

January 1988

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Recommended Citation

John Coleman, *The International Competitive Aspects of U.S. and Canadian Financial Incentives to Exports*, 14 Can.-U.S. L.J. 237 (1988)

Available at: <https://scholarlycommons.law.case.edu/cuslj/vol14/iss/31>

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The International Competitive Aspects of U.S. and Canadian Financial Incentives to Exports

*John Coleman**

Why would a finance official be interested in export incentives, and export credits in particular? Why did I get involved with the Organization for Economic Cooperation and Development (OECD) Consensus on Export Credits? Why are these issues of equal concern to my colleagues in the U.S. Treasury Department? The interest of Finance and Treasury officials with export incentives stems from the increasing cost and market distorting effects of those incentives which run counter to government finance and sound economic policy objectives. This interest has grown, particularly since the early 1970s, because of government policies which have been characterized by intense competition in supporting export sales.

There is a good deal of common ground between the United States and Canada in their approaches, and government policies with respect to export incentives. Generally our governments are on "the side of the angels" on this subject. They see the need to maintain international trade in capital goods, and the need for governments to reduce the risk for private sector exporting to many developing countries. However, risk reduction services should be provided at the least cost to the taxpayer and without causing market distortions and unfair competition. Subsidized operations should not be instituted that increase budgetary expenditures.

Also, Treasury and Finance officials see federal export financing as representing an important portion of the financial flows to developing countries, another portion being private financial flows. Since the onset of the debt crisis in 1982, the role of federal export incentives has taken on increased importance as a means to finance world trade.

Financial incentives for exports are, to an important extent, governed by the rules of the OECD Consensus on Export Credits, formally called "The Arrangement." The OECD Consensus is an agreement among the governments of twenty-two OECD member countries (excluding Turkey and Iceland) which sets out guidelines for government-backed export credits. The guidelines are aimed at limiting export financing competition among governments and ensuring a relatively level playing field for all exporters with respect to export financing.

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There are other financial incentives available in addition to export financing. These include trade promotion activities such as feasibility studies and technical assistance activities. Foreign aid programs also play a role in supporting export activity and industrial rehabilitation. Furthermore, industrial grants and special tax treatment for sectors primarily involved in export markets, e.g., the aerospace industry, are indirect means of export incentives.

However, the focus of this Article will be on the OECD Consensus on Export Credits. First, the purpose of the OECD Consensus and its areas of coverage are described. Second, its legal status is discussed. Third, its evolution and future direction are discussed. Fourth, elements of the future direction of the Consensus are highlighted. These include: a further movement toward market related financing, more efforts to control mixed credits (highly subsidized financing transactions with aid connotations) and to lengthen repayment terms on ordinary credits, encouragement for further cooperation among export credit agencies on "cover policy" (the decision on supporting export transactions in markets of doubtful creditworthiness) and improving co-financing arrangements among export credit agencies. Fifth, the effectiveness of the OECD Consensus is considered.

I. WHAT IS THE OECD CONSENSUS?

The OECD Consensus is a cartel; but it is a cartel with a difference. It was not formed with the objective of monopolizing or of distorting market forces. Rather its goal is to reinforce fair competition in the market. It is aimed at reducing government-backed export financing subsidies; thereby promoting an environment where international competition for export markets is on the basis of product, price, quality, delivery and after sales service.

The main feature of the Consensus is an arrangement which sets a floor on interest rates, minimum cash payments of 15%, and maximum repayment periods. It applies to official export credits lasting two years or more. The schedule of minimum interest rates (called in Consensus jargon "the matrix") varies according to recipient country and by length of repayment period. Rates are higher for countries categorized as "rich" (mainly OECD countries); states classified as "intermediate" (e.g., South Korea) or "poor" (e.g., India) receive longer maturities and lower interest rates. Rates are currently 10.4% for rich countries, 9.35% for intermediate countries and 8.0% for poor countries.

For countries whose market interest rates are below the matrix rates (e.g., Japan, Switzerland) a system of commercial interest reference rates ("CIRRs") applies. In general, CIRRs are based on five year government bond yields in the secondary market plus 100 basis points.

In recognition of development aid objectives, the Consensus makes allowances for aid motivated transactions. However, it sets a minimum

permissible element for concessional financing for such transactions. Currently, the required minimum grant level for aid motivated or mixed credit transactions is 35%. The minimum for grants to the least developed countries is 50%. Moreover, before making such a highly concessional offer, prior notification of twenty working days must be given to all other Consensus participants of the terms being offered. This allows other participants an opportunity to offer matching concessional financing. In the case of offers with a grant element exceeding 50% only *ex post* notification is required. The OECD Consensus also provides participants with the right to match more favorable terms offered by non-participants. This is becoming more of an issue as increasing numbers of newly industrialized countries, such as Brazil, offer highly competitive government-backed export credits.

There are a number of sector understandings which complement the Consensus and provide special terms. These include understandings concerning nuclear power plants, aircrafts, ships, and satellite communication stations. Military and agricultural commodities are excluded from the list of products covered by the Consensus.

The first version of the OECD Consensus was agreed to in 1978. It was born of a compromise between North America and Europe. On one side the United States and Canada agreed to forego the practice of offering long repayment periods of over ten years. On the other side, the European Community (EC) agreed to forego its practice of offering large interest rate subsidies. The trademark of compromise has remained with the OECD Consensus. The fear of costly and self-defeating credit competition has led participants to settle for less than their desired positions. Over time the spirit of compromise and the "club" atmosphere among participants, particularly in the informal "directorate" of the United States, the EC, and Japan, has strengthened the Consensus.

The main thrust over the years of the strengthening has been in two areas. First, minimum allowable interest rates have been brought closer in line with market rates, thereby reducing the scope for interest subsidies by governments. Second, rules and procedures for offering mixed credits have been made more transparent through prior notification requirements and more costly through increases in the minimum permissible interest subsidy or grant element. These measures are aimed at creating a clearer demarcation between commercially motivated and aid motivated transactions.

II. WHAT IS THE LEGAL STATUS OF THE OECD CONSENSUS?

The Consensus Arrangement on guidelines for officially supported export credits is an arrangement among certain OECD participants which was developed within the framework of the OECD and for which the OECD provides secretariat service. It is *not* an act of the OECD council and thus it is *not*, in a formal sense, a legal instrument of the

OECD. An act of the OECD is binding on its members in accordance with their constitutional procedures.

The Consensus Arrangement replaced a less elaborate 1976 understanding among the G-7 countries (United States, Japan, West Germany, United Kingdom, France, Italy, Canada). This understanding was formalized through a set of unilateral, but parallel, declarations by the seven countries to the effect that similar government policies would be followed in the field of export credits. Other OECD countries subsequently made similar parallel pledges. By 1978, this set of unilateral declarations had been transformed into one document which became effective on April 1, 1978.

While the OECD Consensus Arrangement is an international agreement, it has never been formalized by official signature. It is doubtful if many governments which subscribe to it have even submitted it for discussion in their parliaments, let alone adopted it as part of their laws and regulations. Yet, twenty-two participants observe it, that is, they take it as the norm of acceptable behavior in the field of federal export credits. In this sense, the OECD Consensus works and is effective. Indeed, despite its loose legal framework it appears to work as effectively or better than many more formal arrangements. Moreover, its informality is an advantage in allowing the OECD Consensus to evolve constantly to help regulate new practices that have been the trademark of export financing activity in recent years.

An integral part of the OECD Consensus guidelines is the exchange of information requirements. All transactions must provide notification. Prior notification for transactions not in conformity with the basic provisions, such as minimum interest rate and maximum repayment periods, must be sent to all other participants. The exchange of information system is important because it is the mechanism for ensuring that all participants are aware of nonconforming financing offers. The sanction open to participants in response to nonconforming financing offers is that they may match the financing terms. The risk of matching by other participants is the key deterrent to the initiation of nonconforming financing offers. If participants believe that nonconforming offers will always be matched, then they will see no advantage to initiating nonconforming offers. On the contrary, the initiator runs the risk of triggering an escalation in export credit subsidy practices.

There have been relatively few cases where the rules of procedure have been blatantly violated. In these cases the contravening country is confronted through a review process. However, one should recognize that it is inevitable in any such type of agreement that participants will always be seeking to explore loopholes or to win some advantage over their competitors. It is also inevitable that such practices sooner or later come to the attention of others. At that time, the loopholes are either closed or the rules clarified to permit the particular practice. In sum, the glue holding the OECD Consensus together is not so much its rules and

sanctions, though these play a role; rather it is the recognition by all participants that disregard of the guidelines could rapidly lead to unrestrained, costly and distorted competition in export subsidies.

III. FUTURE DIRECTIONS FOR THE OECD CONSENSUS

There remains a number of important issues for Canada and for the United States in promoting further improvements to the OECD Consensus. These include: further movement toward market rate financing, more control on mixed credits and lengthening the repayment terms on ordinary credits, further cooperation on export credit cover policy, and enhanced co-financing arrangements.

The tremendous changes and innovations in the international financial and capital markets and the inexorable move to the globalization of these markets argue strongly for the OECD Consensus to adopt a fully differentiated interest rate system based on commercial interest reference rates (CIRRs) for each of the member currencies. Currently, CIRRs are used only for currencies with interest rates below the OECD Consensus matrix rates. However, with the differences in interest rates and currency swap arrangements it is relatively easy to provide subsidies in Japanese yen or Swiss franc currencies by initiating an offer at matrix rates in a high interest rate currency and swapping the loan into a low interest rate currency. The adoption of a fully differentiated rate system would imply the abolition of the matrix interest rate option. In practical terms it would fulfill the longstanding goal of the United States and Canada to ensure that official export credits were offered on market terms whatever the currency of denomination — a level playing field.

Despite the significant steps agreed upon in the spring of last year to discipline mixed credit or tied-aid credit support, important export markets remain in which the effectiveness of the new discipline is in question. There is a need for the Consensus to contemplate further measures to control mixed credits. There is some anecdotal evidence to suggest that recent increases in the minimum grant element have not diminished the volume of mixed credit offers, but rather only served to heighten the cost of granting mixed credits. For example, in Indonesia, mixed credit activity is increasing. This is a result of trade opportunities, the country's creditworthiness, and its policy of requiring credits with an aid element of at least 40% as a bidding requirement for public sector projects.

Clearly, when the motivation is commerce and not aid, government-backed support at these concessional levels makes no economic sense. Nonetheless, many OECD governments do not seem deterred by the costs. The explanation probably lies in part in the fact that in many countries, such as Japan and France, the concessional element is provided through their aid program. Countries such as the United States and Canada, which in the past made little use of mixed credits, have begun using them quite actively. The stated motivation is deterrence, but

in this area it is often difficult to tell who fired the first shot. Unless further efforts are made to discipline mixed credits, "mutual deterrence" could turn into "mutual assured destruction." It also raises the question as to whether there is a risk of turning export credit agencies into aid agencies.

Nonetheless there are those who argue against increased discipline on mixed credits. The argument is that there is a need to increase the financial flux to the developing world and that mixed credits serve to increase both aid and commercial flows to developing countries. One approach to reduce the validity of such an argument would be to allow participants to offer regular non-subsidized export credits at longer repayment terms than the current ten year maximum.

Mr. John Bohn, the president of the U.S. Export-Import Bank, raised the issue of longer loan repayment terms about a year ago. At that time it was greeted with consternation by many of the OECD Consensus participants. However, with an increasing number of participants interested in moving to a fully differentiated interest rate system, a lengthening of the maximum repayment terms may now prove more acceptable. Such a lengthening would not imply an increase in interest rate subsidies if linked to a move to a differentiated rate system. Mr. Bohn, in support of his proposal, noted the importance of tailoring loan repayment terms to the capacity of developing countries to repay, so as to avoid constant debt rescheduling. He also noted that stretching out repayment terms would work to increase demand for capital goods exports by developing countries. Finally, he noted that many capital goods projects and the associated machinery and equipment have life cycles well in excess of the current loan repayment terms authorized by the Consensus. Extending loan repayment terms to better match the useful life of the capital goods exports would therefore not be financially imprudent. John Bohn's ideas have a familiar ring indeed. His arguments are ones which Americans and Canadians put forward a decade ago when the Consensus was being formed. The question is whether they can be advanced now without upsetting the historic compromise.

The world debt crisis today is distinguished by many developing countries with long-term balance of payment problems which will take many years of economic adjustment to resolve. A good number of these countries will not be in a position to meet their full foreign debt service obligations in the near to medium term. The OECD Consensus participants exchange information on the cover policy attitudes of their export credit agencies. These exchanges of information are not aimed at formal harmonization of cover policies. Nonetheless, the exchanges provide an opportunity for a state to review cover policy positions in terms of the economic adjustments undertaken by debtor countries and the progress made in dealing with their debt. The exchanges serve to reinforce the good or the bad news on the debtors' progress and thereby lead to better informed export cover policy decisions.

Further cooperation among export agencies on cover policy would be advantageous. Its purpose should be to strengthen the collective determination to avoid undue risks through withholding cover to countries not addressing their debt problems in a responsible way. It should also encourage, in cooperation with the International Monetary Fund and World Bank, the resumption of financial flows to developing countries that are experiencing economic difficulties but that are undertaking reforms to address their problems.

Another area where strengthening relations on export credits would be mutually advantageous is on co-financing arrangements among export credit agencies. Improved bilateral cooperation between the United States and Canada in this area would seem particularly advantageous given the already strong integration of our economies. Moreover, the advent of the Free Trade Agreement is likely to move us further in this direction. In this area, as in many others, Canada and the United States have an opportunity, through bilateral cooperation, to set an example for multilateral progress.

IV. EFFECTIVENESS OF THE OECD CONSENSUS

It is difficult to assess the effectiveness of the OECD Consensus on Export Credits because in the last five years the bottom has fallen out of the capital goods export market due to the debt crisis. Since 1982 there has been a marked decline in annual federal export financing volumes for credits with repayment terms of five years or more. The annual volume in 1986 of (U.S.) \$8.4 billion is about 60% below the 1982 level of (U.S.) \$20.4 billion. Moreover, 1987 preliminary estimates show a further decline from 1986 levels. However, it is difficult to ascertain the extent to which the decline is attributable to market forces and the extent it is attributable to the many reforms during this period in the OECD Consensus guidelines.

Of course, one's judgment on the effectiveness of the OECD Consensus is heavily dependent on the choice of the standard of measure. The gloomy view might be that while the OECD Consensus has managed to reduce interest rate subsidies on ordinary lending, it has not achieved success in dealing with mixed credits. Mixed credit practices continue at an active pace, albeit a more costly one, causing disruptions to both commercial and development aid activities.

However, a good case can be made for a more sanguine view. I believe that the increase in the minimum permissible grant element for mixed credit transactions has helped to make a clearer demarcation between trade motivated and aid motivated transactions although it does not appear to have significantly reduced the volume of this business. A substantial further increase in the minimum permissible grant element would be desirable in making the demarcation even clearer, although it must be recognized that there will always be tradeoffs among foreign pol-

icy, trade, aid and industrial policy interests. Since the major part of the 1982-86 decline in official export financing volumes has occurred in OECD markets where subsidies for official financing have been virtually eliminated over the last five years, it is probably safe to assume that the OECD Consensus guidelines have had a significant effect in these markets by shifting financing to the private sector. This would suggest that the price system works and that its continued application should wring the remaining subsidies out of official export financing.

The OECD Consensus also has had an important impact in providing for fairer competition. It has brought, through its rules, order from the anarchy that previously existed in this area. However, the Consensus is a little like a bicycle; it must move forward to stay upright. It is inevitable that with time the guidelines become less effective in controlling federal export credit support as new techniques to exploit loopholes in the rules develop; thus there is a never ending need to adjust the rules and to maintain a mood conducive to reform and adaptation. Otherwise, there is the risk that, with time, countries will take the Consensus arrangement less seriously. At the same time, the process of adaptation must be carefully, even grudgingly pursued; otherwise, the rules will have little credibility. Finding the right balance, the right tension between rules and practices is the challenge always facing the OECD Export Credits Consensus.