for tied aid. Ten days later, Japan notified the Consultations Group that it was converting its support for the power projects from tied aid to untied aid. In addition to on-going concerns about the *de facto* tied status of untied aid, the ease and speed with which Japan was able to switch from tied to untied aid raises further concerns about whether there are really significant differences between the two forms of aid financing within the Japanese government.

Given the volumes of untied aid that will probably continue to be provided by Japan in the future – averaging over $8 billion annually between 1995-2002, and the fact that Japan seems to be able to switch between its tied and untied aid programs with great ease, untied aid has become an issue of concern equal to what tied aid was prior to the Helsinki Package of disciplines. As a consequence of these and previous cases[3], and the long-standing perception that some, if not

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[2] Japan was the predominant provider of untied aid credits, at almost of 90% of the OECD total from 1992 through 2001. The untied aid figures for Japan include Other Official Flows (OOF). Japanese OOF comprises untied loans with usually zero concessionality that is used primarily for balance of payment financing. Japanese OOF comprises approximately 17% of the untied aid volumes in Figure 14 for the years 1995-2001.

[3] See the 2000 *Competitiveness Report* for a description of the Severnaya power plant in Azerbaijan, for which Japan offered untied aid support that was determined by the Consultations Group to be not truly untied

much, of Japan's untied aid program is *de facto* tied, the United States has been advocating that the Participants extend the OECD tied aid disciplines to untied aid. These three disciplines are: 1) the commercially viable project prohibition; 2) the 35% minimum concessionality requirement; and 3) the country limitation on eligibility (no country recipients with per capita income above $2,995). Given Japan's unwillingness thus far to bring discipline to untied aid, the United States is considering whether to make Japanese untied and tied aid a target of the TACPF as a means to promote agreement on OECD disciplines.

Non-Helsinki Tied Aid for Commercially Viable Projects

Non-Helsinki tied aid includes *de minimis* aid (under approximately $2.6 million), aid to the least developed countries (LLDCs; such aid must have a minimum of 50% concessionality), tied aid credits that are more than 80% concessional and tied aid for ships. Cumulatively, since the implementation of the Helsinki rules, *de minimis* aid and aid to LLDCs has totaled approximately 20% of Helsinki-type tied aid. Considering that these credits are not subject to all of the Helsinki disciplines, there is some concern that these two exceptions provide an opportunity for donor countries to obtain market presence through tied aid credits in commercially viable sectors. U.S. exporters have raised concerns about the use of *de minimis* tied aid by other OECD donors in major markets such as China to establish footholds in new sectors or technologies. China represented the largest target market for *de minimis* notifications in 2001, with 53.6% of total volume notified. There is some implication of such use in the patterns of *de minimis* activity from the Group 3 countries of Spain, Austria, Denmark and the Netherlands. However, overall *de minimis* tied aid in 2001 declined to its lowest level since 1993 and totaled just under $100 million.

Ex-Im Bank Tied Aid Activity

Figure 15: Ex-Im Bank Tied Aid Authorizations

	1997	1998	1999	2000	2001
Authorizations	2	1*	3	0	2
Amount Financed (U.S.$ MM)	$75.5	$16.6*	$54.7	0	$59.3

*Authorization subsequently cancelled as bidding decision deferred.

Figure 15 provides details on Ex-Im Bank's authorizations for tied aid transactions in the past five years[4]. In summary, Ex-Im Bank has authorized eight transactions in the past five years, providing approximately $200 million worth of official export credit support. This figure puts Ex-Im Bank on the top half of the donors over this period, but represents less than 1% of Helsinki tied aid activity in those years.

[4]During this five-year period, Ex-Im Bank notified a total of 13 tied aid offers with a value of $368 million.

EVALUATION OF SUBJECTIVE DATA

Few survey respondents replied to questions about Ex-Im Bank's tied aid policy competitiveness. The few respondents that did comment tended to rank Ex-Im Bank as less competitive than other ECAs.

CONCLUSION

While the Helsinki Package has successfully disciplined the provision of tied aid credits, significantly reducing overall volumes and directing aid to countries and sectors that cannot sustain market financing, trends within the past few years indicate a willingness among some countries to consistently devote significant resources to providing their aid in a tied form. While the OECD tied aid rules have eliminated the systemic use of tied aid to distort trade, the United States needs to be vigilant to ensure that such aid is used for real development purposes and not to create longer-term commercial advantages.

In addition, some countries may be using carve-outs to the Helsinki disciplines (primarily untied aid and *de minimis* exceptions) to provide aid credits to commercially viable projects (and gain long-term commercial advantages). So long as Japan continues to resist disciplines on untied aid, and in some cases, such as when it provided tied aid to a project deemed commercially viable, and is prepared to treat even the letter of the law flexibly, the competitive prospects of U.S. exporters will be constrained in certain overseas markets. Use of the TACPF to leverage OECD negotiations on untied aid disciplines would address this problem. The United States also needs to continue to monitor the levels of *de minimis* tied aid and be prepared to use the TACPF to neutralize such credits when they are used to establish foothold in new sectors or technologies.

Hence, viewed in the context of its accomplishments in leveling the playing field for U.S. exporters, Ex-Im Bank's tied aid policies and practices in 2001 appear less than fully competitive.