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# DEVELOPMENTS IN THE FINANCING OF INDUSTRIAL PROJECTS IN DEVELOPING COUNTRIES SINCE 1982


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81

Official involvement in medium- and long-term export credit developed in the first instance because of concern in exporting countries that buyers of their exports of capital goods should have adequate access to credit. Later it was extended to softening the terms of credit, chiefly by subsidizing interest rates. In the past three years several events have occurred which have affected both the availability and the terms of officially supported export credit.

Debt problems and economic recession have caused export credit agencies to suffer substantial losses. While this has made them more cautious, they have also been under pressure to maintain exports. Charges in the international Arrangement on export credit have reduced interest rate subsidies for export credit but increased the concessionality of mixed credits. At the national level, shifts in the policies of individual countries have occurred in response to political or economic developments.

This paper begins by examining how the export credit agencies have responded to the deterioration in the international economic environment. It then analyses the changes in the Arrangement and the continuing debate about mixed credit. There follows an account of how these issues have been dealt with in each of five countries (France, the Federal Republic of Germany, Japan, the United Kingdom and the United States) and of the evolution of their national policies and practices. Finally, there is a summing up section.

Debt, recession and export credit agencies

All the major export credit agencies are formally or informally required to encourage exports and to avoid making losses. It is not easy to strike a balance between these two requirements even when markets are buoyant and buyers are in a relatively healthy financial state. When markets are shrinking and buyers are unable to pay it becomes much more difficult.

Short-term export credit insurance forms an important part of the business of some official export credit agencies. All of them are involved in medium-term and long-term export credit to developing countries, since as a rule this is made available only if an official guarantee has been obtained. In some cases the guarantee also permits a[illegible] finance

provided by the government, often with a subsidized interest rate. If an official guarantee is withheld, credit will probably be impossible to obtain, or it may be offered only on less favourable terms.

The economic recession of the early 1980s and the debt problems which it exacerbated had particularly serious effects in developing countries, where much of the business of export credit agencies is concentrated. The combined total of claims paid out each year by agencies in the OECD countries was about $2.7 bn in 1979-81 and then rose to more than $4 bn in 1982 and more than $5 bn in 1983. Income from premiums was depressed because developing countries were cutting back on imports, particularly of manufactured goods, which account for the bulk of credit insurance. The annual total for 1979-81 was about $1.7 bn, but after rising to just under $2 bn in 1982 it declined to less than $1.6 bn in 1983. Up to 1982 recoveries were sufficient to ensure that at worst the agencies made small losses, but in 1983 claims exceeded premiums and recoveries by about $2.5 bn, and virtually all the agencies of North America, Western Europe and Japan suffered significant losses.

These losses resulted in pressure on the export credit agencies to adopt a more cautious approach. This was reinforced in many countries by concern to limit budget deficits. On the other hand, producers of capital goods faced a decline in demand both in domestic and in foreign markets and the emergence of new competitors in some newly industrializing countries (NICs), such as Brazil, India and South Korea. Moreover, the deterioration in the financial circumstances of many buyers meant that they were seeking more rather than less favourable treatment. Hence the export credit agencies were also under pressure to assume a more flexible attitude.

Although export credit agencies have not set out to coordinate their responses to the conflicting pressures exerted on them, their reaction has been broadly similar. One framework in which they do seek concerted action is Paris Club reschedulings. These deal with government-to-government debt, including officially guaranteed export credit. During 1980-84 some twenty developing countries rescheduled their debt, some of them more than once. The purpose of the Paris Club is to ensure uniformity of treatment among groups of debtors and creditors. In general, once a country requests a rescheduling, export credit agencies take it off cover for new medium- and

long-term credits. Views differ somewhat as to when and how cover for such countries should be resumed, but the trend is towards resuming it at an earlier stage.

A regular channel of communication among credit insurers is provided by the Berne Union, which is a group of 42 agencies (several of them in developing countries). Among other things, it acts as a clearing house for information about markets and claims. Although there is no attempt to establish a common view, this exchange enables agencies to gain an insight into one another's attitudes, and hence facilitates some uniformity of approach. Officials of agencies in European Community countries also meet frequently in that framework.

Competition sometimes results in convergence of agencies' positions. An example of this was the contract to build Egypt's first nuclear reactor. In August 1983 the US Eximbank announced that it did not consider the project viable, and so would not provide insurance cover for US bidders. It added, however, that it would review its position if European bidders obtained cover from their official export credit agencies. Subsequently, French, Italian and Japanese bidders secured support from their respective agencies, and the Eximbank then agreed to give Westinghouse cover for part of the credit. This left only the German bidder without an official guarantee. The matter went to the Cabinet, which in January 1985 decided to approve a guarantee.

On the whole export credit agencies have become more cautious in dealing with credit to developing countries, but there are exceptions. A general exception is France, which, though it has been more careful, has not drawn in its horns to the same extent as others. Coface alone among the five major export credit agencies during 1979-83 increased the proportion of its country's exports which it insured. A more specific exception is that agencies have made more effort to maintain cover in markets which are important to their exporters: the UK in Nigeria, the US in Brazil. An important sectoral exception is aircraft, which have continued to be covered in markets where cover has been withdrawn or restricted for other goods. This is a reflection of the acute competition in the sector, particularly between Airbus and Boeing.

The increased caution of the export credit agencies has been mani-

fested in various ways. While taking some countries off cover altogether, for other countries they have placed ceilings on the amount of cover they will permit. They have endeavoured to improve their forecasting ability, so that they can curb their exposure in a market before it gets into serious difficulty. Projects are evaluated more rigorously, and the more marginal projects which might have been accepted a few years ago are nowadays refused. In some cases agencies have limited their responsibility for the risk by requiring guarantees or sureties from the exporter or the importer, or by guaranteeing a smaller proportion of a credit than they would have done in the past.

Besides being more cautious, agencies have sought to maintain their income by raising the premiums they charge. There is some evidence in the FRG and the UK that this has been counterproductive in that it has resulted in the official agencies losing business to the private sector. The business they have lost is the least risky (notably, exports to developed countries), which the private sector is willing to insure more cheaply. This means that the quality of these official agencies' portfolios has deteriorated, and raises the possibility that they will have to increase premiums further, with the danger that more of their better business will be diverted to the private sector.*

The restraint of the official export credit agencies has prompted exporters and, in particular, banks to try to develop alternative ways of ensuring that payment is received for goods sold on credit. The private insurance sector, as well as insuring some of the better risks more cheaply than the official agencies, has in a small way taken on business that they would not because it was in a country which was off cover, or it did not meet their criteria. For both commercial and legal reasons, however, the private sector is unable to take on much business of this sort. In London there has been a rapid expansion in forfaiting (issuing promissory notes guaranteed by the importer's bank). It generally entails credit of two to five years, but it is unlikely to be feasible for a country which has debt difficulties. In absolute terms the volume of business is small. Countertrade, a system used for many years in trade with Eastern Europe,

*Economists refer to this type of vicious circle as 'adverse selection'.

has recently been extended to trade with a number of developing countries. Arranging such deals is, however, intricate, time-consuming and gruelling, and yields a relatively low return to the banks.

There has been more interest in co-financing with the World Bank, especially since it revised the formula so that it will now participate in a loan with commercial banks as well as providing its own parallel loan. Nonetheless, the Bank applies bureaucratic procedures, and negotiations are usually complex and protracted. Greater use has been made of mixed credit, which will be discussed in a later section. Altogether, few practicable alternatives have been found to the medium- and long-term export credit insurance extended to developing countries by the official agencies. Ultimately, most business that is not considered good enough for an official agency to insure will not be seen as worthwhile by the private sector. Indeed, there have been instances where a developing country importer has obtained an official guarantee but has been unable to raise a commercial loan to complement the official export credit.

To what should be attributed the steep decline in medium- and long-term export credit to developing countries? The increased risk aversion of the official agencies has had some impact. The effects of higher insurance premiums and reduced interest rate subsidies (explored in the next section) have probably been marginal. The single most important factor by far has been the sharp reduction of imports which the developing countries have found themselves obliged to undertake. They have had to establish import priorities and have tended to give precedence to food, energy, medical supplies and, in some cases, armaments. The result has been very much lower demand for capital goods in almost all markets outside South-East Asia. Most recently the oil exporters have had to retrench as world demand and prices for oil declined. Official trade credits to Saudi Arabia were $2.3 bn less in the first half of 1984 than in the second half of 1983. For Algeria the figure was $2.0 bn. Since both these countries are considered creditworthy, the explanation is more likely to lie in reduced demand for credit than in reduced supply.

If there is no further deterioration in the debt situation, which is probably a strong assumption, the export credit agencies are likely to re-establish balance or a small surplus within two or three years, albeit

on a smaller volume of business in most cases. For exporters and banks the outlook is bleaker. The capital goods sector has been hard-hit by the recession. In 1983 several important firms had net losses, a West German construction equipment group went bankrupt, and Creusot-Loire, the major French company, had to be rescued from a similar fate. Since then signs of improvement have been scant. An executive of Kraftwerk Union said in May 1985 that the present world market for conventional power stations was enough to keep busy only about one eighth of the manufacturing capacity of plant suppliers.

The experience of the banks reflects that of the exporters. There are fewer contracts, and of those they pursue they are successful in only about half as many cases as in the 1970s. Furthermore, stiffer competition has pared down the margins on export finance, so that even when they succeed the returns are smaller. As a result, a number of smaller banks have withdrawn from export finance business. The larger banks are still able to make money, though not handsome profits, from export finance, but even they will not continue indefinitely to maintain large departments if activity does not pick up.

Developments in the OECD Arrangement since 1982

In the summer of 1982 some important changes were made to the OECD Arrangement on Guidelines for Officially Supported Export Credits: a few countries were moved from the intermediate to the relatively rich category, and about forty from relatively poor to intermediate; the minimum interest rates for rich and intermediate categories were increased; the US agreed to stop offering credits with maturities of more than 10 years; Japan, because of its low market interest rates, was allowed to offer official credits in yen at a rate below the minimum; mixed credit with a grant element of less than 20% was outlawed; the period for which a prior commitment could continue to be offered after a change in minimum rates was cut back to six months; and the overall discipline of the Arrangement was made tighter.

Since then there have been further developments regarding both interest rates and mixed credit. Following prolonged and arduous negotiations, it was agreed to allow official credits in other low-interest rate currencies (LIRCs), bes[illegible]n, to be offered at rates related to their

market rates; and to introduce a mechanism for automatically adjusting the matrix of minimum rates in line with changes in market rates. Mixed credit, not surprisingly, proved to be an even more vexed issue, which has yet to be fully resolved. A decision has been reached, however, to increase the minimum grant element to 25% and to extend notification requirements. Progress was made on sector agreements. In July 1984 it was agreed that nuclear power stations should be brought within the Arrangement with interest rates 1% higher than those in the matrix and a maximum term of 15 years. Recently an agreement on aircraft was initialled, and it is now being examined by the administrations of the four countries involved. Once this is signed, only military equipment and agricultural commodities will be outside the Arrangement.

Agreement on LIRCs was achieved in August 1983. Since, except in Japan, the commercial banking system did not offer fixed-rate medium-term export finance, the central banks were asked to construct a rate which would be appropriate if such finance existed. These commercial interest reference rates (CIRRs) were constructed for eight currencies* by their respective central banks and submitted to other participants for approval. The principles for calculating the CIRRs are obscure enough to admit differing interpretations. Most central banks proposed a CIRR that was significantly higher than the floating rate at which their own exporters could offer commercial credit with an official guarantee. Some CIRRs were disputed, though usually the view of the currency's central bank prevailed. No agreement has so far been possible on the CIRR for the US dollar. The CIRRs for the yen and the other eight currencies are set every month. Once a currency's CIRR falls below the highest rate in the matrix (i.e., the rate for relatively rich countries), it becomes a LIRC, and export credit agencies are allowed to support fixed-rate finance at the CIRR.

In the almost two years since these changes were made, the use of LIRCs has been mostly confined to exporters in the currency's own country.

*Austrian Schilling, Canadian dollar, Deutschmark, Finnmark, Dutch guilder, Swiss franc, sterling and US dollar.

The US dollar continues to be the only currency which is extensively used for foreign-currency financing of export credit, and it, like the Canadian dollar and sterling, has yet to become eligible to be a LIRC. The low use of LIRCs by exporters in other countries is chiefly explained by the fact that the CIRRs have been so much higher than commercial rates. Exporters have usually been most competitive when offering credit in their own currencies. An exception may be a situation in which an exporter from a non-LIRC country is competing with an exporter from a LIRC country. It may then be advantageous to offer a LIRC from a country which is not involved in the competition. For example, a British exporter competing with a Japanese exporter in the Philippines might offer Swiss franc financing.

Bankers point out that buyers are becoming more astute in evaluating offers and may not necessarily be attracted by a currency with a low interest rate. Also, some borrowing countries prefer credits to be in the exporter's own currency. They note, too, that in the depressed state of the market there has been some reticence about pressing an unfamiliar formula on buyers. It is sometimes suggested that LIRCs were never expected to be used much by exporters outside their own countries, but provision had to be made for this to take them politically acceptable to non-LIRC countries. Nonetheless, participants in the Arrangement have expressed sufficient concern about why the system has not been working properly for the Chairman, Axel Wallen, to initiate a study to investigate the way in which the CIRRs are constructed, as well as the margins that are applied to LIRCs, and the problem of currency swaps for credits in non-LIRCs. The signs are that this study will suggest revisions in the rules for constructing the CIRRs, but is unlikely to tackle the fundamental difference between governments which want to be able to subsidize and those which want government involvement to be confined to pure cover, that is, guaranteeing commercial credits.

The main issue at stake in Arrangement negotiations during 1983 was the introduction of an automatic mechanism for adjusting the matrix rates. Some participants, notably France, were unwilling to concur unless it was accompanied by a sizable (2%) reduction in matrix rates. They argued that this was appropriate because market interest rates had declined since the cha[illegible] July 1982. As 1983 proceeded, however, market rates began to

rise again, and their case was weakened. Hence, in October 1983 it was agreed to reduce the matrix rates by 0.5 for the poorest countries and for credits with terms of 2-5 years to intermediate countries, and by 0.65 for 5-10 year credits to intermediate countries, and at the same time to introduce automatic adjustment. This entailed reviewing every six months, in January and July, changes in the interest rates for government bonds in the five currencies which comprise the special drawing right (SDR), weighted in accordance with their weighting in the SDR.* If in the last month of the previous six months (i.e., December or June) this weighted average of bond rates has changed by more than 0.5 from the last month of the preceding six-month period (i.e. June or December), then the matrix moves commensurately. If bond rates moved down, matrix rates were to move down by half as much until the reductions of October 1983 had been clawed back. Otherwise the change in the matrix was to equal the change in bond rates.

The first review was in January 1984. Bond rates had risen by only 0.4 so the matrix was left unchanged. In July 1984, however, matrix rates were raised by 1.2. By January 1985, bond rates had declined again. Matrix rates for rich countries were reduced by 1.35. Those for intermediate and poor countries were reduced by the same amount adjusted by the amount of the October 1983 reductions. Thus the clawback was effected in one go. The matrix rates from July 1982 to date are shown below:

| | Relatively rich | | Intermediate | | Relatively Poor | |
|---|---|---|---|---|---|---|
| | 2-5 years | 5-8½ years** | 2-5 years | 5-8½ years | 2-5 years | 5-10 years |
| July 1982 | 12.15 | 12.4 | 10.85 | 11.35 | 10 | 10 |
| Oct. 1983 | 12.15 | 12.4 | 10.35 | 10.7 | 9.5 | 9.5 |
| July 1984 | 13.35 | 13.6 | 11.55 | 11.9 | 10.7 | 10.7 |
| Jan. 1985 | 12.0 | 12.25 | 10.7 | 11.2 | 9.85 | 9.85 |

*US dollar, 42%; Deutschmark, 19; French franc, yen and sterling, 13% each.

**Credits of more than 5 years are permitted for relatively rich countries only in exceptional cases.

The changes effected in 1983 transformed the interest-rate provisions of the Arrangement. A single set of interest rates which was changed infrequently and irregularly, and could permit large subsidies when market interest rates were high, was replaced by a system which permitted three different forms of officially supported export credit. For LIRCs there was 1) pure cover finance, i.e. officially guaranteed commercial credit, usually with a floating interest rate, or 2) official finance at a fixed rate (the CIRR) which was linked to market rates. For currencies which were not LIRCs, 3) finance had to comply with the matrix rates, which were reviewed every six months and changed automatically with changes in market rates. This ensured that interest rate subsidies would be limited regardless of movements in market rates, and ended the need for laborious negotiations among the participants each time that there was disagreement about whether the matrix should be changed.

Whether a currency is a LIRC or subject to the matrix is unlikely to change unless its market interest rate moves more quickly or in a different direction from others. The US dollar, in particular, is unlikely to become a LIRC because of its large (42%) weighting in the SDR. Any decline of 1.2 or more in the dollar bond rate will trigger a downward revision of the matrix. Furthermore, if, as tends to be the case, other interest rates move in line with dollar rates, there will be all the more downward pressure on the matrix.

The automatic adjustment mechanism appears to be operating satisfactorily. Changes in the matrix are usually foreseeable and may be anticipated to some extent. For example, in the weeks before the increase of July 1984 some bunching of letters of commitment was evident, and there may have been some postponement of business running up to the reduction of January 1985. These are, however, fairly trivial snags compared with the problem of prior commitments which used to arise when there were changes in the matrix under the old system. Some fault has been found with the adjustment mechanism itself, notably by the French administration, which questions whether the US dollar should have such a large weight in determining movements in the matrix, particularly since the US share of world trade is much less than 42%. French officials point out that because the US has kept its interest rates unusually high, the matrix has been higher than it would have been if the dollar's weight had been less. It is also suggested

that instead of comparing rates during the last month of each six-month period, it would be preferable to take the last three months or the whole six months.

Governments which have sought to eliminate interest-rate subsidies, such as the United States and Germany, are sufficiently satisfied with the reduction and control that have been achieved, that they are prepared to accept that the system should permit some subsidy. Some concern has been expressed at the practice of currency swaps. Transforming a loan denominated in one currency into a loan denominated in another (with an appropriate interest rate) is a service which banks can provide. In the context of officially supported export credit a currency swap is significant when it is from a matrix currency to a LIRC. If there is a subsidy equivalent to, say, 2% on the matrix currency, that subsidy can be transferred to the LIRC so that, for example, a yen credit can carry an interest rate 2% below the commercial rate for the yen. Since the swap is carried out by a bank after the official export credit agency has provided the credit, it is beyond the agency's direct control, but if it becomes clear that this practice is taking root the Arrangement participants can be expected to seek ways of eliminating it.*

There is broad agreement that the revisions to the Arrangement have accomplished their main objective, namely, to neutralize official export credit as a competitive element in capital goods exports. This raises the question whether the distortions which were present before have been removed altogether or have shifted to another arena. Swaps are one instance of a new distortion. There has also been a significant increase in the use of

*Besides allowing interest rates below commercial rates, the matrix comprises an inherent subsidy in that rates are lower for poor countries than for richer ones, and that there is little or no difference between rates for 2-5-year credits and those for longer maturities. In addition, the provision by governments of finance or insurance itself embodies a subsidy if the market would not take on the business, or only at a higher price.

mixed credit. Many believe, however, that this was a development which was occurring anyway, because of the difficulty of securing orders in depressed markets, rather than an effort to boost an alternative form of concessional finance as export credit became less concessional.

For those countries which were moved from the poor to the intermediate category in July 1982, the increases in the matrix rates were substantial: from 10% to 10.85% for credits of 2-5 years and to 11.35% for more than 5 years. Increased rates do not, however, appear to have played a significant role in lowering the volume of export credit. This has resulted chiefly from the austerity measures that many developing countries have had to adopt and, to a much lesser extent, from greater risk aversion on the part of export credit agencies. In the past two or three years developing countries have been obliged to curtail their international financing, and when they have sought to borrow have found it expensive, if not impossible. Less favourable interest rates for export credit have simply been one more element in a generally adverse climate. To the extent that developing countries have been willing and able to take on new medium- and long-term export credit, they have accepted higher interest rates. The permanent reduction in interest rate subsidies brought about by the adoption of the automatic adjustment mechanism seems to have been largely unnoticed by developing countries. This may be partly because many of them have negotiated so few new contracts since 1983, and partly because since July 1982 matrix (nominal) rates have been at or below the levels set then, except during the six months from July 1984 to January 1985.

Developments in mixed credit

The use of mixed credit has increased steadily during the 1980s. Precise figures are difficult to come by. Participants in the Arrangement do not always respect the requirement to report mixed credits, and in any case the figures are not normally published. Reported mixed credits reached a peak of US $6.4 bn in 1982, then declined to US $3.7 bn in 1983, and the indications are that they rose again in 1984. Mixed credit appears to be concentrated on a small number of countries and sectors. Probably a dozen countries receive 75% of all mixed credit. They include Cameroon, China, India, Indonesia, Pakistan, Philippines, Thailand, Zaire and Zimbabwe. The

sectors in which mixed credits are most prevalent are energy, steel, transport and communications.

Until the mid-1970s mixed credit was in effect the exclusive preserve of France. A part of Japan's aid programme had similar characteristics though it was not mixed credit. These practices were regarded as aberrations and were accepted, albeit reluctantly, by other OECD countries. Since the late 1970s mixed credit or similar facilities have been introduced by a dozen other countries, and in the past two or three years the reporting through the Arrangement indicates that more countries are chasing fewer contracts, with more concessional funds.

This rapid expansion from the end of the 1970s and the prospect of mixed credit being extensively used to gain commercial advantage caused concern. Originally the Arrangement, which uses the term 'tied aid credits', required only that participants should give at least 10 days' notice (prior notification) before issuing a commitment to a tied aid credit with a grant element of less than 15%, and notice at the time of commitment (prompt notification) for a credit with a grant element of 15%-25%. In July 1982 the Arrangement was revised so as to exclude mixed credits with a grant element below 20%, to require prior notification of mixed credits with a grant element between 20% and 25% and prompt notification of those with a higher grant element.*

*A mixed credit combines an export credit with aid funds. The grant element of a loan is arrived at by calculating the amount of capital that would need to be invested on commercial terms (conventionally taken as 10%) to yield the same stream of repayments as the loan in question. The more concessional the loan, the smaller is the corresponding amount of capital, and the larger the difference between them. It is this difference, usually expressed as a percentage of the loan, that is the grant element. Hence the grant element measures the concessionality or 'softness' of a loan: the lower the grant element, the closer the terms are to market terms. Raising the grant element of a mixed credit entails either increasing the proportion of aid in the credit, or improving the terms of the aid through a lower interest rate or longer maturity.

The 1982 revisions sought to deter participants from using mixed credit by two means: making mixed credit more expensive (often referred to as increasing discipline); and reducing the commercial advantage to be derived from mixed credit by ensuring that competitors were informed of offers in advance (increasing transparency). Participants have complied with the higher minimum grant element and, for the most part,* with the notification requirements. The result has not been, however, that they have been persuaded to use mixed credit less. Rather they have accepted that mixed credit should be more concessional. The volume of reported mixed credit did decline in 1983, but this was the result much more of developing countries with financial difficulties deciding to defer, scale down or abandon projects than of exporting countries being less willing to offer mixed credit.

The increasing use of aid in a commercial context was also taken up in another OECD forum, the Development Assistance Committee. In June 1983 the members of the DAC (who are virtually the same as the members of the Export Credit Group) subscribed to a set of 'Guiding Principles for the Use of Aid in Association with Export Credits and Other Market Funds'. These defined associated financing as transactions which associated in law or in fact a concessional component and a non-concessional component, one or both of which was tied to procurement in the donor country. Hence it included mixed credit, mixed financing, parallel financing and other combinations. The DAC members undertook to devote associated financing primarily to development objectives; to tailor the terms to the circumstances of each developing country; and to assist developing countries to get value for money, in particular by seeking to ensure that large projects were awarded on the basis of international competitive bidding.

Members also agreed that there should be regular reporting and review of associated financing. The first review, in mid-1984, assessed trends in associated financing during 1981-83. The review noted that the data reported

*A recent exception occurred in March 1985 when France notified other participants only six days before the bids were due that it intended to offer mixed credit to Thailand for exports of power plant components. This gave rise to protests from the export credit agencies of Canada, Japan and the United States.

by DAC members had to be treated cautiously. It was possible that members had differed in their interpretation of the guiding principles, and that some had applied them too restrictively. Diplomatically the review added, 'the occurrence of under-reporting cannot be excluded'. Reported commitments amounted to US $3.5 bn in 1981, rose to US $5.1 bn in 1982, and fell to US $1.9 bn in 1983. This erratic pattern was explained chiefly by the 'lumpy' nature of such transactions - a few large projects bunching in one year could have a significant impact on the statistics. The decline in 1983 might be due to retrenchment in developing countries and, to a lesser extent, to the raising of the minimum grant element, though the fact that the average grant element of associated financing rose from 18% in 1981 to 25% in 1983 suggests that members were more than willing to observe the higher grant element. In the three-year period 1981-83, France provided about 45% of all associated financing, the UK 22% and Italy and Japan about 9% each. The remaining 15% was accounted for by eleven other countries.

The reported commitments for associated financing appear to be smaller than the sums for tied aid credits reported under the Arrangement. The DAC, however, also collected data on less concessional aid (i.e., with a grant element below 50%), which may include transactions whose effect is similar to that of associated financing, particularly when they are tied to procurement in the donor country.* When the figures for less concessional aid not related to associated financing are added to those for associated financing the totals are US $5.7 bn in 1981, US $6.7 bn in 1982 and US $3.7 bn in 1983, which is similar to the sums for tied aid credits.

As the first review of associated financing showed, the volume is relatively small. Reported commitments of associated financing accounted in 1981 for 4% of total bilateral aid and 4% of total export credits, in

*The amounts of less concessional aid not related to associated financing were US $2.2 bn in 1981, US $1.6 bn in 1982 and US $1.8 bn in 1983. Of the 1983 amount, 55% was available only for procurement in the donor country and a further 30% only in the donor country or in developing countries.

1982 for 6% and 5%, and in 1983 for 3% and 2% respectively. Even this level causes some worries, but what provokes most anxiety is the danger that these forms of financing will become much more widespread, unless they are checked. The United States has been especially concerned at such a prospect, and once the changes in the interest rate provisions of the Arrangement had been accomplished in 1983, the US began in 1984 to concentrate its efforts on the issue of mixed credits. This together with the increased activity in the DAC has generated much discussion of whether mixed credit should be further controlled and, if so, how.

Mixed credit is criticized on the grounds that it can distort trade by deflecting buyers from selecting those bids which are most competitive in terms of technical quality and price, and can distort aid by influencing recipients to use aid money in ways which do not particularly benefit their development. Trade distortion and aid distortion may be two sides of the same coin: if a sum of aid is used for commercial rather than developmental purposes then both types of distortion probably occur. Neither, however, is easy to pinpoint precisely.

Trade distortion is implicit in the fact that some markets have been 'spoiled', i.e., that for certain categories of capital goods exports concessional financing is virtually a prerequisite. A recent report by the British company Hawker Siddeley reviewed 29 contracts for railway locomotives and showed that several of them had been won by competitors in other exporting countries who had been able to include an offer of concessional finance in their initial bid. The report concluded that the British government's unwillingness to follow suit 'effectively precludes British companies from a number of markets'.

The most clear-cut example of a spoiled market is probably Indonesia. For some years Indonesia has been plied with offers of mixed credit by exporters of capital goods. Then in October 1984 a presidential decree was issued declaring that, with certain exceptions, all public-sector development projects for which export credit or mixed credit was offered were to be put out to international tender. At first blush this appears to strike a blow against the use of mixed credit to gain a commercial advantage, but one of the three exceptions is very significant. This states that international tendering can be dispensed with if for the entire project a credit is offered with a grace period of at least 7 years, a maturity of at least 25 years ...

an interest rate of not more than 3.5%.* These are typical terms for Japan's equivalent of mixed credit. That they should set the standard for an important and expanding market like Indonesia has caused disquiet in some exporting countries.

Fears of the implications of such developments have also been evident in the response to the recent evolution of China's economy. The planned modernization of the economy will generate sizeable demand for capital goods exports from OECD countries. China has been pressing for these to be financed on concessional terms. If concessional finance became the norm for capital goods exports to China, it would require a major commitment of aid funds. This prospect initially prompted the OECD countries to engage in an informal pact to refrain from offering concessional finance to China, but this has now been breached on several occasions.

All the Arrangement participants formally disapprove of mixed credit being offered to seize a competitive advantage. Everyone claims only to use mixed credit either for developmental purposes or defensively to match a mixed credit proposed by a competitor. Most, however, depart from their declared policy and use mixed credit to steal a march on competitors, though some do it much more than others. Even if they did not, there would still be some problems. For one thing, although a mixed credit may be genuinely developmental in intent, it may distort trade, and a competitor may feel this justifies a matching offer. Furthermore, donor governments often use the fact that a mixed credit has been negotiated with the recipient government as part of a bilateral aid package as a demonstration of its developmental nature. But this does not necessarily follow. A firm in the donor country can usually acquire a good idea of what projects are in the offing in the recipient country and can seek to have a project which it would like to supply included in the bilateral aid programme. Such pre-emption of competitive bidding for a project can also be a distortion of trade.

Some evidence of aid distortion was presented in the first review of associated financing. It found that associated financing was primarily directed to sectors and projects with relatively high and quick returns. Of

*The other two exceptions are projects which only one country is capable of supplying and follow-on orders with the same or better credit terms than the previous order.

the total for 1981-83 energy accounted for 30%; industry, 20%; transport, 20%; food and agriculture, 10%; communications, 5%; and health and social infrastructure, 2%. The review also observed that, though in principle the procedures and monitoring for associated financing should be no different from those for all aid, in practice they sometimes were, particularly when trade considerations entered into the selection of a project. It further noted that associated financing was often directed to isolated projects which were not part of a concerted donor programme, and that in many cases associated financing projects were the result of initial contacts between the supplier and the recipient rather than flowing from longer-term aid programmes. The review identified the most controversial instances of associated financing as projects which would normally be expected to be financed commercially or with regular official export credits (notably, remunerative projects in stronger developing countries), but for which concessional finance had been offered as a means of gaining advantage against strong competition.

A number of countries, while not denying that distortion may occur, argue that it is wrong to dismiss all mixed credits and comparable forms of financing. They point out that at a time when aid budgets are restricted and commercial lending to developing countries has been curtailed, mixed credit is permitting a larger flow of funds to developing countries than would otherwise be possible. Those developing countries whose capacity to service their debt is limited are able to obtain finance on better terms than the market offers them. For countries which have reached a level of development that warrants access to some concessional resources but not to large amounts, mixed credit is a particularly appropriate form of finance. Furthermore, the quality of export credit and commercial financing in mixed credit is improved because it is evaluated and monitored by aid agencies.

Several of these assertions are open to challenge, but it has been widely accepted that some mixed credit and less concessional tied aid has developmental value. This acceptance has called into question the US approach to controlling mixed credit, namely, to eliminate all credit with a grant element below 50%. Increasing attention has been given to ways of distinguishing between credits which are primarily commercial in intention or effect and those which are developmental. Another issue to emerge from

the debate has been the problem of definition. The Arrangement's term 'tied aid credit' embraces French and British mixed credit but not German or Japanese. Germany reports/its pre-blended credits under the Arrangement, but Japan does not report transactions which are effectively tied aid credits. This has prompted proposals for revising the definition of tied aid credits.

After a year of arduous negotiation some further revisions to the Arrangement were agreed in April 1985. The minimum grant element was raised to 25% and prior notification was introduced for credits with a grant element of 25% to 50%. For contentious offers of mixed credit there was to be face-to-face consultation among the participants involved. Finally, the secretariat of the OECD Trade Committee was asked to prepare by the end of September a study of how further to reinforce transparency and discipline, including consideration of characteristics which were common to aid but not to export credit.

The area which will probably see some progress soon is the definition of tied aid credit. The main obstacle is Japan. The new definition would cover semi-tied aid, which would include what Japan calls untied developing country aid. This is aid which can be used for procurement only in Japan, the recipient country or a developing country recognized by Japan. Japan is resisting the proposal to classify such aid as tied, but it seems likely that a satisfactory solution will be found.

The prospects for further raising the minimum grant element are less certain. The United States continues to press for an increase to 50%. A smaller increase, e.g. to 35%, would capture only some countries' mixed credit (France, UK, Canada) but would leave others untouched (Germany, Italy, Japan). There would also be a risk that those participants whose mixed credits at present have a grant element below 35% would decide to raise it rather than cut back their mixed credits. Hence the US argues for 50% on the grounds that it would capture virtually all mixed credit, and that it would be a large enough increase to deter participants from responding by making their mixed credit more concessional. This is resisted by those who wish to retain the possibility of offering mixed credit with a lower grant element. Others object that if the US is wrong, and an increase to 50% is not a sufficient deterrent, the situation will be worse still with participants allocating larger am[illegible] their aid budgets to

mixed credit so as to conform with the higher minimum grant element. Japan is thought particularly likely to do this because its grant element is already about 40-45%, and most of the financing of this sort from Japan goes to relatively rich countries in South-East Asia which are politically and economically important to Japan. If Japan were to respond in this way, other participants might feel that they had to as well.

Establishing an effective way of distinguishing tied aid credit with a commercial purpose from that with a developmental purpose promises to be difficult. The motive for a credit offer is not easily pinned down, and the effect may become evident only after the event. One approach would be to exclude mixed credit for certain sectors, but this has little support among Arrangement participants, not least because of the problem of drawing boundaries between sectors. The DAC Guiding Principles include an undertaking to ensure that if associated financing is provided for least-developed countries the grant element is high, and to restrain strictly the amount of financing with an aid component that is provided for stronger developing countries. This implies that mixed credit should be limited to middle income developing countries. Differentiation by country could be applied by confining mixed credit to the poorest category of countries (particularly if some countries now in the poorest category were promoted to the intermediate category), but it seems unlikely to meet with the approval of most participants. The Trade Committee secretariat has been focusing on the process by which credits are arranged: the tender procedure; the existence of a feasibility study; the division of responsibility among government departments; and the speed of decision-making.

A more limited but more specific suggestion is to eliminate 'double tying', that is, stipulating that aid must be used for procurement in the donor country and for a particular project. The broadest consensus exists on reinforcing notification requirements. Longer notice not only rules out the possibility of last-minute offers, but also, by permitting more effective matching, dissuades countries from offering mixed credit to gain a commercial advantage. It is also hoped that more face-to-face consultation will result in participants more often adopting a common front in refusing to provide mixed credit for a particular project. Much of this discussion assumes, however, that participants want to see an end to the commercial use of mixed

credit. Most participants would indeed favour this, if it was respected by everyone else. But a few (notably France and Japan) probably want to retain the option to use mixed credit commercially, and that will further complicate matters.

Country perspectives

a) France

The main innovation of recent years in France's export credit policy has been the introduction of foreign-currency financing in 1982. This was prompted by several considerations. Partly it was thought that French exporters' competitiveness would be enhanced if they could offer financing in currencies other than francs, particularly those with low interest rates. Other reasons were that it would reduce the cost of subsidizing interest rates, and would benefit the balance of payments, and hence the exchange rate. Budget and balance-of-payments factors seem to have weighed more heavily, since there is evidence that in some cases foreign-currency financing was pressed on buyers whose preference was for francs. Lately France has become more flexible in offering buyers a choice between franc and foreign-currency financing. The dollar is by far the most frequently used currency, accounting for 90-95% of the total, the rest being Deutschmark, Swiss franc and yen. Recently arrangements have been made for financing in ECU but but they have not yet been used. In 1983 foreign-currency financing accounted for 8% of new credits and in 1984 for 24%. The proportion is thought unlikely to rise much further.

Export credit policy has also been affected by two more general developments arising from the adverse experiences of the French economy in the early 1980s. First, the imperative of reducing the budget deficit has necessitated lowering subsidies. The Trésor acknowledges that this has probably caused French exporters some difficulty but says that the result is a healthier situation. The DREE, though it is less positive, accepts that there is not as much subsidy available now as in the past. Second, greater emphasis has been placed on short-term trade. This reflects several considerations: it costs less to support; yields quicker returns; entails lower risk, because it is spread over a broader range of markets; and offers better opportunities than the depressed market for

projects. The shift is, however, only partial. France is certainly not neglecting projects, which still represent 6% to 10% of its exports.

Coface, the French export credit insurance agency, suffered substantial losses in each of the years from 1979 to 1983, except 1981. Moreover, these losses are probably understated, since Coface treats a claim as recovered as soon as agreement has been reached in a Paris Club rescheduling. The main reason for the losses has been the high level of claims. The value of exports insured has declined since 1980 but this reflects the general decline in French exports. Indeed, as a percentage of total exports, exports insured have increased. The effect on premium income of the decline in the value of exports insured has been partly offset by higher premiums.

The response of the Trésor to the losses of Coface has been in line with its overall insistence on cutting budget liabilities. It has instructed Coface to charge more realistic prices, to take precautions and not to assume large risks. Those in the administration who are responsible for export promotion complain that as a result Coface has become expensive, slow and bureaucratic. Coface has displayed more caution in the past few years, but not to the same extent as the agencies of other countries. Like other agencies, Coface goes off cover completely for a country undergoing a rescheduling. In a market which offers a possibility of increasing the share of French exports, however, Coface will delay going off cover longer and will resume cover sooner than other agencies. Hence, few countries are off cover, though between 60 and 70 have had ceilings placed on their exposure or are 'under surveillance'.

French officials argue that it is not sensible to abandon a country which has become riskier, particularly since this applies to the majority of developing countries. Account must be taken of obligations to former colonies and other political relationships; of the reputation of French exporters; and of the likelihood that a country such as Brazil will in the future become an important market again. Consequently French policy is to be more selective and more exigent but to avoid coming off cover altogether. A country which respects its undertakings is kept on cover even if it is in difficulty. Coface examines individual contracts more closely and requests the exporter and the French embassy in a country to investigate projects more carefully. [illegible] set up a special country risk division.

Banks and exporters are asked to provide more by way of guarantees and sureties, and premiums have been raised. In some cases the provision of financing has become less generous in that the French government supports a smaller proportion of the total credit, leaving the buyer to find a larger proportion of local costs from other sources.

The changes in the Arrangement are seen as having resulted in a situation which is less favourable for France. French export financing is now less competitive, but financing is no longer fundamental, and other factors, such as a high inflation rate, have probably influenced competitiveness more. The Trésor hopes that French interest rates will decline sufficiently for the franc to become a LIRC. There are reservations about some aspects of the matrix, such as the method for determining automatic adjustment, but France recognizes the need to control competition in export credit and broadly accepts the revised Arrangement.

France has also accepted the changes affecting mixed credit, but is resisting the idea of further modifications. French mixed credit is directed chiefly to telecommunications, transport, infrastructure and energy. It amounts to between FF 2 and 2.5 billion a year, or roughly 10% of the total aid budget of about FF 20 bn. In the past few years this amount has declined because there have been fewer suitable projects in developing countries. This smaller amount has, however, been on more concessional terms. French officials point out that the DAC's statistics show that associated financing from Japan and the UK has been increasing. Mixed credit is the only form of financial aid which France provides for non-Francophone countries, though some also goes to Francophone countries. Altogether mixed credit goes to some thirty or forty countries, the major recipients being Brazil, China, India, Indonesia, Morocco and Tunisia. There is some differentiation among countries, with the poorer ones getting mixed credit with a somewhat higher grant element.

Within France's total aid budget there are allocations for individual countries. French officials say that the initiative for a mixed credit usually comes from the recipient country, which approaches the French authorities with a project. This is first examined by a commercial counsellor on the spot. It is then analysed in Paris by the Trésor in consultation with the Ministries of Development Cooperation, Trade and Industry, and Foreign Affairs. Considerati[illegible] to the nature of the project - its develop-

mental features and its place in the country's development plans - the country's ability to repay, and the likely impact on French exports. If all the criteria are met, a financial protocol is drawn up between the Trésor and the recipient government, within the overall aid allocation for the country.

The French government insists that it does not use mixed credit for competitive purposes and that it does not wish to be the driving force behind mixed credit, but it sees mixed credit as a way of helping developing countries. If the minimum grant element of mixed credit is again increased, the volume will have to be reduced. This will oblige developing countries to turn more to commercial financing and hence raise their cost of financing. France would like first to see the existing rules regarding notification and matching better respected. It would also welcome reinforcement of the notification requirements, but it opposes any further increase in the minimum grant element.

b) Federal Republic of Germany

The proportion of exports for which the government provides credit insurance and guarantees (through Hermes, a private company) is much smaller in the FRG than in some other major exporting countries. Government support is highly concentrated on developing countries, and to a lesser extent on Eastern Europe. Consequently there have been large claims, particularly in 1983 and 1984. Government credit insurance business, after showing a small surplus in 1982, made large losses of DM731m in 1983 and DM 1.2bn in 1984.

Because of economic recession and debt problems in developing countries, orders for exports of capital goods were declining noticeably in the second half of 1982. Exporters began to argue that since exporting to developing countries was becoming riskier the government should provide increased cover, so as to protect employment in the capital goods sector. In February 1983, the cabinet of Herr Kohl, who had come to office in October 1982, decided that the boundary of justifiable risk could be extended if a contract served overall economic policy and employment policy. The FRG would, for example, resume guarantees for countries such as Brazil, Mexico and Yugoslavia which had completed stabili[illegible] agreements with the IMF. The Hermes scheme was not, however, to be [illegible], that is, over the years surpluses were expected to

offset losses.

As 1983 proceeded and the size of the losses in store for Hermes became evident, the government determined to raise premium income. It linked this to increased cover, saying that if Hermes was to assume greater risks, exporters would have to pay more. Aggregate premium was to be raised by 40%. The increase would be relatively greater for credits to public entities since they would now be subject to the same rates as private entities, which previously had been higher. Also premium rates were now to be the same regardless of the amount of a credit, whereas before they had been lower for larger credits. No-one, however, was to incur a premium increase of more than 50%. At the same time insurance cover would be improved and claims for medium- and long-term credits facilitated. These changes were to come into effect at the beginning of October 1983 but after strong representations from exporters' organizations they were postponed until 1 April 1984.

Although cover has been improved, the German authorities have acted rather cautiously towards countries in debt difficulties, withholding cover very promptly as soon as there has been a technical default and restoring cover only after a rescheduling agreement has been signed. Industry has felt that in some cases Hermes has been off cover when other agencies have not, and in Latin America, for example, only Colombia and Ecuador are not subject to some kind of restriction, and most countries are covered only for very short-term credits and for small amounts. Exporters have pressed for an easing of the regulations but this has been refused because they are governed by requirements in the budget law regarding government guaranteed debt.

The volume of export credit business insured by Hermes has declined since 1982 both in absolute terms and as a proportion of total exports (from 9.2% in 1981 and 1982 to 7.7% in 1983 and 6.6% in 1984). Part of the explanation for this is that fewer German exports are going to developing countries. In 1984 higher premiums may have been another factor.

The changes in the matrix are seen as being very important. The FRG does very little subsidizing of interest rates and ideally would like such subsidies to be ended. Although subsidies are still permitted, the increase in matrix rates combined with the automatic adjustment mechanism ensure that they [illegible] limited. Furthermore, the LIRC system means that, as long

as the CIRR for the DM remains below matrix rates, the FRG can offer rates below the matrix on the small amount of subsidized financing that is available. In fact, lately commercial interest rates in the FRG have been so low as to make uncompetitive the officially supported fixed-rate finance from the KfW and the AKA, and the take-up from these two sources has been very low. Hence virtually all export credit is currently being provided on commercial terms, and government involvement is confined to Hermes insurance and guarantees. Lower German commercial rates and high matrix rates have made German export credit more attractive. Exporters believe, however, that this has had little impact on exports of capital goods to developing countries. These have been far more affected by negative factors, most of all slack demand but also restrictions on cover.

Concern about the prospects for employment in the capital goods sector together with the increased use of mixed credit by other OECD countries has prompted a significant shift in German aid policy since 1982. The use of mixed financing has expanded rapidly to reach 22 completed contracts involving a total of DM 1,963 m in 1984. This sum comprised DM 1,118 m of capital aid and DM 845 m of KfW financial credits, and accounted for about 45% of total bilateral aid funds. German officials are at pains to emphasize that this mixed financing is not mixed financing as defined by the OECD, but pre-blended credit, which does, however, fall within the OECD tied aid credit category. Pre-blending means that financial credits are mixed with aid funds and offered to the borrower as a single credit.

The initiative for mixed financing almo[illegible] [illegible]ariably comes from the Ministry for Economic Cooperation, which offer[illegible] [illegible] developing country the opportunity to accept mixed financing for certain projects. Mixed financing is subjected both to aid procedures and to export credit procedures. The KfW evaluates the developmental aspects of a project, and the Interministerieller Ausschuss and Hermes consider the economic and risk aspects. The Ministry for Economic Cooperation tries to persuade the other ministries and Hermes to be broad-minded in assessing risks in mixed financing, but in some cases the terms of payment or the security offered have been unacceptable to Hermes.

The administration insists that mixed financing is not export promotion. I[illegible] [illegible] used in particular for large projects where aid needs to be eked out. [illegible]ivation and technique is the same for mixed financing as for aid, but

mixed financing provides some spin-off for German industry. Officials point to the fact that the process of evaluating a project usually takes about six months, and note that there have even been instances where a project has been drawn up and it has then proved impossible to find a German exporter to undertake it. They acknowledge, however, that large exporting companies usually know about forthcoming projects in developing countries and may ask the Ministry for Economic Cooperation to seek to include mixed financing for them in bilateral aid programmes. The increased use of mixed financing is justified as a marginal adjustment in German aid policy in response to major changes in the way other countries use mixed credit for export finance. For some years the FRG avoided emphasizing other countries' use of mixed credit because it knew that this would generate demands for similar facilities from German industry, but as mixed credit practices became more widespread they could no longer be ignored.

The FRG does not offer mixed financing to the least developed countries. The grant element of mixed financing depends on how much aid is available for a particular country. It averaged 46% in 1982, 60% in 1983, and 54% in 1984. This compares with a range of 62%-84% in any one year for pure aid. Less than a quarter of mixed financing has a grant element below 50%.

No matching fund exists in the FRG, though there has been some pressure from industry to establish one. The Ministry of Economic Cooperation has resisted because aid funds are limited and have to be spread among a number of countries. Also matching might not permit a proper evaluation of a project, because of the need for a speedy response. There have been a few occasions, however, when exporters have said that they had no chance of winning an order unless they could include capital aid in their offer of finance. If spare aid funds have been available for the country concerned, and if it has been agreeable, the ministry has then provided mixed financing.

The government supports all efforts to distinguish between, on the one hand, aid and, on the other, the participation of developing countries in the world economy, which should be subject to the same market conditions as for other countries. It favours raising the minimum grant element but would prefer a level of 35% rather than 50%. It believes that 35% would be sufficient to stop trade distortion whereas 50% would touch credits which were genuinely aid-motivated and would run up against serious budget constraints. the minimum grant element were increased to 50%, however, German policy ld not be affected.

c) Japan

The Export Insurance Department (EID) of the MITI covers a large volume of exports, representing a higher proportion of total exports than ECGD of the UK or, until 1983, than Coface. Its premiums are lower than those of other agencies and its approach to risk is very careful. Because of this caution the claims EID has had to pay out have been relatively low, but because premium income is also low it has suffered losses since 1982, albeit smaller losses than most other major agencies. MITI is required by law to alter premiums to offset outflows for claims. Hence medium-term premiums were increased in 1983(by 40%)and again in 1984.

The EID's losses have also had the effect of making its approach to risk yet more cautious. MITI is forbidden by law to offer cover on countries which are rescheduling public or private debt, or have indicated that they intend to, though it is allowed to grant special exemptions. It usually tends to follow closely the principal supplier in a market and to come off cover as soon as they do. MITI's policy is also to come off cover for all classes of debt (short- and long-term, public and private) even if the problem is confined to only one. Before restoring cover for rescheduling countries, it insists on three conditions being met: that a bilateral agreement has been signed; that debt repayments have proceeded without interruption for at least a year; and that they will continue for the immediate future. As a result, in 1983 there were 30 countries off cover or on very restricted cover. In February 1984 the EID was reported to have taken 25 countries off cover, and to have restricted cover for a further 27. Cover was resumed for seven countries in June 1984, but only for short-term credits of small amounts, and only if the exporter took on 30%-40% of the risk and paid a premium surcharge of 200%-500%. Japanese exporters have been dissatisfied with the EID's conservative attitude which they believe has put them at a disadvantage with exporters from countries whose export credit agencies have been more flexible.

Another source of discontent is the changes in the Arrangement. Japanese exporters point out that it is possible to subsidize interest rates on currencies which are subject to the matrix but not on LIRCs. Moreover, the CIRR for the yen has been set too high and the margin too large. Hence, while export credit agencies in other countries can offer a subsidy on their domestic currency, the Japan Eximbank effectively charges a premium. Since MITI

is reluctant to provide pure cover and Japanese commercial banks are reluctant to lend on their own account, Japanese exporters for the most part continue to use the Eximbank, particularly for large items. The Bank is uncomfortably aware of the difficulties and would like to see the basis for calculating the CIRR changed. The administration, however, seems to prefer to wait and see if the gap which has opened up between the prime rate, on which the CIRR is based, and commercial rates will narrow again and so make Eximbank funds more competitive. This attitude may be partly explained by the fact that MITI believes that when Japanese exporters have lost contracts the main reason has been price rather than financing or any other factor.

In the context of discussion about mixed credit increasing attention has been focused on Japan. The channel for Japan's equivalent of mixed credit is the Overseas Economic Cooperation Fund, which derives its resources roughly equally from the aid budget and from postal savings deposit funds. About 85% of the OECF's disbursements go to 11 countries, all of which are in Asia, except for Egypt. The OECF administers the LDC untied aid programme, which accounts for between a quarter and a third of Japan's bilateral aid. This aid can be spent only in Japan, the recipient country or a developing country recognised by Japan. In practice about 60%-70% of LDC untied aid is spent in Japan, and most of what is spent in developing countries is for commodities. Hence, in effect LDC untied aid is both associated finance and tied aid, but technically it is neither. Japan has agreed to report it under the DAC associated financing scheme but has not yet begun to do so. It has firmly refused to accept that LDC untied aid should be reported as tied aid credit under the Arrangement. Consequently other participants in the Arrangement have proposed expanding the definition of tied aid credit specifically to include partially tied aid. Japan is unhappy about this but will probably be obliged to accept it.

Japan's stance on tied aid credit is similar to that of France. It argues that it is a way of stretching aid funds, and that it enables developing countries to do things which would not otherwise be possible. It also defends the idea that national interest should be a consideration in determining the allocation of aid. The Japanese government is in a particular difficulty in that it has given international commitments to increasing aid, but

there is no constituency in Japan for doing this unless aid is tied.

Japan is not keen to see further changes in the tied aid credit provisions of the Arrangement, and says that tied aid should be a matter for the DAC, not the Trade Committee. It attaches importance to consolidating the existing Arrangement and ensuring fair treatment before proceeding further. Greater transparency would be welcome, and a rise in the minimum grant element above 25% would be acceptable if it were well respected. A minimum of 50%, however, would be out of the question, at least for the time being. Since less concessional aid is appropriate for LDCs at a certain level of development, it might be necessary to differentiate tied aid credit according to the economic status of the recipient.

d) United Kingdom

The conflicting forces which impinge on export credit agencies are perhaps more evident in the UK than elsewhere. The capital goods sector actively defends its case, strongly supported by the Department of Trade and Industry and the National Economic Development Office, but as its role in the economy has contracted it has carried less weight with the Treasury, which under the Thatcher administration has been particularly keen to curb public expenditure. Since debt problems began to emerge the annual reports on ECGD of the House of Commons Public Accounts Committee and the Comptroller General have been given greater prominence than usual. In addition there has been a flurry of special reports.

In October 1982 the Confederation of British Industry issued a report which asked that ECGD should have more autonomy and more flexibility. In response to this the government in August 1983 set up a committee (the Matthews Committee) to examine the structure, functions and status of ECGD. When it reported in April 1984 the Matthews Committee recommended that ECGD should become a private corporation. Seven months later the government rejected this recommendation and announced that the Treasury and the Bank of England would investigate the possibility of ECGD becoming a private export bank. Meanwhile, in January 1984, the government had released a report (the Byatt report) completed 14 months before by a group of government economists led by Treasury economists. This report, which had been produced as a contribution to the 1983 debate about changing the Arrangement, concluded that the cost of winning large overseas orders was rarely justified on

economic grounds. The conclusion was rebutted in detail in a document issued by NEDO in April 1984. The controversy continues, and in 1985 ECGD has been the subject of inquiries by committees of both the House of Commons and the House of Lords. To date, however, ECGD has remained fundamentally unchanged.

ECGD has suffered losses in each of the past three years, chiefly because of the mounting claims it has had to meet. As a result, in 1983 it had for the first time to borrow from the government's consolidated fund, in which it had previously been an investor. Barring unforeseen developments, this situation is expected to continue for a further three to five years. The effects have been a steady rise in premiums, a reduction in risk-taking and greater scrutiny by the Treasury and others.

Premiums have been increased by at least 5% each year since 1982. Exporters with bad claims records have been required to take on a larger share of the increases and to assume responsibility for a higher percentage of the risk. In addition, temporary surcharges of up to 50% have been applied to markets with 'exceptionally high' political risks. This entails about fifty countries from categories C and D, the riskiest two of ECGD's four categories. Despite the efforts to minimize the impact on business with good risks, ECGD has found that it has been able to attract less of this business. In the case of developed countries this is also explained by changes in the matrix which, combined with lower commercial interest rates, have reduced to negligible amounts the interest-rate subsidy on export credit guaranteed by ECGD. Consequently, the average risk of ECGD's portfolio has deteriorated, partly because some markets have become riskier and partly because it is getting less business in good markets. In 1979, of ECGD's total exposure of £17,985m, C and D countries accounted for £7,370m (41%); in 1983, they accounted for £16,280m (51%) of an exposure of £32,129m. Another consequence is that ECGD is ensuring a smaller percentage of UK exports (29.6% in 1983, against an average of more than 35% during the previous decade). Nonetheless, ECGD probably continues to have a better balanced portfolio than most export credit agencies.

In seeking to strike a balance between maximizing export promotion and minimizing risk, ECGD has tended to treat its financial objective of operating at no net cost to public funds as the overriding constraint, perhaps because of its accountability to Parliament. In markets which are poor risks it has

come off or reduced cover much sooner than it would have in the past, though in better risk developing countries it has continued to be at least as flexible. In the course of 1984 it became evident that policy was erring in the direction of excessive rigour, causing worthwhile business to be lost. There was pressure both from exporters and from developing countries, and at the end of the year the government announced that ECGD would resume cover more quickly for countries which had rescheduled their trade debts to British suppliers insured by ECGD and for goods and services which 'contribute to the economic recovery of the debtor country'. UK exporters have complained, however, that restrictions remain severe compared with those applying to exporters from France and the United States. For Brazil, for example, ECGD's credit ceiling is reported to be £50m whereas the US Eximbank's is $1.5bn (£1.1bn). In addition, it appears that a narrow definition is being placed on exports which 'contribute to economic recovery'.

The changes in the Arrangement have been welcomed by the UK government. The higher matrix rates together with lower market rates have greatly reduced the cost of interest rate subsidies. In 1981/82 when the matrix minimum rate for poor countries was 8.5%, the average 3-month interbank rate for sterling was 15.2%, and the average 6-month Eurodollar rate was 17.3%, the cost of interest support for sterling and foreign currency export finance was £585.3m. By 1983/84 the rates were respectively 9.5%, 10.6% and 11.0%, and the cost of interest support had declined to £330.6m. It was somewhat higher in 1984/85 because commercial interest rates rose again, and unless commercial rates again decline significantly it will remain sizeable for a few years, because of outstanding commitments made when matrix rates were lower. For exports to rich countries the interest subsidies have been small or non-existent, and the prospect of commercial rates declining further has made fixed-rate financing less attractive. These factors, and higher premium rates, have resulted in a shift of business away from ECGD. For exports to developing countries the subsidy is smaller than it was but still worth having. In most cases the problem is first whether there is a market and second whether cover is available. With a few exceptions, such as India and Malaysia, the increase in interest rates appears to have had very little impact.

The UK's Aid and Trade Provision (ATP), from which it draws the aid component of mixed credits, has for several years stood at £66m, about 10% of the total aid budget. The most that has been taken up is £53m in 198[illegible],

and it is used almost exclusively for exports of capital goods, though it is explicitly intended for services too. Although the ATP is administered by the Overseas Development Administration, and mixed credits have to meet developmental conditions, the initiative for a mixed credit comes from the exporter, who believes he is competing with a mixed credit offer from another country. Mixed credit offers generally require speedy decisions, and often go to countries with which the UK does not have a continuing aid programme. Since 1980 the criteria for using ATP funds have been broadened in that an exporter no longer has to demonstrate that mixed credit is being offered by a competitor for a specific contract. Instead, it is sufficient if the contract is in a country where other countries usually make mixed credit available. This has had the effect of relaxing the requirement that mixed credit should be used only to match foreign competitors. The shift was formally recognized in October 1984, when the Treasury changed the rules so as to allow British companies to offer mixed credit at the initial stage of bidding for a contract.

Bankers and exporters, however, continue to be dissatisfied with the scheme. They argue that many developing countries do not like mixed credit which comprises one component on soft terms and another on relatively hard terms, involving interest at close to market rates and repayment over a comparatively short period. These countries prefer less concessional aid, such as the FRG's mixed financing or Japan's partially tied aid. That the UK's mixed credit has the same grant element as these other forms of financing is not sufficient. Pressure for changing the scheme has intensified since May, when Turkey awarded the contract to build the second bridge across the Bosphorus not to the British company which built the first bridge but to a Japanese company which had included a substantial amount of aid in its bid. The Japanese bid did not contravene the Arrangement, and quite apart from the financing it offered a more competitive price. Nonetheless, UK exporters have been using this opportunity to urge the government to revise the ATP scheme. In this they are broadly supported by the Department of Trade and Industry, which advocates selective support on the grounds that where UK industry is capable of bidding competitively it should not be deprived of the chance by distortions created by competitors.

The Overseas Development Administration, like the Treasury, is anxious to avoid any change which expands the commercial use of aid. The ODA is

however, careful to point out that the use of mixed credit by the UK is less extensive than DAC figures (frequently quoted by other OECD members) indicate. The reason why the UK is shown as being the source of the second largest amount of associated financing (22% of the total) is that any package including export credit has to be reported, even if it is only a very small proportion. Hence the reporting system has captured items such as a large package to India, which had a grant element of more than 85%. While acknowledging that the ATP scheme is sometimes abused, the ODA believes that it is more effective than other countries' schemes in minimising distortions.

In the Arrangement negotiations the UK is seeking further curbs on mixed credit, and if agreement can be reached this will probably be acceptable to all concerned. An increase in the minimum grant element to 35% would, however, eliminate most of the mixed credit that the UK does at present while not impinging on Japan's partially tied aid. The Treasury would certainly resist on expenditure grounds any pressure to match Japanese terms and would favour a minimum grant element of 50%. The Department of Trade and Industry, for its part, is less keen on 50% because it may limit the donor's latitude of discretion.

e) United States

During the past year proposals have been under discussion for the most radical change in the Eximbank's programmes in its 51-year history. Since early in the Reagan Administration the Office of Management and Budget had made clear its view that the direct lending programme of the Eximbank should be terminated. Whether the president shared this view was uncertain. In his January 1983 state of the union message he warmly endorsed the Eximbank. By December 1984 the budget deficit was being treated more seriously, and the president declared that it was very important to save money on programmes which benefitted only a few, and he singled out Eximbank as an example. Consequently the OMB proceeded with a proposal which would end the direct lending programme and replace it with an interest rate make-up scheme, known as I-Match. At the same time the Eximbank's guarantee authorization would be raised from US $10 bn to US $12 bn a year to enable it to support more export finance from the commercial banks.

The OMB objects to the direct lending programme partly because it incorporates a subsidy which is distorting, and partly because the ann[illegible] authorization of US $3.8 bn is a burden on the budget. The I-Match scheme would clearly identify the subsidy, and at US $136m would be only a sma[illegible] charge on the budget. The OMB a[illegible]

direct lending is treated as an expropriation whereas in fact it is a loan which is repaid, but says this is irrelevant. The proposals have caused an outcry within the capital goods sector, which has substantial influence in Congress. The House Banking Committee passed a resolution opposing the change, but the Senate Budget Committee passed a budget resolution which assumed it would happen. The issue is now part of the broader controversy about the budget and may in the end be settled as part of a trade-off with some unrelated issue, rather than on the basis of considerations about the role of Eximbank. The administration claims that the change would have very little impact on borrowers who would continue to deal with Eximbank as before. The difference would be that Eximbank instead of lending out of its budget authorization would arrange financing through the Private Export Funding Corporation. Exporters, however, are sceptical about how it would function and about the cost. They also believe that US $136m is too small a sum to enable Eximbank to provide sufficient interest-rate support. One point which seems quite clear is that under the I-Match scheme it would be virtually impossible for the United States to offer mixed credit.*

Since October 1983 the Foreign Credit Insurance Association has been fully controlled and underwritten by the Eximbank. Between them they cover only a small proportion of total US exports. Since 1983 they have incurred losses which, though fairly small in absolute terms, are significant in relation to the volume of business. Despite these losses the Eximbank has taken the view that the industrialised countries should take on more risk to help debtor countries to finance their trade. The Treasury too believes that it is appropriate for Eximbank to help ease developing countries' liquidity problems. This requires creativity in devising suitable financing arrangements. Eximbank has, for example, become more flexible in its treatment of local costs. Developing countries, for their part, should be willing to

*It should be evident by the end of August whether I-Match is going to materialize. If it is, it may be worth saying some more about it.

accept IMF conditions. In practice these efforts have been mainly directed at major markets in Latin America (Brazil and Mexico).

The United States was the chief protagonist of higher matrix rates and the automatic adjustment mechanism. Treasury officials are satisfied that as a result of these changes and the decline in market interest rates most, though not all, interest-rate subsidy has been eliminated. They are particularly pleased that the automatic adjustment mechanism provides insulation from the large subsidies which could develop before when interest rates rose. In the private sector views differ about the implications of the reduction in the subsidy. Some bankers say that the financing package is still the most important single item, particularly since the strong dollar has put US exporters at a disadvantage. Others argue that whereas a few years ago - when the dollar was competitive, the absorptive capacity of buyers was good, and US interest rates were high - the offer of a concessional interest rate had a significant effect on exports, now - when the dollar is uncompetitive, many buyers are restricting imports and are regarded as poor credit risks, and US interest rates are comparatively low - it is much less important to be able to offer a concessional interest rate.

The administration has continued to oppose the use of mixed credit, though its attitude has become somewhat more flexible. There are pressures from Congress for Eximbank to respond more to other countries' mixed credits but they have had little practical effect. A proposal to create a 'war chest' of $1bn to enable the Eximbank to offer mixed credit is periodically revived but has yet to be passed. When the Eximbank's charter was renewed in 1983 Congress included a provision permitting mixed credit, but no funds have been appropriated for this. AID funds are largely committed in advance so it has few discretionary funds and these only in a few countries. Eximbank has a limited programme of matching, which it finances from its own reserves. Neither agency is enthusiastic about offering mixed credits. There have been two to Egypt, with which the US has a special aid programme, and two offers which have not yet resulted in a contract.

The United States objects to the use of mixed credit both because it distorts trade and because it diverts aid away from the purposes and the people for which it is needed most. It is continuing to press for an increase in the minimum grant element to 50%, but there are signs of greater understanding

of the position of countries which claim that there is a genuine developmental justification for mixed credits with a lower grant element. The German case probably arouses more sympathy than the French or the Japanese. Consideration is being given to how 'aid-worthy' mixed credits might be distinguished from others, but the prospect of achieving agreement within the OECD on this is thought to be remote.