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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. During the past 25 years, the federal government has deregulated broad swaths of the US 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 US 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 US government export finance agency, the US Export-Import Bank of the United States, might appear as a vestigial anomaly left over from an earlier era. Is this the case?

The Export-Import Bank has two primary missions. The first is to correct market failures that prevent the financing of otherwise creditworthy cross-border transactions. The second is to level the playing field for US exporters facing foreign competitors that receive attractive, government-supported export financing. The US 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

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failures in cross-border financing continue to exist. This chapter will examine the second mission of Ex-Im Bank: How level is the playing field for US exporters? Although Ex-Im offers a range of different programs and products, the chapter 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 the chapter reviews US 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 US exporters continue to experience a competitiveness gap and analyzes the reasons why a gap remains. This section examines the operating culture and emblematic policies of Ex-Im Bank as compared with foreign export credit agencies (ECAs). The analysis in the third section focuses on a growing phenomenon in government-supported international finance: the market window. The nature and extent of government support is described, the activities of market windows are reviewed, and the role these windows play in contributing to the perceived competitiveness gap is examined. The fourth and last section identifies several options for Ex-Im Bank to consider in addressing the competitiveness gap. The options discussed include:

- Changing Ex-Im's policies and procedures to better align them with business practices;
- Modifying Ex-Im'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 US market window.

The Old World of Officially Supported Export Credits

Since the mid-1970s, the US Export-Import Bank's approach to leveling the playing field for US exports has consisted of a two-pronged approach. On the one hand, Ex-Im offered transaction-specific financing that was designed to be competitive with that offered by other governments that supported their exports with officially supported export credits. The objective was to make the combined value of the tenor, interest rate, risk

1. For programmatic purposes, Ex-Im Bank defines a "long-term" transaction as one with a total term of more than 7 years or a financed value of more than $10 million.

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premiums, 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," because 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. For 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 industrial 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, and 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 rose 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, because 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 US 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. The Arrangement placed limits on subsidies offered in official export credits. The product of these negotiations is called an "arrangement"

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and not a treaty because it is generally not legally binding. In fact, it is generally referred to as a "gentleman's agreement" 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. 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 (France, Germany, Spain, the United Kingdom, and the United States). 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 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 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 is portrayed as a success. The annual level of tied aid credits has dropped by half. All the 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, US exporters perceive that they are still at a competitive disadvantage. In

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discussions with exporters of capital equipment and sponsors of major projects, they report that the playing field is not level.[2] 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 US enforcement should leave US 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 US exporting community?

The competitive difficulties perceived by US 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 twenty-first 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 during the past several years to recognize the scope of change. Such mergers are taking place in virtually all industries, including heavy manufacturing, pharmaceuticals, telecommunications, and finance. Premier corporate marquees have been swallowed up. The Chrysler Corporation, a major US automobile producer that was deemed sufficiently valuable only 20 years ago to receive a federal government financial bailout, has been taken over by a German company, now known as DaimlerChrysler.

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 important, the availability of modern, low-cost telecommunication and networking technologies. In particular, the advent of networking technologies—Internet, extranet, intranet—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.

2. The discussions were with major US and multinational companies that are members of the National Foreign Trade Council, the International Energy Development Council, and the Coalition for Employment through Exports.

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Time frames are also being compressed, enabling ever faster responses to customer needs and demands.

These new enterprises, with operations on multiple continents, have the communication networks, the decision models, and the data systems to make possible 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 the cost-minimizing, revenue-maximizing options available to the firm. The enterprise has multiple locations from which to fill its order book, and production consequently 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

The US Export-Import 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 generally finds that Ex-Im is competitive with other ECAs. However, when the assessment looks at operating policies and procedures, and how these factors affect the measurement of competitiveness, Ex-Im fares less well. This conclusion is derived from a survey of knowledgeable Ex-Im customers. It consistently ranks Ex-Im as less competitive in these areas than its Group of Seven counterparts. Although the findings are based on responses from a small number of Ex-Im 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.[3]

Officially supported export finance programs that mesh well with financial market innovation and the 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.

3. Meeting between US exporters and the Trade Promotion Coordinating Committee staff, Washington, 16 February 2000.

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Ex-Im Bank's legislation, policies, and operating procedures reflect the earlier era in which it 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's early years went to sovereign borrowers. The dominant role of foreign government entities as purchasers of exports financed by Ex-Im, and unique US products in certain sectors, meant that the business imperative of private borrowers did not intrude on Ex-Im'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's policies and procedures also represent an accommodation to the priorities of an earlier era. These policies and procedures reflected a specific intent: to create as many US jobs as possible. The policies were directed at ensuring that foreign-produced goods and the jobs that they represented did not receive the benefit of Ex-Im financing. The mandate of promoting US 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 providing other transportation infrastructure.

The world of the twenty-first century is far different from the world in which such policies and procedures were developed. Competition in international markets is intense. The past 20 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 have 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 is to provide genuine value to US exporters.

Ex-Im 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 Ex-Im's ability 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 US content requirement, disbursement procedures, additionality, economic impact, and local-cost financing; and to the requirement to ship exports financed by Ex-Im on US-flag vessels. These policies and operating procedures lead

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to long response times, cumbersome tasks that do not mesh well with business imperatives, Ex-Im's questionable reliability as a partner, and an unwillingness to undertake cooperative agreements with other export credit agencies to cofinance transactions. The examples are:

- The Ex-Im Bank will finance only the US content embodied in US 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 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 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 US content in one line item for a specific project cannot offset lower US content in another line item. In other words, not only must the entire transaction be 85 percent US content to qualify for the maximum available financing, but each separate line item must also meet the same requirement.

- Exports financed by the Ex-Im Bank are required to be shipped on US-flag vessels. The US-flag fleet is so small, and its service so limited, that the majority of transactions seek a waiver from the Maritime Administration to use foreign flag vessels. When a waiver is not granted, cost and time are added to US export performance. For example, when no waiver has been granted, heavy construction equipment that is most efficiently shipped by driving it onto "RoRo" ("roll-on, roll-off") ships has had to be broken down into various parts, and shipped in various stages of disassembly, so that it could be placed on the only US-flag vessel available. US exporters have reported sourcing from foreign factories (using foreign ECA financing) to avoid the added cost and inconvenience of US-flag shipping. Even when a waiver is granted, the uncertainty as to whether or not a more costly US-flag alternative will have to be used adds time and cost to using Ex-Im. 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, some uncertainty over the availability of Ex-Im financing will always be inevitable. There will always be a degree of uncertainty as to whether a foreign borrower will be found sufficiently creditworthy to justify approval of any particular transaction. This uncertainty is an unavoidable element of any

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bank financing. Similar to a commercial bank that must make a judgment as to the creditworthiness of a prospective borrower, Ex-Im is prohibited from putting public funds at risk unless there is a reasonable assurance of repayment. But in the case of Ex-Im, there is always also the political risk that foreign policy sanctions, or congressional or Executive Branch action (such as the recent State Department directive that temporarily blocked Tyumen Oil financing in Russia), could intervene to prevent financing from going forward. The perception of Ex-Im 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 a patina of unreliability on Ex-Im.

- 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 has such burdensome administrative and policy requirements, it has generally refused to participate in such joint undertakings. Because Ex-Im is not willing to accept the administration of transactions by other ECAs—whose requirements are far less intrusive than Ex-Im's—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.[4]

Ex-Im Compared with Foreign ECAs

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

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

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in successful business, some ECAs have become highly customer focused. Response time and cycle time have been shortened 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 allow exchanges of information with customers and quick responses to customer needs.

Furthermore, foreign ECAs are able to support their exporters with a greater degree of flexibility than is Ex-Im. In part, this reflects a different view of the role of foreign ECAs in the financial markets. Foreign ECAs are not viewed exclusively as lenders of last resort. Consequently, applicants do not have to prove that there is no alternative source of funding 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 for exports financed by Ex-Im. For example, the Japan Export-Import Bank (JEXIM) and its successor, 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 US Export-Import Bank in an actual transaction demonstrates the differences in the requirements and operating practices and how they affect the transaction. A US company was unable to access planned Ex-Im financing for a large export because of the imposition of US foreign policy sanctions. The US 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, while requiring only 30 percent Japanese content. A transaction comparable to the one that JEXIM was willing to finance in its entirety—that is, one with 30 percent US content—would not have qualified for Ex-Im financing. (By comparison, Ex-Im would have required a minimum of 51 percent US content for any financing, and then would have financed only the *lesser* of 100 percent of the US content in the transaction, or 85 percent of the entire transaction.)

In this example, the US 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 not all that bad from a US national perspective. After all, JEXIM financed the entire transaction, including some not-insignificant quantity of US exports, without the US 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 US company found transacting business with JEXIM a very positive experience, and it is looking forward to doing more deals in Japan.

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The US government's short-lived sanctions resulted in the loss of a large US 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 partner. The imposition of such sanctions is a foreign policy decision. And, as such, it lies beyond the purview and competence of Ex-Im. The authority to impose such sanctions rests with Congress, the president, and the secretary of state. Ex-Im 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 and other ECAs.

The 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.

In the 1970s and 1980s, the competition between industrial countries for export markets using subsidized export credits 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. 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 have been accompanied by the growing importance of government-supported international finance that is not constrained by the Arrangement. These government-supported organizations 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 thus 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, the Export Development Corporation (EDC). Market window support for a transaction is typically

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"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 Kreditversicherungs 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 on 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 the US Export-Import 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 that they do not have to abide by 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 marketplace 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 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 during the past decade. They are now powerful and important players. Both KfW and EDC process most of their long-term export financing through their market windows. With the market windows, GSIFIs can grow their

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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 GSIFIs 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 GSIFIs are also recognized by exporters as 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, and processing deals according to market terms, market window GSIFIs 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 GSIFIs 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 GSIFIs and their financial underpinnings. GSIFIs 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 GSIFIs, KfW and EDC.

Germany's Kreditanstalt für Wiederaufbau

Kreditanstalt für Wiederaufbau 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-sized enterprises.

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 it 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 of outstanding

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loans was in the area of domestic investment, and approximately 20 percent of its total portfolio was devoted to export and project finance.[5] 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 9.0 billion euros.[6] Most of KfW's export and project finance business is conducted through the market window, outside of Arrangement guidelines. Of these 9.0 billion euros in new commitments, approximately 7.8 billion euros represented market window transactions.[7] 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.[8] Other justifications are also given, such as the recent increase in the demand for multisourced financing structures due to the globalization of production, and the increase in demand for financing coupled with the limited availability of official support funds tied to German exports.[9]

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 the 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 trans-

5. KfW Presentation, Frankfurt, 27 April 2000, 12.

6. KfW Presentation, Frankfurt, 27 April 2000, 11.

7. KfW Presentation, Frankfurt, 27 April 2000, 21.

8. Discussions with Heinrich Heims, senior vice president, KfW Export and Project Finance, Frankfurt, 27 April 2000.

9. KfW Presentation, Frankfurt, 27 April 2000, 22-23.

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action.[10] 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 nonfinancial 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 the 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 simply: KfW's salary structure is not determined according to government pay scales, but rather according to the comparative salaries of similar positions in the German commercial banking industry. The relatively similar compensation relative to that of colleagues in the private sector, as well as some of the elements of the 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 DM1 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 its cost for borrowed funds to

10. KfW Presentation, Frankfurt, 27 April 2000, 24.

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a rate that is very close to that of the German federal government. Estimates indicate that KfW's cost of money for a representative 5-year term is about 35 basis points above that of the German government. When borrowing in the US 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.[11]

- 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, its 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 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 likely have 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 would find possible.[12] This capability creates a situation in which KfW competes with

11. The history of the US savings and loan (S&L) 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 US government up to a maximum of $100,000. Because of the protection provided to depositors by the US 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.

12. The government financial support provided to KfW sounds very much like the support that the US Export-Import Bank received in an earlier period, before the implementation of US governmentwide reforms in budgeting for credit programs. Ex-Im Bank

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the private sector. Business firms report that KfW may finance transactions at a spread over the London Interbank Offered Rate 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. US 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 that 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 US President Ronald 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 chapter is able to provide the particulars of only three transactions in which KfW participated. Because so few transactions are referenced, there are not enough data to quantify the inherent subsidy, if any, in KfW's market window deals. Nevertheless, the specifics of the following transactions 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 OECD

received an initial capitalization from the US Treasury of $1 billion in the late 1940s. Starting with that initial capital, Ex-Im operated profitably until 1982. During that period, it accumulated $2.2 billion in retained earnings, and it returned $1.1 billion in dividends to the US 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.

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Arrangement 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 reported 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.[13] To support earlier sales of 41 aircraft in the US market, Airbus had assumed the credit risk of two US airlines—United and American—at a time when US 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 US airlines. If everything went well, the lease payments from the airlines would flow 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 US 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 US 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 had been 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 US Export-Import Bank's 65th anniversary conference in May 2000, KfW reported that it was planning to lay off 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 doing so for the express purpose of helping Airbus become more competitive.

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

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- The third transaction involved KfW's participation in the financing of Boeing B-717 aircraft to a no-frills startup airline, Air Tran (formerly known as ValuJet). KfW participated in the transaction because BMW/Rolls-Royce 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 in one another's market. Furthermore, the term of the financing exceeded the maximum LASU tenor by 3 years.

Hence, when the US Export-Import Bank faces the competition provided by the German 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 during 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.[14] Another way of interpreting such a forecast is to conclude that the level of government-supported export

14. Discussions with Hans Reich, chairman of KfW, Frankfurt, 27 April 2000. Reich presents the same positions in chapter 15 of this volume.

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finance that is unconstrained by the OECD Arrangement will continue to grow.

Canada's Export Development Corporation

The Export Development Corporation'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 more than 40 percent of Canadian GDP in 1998 (EDC 1999, 2). However, Canada does not see itself as having an easy road in the world market. Canadian leaders see their country as at a disadvantage in comparison to the United States or the European Union. In fact, in comparison with the United States, Canada suffered a significant decline in the 1990s in relative per capita GDP, when measured on the basis of purchasing power parity. 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 this 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" (EDC 1999, 1).

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

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end users (EDC 1999, 37-39). 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 EDC's 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 (EDC 1999, 37). 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 US$13 billion in new loans, guarantees, and export credit insurance, supporting US$16.7 billion worth of US exports to markets worldwide.[15] To accomplish this level of support, Ex-Im Bank received an annual government appropriation of US$765 million and employed a staff of about 400 personnel. By contrast, EDC, operating in a Canadian economy only about a tenth the size of the US 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, as with KfW, EDC borrows with the full faith and credit guarantee of its owner, the government of Canada. Consequently, its cost of money is less than that of the most creditworthy commercial bank. It pays no taxes, and it pays no dividends to its owner. Its 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.[16]

Why is there such a dramatic difference in the relative performance of the two organizations? In the words of the president of EDC, A. Ian Gillespie, "They [US Ex-Im Bank] get an annual appropriation that is more than the entire capital invested in EDC.[17] They are a lender of last

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15. US Export-Import Bank, *1999 Annual Report*, "At a Glance" section.

16. Export Development Corporation, *1999 Annual Report*, 31.

17. Any comparison of dollar amounts between the funding of Ex-Im Bank under US government credit reform rules and the capitalization of EDC is at a minimum meaningless and, if pursued, disingenuous. Under US appropriations rules, as applied to Ex-Im Bank, profitable transactions are not permitted to cross-subsidize money-losing

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resort. We [EDC] are not. That is one of the big differences."[18] 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."[19]

The Impact of Market Windows on US Companies

Ironically, US-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 US 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.

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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 profitable.

18. Canadian Senate, "Proceedings of the Standing Senate Committee on Banking, Trade, and Commerce," Issue 2, "Evidence," 2 December 1999, 6. The committee met to discuss the Export Development Act.

19. Canadian Senate, "Proceedings of the Standing Senate Committee on Banking, Trade, and Commerce," Issue 4, "Evidence," 15 December 1999, 11. The committee met to discuss the Export Development Act's operations and success in discharging its mandate from the 1993 revisions to act.

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Although many large US 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 such as Boeing, which have most of their manufacturing facilities located 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 British, French, German, 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 euros, with new commitments in 1999 of 3.1 billion euros.

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 with 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.[20] 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-à-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 because Ex-Im is constrained by LASU. The understanding of LASU is that countries will not use officially supported

20. Discussions with Scott Scherer, vice president, Boeing Customer Financing, Seattle, 24 April 2000.

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Table 9.1 Boeing versus Airbus: New aircraft sold, 1996-99 (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, http://www.airclaims.co.uk.

export credits to finance the sale of aircraft to countries that produce a similar class of aircraft. This means that, whereas Boeing cannot sell in the aircraft market in France, Germany, Spain, and the United Kingdom with Ex-Im Bank support, Airbus is able to sell in the US 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. Although 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's growing market share for new orders. The statistics in table 9.1 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 marketplace, 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, it has been forced to either lower its aircraft price or offer better financing on its 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, 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 percent of its aircraft deals in 1999.[21] Nevertheless, it is clear that access to KfW and other government-

21. Discussions with Ludolf Rischmueller, vice president, KfW Export and Project Finance/Aerospace Division, Frankfurt, 27 April 2000.

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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 US exporters is a result of:

- Ex-Im Bank policies and operating procedures, and
- Market windows: 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

The US Export-Import Bank should complete a top-to-bottom review of 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 Bank finances less than 2 percent of it. These data are not presented to obscure the fact that in certain markets and product lines Ex-Im supports a much larger share of US exports. However, given the size of total US exports, relative to the value of exports that Ex-Im finances, it seems reasonable to expect that the 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 foreign ECAs or market windows whose customers perceive them as having the best performance. The benchmarking effort would yield valuable insights into how Ex-Im compares with 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 chapter could be improved fairly easily. Changes in how

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domestic- and foreign-content requirements are administered could help meet the needs of exporters without altering the basic requirements regarding US content:

- Ex-Im Bank could allow exporters with multiple line items sold under a single contract, or to a single project, to apply the US 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, US content would not be diminished.

- Verifying US content does not require that documents be carefully examined before a shipment can be approved for funding. US content could be confirmed with an exporter certification and enforced with postshipment audits. Turnaround 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 US 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 Ex-Im Bank's charter. The problems associated with the requirement to ship exports financed by Ex-Im on US-flag vessels fall into his category:

- The current small size of the US-flag merchant marine, coupled with the disruption to US export business, appears to be a good reason to alter the implementation of the requirement that exports financed by Ex-Im Bank be shipped on US-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 legislation to reform sanctions. This legislation is currently under consideration by Congress.

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Responding to the Challenge of Market Windows

The US Export-Import Bank must respond to the challenge of market windows if it is to carry out its mission of leveling the playing field for US exporters. An effective response must start with an acknowledgment 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 from those provided by the Arrangement*. Of course, the OECD needs to be notified of such derogations, 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 transactions authorized by Ex-Im Bank, under "credit reform" accounting. However, as currently computed, Ex-Im 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 of 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, but not a roadblock, in deciding the course of action. 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 US exporters, it does not warrant unlimited US 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

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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 the same day process an official-window transaction. In today's GSIFIs, separate departments for market window transactions do not exist. Instead, such transactions are 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 important, 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 or expanding market window activity. And that process itself has the potential to fundamentally undermine the Arrangement.

Negotiate and Match

The US 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 US strategy could be to expand the Arrangement 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 US strategy of 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. Although keeping a war chest has certain complexities, they would be similar to the problems that arose in implementing

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the two-track tied aid policy: matching foreign subsidized transactions while negotiating.

For instance, if a US 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 reopened. 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 purchasers early in the process that Ex-Im Bank stands ready to match any GSIFI terms that are better than the OECD Arrangement.

Create a US Market Window

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

GSIFIs such as KfW enjoy several tremendous advantages that enable them to function effectively. First, for example, KfW gains a great benefit from its recourse to the full faith and credit of the German government. Second, 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 US law, no entity can extend the full faith and credit of the US government without recognizing in the budget the expected cost that this entails. Both an authorization and an appropriation are required.

Hence, no US market window could have a low-cost source of funding comparable to KfW, unless either the US budget provided an annual appropriation or the market window was permitted to utilize accrued profits outside the budget process. If a US 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 US 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 US government, but would be sufficiently creditworthy 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, such as Fannie Mae. In this case, the organization

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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 loans guaranteed by Ex-Im Bank, would assume responsibility for managing a fund for market window transactions.[22] The fund would need an initial capitalization from Ex-Im Bank, commercial banks, and exporters. The portion of Ex-Im's capital investment should be such that it would be a minority shareholder. The Bank's investment would require a one-time request for an appropriation from Congress, which is easier to achieve than annual requests for appropriations. 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 on the basis of 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: (1) diversification, that is, the portfolio does not have the concentration of risk of an individual export transaction; and (2) 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 US Treasury notes. 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, if 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.

22. As with KfW and EDC, the new fund would have a tax-free or tax-preferred status (Private Export Funding Corporation, *1999 Annual Report*, 3).

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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 internal reforms of the US Export-Import Bank. And realizing such benefits requires neither new resources nor the 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 that new entities 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 US exporters report they must contend.

While these changes are under way, the US Export-Import Bank can explore the opportunities presented by both the negotiating route and the creation of a US market window that would be most consistent with the US approach to cooperation between government and the private sector.

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