
The New World of Government-Supported International Finance

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The United States has achieved great economic success with policies that rely on private markets. Over the past 25 years, the federal government has deregulated broad swaths of the U.S. economy, including financial markets, placing greater reliance on private sector decision-making in place of government regulation. While economies with greater reliance on government allocation of capital have stagnated, the performance of the U.S. economy has reached unparalleled levels of success: the longest economic expansion in history; the lowest unemployment rate in 30 years; sustained low inflation; and a rising standard of living for the American people. In this environment, a U.S. government export finance agency, the Export-Import Bank of the United States (Ex-Im Bank), might appear as a vestigial anomaly left over from an earlier era. Is this the case?

The Export-Import Bank has two primary missions: first, correcting market failures that prevent the financing of otherwise credit-worthy cross-border transactions; and second, leveling the playing field for U.S. exporters facing foreign competitors that receive attractive government-supported export financing. The U.S. policy of relying on markets whenever possible, does not invalidate either of these roles. The market's reaction to the 1997 Asian financial crisis provides ample evidence that market failures in cross-border financing

continue to exist. This paper will examine the second mission of Ex-Im Bank: How level is the playing field for U.S. exporters? While Ex-Im offers a range of different programs and products, this paper will focus on government support for long-term transactions,¹ the type of transaction that accounts for the overwhelming value of Ex-Im financing.

The first section of this paper reviews U.S. efforts to reduce export finance subsidies and level the playing field for all exporters through negotiations in the Organization for Economic Cooperation and Development (OECD). The second section reports that U.S. exporters continue to experience a competitiveness gap and analyzes why a gap remains. This section examines the operating culture and emblematic policies of Ex-Im Bank as compared with foreign export credit agencies. The analysis in the third section focuses on a growing phenomenon in government-supported international finance, the market window. The nature, extent of government support, and the activities of market windows are reviewed, and the role they play in contributing to the perceived competitiveness gap is examined. The last section identifies several options for Ex-Im Bank to consider in addressing the competitiveness gap. Options discussed include:

- Changing Ex-Im Bank's policies and procedures to better align them with business practices;
- Modifying Ex-Im Bank's approach to the OECD Arrangement to reflect a greater reliance on the business case of a transaction when setting financing terms, rather than a rigid adherence to Arrangement terms;
- Addressing the consequences of market windows within the OECD Arrangement; and
- Considering how to create a U.S. market window.

The Old World of Officially-Supported Export Credits

Since the mid-1970s, Ex-Im Bank's approach to leveling the playing field for U.S. exports has consisted of a two-pronged approach. On the one-hand, Ex-Im Bank offered transaction-specific financing that was designed to be competitive with that offered by other governments who supported their exports with officially-supported export credits. The objective was to make the combined value of the tenor, interest rate, risk premia, and repayment terms at least equal to that offered by competitors. This approach to leveling the playing field can be successful on an individual transaction basis. However, it has limits and drawbacks. A significant limit is that information as to what other governments are offering is typically imperfect. What you do not know about, you cannot match or offset. A major drawback is that matching tends to be very expensive. A bidding war in export credits requires large budget outlays in exporting countries. It can also lead to significant costs for developing country "beneficiaries," as the financing subsidies distort purchasing decisions.

The imperfect nature of a policy of meeting the transaction-specific subsidies offered by competitors led the United States to the second element in its approach to leveling the playing field. Over more than two decades, the United States has spearheaded negotiations in the OECD to reduce (and eventually eliminate) government-supported export credits as a distorting factor in international trade decisions. When the negotiations began, governments of developed countries were engaged in intense competition to win export sales. Export credit agencies were offering extremely attractive financing to grow their exports. Project and export decisions revolved less around quality and price, more around the availability of cut-

rate financing. Tenors were lengthened. Interest rates were offered that were below the cost of money. Some foreign aid was used to subsidize export sales in an effort to “buy” the export sale. And, exposure fees were insufficient compensation for the level of risk that an ECA would assume. In this market environment, the exporter able to offer the largest export finance subsidy could win the sale to the exclusion of other considerations.

By most accounts, the decision to try to negotiate limits on government finance subsidies for export sales was the right course of action. As the cost of export finance subsidies spread out of control, governments realized that they could not continue to offer ever-higher amounts of these subsidies. Governments were facing real budget constraints. Furthermore, costly export finance subsidies did not necessarily yield an increase in national export sales, since multiple ECAs offered comparably generous terms. The situation became equivalent to a classic arms race. Even if no export sales were gained as a result of the export finance subsidies, because everyone was offering them, no single government could unilaterally end its subsidies without its exporters losing sales.

The negotiations yielded success. The combined impact of the U.S. willingness to keep the pressure on, with generous Ex-Im financing terms, and the high budgetary cost of the export finance subsidies in an era of worldwide budget pressures, produced an OECD agreement in 1978 known as the “Arrangement on Guidelines for Officially Supported Export Credits.”² The Arrangement placed limits on subsidies offered in official export credits. The product of these negotiations is called an “arrangement” and not a treaty because it is generally not legally binding. In fact, it is generally referred to as a “gentlemen’s agreement”³

because the participating countries (the “participants”) commit to adhere to its terms without the binding elements of a treaty.

In the more than two decades since the first OECD Arrangement, there have been a series of successive agreements that yielded ever-tighter restrictions on the terms of officially-supported export financing. With each successive agreement, the terms of OECD-sanctioned officially-supported export credits moved closer to market norms. In addition, a significant update was made in the 1980s with the inclusion of the “Large Aircraft Sector Understanding” (LASU) in the Arrangement.⁴ It limits the repayment term for financing aircraft exports to 12 years. Furthermore, there is an understanding that producer country ECAs will refrain from financing aircraft sales in each other’s home markets (the United States, Germany, France, the United Kingdom, and Spain). With the success of the most recent negotiations in 1998, the discipline of the Arrangement is now applied to all the aspects of a transaction that determine its true financial cost: the tenor of loans, the interest rate, the repayment schedule, risk fees, and tied aid.

In addition to the acceptable terms of an officially-supported export finance offer, the OECD Arrangement includes a key element to promote compliance: a transparency commitment. Because the OECD Arrangement is a gentlemen’s agreement that lacks a dispute resolution mechanism, compliance is reinforced by the commitment of each participant to make known any deviations or “derogations” from the terms of the Arrangement. Participants in the Arrangement always have the option of offering export-financing terms that deviate from the accepted terms of the Arrangement. However, if they

do, their commitments under the OECD Arrangement require them to notify other participants that they are deviating from accepted terms. The purpose of the notification is to enable other participants to match the terms of the derogation. The logic behind this approach is the expectation that few governments will likely offer better than OECD terms if they know that other governments have the option of matching and offsetting any advantage gained by the special financing offer.

The real-world benefit for exporters should be fewer government-introduced obstacles to successfully selling in international markets. Constraints on the use of government-subsidized export financing should yield a more level playing field for all exporters. In reported statistics, the OECD Arrangement on Guidelines for Officially Supported Export Credits is portrayed as a success. The annual level of tied-aid credits has dropped by half. All important parameters of a transaction that affect its true financing costs are circumscribed by the Arrangement. And the interest cost of government-supported export credit has moved closer to market rates.

However, the successes in Paris at the OECD notwithstanding, U.S. exporters perceive that they are still at a competitive disadvantage. In discussions with exporters of capital equipment and sponsors of major projects, they report that the playing field is not level.⁵ Why not? It is reasonable to assume that successful negotiations, coupled with Ex-Im Bank willingness to match derogations from the Arrangement, should have leveled the playing field. An effective agreement and active U.S. enforcement should leave U.S. exporters feeling that the playing field has been leveled and their ability to compete in foreign markets

has improved. What accounts for the gap between reasonable expectations about the Arrangement and the perceptions of the U.S. exporting community?

The competitive difficulties perceived by U.S. exporters have several explanations. Some are tied to the transformed nature of business in the world market; some are tied to the policies and practices of Ex-Im Bank itself; and some are tied to the rise in importance of a new type of government support for the financing of international transactions, the market window.

The New World of Global Competition

The quaint world of national champion companies battling for sales in foreign markets is gone. Even the world of the old multinational enterprise, which met the needs of different markets by producing products in and for those markets, is also rapidly changing. The world of the 21st century is a world of multinational enterprises with divisions and suppliers integrated into worldwide supply chains. One need only look at the wave of cross-border mergers that has swept the industrial world over the past several years to recognize the scope of change. Such mergers are taking place in virtually all industries, including heavy manufacturing, pharmaceuticals, telecommunication, and finance. Premier corporate marqueees have been swallowed up. The Chrysler Corporation, a major U.S. automobile producer that was deemed sufficiently valuable only twenty years ago to receive a federal government financial bailout, has been taken over by a German company, Daimler Benz.

The new multinational enterprise represents a business model that results from the confluence of falling barriers to trade and investment, falling transportation costs and, most importantly, the availability of modern low-cost telecommunication and networking technologies. In particular, it is the advent of networking technologies – Internet, extranet, intranet – that is having a transforming impact on business and making possible a new level of integration of operations worldwide. As a result, everything is changing: the boundaries of the firm; all business processes; and the nature of products. It is also compressing time frames, enabling ever-faster response to customer needs and demands.

These new enterprises, with operations on multiple continents, have the communication networks, the decision models, and the data systems that permit real-time decision-making with more complete information than ever before. Production decisions are optimized on a real-time basis to take advantage of all of the cost-minimizing and revenue-maximizing options available to the firm. The enterprise has multiple locations from which to fill the order book and, consequently, production is not tied to any particular national location.

On the finance side, there is also unparalleled change. Financial market innovation is making it possible to structure transactions in new ways that separate the components of risk and return in order to fund transactions most efficiently. Innovations that started out little more than two decades ago with the securitization of home mortgages and commercial paper have transformed the structuring of financial transactions in nearly every market.

The Role of ECA Policies and Procedures

Ex-Im Bank Requirements

Ex-Im Bank is directed by statute to meet the export finance competition presented by other governments. It prepares an annual assessment to report on how well it is fulfilling this legislative mandate. The part of the assessment that focuses on comparing such items as interest rates and fees charged by Ex-Im Bank and other export credit agencies (ECAs) generally finds that Ex-Im Bank is competitive with other ECAs. However, when the assessment looks at the operating policies and procedures, and how these factors affect the measurement of competitiveness, Ex-Im Bank fares less well. This conclusion is derived from a survey of knowledgeable Ex-Im Bank customers. It consistently ranks Ex-Im Bank as less competitive in these areas than its G-7 counterparts. Although the findings are based on responses from a small number of Ex-Im Bank customers, they are consistent with the views of the exporter community reported to this author. Exporters report that Ex-Im's policies and procedures are a major contributing factor in the growing competitiveness gap.⁶

Officially-supported export finance programs that mesh well with financial market innovation and realities of the new multinational enterprise can be a significant help to their exporters. However, ECAs that are designed to meet the needs of yesterday's national champions are unlikely to meet the export finance needs of the new globalized environment.

The legislation, policies and operating procedures of Ex-Im reflect the earlier era in which the Bank was created. It was a time in which the role of the government in the economy was greater and the benefits offered by Ex-Im's programs were richer. Most

lending to developing countries in Ex-Im Bank's early years went to sovereign borrowers. The dominant role of foreign government entities as purchasers of Ex-Im Bank financed exports, and unique U.S. products in certain sectors, meant that the business imperative of private borrowers did not intrude on Ex-Im Bank's operating culture. Furthermore, the below-market interest rates offered were a major benefit to foreign purchasers. The benefit conferred on the borrower provided more than sufficient compensation for the burdens of government-centered operating policies and procedures.

Ex-Im Bank policies and procedures also represent an accommodation to the priorities of an earlier era. In Ex-Im Bank's case, the policies and procedures reflected a specific intent to create as many U.S. jobs as possible. Ex-Im Bank's policies were directed to ensuring that foreign-produced goods and the jobs that they represented did not receive the benefit of Ex-Im Bank financing. The mandate of promoting U.S. job creation in the aftermath of the Great Depression included not just the production workers directly and indirectly employed in producing the exported item but also, by extension, workers involved in building ships, manning the merchant marine, and other transportation infrastructure.

The world of the 21st century is far different than the world in which such policies and procedures were developed. Competition in international markets is intense. The past twenty years have seen a steady withdrawal of government from microeconomic decision-making in favor of the competitive market. At the same time, the economic value of Ex-Im Bank's financing has declined, as ever more successful OECD negotiations moved officially-supported export credits closer to market norms. Today, customer focus, compressed-cycle

times, and transaction norms that mesh well with the realities of the business world are essential if Ex-Im bank is to provide genuine value to U.S. exporters.

Ex-Im Bank has innovated over the years. However, it has not done so at a pace that enables it to remain competitive. The combination of administrative burden, legislative requirements, and the residue of threats to its existence in recent Congressional efforts to end “corporate welfare,” have all combined to weaken the ability of Ex-Im bank to stay current with the needs of the exporting community. The result is a long list of policies, procedures and requirements that no other export credit agency imposes at all, or to the same degree, on its customers.

A few examples illustrate the impediments to effective operation. They relate to such matters as administrative procedures regarding U.S. content requirement, disbursement procedures, additionality, economic impact, and local-cost financing; and the requirement to ship Ex-Im Bank financed exports on U.S. flag vessels. These policies and operating procedures lead to long response times, cumbersome procedures that do not mesh well with business imperatives, the questionable reliability of Ex-Im Bank as a partner, and an unwillingness to undertake cooperative agreements with other export credit agencies to cofinance transactions.

- Ex-Im Bank will finance only the U.S. content embodied in U.S. exports. This is a core policy requirement that is more stringent than the domestic content requirements imposed by other ECAs. Because the maximum percentage of a transaction that Ex-Im

Bank may finance is 85 percent, it permits up to 15 percent of a financed export to consist of foreign content without affecting the amount of Ex-Im Bank financing that is available. However, without addressing the desirability of such a stringent limitation in a world where the business norm is integrated worldwide-supply chains, the requirement imposes unnecessary administrative costs. Every individual contract line item in a large project is analyzed to ensure that the 85 percent requirement is met. Higher U.S. content in one line item for a specific project cannot offset lower U.S. content in another line item. In other words, not only must the entire transaction be 85 percent U.S. content to qualify for the maximum available financing, each separate line item must also meet the same requirement

- Ex-Im Bank financed exports are required to be shipped on U.S. flag vessels. The U.S. flag fleet is so small, and its service so limited, that the majority of transactions seek a waiver from the Maritime Administration (MARAD) to use foreign flag vessels. When a waiver is not granted, cost and time are added to U.S. export performance. For example, heavy construction equipment that is most efficiently shipped by driving it onto “RoRo” (“Roll-on Roll-off”) ships have had to be broken down into various parts, and shipped in various stages of disassembly, in order to be placed on the only U.S. flag vessel available, when no waiver was granted. U.S. exporters have reported sourcing from foreign factories (using foreign ECA financing) to avoid the added cost and inconvenience of U.S. flag shipping. Even when a waiver is granted, the uncertainty as to whether or not a more costly U.S. flag alternative would have to be used adds time and cost to the use of Ex-Im Bank. Furthermore, the

use of a foreign flag carrier under current policies adds to the computation of foreign content in the transaction, lowering the availability of Ex-Im financing as a percentage of the total transaction.

- Exporters and foreign applicants perceive Ex-Im Bank as an unreliable business partner. In fairness to Ex-Im Bank, some uncertainty over the availability of Ex-Im Bank financing will always be inevitable. There will always be a level of uncertainty as to whether a foreign borrower will be found sufficiently credit worthy to justify approval of any particular transaction. This uncertainty is an unavoidable element of any bank finance. Similar to a commercial bank that must make a judgment as to the credit worthiness of a prospective borrower, Ex-Im Bank is prohibited from putting public funds at risk unless there is a reasonable assurance of repayment. But in the case of Ex-Im Bank, there is always also the political risk that foreign policy sanctions, or Congressional or Executive action (such as the recent State Department directive that temporarily blocked the Tyuman Oil financing in Russia), could intervene to prevent a financing from going forward. The perception of Ex-Im Bank as a reliable financier is further impaired by a combination of self-imposed policies and procedures. End-use restrictions and the routine requests for exporters to document either the lack of private sector financing or the availability of foreign officially-supported competition, all introduce an element of uncertainty on top of the core requirement of finding a reasonable assurance of repayment. Such factors have combined to impose on Ex-Im Bank a patina of unreliability.

- These impediments, as stand alone problems, impose one set of costs. However, their negative consequences are exacerbated by the role they play in preventing Ex-Im Bank from participating in one of the most important developments in export financing – cofinancing with other ECAs. Large exports, whether capital equipment or complete projects, typically involve sourcing major components from several different countries. Other ECAs have demonstrated the ability to enter into cooperative agreements with each other, particularly in Europe and Canada. Such agreements result in transaction-specific financing in which one ECA takes the lead responsibility for administering the transaction, with the other ECAs accepting the administration of the transaction by the lead ECA. However, because Ex-Im Bank has such burdensome administrative and policy requirements, it has generally refused to participate in such joint undertakings. Since Ex-Im Bank is not willing to accept the administration of transactions by other ECAs whose requirements are far less intrusive than Ex-Im Bank’s requirements, exporters must duplicate their documentation efforts. Exporters report that they respond by choosing to supply from countries with flexible cofinancing arrangements and the United States loses exports.⁷

Ex-Im Compared to Foreign Export Credit Agencies

Some foreign ECAs have adopted a business model that is built from top-to-bottom to respond to customers’ needs. Just as the private sector has changed in recognition of the critical role that customer focus plays in successful business, some ECAs have become highly customer focused. Response time/cycle time is shortened to be sure to meet the needs of applicants. The structuring of transactions is flexible. Extraneous requirements are kept to a

minimum. Modern information technology is fully deployed to take advantage of its ability to exchange information with customers and respond quickly to customer needs.

Furthermore, foreign ECAs are able to support their exporters with a greater degree of flexibility than Ex-Im Bank. In part, this reflects a different view of the role of foreign ECAs in the financial markets. Foreign ECAs are not viewed exclusively as a lender of last resort. Consequently, applicants do not have to prove that there is no alternative source of funding in order to qualify for ECA financing. In addition, no other ECA has a requirement that exports be carried on a national flag carrier. And the required level of domestic content in a financed export may be significantly lower than that required in an Ex-Im Bank financed export. For example, the Japanese Export-Import Bank (JEXIM) and its successor entity, the Japan Bank for International Cooperation (JBIC) have had as little as a 30 percent minimum requirement for Japanese content. The amount of required Japanese content is determined by the nature of the transaction and through negotiation. Once the minimum Japanese content is met, the entire transaction amount may be financed.

A comparison of JEXIM to the U.S. Ex-Im Bank in an actual transaction demonstrates the differences in the requirements and operating practices and how they affect the transaction. A U.S. company was unable to access planned Ex-Im Bank financing for a large export because of the imposition of U.S. foreign policy sanctions. The U.S. company turned to JEXIM. After the company reordered its supply arrangements, JEXIM financed the entire value of the transaction that was to have been financed by Ex-Im Bank, while requiring only 30 percent Japanese content. A transaction comparable to the one that JEXIM was willing to

finance in its entirety, i.e. one with 30 percent U.S. content, would not have qualified for Ex-Im Bank financing. (By comparison, U.S. Ex-Im Bank would have required a minimum of 51 percent U.S. content for any financing, and then would have financed only the lesser of 100 percent of the U.S. content in the transaction or 85 percent of the entire transaction.) In this example, the U.S. company expended additional effort to source material for the deal from Japan so that it would qualify for the loan. Some observers might consider the outcome is not all that bad from U.S. national perspective. After all, JEXIM financed the entire transaction, including some not-insignificant quantity of U.S. exports, without the U.S. taxpayer incurring any risk. However, looking at it from the other side, JEXIM's flexibility won exports from Japan that otherwise would not have taken place. More important, from a long-run perspective, the U.S. company found transacting business with JEXIM a very positive experience and it is looking to do more deals in Japan in the future.

The U.S. government's short-lived sanctions resulted in the loss of a large U.S. export in the short run, possible loss of follow-on exports in the future, and further weakened the business community's view of Ex-Im Bank as a reliable business partner. The imposition of such sanctions is a foreign policy decision. And, as such, it lies beyond the purview and competence of Ex-Im Bank. The authority to impose such sanctions rests with Congress, the President, and the Secretary of State. Ex-Im Bank cannot be blamed for the action or the consequences. However, from the perspective of the exporting community, it was just one more case of why exporters feel there is a significant competitive gap between support for exports offered by Ex-Im Bank and other ECAs.

Growth of Market Windows

In all spheres of competition, the challenge that is faced is always a moving target. Whether it is the conduct of business or the conduct of war, nothing is static. For every advantage there is always an innovation that counters that advantage. The effectiveness of the innovation fades quickly as further innovation renders its advantage ineffective.

The competition between developed countries for export markets using subsidized export credits in the 1970s and 1980s led to agreements to constrain that competition. The OECD Arrangement is generally credited with reducing the use of export finance subsidies by Export Credit Agencies (ECAs). However, the disciplines of the OECD Arrangement apply only to transactions that are financed with officially-supported export credits. If a transaction receives government-supported financing from an entity or part of an entity that is not considered to be covered by the Arrangement, or that is not explicitly tied to an export requirement, it is not covered by the disciplines of the Arrangement. The very success of the OECD Arrangement created incentives to push the competition for export markets into new areas beyond the reach of the Arrangement.

The expanded scope and success of the OECD Arrangement has been accompanied by the growing importance of government-supported international finance that is not constrained by the terms of the OECD Arrangement. These government-supported organizations operating outside the Arrangement claim that such financing is at commercial or market terms. Thus, it has come to be referred to as financing provided by a “market window,” as

distinct from government- supported financing that falls within the purview of the Arrangement, and is provided through an “official window.”

Currently two government entities operate very active market windows. They are the German market window, Kreditanstalt für Wiederaufbau (KfW), and the Canadian market window, Export Development Corporation (EDC). Market-window support for a transaction is typically “tied” to a determination of national interest, not to a specific level of domestic content in a financed export.

The unclear meaning of the term “market window” has prompted this author to propose the use of a more meaningful designation to describe such entities: “Government Supported International Finance Institution” (GSIFI). In the case of Germany, the export credit insurance of Hermes falls within the disciplines of the OECD Arrangement. However, by common understanding from the beginning of the OECD Arrangement, most of the international finance activity of KfW does not. KfW is free to support most transactions in any way that it chooses, if it does not purchase Hermes cover for that transaction. In the case of Canada, financing by EDC that is at market terms is free of OECD constraints.

The term “market window” does not refer to a specific office in a GSIFI or a separate institution, but rather to the conditions applied to a deal during review and execution. An “official window,” such as Ex-Im Bank would evaluate and approve a transaction based on the OECD Arrangement terms and internal policies. However, a GSIFI with a market window would evaluate whether the best outcome for the potential transaction is to support it

according to commercial terms -- via the market window -- or according to OECD Arrangement terms -- via the official window. Once that decision is made, the deal will be evaluated according to very different criteria. For instance, terms for an official window deal will be determined by what is allowed by the OECD Arrangement. The rationale for the restrictions is that such GSIFI financing has an inherent government subsidy, measured or unmeasured.

However, GSIFIs that offer market-window financing claim they do not have to abide by terms in the OECD Arrangement because they are not subsidizing the deals explicitly, or rigidly tying them to exports. They claim that market-window terms reflect norms of the market place and are not officially-supported export credit deals. They emphasize that their market windows are acting like commercial banks and only process commercially-viable deals on market terms. In their view, because commercial banks are not subject to the OECD Arrangement, GSIFIs' market windows should not have to abide by the Arrangement either. But is this line of argument valid? Government ownership and benefits make possible terms that are better than the market can offer.

Examination of Market Windows

The German and Canadian market windows have grown rapidly over the past decade. They are now powerful and important players. For both, KfW and EDC, most of their long-term export financing is processed through their market windows. With the market windows, GSIFIs can grow their portfolios by attracting more customers with financing terms, such as tenor, that may be somewhat better than those prevailing in the private capital market or

allowed by the Arrangement. In large international deals, their better terms are appealing enough that deal sponsors report they often alter their procurement plans to source equipment from the market-window country, in order to qualify for the financing package. Not only may market window GSIFs offer terms that are more attractive than traditional ECAs (observing the OECD Arrangement) but, market windows generally have far fewer policy restrictions regarding documentation and loan qualification. Market window GSIFs are also recognized by exporters for providing superior customer service, a result of their business-oriented corporate culture. They behave as businesses that recognize the need to please their customers in order to generate future business. In acting like a business, processing deals according to market terms, market window GSIFs sometimes win deals that might otherwise have been supported by the international commercial banking community. This leads to some criticism from commercial banks that market window GSIFs compete in an unfair manner.

How do market windows compete with commercial banks, and is this competition “unfair?” The answer to these questions lies in the mission of GSIFs and their financial underpinnings. GSIFs have national interest missions, and they receive considerable support in one way or another from government resources. This point is illustrated by describing the operations and the benefits received by the German and the Canadian GSIFs, KfW and EDC.

Germany’s Kreditanstalt für Wiederaufbau (KfW)

KfW serves a wide variety of financial purposes for the German government. It is responsible for fulfilling needs in the German economy through domestic investment, export and project finance, foreign development aid, and other advisory and financial services. Thus,

following the reunification of East and West Germany a decade ago, domestic investment priorities became significantly concentrated in the five former East German states, requiring KfW's deep involvement in projects such as housing renovations. KfW also supports the growth of companies in the rest of Germany, with a focus on small and medium enterprises (SMEs).

Another major role that KfW plays is in financing exports and large German-sponsored projects in foreign countries. To a lesser degree, KfW disburses foreign aid and finances projects in developing countries on behalf of the German government and offers advisory services to other parts of the government in its areas of financial expertise. In 1999, the majority (approximately 65 percent) of KfW's portfolio in terms of loans outstanding was in the area of domestic investment and approximately 20 percent of its total portfolio was devoted to export and project finance.⁸ The remaining 15 percent represented support for developing countries and advisory and other services.

In terms of new commitments (loans, guarantees, grants), KfW's export and project finance section had a book of business in 1999 of Euros (€) 9.0 billion.⁹ Most of KfW's export and project finance business is conducted through the market window, outside of Arrangement guidelines. Of these €9.0 billion in new commitments, approximately €7.8 billion represented market-window transactions.¹⁰ Without the market window, KfW's support for export and project finance would be relatively small.

One of the justifications KfW provides for its extensive utilization of a market window is that KfW is not supported by annual appropriations from the German government. KfW claims that it favors business in the German domestic market and cross-subsidizes it with the profits earned on export and project finance business.¹¹ Other justifications are also given, such as the recent increase in the demand for multisourced financing structures due to globalization of production, and the increase in demand for financing coupled with limited availability of official support funds tied to German exports.¹²

How does the KfW market window operate? On initial review, a potential KfW transaction is considered according to whether it fits best as an officially-supported export credit deal or whether market-based financing would be more appropriate. This review is heavily influenced by KfW's tolerance for the risk in the transaction. The borrower's preference is taken into account, as well as the availability of government funds for an official-window deal. If the decision is made to structure the transaction through the official window, with the support of export finance and insurance, then KfW claims that terms will comply with OECD Arrangement. If the transaction best fits in the market window, it will be analyzed according to risk versus return principles, in a similar fashion to what is done at commercial banks.

KfW tends to be more flexible than private commercial banks in accepting higher levels of risk during an economic downturn, if KfW's long-term forecast is optimistic. According to KfW, its profit on a market-window deal is determined by the market rates for the specific transaction.¹³ Sometimes KfW will do "blended deals" whereby part of the

transaction is supported through the official window, and guaranteed with Hermes cover, while direct lending for the remaining portion is supported by a variety of commercial banks and the KfW market window. In these cases, KfW will take on the risk for the part of its lending not covered by Hermes. The result is that the German exporter becomes more competitive by offering total financing for a project from a single source.

From the perspective of business, a strength of KfW's market window is that its deals are subject to few restrictive non-financial policies. The most important residual policy requirement is that the deal must benefit the "German interest." Such a finding can be made if there is a German export, a German investment, or involvement of a German company. Beyond this major requirement, the specifics are flexible. For instance, the required German content can vary according to the deal.

Another strength that KfW offers is a pool of talented, experienced personnel with an intimate understanding of the market. They are innovative in their approach to structuring transactions, creative in weaving together cooperative partnerships with banks, and superb in managing the customer relationship. How does KfW attract and maintain personnel with such a high degree of commercial expertise? Very simple – KfW's salary structure is not determined according to government pay scales, but rather according to the comparative salaries of similar positions in the commercial banking industry in Germany. The relatively similar compensation compared to colleagues in the private sector, as well as offering some of the elements of job security of a government organization, are important factors in attracting and keeping talented financial experts.

KfW is a powerful player in the world trade finance market because of its successful operating culture and because it receives considerable government support and benefits. KfW points out that it is in the business of making money and that it does not receive a government appropriation. That is true to the extent that government support is measured by the presence or absence of an annual appropriation. Nevertheless, KfW does receive significant financial benefits from the German government. The following are a few examples:

- KfW's initial capitalization of DM 1 billion came from government sources. Its shares are 80-percent owned by the German federal government and 20-percent owned by the German state governments.
- KfW borrows with the full faith and credit of the German government. Therefore, its cost of funds is lower than that of any private financial institution. This benefit lowers the cost of borrowed funds to a rate that is very close to the German federal government's borrowing cost. Estimates indicate that KfW's cost of money for a representative five-year term is about 35 basis points over the German government's cost of money. When borrowing in the U.S. market, the cost is 3 to 5 basis points above the Fannie Mae rate for a comparable term. KfW's status as a German government-guaranteed borrower also means that its access to borrowed funds does not depend on the quality of its assets. KfW's access to liquidity, and the interest rate paid on its borrowings, will be the same irrespective of the risk in its portfolio or the

level of accounting profit. As a theoretical matter, KfW could be insolvent and still be able to borrow at the same rate.¹⁴

- KfW does not pay dividends to its shareholders. German law forbids it from returning any of its profits to its shareholders. The only thing that it can do with its profits is to retain them, accumulate them, and lend them out. Hence, the annual accumulation of retained earnings is the equivalent of an annual infusion of public support for KfW. In 1999, net income was DM528 million. This represented the equivalent of a DM528 million infusion of public funds. From its creation in 1948 through 1999, KfW has accumulated DM10.6 billion in capital, reserves, and retained earnings. Hence, KfW has available for its financings DM10.6 billion on which it pays no interest or dividends. The cost of this capital is essentially zero.
- KfW pays no taxes on its profits. German law exempts KfW from paying taxes. This tax-free status provides the equivalent of an annual tax-expenditure subsidy to KfW. For example, if KfW were a private financial institution, it would have likely paid income taxes at a rate of about 30 percent on its profits in 1999 -- or DM158 million for that year.

The government benefits give KfW significant leeway to operate profitably while still offering financing on significantly more attractive terms than a financial institution owned by private shareholders could find possible.¹⁵ This capability creates a situation in which KfW competes with the private sector. Business firms report that KfW may finance transactions at

a spread over Libor as much as a full point less than the rate offered by commercial banks. Unfortunately, it is difficult to know the terms of KfW financing because the terms of individual transactions are not publicly available. KfW has no obligation to release the terms of its financings, and it does not do so. When this author requested the actual terms of representative international transactions, KfW declined to provide the information. Furthermore, parties to the transactions financed by KfW are constrained from releasing the particulars by confidentiality covenants in the loan agreements. U.S. multinationals that have had transactions financed by KfW were unwilling to provide the details of those transactions that would violate the confidentiality covenants. They report that they find the business relationship with KfW beneficial and they intend to conduct future business with KfW. Providing information on specific transactions would damage their longer-term business relationship.

This circumstance is very troubling. The value of the financial support that KfW receives from the German government is considerable. Given the extent of that support, the burden should be on KfW to do more than just claim that it operates on market terms. It should provide the transaction specific data that would permit an independent assessment of its claim. As President Reagan observed, citing an old Russian folk saying that he applied to international arms agreements: “Trust, but verify.”

As a consequence of KfW’s reluctance to reveal deal-specific information, this paper is able to provide the particulars of only three transactions in which KfW participated. Since so few transactions are referenced, there is not enough data to quantify the inherent subsidy, if

any, in KfW's market window deals. Nevertheless, the specifics of the transactions discussed below do raise important questions about KfW's operations and provide support for the view that KfW needs to make available considerably more information about the specifics of its activities.

- The details of this first transaction were provided on condition that the particulars be kept confidential. This financing supported a German export to Latin America and included Hermes cover. Because Hermes insured the transaction it should have conformed to the OECD terms. Nevertheless, it deviated from the OECD terms by offering a repayment schedule that did not consist of level (i.e. equal annual) principal payments. The repayment schedule was back-loaded, with a disproportionately large amount of the principal repaid in the latter half of the term. As a Hermes-insured transaction that deviated from the Arrangement, it should have been notified to the OECD. However, when this author checked the database of OECD notifications, there was no evidence that Hermes notified other parties about the terms of this transaction.
- A second transaction involved KfW's support for cleaning up the balance sheet of Airbus Industries in preparation for the conversion of Airbus into a single corporate structure.¹⁶ To support earlier sales of 41 aircraft in the U.S. market, Airbus had assumed the credit risk of two U.S. airlines -- United and American -- at a time when U.S. airlines were having financial difficulties. In the original transactions Airbus sold aircraft to the ultimate lessor, leased them back and, in turn, subleased them to the two U.S. airlines. If everything went well, the lease payments from the airlines flowed

through Airbus to the ultimate lessor. But, in the event the airlines failed to make their lease payments, Airbus was still obligated to continue to make its contractual payments to the ultimate lessor. In the fall of 1999, a complex structure employing “Enhanced Equipment Notes” was used to transfer almost \$1.1 billion in U.S. airline credit risk from Airbus to the capital markets. KfW assumed the risk for \$800 million of this transaction. Taking on \$800 million of a \$1.1 billion deal is inconsistent with what a commercial bank would do. Under normal circumstances, a major U.S. money center bank might pick up \$50 to \$100 million of the risk. Under unusual circumstances, a large multinational bank might pick up as much as \$200 million. If KfW retained this exposure on its books, it was not acting like a commercial bank. If it were acting like a commercial bank, then the majority of the exposure would have been laid off in the market. In discussions with KfW following the Ex-Im Bank 65th Anniversary Conference in May 2000, KfW reported that it was planning to layoff about half of this transaction. Even if KfW is successful in doing this, it will still be left with a concentration of risk far greater than that which a private commercial bank would accept. Furthermore, irrespective of how KfW resolves its balance sheet problem, this transaction remains a clear example of KfW undertaking a financing that a commercial bank would not have undertaken, and it did so for the express purpose of helping Airbus become more competitive.

- The third transaction involved KfW’s participation in the financing of Boeing B-717 aircraft to a no-frills start-up airline, Air Tran (formerly known as ValueJet). KfW participated in the transaction because BMW/RR engines powered the aircraft in

question. KfW's participation consisted of purchasing the mezzanine tranche of a private placement with a term of 15 years. No ECA covered by LASU could finance such a transaction because of the understanding not to finance into one another's market. Furthermore, the term of the financing exceeded the maximum LASU tenor by three years.

Hence, when Ex-Im faces the competition provided by KfW, it knows that it faces a competitor that operates with the equivalent of significant public financial support and has the capability to provide below-market financing, yet still make a profit. However, because the terms of KfW-financed transactions are generally not available, Ex-Im does not know the practical effects on a transaction-by-transaction basis. The terms of a financing may be very profitable for KfW in an accounting sense, because of its low cost of capital. However, there could still be a significant subsidy, in a private market sense, if the fees and interest rate charged are not adequate compensation for the level of risk in the transaction: any individual transaction could have a significant subsidy.

The competitive situation that prevails with KfW is similar to the context that existed before there were any agreements limiting tied aid. The business community had strong anecdotal evidence that it was experiencing major export losses. However, because information on tied-aid-supported transactions was not publicly released, no one had the data to estimate the extent of tied aid being offered, or the export sales being lost as a result. However, as was subsequently learned, the absence of publicly-available data did not mean

the absence of a problem. Only after the United States pressed for OECD tied-aid rules was reporting required for such deals.

In the opinion of Hans Reich, the Chairman of KfW, the German market window will continue to grow over the next decade. He cited the increasing demand from borrowers for innovative financial structures that do not fit the OECD Arrangement, but can be fashioned on what he considers to be market terms. Reich also mentioned the decreasing appetite of the German government and foreign governments to subsidize exports through officially-supported export credits. This latter trend will promote the growth of market windows as a means of avoiding direct subsidies through the official window.¹⁷ Another way of interpreting such a forecast is to conclude that the level of government-supported export finance that is unconstrained by the OECD Arrangement will continue to grow.

Canada's Export Development Corporation (EDC)

EDC's role and mission are a reflection of how Canada views its economic and trade situation. Exports are viewed as a vital component of the Canadian economy today and the foundation of its economic success tomorrow. In fact, exports accounted for over 40 percent of Canadian GDP in 1998.¹⁸ However, Canada does not see itself as having an easy road in the world market. Canadian leaders see their country at a disadvantage in comparison to the United States or the European Union. In fact, compared to the United States, Canada suffered a significant decline in the 1990s in relative per capita GDP, when measured on a purchasing-power-parity basis. As international competition increases in the global economy, Canada fears that it could fare even more poorly. Additionally, because of its smaller economy,

Canada does not possess the bargaining power to shape the OECD Arrangement rules on official-window financing in a way that would reflect Canadian trade finance practices.

Canada has a tradition of more dirigistic economic policies than the United States. In light of both that tradition and how Canada sees itself in the world economy, EDC was given a broad mandate from parliament to support exports through a variety of flexible means. The Canadian Export Development Act generally assigns EDC the mission, “to support and develop directly or indirectly, Canada’s export trade and our country’s capacity to engage in that trade and to respond to international business opportunities.”¹⁹

With this broad mandate, EDC has created a very active market window to fulfill its assigned mission. EDC’s market-window transactions are evaluated on the extent to which they benefit the Canadian economy and are in the best interest of Canada. Once a deal meets these criteria, EDC officers decide how best to finance it. Very few policies exist to restrict EDC officers in their structuring of deals. Flexibility is the norm in EDC. Most of EDC’s trade finance deals are done on “market terms” through the market window.

EDC has the legal authority to utilize a wide variety of alternative ways to support Canadian exports. As might be expected, it offers export credit insurance, loan guarantees, and direct export loans. The revised act in 1993 also gave it the authority to: offer domestic financing to help smaller companies build exporting capabilities; create subsidiaries and special purpose vehicles in partnership with the private sector to leverage EDC capital with private sector capital and expertise; and assume a direct equity position in certain goods that

are leased to foreign end-users.²⁰ The act also altered foreign-content rules to simply require proof that Canada benefits from a transaction

After passage of the revised Export Development Act in 1993, the volume of its activity grew rapidly. For example, in 1993, EDC had a volume of CAN\$3 billion in export deals and 2,057 customers. By 1997, the volume of export deals was CAN\$29 billion and EDC did business with 3,711 customers.²¹ Undoubtedly, EDC's market-window capabilities have enabled it to participate in a greater number and variety of deals, using innovative structures that benefit customers, and win strategic transactions for Canada in the international market.

A comparison of EDC and Ex-Im financing activity in recent years illustrates how EDC's broad mandate has been translated into a relatively large and important role in the financing of Canadian exports. In 1999, Ex-Im Bank authorized \$13 billion (USD) in new loans, guarantees and export credit insurance, supporting \$16.7 billion (USD) of U.S. exports to markets worldwide.²² To accomplish this level of support, Ex-Im Bank received an annual government appropriation of \$765 million (USD) and employed a staff of about 400 personnel. By contrast, EDC, operating in a Canadian economy only about a tenth the size of the U.S. economy, supported CAN\$40 billion of exports in 1999. To accomplish this level of export support, it employed a staff of about 800 personnel, used a range of economic benefits from the Canadian government, and in the process reported a profit of CAN\$118 million.

The Canadian government's financial support for EDC is analogous to the German government's support for KfW. Similar to KfW, EDC receives no annual appropriation. However, like KfW, EDC borrows with the full faith and credit guarantee of its government owner, the government of Canada. Consequently, its cost of money is less than that of the most credit-worthy commercial bank. It pays no taxes, and it pays no dividends to its owner. Earnings and reserves are accumulated to support further program expansion. At the end of 1999, EDC had almost CAN\$1 billion of paid-in government capital, just over CAN\$800 million of accumulated retained earnings, and more than CAN\$2.3 billion in its loan-loss reserve.²³

Why such a dramatic difference in the relative performance of the two organizations? In the words of the President of EDC, A. Ian Gillespie, "they [Ex-Im] get an annual appropriation that is more than the entire capital invested in EDC."²⁴ They are a lender of last resort. We [EDC] are not. That is one of the big differences."²⁵ Another way of describing a GSIFI that is not a lender of last resort, is that it competes with commercial banks. As it turns out, EDC is the recipient of a good amount of criticism from Canadian banks, even though it works very well with commercial banks in individual transactions. One Canadian senator even described the unfair competition between EDC and Canadian banks as EDC's "biggest problem."²⁶

Impact of Market Windows on U.S. Companies

Ironically, U.S. based multinationals – as corporate entities – do not see themselves as seriously disadvantaged by the rise of foreign market windows. They can access foreign

market-window financing because they can source equipment in countries that will provide attractive financing. In such cases, exporters often comment that content restrictions are liberal and loan terms are acceptable. They have also praised the efficiency of market windows, in that they act like banks by cooperating well with other financial institutions and by responding to customers with superior service.

From a public policy perspective, this outcome is troubling. The primary objective behind the OECD Arrangement was to reduce the extent to which government support for export finance influenced export decisions. When U.S. multinationals say that they are not troubled by the rise of foreign market windows because they can shift production to another country and access that financing, they are saying that government-supported export financing is influencing decisions on what to produce and where to produce it. This is hardly an indication that the OECD Arrangement has succeeded in its primary mission.

While many large U.S. companies and foreign multinationals report that they can find ways to take advantage of attractive financing made available by foreign market windows, other companies, the most notable being the Boeing Corporation, have far fewer options. Companies like Boeing, which locate most of their manufacturing facilities in the United States, do not generally have the flexibility to take advantage of the attractive financing offered by foreign market windows.

Boeing believes that its only major competition in the world market, Airbus, has a powerful advantage in its ability to access financing from KfW and European state-supported

banks. Airbus is a consortium of German, French, British and Spanish government and private entities. The governments of these countries have supported Airbus with concessional financing and very large grants. In addition, they have supported aircraft sales with attractive financing from GSIFIs. In KfW's case, it reports that its total aircraft portfolio is about €14.1 billion, with new commitments in 1999 of €3.1 billion.

Because KfW, in its customer-centered approach to business, is able to commit support early in the aircraft sales cycle, Airbus has a competitive advantage. Ex-Im Bank cannot commit to a transaction until the transaction is analyzed and the Board approves the application. In addition, KfW is willing to support structures that provide effective tenors of 15 and 18 years for the financing. Such tenors are especially attractive when compared to the 12-year limit on aircraft financing under the OECD Arrangement.

According to Boeing, the fact that Airbus can point to KfW as a reliable partner in customer financing from the earliest sales discussions has definitely affected Boeing's sales.²⁷ The problem for Boeing is that it cannot guarantee Ex-Im's support to a customer until Ex-Im completes a lengthy review process. Additionally, unlike KfW, Ex-Im cannot commit to any terms outside of the OECD Arrangement because it only has an official window. Boeing believes that it lost the "Latin Trio" sale to three Latin American airlines in 1997 because Airbus had KfW's early approval for a financing structure that provided for what amounted to 18-year financing. KfW also has the capability to participate in innovative operating-lease structures. KfW participates as a part owner, along with private banks, in a leasing company that supports Airbus sales. Ex-Im is prohibited from investing in such a fashion.

Boeing also has a financing disadvantage vis-a-vis Airbus in that Airbus can sell its aircraft to the United States (Boeing's home market) using market windows. However, Boeing cannot sell to Airbus countries with Ex-Im Bank support since Ex-Im Bank is constrained by the LASU agreement. The understanding of the LASU agreement is that countries will not use officially-supported export credits to finance the sale of aircraft to countries that produce a similar class of aircraft. This means that while Boeing cannot sell into the aircraft market in Germany, France, Spain and the U.K. with Ex-Im Bank support, Airbus is able to sell in the U.S. market with support from KfW's market window. And, KfW is not the only government-backed financier supporting Airbus sales.

Airbus has been steadily gaining market share from Boeing. While many factors influence the success or failure of a sales campaign, Boeing's view is that the availability of market-window financing for Airbus sales is a contributing factor in Airbus growing market share for new orders. The statistics in Table 1 illustrate the trend in world-market share.

Consumers and airlines have benefited from the intense competition between Boeing and Airbus. If the competition merely reflected two private companies battling it out in the market place, there would be less cause for government concern. However, this is not the case. Airbus is in the business of building large civil aircraft only because the European governments have provided Airbus with massive subsidies for product development and have actively aided the marketing of their aircraft. Boeing claims that in order to make sales in competition with market-window financed Airbus, they have been forced to either lower their

aircraft price or offer better financing on their own account. In trying to match market-window benefits to the bottom line of the deal, Boeing's own bottom line has suffered by the amount of concessions it has had to offer to match market-window proffered benefits. Because Airbus has market-window support, Boeing has had to underwrite more deals itself than it normally would. This reality adversely affects Boeing's profitability, credit rating, and stock price and, therefore, costs of funding.

KfW emphasizes that it is open for Boeing business. In fact, KfW reports that Boeing represented about 15% of its aircraft deals in 1999.²⁸ Nevertheless, it is clear that access to KfW and other government-supported finance that is not constrained by the OECD Arrangement has been an aspect of Airbus's market success.

The Public Policy Response: What Should Ex-Im Bank do?

The competitiveness gap in export finance perceived by U.S. exporters is a result of:

- Ex-Im Bank policies and operating procedures, and
- Expanded foreign government-supported international financing that is outside the OECD Arrangement.

The appropriate response is to address each of the causes of the competitiveness gap, in turn.

Ex-Im Bank Policies and Operating Procedures

Ex-Im Bank should complete a top-to-bottom review of all its policies, operating procedures, and corporate culture with the aim of closing the competitiveness gap. At the core of such a review should be the goal of having Ex-Im Bank procedures and requirements mesh well with normal business practices.

The United States exports almost \$1 trillion a year in goods and services. Ex-Im finances less than two percent of it. These data are not presented to obscure the fact that in certain markets and product lines Ex-Im Bank supports a much larger share of U.S. exports. However, given the size of total U.S. exports, compared to the value of exports that Ex-Im Bank finances, it seems reasonable to expect that Ex-Im Bank should try to structure its procedures so that they are compatible with normal business practices. Any internal matter that Ex-Im Bank has the authority to change should be on the table for improvement. The cumulative impact of a large number of relatively small changes can be dramatic.

A second initiative that Ex-Im Bank should undertake is to benchmark its processes and procedures against those institutions that are viewed as “best in class.” Such institutions could be in the private sector, or they could be the foreign ECAs or market windows, whose customers perceive as having the best performance. The benchmarking effort would yield valuable insight into how Ex-Im Bank compares to the competition, what improvements may be realistically expected, and how modern communications technology might be deployed to reduce cycle time in responding to customers.

Just by way of example, some of the representative problems cited earlier in the paper can be improved fairly easily. Changes in how domestic and foreign content requirements are administered could help meet the needs of exporters without altering the basic requirements regarding U.S. content.

- Ex-Im Bank could allow exporters with multiple line items sold under a single contract, or to a single project, to apply the U.S. content requirement to the contract or project in its entirety -- rather than to each line item individually. Businesses would be free to optimize their logistics operations without jiggering individual items to meet Ex-Im Bank administrative requirements. The administrative burden and conflicts with ongoing business imperatives would be reduced. At the same time, U.S. content would not be diminished.
- Verifying U.S. content does not require that documents be carefully examined before a shipment can be approved for funding. U.S. content could be confirmed with an exporter certification and enforced with post-shipment audits. Turn-around time on transactions could be shortened and the administrative burden dramatically reduced.

The parties with the greatest interest in promoting such changes are probably different from those who might have pursued them 15 or 20 years ago. Multinational enterprises appear to be less concerned about the competitiveness gap than in the past. Their representatives openly admit that they have the capability of sourcing product from a number of different countries. To the extent that government-supported export finance with more flexible content

rules is available from multiple countries, multinational firms adapt product sourcing patterns accordingly -- possibly to the detriment of U.S. workers. Consequently, labor representatives should take an active role in working with Ex-Im Bank to close this competitiveness gap.

Other changes ultimately require congressional passage of amendments to the Ex-Im Bank charter. The problems associated with the requirement to ship Ex-Im financed exports on U.S. flag vessel's falls into this category.

- The current small size of the U.S. flag merchant marine, coupled with the disruption to U.S. export business, appears to be a good reason to alter the implementation of the requirement that Ex-Im Bank financed exports be shipped on U.S. flag vessels. The requirement could be made less burdensome through negotiations with the Maritime Administration. Elimination of the requirement would require legislative action.
- The adverse effects of foreign policy sanctions on Ex-Im Bank reliability will only be ameliorated by the passage of sanctions reform legislation. Legislation is currently under consideration by the Congress.

Responding To The Challenge of Market Windows

Ex-Im must respond to the challenge of market windows if it is to carry out its mission of leveling the playing field for U.S. exporters. An effective response must start with an acknowledgement that events have overtaken the OECD Arrangement and LASU. Different

responses are possible, each varying with respect to its cost, risks, difficulty of execution, and probability of success.

Derogate and Notify

The simplest response to the market-window challenge starts from the premise that the business case underlying any transaction should determine the financial structure of the transaction, especially with respect to tenor and repayment terms. The flexibility and creativity of market windows in structuring transactions to meet customer needs demonstrate the gap between business needs and the OECD-sanctioned terms. Ex-Im Bank can directly meet market-window competition by deciding, as a matter of general policy, to derogate from the OECD norms *when the business case of a transaction supports tenor and repayment terms that are different than those provided by the Arrangement*. Such derogations, of course, need to be notified to the OECD, and other countries are then free to match these terms.

Such a change in policy would entail two types of costs. Longer average tenors may increase the budgetary cost of Ex-Im Bank-authorized transactions under “credit reform” accounting. However, as currently computed, Ex-Im Bank may be over-reserving for estimated losses. If a case can be made for altering the current model for computing reserves, some or all of the added cost, of longer tenors, or uneven repayment schedules could be absorbed without additional appropriations.

However, a derogate-and-notify policy could place the OECD Arrangement at risk. A strong response from other countries could lead to an unraveling of the Arrangement. This

possibility should be a consideration in deciding the course of action, but not a roadblock. Given the activities of the market windows, the Arrangement is already at risk. Furthermore, given the role of market windows in frustrating the effectiveness of the Arrangement in leveling the playing field for U.S. exporters, it does not warrant unlimited U.S. support. Therefore, an initiative along these lines should include an evaluation of the potential impact on the Arrangement and an “eyes open” recognition of the consequences for the Arrangement of both inaction and any potential new initiative.

The appearance of a direct attack on the OECD Arrangement might possibly be reduced if the decision to derogate were simply characterized as transactions financed under “Ex-Im Bank’s own market window”. In support of this proposal is the fact that KfW and EDC did not “create a new structure” to do market-window activities. These institutions simply decided to start processing transactions outside the OECD disciplines. They handle market-window and official-window export credit transactions side-by-side. The same loan officer who handles a market-window deal may in the same day process an official-window transaction. In today’s GSIFIs, separate departments for market-window transactions do not exist. Instead, it is viewed as another type of offering that the GSIFI has at its disposal, just as a bank offers a variety of loan facilities to its clients.

More importantly, doing nothing also places the Arrangement at risk. As suggested above, the rise of market windows is itself a direct threat to the Arrangement. The growth and activities of KfW and EDC are not going unnoticed. If nothing is done to repair the competitive imbalance, other countries will respond by creating and/or expanding market-

window activity. And, that process itself has the potential to fundamentally undermine the Arrangement.

Negotiate and Match

The U.S. Government could address the market-window erosion of the OECD Arrangement by negotiating a set of rules to control this activity, just as officially-supported export credits are subject to limits. This approach could be patterned after the effort to negotiate restrictions on tied aid by combining a negotiation initiative with a direct response to market-window practices. In effect, a negotiate-and-match initiative would attempt to pull market windows within the disciplines of the OECD Arrangement. An objective of the U.S. strategy could be to expand the OECD agreement to include in the definition of “officially-supported export credits” all export-related financing that benefits from any form of government support.

To strengthen the position of the United States at the negotiating table, part of the strategy should include extra budget support (which could be characterized as a “war chest”) to ensure that Ex-Im Bank has adequate resources to match market-window deals on a transaction-by-transaction basis. Utilization of this “stick” would be analogous to the earlier U.S. strategy in pursuing limits on tied aid through the OECD--a strategy that resulted in the meaningful restrictions that have been successfully applied.

One of the challenges for such a negotiating strategy is to develop sufficient incentives, against known major resistance, to negotiating an OECD agreement that would

encompass market windows. A credible “war chest” threat will require Congressional support, both in policy and budget terms, and that, in turn, will require a broad consensus within the executive branch. While operation of a war chest has certain complexities, they would be similar to the problems that arose in implementing the two-track tied aid policy: matching foreign subsidized transactions while negotiating. For instance, if a U.S. company cannot name what terms a foreign market window is making available to a competitor on a bid, how can Ex-Im Bank match the market window? Also, the question of timing in the bidding process is critical. If an American company learns too late about a market-window supported competitor, the war chest will be no consolation because bidding will not be re-opened. In the tied-aid situation, Ex-Im Bank developed the “competitive letter of interest” which exporters could use effectively with prospective buyers at early stages in the bidding process. This letter of interest would notify foreign purchases early in the process that Ex-Im Bank stands ready to match any GSIFI terms that are better than the OECD Arrangement.

Create a U.S. Market Window

The most important question to address when considering the creation of a market window is whether it is possible, within the U.S. governmental system, to create a U.S. market window that could be competitive with foreign market windows.

GSIFIs like KfW enjoy several tremendous advantages that enable them to function effectively. For example, KfW gains a great benefit from its recourse to the full faith and credit of the German government. Secondly, it retains and accumulates all of its earnings tax-free. Those features make its cost of funds exceptionally low. The German budget process

does not require an appropriation in recognition of the contingent liability that extension of a full faith and credit guarantee entails. However, under U.S. law, no entity can extend the full faith and credit of the U.S. government without recognizing in the budget the expected cost that this entails. Both an authorization and an appropriation are required.

Hence, no U.S. market window could have a low-cost source of funding comparable to KfW, unless either the U.S. budget provides an annual appropriation or the market window was permitted to utilize accrued profits outside of the budget process. If a U.S. market window requires an annual budgetary appropriation, there is less advantage to creating a market window than in granting a simple budget increase for Ex-Im Bank. Moreover, under Arrangement rules, annual budget support could bring the U.S. market window within the OECD disciplines.

An alternative approach would be to create a hybrid institution that would not enjoy the full faith and credit of the U.S. government, but would be sufficiently credit worthy that its cost of funds would be as low as possible for a private-sector borrower. Many differing viewpoints exist on how to build the foundation and supporting structures for such an institution. One such model is based on the structure of government supported enterprises (GSEs), such as Fannie Mae. In this case, the organization could receive government support through an equity infusion, as well as through a legislated privileged status.

Another model for consideration resembles more of a special fund than an institution. In this model, the Private Export Funding Corporation (PEFCO), which already arranges

funding for Ex-Im Bank-guaranteed loans would assume responsibility for managing a fund for market-window transactions.²⁹ The fund would need an initial capitalization from Ex-Im Bank, commercial banks and exporters. The portion of Ex-Im Bank's capital investment should be such that it would be a minority shareholder. Ex-Im Bank's investment would require a one-time request for appropriation from Congress, which is easier to achieve than annual requests for appropriations. In order to induce commercial banks to invest in the fund, the underwriting of notes would be limited to banks and investment companies that have some predetermined amount of equity in the fund, with preferences being given to shareholders based on the size of their equity participation. For an exporter seeking financing from the fund, the amount of credit available would be related to its equity investment in the fund. For exporters, an investment in such a fund has two attractive aspects: a) diversification, that is, the portfolio does not have the concentration of risk of an individual export transaction; and b) the risk of a portfolio is lower than the sum of the risks of the individual transactions.

Exporters would be required to leave their equity in the fund as long as the financing balance to their foreign customers remained outstanding. The fund's equity initially would be invested in higher quality assets, potentially a mixture of AAA and AA bonds, and some U.S. Treasuries. As loans were made, promissory notes from the fund's borrowers would be added. This combination of investments and promissory notes would be used to collateralize the fund's bonds. Additionally, private insurance could be acquired for individual transactions, when possible, to reduce the risk level of the portfolio. Because the overall diversified portfolio would be less risky than the sum of the risks of the individual loans, the

average cost of the funding and terms of the loan would be more attractive than terms available for one-off financing vehicles.

To place the fund on a more equal footing with KfW and EDC, for example, profits that are retained could be exempt from taxation. This would enable the fund to grow more quickly, lower the cost of its equity funds, build reserves against possible losses faster, and reduce the need for additional equity from the investors. The majority private ownership, coupled with private management, could allow the fund to function like a market window and offer loan terms that would not be bound by the OECD Arrangement.

The Optimal Path

At the end of the day, the optimal path is the one most likely to yield the highest benefit-to-cost ratio. Improvements in customer focus and operating efficiency that are potentially significant can be realized with Ex-Im internal reforms. And, realizing such benefits requires neither new resources nor creation of a new organization. Furthermore, an Ex-Im policy adjustment that defers to the business case as the dominant consideration in the structuring of a transaction holds significant appeal. It goes right to the heart of the competitiveness gap created when market windows offer tenor or repayment schedules that are longer than permitted by the OECD Arrangement. It too is a relatively simple solution that does not require new entities to be created. A more customer-friendly Ex-Im Bank, offering financing terms that are tailored to the business case of a transaction, would go a long way toward closing the competitiveness gap with which U.S. exporters report they must contend.

While these changes are underway, Ex-Im Bank can explore the opportunities presented by both the negotiating route and the creation of a U.S. market window that would be most consistent with the U.S. approach to government-private sector cooperation.

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Table 1: Boeing vs. Airbus: New Aircraft Sold, 1996-1999, (in percent)

Year	Boeing	Airbus
1996	70.4	29.6
1997	56.8	43.2
1998	54.9	49.1
1999	43.5	56.5

Source: Airclaims Limited: www.Airclaims.co.UK

Endnotes

* The author wishes to thank Cheryl Ingstad for outstanding collaborative assistance in the preparation of this paper. The author also wishes to thank Raymond Albright, Kenneth Hansen, James Hess and Rita M. Rodriguez for reading earlier drafts of the paper and providing most helpful comments and suggestions from which the paper greatly benefited. Responsibility for all errors rests with the author.

¹ For programmatic purposes, Ex-Im Bank defines a “long-term” transaction as one with a total term of more than seven years or a financed value of more than \$10 million.

² Organization for Economic Cooperation and Development, *Arrangement on Guidelines for Officially Supported Export Credits*, 1978/1998.

³ Organization for Economic Cooperation and Development, *Arrangement on Guidelines for Officially Supported Export Credits*, 1978/1998.

⁴ Organization for Economic Cooperation and Development, *Arrangement on Guidelines for Officially Supported Export Credits, Annex III*, 1998: 51-62.

⁵ Discussions with major U.S. and multinational companies with memberships in the National Foreign Trade Council, the International Energy Development Council, and the Coalition for Employment through Exports.

⁶ Meeting between U.S. exporters and the Trade Promotion Coordinating Committee (TPCC) staff, Washington, DC, February 16, 2000.

⁷ The problem of cofinancing is further complicated by the fact that most other ECAs provide long-term insurance in contrast to Ex-Im Bank’s direct loans and guarantees. These different products have major differences in legal documentation.

⁸ KfW Presentation, Frankfurt, Germany, April 27, 2000:12.

⁹ KfW Presentation, Frankfurt, Germany, April 27, 2000: 11.

¹⁰ KfW Presentation, Frankfurt, Germany, April 27, 2000: 21.

¹¹ Discussions with Heinrich Heims, Senior Vice President, KfW Export and Project Finance, Frankfurt, Germany, April 27, 2000.

¹² KfW Presentation, Frankfurt, Germany, April 27, 2000: 22-23.

¹³ KfW Presentation, Frankfurt, Germany, April 27, 2000: 24.

¹⁴ The history of the U.S. S&L (savings and loan) crisis in the 1980s is a good example of how this works in the extreme. Individual deposits in S&Ls were (and still are) insured by the U.S. government up to a maximum of \$100,000. Because of the protection provided to depositors by the U.S. government, an S&L's ability to attract deposits was (and is) not totally dependent on the quality of the institution's balance sheet. The cost of the crisis grew large because insolvent institutions were able to remain open for business – and liquid --because they remained able to attract new deposits until the day government regulators shut them down.

¹⁵ The government financial support provided to KfW sounds very much like the support that Ex-Im Bank received in an earlier period, before the implementation of U.S. government-wide reforms in budgeting for credit programs. Ex-Im Bank received an initial capitalization from the U.S. Treasury of \$1 billion in the late 1940s. Starting with that initial capital, Ex-Im Bank operated profitably until 1982. Over that time period, it accumulated \$2.2 billion in retained earnings and it returned \$1.1 billion in dividends to the U.S. Treasury – despite the fact that during the latter years it lent money at a negative spread. That is, it made loans at a rate of interest below its cost of borrowing. This

financial performance was made possible because it paid no interest on the pool of funds created by the retained earnings and the initial capital used in its lending programs.

¹⁶ The particulars of this transaction were presented at the Air Finance Conference held in New York in late 1999.

¹⁷ Discussions with Hans Reich, Chairman of KfW, Frankfurt, Germany, April 27, 2000. Hans Reich presents the same positions in this volume.

¹⁸ EDC. 1999. Creating Capacity: An Evaluation of EDC's Role in Canada's Export Credit System. Canada (March): 2.

¹⁹ EDC. 1999. Creating Capacity: An Evaluation of EDC's Role in Canada's Export Credit System. Canada (March): 1.

²⁰ EDC. 1999. Creating Capacity: An Evaluation of EDC's Role in Canada's Export Credit System. Canada (March): 37-39.

²¹ EDC. 1999. Creating Capacity: An Evaluation of EDC's Role in Canada's Export Credit System. Canada (March): 37.

²² Ex-Im Bank. 199. 1999 Annual Report, FY 1999 At A Glance, section. Washington, DC.

²³ EDC. 1999. 1999 Annual Report. Canada: 31.

²⁴ Any comparison of dollar amounts between the funding of Ex-Im Bank under U.S. government credit reform rules and the capitalization of EDC is at a minimum meaningless, and if pursued, disingenuous. Under U.S. appropriations' rules, as applied to Ex-Im Bank, profitable transactions are not permitted to cross-subsidize money-losing transactions. Only transactions with a negative present-discounted value are accounted for and charged against Ex-Im Bank's appropriation. For example, if on any given day

Ex-Im Bank were to approve two transactions, and one had a positive present-discounted value of \$100 million, and the second had a negative present discounted value of \$1 million, the charge against Ex-Im Bank's appropriation for these two transactions taken together would be a negative \$1 million. The transaction with the \$100 million profit would show up, for budget purposes, as a "zero" cost transaction. EDC (and for that matter KfW) is "profitable" because it is able to cross-subsidize money-losing transactions with the gains from profitable transactions. If Ex-Im Bank were to keep its books in the same way that EDC's books are kept, it could also be deemed to be profitable.

²⁵ Canadian Senate. 1999. Proceedings of the Standing Senate Committee on Banking, Trade and Commerce. Issue 2 – Evidence (December 2): 6.

²⁶ Canadian Senate. 1999. Proceedings of the Standing Senate Committee on Banking, Trade and Commerce. Issue 4 – Evidence (December 15): 11.

²⁷ Discussions with Scott Scherer, Vice President, Boeing Customer Financing, Seattle, WA, April 24, 2000.

²⁸ Discussions with Ludolf Rischmueller, Vice President, KfW Export and Project Finance/Aerospace Division, Frankfurt, Germany, April 27, 2000.

²⁹ Like KfW and EDC, the new fund would have a tax-free or tax-preferred status. PEFCO. 1999. *Private Export Funding Corporation 1999 Annual Report*. New York: 3.