Statement of
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before the
Subcommittee on Foreign Operations
Committee on Appropriations
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NOTICE

This statement is not available for public release until it is delivered at 10:30 a.m. (EDT), on Wednesday, May 6, 1987.

Mr. Chairman, I am pleased to have the opportunity to discuss the Administration's proposed restructuring of foreign military sales (FMS) debts. My statement this morning will cover three areas.

First, I will describe the budgetary treatment of the Administration's proposal. Second, I will contrast the budget effect with the real costs of debt relief, since these costs are obscured by our current cash-based budget accounting system. Third, I will discuss how credit reform might affect the budgetary treatment of such transactions.

RESTRUCTURING THE FOREIGN MILITARY SALES DEBT

The Administration has developed two options for providing debt relief to foreign countries that have borrowed from the U.S. Government to finance purchases of military goods and services. Neither option would require new appropriations by the Congress. The FMS loans covered by the Administration's proposal are those that have been provided by the Federal Financing Bank (FFB) and guaranteed by the Department of Defense. One option is to allow countries to prepay their FFB loans at par without a prepayment penalty. The second option is to allow countries to capitalize part of the current interest due on their loans and to make a lump-sum payment at the end of the loan repayment period.

The prepayment option would be of advantage to countries with access to capital markets and that can borrow at lower interest rates than they are

paying currently on their FFB debt. The option to capitalize interest is designed for countries that are experiencing difficulty making their current payments, but cannot refinance without direct U.S. assistance.

The budgetary treatment of the proposed FMS debt restructuring as it is reflected in the President's 1988 budget is shown in Table 1. The net budget effect is to reduce the Administration's estimate of the deficit by $1.0 billion in 1988 and to raise the annual deficit by similar amounts over the next several years.

This budgetary effect is remarkable and misleading. It appears to suggest that the U.S. Government can provide debt relief to other countries and at the same time improve its own financial condition in the short run. This counterintuitive result is explained by the way credit programs are treated in our current cash-based budget accounting system.

Prepayment Option

Existing FMS loan contracts give the borrower no right of prepayment, but provide that the lender (the FFB) may demand full repayment of the outstanding balance in case of default. The prepayment restriction apparently can be circumvented by declaring the loan in default and calling in the principal balance and accrued interest. Under the Aministration's prepayment option, the funds necessary to repay the FFB loans must be obtained by the borrower from private sources without a new U.S. Government guarantee.

Since loan repayments are recorded in the cash-based budget as offsetting collections in the lending account, the FMS loan prepayments would have the short-run effect of lowering outlays in the foreign military credit sales account, and reducing the budget deficit for 1987 and 1988. The President's budget assumes that loan prepayments will amount to $574 million in 1987 and $1.7 billion in 1988. In 1989 and beyond, however, the forgone payments of principal and interest would result in higher budget outlays and deficits.

TABLE 1. THE BUDGET IMPACT OF THE PROPOSAL FOR RESTRUCTURING THE FMS DEBT (By fiscal year, in millions of dollars)

	1987	1988	1989	1990	1991	1992
Prepayment Option						
Foreign military credit sales						
Loan prepayments and forgone principal repayments						
Budget authority	0	0	0	0	0	0
Outlays	-574	-1,724	328	292	254	247
Interest on loans to FFB						
Forgone interest payments						
Budget authority	24	127	218	213	182	155
Outlays	24	127	218	213	182	155
Subtotal						
Budget authority	24	127	218	213	182	155
Outlays	-550	-1,597	546	505	436	402
Interest Capitalization Option						
Interest on loans to FFB						
Budget authority	427	643	626	605	579	552
Outlays	427	643	626	605	579	552
Net Outlays/Deficit Effect						
Budget authority	451	770	844	818	761	707
Outlays	-123	-954	1,172	1,110	1,015	954

SOURCE: Office of Management and Budget.

Interest Capitalization Option

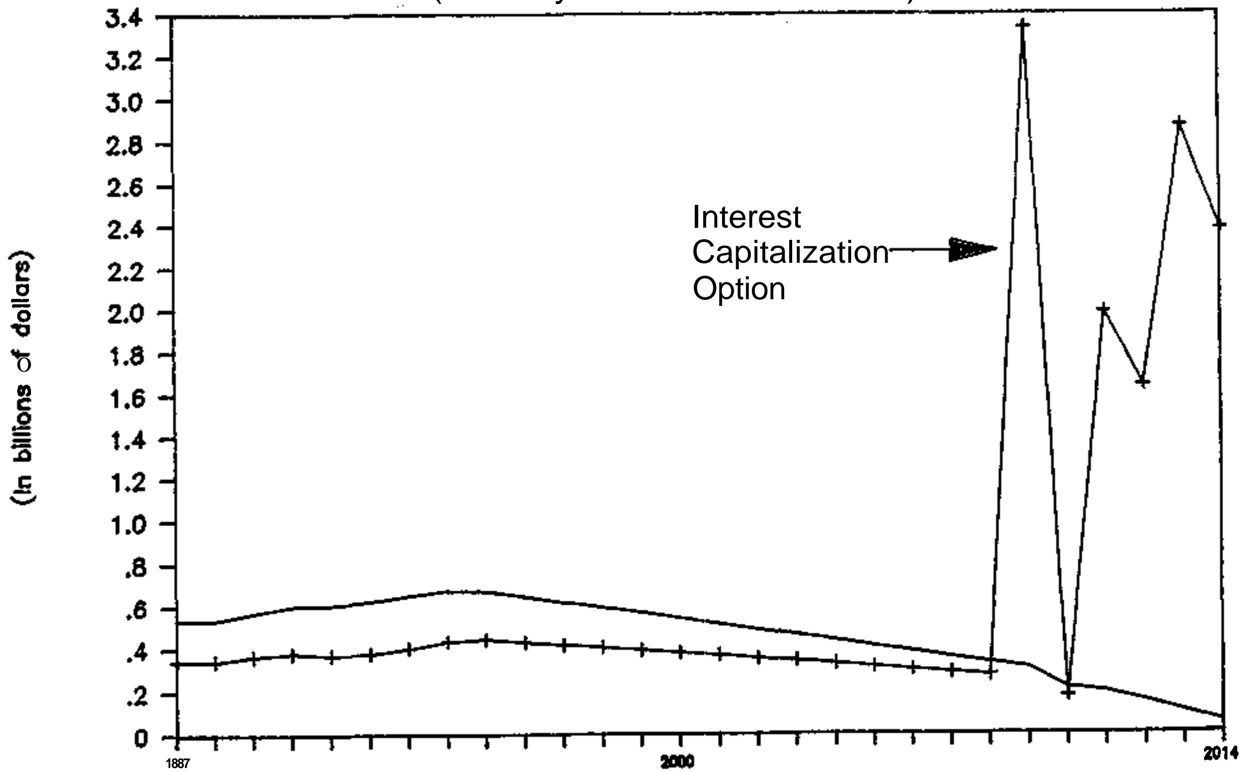
The second option developed by the Administration would allow countries to defer part of the interest currently due on their FFB loans, but to make up these payments--plus interest on the deferred payments--at the end of the loan period. In effect, the FFB would be making new loans to cover the deferred interest payments that would be payable on maturity of the original loan. To take advantage of this option for capitalizing interest, the debtor country must correct any deficiencies on its FFB loans.

Instead of showing this option as new FFB loans, however, the Administration's budget for 1988 treats capitalized interest on FMS loans as forgone interest collections by the FFB. This treatment has the effect of raising budget authority and outlays in all years up to the time of repayment, as shown in Table 1. The advantage of this approach over a direct loan is that the budget effect is hidden in Function 900 (Net Interest), spread over the remaining life of the existing loans, and does not require Congressional appropriations.

CBO estimates that capitalizing interest for Egypt, one of the countries that may find this option attractive, would reduce its current interest payments by $200 million per year over the next several years. For each dollar in interest capitalized in fiscal year 1987, Egypt would owe nearly 5 dollars payable in the years 2009 through 2014. This is shown graphically in Figure 1. Egypt's cash flow burden would be reduced in the short term, and it would receive some real economic benefit by being able to borrow essentially at the U.S. Treasury's cost of money rather than at market rates.

Making the balloon payment at the end of the loan repayment period, however, is likely to be a problem for both the debtor countries and future Congresses. Receiving short-term, cash flow relief would be an advantage for debtor countries if they used the intervening years to improve the performance of their economies so they could more effectively meet their future liabilities. Structural adjustment, however, does not appear to be a condition for the interest capitalization option. Therefore, it is quite possible that this option is a short-term palliative that delays but increases the severity of the FMS debt burden for affected countries.

Figure 1. EGYPTIAN FMS REPAYMENT STREAM
(fiscal years 1987 - 2014)



SOURCE: Congressional Budget Office
NOTES:
——— Current
+++ Interest Capitalization Option

REAL COST TO THE U.S. TAXPAYER

Despite the short-term reduction in the budget deficit resulting from prepayment of the FMS loans, the U.S. Government suffers a net loss on the transaction. The reason is that the FFB is giving up a high interest rate asset but cannot refinance its own high interest-rate debt to the Treasury that it borrowed when the FMS loans were disbursed. To understand the nature of the FFB loss, consider that the U.S. Treasury issued 30-year bonds in 1982 with interest rates of 14.25 percent. Now that market interest rates have fallen, these bonds trade for $158 per $100 face value. If the U.S. retired these bonds at par, current bond holders would suffer a loss of $58 per bond. Similarly, the FFB loss is the difference between the appreciated value of the fixed FMS loans and the amount the FFB is to accept in prepayment. This loss is the prepayment penalty the FFB would normally charge to enable it to continue to meet its own interest payments.

The interest loss to the FFB from the Administration's FMS loan prepayment option can be substantial. For the three countries most likely to prepay--Korea, Spain, and Oman--we estimate the present value of the interest loss to be around $200 million. For Korea alone, we estimate that prepayment of its FFB loans at par in July 1987 would result in an interest loss of $115 million on collections of $653 million. For the nine countries assumed to prepay by the Administration in its original budget estimates, the interest loss to the FFB would be approximately $350 million.

The option for capitalizing interest also has a cost to the U.S. Government in the same way that a new FMS loan would have a cost. The estimated costs for FMS loans at FFB interest rates is approximately 35 cents per dollar loaned, principally for default costs. Therefore, the approximate cost of the option for capitalizing interest, using the Administration's estimates, is $210 million on a total loan volume of $0.6 billion. If in the end, of course, these new loans are forgiven, then the cost to the government would be their full value.

These cost effects are obscured by the way credit programs are treated in the budget. Instead of showing up as costs in the year they are incurred, they are spread over several years. Furthermore, as shown in Table 1, the near-term effect is to reduce government cash outlays and the deficit. This effect gives the appearance that debt relief costs nothing and leads to significant budget savings.

CREDIT REFORM

The Administration recognizes the distortions of cash-based accounting for credit programs and is proposing a major reform for their budgetary treatment. CBO agrees that the Administration's proposal to highlight the subsidies rather than the cash flows involved in credit programs makes a great deal of sense and is a major step forward. Indeed, this was recommended 20 years ago by the President's Commission on Budget Concepts. Unfortunately, the Administration's credit reform proposal applies only to new credit activity and not to the restructuring of existing

loans such as the FMS credits. Further, the proposed credit reform does not carry through to the budget deficit. As a result, under the Administration's credit reform proposal, the FMS loan restructuring would still be shown as reducing outlays and the deficit. No cost of FMS debt relief would be recognized.

Nevertheless, the Administration's credit reform proposal is an important one that should be considered favorably by the Congress. It would change the manner in which funds are appropriated for credit programs. Instead of appropriating budget authority for new direct loans, appropriations would be provided only for the subsidies embodied in direct loans and loan guarantees. A new credit revolving fund would be created in the Treasury to handle all the associated cash flows for new loans and guarantees. As agencies originate new loans and make new loan guarantee commitments, they would use their subsidy appropriations to pay the estimated subsidy value of those credits to the central revolving fund. The central fund would then disburse loans and make guarantee payments. It would finance these outlays with subsidy payments from the agencies, repayments, recoveries, loan sales, and with borrowing from the Treasury.

The Administration proposes that subsidy cost estimates would be obtained both by calculation and by sales and reinsurance. Loans that could be readily sold would be marketed to investors. Where private credit insurance is available, the government would reinsure its risk. In the case of loans regarded as unsuitable for sale, such as those to foreign countries—

including FMS loans--and for uninsurable guarantees, the central credit revolving fund would calculate the subsidy and charge the agencies that amount.

This proposed change in the budgetary treatment of credit programs would be a major improvement. It would put credit programs on an equivalent basis with direct grants. For FMS credit programs, only concessional loans would be included in the Administration's credit reform proposal. Forgiven loans would not be included because they are grants.

In the spirit of credit reform, an alternative procedure to the one chosen by the Administration to provide relief to FMS debtors would be to seek appropriations for the FMS debt restructuring options. For the prepayment option, the appropriation would pay for the FFB penalty that normally would be charged for loan prepayments. For the interest capitalization option, the appropriation would provide the spending authority to forgo the collection of interest payments owed on the FMS loans. The net budgetary effect on outlays and the deficit would be the same, but this procedure would give Congressional approval in advance and would make the costs more visible.