INTERNATIONAL REGULATION OF OFFICIAL TRADE FINANCE:
COMPETITION AND COLLUSION IN EXPORT CREDITS AND FOREIGN AID

by

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International Regulation of Official Trade Finance:
Competition and Collusion in Export Credits and Foreign Aid

by

Peter C. Evans

Submitted to the Department of Political Science on May 23, 2005 in partial fulfillment of the requirement for the Degree of Doctor of Philosophy in Political Science at the Massachusetts Institute of Technology.

Abstract

Advanced industrial countries provide over $120 billion annually on various terms and conditions to support exports and investments abroad. The regime governing these official trade finance (OTF) flows has puzzling features. The legal basis of the regime, officially known as the Arrangement on Guidelines for Officially Supported Export Credits (Arrangement), is ambiguous. Its proceedings are secret. Its membership is restricted to a relatively small number of states. Finally, some sectors and modes of finance are more tightly regulated than are others. Some are not regulated at all. My research goal was not only to explain the unusual institutional features and scope of the regime as it currently stands, but also to explain why this regime emerged. I argue that the Arrangement is best understood as a cartel comprised of the leading suppliers of state-backed trade finance. Supplier states comprise the rich industrial countries that “produce” official export finance or “give” foreign aid to finance the exports of capital goods, military equipment and agricultural products sought by buyer states. Buyer states are generally developing countries, which have limited ability to pay in cash or self finance these imports. The cartel serves the collective interest of supplier states in: 1) controlling the predatory use of export finance to shift rents from one supplier state to another; 2) controlling the unintentional transfers of wealth from supplier states to buyer states. By colluding to limit competition through jointly agreed upon rules, supplier states increase their market power vis-à-vis buyer states. The Organization for Economic Cooperation and Development (OECD) became the forum of choice for the Arrangement because it permitted secrecy and selective membership that better aligned the interests of supplier states against buyer states. However, cartels, whether market distorting or market correcting, are imperfect arrangements. To succeed they require the control of a large market share, the presence of weak and disorganized buyers, and access to information on financing terms on a timely, ex ante basis. The body of evidence gathered for this dissertation shows this to hold true for official trade finance, explaining the variation in rule formation across sectors and across modes of financing.

Thesis Supervisor: Kenneth A. Oye

Title: Associate Professor of Political Science
ACKNOWLEDGEMENTS

My interest in government provision of trade finance was sparked during several trips to China as part of a collaborative research project between MIT, Tokyo University and Tsinghua University. During these trips, I had the opportunity to witness the intense competition between U.S., European and Japanese vendors as they vied for multi million dollar power plant contracts tendered by Chinese authorities. Invariably, when speaking to one vendor, I heard complaints about the special financing terms and conditions enjoyed by competitors and the skill of Chinese officials in playing one bidder against another. As I dug more deeply into the subject, I became increasingly interested in a little known body of rules that seeks to regulate the tendency of states to engage in credit races.

The effort to understand the effects and limitations of these rules ultimately led beyond the power sector to an array of other contested sectors including civil aircraft, ships, agricultural goods and military equipment. It also led beyond China to trade competition across the developing world. Gathering information for this dissertation took several years. During this time, I was fortunate to have the opportunity to travel widely, including trips to Beijing, Paris, Frankfurt, Ottawa, Stockholm, Sydney, Tokyo, and Washington, D.C. I would like to extend my gratitude to the Japan Foundation, the Alliance for Global Sustainability, MIT Center for International Studies, Energy, Technology and International Affairs Research Award, and the Carroll L. Wilson Award, MIT Entrepreneurship Center for their generous support in funding my research travel.

I have incurred many debts along the way. By far my greatest debt is to Kenneth A. Oye, my thesis supervisor and advisor. He played a seminal role in turning my enthusiasm for empirics and various deals taking place across the world into more critical thinking about how they relate to deeper questions of international political economy. I learned a tremendous amount taking his courses and then serving as a teaching assistant for his course Science, Technology and Public Policy. I benefited as well from co-authoring a paper published by the Institute for International Economics and a report for the U.S. Trade Policy Coordinating Committee. I have fond memories of the various research trips we took together in the United States and abroad. I would also like to extend my appreciation to Richard J. Samuels and Edward Steinfeld who carefully read and commented on my dissertation as it evolved. When I first started out, Ed advised that the best dissertation is a done dissertation. While easier said than done, in the end, I can say that it is indeed true.

The ability to do quality social science research often depends on the willingness of practitioners in the field to share their time and knowledge. In the course of researching this dissertation I faced more than a few roadblocks in securing information and meaningful interviews. However, I was also fortunate to identify a number of extremely helpful current and former officials involved the world of official trade finance. I am especially indebted to the following individuals for their willingness to share their time and insights: Raymond Albright, Venessa Allen-Murry, Bob Crick, James Cruse, Steve Cutts, David Drysdale, Robin Epstein, Delio Gianturco, Emanuel Glimet, Fumio Hoshi, Bengt Johansson, Frans Lammersen, Jean Lecocguic, John D. Lange, Tadashi Maeda, Saila Turunen, Steve Tvardek and Todd Winterhalt.
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ACRONYMS AND ABBREVIATIONS

ALASECE  Associacion Latinoamericana de Seguradoras de Credito a la Exportacion
APEC     Asian Pacific Economic Cooperation
ASCM     Agreement on Subsidies and Countervailing Measures
BIS      Bank for International Settlements
CAP      Common Agricultural Policy
CIRR     Commercial Interest Reference Rates
CRS      Creditor Reporting System
DAC      Development Assistance Committee
DCS      Direct Commercial Sales
DELG     Defense Export Loan Guarantee
DLF      Development Loan Fund
DOD      Department of Defense
EC       European Commission
EU       European Union
ECA      Export Credit Agency
ECG      Group on Export Credits and Credit Guarantees
ECGD     Export Credit Guarantees Department
EDC      Export Development Canada
EEP      Export Enhancement Program
EID/MITI Export Insurance Division, Ministry of International Trade and Industry
FMS      Foreign Military Sales
GAO      U.S. General Accounting Office
<table>
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<tr>
<th>Abbreviation</th>
<th>Full Name</th>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IEA</td>
<td>International Energy Agency</td>
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<tr>
<td>JEXIM</td>
<td>Japan Export Import Bank</td>
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<tr>
<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau</td>
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<tr>
<td>LASU</td>
<td>Large Aircraft Sector Understanding</td>
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<tr>
<td>LDC</td>
<td>Less Developed Country</td>
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<td>MPB</td>
<td>Minimum Premium Benchmarks</td>
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<td>MMI</td>
<td>Matrix minimum interest</td>
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<tr>
<td>MWI</td>
<td>Market Window Institutions</td>
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<tr>
<td>NAC</td>
<td>National Advisory Committee on International Monetary and Financial Policies</td>
</tr>
<tr>
<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
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<tr>
<td>NIEO</td>
<td>New International Economic Order</td>
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<tr>
<td>OEEC</td>
<td>Organization for European Economic Cooperation</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<tr>
<td>OLIS</td>
<td>On Line Information System</td>
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<td>OOF</td>
<td>Other Official Flows</td>
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<td>OTF</td>
<td>Official trade finance</td>
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<td>PROEX</td>
<td>Programa de Financiamento as Exportacoes</td>
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<td>STE</td>
<td>State Trading Enterprises</td>
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<td>SDR</td>
<td>Special Drawing Rights</td>
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<tr>
<td>UMM</td>
<td>Uniform Moving Matrix</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<td>US Ex-Im</td>
<td>U.S. Export Import Bank</td>
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<td>USDA</td>
<td>U.S. Department of Agriculture</td>
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CHAPTER ONE: INTRODUCTION

Official trade finance (OTF) presents a difficult regulatory challenge for an open world trade system. On one hand, state-backed financial interventions in support of cross border trade and investment are roundly criticized for distorting international and domestic markets.¹ A favorite instrument in the mercantilist and protectionist’s tool kit, states have long used subsidies associated with a range of financial instruments (e.g. export insurance, export guarantees, export credits and official development assistance) to help national firms expand market share abroad as well as protect market share in already established markets at the expense of firms from competing states.² On the other hand, the right of states to provide financing on more preferential terms than private sector actors are willing or able is stoutly defended as an essential instrument to overcome market failures and to achieve a wide range of economic, social, environmental, developmental, and strategic objectives.³ The projects underwritten through financial interventions may be beneficial to the state supplying the subsidy and

the state receiving the subsidy (joint products). Or, if they go to support activities that yield benefits that are nonrival and nonexcludable, they may potentially benefit all states in the international system (pure public goods). 4

The different purposes to which state-backed export financing can be applied and its ambiguous trade effects—sometimes benefiting but sometimes hurting trade competitors—has generated conflicting demands for international rules. In some cases states supplying OTF (supplier states) have pressed for rules that distinguish between subsidies that distort trade in private goods and those that enhance the provision of public goods; in other cases they have resisted the establishment of international rules. These competing preferences have contributed to the long and often difficult bargaining process that has characterized the establishment of rules that govern the provision of public export financing.

As the literature on international cooperation demonstrates, international institutions can help states achieve their interests by establishing and enforcing rules. However, institutional arrangements are not predetermined. States face choices in what institutional venues will be selected and how these venues will be constituted. In the case of OTF, bargaining and enforcement have been attempted through several different

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4 A variety of taxonomies have been developed to draw distinctions between private goods, which have the property of being rivalrous and excludable in consumption, and public goods that are nonexcludable and nonrivalrous in consumption. Depending on their purposes and properties, public goods may be further divided into “impure public goods” such as club goods (nonrivalrous in consumption but excludable) or common pool resources (nonexcludable but rivalrous) and “pure public goods” (nonrivalrous in consumption and nonexcludable). See Inge Kaul, Isabelle Grunberg and Marc A. Stern, “Defining Global Public Goods,” in Inge Kaul, Isabelle Grunberg and Marc A. Stern, eds., Global Public Goods: International Cooperation in the 21st Century (New York: Oxford University Press, 1999); and Marco Ferroni and Ashoka Mody, eds., International Public Goods: Incentives, Measurement, and Financing (Boston: Kluwer Academic Publishers, 2002).
institutions. Bargaining has taken place through the World Trade Organization (WTO), its predecessor the General Agreement on Trade and Tariffs (GATT), and the International Union of Credit and Investment Insurers (Berne Union). But these are not the most important forums established to police OTF. Since the 1970s, the primary locus of rule making and enforcement has taken place through an institution known as the Arrangement on Guidelines for Officially Supported Export Credits (commonly known as the Arrangement). The agreement specifies many aspects of official support depending on country category and industry sector. The agreement operates with institutional support provided by the Organization for Economic Cooperation and Development (OECD), but is not an official act of the organization nor does it report to the Council of the OECD.

Three features of the Arrangement are noteworthy. First, the Arrangement has unusual institutional characteristics. Its legal basis is ambiguous; it is neither a formal agreement nor a treaty. Its proceedings are secret. Its membership is restricted to a relatively small number of states (22 member states vs. the WTO’s 144 member states). Second, the Arrangement’s rules vary in strength across sectors. Some sectors are more tightly regulated than others. Some fail to be regulated at all. Third, the Arrangement’s

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5 In its nascent stages the Arrangement went by other names. In very early period (1974-1975) it was referred to as the “Gentleman’s Agreement.” As the agreement developed and expanded in scope (1976-1977), it became known as the “Consensus.” In 1978, it was renamed the Arrangement but previous names lingered on well into the 1980s, particularly the Consensus.

rules vary in strength across different modes of financing. Here, again, some modes of financing are tightly regulated while others fail to be regulated at all.

These features present a puzzle that is not well explained in the existing international political economy literature. Economists have long recognized that trade policies tend to be biased toward import protection over export support. This asymmetry is explained by the fact that export subsidies require an expenditure of government revenue, while import tariffs generate revenue. While the limitation that expenditure requirements impose on endogenous revenue-seeking helps to explain why states may have a general interest in limiting export subsidies, it fails to explain the variation found in the scope of the regime governing OTF. In some cases, the leading suppliers of credit have successfully constrained competitive subsidization; in other cases they have not.

Similar weaknesses are found in the political science literature, which emphasizes the role of national interest and material power in explaining the outcome of interstate bargaining. Political scientists such as Andrew Moravcsik have explained the regime governing export finance as a product of U.S. hegemonic power. One weakness of this interpretation is that it fails to explain the choice of institutional arrangements.

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Hegemonic power cannot explain why supplier states did not choose to regulate export finance through a more formal and transparent agreement, or one with more open membership and the option for third party adjudication of disputes. Another weakness is that it does not explain why U.S. preferences were realized in some areas and not in others or why some preferences were realized relatively quickly while others dragged on for more than a decade. Excessive attention to the role of the U.S. in explaining the OTF regime risks misunderstanding how the regime was formed and why it has the contours that it does.

Explaining the scope of international cooperation has been recognized as a general weakness of the regimes literature. In an essay outlining unsolved puzzles and gaps in the literature written a decade ago, Robert Keohane noted that our understanding of the sources of change in international regimes over time and the causes of variation across issue-areas were limited. Keohane asked: “Why [do] their institutional arrangements, including membership, strength, and scope, vary so much; and what accounts for variations in the rights and rules that they establish, and in the principles underlying those rights and rules?”10 Despite the growing volume and sophistication of the literature on international regimes, satisfactory answers to these questions remain to be developed. We still lack a good explanation for variation in institutional membership, strength, and scope. The regimes literature has focused almost exclusively on instances where regimes have been formed with little attention to nonregime outcomes.11 How

11 Examples include: Robert O. Keohane, After Hegemony: Cooperation and Discord in the World Political Economy (Princeton: Princeton University Press, 1984); Peter M. Haas, Saving the Mediterranean: The
much confidence can we have in theories of international cooperation that rest on case studies that display little or no variation on the dependent variable?

In this dissertation, I provide an explanation for the regime governing OTF supplied on a bilateral basis and the variation that we find in the scope of this regime. My research goal is to explain the unusual institution characteristics of the Arrangement and why cooperation has been more contentious and difficult to realize under certain institutional settings and in some sectors and forms of financing than in others. Between 1991 and 2000, the world’s advanced industrial states provided over $822 billion in medium and long-term export credits and $186 billion in bilateral aid.12 This dissertation explains the regime that supplier states have established to police the terms and conditions of these financial flows and the distributional consequences for suppliers and buyers. It contributes to deepening our understanding of the political economy of subsidy regulation in the face of mixed incentive for states to compete and to collude. Despite the important role that the regime plays in regulating the terms and conditions of capital flows between developed and developing countries, this is an area of trade policy that has received limited attention in the international political economy literature.13


12 The conventional definition of medium-term business is credit, insurance or guarantees having a term of between one and five years; for long-term business the term is more than five years. See Table 1 below for more complete information on the official financial flows regulated by the OECD Export Credit Arrangement.

Argument in Brief

The study of rule-based cooperation at the international level has resulted in competing schools of thought emphasizing different explanatory variables. The international relations literature is divided between three seemingly distinct and incompatible accounts of international regimes. Some scholars have focused on the role of institutions in helping states realize their common interests. Other scholars explain regimes as a reflection of the economic and political interests of the most powerful members of the international system. A third group has focused on how norms influence interstate behavior. These divisions have led some to suggest that the study of regimes can be classified as interest-based, power-based, or knowledge-based depending on the explanatory variables on which they concentrate. Andreas Hasenclever, Peter Mayer, and Volker Rittberger suggest “we can talk of three schools of thought within the study of international regimes corresponding to these three approaches: neoliberalism, which bases its analysis on constellations of interests; realism, which focuses on power relationships; and cognitivism, which emphasizes knowledge dynamics, communications, and identities.”

Limiting analysis to one or even two of these schools yields unsatisfactory results. None of the major competing theoretical frameworks alone can satisfactorily explain

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regime scope. I argue that to explain the contours of a regime, like the one governing OTF, a more integrated approach is required. A more integrated approach sacrifices explanatory parsimony by introducing more variables but offers a more complete and satisfying result. To explain the scope of the OTF regime, I argue that the interaction of interests, institutions, and norms jointly determine outcomes. Interest-based, institutional-based, and norm-based accounts must be joined to fully understand the creation and scope of international regimes. This begs two sets of questions when attempting to explain the OTF regime: First, what interests, what institutional arrangements, and what norms? Second, how do these variables interact to produce certain institutional arrangements and rules in some areas but not in others?

The first variable to consider is supplier states preference for rules. A range of factors—some working in favor of cooperation and some working against cooperation—influence preference formation. I argue that because official suppliers of trade finance have an interest in generating and not loosing wealth, they will share a general preference for rules that stop unintentional wealth transfers from suppliers to buyer states caused by unrestrained credit competition. They will also share a preference in curbing the negative trade effects associated with intentional wealth transfers. This is because the provision of subsidies offers an opportunity to poach contracts (also referred

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15 It should be noted that explaining regime scope is not simply a levels-of-analysis problem as identified by scholars such as Peter Gourevitch, "The Second Image Reversed: The International Sources of Domestic Politics," *International Organization*, vol. 32, no. 4 (Autumn 1978), pp. 881-892. Explaining regime scope requires more than taking account of system-level and domestic-level variables.

16 Social science theorizing often involves a trade-off between parsimony and good explanation. Some scholars advise researchers to follow the principle of parsimony, while others argue that it is a mistake to insist on parsimony as a general principle in designing theories. For a discussion of these points and a defense of not adopting parsimony as an overriding principle in research design, see Gary King, Robert O. Keohane and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton, NJ: Princeton University Press, 1994), pp. 19-20.
to as "rent snatching" and "rent shifting" in the strategic trade literature\(^{17}\). Competing suppliers have an interest in ensuring that deliberate official financial transfers do not unfairly harm their exporters. This is true whether the nominal reason given for the transfer is equity, security or environmental protection. These general preferences are consistent with assumption found in the international relations literature, which posit that states will seek wealth and power and are concerned with their relative standing vis-à-vis other states.\(^{18}\)

At the same time, domestic politics can shape preference formation in ways that work against cooperation. Indeed, the literature on rent seeking shows that it is not possible to assume that states will always adopt policies that maximize their economic interests.\(^{19}\) This is because domestic interest groups, acting on their own or through the formation of coalitions, may capture the policy process in ways that maximize their own private interests, but are at odds with the maximization of national welfare. Initially scholars focus on the rent-seeking behavior of private sector actors.\(^{20}\) However, as

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\(^{18}\) While different schools of international relations thought debate their relative weight, all agree that states are concerned with maximizing wealth absolutely and relatively. See David A. Baldwin, ed. *Neorealism and Neoliberalism: The Contemporary Debate* (New York: Columbia University Press, 1993).


\(^{20}\) According to this line of argument, manufacturing firms will seek to maximize profits through tariffs or subsidies if they face comparative disadvantage or if they believe they can capture excessive rents through
subsequent studies showed, manufacturers, agricultural interests and military contractors may join forces with politicians and bureaucracies. State institutions are not neutral actors but may also be source of rent seeking behavior. Domestic actors also have non-material interests. Security, welfare, and environmental objectives preferred by powerful domestic groups can also shape state preferences in international negotiations. Given differences in economic and social circumstances, the degree of state autonomy (i.e. the ability to fend off interest group pressure) and the power of various domestic groups, the way in which these competing material and non-material goals are reconciled will vary from state to state. This, in turn, will shape the willingness to accept international constraints on financial interventions in international markets. Domestic political processes can generate preferences that override the general preference that states may have in restraining unintended wealth transfers. In short, whenever preferences become more heterogeneous with regard to export subsidy practices, collective action will be more difficult, thereby limiting regime expansion.

While preferences provide a starting point, it is necessary to look further to the factors that influence which preferences will be realized to understand regime scope. An
important variable is the institutional arrangements that supplier states choose to achieve their joint interest in regulating OTF. I argue that the institution of choice is a cartel. This is because an exclusive institution limited to states “producing” export finance is best able to restrict and police credit competition. I define a cartel broadly to mean an institution formed by a group of common economic actors (e.g. sellers) who cooperate to coordinate market behavior in order to fix prices or otherwise change the terms of economic exchange in ways that favor members of the group.\(^{22}\) However, as will be discussed at greater length in Chapter 2, cartels are only effective under certain conditions. For example, cartels work best when they control a large market share of a particular good or service. If the cartel’s market share is too small it is unlikely to be able to restrain the incentive of members to defect in the face of lower prices offered by non-cartel members.\(^{23}\) When a large market share and other conditions conducive to cartel formation are met, collective action will be facilitated. Where the conditions that permit cartelization are not met, collective action will be more difficult, setting boundaries on regime membership and rule construction. This will be true even when supplier states have a preference for rule creation.

The third variable to consider is the role that norms can play in favoring some policy choices over others. I argue that beliefs concerning free trade and market-based pricing of credit provide guidance to supplier states regarding the need for rules and

\(^{22}\) It is often assumed in the economic literature that cartels automatically reduce economic welfare. My definition purposely avoids such normative claims, leaving open the possibility that the actions of a cartel to limit competition and fix prices can cause or correct market imperfections.

which rules should be selected. Norms can facilitate rule-based cooperation by offering states engaged in negotiations salient solutions to bargaining problems. A judgment that certain subsidy practices violate norms of free trade not only defines illegitimate financing practices but also defines what financing practices may be subject to retaliation and reputational damage. However, free trade is only one of a number of different norms that compete for the attention of state actors. Other norms include international security, domestic security (e.g. food security and energy security) and domestic equity, and international equity. Where free trade norms face no competition from competing norms, they facilitate institution building and regime expansion. Where these norms face strong competing norms, collective action will be stymied, setting limits on rule construction and compliance.

The three variables (preferences, institutions and norms) will interact with each other in positive or negative ways to either extend or restrict the scope of the OTF regime. For example, states that have a preference for restricting credit competition are likely to be successful if they control a large market share. Likewise, the establishment of a cartel-like arrangement provides a regular forum for states of subsidy control to drawn on free trade norms and persuade others in ways that would be more difficult under more *ad hoc* bargaining arrangements. Ultimately, the scope of rules set by the OECD Export Credit Arrangement will extend to those areas where the interests of suppliers, institutional arrangements and norms reinforce one another.
Significance of Regime Scope

Developing a better understanding regime scope is valuable on several counts. First, there is the issue of redistribution. The ability of supplier states to restrict “races to the bottom” in some areas but not in others has distributional consequences. More stringent rules generally favor OTF suppliers by making financing more expensive. If prices are increased sufficiently, suppliers can even shift from a position of paying out subsidies to a position of collecting profits. On the other hand, areas where rules are weak or nonexistent can continue to be exploited by users of OTF with sufficient market power to secure financial windfalls. Explaining regime scope can reveal where and why these welfare effects occur.

Second, there is the relationship between markets and states. Each one constitutes a type of allocative mechanism, ones but that operate under very different imperatives. As Robert Gilpin argues, “Whereas the logic of the market is to locate economic activities wherever they are most efficient and profitable, the logic of the state is to capture and control the process of economic growth and capital accumulation in order to increase the power and economic welfare of the nation.”24 Depending on the perceived national interest, policy makers may be unwilling to seed certain outcomes to the “logic of the market” including the terms and conditions of export finance. Explaining regime

scope can shed light on where and why states chose to embrace one mechanism over the other.

Third, there is the question of how states respond to differences between private and public goods. An open world trading system demands that states be prevented from pursuing predatory income transfers associated with trade in private goods while simultaneously being encouraged to supply public goods and correct market failures. This involves a combination of policing and cajoling, because, as John Conybeare explains, “…free trade exhibits excludability and rivalry, and is fundamentally a problem of predatory income transfers, whereas the public good situation centers on the problem of inducing free riders to contribute to the supply of the public good.”25 Explaining regime scope can shed light on when and why states will chose policing over cajoling and vice versa in the regulation of OTF.

Finally, there is the issue of legitimacy. The scope of the regime’s membership determines who is present during negotiations, who determines the agenda, and, consequently, who determines the rules. A growing number of scholars have argued that if certain stakeholders are excluded from institutions established to develop and enforce rules, the international legitimacy of the rules can be weakened.26 Explaining regime scope can reveal where and why legitimacy concerns are most likely to arise.

Official Trade Finance

Before discussing the independent variables and research design in greater depth, I turn first to the dependent variable. Regime scope in this study refers to the institutions and rules that have been established and not established over the past 50 years to regulate OTF. Bilateral OTF encompasses a range of financial instruments offered by a government to support export transactions, including direct loans, guarantees and insurance. These transactions may be offered on market terms, above market terms, or below market terms. Financing supplied at below “market terms” may be “hard,” meaning that it has little concessionality, or “soft,” meaning that it has a relatively high level of concessionality or is fully concessional in the case of grants. Often it is difficult to determine what the exact terms are in relation to the “market” since OTF transactions are generally supplied in areas where private suppliers of finance are limited or completely absent. In the case of export credits, the major supplier states have established proxies for “market” interest rate. The benchmark method used now is the Commercial Interest Reference Rate (CIRR). In the case of deliberate “aid” subsidies, formulas have been developed to measure concessionality levels referred to as the grant element.

[27 For an overview of the range of financial instruments offered by governments see Malcolm Stephens, The Changing Role of Export Credit Agencies (Washington, DC: International Monetary Fund, 1999).]

[28 CIRRs are calculated monthly and are based on government bonds issued in the country’s domestic market for the country’s currency. In the case of the U.S. dollar, the CIRR is based on the U.S. Treasury bond rate linked to the maturity of the transaction: a) 3-year Treasury bond yields for repayment terms up to and including 5 years; b) 5-year Treasury bond yields for over 5 years and up to and including 8.5 years; and c) 7-year Treasury bond yields for over 8.5 years.]

[29 The grant element is based on the difference between the face value of a loan and the discounted present value of the service payments to be made by the borrower during the life-time of the loan. This figure, known as the ‘grant equivalent’, is then expressed as a percentage of the face value to get the grant element.]
The world’s advanced industrial countries have engaged in an effort to define, categorize and regulate OTF since the 1950s. Figure 1 presents the major elements of the OTF regime as it stood in the year 2000 by different types of financial instruments, procurement policy, subsidy level, coverage of international agreements and purpose. OTF comprises two major types: 1) export credits (loans, insurance and guarantees) issued by Export Credit Agencies (ECAs) to promote trade and more commercial
transactions; and 2) official development assistance (ODA) offered to support non-commercial goals such as poverty alleviation in recipient countries. However, OTF may also combine export credits and ODA to form mixed credits.

In most cases, states supplying OTF restrict the goods and services that may be purchased with these funds to their own national firms. When ODA is offered with procurement restrictions linked to the donor country it is referred to as “tied aid.” In addition to these basic financial instruments, which are regulated through a number of different international agreements, there are financial instruments that are not regulated. One of these instruments is the market window, which is an operational part of a government-sponsored enterprise (GSE) that provides a wide range of financial services including international export and investment financing. The other instruments are untied ODA and highly concessional foreign assistance, which is not recorded as ODA (indicated by the label “Other” in Figure 1). Examples of highly concessional tied aid that is not reported as ODA include such programs as Japan's 10-year $1 billion Green Aid Plan for energy efficiency and clean coal technology in Asia, and U.S. military aid.30

Official trade finance is understudied in the political economy literature. Recent scholarship has addressed the causes and consequences of financial globalization, the regulation of private banking institutions, measures taken to avoid international financial

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instability, and the challenges of financing global public goods. However, comparable attention has not been devoted to explaining the regulation of public trade credits and guarantees. This is surprising given the significant role that bilateral financing and refinancing facilities, as well as insurance and guarantee arrangements used to cover credit granted by private institutions, play in international markets, particularly in North-South trade. ECAs, through which a large portion of OTF is channeled, are the largest source of public finance in the world. Between 1982 and 2001, ECAs supported $7.3 trillion worth of exports and $139 of foreign direct investment, primarily to developing countries. In 2001, ECAs collectively provided over $395 billion in short-term credits, $60 billion in medium and long-term credits, and $17 billion in investment insurance.


34 These figures are the closest approximation of the official export credits and credit insurance that is publicly available. They are based on business reporting by the 51 agencies from 42 countries that are members of the Berne Union, Berne Union Yearbook 2003, London, 2003, pp. 189-190. Since these figures are self-reported Berne Union members and details on coverage is not made public, it is not possible to determine if these figures include all government-supported business.
Figure 2. Official Trade Finance and Other Foreign Capital Flows to Developing Countries

This compares to an annual average of approximately $40 billion in loan commitments from multilateral development banks, about half of which are made by the World Bank Group.35 As shown in Figure 2, OTF exceeded the foreign direct investment (FDI) and non-FDI capital flows to developing countries until the mid-1990s.

35 The multilateral development banks (MDBs) comprise the World Bank Group made up of the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), and the Multilateral Investment Guarantee Agency (MIGA), and five regional development banks including the Inter-American Development Bank Group (IDB); the Asian Development Bank Group (ADB); the African Development Bank Group (AFDB), the European Bank for Reconstruction and Development (EBRD), and the North American Development Bank (NADBank). For aggregate figures on MDB lending see U.S. Department of Treasury, Office of International Affairs at http://www.ustreas.gov/offices/international-affairs/intl/.
ECA support is perhaps best known for its role in financing commercial aircraft sales in the context of the legendary Airbus-Boeing rivalry;\textsuperscript{36} however, public credits play an important role in the lesser known but no less intense aircraft rivalry between Bombardier (Canada) and Embraer (Brazil), as well as in the sale of a wide range of other goods and services including telecommunications equipment, heavy machinery, steel plants, environmental technology, military equipment, construction engineering services, and agricultural products. OTF has contributed to financing up to 25 percent of total capital good exports, depending on the country and time period.\textsuperscript{37}

There is a substantial literature on the topic of foreign aid. Scholars have focused on the historical evolution of aid, the political and economic motivations driving donors to provide aid, and the effectiveness of aid allocations.\textsuperscript{38} However, there is relatively little systematic attention to the rules designed to police the competitive trade consequences of aid subsidies and how they relate to the larger OTF regime. Over the past 15 years, the rules governing OTF have been extended to cover a growing portion of ODA flows through the Helsinki Tied Aid Disciplines negotiated through the OECD

\textsuperscript{36} See, for example, Marc L. Busch, \textit{Trade Warriors: States, Firms, and Strategic-Trade Policy in High-Technology Competition} (New York: Cambridge University Press, 1999), Chapter 3.

\textsuperscript{37} In the 1970s, ECAs were a major source of export financing, supporting an average of 13 to 19 percent share of national capital goods exports of the largest industrial countries. Additional export was also provided through long-term loans and other forms of official development assistance (ODA). In recent years this level has fallen. In 2000, official sources supported approximately 2-6 percent of major industrial country exports.

Table 1. Finance Flows Regulated by OECD Export Credit Arrangement (millions of US dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Berne Union M/LT Credits t</th>
<th>Regulated M/LT Credits tt</th>
<th>Net Bilateral ODA</th>
<th>Regulated Aid Flows ttt</th>
<th>Total Regulated Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>119,000</td>
<td>66,841</td>
<td>56,678</td>
<td>9,760</td>
<td>76,601</td>
</tr>
<tr>
<td>1992</td>
<td>113,000</td>
<td>71,661</td>
<td>60,850</td>
<td>9,691</td>
<td>81,352</td>
</tr>
<tr>
<td>1993</td>
<td>78,000</td>
<td>62,304</td>
<td>56,486</td>
<td>3,994</td>
<td>66,298</td>
</tr>
<tr>
<td>1994</td>
<td>86,000</td>
<td>77,724</td>
<td>59,152</td>
<td>5,456</td>
<td>83,179</td>
</tr>
<tr>
<td>1995</td>
<td>87,000</td>
<td>60,417</td>
<td>58,926</td>
<td>3,777</td>
<td>64,195</td>
</tr>
<tr>
<td>1996</td>
<td>79,000</td>
<td>59,664</td>
<td>55,622</td>
<td>3,885</td>
<td>63,550</td>
</tr>
<tr>
<td>1997</td>
<td>64,000</td>
<td>65,081</td>
<td>48,497</td>
<td>3,202</td>
<td>68,283</td>
</tr>
<tr>
<td>1998</td>
<td>61,000</td>
<td>59,825</td>
<td>52,084</td>
<td>3,655</td>
<td>63,480</td>
</tr>
<tr>
<td>1999</td>
<td>61,800</td>
<td>49,038</td>
<td>56,428</td>
<td>5,526</td>
<td>54,564</td>
</tr>
<tr>
<td>2000</td>
<td>73,000</td>
<td>58,154</td>
<td>53,734</td>
<td>5,690</td>
<td>63,843</td>
</tr>
<tr>
<td>cumulative total</td>
<td>821,800</td>
<td>630,708</td>
<td>555,456</td>
<td>54,636</td>
<td>685,344</td>
</tr>
<tr>
<td>average/yr</td>
<td>82,180</td>
<td>63,071</td>
<td>55,846</td>
<td>5,464</td>
<td>68,534</td>
</tr>
</tbody>
</table>

Note: M/LT = medium and long term credits (credits with repayment terms of one or more years).
† Although incomplete, since 34 countries offering export credits are not Berne Union members, it provides the best available indicator of total M/LT export credit flows.
†† Regulated flows per terms of the OECD Export Credit Arrangement.
††† Regulated flows per terms of the Helsinki Tied Aid Disciplines established under the OECD Export Credit Arrangement.


Export Credit Arrangement. The last column of Table 1 presents an estimate of the total financial flows regulated by the Arrangement. Over the period from 1991 to 2000, these rules fixed the terms and conditions for a total of $685 billion in medium to long-term finance or an average of nearly $70 billion a year. Of this total, regulated ODA flows have constituted $54 billion or approximately $5.5 billion a year. Thus, nearly 30 percent of total bilateral aid flows are now subject to regulatory controls.

When rules governing OTF were weak, industrial states supplying credits expressed growing concern over the unintended wealth transfers to developing countries caused by unrestricted credit competition. At their peak in the early 1980s, unintended
transfers climbed to an estimated $7 billion a year. A World Bank study of the seven
largest export credit suppliers (Canada, France, Germany, Italy, Japan, the United
Kingdom and the United States) estimated the subsidies to range from $1.5 billion to $3.5
billion in 1980. The study estimated that buyers likely captured between 50 and 100
percent of this subsidy. Because the Arrangement was only able to control and not
eliminate subsidization, unrestricted competition continued to be a problem from the
perspective of supplier states well into the 1990s. One official of the Arrangement
estimated that the average incidence of subsidies in all officially supported export credits
offered by member states in 1993, more than a decade after financial regulations were put
in place, to be around 6 percent. Credits in that year financed approximately $100 billion
in trade suggesting that unintended export credit subsidies in that year were still
approximately $6 billion.

It was not until the mid 1990s that industrial country ECAs began to break even
as a group on a net cash flow basis. This stands in contrast to cumulative losses of over
$60 billion from 1981 through 1996. Throughout the 1980s and into the 1990s, claims
payments averaged over $10 billion a year. This amount exceeded the income of ECAs
earned through premium fees and recoveries by a wide margin. By the end of 1990s,

39 The range is based on whether the financing was provided on fixed or floating rates. See Heywood
Fleisig and Catharine Hill, The Benefits and Costs of Official Export Credit Programs of Industrialized
40 John Ray, Managing Official Export Credits, p. 25.
41 Because the accounting systems and practices of agencies vary widely, including some that are recorded
on a cash basis and do not permit assessments of financial position on an accrual basis, net cash flow is the
only indicator for which data are available on a reasonably consistent basis.
Export Import Bank, December 17, 2002, p. 5.
43 Kuhn, Michael G., Balazs Horvath, and Christopher J. Jarvis, Officially Supported Export Credits:
the financial position of industrial country ECAs had improved significantly. In 1996, nearly all the major industrial country ECAs regained profitability. Since this time, the collective net profits of the group have averaged approximately $3 billion a year.

Changes in the macroeconomic environment were a major contributing factor. The easing of the debt crisis and better economic conditions in developing countries improved the ability of supplier states to collect outstanding balances. The lower interest rate environment, prevailing since the mid 1990s, has reduced financing terms as a strategic variable in winning overseas orders. However, it also can be attributed to the expansion of trade finance disciplines, which more tightly regulate the behavior of the world’s largest suppliers of official export finance.44

At this point, it is worth noting that export credits are an unusual product in that they are so closely tied to the product that they support. First, loans, guarantees, and insurance are not valued for themselves but for what they can do to facilitate and protect economic exchange. Therefore, the type of good financed—be it wheat or locomotives—will influence whether the financing is short or long-term. In addition, the cost of financing is not only a function of the source of “production” inputs (e.g. interest rates + subsidy in the originating country) but the level of risk (commercial and political) in the recipient country). Second, there is little if any secondary market for trade finance. Unlike commodities such as copper, tin or governments bonds, export credits and foreign aid are not available for resale. Finally, creditor-debtor relationships created through export finance are not simultaneous exchanges (“spot transactions”) in which each party

comes away with what the other party gave them. Rather, they form long-term contractual relationship where the creditor loans or guarantees a sum to the debtor in exchange for a stream of repayments extending into the future. In the case of guarantees, the issuer carries a liability for repayment through the full life of the loan, making it rare for creditors to be indifferent to the fate of borrowers. These special characteristics must be taken into account in explaining the ability of countries to cooperate in the area of official trade finance.

Institutional Arrangements

As shown in Figure 3, there are three institutions that have attempted to address the competitive aspects of official trade finance. The Arrangement on Guidelines for Officially Supported Export Credits (Arrangement) has emerged as the most important among the three. In contrast with the others, it is the most exclusive, consisting of only 22 credits, however, its practical effect has been limited. Prior to the 1970s, provisions against export subsidization that applied to export credit and credit guarantees were largely ignored. Steps to address these weaknesses were undertaken during the Tokyo Round that produced the Agreement on Subsidies and Countervailing Measures (ASCM), also known as the WTO Subsidy Code. However, the major export credit supplier states found the rules too general and the dispute resolution mechanism inadequate to

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45 Figure 1 above identifies the Development Assistance Committee (DAC) as a fourth institution that has played a role in managing OTF. However, because the DAC has focused on improving the quality of ODA and not in policing the competitive aspects of concessional finance, it has not been included in Figure 2.

police OTF related subsidies effectively. Since the end of the Tokyo Round concluded in 1978, the GATT/WTO delegates significant authority to the Arrangement to set export credit terms and conditions. The WTO has only addressed one export credit related dispute, whereas the Arrangement has addressed hundreds, if not more. At one time, International Union of Credit and Investment Insurers (Berne Union) was explored as a

Note: Membership by number of countries in 2000. The Development Assistance Committee (DAC) of the OECD is excluded as it does not serve to regulate subsidies.

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48 For a discussion of the one dispute between Canada and Brazil over regional jet aircraft export subsidies addressed by the WTO, see Helena D. Sullivan, “Regional Jet Trade Wars: Politics and Compliance in WTO Dispute Resolution,” Minnesota Journal of Global Trade, vol. 12 (Winter 2003), pp. 71-108. Comprehensive, publicly available statistics on disputes addressed through the Arrangement are not available. However, an indicator of the volume of disputes can be gleaned from the implementation of the Helsinki Tied Aid Disciplines. Although representing only a small part of the Arrangement, a special Consultations Group established under the Arrangement to monitor the agreement addressed a total of 119 disputes between March 1992 and March 1999. See F. Lammersen and Anthony D. Owen, “The Helsinki
place to regulate trade finance. However, this forum proved unsatisfactory to supplier states and was abandoned as a regulatory forum in the early 1960s. The Berne Union continues to play a coordination function among ECAs, but more along the lines of a trade association than as a regulatory body. Therefore, one puzzling feature of the OTF regime is why the GATT/WTO and Berne Union largely failed as a regulatory forum, whereas the OECD Arrangement succeeded.

Rule Construction

In addition to variation in institutional arrangements, there is significant variation in the sectors, the types of financing, and the type of credit-related externalities covered by the Arrangement. These patterns are shown in Figure 4 and are discussed in turn below.

Sectors

Supplier states have focused on developing specific sector's agreements, as well as reaching agreements to regulate many sectors at once. Large, ocean-going ships were the first sector to be regulated. The Understanding on Export Credits for Ships was being offered at the time. A broader agreement covering general capital goods was reached in 1976, which was subsequently expanded and formalized as the Arrangement in 1978. The

agreement set financing terms for general capital goods with the exception of satellite ground stations, conventional power plants, and steel mills, which included certain exemptions. In 1984, a more comprehensive sector agreement was concluded on nuclear power plants. In 1985, the Large Commercial Aircraft Sector Understanding (LASU) was concluded and was incorporated into the Arrangement the following year. However, differences remained between these special sectors and other capital goods and services. Despite varying levels of effort over the years, no rules apply to agricultural goods or to military goods. These sectors were excluded when the Arrangement was formalized in 1978 and have not been included as of this writing.

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Types of Financing

Export credits have been a major target of regulation. There are a variety of ways that the terms of financing can be manipulated. The three most important are the down payment, rate of interest, and term of the credit. However, there are also other elements that can be manipulated. These include extraordinary support such as local cost support, interest during construction, exchange rate risk insurance, and inflation risk insurance. A package of measures must therefore be negotiated to fully regulate export credits. One of the most difficult aspects of these negotiations was reaching a common formula for setting interest rates. This process began with the establishment of a matrix of minimum interest rates in 1974. Members then shifted to a uniform moving matrix in 1983, with some countries adopting CIRR. A standard formula for calculating CIRRs was established in 1986. However, it was not until the Schaerer Package was adopted in 1994 that CIRRs became the standard method for establishing interest rate floor for all Arrangement members.

Risk premium fees are an area of financing that has come to be regulated much more recently. Most ECAs were setting premium rates too low to cover all contingent liabilities, but any supplier that attempted to raise rates to more closely reflect losses risked being placed at a competitive disadvantage. The Knaepen Package, adopted in

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1997 and effective in 1999, sought to address these problems. The agreement established a floor that members of the Arrangement follow in setting premium rates. These minimum premium benchmarks (MPBs) are based on an econometric model of country risk. The objective is to set prices to reflect sovereign and country credit risks and ensure that ECAs generate sufficient revenue to cover their long-term operating costs and losses. The rules apply to all medium and long-term transactions except those in the agriculture and military sectors.

The practice of combining export credits with tied aid funds to create “mixed credits” generated considerable controversy in the 1980s. The practice satisfied buyers who often demanded softer terms but angered competitors who were unable or unwilling to match the terms. Measures were taken in 1985 to strengthen regulations on this type of financing. A more comprehensive and stringent set of measures was introduced with the introduction of the Helsinki Package in 1991, which substantially expanded the rules governing tied aid credits. Technical details worked out in the process of implementing the Helsinki rules led to the establishment of Ex Ante Guidance for Tied Aid in 1996. Coverage under these rules and implementing procedures is not total. The rules do not apply to the poorest developing countries or to projects below $2.5 million SDR.

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53 *Arrangement on Guidelines for Officially Supported Export Credits*, pp. 22-29.
A Market Window Institution (MWI) is a financial institution that is government owned or directed, that benefits directly or indirectly from government support, and that claims to operate on a commercial basis. MWI transactions are weakly regulated. Such transactions are subject to the WTO’s “benefit to the borrower” test set forth in the ASCM’s definition of a subsidy.\textsuperscript{54} However, this test is only available on a post hoc, case-by-case basis. In addition, there is little transparency regarding market window financing, because the institutions that offer these instruments claim the same need for commercial confidentiality for competitive reasons as private market financial institutions. Market windows have come under increasing scrutiny since the mid-1990s because of their potential to distort trade and investment patterns and avoid the requirements imposed through the Arrangement. Since market windows benefit from a wide range of government subsidies, including government capital contributions, tax exemptions, and free government guarantees, critics point out that they have the potential to create unfair financial advantages for foreign buyers of domestic exports through subsidized financing.\textsuperscript{55}

Unlike tied aid, untied aid remains unregulated. Untied aid would generate few concerns if it were freely and fairly accessible to finance sales from all exporters regardless of nationality. However, there have been longstanding accusations that although officially untied, these credits may be in fact tied through a variety of backdoor

\textsuperscript{54} This test means that, if the financing offered by a government to a foreign purchaser of a national export is on terms and conditions that are better than what the borrower could have obtained in the private market, the financing is a prohibited subsidy. See WTO Agreement on Subsidies and Countervailing Measures, Part 1, Article 1.

measures. Another concern is that the lack of regulation provides incentives for donors to shift aid resources away from legitimate development projects and use them to fund commercially viable projects that could be financed by the private sector or official export credits subject to regulation.  

Investment credits are another financial instrument that remains unregulated. Investment finance can take the form of direct loans, guarantees and insurance. Each of these instruments provides a means by which states can support the overseas expansion of their multinational corporations (MNC). As some have argued, “public credit can be more readily used as an instrument of industrial policy since it permits targeting of individual sectors/projects as opposed to the traditional instruments of foreign direct investment (FDI) policy.” In contrast to standard export credits and tied aid transactions, states face no reporting requirements on their FDI transactions. There are no rules that prevent a state from subsidizing MNC investment or that force them to disclose in the terms of the financing that they support FDI.

56 See, for example, Margee M. Ensign, Doing Good or Doing Well? Japan’s Foreign Aid Program (New York: Columbia University Press, 1992).
57 U.S. Department of Treasury, “Report to Congress on the U.S. Treasury Department’s Efforts to Advance Multilateral Negotiations to Discipline Untied Aid,” submitted to Chairman Michael Oxley & (Ranking Member) Barney Frank of the House Committee on Financial Services and to Chairman Richard Shelby & (Ranking Member) Paul Sarbanes of the Senate Banking, Housing and Urban Affairs Committee, June 29, 2004.
Externalities

Official trade finance can have a variety of spillover effects through the transactions that its supports. These spillover effects, or externalities as they are commonly called in the welfare economics literature, arise when the total social cost or benefit associated with the production or consumption of a good is not reflected in the private costs or benefits to the exporter or importer of the good.\(^5\)\(^9\) Externalities can be positive or negative. A positive externality results when part of the benefit of producing or consuming a good accrues to actors other than the producer or purchaser. A negative externality results when part of the cost of a good is born by actors other than the producer or purchaser. Externalities are significant because, when present, they have the potential to undermine the ability of the market to maximize social utility. If some costs or benefits are not reflected in determining the price of official trade finance then the incentives facing buyers and sellers will change. Transactions involving a positive externality will be undersupplied from the point of view of society as a whole, while transactions involving a negative externality will be oversupplied from the point of view of society as a whole.

In the past decade, supplier states have been under increasing pressure to control a range of negative externalities associated with OTF backed transactions. Corruption is one example. OTF supports investment projects worth millions and sometime billions of

dollars. These conditions make OTF highly susceptible to various forms of direct and indirect corruption. Corruption can take place directly when public support is used to underwrite contracts, which include the costs of illicit payments. It can take place indirectly when public finance agencies ignore the track record of companies that have been involved in corruption scandals, fail to investigate corruption allegations made against a company, and fail to ensure that contracts backed by official trade credits have fair, public and competitive tendering systems and transparent public accounting systems. Critics have also accused official support of helping autocratic governments maintain their hold on power by supporting public largess that could not be financed on private commercial terms.

Environmental externalities are another example. Since official finance plays an important role in supporting large-scale infrastructure projects throughout the developing world, it may abet negative environmental impacts that are not fully accounted for in the price of the transaction. This is particularly true for OTF used to finance large dams, coal and nuclear power plants, roads, oil and gas pipelines, and chemical, steel and other large industrial facilities. In addition to being local and regional, the environmental externalities can also be global. Critics have pointed to the policy perversity associated with governments negotiating approaches to addressing climate change while at the same

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60 Recent examples of billion dollar projects supported with export credits include the $22 billion Three Gorges Dam in China; the $3 billion gas pipeline from the Papua New Guinea to Australia; the $3.6 billion Baku-Tbilisi-Ceyhan oil pipeline project that will carry oil from the Caspian to the Mediterranean; and the $1 billion Cernavoda (phase 2) nuclear power station in Romania.
62 This charge has been leveled at the extensive backing that Indonesia received under the Suharto regime. See Peter Bosshard, “Publicly Guaranteed Corruption: Corrupt Power Projects and the Responsibility of Export Credit Agencies in Indonesia,” Berne Declaration, November 2000.
time exacerbating the problem by promoting fossil fuel projects with official trade
credits. Variation in the degree to which export credit agencies traditionally have
attempted to internalize environmental externalities has prompted calls for common
standards least they cause the same type of competitive race normally associated with
subsidies.

The social spillover costs associated with large infrastructure projects are a third
element. Projects supported by export credits or foreign aid can also have large negative
impacts on local populations. Tens of thousands of people have been displaced by
projects supported with official credits, most notably large-scale dams. Inadequate
resettlement plans and other project impacts have been especially damaging for
communities of indigenous peoples. These negative consequences have led to calls for
agencies providing official finance to undertake human rights assessments. Such
assessments would include an evaluation of the project, including local participation and
consultation; monitoring of the project by the local community; and the appointment of
an independent inspection panel, human rights rapporteur or sector-specific monitoring
agency to ensure compliance.

Finally, military transfers may also generate externalities. Easier credit terms
permit countries to acquire more fighter jets, missile systems, and other military
equipment than buyers otherwise could. This can contributing to destabilizing arms


buildups, which have been noted in different periods in the Middle East, Asia and parts of Africa.65 It can also distort developmental priorities by shifting resources away from economic development and basic human needs, while bolstering the power base of corrupt ruling elites.66 It has also been criticized for abetting external aggression and internal repression. Two well-documented examples include British support for arms sales to Iraq in the 1980s and to Indonesia in the 1990s, which in the latter case were subsequently deployed in the government’s campaign against the independence movement in East Timor.67

In practice, securing agreement among states on rules to address externalities is complex and far from straightforward. One reason is that a single project can have both positive and negative externalities, which generates benefits for one party but imposes costs on another. Transborder energy pipelines illustrate the problem. One example is the controversial contract tendered in the early 1980s to construct a 3,600-mile pipeline to transport natural gas from the Yamal peninsula in the Russian Arctic to Western Europe.68 The United States opposed this project because of the negative security

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externalities that it would create. Washington feared that the project would strength the Soviet Union, its sworn enemy at the time. France and Germany, by contrast, saw the project as adding to their energy security needs. Subsidized export credits provided a way to ensure that these positive energy security externalities would be realized. A more recent example is the proposed gas pipeline linking Iran to India via Pakistan. The United States opposes this project on security grounds, in this case out of concern that it would undermine its effort to pressure Iran to abandon its nuclear ambitions. India, by contrast, views the pipeline as vital to its growing energy needs. It is promoting this project not only for commercial reasons but because the project is expected to generate positive externalities in the form of energy supply diversification. The fact that the same project can have different external costs and benefits for affected participants complicates the ability to form a consensus on the formation of common international rules.

Another reason is the competition caused by differences in how states choose to address (or not address) externalities. For example, a buyer state—particularly one that values economic development over environmental protection—may be indifferent to the emissions generated by a coal-fired power plant or other capital equipment that it is seeking to import. Or the buyer may only be concerned with certain externalities such as large particulates (local externality) and not others such as sulfur dioxide associated with acid rain (regional externality) or carbon dioxide associated with climate change (global externality). A supplier state may seek to overcome the indifference of the buyer state by requiring corrective measures as a condition of financing. However, other supplier states

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competing in the market may chose not match the policy intervention. If at least one other seller shows its indifference to correcting the externality by offering to finance the product without conditions then the first supplier state’s intervention will be ineffective. Setting international rules under these conditions is difficult given the strong incentives for competition-in-laxity, where the act of one state lower regulations creates incentives for others to follow suit. Unilateral policy interventions are likely to fail. As David Sandalow, assistant secretary of state for oceans, international environmental, and scientific affairs observed: “Unless all countries with export credit agencies come together, we run the risk of a race to the bottom, he said, adding that varying standards could see developing nations “shop around” in search of export credit agencies willing to finance environmentally harmful projects.”

Conflicting Assessments

Official trade finance and the rules established to govern the terms and conditions on which it is supplied has generated conflicting assessments. There is little doubt that the rules have redistributive consequences. However, there are contrasting views over whether the effects are benevolent, controlling unwarranted financial interventions in the

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market or predatory, selectively hardening credit terms in some areas while permitting a
form of unrestricted dumping in others.

Some see the Arrangement as a highly effective framework for promoting a level
playing field among exporters and suggest that without the disciplines it has imposed,
credit suppliers risk reverting to a state of nature in which credit wars and wasteful
subsidization prevail. On the Arrangement’s 20th Anniversary in 1998, officials serving in
the secretariat commented: “Before the Arrangement came into existence, there were no
detailed rules (apart from the subsidies code of the GATT) governing the terms which
could be offered by ECAs. In this environment, a credit race threatened and interest rate
subsidies flourished.” As U.S. Treasury Secretary, Lawrence H. Summers hailed the
Arrangement stating: “It has had enormous—and underappreciated—success in
preventing much counterproductive, expensive subsidy competition in international
trade.” Some legal scholars have been impressed with the Arrangement’s “ability to
generate widespread compliance.”

Others are less sanguine. Critics charge that export finance programs continue to
be a source of corporate welfare that benefits a few at the expense of the world’s poor.
Rather than eliminate trade distortions, they argue that the regime sanctions export
subsidies and limits accountability. As one critic stated: “The rich countries preach free

73 Steve Cutts and Janet West, “The Arrangement on Export Credits,” The OECD Observer, no. 211
74 See Lawrence H. Summers, “Continuing the Fight against International Trade Finance Subsidies,” in
Gary Hufbauer and Rita Rodriguez, eds., The Ex-Im Bank in the 21st Century: A New Approach? Institute
75 Janet K. Levit, “The Dynamics of International Trade Finance Regulation: The Arrangement on
markets and increased transparency to developing countries, while their ECAs work surreptitiously to subsidize trade—they are excluded from coverage by the World Trade Organization—and under the pretext of commercial confidentiality, most refuse to release the most basic information on their activities.76 Others have been critical of the incomplete basis of the international rules, noting that the Arrangement has failed to regulate important sectors (e.g. agriculture and military credits), certain forms of financing (e.g. investment credits, market window and untied aid transactions) or to incorporate a range of credit-related externalities.77

The closed and nontransparent nature of the Arrangement has prompted criticism from a variety of quarters raising questions about the legitimacy of how international credit rules are determined. Brazil has been at the forefront of developing countries in criticizing the OECD Arrangement, arguing that it is inappropriate to give a handful of countries “carte blanche” to set international export credit rules.78 India has also objected to recent proposals by the EU in 2002 to expand the safe harbor provisions of the WTO beyond interest rates in order to formally include pure cover, that is insurance and guarantees. Nonstate actors have also organized campaigns to reform ECAs. Basic demands were presented in the Jakarta Declaration, originally signed by 50 NGOs from

12 countries in 2000. The Declaration has since been indorsed by over 345 NGOs from 45 countries. The primary goal is to draw attention to the potentially adverse environmental, social, human rights and economic consequences of ECAs. It also focused on the lack of transparency and meaningful public participation afforded through the OECD’s Working Party on Export Credits and Credit Guarantees.

A final issue that has received less systematic attention is the impact of subsidy policing and the incentives to provide aid. This relationship has been long recognized but rarely systematically studied. Writing in 1970, Robert Baldwin warned, “A policy designed to regulate current export-credit programs must balance their undesirable export-subsidizing effects against their aid-expending effects.” In other words, if policing export subsidies trumps cajoling new resources from donors, aid may dry up as states are less able to capture and therefore justify international outlays. Most recent studies of foreign aid attribute the decline in overall giving to such factors as the end of the cold war and aid fatigue. However, the decline may also be due to more aggressive policing of subsidy practices under the Arrangement.

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80 For NGO views on the lack of transparency and meaningful public consultation in the OECD Working Party on Export Credits and Credit Guarantees see Jakarta Declaration, especially paragraph 3.
82 Richard Grant and Jan Nijman, eds. The Global Crisis in Foreign Aid, (Syracuse, NY: Syracuse University Press, 1998).
The Puzzle of Regime Scope

What explains the scope of a regime? Since regimes wax—and sometimes wane over time—scope is a dynamic concept. Explanations that account for the contours of a regime must be able to explain the institutional arrangements in the formative periods as well as in more mature periods. This includes the regimes’ membership, monitoring mechanisms, dispute resolution mechanisms and enforcement mechanisms. My research goal is not only to explain the scope of the regime governing export finance as it stands today, but also to explore how it has evolved over time. Thus, in this analysis, regime scope refers to the following elements:

- Institutional arrangements
  - Membership- the institutions and countries that are permitted to participate in the formation, monitoring and enforcement of rules;
  - Transparency- the mechanism that are established monitor member compliance and who has access to this information;
  - Enforcement- the mechanisms established to resolve disputes and punishing violations.

- Rule Construction
  - Sectors- the types of products that utilize public export finance;
  - Modes of financing- the different types of financing instruments that states use to support the export of goods and services;
  - Externalities- the positive or negative spill over effects associated with export finance.
Argument

The scope of the regime governing OTF is determined by three factors. The first source of variation arises from the mixed interest of states. Suppliers and recipients of OTF have divergent interests as they stand on opposite sides of financial transactions. Suppliers of export finance have a common economic interest in controlling the terms and conditions of OTF that diverges from the economic interests of recipients in unrestricted competition. As a group, it is in the interest of supplier states to: 1) minimize the cost of intervening in markets to promote exports; 2) counter the strategic behavior of rival exporters; and 3) counter the market power of recipient buyers.

At the same time, supplier states also face two forms of pressure that can undermine these general group interests. The contours of rule formation will also be shaped by domestic-level pressure arising from interest groups within each supplier state. These demands will vary. In the case of industrial policy, some groups will press the state to provide preferential support for rising industries, while others will place demands on the state to protect declining industries. If domestic-level actors are sufficiently well organized and powerful, demands to pick winners and protect losers may cause some states to reject international rules that have the effect of imposing limits on such rent seeking behavior. As Robert Putnam has argued, international agreement requires a simultaneous reconciliation of domestic and international imperatives. He illustrated this dynamic through his metaphor of a “two-level game” in which policy makers negotiate simultaneously over domestic constraints and the international bargain.

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Fundamentally, distributional consequences and pressure group behavior in the domestic arena sets limits on bargaining outcomes in the international arena.

The second source of variation in the regime arises from the strengths and weaknesses of the cartel as a form of institutional organization. The formation of a cartel provides the institution basis for supplier states to restrict credit competition and monitor and enforce agreements. It also provides the institutional basis for bargaining among members to extend the coverage of regulations. However, cartels are imperfect institutional solutions to collective action problems. Even when there is a common economic interest among supplier states to collude and restrict credit competition, there is no guarantee that they will succeed. An individual state has an incentive to withhold its contribution and enjoy the benefits of predatory trade policies. The ability of supplier states to achieve their collective interests will depend on their success in forming collusive arrangements to overcome this collective action problem. As a group, supplier states are more likely to be successful if the conditions spelled out in cartel theory hold, such as a large market share of the relevant market. (The specific conditions are described more fully in Chapter 2). If the conditions associated with a successful cartel are not met, then rules are will be more difficult to form even when a common economic interest exists.

The third source arises from variation in the strength of norms encouraging free trade. Neither interests nor the successful formation of an institution fully explain why one set of rules is superior to another. The jointly optimal policy for rational, utility-
maximizing producer countries operating in imperfectly competitive markets would be to impose a tax on exports to third world countries.\textsuperscript{84} The cartel-like features of the OECD Export Credit Arrangement provide a means for creditors to collectively enhance their market power. Free trade norms grounded in neoclassical welfare economics provide a powerful set of prescriptions regarding the costs of protectionist subsidization as well as exploitive taxation. However, there are limits to the guidance offered by free trade theory. Its normative power is greatest when it is applied to perfectly competitive private markets. It offers weaker prescriptive advice when considering instances of market failure and public goods. Moreover, free trade is not the only norm that offers guidance to how policy makers should treat public financial interventions in export markets. Depending on the issue area, free trade norms may compete with other norms that have equal or greater acceptance. Competing norms include national security, environmental protection and social equity. Where free trade theory provides clear normative guidance, they will support the establishment of stringent rules. Where free trade theory provides less clear normative guidance, they will provide ambiguous and weak focal points. If norms do not provide clear, broadly accepted focal points around which supplier states expectation can converge, then rule formation will be frustrated, even when a common preference for limiting credit competition exists and cartel-like institutions to implement them have been established.

Interests, institutions and norms are variables that interact with one another. This interaction may support or undermine regime expansion. As noted above, norms can

inform interests by providing clear causal explanations why certain rules should be adopted over others and why certain institutional arrangements are needed. The three variables can therefore work together to support rule formation and institution building. However, if one of these elements is “out of sync” then rules are likely to be weak, if realized at all. For example, even when normative economic theories are clear-cut and the institutions exist to implement them, system-level or domestic-level pressure may shape state interests in such a way as to cause them to block rules that restrict their autonomy. These dynamics help us to understand regime scope. It is where interests, institutions and norms are concordant that international economic regulation is most likely to expand. In the case of OTF regime, this concordance occurs where the collective interests of supplier states overrides individual interests, the conditions for the formation of a cartel hold, and the welfare theory of trade provides clear normative unrivaled guidance.

Propositions

The forgoing discussion provides a framework for explaining how preferences, institutions, and norms jointly influence regime scope. Considering these variables together yields a rich array of possible propositions that can be tested. In this dissertation, I propose to concentrate on four:

The institutional arrangements governing OTF will reflect the divergent preferences of buyers and sellers, yielding an exclusive, cartel-like institution comprised of export credit suppliers.
Stringent rules are most likely to be established when: 1) the preferences of supplier states converge; 2) the institutional and market structure requirements necessary for a stable cartel are met; 3) the prescriptive norms regarding subsidies are clear, durable and widely accepted.

Rule construction will be more difficult and less likely when: 1) the preferences of supplier states are heterogeneous; 2) the institutional requirements of a cartel are not realized; 3) the prescriptive norms regarding subsidies and free trade are unclear, fragile or only narrowly accepted.

Rule construction will be unlikely when: 1) the preferences of supplier states are strongly heterogeneous; 2) the institutional requirements for the formation of a stable cartel are not present; 3) the prescriptive norms regarding subsidies and free trade are lacking.

Methodology

Congruence procedure and process tracing are used to test the propositions generated by the framework. Congruence procedure involves making a number of paired observations of values on the independent variable and dependent variable across a range of circumstances within a case. This methodology is supplemented where appropriate by more detailed analysis of the chain of events or decision making process through

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which an outcome is achieved. Process tracing provides an additional opportunity to investigate the cause-effect links between the independent variables and the scope of the regime.\textsuperscript{86}

Since selection bias can undermine the validity of a test, special care is needed in selecting the units of analysis. Four criteria were used for this purpose. First, the area had to capture important aspects of the trade finance regime. Importance was judged with respect to welfare consequences, considered on a global basis, as well as on the basis of individual suppliers or recipients. Second, attention was also given to the “contrast space” around which the study was organized. David Collier and James Mahoney recommend that it is important to identify the specific contrasts on a specific dependent variable of interest, which also helps to determine the appropriate frame of comparison for evaluating explanations.\textsuperscript{87} It was therefore considered just as important to include areas where institutional arrangements failed and rules were not constructed as it was to include areas where institutional arrangement succeeded and rules were constructed. Finally, there had to be sufficient data to properly undertake analysis.

These criteria, with the elements of scope noted above, yield the following approach. The institutional aspect of scope will be evaluated by comparing and contrasting the GATT, Berne Union and the Arrangement. The construction of rules will be evaluated in three parts. The first part will focus on sectors by comparing and contrasting the formation and non-formation of rules on capital goods, military

\textsuperscript{86} King, Keohane and Verba, pp. 43-46.
equipment and agricultural commodities. The second part will focus on types of financing by comparing and contrasting the formation and non-formation of rules concerning export credits, tied aid and market windows. The third part will focus on externalities by comparing and contrasting the formation and non-formation of rules on bribery, environment and military related financing.

The areas examined in this dissertation therefore cover most but not all aspects of the official export credit regime. First, more attention is devoted to the Arrangement than to the Development Assistance Committee (DAC), given the dominance of the former in setting rules. Second, not all rules are examined. Two aspects of the regime covered less systematically are country categories and procedural rules. These aspects of the regime have also been a source of conflict between members. For example, the fall of the former Soviet Union prompted a debate over how countries in Eastern Europe and the Caspian would be treated after having gained independence.88 Developing and developed countries are eligible for different financing terms, and therefore the categories in which they were placed had consequences for the terms and conditions on which they can receive financing. The institutions and rules examined in this dissertation therefore do not provide a complete test of the combined interest, institutional and norm model developed here.

88 Personnel communication, official, U.S. Department of Treasury, August 9, 2003
Publicly available information on the measures taken by industrial states to establish and enforce rules on official trade finance is limited. Public disclosure of the proceedings of the Berne Union and Arrangement are restricted to member governments. What is publicly available is largely limited to the writings of a handful of direct participants. The trade press fills some gaps but suffers from considerable unevenness. Some aspects of export credit rule formation are much better documented than others, largely driven by the agenda of states that have attempted to shape opinion around specific issues.

To establish a more complete empirical record to test the proposition posed by this dissertation, it was necessary to supplement the limited published accounts of collusion and non-collusion in official trade finance with other source material. Interviews with individuals knowledgeable about export credits and the negotiation process between creditor states provided valuable additional information. I conducted a total of 116 interviews between 1998 and 2002. This included interviews with the current and former staff of the secretariat of the Berne Union and OECD trade directorate, which serves as the secretariat for the Arrangement. It included interviews

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with officials of the major export credit agencies, including: Britain’s Export Credit Guarantees Department (ECGD); Canada’s Export Development Canada (EDC); France’s Compagnie Française d’Assurance (Coface); Japan’s Japan Bank of International Cooperation (JBIC), Sweden’s Exportkredit-anamnden (EKN); and U.S.’s Export-Import Bank (Ex-Im Bank). I interviewed officials of government ministries with oversight responsibilities over ECAs or represented the government at the OECD and other relevant forum. These officials included Canada’s Department of Finance, France’s Ministry of Economy, Japan’s Ministry of Economy, Trade and Industry and the U.S. Department of Treasury. In addition, I also interviewed knowledgeable individuals from different industry sectors (aircraft, power, telecommunications and heavy equipment) from commercial banks in Canada, Japan, Germany and the U.S., as well as several trade associations. Finally, I interviewed several nongovernmental organizations that have taken an active interest in export credit issues in recent years.

In addition to these interviews, I was fortunate to have the opportunity to examine critical primary documents. The aide memoirs summarizing the meetings of Arrangement were among the most valuable sources. I was able to examine aide memoirs for 42 of these meetings, clustered largely in the 1988 to 2001 period. This

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94 Center for International Environmental Law (U.S.), Environmental Defense (U.S.), Friends of the Earth (Japan), Les Amis de la Terre (France) and EDC Working Group (Canada).
95 There are two bodies that address export credits within the OECD: Participants to the Arrangement on Guidelines for Officially Supported Export Credits (Arrangement) and the Working Party on Export Credits and Credit Guarantees (ECG). As of December 2001, there had been 80 meetings of each group.
represents approximately one quarter of the 160 meetings that have been held over the past 20 years. Although incomplete, these documents provided valuable insight into what issues were discussed and the positions that states took. I also had the opportunity to read the negotiating instructions and trip reports prepared by U.S. negotiators to the Arrangement over a 20-year period from 1980 to 2000. These documents not only provided direct evidence of the strategy and motivations of one of the key players involved in the negotiations, but also often included summaries, albeit from the U.S. perspective, of the positions and tactics of other regime members. Together, these sources provided a more complete empirical basis to understand the motivations and basis for state behavior. They also provided the context from which more pointed questions could be asked during the interviews cited above.

Chapter Overview

The rest of the dissertation is organized as follows. Chapter 2 presents the economic and political science literature relevant to my independent variables. It reviews the factors that shape state preference toward OTF rules and how they differ between buyers and suppliers. It reviews the literature on international conditions and how a cartel-like institution can serve the interests of suppliers of OTF in constraining credit competition. It reviews the literature on norms and how they can enable or constrain state behavior, with special attention to the ideas derived from welfare economics that have shaped the normative discourse concerning economically optimal trade finance policy. It then introduces competing explanations that have been offered to explain the OECD Export Credit Arrangement.
Chapters 3 through 6 present the dissertation’s primary measures of regime scope, including institution arrangements, variation in regulation across sectors, variation in regulation across modes of financing and variation in regulation across different credit related externalities.

Chapter 3 examines why the Arrangement emerged as the central forum for regulating OTF. It argues that supplier state preferences, institutional arrangements, and free trade norms each played a role. The oil shocks of the 1970s galvanized supplier state preferences for stricter rules. The evidence supports the proposition that the Arrangement, as an exclusive and secretive cartel-like institution, provided a more effective means to police credit practices and halt unintended wealth transfers to buyers using official credits than alternative institutions. Moreover, free trade norms supported these institutional arrangements even though they left the Soviet Union and developing countries materially worse off.

Chapter 4 examines the variation in the OTF regime by sector. It finds that as predicted, supplier states a general interest in regulating all sectors. However, variation in state preferences for rules across sectors, variation in the satisfaction of cartel requirements, and variation in the strength of free trade norms have made this more difficult and even impossible in some sectors. For example, domestic politics have caused certain suppliers to reject rules in shipbuilding, agriculture and military equipment. The evidence also shows that free trade norms were weaker and less well
accepted in the sectors that failed to be regulated. In the agricultural sector they competed with food security norms. In the military equipment sector they competed with national security norms.

Chapter 5 examines the variation three modes of financing (export credits, mixed credits, untied aid and market window transactions). It argues that interrelated role of state preferences, cartel dynamics, and variation in the strength of free trade norms explain the variation in rules. The evidence from these cases confirms the importance of norms in providing focal points in the case of export credits but the change in the case of mixed credits where free trade norms competed with equity. The inability of suppliers to establish rules for market window transactions illustrates the weakness of cartels when members refuse to supply information that could verify deviant behavior.

Chapter 6 concludes by focusing on the dissertation’s most important observations, evaluating the limitations of the cartel thesis and exploring some of the policy implications raised by the preceding analysis.
CHAPTER TWO: THEORETICAL FOUNDATION AND LITERATURE REVIEW

"The postwar liberalization of trade can be attributed to a richly textured interplay of interests, ideologies, and institutions." - Jagdish Bhagwati, 1988*

This chapter examines the theoretical underpinnings of Bhagwati’s observation in the context of this dissertation’s focus on publicly supplied export finance. The chapter is divided into two sections. The first section examines the independent variables I draw on to explain the scope of the regime governing official export finance. It provides a theoretical explanation for situations in which states will have a preference for cooperation, why certain institutional arrangements were chosen to facilitate cooperation, and what role norms have played in shaping the specific content of rule-based cooperation. The second section reviews the strengths and weaknesses of previous efforts to explain the Arrangement in theoretical terms.

State Preferences

Several factors influence a state’s preferences toward the international regulation of OTF. A central factor is whether the state acts as a buyer or supplier in a financial transaction. States relying on publicly supplied financial instruments to purchase and import goods and services have an interest in obtaining the most favorable financing terms possible. Buyer states not only welcome subsidies but actively seek them out to

enhance national economic welfare. The interests of supplier states are more complex. Supplier states have a collective interest in restraining subsidies in order to constrain the unintended redistribution of wealth. However, they also often have an individual self-interest in providing subsidies to promote exports and achieve other national interest goals that may involve export finance subsidies. Supplier states, therefore, have mixed motives: they have an incentive to cooperate but also an incentive to resist regulations or cheat on those that have been established.

*Characterizing the Interests of Buyer States*

Buyer states have a long history of attempting to enhance their bargaining position to secure the best financing terms possible when purchasing private goods from overseas suppliers. One tactic states have used is to leverage their sovereign right to control trade at the border. Beginning in the 1950s, a number of developing countries began to link import licenses directly to favorable financing terms for the growing volume of capital goods they were importing. Another tactic is to use the central government’s control over economic development and large-scale infrastructure development to gain leverage. In the early 1980s, Indonesia issued a Presidential Decree making highly concessional credits mandatory for all public-sector infrastructure.

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97 These conditions were motivated in part by balance of payments difficulties that Brazil, Argentina, India and other developing countries faced. Foreign credit lines on deferred payment plans eased these constraints and therefore became highly prized. As Claudio Segré noted in his 1958 study: “Companies have learned from experience that the payment terms often count, in the eyes of exchange control authorities, as much as the priority of the proposed investment.” See Claudio Segré, “Medium Term Export Finance: European Problems and Prospects,” *Quarterly Review* (*Banca Nazionale del Lavoro*), no. 45 (June 1958), p. 125.
projects. In some cases, buyer countries have acted in concert to secure subsidized financing. Pooled civilian aircraft tenders offer one example of an effort to gain the bargaining advantages of a single large buyer. In 1996, three Latin American aircraft carriers, LAN Chile, TAM and Grupo TACA, dubbed the “Latin Trio,” jointly announced their intention to acquire 80 firm orders and 89 options for passenger aircraft in a deal estimated to be worth $4 billion. The tender attracted attention because none of the carriers could individually acquire enough planes to obtain the discounts that are granted to large airlines with large orders, let alone more favorable terms. By combining forces, the Trio was able to secure a mismatch loan structure from Airbus, which Boeing and the U.S. Export-Import Bank argued breached the maximum repayment terms established under the Large Aircraft Sector Understanding (LASU).

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98 The Presidential Decree demanded that loans for large-scale infrastructure projects financed from abroad carry an interest rate of no more than 3.5 percent and a repayment of 25 years and seven years grace period on the start of repayment. The Decree was justified as necessary for Indonesia to reduce public expenditures and keep important public works projects on schedule. See Christian Tyler, “Indonesian Loan Terms A Hurdle for Britain,” Financial Times, May 22, 1986; and John M. Brown, “Jakarta Becomes Centre of Soft Loan Battle,” Financial Times, December 12, 1986.

99 I would like to thank Terina Golfinos, Managing Director, Structured Export Finance, Americas, ING Financial Markets, for bringing this case to my attention.


101 A mismatch loan structure refers to a two-part credit transaction. The first part consists of credits and guarantees supported by ECAs on terms set forth under the Large Aircraft Sector Understanding (LASU), which sets a 12-year maximum repayment term. Commercial lenders financed the remaining portion with support from the manufacturer in the form of either residual values guarantees or commitments to refinance. By combining these elements together, the repayment period can be extended to as much as 18 years, with significant savings to buyers but well beyond the 12 years permitted by LASU. Boeing claimed that it was unable to match these financing terms due to Airbus Industries’ ability to backstop favorable financing terms for airlines with weak credit ratings. This was possible, Boeing argued, because Airbus faced fewer balance sheet limitations due to its status as a government backed partnership. In a post-mortem conducted by Boeing to evaluate the reasons for losing the contract, the company estimated that the net effect of the more favorable financing garnered through the mismatch loan structure was approximately $20,000 per month per airplane in favor of Airbus. Personal communication, official, Aircraft Financial Services, Boeing Corporation, January 24, 2003. See also, “Paper on Options Available to U.S. Government to Address the Airbus/European ECA Support of the Mismatch Structure,” Memorandum to Dorothy Robyn, Special Assistant to the President for Economic Policy from Jackie Clegg, Vice-Chairman, Export-Bank of the U.S., November 23, 1998.
Buyer countries have also sought, individually and collectively, to increase the provision of foreign aid with varying degrees of success. The intensification of the Cold War in the 1950s and 1960s provided an opportunity for buyer countries such as India, Egypt, Indonesia and Cuba to play the U.S. and Russia off against one another to secure larger volumes of financial assistance or better terms on the assistance they received. In the 1970s, buyer countries organized collectively to press for better terms of exchange with rich countries of the North. The Group of 77 made demands for more concessional financing as part of its call for a New International Economic Order. More recently, developing countries used the International Conference on Financing for Development for increased aid and other policy changes to reverse the net financial flows from the developing to the developed world.

Given the interest of buyer countries in securing the best financing packages possible, we should expect buyers to have little interest in rules that restrict competition in the terms of OTF or policies that harden the terms on which OTF is provided. We should expect buyer countries not only to object to interest rate floors and other constraints on export financing, but also to resist their introduction where possible.

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Characterizing the Interests of Supplier States

Supplier states stand on the other side of export and investment transactions. Their interest in constraining subsidized export financing is more complex. There is a wide range of reasons why states subsidize export financing. A common motivation is to promote exports in order to help national firms gain competitive advantage, capture market share and shift rents. These interventions may be motivated by national interest considerations. As Marc Busch has eloquently argued, state interventions may be motivated by the desire to capture positive externalities associated with the export of certain goods. States will have a strong incentive to intervene in industries in which the state can consume and internalize the linkage and spillover effects generated by the industry.\textsuperscript{105} The interventions may also be motivated by domestic interest group politics as detailed in the theories of endogenous protection and rent seeking.\textsuperscript{106} States are more likely to intervene by extending special export financing to those areas of the economy where political coalitions have been effective in capturing trade policy for their own benefit.

\textsuperscript{105} Marc L. Busch, *Trade Warriors: States Firms, and Strategic-Trade Policy in High-Technology Competition*, pp. 4-7.

The desire to capture economic spillovers or pressure to meet the demands of interest groups are not the only reasons that states provide export subsidies. States may be motivated to fill gaps in the funding provided by private financial markets. For example, scale effects and information asymmetries may contribute to incompleteness of private financial markets. State intervention can offset possible financial market failures by providing financing that is "undersupplied" by commercial banks or by insuring exporters against risk. States intervene to correct for failures of nonfinancial markets. Examples include subsidizing credit for environmentally beneficial projects or denying credit to projects not meeting environmental standards. Finally, states will provide subsidies in order to counter unfair competitive advantage gained by the provision of subsidies by others. 107

The theoretical and empirical literature explaining the reasons why states provide export subsidies is well developed. The purpose here is not to recount in detail these motivations but to explain why sovereign states would agree to rules that constrain the terms and conditions on the financing that they supply. I argue that there are two distinct interests that motivate supplier states to cooperate in the formation of common international rules.

The first preference for cooperation arises from the collective interest in establishing regulations that stop unintentional wealth transfers caused by the combination of unrestricted competition among suppliers and the bargaining power of buyers. In most export transactions, several competing suppliers are offering products and financing. If one state offers subsidies and others emulate, supplier states risk being pulled into a bidding war. A bidding war results in a windfall for buyers but causes a costly drain on supplier state’s treasuries. Some economists have likened this situation to a prisoner’s dilemma “where once they [subsidies] are offered by some exporters, other exporters are forced to follow suit to maintain market share, and importers end up extracting the majority of the credit-related benefits.” However, actual conditions are often more complex than is portrayed in a two party prisoner’s dilemma model. Projects supported with official credits are often of high visibility with strong national interest implications for the importing country. The actions of third party buyers can alter the incentives for one of the supplier states to defect. The supplier, in turn, may have an interest in establishing a favorable relationship with the buyers for reasons that extend beyond the specific contract in question. Examples include subsidies provided for historical reasons associated with past wars (e.g. Japan’s foreign aid to China) or colonialism (e.g. British and French’s foreign aid to former colonies). The prisoner’s dilemma disregards the influence of third parties.

109 One example is the controversial contract tendered in the early 1980s to construct a 3,600-mile pipeline to transport natural gas from the Yamal peninsula in the Russian Arctic to Western Europe. The Soviet Union used its influence in Europe to disrupt efforts by the United States to block subsidized financing for the project. See Gordon Crovitz, Europe’s Siberian Gas Pipeline: Economic Lessons and Strategic Implications, Institute for European Defence and Strategic Studies, 1983; and Antony J. Blinken, Ally Versus Ally: America, Europe and the Siberian Pipeline Crisis (New York: Praeger Publishers, 1987).
To counter exploitation by buyers that results in costly bidding wars, supplier states will have an interest in organizing a collective response. As John Kenneth Galbraith argued in his work on the incentives to develop countervailing power in economic exchange, economic agents facing market power will have a strong incentive to organize resistance. In Galbraith's words: "the existence of market power creates an incentive to the organization of another position of power that neutralizes it." By organizing, states supplying credits can counteract the bargaining power of buyers and reduce their subsidy expenditures by collectively establishing regulations on credit terms and conditions. They can avoid a competitive race that leaves all suppliers worse off by establishing price floors, maximum repayment periods, minimum cash payments, and other conditions. An important factor underlying rule formation is the dual interest that supplier states have in both limiting competition and halting the redistribution of wealth to buyers.

The collective interest in international OTF regulation is also consistent with George Stigler’s theory of economic regulation. Stigler was a pioneer in arguing that far from resisting regulations, industries are often the principle demanders of regulation, not for the benefit of the public at large, but for the private benefits that regulation can provide. According to Stigler, among the main policies that industry seeks are: 1) direct and indirect subsidies, 2) control over entry by new rivals, 3) manipulation of substitutes and complements, and 4) price controls. The relevance of Stigler’s theoretical work is

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clear when we substitute export credit agencies for industry. ECAs constitute a group of economic actors that “produce” export finance. As a group, these economic agents have an interest in harnessing international rules to improve their economic condition. They have an interest in fixing prices to avoid losses caused by excessive competition, thereby increasing their profitability.

The second preference for cooperation arises from the interest in curbing the negative competitive effects associated with intentional wealth transfers. As noted above, there are many instances in which a state will find it in its interest to transfer wealth intentionally to other states to achieve a variety of noneconomic objectives. Examples range from subsidizing the cost of water treatment facilities to improve sanitation in a specific country to subsidizing the cost of high-speed patrol boats to interdict drug traffickers. States offering subsidies can capture part of the benefits of such wealth transfers by requiring that the funds only be spent on the goods and services of their own national firms. However, while the recipient gains the benefit of the lower cost of goods and the supplier of low cost financing captures additional export sales, the transactions can have negative trade impacts. Competing suppliers who lack access to comparable preferential financing are placed at a distinct competitive disadvantage.

These trade effects can be illustrated by the example of a joint product like a power plant financed with low interest loans and guarantees. Concessional financing not only makes the plant components more affordable for a poor, high-risk country to import, but also provides a sale for the supplier state’s heavy electrical equipment manufacturing
industry. The recipient and at least one of the donor’s exporters will therefore view the financing favorably. However, this is not true for competing suppliers. Tied concessional financing can place competing power plant suppliers at a disadvantage relative to rivals, which do not have access to favorable financing terms. Even though the project may have developmental benefits for the recipient buyer, from the perspective of the competing exporter, tied concessional financing is a predatory trade instrument that should be constrained.

A similar interest in regulation can arise from intentional wealth transfers directed toward underwriting the provision of public goods. Economists going back as far as John Stuart Mill and Henry Sidgwick have noted that markets will undersupply products or services that have the characteristics of public goods. A classic example is the navigational benefits provided by a lighthouse.112 Since it is difficult to charge passing ships for the benefits of safer navigation that the lighthouse beacon provides, a private provider will find it difficult to collect sufficient revenue to cover the cost of the facility. In addition, a ship passing a lighthouse does not diminish another ship’s consumption of the valuable information provided by the lighthouse beacon. The features of being nonrivalrous and nonexcludable provide the standard rationale for government intervention to pay for the lighthouse.113 However, the “public” feature of the lighthouse describes the outputs (navigational information) not the inputs that make the provision of this information possible. The inputs include the engineer services needed for design and

the construction materials needed to build the tower and beacon. The inputs are private goods that are rivalrous and excludable. Firms that supply these private inputs can be at a competitive disadvantage if they do not have access to public financing or have access at terms that are less favorable to rival suppliers.

The fact that tied financing for public goods can shift trade explains why this type of OTF can also generate trade conflict and demand for international rules. The amount of financial resources directed toward the provision of international public goods is sizable. Recent estimates suggest that OECD countries spent as much as $5.8 billion annually on international public goods in the late 1990s. If spending on international security is included, then this figure is likely to more than double. Comprehensive statistics are not publicly available, but a rough estimate suggests that aid and trade credits for military goods and services during the same period exceeded $10 billion annually. Even though the subsidies may yield national or international public benefits, such subsidies can represent a predatory instrument that deserves to be constrained from the perspective of rival exporters.

Since supplier states vary in industrial composition and power, it is important to know which states are likely to have the strongest preference for rules to regulate OTF. There are three basic choices that a given supplier state has in responding to the subsidy practices of other supplier states. First, a supplier state can emulate the practices of others. Second, a supplier state can tolerate divergent practices. Third, a supplier state can push to regulate, trying to persuade others to converge towards its practices.

Which response will a supplier state pursue? Realist theory offers ambiguous guidance.\(^1\) The tenants of realism have been used to argue that states are positional actors, motivated less by the prospects of absolute gains than the need to maintain or enhance their position relative to other states in order to ensure survival.\(^2\) While realism is helpful in explaining the system-level pressures that motivate state behavior, the theory remains underspecified at the level of detail required to understand when a supplier state will have an interest in securing international rules. The framework does not clearly specify how states will engage in self-help, how states prioritize military security over

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\(^1\) Realists argue that states are motivated primarily by the will to survive. Power is vital to states as an essential means to this end. Structural features inherent in the international system explain these motivations. Because there is no over-arching international authority to mitigate the use of violence, realists argue that states reside in a system that is competitive at its core. The assumption that states reside in a Hobbesian state of nature means that they have powerful incentives to take advantage of other states and to view cooperation warily. Realism has its intellectual origins in the writings of classical realists such as E.H. Carr, *The Twenty Years’ Crisis, 1919-1939*, Hans Morgenthau *Politics Among Nations* and historical precursors stretching back to Thucydides’ *History of the Peloponnesian War* and Hobbes’ *Leviathan*. Modern realism, also referred to as neorealism and structural realism, is traced to Kenneth Waltz, *Theory of International Politics* (Reading, MA: Addison-Wesley, 1979). For a discussion of important distinctions between modern realists see Stephen G. Brooks, “Dueling Realisms,” *International Organization*, vol. 51, no. 3 (Summer 1997), pp. 445-477.

economic capacity, why one set of economic policies will be preferred over another, or how domestic sources of pressure motivate state behavior.  

Greater predictive power can be achieved by turning to an examination of the state’s domestic circumstances and the ways in which a state’s domestic politics can restrict its basic choices and strengthen a preference for others. One factor involved here is the amount of revenue that is available for subsidization. States with limited resources to expend on subsidies, either because they are small and lack the tax base or because they face a hard budget constraint caused by political resistance to export subsidies, will find it more difficult to match the subsidy practices of other states. If emulation is not possible, the state is left with the option of tolerating divergent practices or pushing others to agree to common rules. A state may choose toleration but this is only to be expected if its interests are not unduly harmed. If toleration becomes costly (e.g., national firms lose exporter contracts), we can expect the supplier state to begin pressing for international rules to “level the competitive playing field.” Another factor that will influence a state’s choices arises from the eligibility rules that it imposes on credit terms. Supplier states may impose conditions (e.g., environmental rules or prohibitions on bribery) on the subsidized financing that it makes available to exporters. Again, if emulation is not possible (e.g., rollback of domestic eligibility rules to meet the lax

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119 As Jeffry Frieden has pointed out it is not sufficient to limit analysis to the proposition that states maximize their power or prospects for survival. Since national power and survival are objectives that are consistent with a wide range of economic policies, preferences derived from these assumptions alone are likely to be ad hoc. Jeffry A. Frieden, “Capital Politics: Creditors and the International Political Economy,” in Jeffry A. Frieden and David Lake, eds, International Political Economy: Perspectives on Global Power and Wealth (New York: St. Martin’s Press, 1995), p. 285.
standards of others), the state is left with the option of tolerating divergent practices or pushing other states to agree to common rules that “level the playing field.”

Understanding the conditions under which states have an interest in regulating subsidies is but a first step in understanding the scope of the rules that govern official export finance. Even when supplier states have a collective interest in limiting unintended wealth transfers to buyers and countering predatory wealth transfers to other sellers, this objective can be difficult to achieve in practice. No state has an interest in agreeing to constraints unless it can guarantee that others will follow. In the worst case, a state will withdraw subsidies only to have competitors continue to engage in such practices. But because transactions supported with export finance generally take place in developing countries, it is often difficult to know the terms and conditions of rival financing offers with any degree of reliability. The regulation of OTF presents information and monitoring challenges that are not present in bilateral trade disputes. Thus, even if states have an interest in establishing rules, this interest alone is unlikely to be enough to ensure that rules will be realized. The identification of interests does not explain how states will engage in self-help or the conditions under which it will be successful.120 To develop these points, I turn first to examine institutions and to the insight provided by cartel theory in particular.

120 As Jeffry Frieden has pointed out, it is not sufficient to limit analysis to the proposition that states maximize their power or prospects for survival. Since national power and survival are objectives that are consistent with a wide range of economic policies, preferences derived from these assumptions alone are likely to be ad hoc. Jeffry A. Frieden, “Capital Politics: Creditors and the International Political Economy,” in Jeffry A. Frieden and David Lake, eds, International Political Economy: Perspectives on Global Power and Wealth (New York: St. Martin’s Press, 1995), p. 285.
Institutions

The functional based account of regime formation advanced by Robert Keohane provides a starting point for understanding how institutions can facilitate international cooperation.\(^{121}\) This explanation derives from liberal assumptions of international relations.\(^{122}\) Central to Keohane’s explanation is the idea that regimes can reduce transaction costs and overcome information imperfections that make cooperation difficult. If a world existed in which there was perfect information and zero transaction costs, ad hoc agreements would be common and no investment would be necessary to construct and maintain regimes. However, because such a world does not exist, states find it useful, if not essential, to invest in regimes. In addition to reducing transaction costs and improving information flows, regimes also raise the cost of violations by improving monitoring capabilities and by creating reputational costs that help to ward against defection. Institutions provide a valuable function by helping states achieve joint goals in the face of incentives to cooperate but also to defect.\(^{123}\) Taking these factors into account, Keohane's theory of institutions suggests that regimes can serve as valuable tools for promoting cooperation in the international system.

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\(^{122}\) Liberal theories of international relations do not assume that states have a single overriding interest, but rather focus on how interests emerge as a result of competition between societal groups within the state and the institutional context in which this competition takes place. These competing groups may not only be motivated by different material interests, but also by different values. Liberal theories, therefore, point to the ways in which domestic politics can influence state preferences on the international stage. Liberal scholars also emphasize the significance of state interdependence. They do not assume that states are autonomous actors with interests that are in constant conflict. Instead, liberal scholars argue that states will seek to achieve their distinctive preferences under varying constraints imposed by the preferences of other states. Liberal theories recognize that conflict will occur but are less pessimistic about the possibilities for international cooperation, given that states will often have mutual interests. For a review of the liberalism in international relations see Friedrich Kratochwil and John G. Ruggie, “International Organization: A State of the Art on an Art of the State,” *International Organization*, Vol. 40, No. 4. (Autumn, 1986), pp. 753-775; Robert O. Keohane, *Neorealism and Its Critics* (New York: Columbia University, 1986); and Andrew Moravcsik, “Taking Preferences Seriously: A Liberal Theory of International Politics,” *International Organization*, vol. 51, no. 4 (Autumn 1997), pp. 513-553.

\(^{123}\) For surveys of this literature see Stephan Haggard and Beth A. Simmons, “Theories of International Regimes,” *International Organization*, vol. 41, no. 3 (Summer 1987), pp. 491-517; Lisa L. Martin and Beth A. Simmons, “Theories and Empirical Studies of International Relations,” *International Organization*, vol.
account, Keohane concludes simply: “Regimes make it easier for actors to realize their interests collectively.”

While functional regime theory helps to explain how institutions assist states in overcoming collective action problems, it remains underspecified. It is insufficient to explain important features of an institution like the Arrangement. Keohane has noted in subsequent writing that some international institutions have open membership, some have conditionally open membership, while others have restricted membership. However, the functional theory of regimes does not adequately explain why states will choose one set of arrangements over another. Functional theories can explain the value of transparency and information exchange among members, but they have more difficulty explaining the demand for secrecy and why participants resist extending transparency to nonmembers. Finally, these theories make rare mention of the fact that an institution can benefit one group of states by making another group of states worse off. A strong positive as well as normative assumption underlying this theoretical framework is the ability of institutions to bring states closer to the Pareto frontier than they could come on an ad hoc basis. As Lisa Martin has written, “motivation behind institutional creation and maintenance is to allow states to reach the Pareto frontier, the set of outcomes at which


However, this assertion disregards the redistributive effects of cooperation on nonregime members.

Greater analytic leverage can be gained by turning to cartel theory. A cartel is an institution concerned with altering the terms of market transactions to the benefit of its members. This goal is accomplished by restricting competition through fixing prices or establishing sales quotas. Participants in a cartel accomplish redistribution by organizing members of one side of market-based transactions. A cartel can be comprised of buyers but is more commonly comprised of sellers. It is a restrictive institution that provides members an effective way to limit competition and shifting costs (or benefits) from one set of market actors to another. In short, cartels are institutions designed to facilitate the redistribution of wealth in a market setting through cooperation.

International cartels can be regarded as one type of self-help regime. As a result, they are compatible with the functional regime theory in pointing to the role of information sharing and transaction cost reduction in solving the collective action problem by encouraging cooperation and discouraging defection from common rules. But cartel theory offers additional insights that standard regime theory cannot. It explains why participants in the Arrangement insist on selective membership. It provides an

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127 Ervin Hexner provides a classic definition of a cartel: “A cartel is a voluntary, potentially impermanent, business relationship among a number of independent, private entrepreneurs, which through co-ordinated marketing significantly affects the market of a commodity or services.” Ervin Hexner, International Cartels (London, Sir Isaac Pitman & Sons, Ltd, 1946), p. 2. The main difference between this definition and the one used in this dissertation is that a cartel can also involve market coordination among governments, not only private entrepreneurs.
explanation for the insistence on selective transparency. Most significantly, from the standpoint of explaining regime scope, cartel theory specifies the conditions under which self-help aimed at the redistribution of wealth is likely to succeed. These conditions derive from specific market and institutional features.

**Market Features**

The literature on cartels identifies specific market structural features. One of the most important features concerns the share of the market that cartel members control collectively. The larger the market share of a particular good or service, the more likely the cartel will be to be able to constrain competition.128 A second condition is that the fringe of suppliers outside the cartel be small. The smaller the proportion of the market they control, the less likely it is that they will be able to undermine the effectiveness of the cartel. A third condition is that the barriers to market entry are high. This reduces the likelihood that the fringe will become larger and more powerful. A fourth condition is that the product lacks ready substitutes. This reduces the likelihood that buyers can find alternatives if prices rise. Fifth, the literature predicts that cooperation among cartel members will be relatively easy if members have the same production costs and produce like products, but will be more difficult if product and cost differences are large or non price factors are an important element of competition. This is because heterogeneity between cartel members causes different preferences and compounds the problems of

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reaching a mutually acceptable agreement on how to divide the gains of collusion.\footnote{29} Finally, the theory assumes that buyers on the other side of the market are small and disorganized. If buyers are large or well organized, they may gain sufficient market power to neutralize and counteract the market power of sellers gained by organization.\footnote{30}

**Institutional Features**

The cartel literature also identifies several institutional features that favor the formation of collusive arrangements. The first is exclusive membership. Although it receives little attention in the literature, perhaps because it is so obvious, a producer cartel is more likely to succeed if it excludes buyers. This institutional arrangement enhances the chances of success by gathering together parties with the similar interests and excluding those with contrary interests.\footnote{31} Second, a cartel must bring together parties with the authority to make credible commitments.\footnote{32} Collusive arrangements are unlikely to succeed if their members do not keep their promises. One way to overcome this problem is to bring together members with the authority to negotiate and implement


\footnotetext[31]{The condition of exclusion is rarely stated in the cartel literature, perhaps because it is so obvious. However, Robert Keohane has noted this condition in passing in a discussion of why different institutions apply different membership criteria: “Restricted institutions (e.g. NATO, OPEC, OECD, EC) deliberately limit membership to a relatively small number of states that have some set of interests in common...Restricted institutions either seek to achieve gains *vis-à-vis* outsiders (a function for which there must be outsiders to exploit) or to build strong bonds of community (requiring similar political systems)...Whatever else they do, restricted institutions engage in *cartelization.*” Robert O. Keohane, “The Analysis of International Regimes,” in Volker Rittberger, ed. *Regime Theory and International Relations* (New York: Oxford University Press, 1993), pp. 39-40, emphasis original.}

agreements. Firms do this by organizing senior level officials from the parent company. Successful producer cartels are rarely formed by subsidiaries or by lower level officials. Third, a cartel must establish a viable monitoring system to detect violations. All cartels have some form of monitoring system that belongs to the organization rather than to the member country, which typically involves some form of third party audit of the transaction prices. Finally, cartels must establish a viable mechanism to punish cheaters. This is typically accomplished by carrying excess capacity (buffer stocks), which can be used strategically to deter defection. It can also be accomplished by adopting a strategy of matching price cuts, which undermines the gains of defection.

These market and institutional features provide the basis for determining the “strength” of a cartel. If the conditions are fulfilled, then we can expect the institution to be capable of supporting joint regulatory objectives. If, on the other hand, the conditions are not met or are only partially met, then we can expect it to be more difficult for members to achieve joint regulatory objectives.

The literature on cartels not only offers a positive theory of collusion but also often makes strong normative claims. Cartels are generally condemned for causing market distortions. Because they facilitate the ability of producers to act like a monopoly to the detriment of consumers, there is a strong presumption that cartels distort

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The market distorting character of cartels provides the standard rationale for state intervention to inhibit their formation, whether they arise in domestic or international markets. While cartels can distort markets, it is a mistake to assume that this is always true. The normative case against cartels is based on the assumption that the equilibrium outcome without a cartel is an undistorted market. However, it is possible for a cartel to be market correcting. This can happen if the equilibrium outcome without the formation of a cartel is not a market that is perfectly competitive but one that is distorted. Under these circumstances, a cartel may be market correcting. Although less common, this can explain why cartels do, at times, receive policy support. Cartels have been justified for their ability to halt cutthroat competition, stabilize prices, secure strategic commodities, and increase employment. Where producer and labor interests have held sway, states have been called on to support (or at least not inhibit) cartel formation. Cartels have also been supported for the defensive reason that they counter the market distorting practices of foreign competitors.


138 A market without distortions is defined by economists as a perfectly competitive market in which there is perfect information, consumers maximize preferences according to a given budget constraint and producers maximize profits according to a set production function. All agents are price takers in the market. Externalities are assumed away as are increasing returns to scale and technological change. This competitive equilibrium is Pareto optimal. See W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., Economics of Regulation and Antitrust, 3rd edition (Cambridge, The MIT Press, 2001), pp. 75-76.


140 The proliferation of collusive arrangement in Europe was one justification for the Webb-Pomerene Export Trade Act of 1918, which permitted U.S. exporting firms to fix prices, allocate markets, exchange
The fact that cartels can cause as well as correct market distortions indicates that their welfare consequences cannot be predetermined, as much of the economics literature implies. The effect these institutions have on the ability of producers to redistribute wealth can improve or adversely affect social welfare. In this respect, the identification of an international institution with the features of a cartel should no more imply its welfare effects than international cooperation should imply an improvement in welfare. To discover welfare consequences, each regime must be evaluated individually. As Keohane acknowledges: “Although international regimes may be valuable to their creators, they do not necessarily improve world welfare. They are not ipso facto ‘good.’” As Helen Milner notes, “cooperation may just be collusion, a way of fixing prices to increase one’s profits.” The functional theory of regimes helps to explain how states can overcome cooperation problems but does not necessarily imply that all will be better off as a result. In the same way, cartels do not necessarily mean the diminution of welfare. They are not ipso facto “bad.”


141 The conflicting welfare consequences may explain why there are not general prohibitions against cartels. Because they sometimes can be useful even to those states that are the most ideologically committed to free trade, Mark Zacher argues that there are no meaningful norms circumscribing the formation of cartels. See Mark W. Zacher, “Trade Gaps, Analytical Gaps: Regimes Analysis and International Commodity Trade Regulation,” International Organization, vol. 41, issue 2 (Spring) 1987, p. 184.

142 Keohane, After Hegemony, p. 73, emphases original.


144 Recent work by Thomas Oatley and Robert Nabors has shown that even voluntary international agreements may leave some parties worse off. For example, during negotiations over international capital adequacy requirements, Japan agreed to the Basle Capital Accord even though it left its banks worse off than before the agreement. Thomas Oatley and Robert Nabors, “Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basle Accord,” International Organization, vol. 52, no. 1 (Winter 1998), pp. 35-54. Others who have drawn attention to the distributional consequences of international cooperation
It is also important to recognize that a group of states may create a regime to challenge the redistributive consequences of another regime. This was clearly the intention behind the sixteen countries that formed the International Energy Agency (IEA) in 1974. The regime was established to prevent counterproductive competition among industrial countries that could result in higher oil prices and to establish shared oil supplies, as well as to restrain demand during supply emergencies. Longer term plans to conserve energy and develop alternative energy sources were also established. It was hoped that if the IEA could not destroy the oil cartel cooperation among consumer nations, it could at least moderate OPEC’s influence over oil prices. Although it proved to be ineffective, the original conception of the IEA had the loose outlines of a buyer cartel. This example demonstrates that regimes do not stand apart from international politics, but are an integral part of the distributive struggles that occur between as well as across states.

A positive theory of cartels advances our understanding of the key features of the Arrangement and the conditions under which it is likely to succeed. However, while it


moves our cause of understanding the regulation of OTF forward, it cannot provide a complete explanation for the scope of the regime. Even when states have common interests and are able to organize collectively and establish an institution to enforce rules, they still face a range of choices regarding the content of those rules. To understand the specific content of the regime, it is necessary to turn to the role played by ideas, both as legitimating principles invoked to justify redistributive outcomes and as focal points selected to overcome bargaining problems.

Norms

A growing literature productively examines how ideas can become norms that influence decision makers and, by extension, state behavior.148 This literature emerged as a reaction to the view that “it is not necessary to know what political actors think in order to explain how they will act.”149 As Robert Jervis argued with respect to ideas and trade, “actors who believe the theory of mercantilism will behave very differently from those who have been schooled in neoclassical economics.”150

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Much of the literature that examines the impact of cognitive processes on policy uses the terms "idea" and "norm" interchangeably.\textsuperscript{151} This is a mistake. As shown in Figure 4, an idea is a much broader conception than a norm. First, an idea can exist inside a single person's mind, while a norm cannot. Norms are inter-subjective and thus must exist in shared social space, such as discourse and public debate. Second, in contrast to ideas, norms are distinguished by their functional role. They either prescribe, proscribe or permit some action or state. In other words, norms are best understood to be a subset of ideas.\textsuperscript{152} Further, rules are best understood as a further subset of norms. Actors use rules to codify and enforce norms more formally. Because rules involve a greater commitment on the part of actors and constraints on behavior we can expect that some but not all norms will become rules.

Scholars have identified several mechanisms to explain how norms can constrain or enable state behavior. First, they may provide specific "road maps" that provide decision makers clear reasons to adopt a specific course of action.\textsuperscript{153} Second, norms may provide "focus points" that help define acceptable solutions to policy dilemmas.\textsuperscript{154} Third, norms may be used by outside actors such as nongovernmental organizations (NGOs) as

\begin{footnotesize}
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\item\textsuperscript{152} I would like to express my gratitude to James Patrick Boyd for alerting me to the important distinctions that should be drawn between ideas and norms. Further development of these distinctions can be found in James Patrick Boyd, Normative Change and Japanese National Identity: Toward a Theory of Norm Dynamics, PhD dissertation, Department of Political Science, Massachusetts Institute of Technology, forthcoming.
\item\textsuperscript{153} Judith Goldstein, Ideas, Interests, and American Foreign Policy (Ithaca, NY: Cornell University Press, 1993), chapter 1.
\end{enumerate}
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leverage to pressure governments to adopt specific policies collectively. Norms can also be fostered by a network of professionals who have expertise in a specific area and claim to have authoritative knowledge—what Peter Haas refers to as "epistemic communities." By providing information and advice based on principled or causal beliefs that they hold in common, these professional communities can reduce uncertainty and provide a "value-based rationale for social action."  

These mechanisms provide an explanation for the emergence of cooperation that is independent of the distribution of power in the international system. Rather than being a post hoc rationalization as some critics have suggested, knowledge-based theories provide an explanation for sources of action that can be prior to and distinct from interests. Focal points may not be initially obvious to participants. As Garrett and Weingast have suggested, focal points may be "constructed," that is, intentionally chosen and promoted by international actors. However, this does not exclude the important role that interests and institutions can play in the process that transforms ideas to norms and norms into rules. It is unlikely that an idea will be advanced that is in no one's interest. A more likely scenario is one in which an idea is in at least one actor's interest. This interest then drives this actor to use dialogue, education and persuasion to win acceptance of the idea from others. If a broader group of actors accept the idea, then the idea becomes a norm that prescribes or proscribes certain behavior. The establishment of

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an institution can help facilitate this process by creating the basis for actors to gather to partake in discourse, knowledge exchange and persuasion.

It can be a mistake to consider norms as continuous variables that have equal effect across time or across issue areas. As Jeffrey Legro has argued, “they do not just exist or not exist but instead come in varying strengths.” Once this characteristic is appreciated, analysis can shift from the question of whether or not norms “matter” to the evaluation of why some ideas are more influential than others in particular situations. The framework developed by Legro is useful in this respect. He presents a three-part scheme for assessing norm strength, which evaluates specificity, durability, and concordance. Specificity describes how well the norms are defined and understood, which can be determined by examining the simplicity and clarity of the prohibition, as understood by relevant actors. Durability refers to how long the norms have been in effect and how effectively they withstand challenges, which can be evaluated in terms of actors’ understanding of and reaction to violations. Concordance indicates how widely the norms are accepted, as indicated by international discussion and institutionalization in laws, treaties or communiqués. In short, these criteria predict that “the clearer, more durable, and more widely endorsed a prescription is, the greater will be its impact.”

Turning to the matter of OTF, we find that export credit and foreign aid have been the subject of a welter of ideas. This is particularly true regarding how subsidies should be managed. As commentators over the years have noted, subsidies are a contentious

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159 Ibid., p. 35.
subject. In his book, *The World Trading System*, John Jackson notes, “...there is great controversy about the economic policies with respect to subsidies in international trade.” Similarly, respected trade economist Robert Baldwin comments on efforts by states to strengthen subsidy rules, noting, “despite these recent developments in providing international guidelines designed to limit the adverse trade effects of subsidies, there is still widespread disagreement within and among nations concerning the effects and legitimacy of various forms of subsidies.” Some analysts have even gone so far as to suggest that reaching an objective standard for defining a subsidy may not be possible. Richard Snape laments: “the definition of a subsidy, and even of a trade-affecting subsidy, is essentially arbitrary and differs according to perception and political persuasion.”

In the midst of these conflicting views, ideas concerning optimal trade policy derived from welfare economics have been influential. The policy prescriptions derived from these ideas have contributed to the establishment of free trade norms that have been drawn upon by supplier states in constructing the Arrangement. Over the years, key architects of the Arrangement, most of them trained economists, have drawn heavily upon economic theory to justify the adoption of the trade finance regulations. But what is often overlooked is that the guidance offered by welfare economics is not equally

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163 For example, Fred Bergsten and Gary Hufbauer, founders of the Institute for International Economics, were both officials at the U.S. Treasury Department and active participants in the formative period during the 1970s when the Arrangement was formalized among the leading suppliers of official trade finance. For policy views during this period see C. Fred Bergsten, *The International Economic Policy of the United States: Selected Papers of C. Fred Bergsten, 1977-1979* (Lexington, Mass: D.C. Heath and Co., 1980).
definitive in all areas potentially subject to regulation. Standard welfare economics generally frowns on export subsidies. However, it also recognizes exceptions when market failures can be demonstrated. Much of the trade finance offered by states is directed to the gray area that extends from functioning markets to failed markets; therefore, the usefulness of norms encouraging free trade in building policy consensus among supplier states at the international level varies across sectors and types of financing.

Ideas Concerning Economically Optimal Trade Finance Policy

Standard economic justifications for regulating official trade finance generate normative claims about the terms and conditions on which OTF should be supplied. Welfare economics begins with the assumption that the first best policy is never an export subsidy.\textsuperscript{164} This is because, as long as each nation is internally efficient in the use of its productive resources before trade, a policy of unrestricted trade is Pareto optimal. Under these conditions, subsidies will simply distort trade and investment patterns and reduce global welfare. Consequently, the welfare theory of trade counsels that it is irrational for a state to provide export subsidies.

Economists argue that such interventions cause inefficiencies in several ways. They distort domestic consumption by raising the domestic price of the exported good. They distort domestic investment by making production more lucrative than it otherwise would be. Domestic consumers are left worse off as are domestic taxpayers who must

pay for the subsidy, generally involuntarily. In order for a subsidy to improve national welfare, the gains to consumers must exceed the losses to consumers and taxpayers. As one economist explains, "Export subsidies might be in the interest of a particular industry, but any welfare gains to this industry are more than offset by welfare losses elsewhere in the economy." 65

There are, however, important exceptions. The prescription against export subsidies assumes that competition is present on both sides of the market and that no market failures exist. When market failures are present, conventional welfare economics holds that government intervention may be justified if the corrective is Pareto-improving. Market failures can be divided into two major categories. One category concerns financial market failures arising from imperfections in capital markets offered in support of private goods. The other category can be thought of as consisting of all non-financial market failures offered in support of public goods. In general, the prescriptions offered by economic theory become more ambiguous as one moves from trade in private goods subject to financial market failures to trade in public goods subject to the many types of non-financial market failures that may exist, including insecure property rights, externalities, information asymmetries, and adverse selection.

65 Salant, p. 3.
Financial market failures

Standard welfare economics accepts the possibility that government intervention may be necessary to correct financial market failures but only under strict conditions. As economic purists are quick to point out, unwillingness on the part of private actors to provide credit is, in itself, not a sufficient indicator of market failure. When the private sector responds to risky loans by charging higher rates or by refusing to take them at all, this does not necessarily mean that a market imperfection is present. William Niskanen argues: “The lack of private credit on terms acceptable to a foreign borrower is not an example of market failure but an important signal of the risks of lending to that borrower.”

Others have pointed out that once governments enter capital markets, the justification for their role can become self-fulfilling: “A government agency may so successfully compete with private competition that it drives it out altogether, and then it might claim that private markets are not providing the service rendered, thereby justifying its public provision.” Thus, the guidance offered by neoclassical economic theory is clear: states should refrain from supplying trade finance except when there is a legitimate financial market failure. The regulatory problem supplier states confront is not a theoretical one but an empirical one of determining whether or not markets are in fact failing.

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The second condition welfare economics councils when correcting for capital market imperfections is to intervene only on “market terms.” As indicated in Figure 5, this means that the financial terms for export credits used to support private goods should contain no subsidy element. The ideal is to price official export credits at a competitive equilibrium where price equals marginal cost. Standard welfare economic theory holds this equilibrium cannot be replaced by another one that would increase the welfare of some consumers without harming others. It is Pareto optimal. Anything more risks distorting markets and shifting rents to the states supplying financing. Anything less risks distorting markets and shifting rents to states using export credits. Given that few of the conditions that normally define perfect competition are met in the case of government provision of credit, especially the case of medium and long term credit, the challenge for states in devising pricing rules is to simulate these optimal price points.

The conditions on procurement adopted by official credit suppliers are less of a concern. Export credits can be 100 percent tied as indicated in Figure 5. As long as export credits are priced to reflect their full opportunity cost, there should be no distortion.

Non-financial market failures

The second category of market failure comprises all non-financial market failures. Here, an unambiguous standard for treating subsidies is more difficult to find.

Conventional welfare economics recognizes that private markets may under-supply

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public goods and that states can improve social welfare by subsidizing the provision of such goods. However, it does not provide a clear rubric for determining in which instances subsidies are legitimate and in which instances they are not.

Arguments over infant industry protection provide one example. The static nature of comparative advantage underlying the theory of free trade ignores the forward linkages that exist between present investment and future production possibilities. The theory can be amended by taking into consideration scale economies, high start-up capital requirements, and the ‘learning curve,’ with costs per unit falling as experience of production is gained. Proponents of infant industry policies argue that such amendments justify the subsidies, tariffs and other protectionist measures. But not all agree. Critics of infant industry protections question the pervasiveness of the conditions and the high cost and high probability of making incorrect interventions. Thus, this area is controversial. Standard economic theory does not provide a clear “focal point” to guide policy makers that might be seeking to establish a standardized rule regarding such interventions.

A similar problem arises with respect to non-economic goals that states pursue. A state may want to become self-sufficient in its production of a product important to national defense, maintain a certain portion of the population in agricultural production,

or avoid sudden economic dislocation in certain sectors. A state may also want to
counteract regional externalities. Examples include measures aimed at correcting trans-
border environmental threats such as the improvement of the safety of nuclear reactors\textsuperscript{171} and the diffusion of cleaner coal technologies to mitigate effects of acid rain.\textsuperscript{172} States
may also have an interest in promoting regional peace and stability.\textsuperscript{173} These are not
objectives for which standard welfare economics offers clear, prescriptive guidance. As
Schwartz and Harper point out, “these reasons can be deplored as misguided by those
who disagree with them, but there is no way in principle to reject them as less legitimate
than others in defining what the particular ‘demand’ is within a country.”\textsuperscript{174}

The lack of clear norms creates a problem in drawing a line between legitimate
and illegitimate subsidies. Financial interventions that are predatory, solely designed to
help firms capture greater market share, have been subject to extensive criticism.\textsuperscript{175}
However, predation can be difficult to prove given the mixed motives associated with
most subsidies. As Robert Baldwin has noted: “Usually, loan and grant activities are
regarded as evidence of desirable aid giving rather than of selfish export subsidization.

\textsuperscript{171} Barbara Connolly and Martin List, “Nuclear Safety in Eastern Europe and the Former Soviet Union,” in
Robert O. Keohane and Marc A. Levy, eds., \textit{Institutions for Environmental Aid: Pitfalls and Promise}
\textsuperscript{172} Koji Morita, “Coal Demand in the Pacific and Possible Environmental Problem,” \textit{Coal in Asia-Pacific},
vol. 5, no. 4 (March 1994), p. 73; See also, “MITI Seeking Anti-pollution Funds,” \textit{Nikkei Weekly}, August
\textsuperscript{173} The Camp David Accords, which established the basis for large-scale economic and military assistance
flows from the U.S. to Israel and Egypt provide an example of this rationale. See Alasdair Drysdale,
“Foreign Aid to the Middle East: Change or Continuity?” in Richard Grant and Jan Nijman, eds. \textit{The
Global Crisis in Foreign Aid}, (Syracuse, NY: Syracuse University Press, 1998), pp. 77-88.
\textsuperscript{174} Warren F. Schwartz and Eugene W. Harper, Jr., “The Regulation of Subsidies Affecting International
\textsuperscript{175} Richard H. Snape, “International Regulation of Subsidies,” \textit{The World Economy}, vol. 14, no. 2 (June
1991), pp. 146-147.
But it is not always easy to disentangle the two. Although many subsidies have legitimate policy goals backing them, as implemented, these subsidies may interfere with a competing state’s legitimate interest on behalf of its own firms.

The result is a clash of competing policy goals: on the one hand, states have legitimate reasons for implementing export subsidies, but on the other hand, rival states competing in the same international markets have legitimate reasons for being concerned about the impact of those subsidies on the competitiveness of their own firms. The lack of clear guidance has made non-financial market failures an area of much greater controversy. If subsidies can enhance efficiency, they may be acceptable from the standpoint of economic theory. In practice, there is often considerable disagreement over when and where this in fact true, providing policy makers with less clear guidance.

Welfare economics provides clearer guidance for the financial terms on which aid subsidies should be allocated. Lump sum transfers (i.e., grants) are considered the most efficient and least distorting type of intervention. There is a natural incentive for governments to provide aid on harder rather than softer terms. Harder terms permit scarce subsidy funds raised from taxes to be spread across a larger number of projects. Grants, rather than loans, measure how concessional a credit must be in order to be counted as aid and not considered as an actionable subsidy. In order to regulate aid credits, governments needed a methodology to measure the degree of concessionality

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176 Baldwin, *Nontariff Distortions of International Trade*, p. 54.
associated with aid credits. If states are to intervene, then lump sum transfers are assumed the most efficient approach.

Welfare economics also provides clearer guidance with respect to procurement conditions. First, because tying can distort the pattern of world trade and impose high costs on recipients when subsidies are present, economists have long advocated that aid credits should be fully untied.\textsuperscript{177} Economists have shown that unilateral aid transfers can damage the welfare of the receiving country and improve that of the giving country when they are tied.\textsuperscript{178} If all market participants have an equal chance to bid for the contracts, recipients are more likely to obtain the goods/services at least cost.\textsuperscript{179} Second, untied aid reduces the chance that a country offering aid subsidies can use these subsidies strategically to divert trade flows and thereby distort international competition.\textsuperscript{180} However, limiting the ability of suppliers to capture the benefits of aid subsidies can reduce the incentives to supply it. If donors are denied some of the benefits of aid subsidies, less aid may be forthcoming. Thus, when developing international rules, creditor states face the problem of striking a balance between devising rules that balance their undesirable export-subsidizing effects against their aid-expanding effects. Although

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untied loans are less trade distorting than tied credits, they can undermine the incentive for creditors to provide financing to address non-financial market failures.\footnote{Robert E. Baldwin, \textit{Nontariff Distortions of International Trade}, pp. 7-12 and 49-57.} There is no clear \textit{a priori} criterion for how this balance can best be struck.

\textit{Credit related externalities}

The legitimating principles invoked to justify the regulation of credit-related externalities are subject to varying degrees of agreement. Norms have developed over the years concerning bribery and corruption, environmental protection, human rights, and international arms transfers. However, the depth of shared understandings and expectations varies considerably among industrial countries, and more dramatically among developing countries.

Norms regarding corruption offer one example. Because social norms vary across countries, what is regarded in one country as corrupt may be considered a part of routine transaction in another.\footnote{Steven R. Salbu, “Extraterritorial Restrictions of Bribery: A Premature Evocation of the Normative Global Village,” \textit{Yale Journal of International Law}, vol. 24, no. 1 (Winter 1999), pp. 223-255.} In developing countries, for example, gift exchange is a major social norm in business transactions, and allegiance to kinship-based or clan-based loyalties often takes precedence over public duties even for salaried public officials. There are even some economists who suggest that corruption may actually improve efficiency and promote economic growth in the face of pervasive and cumbersome regulations in developing countries. At the very least, bribery may indicate the
unavoidable price of dealing with market failures. As Samuel Huntington offers, corruption is often linked with modernization and in modest amounts, bribes can serve as much-needed lubricant required to overcome rigid administration.

At the same time, norms are rarely static. They can become more influential in one period than another. One mechanism through which this may happen is through “value activists” or “norm entrepreneurs” who actively work to promote the acceptance and spread of principled beliefs. Environmental conditions can also be significant. A change in external circumstances can make policy makers more receptive to certain norms. Finally, certain ideas can be more persuasive than others, because their causal reasoning seems to offer a more appropriate solution than others.

All of this suggests that the impact norms may have on shaping state behavior is not constant. If a norm becomes clearer and more widely endorsed among relevant decision makers, it is more likely to have an impact at the international level. As norms gain strength, they can facilitate the regulatory convergence on a single standard. However, if differences in beliefs and causal reasoning persist, then norms are less likely to support convergence on a single standard. In this way, norms are likely to be more influential in some areas than in others.

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Competing Explanations

Most of the literature on the governance of official credits is confined to policy and legal analysis that interprets trends or advocates particular policy changes.\textsuperscript{186} An article by Andrew Moravcsik published in 1989 represents one of the few theoretical treatments of the Arrangement by a political scientist.\textsuperscript{187} Moravcsik explains the Arrangement in terms of three variables: the structure of domestic financial institutions, the hegemonic power of the United States, and the functional value of reliable information exchanged within the regime. It is a model built on a view of international cooperation involving three stages: 1) the formation of a state’s preference for cooperation; 2) interstate bargaining; and, 3) compliance.

Rather than being formed by ideology or commercial market position, Moravcsik argues, preferences are better understood in terms of what he refers to as “institutional cost.” This is narrowly defined as the cost of providing a credit and the resources available to agencies. Export credit agencies do not have the same political mandates or institutional capacities. Some countries require their national export credit systems to be self-sustaining, whereas others operate under much more liberal public funding. In the


\textsuperscript{187} Moravcsik, “Disciplining Trade Finance.”
latter case, budgetary costs are not restricted by law, and any shortfalls are provided by government revenue. Moravcsik’s argument provides a valuable starting point for understanding the regulation of OTF by drawing attention to the fact that states which impose harder budget constraints on their national export credit systems and are placed at a competitive disadvantage for doing so are likely to have a strong preference for harmonizing credit rules at the international level.

However, the model has a number of weaknesses. By focusing only on budget pressures, Moravcsik overlooks other factors that can motivate states to seek out international rules. For example, a state that is pressured by domestic interest to impose higher levels of conditionality on its OTF than its competitors will be motivated to internationalize these standards lest its exporters be placed at a disadvantage. The case of bribery and environment in which the US imposed higher standards on its ECA as a result of domestic pressures serves as an example. Budgetary considerations are therefore only one element in the formulation of state preferences for multilateral rules. A more complete explanation for preference formation than “institutional cost” would be a state’s interest in maintaining international competitiveness. Institutional cost also does not help to explain instances in which states are willing to bear budgetary costs and show little or no interest in international rules.

Moravcsik’s formulation suffers from other limitations, including the misapplication of hegemonic stability theory. As noted above, the theory explains how

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188 Moravcsik (1989) writes: "The historical record strongly supports the view that the United States lent decisive support to liberalization efforts, as the hegemonic stability theory would predict. American
the leadership of a dominant power can overcome the problem of supplying public goods that are essential for international stability and prosperity. But as Conybeare has noted, free trade does not meet these conditions, since the benefits are largely excludable and subject to rivalry in consumption. In fact, dominant powers should have more of an incentive to adopt trade restrictions since they will have a greater capacity to divert world income toward themselves. Free trade is better understood as a prisoner’s dilemma, which requires a system of deterrent threats to prevent the unilateral initiation of a tariff.\textsuperscript{89} A similar logic applies to public credit aimed at supporting private goods. The problem is not to compel other states to increase their contribution, but to establish mechanisms that restrict rival suppliers from offering credit terms that place others at an unfair disadvantage. Foreign aid tracks more closely to the public goods problem raised by hegemonic stability theory.\textsuperscript{90} However, the Arrangement’s concern with foreign aid has been narrow, more concerned with policing instances of predatory behavior than with cajoling other advanced industrial country members to provide more aid.

The nearly exclusive attribution of outcomes to U.S. power is also problematic. Moravcsik asserts that U.S. hegemony is central to understanding the regime: “The evidence strongly suggests that the formation of the trade regime resulted from an exercise of coercive power by the United States. France and the United States engaged in

\textsuperscript{89} Conybeare, p. 11.

a simple bargaining game, and France lost.”\textsuperscript{191} While there is little doubt that the U.S. played a leadership role in the Arrangement from the 1970s onward and clashed with France on certain issues, this does not mean that the U.S. dictated outcomes. Changing global economic conditions and the political and economic integration of Western European states were also important factors. This conclusion is supported by David Blair’s analysis of the regime:

\textbf{"The distribution of power resources within the export credits issue area also fails to explain the outcome of bargaining in the OECD… The apparently greater resolve of the EC member countries, France in particular, enabled the Community to block a greater restriction of subsidy practices until such a time as the preferences of Community members had shifted in favour of such restrictions. This change in interest definition, furthermore, resulted primarily from internal economic and political developments and at certain time from fluctuations in international financial markets, rather than from the direct exercise of US power."}\textsuperscript{192}

Care is needed in adopting a power-bargaining model, which casts the U.S. in the role of an all-powerful but benevolent hegemon. First, as Blair explains, the motivations for changes in rules may lay elsewhere. Second, the model cannot explain cases like the 1969 shipping agreement that was concluded without the U.S. and which the U.S. did not join until the 1990s. Third, the model cannot explain the institutional arrangements established to regulate OTF. Why did the OECD emerge as the institutional venue of choice for policing official credits? If bargaining power was crucial, why did the U.S.

\textsuperscript{191} Moravcsik, p. 199.
not simply wield its dominance through institutional forums that already existed such as the Berne Union or the GATT? A narrowly conceived power-bargaining model ignores the broader collective interest that supplier states have in shifting the terms of economic exchange vis-à-vis buyer states.

Finally, Moravcsik’s framework ignores the role of ideas in facilitating agreement among OTF suppliers. The model implies that rule formation was simply a matter of organizing sufficient resources to monitor members and retaliate against defectors. Norms regarding free trade and the relationship between subsidies and market failures are not considered. The model treats the issue of export subsidies as unproblematic with little attention to the difficulty that suppliers face in developing rules that distinguish between legitimate and illegitimate subsidies. A cursory examination of the history of the negotiations suggests that this was far from the case. Norms regarding export subsidies were constructed over time by supplier states, with the application to some areas taking longer than others.

The claim that the regime governing official trade credits can be understood as a cartel is controversial. It has been asserted by some, rejected by others, but never fully explored or tested. Andrew Moravcsik has written “… the OECD Arrangement is in essence a cartel designed to restrict political economic competition among credit agencies.” Legal experts have made similar claims. According to Marcos Orellana, “The Arrangement can be understood as a cartel-like, price fixing mechanism, where the

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largest lenders of export credits establish limits on competition, in terms of the interest
and premia fees, to prevent running substantial losses, and thus to avoid risking
intensified scrutiny by their own national parliaments or governments. It is an agreement
by the richest countries in the world, and therefore its provisions are tailored for their
needs.”¹⁹⁴ This echoes the view of Donald Dekieffer, another trade lawyer, writing a
decade earlier: “The OECD Arrangement on Guidelines for Officially Supported Export
Credits is the type of agreement which, if entered into by American financial institutions,
would clearly violate a plethora of antitrust laws. It is quite simply a price-fixing
agreement whereby the major lending parties in the world agree not to compete with each
other in the area of interest rates. Here, the OECD member states have agreed to ‘floor
rates’ for various types of government support used to promote exports.”¹⁹⁵

Others reject the cartel comparison. Daniel F. Kohler and Peter H. Reuter admit
that the Arrangement is intended to restrict competition, but argue that since the
agreement is among governments and not among profit-oriented corporations, the cartel
comparison is inappropriate. They argue that because governments are not constrained by
markets to make the economic calculations of marginal costs and revenues that determine
the competitive outcome in markets, there is little reason to believe that, absent an
agreement, there would be a welfare-maximizing level of export subsidies. If the
Arrangement has the effect of restricting the total flow of export subsidies, then in their

¹⁹⁴ Marcos Orellana, “Export Credit Agencies and the World Trade Organization,” Center for International
Environmental Law, draft issue brief, November 2003, pp. 4-5.
¹⁹⁵ Donald E., DeKieffer, “The Role of Export Credits in International Trade,” in John H. Jackson, Richard
O. Cunningham and Claude G.B. Fontheim, eds., International Trade Policy: The Lawyer’s Perspective
view, the agreement increases global welfare. This conclusion rests on a deep skepticism regarding the ability of export subsidies to improve economic welfare and is consistent with the image common among trade economists that governments are fundamentally incompetent or beholden to special interests. It also rests on a belief that if income redistribution is the intended goal, then it is achieved more efficiently through direct, lump-sum transfers with open procurement (i.e. financing that is not tied to procurement from donor firms). Therefore, like officials working within national trade finance programs, they object to the cartel characterization because they see the Arrangement moving official export credit practice closer to the norms of the competitive market ideal. As opposed to gouging consumers and destroying competitors, they see the regime improving the efficiency and fairness of the global trade system.

My own view is that the welfare consequences of cartels can and should be separated from the insight that cartel theory provides in understanding the conditions under which sellers (or buyers) can successfully organize to restrict competition. Cartel theory provides a positive theory of collusion. It provides a basis for predicting the type of institutional arrangements that are required for economic actors to successfully limit competition. The implications of collusion are another matter. It is a mistake to automatically assume that collusion always undermines social welfare. This judgment must be made through separate analysis.

I now turn to this history and examine it in greater detail in order to test my alternative proposition that interests, institutions and ideas must be joined to explain the scope of the regime governing state intervention in international capital markets.
CHAPTER THREE: INSTITUTIONAL ARRANGEMENTS FOR COLLUSION AND REDISTRIBUTION

This chapter explains the institutional arrangements that supplier states established to govern OTF. The examination begins in the 1950s, when unrestricted export credit competition emerged as a policy concern. It then proceeds through the next three decades to show how the convergence of interests and institutional factors made the OECD Export Credit Arrangement a more attractive and effective forum for supplier states to regulate OTF than alternatives like the Berne Union and the GATT/WTO. The evidence confirms the proposition that an exclusive and secretive cartel-like arrangement comprised of export credit suppliers provided the policing function necessary to restrict credit competition and halt unintended wealth transfers from developed to developing countries.

Competition Breaks Out

Calls for stronger measures to manage export credit competition between industrial states began in the 1950s. Eugene Black, President of the World Bank, described the problem in a presentation to the Board of Governors in 1955 with a note of alarm: “The situation is becoming serious… too much credit given, under the pressure of competition, sometimes on inappropriate terms and for the wrong purposes… So a race is developing, a race in which none of the competitors can win because the faster each one goes, the faster will all the others go.”\textsuperscript{198} Academic observers raised similar warnings. A

\textsuperscript{198} “International Bank for Reconstruction and Development”, \textit{Report}, 1954, pp. 9-11. It should be noted that the president of the World Bank was not a dispassionate observer. His concern for stemming the credit
European scholar wrote in 1959: “A multilateral solution has become extremely urgent in view of the turmoil within industrial countries of private groups whose only interest is to press their own exports at all costs, even at the cost of a credit race, of considerable losses to their own country’s Treasury, of the debasing of their own currency.” An American scholar writing within the same time period struck a similar note of alarm: “Tinder for an international credit conflagration appears readily available.”

While the problem of uncontrolled export credit competition between leading industrial states was apparent as early as the 1950s, the specific supply-side response was not. There was a range of competing institutional design options available. States supplying OTF could strengthen or expand existing institutions. They could create wholly new institutions. They could make membership in either the existing or new institutions open to all states, or restrict it to only a few. Actual representation within the forum could be drawn from export credit institutions or from their governments. In practice, a number of different approaches were tried. Initial efforts focused on the Berne Union, a grouping of insurance and export credit agencies that had been established in the 1930s. Efforts aimed at containing competition were also taken in the early years of the race was partly motivated by desire to defend his newly created institution from encroachment, particularly by the U.S. Export Import Bank. From 1948 through the mid 1950s, Black criticized long-term loans provided by Ex-Im Bank, which undercut the terms that the World Bank could offer. For a history of the tensions between the World Bank and Export Import Bank during these early years, see Edward S. Mason and Robert E. Asher, The World Bank Since Bretton Woods (Washington, DC: The Brookings Institution, 1972), pp. 496-500.

199 Errezero, “Export Credits to Under-Developed Countries on a Multilateral Basis,” Banca Nazionale del Lavoro Quarterly Review, vol. 12, no. 50, p. 332.
International Bank for Reconstruction and Development (IBRD). There were also some measures taken through the GATT. However, it was ultimately a forum created with the support of the OECD that emerged as the primary forum for monitoring and regulating export credit terms and conditions. The following sections examine both the failed and successful efforts in greater detail, beginning with the Berne Union.

**Berne Union**

The Berne Union was established in 1934. The organization brought together the export credit agencies of France, Italy, Spain and the United Kingdom who pledged “to work for the rational development of credit insurance in the international field by improving the information services of full members by means of making known to one another the results obtained in this sphere and, generally, to foster the regular exchange of views regarding essential questions of credit insurance as well as on the problems which arise in the field of technique and organization.” The agreement when on to state that

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201 Bank staff began gathering information on official medium-term credits from governments and organized consultations among countries. See Marx, p. 272.

202 It should be noted that regional organizations have also taken up export credit issues. The most extensive regional efforts to manage export credits have taken place within the context of the European Community. The 1958 Treaty of Rome set restrictions on official aid to national exporters that distorted competition among member states. On this basis, members of the Community worked to limit their official export credit programs within the Community, but not in third country markets. Regional forums have also been in Latin America, Africa and the Carnes group, comprised of countries concerned with agricultural trade. However, these regional and sector-based forums have never provided the basis for international regulation for export credit practices. Regional cooperation among export credit agencies is described a greater length in Delio E. Gianturco, *Export Credit Agencies: The Unsung Giants of International Trade and Finance* (Westport Conn: Quorum Books, 2001), pp. 49-65.

203 The Berne Union was initially called the Union of Insurers for the Control of International Credits. In 1957 the name was changed to the Union of Insurers of International Credits and again in 1974 to the International Union of Credit and Investment Insurers.
members “agree on their honour, not to conceal nor put forward in their communications
to one another any fact or item of information like to mislead the other members.”

In the first two decades of its existence, the Berne Union attracted little attention
and largely focused on technical issues related to export credit markets. The organization
largely served as a forum for pooling information on the credit standing of borrowers. In
these early years the institution’s membership remained limited. The importance of
export finance was also significantly curtailed by the international trade dislocations
caused by World War II. The situation changed significantly after World War II. From
the 1950s onward, state financial interventions in export markets grew, increasing friction
between exporting states. In this environment, the Berne Union came under increasing
pressure to coordinate the policies of its members and to standardize the terms and
conditions on which insurance/ guarantee cover was granted.

A number of factors converged to elevate the importance of export financing in
the post-War period. On the economic front, changes were taking place in the structure
of export products. Among the most significant was the growing importance of
manufactured goods exports. In 1900, capital goods represented only 6.7 percent of
export for the 10 leading industrial countries. By 1954 this figured had climbed to 37.9
percent. There was also a significant change in the make-up of the manufactured
goods themselves, which increased in both size and cost. Economies of scale in heavy
electrical equipment, steel plant, aircraft, and industrial parts brought significant

204 Quoted in Daniel Marx, Jr. footnote 33.
205 Robert E. Baldwin, “The Commodity Composition of Trade: Selected Industrial Countries, 1900-1954,”
productivity gains. To reap these gains, manufacturers increased the size and complexity of the equipment significantly, which, in turn, drove up unit costs, often dramatically. The result was that deferred payment plans became increasingly important criteria for buyers in their purchasing decisions. This was particularly true for developing country buyers, which faced difficulty in raising large sums necessary to pay for the equipment without some form of deferred payment plan.\(^\text{206}\) At the same time, traditional commercial lenders exhibited a reluctance to finance these large transactions in countries where the risk of nonpayment loomed large.

Exporting states increasingly stepped in to fill the perceived gap in international trade finance with publicly backed financial instruments. Governments that did not already have export financing vehicles created them after the war. The volume of official financing grew rapidly, especially after the mid-1950s.\(^\text{207}\) In the case of the UK, 11.5 percent of exports were backed by the Export Credit Guarantees Department (ECGD) in 1949-50. Ten years later, 23 percent of the UK’s exports were covered by contracts. In the case of Germany, the statutory ceiling for government-backed insurance cover was increased ten-fold between 1951 and 1960. For countries that lacked official financing schemes, emulation became the order of the day. Canada established the Export Credit Insurance Corporation (ECIC) in 1944. This institution was supplemented in 1959 by the Export Finance Corporation to supply medium-term supplier credits “to insure that the

\(^{206}\) For a discussion of the increasing importance of finance during this period in the context of heavy electrical equipment sales to developing countries, see Barbara Esptein, *Politics of Trade in Power Plant: Impact of Public Procurement* (London: The Atlantic Trade Study, 1971), pp. 30-37.

cost of financing medium-term paper compares favorably with cost in other countries. 208

The Japanese government established Ex-Im Bank in 1950 to offer medium and long-term export financing in cooperation with private financial institutions. Insurance operations were lodged with the Export Insurance Division of the Ministry of International Trade and Industry (EID/MITI). By the end of the 1950s, all the major OECD countries had established one or more official export financing facilities to support export transactions.

At the same time, political developments were reconfiguring export markets in ways that tended to increase competition between the major exporting states. Decolonialization and the new emphasis on free trade promised to open up new markets and break restrictive trade patterns. This included a concerted effort by the United States to end the sterling bloc, which had created a restrictive trade domain between Britain and its colonies and dominions. 209 However, political developments associated with the onset of the Cold War worked in the opposite direction. By the 1950s, U.S. policy makers had become increasingly concerned with containing the spread of Communism. The policy of containment devised by the United States, with its strong emphasis on economic warfare aimed at denying trade with Communist countries, had the effect of shrinking export markets. 210 As East-West tensions rose, the US pressed Britain and other


210 A memorandum from President Truman in December 1950 to this policy departments began: “It is necessary that we now take such measures as are feasible to prevent the flow to countries supporting Communist imperialist aggression of those materials, goods, funds and services which would serve materially to aid their ability to carry on such aggression. We must enlist the cooperation and support of other nations in carrying out those measures; and in securing such support we must stand ready to take such
European countries, often using Marshall Plan funds as leverage, to secure a trade embargo against Russia and Eastern Europe.\textsuperscript{211} The reduction in East and West trade concentrated export competition in the markets that remained. Containment shrunk markets in Asia as well. As a result of Cold War tensions, Japan severed diplomatic relations with China, (Japanese exports to China were constrained by Chinacom and Cocom restrictions), which before 1940 had been Japan’s chief export market.\textsuperscript{212}

Finance based competition was also stimulated by the rise of American power and its increasing expression through financial interventions in export markets. The United States took the international stage after WWII with a range of multilateral initiatives. It assumed a leading role in building international financial institutions, including the International Monetary Fund, the International World Bank, and regional development banks. The construction of these institutions began with a strong belief that a multilateral approach to financial cooperation provided a way to remove political tensions that arose between the granting and receiving nations and to remove politics associated with the administration’s political affiliations or with the race or creed of recipients.\textsuperscript{213}

Bilateral financial interventions were not abandoned. Indeed, they far exceeded multilateral flows, particularly after the Cold War intensified after 1948. The U.S. continued its active support of Bretton Woods financial institutions but channeled most

\textsuperscript{211} U.S. Ex-Im Bank was prohibited from extending credits to China until the China Trade Bill was passed in January 1980.
financial flows through bilateral facilities. In the immediate aftermath of the war, these
bilateral financial initiatives were focused on relief and reconstruction and generally took
the form of grants. By the mid-1950s, the U.S. had shifted the terms of its financing from
grants to concessional loans repayable in local currency, supporting economic growth.
Between 1945 and 1965, the U.S. government provided a total of $116 billion in bilateral
financial flows on varying terms and conditions for a range of activities. Most of this
financing was directly or indirectly tied to contract orders from American producers.214
By contrast, total bilateral financial flows channeled through the World Bank were only
$10.04 billion over the same period.215

During this period, the U.S. both strengthened existing institutions and established
new ones. One of the existing institutions fortified during this period was the U.S.
Export-Import Bank. The legal and institutional basis of the bank was made permanent
in 1945 and further strengthened by the passage of the Export-Import Bank Act of 1954,
which reaffirmed the independent status of the bank and its role as a quasi-commercial
source of developmental capital. By the end of the Truman administration in 1953, the
Bank was administering loans in forty-eight countries and the Bank’s staff steadily
increased, growing from 130 in fiscal year 1951 to 234 in fiscal year 1959.216 Other
institutions were established to manage the growth in U.S. concessional lending

214 For a detailed breakdown of these figures see David A. Baldwin, Foreign Aid and American Foreign
Baldwin’s figures, the composition of these flows consisted of $35 billion for military programs; $40
billion for AID and predecessor agencies; $13 billion for Marshall Plan; $13 billion for Food for Peace; $9
billion for Export-Import Bank and $19 billion for other programs.
216 William H. Becker and William M. McClenahan, Jr., The Market, the State, and the Export-Import Bank
programs. This began with the establishment of the Development Loan Fund in 1957 to finance social development projects. The DLF and other concessional programs were eventually consolidated into the Agency for International Development in 1961. These tied soft loan facilities became an important source of low cost capital for American exporters. According to data collected by the National Electrical Manufacturers’ Association, half of export sales of heavy electrical equipment produced by General Electric and other American manufacturers in the 1960s were supported by AID soft loans.217

The expansion of U.S. export financing programs contributed to increasing competition with other industrial exporting states along several different fronts. One dimension was credit tenor. Recognizing the growing potential for an export credit race, the members of the Berne Union agreed in 1953 to establish a maximum limit of five years repayment terms on official export credits. However, by the end of the 1950s, departures from this five-year limitation had become increasingly frequent. Longer repayment periods were granted de facto by adopting late “starting points” from which to count repayment periods. The growing practice of tying concessional financial allocations to procurement also aggravated competition. In 1949, the British Export Guarantees Act stipulated that funds allocated under the program must be used to purchase goods and services from the United Kingdom. It also became known that the highly concessional loans available from the U.S. DLF program would be tied to specific purchases of American goods. Other nations quickly followed. Germany’s Ministry for

217 For the period 1962-67, USAID loans supported 44 percent of American turbine-generator exports, 91 percent of power transformer exports and 60 percent of power circuit breaker exports. Epstein, p. 32.
Economics pressed for linking assistance to purchase of German goods and services. In 1963, the German government announced that all capital assistance from Germany would be project-tied. Procurement restrictions rapidly became the general practice, even among countries not facing balance of payments constraints. The expansion of foreign assistance programs and the inherent difficulty in separating the commercial motivations of donors further muddied the distinction between aid and trade credits.

The beneficiaries of official export credit exploited the growing export credit competition. The ability to demand more favorable terms became easier as the manufacturing bases of Europe and Japan recovered. Soon there was excess capacity, which worked to the advantage of buyer countries. Buyers were also able to use a variety of administrative mechanisms as a point of leverage. One strategy was to make import licenses contingent on financing terms. The developing country governments let it be known that licenses would only be granted to firms that brought favorable financing packages. Broader political considerations were also used to secure more favorable terms. For example, Latin American countries believed that since they had cooperated with the United States during the war at some hardship to their economies, including the cost of rising prices and depletion of material resources, they had a legitimate claim to financial assistance. To ward off more excessive demands, the Eisenhower

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218 John White, “West German Aid to Developing Countries,” *International Affairs*, vol. 41, issue 1 (January 1965), p. 82.

219 These conditions were motivated in part by balance of payments difficulties that most developing countries faced. Foreign credit lines on deferred payment plans eased these constraints and therefore became highly prized. As Claudio Segré noted in his 1958 study: “Companies have learned from experience that the payment terms often count, in the eyes of exchange control authorities, as much as the priority of the proposed investment.” p. 125.

220 Behrman, pp. 455.
Administration increased U.S. Ex-Im Bank’s lending authority and lent its support to loans pending in the region.

Developing countries also played on Washington’s desire to support the establishment of free and independent governments and counter what was viewed as a growing Sino-Soviet economic offensive. In the 1950s, the Soviet Union began providing long-term loans at rates of interest lower than those available from international agencies or from the United States. From 1955 to 1965, the number of economic cooperation agreements that the Soviet Union signed with countries expanded from two to twenty nine. The lack of rules governing financing terms raised concern over the potential for extortion. A former U.S. diplomat warned in 1958: “Engaged in competitive co-existence without ground rules of any kind, both the United States and the Soviet Union are exposing themselves increasingly to blackmail from underdeveloped countries in quest of foreign aid.”

The multinational firms engaged in exports also contributed to the competition by bringing stories from the field of the lavish support competitors received from their governments. The veracity of these tales were difficult to judge, but they were politically potent nonetheless. An observer of the situation in Europe in 1959 captured the pressure that exporters placed on their governments to do more:

Competition among European countries is generated by pressures of internal industrial groups, public and private, on their respective

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Authorities to obtain an increase of global medium and long term facilities … (and) reduction of rates of interest and the extension of periods of settlement. They say they would lose important contracts, auction or orders if they lacked the finance that foreign competitors could easily find elsewhere, an argument that is highly debatable because it is advanced in almost all countries exporting capital goods. This competition is kept alive by the skill with which entrepreneurs and even official circles in importing countries manage to propagate the most fantastic tales of facilities obtained in this or that exporting country (instances of this nature are endless), tales having the sole aim of creating an atmosphere of mistrust and suspicion which is liable to endanger cooperation among European countries, but succeeds in extracting a few concessions from one or another and breaking up the united front, where this exists.222

From the mid-1950s onward, European exporters pressed their governments to extend the repayment periods on official support beyond five years. A common justification was that the U.S. Export-Import Bank’s development loans were permitting American exporters to sell on terms that European suppliers could not match. This was even truer of soft loan programs introduced after 1954 that issued dollar loans that could be repaid over a period of 30 to 40 years at low-interest rates and in local inconvertible currency.223 Exporters from Germany lobbied for long-term export credit insurance that would enable them to secure bank financing on similar terms. In a 1956 memorandum to its government, the Confederation of German Industries specifically recommended the creation of an institution similar to the Export-Import Bank to finance export credits with

223 Baldwin, p. 40.
maturities exceeding five years. These lobby efforts met with a sympathetic response.
The German government designated Kreditanstalt für Wiederaufbau (KfW), the agency
charged with domestic post-war financial reconstruction, to expand its responsibilities to
include long-term export credits. In 1961, KfW was designated the official executive
agency for the German foreign development aid program. That same year, the United
Kingdom and Italy introduced a system for direct credits to foreign buyers in excess of
five years for large capital projects including ships, steel mills, and pipelines. By 1962,
Belgium, Denmark, Sweden, and the Netherlands had also introduced longer term export
financing programs.

While European governments were expanding the reach of their official finance
programs in response to the competitive threat posed to their exporters by the U.S., the
need to retain competitiveness was being sounded in Washington. Westinghouse Electric
Corporation organized a group of U.S. companies to resist measures by the Eisenhower
Administration that were viewed as weakening the Ex-Im. The group found a
sympathetic hearing in Congress. A study by the staff of the Senate Committee on
Banking and Currency found that Ex-Im’s programs, far from being excessive, did not
meet the immediate credit needs of capital goods exporters, who were increasingly
concerned about European competitors supported by financial assistance from their
governments. These concerns about competitiveness were taken up by the Bank itself,
which argued that it was uniquely able to serve the national interest and meet the

224 United Nations, Export Credits and Development Financing, vol. 1 and 2, Department of Economic and
225 The background and content of ‘A study of the Operations in Latin American Countries of the Export-
Import Bank and their Relationship to the Expansion of International Trade’ by the Senate Committee on
Banking and Currency is recounted in Becker and McClenahan, Jr. pp. 97-104.

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practices of other governments. Testimony in 1955 by the president of the Ex-Im Bank before Congress is typical of the arguments made before Congress:

Within the last two years the situation in the foreign trade field has changed from a seller’s market to a buyer’s market. Manufacturers of other countries, principally the countries of Western Europe and Japan, are now offering extended terms of payment to potential foreign customers. In many instances they are able to do this only because of financial assistance from their own government in the form of export credit insurance.\(^{226}\)

From this time onward competitiveness became a central feature of domestic debates over official export finance. Not only was it used successfully to blunt the Eisenhower Administration’s original plan to limit Ex-Im’s mandate, but it also served as part of the rationale to expand the scope of programs offered by the bank. Even when the goal of an expansionist trade policy was embraced to resolve the growing balance of payments and decline in American gold stocks, the policy was presented in terms of the need to maintain competitiveness. This need was underlined in a special address by President John F. Kennedy to Congress shortly after he entered office in 1961. Kennedy identified Ex-Im Bank as a key actor in expanding U.S. exports, warning that American export guarantees and financing were not adequate nor “comparable to those offered by foreign countries, especially those offered to small and medium-sized exporting concerns.” He specifically directed the President of Ex-Im to establish “a new program

\(^{226}\) U.S. Congress, House, Committee on Appropriations, *Hearings, Supplemental Appropriations Bill*, 1956, 84\(^{th}\) Congress, 1\(^{st}\) Session, 1955, p. 3.
to place our exporters on a basis of full equality with their competitors in other
countries.”

One reason that concerns about competitiveness could be raised with such
potency on both sides of the Atlantic was the variation in their respective export
financing programs. The U.S. program was heavily orientated toward loans provided
directly to buyers; therefore, exporters could argue that they were at a competitive
disadvantage because of the lack export insurance. The situation in Europe was more or
less the reverse. Most countries had strong insurance programs but lacked direct loans
and in some cases guarantee facilities. Since no government offered a comprehensive
array of financing services, it was possible for each side to claim to be at a competitive
disadvantage. Under these conditions, it was difficult for governments resist domestic
demands for expanded coverage to cover gaps, lest their exporters be placed at a
competitive disadvantage. This dynamic played out through the late 1950s, so that by the
early 1960s the scope of official financing had expanded significantly among the major
industrial countries.

Attention turned to the Berne Union as export credit competition intensified. To
many, the organization initially appeared to provide a ready forum to work out
harmonized credit terms and enforcement mechanisms. However, these efforts ultimately
failed. By the early 1960s, the organization had gained a reputation for ineffectiveness.
In a June 1961 meeting in Vienna, the Berne Union issued a communiqué stating: “The

227 Quoted in Becker and McClanahan, Jr. p. 113.
meeting reaffirmed that Berne Union members would continue to co-operate in restricting any general lengthening of terms of credit beyond five years in their field of operation.” This statement caused the Economist to quip: “The innocent may blink at this apparently sanguine extract form the communiqué: has the five-year limit not been breached wide open?”

The magazine further noted a sense of defeatism among members arising from their inability to make their agreements stick: “The atmosphere at Vienna appears to have been that of quiet resignation rather than outraged protest.”

The Berne Union is a closed organization, and its archives have not been made open to the public. A full accounting of what transpired at meetings during those critical years is therefore not available. However, secondary sources from accounts written by participants in the meetings and reports on export credits by international agencies in subsequent years suggest the general outline of what transpired. Members of the Berne Union attempted to manage the growing competition by setting terms and conditions on official credits. They agreed that commercial credits for capital goods should be limited to five years, with a down payment of at least 20 percent. However, the scope of this rule became a matter of dispute. A number of members argued that the five-year credit limitation should only be applied to suppliers’ credits and not to buyers’ credits. This interpretation gave countries that were unwilling or unable to provide soft long-term loans a way of meeting the competition caused by the U.S.’s introduction of

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229 Requests for access to the Berne Union’s historical records for this research were denied. This is consistent with the experience of other researchers. As Daniel Marx noted in 1963, “Exceedingly little is published about the Berne Union whose meetings are conducted with utmost privacy.” Footnote 33, p. 268.
230 Joan Pearce, Subsidized Export Credit, p. 42.
development loans. The consequences were predictable. Data supplied to the Berne Union from members indicated a 10-fold increase in the number of transactions exceeding the 5-year limit. In 1960, members reported a total of $78 million in credits beyond 5 years; by 1963 this figure had grown to $709 million.231 Given the incomplete nature of reporting, the actual number of transactions that breached the guidelines was undoubtedly larger.

In addition to the effort to setting common standards, measures were also taken to enhance the organization’s monitoring and enforcement capabilities. In 1953, members agree to hold regular consultations in which the members exchanged information and views on export credit operations in general, as well as on individual transactions. In 1958, members formally adopted procedures for question-and-answer, which gave each member the right to question any other member on the contemplated terms and conditions being negotiated for an insurance contract. Steps were taken to further improve these procedures at the extraordinary general meeting at Berne in January 1960 and the Management Committee meeting in Paris in April 1965.232 In 1962, members agreed to compulsory disclosure of ‘tied’ buyers’ credits.233 In practice, information was provided on a post hoc basis and was often incomplete, if it was supplied at all. The question and answer procedures also proved to be insufficient to instill adequate discipline within the group.

231 United Nations, Export Credits and Development Financing, vol. 1 and 2, Department of Economic and Social Affairs, United Nations, New York, 1967, p. xii. It is unclear if these figures include the United States.
233 IMF Staff Papers, p. 61.
Two explanations have been commonly advanced to explain the Berne Union’s inability to control competition among export credit suppliers and the bargaining power of buyers. One explanation concerns the weak negotiating authority of the Berne Union participants. The group brought together representatives of government-owned ECAs, as well as private providers of export finance that managed business on behalf of their governments. However, it did not include treasury ministries or other government bodies that had final authority over export credit policy. As a result, representatives attending Berne Union often did not have the authority to make binding commitments. The lack of broad policy authority made it difficult to resist when these institutions were directed by their governments to offer financing terms that went beyond the terms recommended by the Berne Union. A 1967 study of export credit practices by the United Nations noted this weakness:

"the fact that governments are not bound by [Berne Union] understandings has also seriously impeded the smooth functioning of the question-and-answer procedure; a member institution may answer that it does not intend to insure a particular transaction on certain terms, and yet subsequently proceed to do so on instructions from its government, with the result that the transaction is concluded before other interested member institutions have had a chance to learn of the new decision and enable potential suppliers in their own country to complete by offering similar terms."\(^{235}\)

Another explanation concerns the group’s limited membership. The Berne Union gained members through the 1940s and 1950s. By 1950, ECAs from Canada and Sweden

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\(^{234}\) Moore, "Export Credit Arrangements," p. 158.
\(^{235}\) United Nations, *Export Credits and Development Financing*, p. 27.
joined founding members France, Italy, Spain and the UK. However, actors with a large share of the market remained outside the group. The Export-Import Bank became an associate member in 1951 but did not acquire full membership until January 1962. The Export Insurance Division of the Ministry of International Trade and Industry (EID/MITI) became a member, but the Japan Export Import Bank (JEXIM) did not.\textsuperscript{236} The Istituto Nazionale delle Assicurazioni of Italy did not become a member until 1960. The membership limitations were not for a lack of trying. With the idea of constraining the U.S. from extending 5-year terms, the European members approached the Ex-Im Bank and requested that it cooperate with the Berne Union.\textsuperscript{237} Japan was also asked to join several years later, but the Soviet Union was not, despite evidence that its behavior contributed to the credit race at the time.

Cartel theory predicts that the presence of a significant fringe of undisciplined suppliers will make it difficult to constrain competition. Several studies have explained the effectiveness of the Berne Union in similar terms. The United Nations study cited above noted this problem by stating: “The Union’s power to act effectively was impaired from the outset by the fact that export credit institutions in a number of industrial countries, which controlled a relatively large part of the world supply of capital goods, were either reluctant to join it or were willing to become associate members only.”\textsuperscript{238} The problem was noted even more forcefully by a report published by the Royal Institute for International Affairs: “The greatest incitement to breach the understanding came

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\textsuperscript{236} Personal communication, Tadashi Maeda, Special Advisor to the Board of Directors, Japan Bank for International Cooperation, December 8, 2003.
\textsuperscript{237} Moore, "Export Credit Arrangements," p. 141.
\textsuperscript{238} Ibid, p. 27.
\end{footnotesize}
from competition with countries that were not members, such as Japan until 1970, and so were under no obligation to keep to the understanding.” 239

Although it has received less attention, the Berne Union’s membership also limited the forms of financing that could be regulated. Since the organization was limited to ECAs, agencies administering other forms of OTF were not apart of the deliberations. It was difficult for the group to effectively discuss long-term development loans and other types of foreign aid, which were an increasingly becoming a source of friction. This left Berne Union largely powerless to place limits on concessional credits, even though commercial and developmental credits had become a growing source of competition between countries.

As cartel theory predicts, weaknesses in authority, membership structure, and issue coverage undermined the Berne Union’s ability to make credible commitments. As cartel theorists have both noted, if cooperation is ever to emerge, each competitor must convince the other that it is serious and that it will match cooperation with cooperation and defection with defection. 240 The Berne Union lacked these capabilities. Members were unable to resist directives from their government to finance projects on terms beyond what the Berne Union statements permitted. They lacked the authority to establish and effectively use reserve capacity to match competitors strategically in ways that would effectively advance agreement. More significantly, the institution

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239 Pearce, *Subsidized Export Credit*, p. 42.

distinguished sellers from buyers but operated with too large a fringe, since it was unable to bring some of the largest sellers within its purview.

In short, the Berne Union was an ineffective cartel. Without an *ex ante* information sharing system, members operated in a fog. Effectively, matching of competitor’s terms and conditions was at best hit-or-miss. Agencies were susceptible to exaggerated claims of exporters and developing buyers. Some agencies responded by liberal “matching” policies that won the support of exporters, but at increasing expense to their Treasury Departments. Those agencies that responded more cautiously, may have won praise for better management of the public purse, but risked attacks from large, exporting firms, which were often large employers and politically well-connected. The inability of the Berne Union to promote the exchange of accurate information among supplier states meant that targeted strategic retaliation that could be used to further an agreement on fixing terms and conditions on credits was not possible.

After 1962 the Berne Union increasingly took on the characteristics of an international trade association. It continued to play a role in export credit finance but one largely limited to establishing guidelines for short-term credits—an area much less subject to government competition. It also continued to serve members as a clearinghouse for information. It was only after the Berne Union dropped the pretense of regulator of export credit competition that its membership criteria began to change. This process took time, but by the end of the 1970s, the institution had shifted from being an exclusive club to a more inclusive group. By 1980, it had 38 members from 29 countries.
including India, Israel, South Africa, Hong Kong, Argentina, Korea, Singapore, Mexico and Cyprus. The former Chairman of the U.S. Ex-Im Bank, John Moore described the transition:

A considerable debate occurred within the Berne Union in the 1970’s as to whether the Union should be a club of the European, North American, and Japanese members or whether it should include the agencies of the developing countries as well. As the breadth of the membership of the developing countries shows, it now appears fairly well established that the Union will be open for membership by an export credit guarantor or insurer meeting the requisite size, experience, and coverage requirement, and paying dues.\(^{241}\)

The Berne Union’s membership has continued to expand. In 2000, the organization could claim a total of 51 members from 42 countries.\(^{242}\) The shift from an exclusive forum to a more open forum is understandable. Once the Berne Union was no longer viewed as a viable forum for regulating competition, membership restrictions lost their rationale.

**OECD Export Credits Group**

As the inability of the Berne Union to regulate export credit competition became increasingly apparent, governments turned their attention to the OECD. For several years, export credits were an agenda item within the Organization for European Economic Cooperation (OEEC), which was established to administer European

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\(^{241}\) Moore, John L. Jr., "Export Credit Arrangements," p. 141.

participation in the Marshall Plan. In 1955, the OEEC adopted recommendations against artificial aid to exporters. This work was carried over when the OEEC was reconstituted in 1960 as the Organization for Economic Cooperation and Development (OECD). The newly christened organization brought together industrial countries from Western Europe, Canada and the United States. Japan joined the organization in 1964, bringing total membership to 21. In 1963, the OECD Trade Committee established a committee to address export credit issues called the Group on Export Credits and Credit Guarantees or Export Credits Group (ECG). The ECG was directed to evaluate national policies relating to export finance and insurance and to mitigate conflicts through multilateral cooperation.

The ECG offered important advantages over other forums in accomplishing this mandate. Unlike the Berne Union, the ECG brought together representatives of government who had the authority to make binding decisions regarding export credit practices. Member countries sent delegations made up of representatives from several ministries to attend the ECG’s biannual meetings. The team representing the United States typically included one or more representatives of the Department of Treasury, Ex-Im Bank, the Commerce Department, and, depending on the issues at hand, the State Department, Trade Representatives Office and U.S. Agency for International Development. Other countries practiced a similar multi-agency approach, as well, sending at the very least representatives of their ECA and treasury ministry. The broader

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243 Initial OECD member states included: Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States.
244 Pearce, p. 43.
245 Moore, "Export Credit Arrangements," p. 159.
representation increased the likelihood that commitments made in Paris would be credible and helped to avoid the commitment problems that plagued the Berne Union.

As a grouping of industrial countries, the OECD captured a dominant share of global OTF and related export industries. In 1960, OECD countries constituted two thirds of world exports, a figure that has remained roughly unchanged through 2000, despite a dramatic increase in the total volume of trade. More significantly for export credit competition, the countries belonging to the OEDC brought together all the important suppliers of aircraft, power plants, machine tools and other categories of large manufacture goods. By bringing together a large market share, the institutional arrangement met a key condition needed to establish a stable cartel.

As a club of the rich industrial countries, the OECD also conveniently separated lenders from borrowers. This arrangement avoided the problem of negotiating in the presence of developing countries, which had contrary economic interests. It also excluded the Communist Bloc countries. The Soviet Union continued to be influential in Eastern Europe within the Soviet’s direct sphere of influence. Some studies estimate that Soviet subsidization grew from less than a quarter of a billion dollars per year in the early 1960s to over $10 billion per year in the late 1970s and early 1980s. Outside of this area, however, Soviet competition was of decreasing significance in nearly all categories.

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of goods with the exception of military equipment. From the 1970s onward, rather than competitors, Communist bloc countries became increasingly large importers of western capital goods and agricultural goods and therefore leading users of official export credits. Thus, the fringe of export credit suppliers that remained outside the OECD countries was relatively insignificant, further ensuring that efforts to constrain credit competition would be successful.

The enhanced authority and market control created by cooperating through the ECG improved the group’s monitoring and enforcement capabilities. One important step was the establishment of the Exchange of Information System in 1972, which permitted member governments to cable one another regarding credit terms and conditions. This system was upgraded in the 1980s to a computerized network known as the On Line Information System (OLIS). Another important step was an agreement to report all export credits over five years on an *ex ante* basis. These mechanisms gave participating states a way to obtain details of the terms being offered directly from competing governments, rather than from exporters or buyers, who could be less reliable sources of information. They also improved enforcement by creating a more reliable way

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249 The importance of establishing systems to monitor jointly the terms and conditions of each member’s export credit offers was well understood, if long in coming. This is evidenced by a 1958 OEEC statement calling for improvements in the reciprocal exchange of information: “the governments of each Member country shall communicate, confidentially and subject to reciprocal treatment, to the government of any other Member country so which requests, the financial results of export risk insurance operations practiced by the government or by institutions controlled by it.” Quoted in Ray, “The OECD ‘Consensus’ on Export Credits,” p. 297.

for members to match derogations from mutually established terms and conditions.

Although far from perfect, members found exclusive information sharing and matching to be a more efficient and effective means of enforcing credit terms and conditions than adopting third party adjudication procedures.251

Finally, the ECG was not subject to ratification or public disclosure rules. The members of the group set their own rules, including the policy of selective transparency. Members concentrated on improving exchange of information but not with outside parties. Deliberations of ECG meetings held at the OECD’s headquarters in Paris have been kept strictly confidential since the group’s founding.252 This included the contents of negotiations, as well as information on credit terms and conditions. The high levels of confidentiality stand in contrast to the DAC, which has adopted more open policies regarding the dissemination of information gathered from suppliers on ODA flows. Unlike the DAC, participants have used business confidentiality to shield official export credit information from release. The differences can be explained by the different institutional demands that exist between policing within a cartel-like institution and cajoling greater global public goods contributions.


252 Personal communication, Bob Crick, Chairman, Participants to the Arrangement on Guidelines for Officially Supported Export Credits. June 11, 1999.
The Arrangement was not an act of the OECD Council and therefore never became a formal legal instrument of the OECD. Instead, it was considered a "gentlemen's agreement" concluded directly between its participants, to whom the OECD simply provided secretarial services. Export supplier states, including Australia, Finland and New Zealand, which were not a part of the original agreements, were pressed to join in 1977 and 1978. These efforts eventually brought the total participants to 22 countries. The informal nature of the agreement avoided the time and challenges of formal ratification. It also helped to keep the agreement out of the public spotlight. The text of the agreement was regarded as confidential and not made public until six years after the Arrangement was formalized.

The institutional advantages that the ECG offered largely remained latent through the 1960s. During this period, export credit competition was viewed as a problem, but not one that was considered acute by all states with a large share of the OTF market. The most significant obstacle to stricter controls was the limited interest of the U.S. and to a lesser extent Canada. At the time, both countries enjoyed a significant cost advantage in extending credit. Through the 1960s, US 10 year government bond rates averaged

254 Efforts by private attorneys in the U.S. to obtain the text under the U.S. Freedom of Information Act were rebuffed by the U.S. government, which stated: "The Arrangement is not a treaty, but an informal undertaking by several of the member states of the OECD which is subject to modification at any time. Therefore, the text has been classified Confidential by the OECD, by agreement of the member countries and cannot be disseminated to the public." This OECD classification is respected by the U.S. Government as "Foreign Government Information" pursuant to Executive Order 12356. Accordingly, the text is exempt from release under the Freedom of Information Act, 5 U.S.C. [§]552(t)(1). See David Simon, "Can GATT Export Subsidy Standards Be Ignored by the United States in Imposing Countervailing Duties?" Northwestern School of Law Journal of International Law and Business, vol. 183 (Summer 1983), note 36, p. 194.
255 The disinclination of the U.S. to accept stricter rules during this period has been noted by several authors including Pearce, p. 43; and Ray, Managing Official Exports, p. 51.
4.67 percent compared to an average of 6.25 for France, Germany and the UK. This gave the United States an average of 1.57 percent lending advantage over its three largest rivals.\textsuperscript{256} The U.S. Ex-Im was profitable during this period, and losses were extremely small. From 1934 to 1970, U.S. Ex-Im supported more than $32 billion in exports but had a loss ratio of less than 0.02 percent.\textsuperscript{257} The bank’s steady earnings meant that it was able to pay out consistent dividends to the treasury. In addition, aid fatigue had not yet set in, and popular support for U.S. foreign assistance was at its zenith. This meant that officials and exporting firms had few complaints. The status quo suited both parties well. Under these conditions, the U.S. had little interest in fixing credit terms and conditions at the international level.

Global economic conditions changed dramatically in the 1970s, shifting the interest of suppliers toward a common agreement. Urgency was created by the macroeconomic impact of the oil shocks and the stagflation that followed in many industrial countries. As indicated in Figure 5, the government’s cost of borrowing rose in every industrial country, in many cases dramatically. The U.S. government’s cost of borrowing rose from less than 5 percent during the 1960s to nearly 8 percent in mid-

\textsuperscript{256} A straight comparison requires some caution, since the U.S. and European approach to official credit financing remained different. However, the long-term bond rate offers a general indicator of the basic competitive differentials that existed through the 1960s. Calculated from International Monetary Fund, International Financial Statistics Online, 10-year bonds, http://ifs.apdi.net/imf/ data retrieved January 2, 2004.

1970s, reaching a peak of 13.9 percent in 1981. The effects were as dramatic or more so in Europe. By 1974, rates had climbed to over 10 percent in France and Germany and to nearly 15 percent in the United Kingdom. Italy experienced the most dramatic increase, where rates climbed throughout the decade, eventually spiking to beyond 20.5 percent in 1981.

At the same time, the changing economic environment caused developing countries to demand better financing terms. First, the majority of developing countries were not oil producers. They did not benefit from higher oil export revenues but rather faced substantially higher oil import bills that drained their economies. The current
account position of these countries worsened dramatically as did total net debt.\textsuperscript{258}

Second, economic stagnation among industrial countries depressed commodity prices and therefore the major source of developing country export earnings. Third, the increase in interest rates among the industrial countries drove up financing costs for capital goods and military and agricultural imports. Together, these developments drove developing country officials to try to contain financing costs. To hedge against the risk of rising interest rates, LDC officials increasingly demanded long-term, fixed rate loans. Commercial banks, which funded their lending on shorter terms and therefore ran substantial funding risk by lending at fixed rates, were unwilling or unable to offer such terms, further spurring demand for official sources of financing. Buyers found that driving hard bargains with OTF suppliers in alliance with exporting firms could be rewarded in large amounts of savings over the life of the loan for large ticket items.

From the perspective of export credit suppliers, subsidization is only attractive if no other state is willing to offer matching terms. But other states were willing to match and overmatch in order to defend their exporter’s market position. Realizing that the cost of export credit competition was only likely to grow, the ministries of finance of the major supplier states agreed to take more forceful countermeasures. The description of the motivation and steps taken jointly by supplier states provided years later by the chairman of the Group on Export Credits and Credit Guarantees from 1973 to 1976 is revealing. His account suggests that 1) buyers were a target of the agreement just as

much as competing OTF suppliers were, and 2) European governments, not the U.S., were the first to press for an agreement:

In 1973, during the Nairobi conference of the International Monetary Fund, the ministers of finance of France, Germany, Italy, Japan, the United Kingdom and the United States agreed to consider concerted action by the exporting countries as to limit the excessive bargaining power of the buyer countries. At the Rome conference, which followed in January 1974, the German Finance Minister Helmut Schmidt took the initiative by inviting high-level experts to a meeting in Bonn on 7-8 February. It was there that the German chairman proposed consideration of a kind of “gentlemen’s agreement” with a minimum interest rate of 7 percent for subsidized parts of export credits and a maximum repayment period based on European practice.259 (emphasis added)

The secret meetings in Nairobi, Rome and Bonn were followed by a series of negotiations among the major export credit supplier states that eventually culminated in the 1978 Arrangement. In May 1974, OECD ministers signed a “trade pledge” in which they agreed to “abstain from destructive competition in official support of export credit” and take “appropriate cooperative actions to this effect in the immediate future.”260 In 1976, the U.S. joined Germany, France, Italy, Japan, and UK in reaching a ‘standstill’ agreement that set a floor on export credit interest rates and tenor. This agreement was expanded and formalized in 1978 to become the Participants to the Arrangement on Guidelines for Officially Supported Export Credits.

Heightened friction in North-South relations may also explain the efforts of supplier states to keep the credit negotiations secret. The 1970s ushered in a period of collective demands by developing countries to change the terms of economic exchange with the wealthy industrialized countries from market based allocation to more authoritative government allocation. The broad framework for these demands was presented in a proposal for a New International Economic Order (NIEO), which aimed to increase the transfer of resources from the developed to the developing world through a program that included rescheduling of debt, transfer of technology, controls on transnational corporations and larger aid commitments. One plank of this effort proposed a plan to stabilize commodity prices in order to halt worsening terms of trade experienced by many developing countries. The United Nations Conference on Trade and Development (UNCTAD) was used as a platform to press for the established mechanisms such as the Common Fund. At a conference in Nairobi in 1976, developing countries presented a proposal known as the “Integrated Program for Commodities,” which proposed the establishment of a ‘Common Fund” to finance commodity agreements for eighteen commodities. Proponents sought $6 billion to capitalize the fund and finance buffer stocks that could be used as an instrument to control prices. The fund would be tapped to buy from the market when prices fell below set brackets and sell when prices rose above these levels. These initiatives failed, however. Efforts to control commodity markets received a cool reception from the industrial countries. Commodity cartels were


262 These commodities were: bananas, bauxite, cocoa, coffee, copper, cotton, hard fibers and products, iron ore, jute and products, manganese, meat, phosphates, rubber, sugar, tea, tropical timber, tin, and vegetable oils.
viewed as protectionist and counter to free market ideals. The initiative floundered when developing countries could not raise the contributions required to capitalize the fund. The developing countries found they needed the industrial countries to fund the commodity cartel’s enforcement mechanism, but as the most important buyers, the industrial countries had little interest in doing so.

The change in Washington’s stance towards limiting credit competition made it possible for major credit suppliers to reach a collective agreement. Initially an obstacle to agreement, the U.S. had moved to the forefront in demanding that supplier states adopt stricter financing disciplines and monitoring procedures by 1976. Several factors contributed to Washington’s reorientation. One was a growing concern about its declining international export competitiveness. By the 1970s, the U.S. no longer held a position of unrivaled economic dominance. In 1972 its share of export trade among OECD countries had fallen to 18% compared to 26 percent in 1960. The size of the U.S. domestic market still gave U.S. manufacturers formidable advantages in economies of scale relative to European and Japanese competitors. The price competitiveness of export finance also remained favorable. Throughout the 1970s, Ex-Im continued to maintain an absolute cost advantage over its major European rivals by as much as 300 basis points or more. The depth of the U.S. bond market also made it easier for Ex-Im to offer long-term financing. However, there was diminishing confidence that U.S. exporters could compete in the face of unbridled subsidization.

For an insightful account of industrial country reactions to the Common Fund proposal see Edmund Dell, “The Common Fund,” International Affairs (Royal Institute for International Affairs), vol. 63, No. 1 (Winter, 1986-87), pp. 21-38.

As the decade wore on, the cost of matching competing financing offers began to erode Ex-Im’s financial position. Ex-Im had a statutory mandate to provide competitive financing for U.S. exporters; however, the bank also had a long-standing policy of financial self-sufficiency. From the time the bank was established, there was little political support for turning Ex-Im into an expenditure agency. Through the 1960s it was possible for Ex-Im’s administrators to be competitive and financially prudent with little conflict. The bank could lend at competitive rates while (?) receiving direct appropriations. However, this became less and less possible in the early 1970s as the negative spread between lending and borrowing rates grew. The Bank’s income fell precipitously from 39.3 percent in 1970 to just 4.3 percent in 1975. As the profitability of public export credits deteriorated, a consensus emerged in Washington that international credit rules were necessary to stop subsidy competition from exposing Ex-Im to potentially serious operational losses, which would have to be met through cash infusions from the Treasury and, ultimately, taxpayers.

A reorientation of the U.S. foreign aid policy also caused Washington to look more favorably on strengthening the distinction between trade and aid financing. By the 1970s, the imperatives of European and Japanese economic reconstruction were long

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past, and the original optimism that drove economic interventions in the developing world was fading. Military rivalry with the Soviet Union continued, but direct economic competition in the developing world was on the wane. Finally, in the wake of Vietnam, skepticism about political returns to large aid expenditures had become widespread. To shore up faltering political support, the U.S. Congress radically revamped U.S. foreign aid policy in 1972. Budget allocations that had subsidized capital goods exports were dropped. The New Directions mandate adopted in 1973 shifted the focus of U.S. foreign assistance policy toward education, social services and other human basic needs, and away from the subsidization of large capital goods exports. These changes were viewed as a way to enhance the developmental orientation of U.S. foreign assistance and reduce the cost of American commitments abroad. However, they left the U.S. without concessional lending instruments that could match other governments in developing country markets. Without the policy environment that had supported the large concessional lending programs of the 1950s and 1960s, U.S. policy makers had few options but to try to develop international rules that would restrict the ability of trade rivals to use their concessional programs in ways that were detrimental to U.S. business interests. These interests coincided with a growing academic literature that was increasingly critical of tied aid and commercially-driven export subsidies.

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270 Examples of this literature include works by Bhagwati, Baldwin and others cited in Chapter 2, pp. TK. For a competing view that trade promotion be more closely integrated with development policy see Nathaniel McKitterick, and B. Jenkins Middleton, *The Bankers of the Rich and the Bankers of the Poor: The Role of Export Credit in Development Finance*, Washington, D.C., Overseas Development Council, No. 6, 1972.
The agreement reached by suppliers helped to contain an all-out credit price war, but it was by no means complete. There were sectors and types of financing that continued to be unregulated. The agreement applied to credits provided by commercial banks that were subsidized by the government through interest make-up schemes, but not to “pure cover” transactions guarantees and insurance. It covered most but not all manufactured goods. It did not cover highly concentrated oligopolistic industries including nuclear power plants, civil aircraft, ships and military goods. It also excluded grains, fruit, oils and other agricultural exports. It did not apply to other forms of official financing, including mixed credits, risk premium fees, or market windows. The result was not an end to subsidization, but the stabilization of subsidization. Looking back at this early agreement Axel Wallen, a former chairman of the ECG wrote: “In those days, one could really ask whether the purpose of the Arrangement was to give free way for bigger and bigger subsidies.” \(^{271}\) However, the ECG did provide institutional arrangements that supplier states found not only more effective than the Berne Union but also more effective than the General Agreement on Trade and Tariffs and its successor the World Trade Organization.

**GATT/WTO**

As the world’s principal trade regulatory and dispute resolution body, the GATT/WTO has been the focus of ongoing attempts to address the problems and conflicts within industry arising from government aid. Successive rounds of negotiations

have established stricter rules regarding subsidies. However, the provisions that applied to export credits and credit guarantees were largely ignored up through the 1970s. Then, in 1979, trade negotiators effectively removed the GATT/WTO from the equation by delegating export credit rule formation and enforcement to the ECG. It was not until the late 1990s that the relationship between the GATT/WTO and the Arrangement resurfaced. First, this came about in the course of establishing the WTO in 1995. The safe harbor permitted for the Arrangement was included as part of the package of provisions that all member countries were asked to accept. This prompted some of the 116 countries that were not part to the Arrangement to complain that they were being asked to accept the terms of an agreement that they had no part in establishing and which was run as a separate body in which they had no representation. Second, it came about through a bitter dispute between Canada and Brazil, the former a member of the ECG and the latter not. Given the central role the GATT/WTO has played in regulating world trade, the puzzle that must be addressed is why it has played such a limited role as a forum for regulating export credits. This section reviews the evidence, which suggests that the reason can be found in that institution’s inability to resolve the problem of complex collaboration or establish countervailing market power to the satisfaction of creditor states.

From the beginning, the GATT treated export credits as a subset of the broader problem of government subsidies in international trade. The basic elements for international subsidy rules were set forth in a paper prepared by the U.S. Department of

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State in 1945 titled "Proposals for Consideration by an International Conference on Trade and Employment."\textsuperscript{273} Strongly reflecting U.S. interests at the time, the paper proposed: 1) prohibition of export subsidies on manufactured products; 2) special and ambiguous rules for export subsidies on non-manufactured ("primary") products; and 3) guidelines for the legitimacy of "domestic" subsidies based upon eventual trade effects rather than on the inherent character of the subsidy itself. The Havana Charter for an International Trade Organization, for which this framework was proposed, never came to pass.

Subsidy provisions appeared in the 1947 General Agreement on Trade and Tariffs but were limited only to notification and consultation procedures. In 1955, the contracting parties eventually accepted rules similar to those that had been proposed in the Havana Charter. These provisions included Article XVI, which prohibited subsidies that resulted in a lower price for manufactured goods on the export market than the domestic market. This established a dual-pricing standard that equated the presence of a lower price in the export market than in the home market with dumping.\textsuperscript{274} The rules related to primary products were substantially weaker: export subsidies were allowed as long as they did not result in the subsidizing country receiving more than an equitable share of the world market.\textsuperscript{275} Only seventeen major industrial countries accepted these provisions, which came into force in 1962.\textsuperscript{276} No developing countries agreed to be so bound.

\textsuperscript{275} Guidance on what did or did not constitute an "equitable share" of the world market was not made clear.
\textsuperscript{276} The countries were: Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Southern Rhodesia, Sweden, Switzerland, the United Kingdom, and the United States.
Specific restrictions relating to official export finance were introduced during this period as part of an effort to clarify the rules for the more general prohibitions against export subsidies. At the urging of France, a GATT working party was convened in 1960 to clarify and strengthen Article XVI.\textsuperscript{277} Unable to develop a consensus on a comprehensive definition of subsidy, the working party devised a list of eight illustrative practices that should be prohibited. Included in this list were practices that have been the basis of GATT/WTO treatment of export credit practices ever since. The relevant provisions from this list defined a prohibited export credit subsidy as: 1) “a grant by governments (or special institutions controlled by governments) of export credits at rates below those which they have to pay in order to obtain the funds”; and, 2) “the charging of premiums at rates which are manifestly inadequate to cover the long-term operating and losses of the credit insurance institutions”\textsuperscript{278}

The effect of these rules was to establish a loose “cost-to-government” standard for determining the presence of subsidies. Although a cost-to-government standard is often portrayed as a market-based standard, it is not. Governments are generally able to borrow at rates that are more favorable than is possible for a commercial borrower. This differential tends to grow as the amount and length of the credit or guarantee increase, making government financing even more attractive for larger, more expensive items.\textsuperscript{279} Substantial benefits can therefore be conferred on borrowers (and exporters) who receive

\textsuperscript{278} General Agreement on Tariffs and Trade, \textit{Basic Instruments and Selected Documents}, Supplement No. 9, (Geneva, February 1961), pp. 186-87.
\textsuperscript{279} Although it is unusual it is not always the case. If a government’s cost of funds is higher than that of the borrower, it will fail to confer a benefit the recipient.
financing supplied on this basis. This is particularly true when the borrower’s credit ratings are weak, since it would be impossible for them to borrow at comparable rates from the private market. The cost-to-government standard was a loose standard in several respects. It implied that ECAs must break even but did not provide guidance as to what this meant in practice. Should it be on a transaction basis or an agency basis? With respect to a time frame, should it be on an annual basis, a ten-year basis or longer? In addition, the definition of long-term operating costs was ambiguous. It did not indicate if this should include the cost of capital, which for most ECAs is zero. In other words, the standard accepted a certain level of implicit subsidization. 280

In political terms these standards were attractive because they set a floor (albeit a rather elastic one) on subsidies, but did not fundamentally challenge ECAs operations. A more demanding standard, based on the rates available from private credit market banks, could have put ECAs out of business. This was something that no industrial country was willing to countenance, given the level of strategic exports that these institutions financed. The cost-to-government standard was strict but not overly so from the perspective of exporters. From a competitive perspective, this standard was particularly attractive for countries that were relatively abundant in capital and had low long-run equilibrium interest rates compared with the rest of the world. 281 The United States has generally fit this description, along with Canada, Germany and Japan. In short, the early

280 The true level of subsidization requires comparing the rate offered by the government lending institution to the exporter as compared to the rate that the exporter would receive from private lenders and/or insurers, or in the case of banks, the cost of additional provisioning in the case of default. Estimates during the 1960s place U.S. Ex-Im’s long-term export credit rates at approximately 2 percent below the private markets, a figure generally considered high compared to Japan and European ECAs, which offered even more favorable terms compared to private sector rates. The 2 percent rate is cited in Baldwin, p. 53. 281 Baldwin, Nontariff Distortions of International Trade, p. 53.
GATT measures are better seen as an effort to rationalize, reduce and codify, but not eliminate, export credit subsidies.

Yet, in practice even these rather lenient rules had a limited effect on export credit competition. By the mid-1970s the GATT’s subsidy provisions were increasingly seen as inadequate and ineffective.\textsuperscript{282} This was true for subsidies associated with export credits as well as for the issue of export subsidies more generally. Critics charged that the few binding obligations imposed were limited in reach, that the kinds or forms of government intervention were inadequately defined, and that the remedies available to injured parties were problematic.\textsuperscript{283} At the behest of the United States, subsidies were added to the issues to be addressed during the Tokyo Round of trade talks (1973-1979).\textsuperscript{284} For the rest of the GATT members, an important issue was restricting the scope of unilateral action available to the United States under its long-standing countervailing duty law. Since U.S. domestic law concerning countervailing measures predated the GATT, the U.S. was not subject to the “material injury” requirements of article VI of the GATT. This meant that other countries had no recourse under the GATT against U.S. countervailing duty actions. There was a strong interest among GATT members in having the U.S. adopt more uniform standards and procedures for the imposition of countervailing measures. This formed the basis for a quid pro quo in which the U.S. agreed to constraints on

\begin{footnotesize}
\begin{itemize}
\item[282] Tarullo, p. 70.
\item[284] At this time there was increasing concern over the growing use of export subsidies as a tool of national economic policy throughout the OECD. See Baldwin, p. 47.
\end{itemize}
\end{footnotesize}
countervailing duties in return for other members accepting greater constraints on the use of subsidies. 285

The U.S. took the lead in drafting the new subsidy provisions. U.S. officials began with an ambitious proposal for a “traffic light” approach to addressing subsidies. Under this scheme subsidies would fall into categories ranging from “green” that would be acceptable and warrant no action to “red” that would be prohibited and be open to retaliatory measures. However, this approach met with strong resistance from European capitals and was eventually dropped in 1976. In 1977, U.S. negotiators shifted to working directly with the European Commission, drafting an outline of an approach that became the foundation for the subsequent agreement. Once an acceptable document was developed, other countries were then brought into the process in the lead up to the Bonn Summit. But this gradual extension meant that developing countries were brought into the process late and had no hand in developing text leading up to the crucial Bonn Summit in 1978. Gilbert Winham later wrote: “The process of pyramidal negotiation ... tended to occur most when the United States and the European Community had a profound but no unbridgeable conflict, as in the negotiations on subsidy/countervail or customs valuation, and it had the effect of excluding the developing countries from negotiations in these areas.” 286

The final agreement of the Tokyo Round concluded in April 1979 strengthened rules on nontariff trade barriers, including barriers related to subsidies. It also contained important changes in the GATT’s treatment of export credits. The final document retained most of the language devised by the 1960 Illustrative list on export credits, which was included in the annex as an “illustrative list” of export subsidies that are subject to the no-subsidy rule. The agreement retained existing language that ECAs should at the very least break even by charging rates sufficient to cover their long-term costs and losses. It also prohibited export credits extended “at rates below those which they have to pay in order to obtain the funds.” However, the negotiators inserted a qualifier and a major exemption. The qualifier stated that subsidies were permitted “in so far” as they are not used to secure a “material advantage in the field of export credits.” This sanctioned the permissibility of ‘official finance’ but not so long as it threatened to injure other exporting countries. This reflected the historic concern with the effects of subsidies rather than their presence per se.

The most significant substantive change came in the form of an exception. Credit practices “in conformity” with “an international undertaking on official export credits” would not be considered a prohibited export subsidy. Although not expressly stated, this international undertaking was understood to be the OECD Export Credit Arrangement. The provision has become known as the “safe harbor” provision, which is widely

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interpreted as making decisions made by the ECG “WTO-proof”. In effect, the provision recognized the ECG as the primary authority for the discussion and elaboration of operational disciplines for export credits and protected countries that were in compliance with its major provisions. This extended to countries that were not a party to the ECG’s proceedings.

The literature on the Tokyo Round glosses over the negotiations specific to export credits, so it is difficult to know exactly how these changes came to be accepted. One of few accounts that touch on this aspect of the negotiations is by Gary Hufbauer and Joanna Erb. They write:

“Although the OECD export credit framework was far more effective than the GATT framework in disciplining export credit subsidies, the OECD norms on interest rates were considerably more lenient than the GATT Working Party standard of ‘cost of money to governments.’ The negotiators in the Tokyo Round thus faced the historical fact that the principal code of discipline in the sphere of export credits had been crafted within the OECD, but the OECD norms entailed a lower standard than the 1960 Working Party Report. By 1979, many countries were unwilling to condemn as export subsidies those practices condoned in the OECD. The Subsidy Code draftsmen thus agreed to incorporate the OECD Arrangement and the OECD Ships Understanding by reference, as a limited exemption from the cost of money to government standards.”

289 For one example of this interpretation see “International Developments in Export Credits and Finance Services,” WTO Considerations, Section XI, Australian Department of Foreign Affairs and Trade at URL: http://www.dfat.gov.au/trade/efic_review/int_dev/section_11.html, p. 2.
290 Hufbauer and Erb. Subsidies in International Trade, pp. 69-70.
This interpretation suggests that simple pragmatic considerations drove negotiators. However, their account ignores the political motivations and the institutional advantages that industrial countries achieved by keeping management of export credits within the ECG. The desire among industrial countries to use the GATT/WTO to buttress their activities in the ECG in lieu of more direct management is not surprising. The GATT had serious institutional disadvantages for containing export credit competition, since it provided a weak institutional basis for establishing countervailing market power.

Compared to the ECG, the GATT dispute settlement process was cumbersome, time consuming, and of questionable effectiveness. The dispute settlement process had lost credibility by the 1970s. This reflected a breakdown in the consensus over rules, as well as the emergence of “blocs” that increasingly pitted the United States, the European Community and developing countries against one another.291 The Tokyo Round brought important improvements, including the elimination of certain procedural roadblocks and the establishment of tighter deadlines for dispute settlement. Even so, the process was still expected take a minimum of 150 days by some of the most optimistic estimates.292 The revised code called on signatories to seek resolution of disputes through a progression of steps, beginning with bilateral consultations, moving through committee-sponsored investigations and conciliation meetings or the formation of working parties, and, finally, the establishment of ad hoc panels that relied on information from the disputants to offer judgments about the relative merits of the positions of the conflicting

291 Rivers and Greenwald, p. 1464.
parties within the boundaries set by the relevant code provisions.\textsuperscript{293} In this amount of time, an exporter could easily lose an aircraft, telecommunications, or other major export order to a rival backed by sweeter financing terms. The nature of trade finance demanded a more responsive dispute resolution system to contain credit competition.

The GATT placed limitations on the remedies available to counter cut-rate export financing. The GATT subjected retaliation to very high standards. Countervailing duties could only be imposed if the effect of subsidization could be shown to cause or threaten material injury or to retard materially the establishment of a competing domestic industry.\textsuperscript{294} The revision introduced in the Tokyo Round also required the U.S. to revise its domestic law so that it also had to follow the GATT's injury test before applying countervailing duties. Irrespective of these new constraints on retaliation, export credits continued to largely involve trade with third countries. The GATT permitted countervailing duties on trade with third countries, but demonstrating injury in these cases was difficult. By contrast, the rules developed through the ECG had no such constraints. Matching procedures incorporated in the Arrangement required no injury test. To match a derogation that had been notified, members only needed to follow certain notification procedures and wait until a short consultation period had lapsed. To match transactions that had not been notified, all a member had to do was to make a reasonable

\textsuperscript{293} Joseph M. Grieco, \textit{Cooperation Among Nations: Europe, America, and Non-tariff Barriers to Trade} (Ithaca: Cornell University Press, 1990), p. 84.

\textsuperscript{294} General Agreement on Trade and Tariffs, Article VI, paragraph 3.
effort to determine whether “non-conforming” terms and conditions would actually be offered.\(^{295}\)

In addition, the GATT did not provide a receptive forum for addressing other types of export financing that were becoming an increasing source of friction. In particular, there were growing complaints from the United States about the predatory use of mixed credits. As noted above, the U.S. had reoriented its aid program away from long-term loans and capital goods support in the early 1970s. Shortly thereafter, U.S. exporters began to complain that mixed credits were widely available to their major foreign competitors and pressured Congress and the Administration to either emulate these programs or to reach an international agreement to contain them. In 1978, the Administration turned to the National Advisory Committee (NAC) to convene a working group to study the mixed credits issue. U.S. Embassies in OECD countries were canvassed to obtain more detailed information on foreign competitor practices. Although there had been little progress in addressing mixed credits in the ECG in 1977 through 1979, U.S. officials held out hope that future negotiations in the ECG could reign in “commercially driven” foreign aid. There was no expectation that this could be achieved through the GATT.\(^{296}\) Developing countries were pressing for more aid to support development goals. Using the GATT to establish rules that would have further restricted


\(^{296}\) Stricter GATT rules do not appear to have even been considered an option. The strategy paper developed by the NAC Working Group on Mixed Credit Financing focuses all of its recommendations on developing stricter rules in the ECG not through the GATT. See “NAC Working Group Report on Mixed Credit Financing in 1976 and 1977,” Memorandum, National Advisory Council, Document 78-275, Office of Assistant Secretary for International Affairs, U.S. Department of Treasury, May 2, 1978.
financing support to developing countries in this environment would have been met with a cool reception, if not with outright hostility.

Another drawback of the GATT concerned the treatment of information. If that forum was to have a chance of succeeding in managing export credit competition, it would be difficult to avoid duplicating the information sharing system that had been agreed to within the ECG. It is difficult to see how it would be possible to monitor and enforce credit disciplines with it. To avoid the problems faced by the Berne Union and the early years of the ECG, this information would need to be provided prior to rather than after a contract was awarded. However, there is little evidence that the major export credit suppliers would countenance the GATT taking on this type of *ex ante* information sharing role. To do so risked releasing key credit information with all GATT contracting parties, including those who were major users of export credits. Responding to the concerns of their exporters, governments would have strongly opposed such measures. The concern over confidentiality even extended to the text of the Arrangement, which was kept confidential for years at the insistence of ECG members. 297

Finally, bringing export credit negotiations to the GATT risked mixing sellers with buyers, whose interests were ultimately in conflict. LDCs generally took the view

297 Request in 1982 for access to official text of the Arrangement under the Freedom of Information Act were rejected by the U.S. Treasury Department which responded: “The Arrangement is not a treaty, but an informal undertaking by several of the member states of the OECD which is subject to modification at any time. Therefore, the text has been classified Confidential by the OECD, by agreement of the member countries and cannot be disseminated to the public. This OECD classification is respected by the U.S. Government as “Foreign Government Information” pursuant to Executive Order 12356.” See David Simon, “Can GATT Export Subsidy Standards Be Ignored by the United States in Imposing Countervailing Duties,” *Journal of International Law and Business*, vol. 5, footnote 36.
that subsidies were a proper and necessary vehicle for development.\textsuperscript{298} Few agreed to sign the Subsidies Code. In the context of heightened tensions between developing and industrial countries over the nature of the global trading system, it was unlikely that OECD countries would have made much progress containing export credit wars had developing countries been added to the mix. As one trade lawyer wrote in 1985: "The whole concept of credit "rate fixing" is anathema to non-OECD members... the LDC's, led by the so-called group of 77 (G77), consider the OECD arrangements to border on the satanic... They, for quite understandable, self-interested reasons, are not enthusiastic about any rule which would have a "chilling effect" upon the willingness of major lending countries to provide cut-rate loans to the Third World."\textsuperscript{299} They also had different interests as exporters. The benchmarks for judging the presence of prohibited subsidies not only advantaged countries with low cost of capital but also those with low sovereign credit ratings.

For all of these reasons, the GATT was an unsatisfactory and unworkable forum from the standpoint of export credit suppliers. Given the opaque language of the safe harbor granted to the ECG in Paris, one wonders if trade negotiators were deliberately seeking to mask the delegation of authority that emerged from the Tokyo Round. The specific language (item k, Annex A) is highly obtuse even for international trade documents. Rather than make explicit reference to the Arrangement, the relevant passage refers to "a party to an international undertaking on official export credits to which at

\textsuperscript{298} Tarullo, p. 64.
least twelve original members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by these original members).” However, a more explicit reference could have inflamed already difficult relations with developing countries. There was already a long-standing history of suspicion and mistrust on the part of developing countries over the GATT’s treatment of subsidies. As Daniel Tarullo observed: “… the United States and other industrial countries appear to have written the rules in their own favor by disallowing manufactured product exports (likely to be granted by LDCs), but permitting some export subsidies on primary products (in which LDCs are more likely to be competitive without subsidies) and also permitting domestic subsidies (which, in the 1940’s and 1950’s, most importantly included farm programs).”

Conclusion

Previous studies have ignored the distributional struggle that stands at the heart of state-backed export finance. Scholars have tended to focus on the conflicts between Arrangement members but have missed the larger struggle between export credit suppliers and buyers. This emphasis has led some to dismiss the idea that the OECD made any particular contribution to addressing the problem of export credit competition. According to Moravcsik, the OECD simply offered a “neutral forum” for negotiations: “The OECD contributed neither a set of metanorms nor opportunities for issue linkage,

300 Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Trade and Tariffs, April 12, 1979, Annex A, paragraph k.
but simply a location for treasury and credit agency officials to continue what they were already doing.\textsuperscript{302} However, this interpretation misunderstands the ways in which the OECD was critical.

The evidence presented in this chapter shows that the interests of suppliers and their ideas about how best to regulate export credit subsidies was not served by just any institutional arrangement. Rather, it was best served by a cartel-like structure, which in turn dictated an important aspect of the regime’s scope.

The OECD emerged as the forum of choice because it neatly did what a regulatory cartel must do to be effective. It offered a way for export credit suppliers to establish countervailing market power against buyers. It offered a superior alignment of sellers against buyers compared to that offered by the GATT/WTO. By bringing governments to the table, the Arrangement offered a level of negotiating authority that greatly improved the chances that agreements would stick. The Berne Union comprised only of ECA representatives was unable to do the same. The Arrangement offered an institutional design that permitted supplier states to engage in selective transparency, exchanging information among members, but not with nonmembers. It offered supplier states a high degree of legal flexibility, which freed them from the type of constraints normally associated with more formal international treaties. At the same time, because the nominal goal of suppliers was to restrict export subsidization on commercial transactions, the exclusive institutional structure did not conflict with norms encouraging

\footnote{Moravcsik, "Disciplining Trade Finance: The OECD Export Credit Arrangement," p. 198.}
free and fair trade. Oddly, the Arrangement served a redistributive cartel-like function for supplier states that was at the same time consistent with conventional welfare economic theories that condemn the distortion caused by predatory trade policies.
CHAPTER FOUR: SCOPE OF REGULATION ACROSS SECTORS

Not all sectors that benefit from official trade finance are subject to regulatory controls. Once established, the Arrangement provided supplier states with the institutional means to regulate OTF. Over the past twenty-five years, members of the Arrangement have used this capability to regulate a range of export sectors. However, the coverage has not been complete, and gaps remain. This chapter focuses on two questions relevant to the scope of the OTF regime: First, why are there general rules for manufactured goods but also special agreements for certain sectors such as ships, nuclear plants, and civil aircraft? Second, why have supplier states been able to regulate capital goods but not agriculture and military equipment?

Supplier states provide OTF to finance a broad range of goods traded in international markets. This chapter begins by examining the scope of rules that apply to general capital goods. General capital goods include items like telecommunications equipment (e.g. radio, television and print media), energy generation and supply equipment (e.g. thermal power stations, pipelines and renewable energy supply equipment); industrial manufacturing equipment (e.g. textile, chemical plants, steel plants); agricultural and food processing equipment (e.g. irrigation equipment, harvesting combines, and milling equipment); water supply and sanitation systems (e.g. desalinization equipment; waste water treatment equipment); and health care related goods (e.g. medical equipment, and search and rescue equipment). Next, the chapter turns to special sector agreements that have been negotiated separately from the main
agreement on export finance. The special sectors include shipbuilding, nuclear power plants and civil aircraft. The second half of the chapter examines two sectors that remained unregulated as of December 2001, focusing first on the agricultural sector and then on the military sector.

In each case, the evidence suggests that state preferences, the satisfaction of cartel conditions and the strength of free trade norms explains the variation in sector coverage more effectively than models that combine the budgetary burden of subsidizing export credits with the hegemonic power of the United States. 303

**Regulated Sectors**

Most manufactured goods are now successfully regulated through the Arrangement. 304 Evidence that major suppliers of OTF had common interests and shared ideas concerning the regulation of export credits for manufactured goods extends back to the 1950s. In the aftermath of the economic dislocations of the 1930s and the Second World War, a consensus emerged across the Atlantic that an open trading system would promote world peace and economic well-being. 305 Trade based on free trade principles

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would avoid beggar-thy-neighbor policies, which had reduced trade and incited retaliation. The application of neoclassical economics to international trade provided a clear causal theory explaining how the removal of protections, including export subsidies, could improve welfare. These ideas were backed by a growing body of work, including James E. Mead’s *The Theory of International Economic Policy*, which set forth the theoretical case for free trade. These ideas helped to create a coherent set of policy prescriptions for the handling of export finance for manufactured goods. These ideas benefited in the early years from norm entrepreneurs like Cordell Hull, who was instrumental, as a Congressman and Secretary of State, in pressing the U.S. to adopt a liberal commercial policy. By the late 1950s, like-minded economists and policy makers from Europe had expanded to form a larger community committed to free trade. There were, however, limits to how widely these norms were accepted. Few developing countries were willing to accept subsidy prohibitions in the face of conflicting ideas about state intervention in nurturing infant industries and economic growth more generally.

The convergence of interest and ideas around export subsidies among the major industrial powers is demonstrated by the attention given to the development of Article XVI 4 of the GATT between 1954 and 1960. It is common to portray the United States as

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Table 2. Market Share of Medium/ Long Term Export Credits

<table>
<thead>
<tr>
<th>Country</th>
<th>1995*</th>
<th>Percent</th>
<th>2000**</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-15</td>
<td>33,699</td>
<td>39%</td>
<td>31,435</td>
<td>44%</td>
</tr>
<tr>
<td>United States</td>
<td>9,039</td>
<td>10%</td>
<td>9,149</td>
<td>13%</td>
</tr>
<tr>
<td>G-7 Countries</td>
<td>50,875</td>
<td>58%</td>
<td>47,853</td>
<td>68%</td>
</tr>
<tr>
<td>Total Arrangement (22 Countries)</td>
<td>60,404</td>
<td>69%</td>
<td>70,800</td>
<td>81%</td>
</tr>
<tr>
<td>World Total†</td>
<td>87,000</td>
<td>100%</td>
<td>70,800</td>
<td>100%</td>
</tr>
</tbody>
</table>

Note: Figure are in millions of US dollars. All OEDC figures have been converted from SDRs (Special Drawing Rights).

*New Medium and Long-term Export Credits, Repayments in Excess of One Year, OECD, TD/ECG(98)12, April 7, 1998.


being at the vanguard of export subsidy control, with France as the recalcitrant laggard. However, it was French trade negotiators who pressed for the permanent implementation of the standstill agreement negotiated in 1954. As recounted by Gerard Curzon, French diplomats took the lead in ensuring the standstill agreement prohibiting subsidies on manufactured products was incorporated into the GATT.\textsuperscript{310} Provisions included in Article XVI 4 were eventually put into practice in 1960. In November of that year, a special declaration was signed among the major exporters of manufactured goods including Austria, Belgium, Canada, Denmark, France, Germany, Italy, Luxembourg,

Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the United States. Japan signed the declaration in 1964. While compliance with subsidy rules under the GATT was weak for the institutional reasons explained in the previous chapter, the collective effort is an illustration of the mutual interest that suppliers had in restricting the use of subsidies as a tool of trade discrimination and the ideas about free trade that backed these preferences.

A final factor that contributed to the application of rules to general manufactured goods was the structure of the market. Underlying market conditions were favorable for sustaining a cartel-like institution in this area. The sectors brought under the terms of the Arrangement were the ones in which industrial countries controlled a dominant share of the market. If the export credits issued by the 51 members of the Berne Union (51 member agencies from 42 countries) is used as a rough proxy for the total market, then the share of medium- and long-term export credits controlled by the 22 member countries of the Arrangement was 69 percent in 1995 and 81 percent in 2000 (see Table 2). Data from earlier periods is not available. However, it is reasonable to assume that the market share figures were even larger prior in the 1970s and 1980s. Once the Arrangement was established in 1978, the fringe of outside suppliers was negligible for most products. Rules were also written so that Arrangement members were free to match the financing terms of non-members. Although developing countries rapidly expanded

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311 The declaration was signed by Austria, Belgium, Canada, Denmark, France, Germany, Italy, Luxembourg, Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the United States.
312 In the course of researching this dissertation, I was unable to obtain reliable data on export credits reported by members of the Arrangement prior to 1990.
313 During the 1970 and 1980s, members of the OECD constituted an even larger share of the world trade.
314 Arrangement on Guidelines for Officially Supported Export Credits, Article 53.
their manufacturing capability through the 1970s and 1980s, they never challenged the dominant position of Arrangement members in the bigger ticket items typically supported with OTF. Substitute sources of financing were also limited. It is true that commercial banks became more active suppliers of short- and medium-term financing in the 1990s, but they rarely offered long-term financing in higher risk developing country markets without the support of state guarantees. On the other side of the transaction, buyers remained largely disorganized, which limited their ability to challenge the price floors established through the Arrangement. Thus, for general manufactured goods, interests, ideas and institutions were aligned in a way that made it possible for OTF supplier states to construct and enforce rules.

**Special Sector Agreements**

Several capital goods industries—namely shipbuilding, aircraft and nuclear power plants—were not addressed through the general terms of the Arrangement. Instead, supplier states attempted to regulate competition through separate, industry-specific, side agreements with varying degrees of success. These three industries share several characteristics that make competition within them more imperfect and more susceptible to heavy government intervention. First, ships, aircraft and nuclear power plants are among the most complex, capital-intensive, and expensive products traded internationally. As a result, compared with most capital goods, unit costs are higher, and non-repayment risks are also higher. Second, each sector has had an oligopolistic

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315 Transactions like the Latin Trio case explained in Chapter 2 in which three Latin Airline companies banded together to jointly purchase aircraft represents a relatively unique case of buyers organizing to increase their market power vis-à-vis sellers.
structure that pits "national champions" at the global level, or those dominated by the
firms of one state, against the firms of other states, determined to enter the market. Third,
the size and importance of each industry, both in terms of technology spillover effects
and employment effects, has made them a significant force in domestic politics. These
factors intensify rent seeking at the domestic level and rent shifting at the international
level. Finally, each industry is linked to national security, providing an additional
rationale for government intervention, which challenges free trade norms. Each of these
factors contributed to active government intervention on behalf of these industries,
including the provision of generous export financing.

Shipbuilding

Shipbuilding is a sector that has been subject to weaker subsidy regulation at the
international level than have standard manufactured goods. The Understanding on
Export Credits for Ships was concluded in 1969, nearly a decade before the Arrangement
was formally established. The agreement set minimum interest rates, maximum terms
of repayment, minimum downpayments, and the relationship to aid programs. It also
established credit notification and matching procedures. A total of 13 countries signed
the Agreement, but the United States was not among them. The lack of U.S. participation
is difficult to square with hegemonic models of regime formation, which posit a central
role for a dominant power in concluding international agreements. However, the
outcome can be explained by cartel theory. After WWII, the U.S. position in the export
market had eroded to a point where, by the 1960, it exported no commercial ocean-going

\[316\] John M. Duff, Jr., "The Outlook for Official Export Credits," p. 918.
\[317\] Conditions were as follows: maximum tenor of 8 years, a minimum down payment of 20 percent; and a
minimum net interest rate of 6 percent.
ships. Japan, by contrast, emerged as a formidable force in world shipbuilding, first splitting European producers and then overtaking them, measured in gross tons of shipbuilding deliveries. Because the U.S. played little role in the world market for commercial ships, its participation was not essential to secure an agreement.

The Understanding on Export Credits for Ships was only partly successful in controlling export subsidies. There are several reasons why this was the case. The problem of sustaining collusion under difficult economic conditions provides an important part of the explanation. The shipbuilding industry has been in a state of chronic overcapacity for over three decades. Cartel agreements have been shown to work best when supply is tight and prices are high, but not when times are bad and demand is depressed. When demand is weak, suppliers have a strong incentive to chase prices downward, which undermines cartel discipline. These conditions defined the shipbuilding industry. Between 1976 and 1990, the industry experienced severe dislocation. The global recession in the late 1970s and early 1980s caused a downturn in demand for merchant shipping. The trend toward flags of convenience also made the industry particularly susceptible to competition-in-laxity due to the ease and low cost of relocation. During this period, the number of shipyards in Europe contracted from 140 to 42; total output fell by 46 percent. At the same time, employment fell by 56 percent in

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321 Dale D. Murphy, Open Economies and Regulations: Convergence and Competition Among Jurisdictions, PhD Dissertation, Department of Political Science, Massachusetts Institute of Technology, June 1995, pp. 81-116.
Europe and by 48 percent worldwide.\textsuperscript{322} The Asian financial crisis from 1997 to 1999 again caused overcapacity and accusations of predatory subsidization, this time against Korea, which, by this time, had overtaken Japan to become the world’s largest shipbuilder.\textsuperscript{323}

The combination of overcapacity and the collapse in prices prompted an array of government support programs to protect market share, of which export credits made up only a portion. Direct and indirect subsidy programs flowing to shipyards included low interest construction loans, grants, subsidized shipyard rationalization and modernization programs, and research and development aid.\textsuperscript{324} By the mid 1980s, these payments had ballooned to approximately $5 billion per year.\textsuperscript{325} The U.S. was one of the few countries to curtail unilaterally most shipbuilding subsidies. In 1981, the U.S. terminated the construction differential subsidy payments, which had been responsible for $3.8 billion in public subsidies between 1936 and 1983.\textsuperscript{326} This program paid the difference between the cost of building a ship in the U.S. compared to building it overseas, but it attracted mounting criticism in the 1970s as the cost differential paid with public money climbed to 50 percent per ship. During the 1980s these unilateral measures were cushioned by the

\begin{itemize}
\item Ray, \textit{Managing Official Export Credits}, p. 115.
\item Todd, \textit{Industrial Dislocation: The Case of Global Shipbuilding}, p. 8.
\item Whitehurst, Jr., \textit{The U.S. Shipbuilding Industry}, p. 131.
\end{itemize}
heavy naval expenditures made by the Reagan Administration. European integration had the effect of facilitating reductions in state aid to shipbuilding among members of the European Community, but not until the late 1980s, and then only very gradually. The EC subsidy ceiling was reduced from 28 percent in 1987/88 to 26 percent in 1989, and to 20 percent in 1990. In 1993 the ceiling was cut to 13 percent.

While the world’s major shipbuilders expressed a desire to control budget costs and reduce trade tension linked to shipbuilding subsidies, these preferences only went so far. Most producers were reluctant to accept limits on export subsidies unless a more comprehensive agreement on subsidies was reached. Agreements that sought to restrict a broader range of state aid in 1970s and 1980s were largely ignored. The closest that the major shipbuilding countries came to a comprehensive, legally binding agreement was in 1994. That year the major shipbuilding nations concluded the Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry (OECD Shipbuilding Agreement), which prohibited nearly all forms of subsidization of shipyards relating to the building, reconstruction and repair of vessels. On the matter of export credits, the agreement required signatories to respect the provisions of Understanding on Export Credits for Ships with certain revisions. The most important revisions included the provision that credits be based on CIRR rates (replacing the prevailing fixed interest rate of 8 percent), that the repayment period be extended

327 With a goal of assembling a 600-ship navy, the Reagan Administration spent approximately $100 billion to buy an average of 19 warships annually during the 1980s. See Loren B. Thompson, “Stormy Seas: U.S. Shipbuilders Face Big Challenges,” San Diego Union Tribune, August 12, 2001.
In contrast to previous years, the U.S. joined the negotiations and played an important role in shaping the final text. Washington’s stance changed as a result of pressure from U.S. shipbuilding interests. Middle-tier U.S. shipyards believed that they had no choice but to reenter the U.S. commercial market and the export market after the collapse of the Soviet Union and the decline in U.S. military spending. Concerned about the difficulty of competing in the face of substantial foreign subsidies, the Shipbuilders Council of America filed a petition under Section 301 of the U.S. Trade Act in June 1989. In exchange for dropping the petition, the U.S. government agreed to press for a more comprehensive international agreement on ship subsidies. In the course of these negotiations, the proponents of tougher international rules attempted to apply pressure by using foreign access to the U.S. market as a point of leverage, but these measures never passed the Senate.

In the end, the OECD Shipbuilding Agreement never took effect. The agreement was ratified by the EU, Japan and Korea, but not by the U.S. Because the agreement required unanimous ratification to take affect, the U.S. Congress’s decision not to ratify meant that the Agreement did not come into force. Domestic constituencies rejected the

331 The petition alleged that shipbuilding subsidies by West Germany, Japan, Korea and Norway violated the GATT Subsidy Code.
333 The legislation had proposed to penalize vessel owners who purchased vessels that were constructed or repaired with subsidies by denying them access to U.S. ports or by levying fines. In contrast to dumping rules under the GATT, no showing of injury was required.
bargain reached by U.S. negotiators. When it came time to ratify the agreement, the American Shipbuilding Association, representing the six largest shipyards, broke ranks with smaller shipyards and convinced key members of Congress to defend U.S. cabotage laws, commonly known as the Jones Act, which required that trade conducted within U.S. coastal water be carried out on U.S. built ships.\(^{334}\) They also preserved a recently established loan-guarantee program operated by the Federal Maritime Administration. The OECD agreement would have reduced loan terms from 20-25 years to 12 years and reduced coverage from 87 to 75 percent. Since the Agreement collapsed, the world’s major shipbuilders have attempted to reach a new agreement without the U.S. However, a stable agreement has been slow to materialize. This has had less to do with bypassing the U.S., which constitutes only one percent of the market, than with inauspicious timing. The Asian financial crisis had the effect of rekindling subsidization and counter subsidization among the largest shipbuilding states.\(^{335}\) Bilateral talks entered into by EU and Korea on indirect state aid and efforts to push forward with a new OECD agreement have failed to yield an agreement.\(^{336}\)

Competing ideas provide another part of the explanation for why a stable agreement has not yet been established. While there was an effort to build on ideas of “normal competition” in the shipbuilding sector, these ideas clashed with others that


justified subsidization. The European Community, Japan, Korea, and the United States all held shipbuilding to be of vital national interest. Some defined this interest largely in economic terms. For example, Japan and later Korea viewed shipbuilding as a strategic industry important to promoting economic growth. Most, however, viewed merchant fleet and a shipbuilding industrial base as critical to national security. The world’s major trading and political powers have long believed in the link between naval power, merchant shipping and shipbuilding. A 1975 study published by the Brookings Institution captures this view: “Of the various justifications commonly offered for public assistance to the U.S. maritime industries, the soundest is the argument that the U.S. flag merchant marine and the U.S. shipbuilding industry contribute importantly to the nation’s security.” The collapse of the Soviet Union and the end of the Cold War moderated this justification but did not eliminate it as other international security concerns filled the vacuum. The Bateman amendment, blamed for scuttling U.S. ratification of the Shipbuilding Agreement, was framed as a measure necessary to protect national security interests. Speaking on the floor of the Senate, Trent Lott, Senate majority leader, made the following comments after announcing the OECD Shipbuilding Agreement “dead in the water:”

U.S. participation in this agreement is essential, but it must be based on the firm understanding that the Jones Act and national security

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requirements regarding vessel construction will not be restricted by other
countries. What America desires is a level playing field, without
compromising our national security interests.  

Similar national security concerns have motivated the thinking of other states. Thus, the world's major shipbuilders not only faced the problem of heterogeneous interests and market conditions that made it difficult to establish a stable cartel-like arrangement, but also faced conflicting ideas about the legitimacy of state intervention in the sector. As a result, the ability of supplier states to extend the scope of subsidy rules to this sector was more difficult.

*Nuclear Power Technology*

The special sector agreement covering nuclear power plants was more successful than that covering ships, but establishing common rules proved to be more difficult than in the case of standard manufactured goods. Again, the intersection of preferences, institutional arrangements and norms helps us understand why. Like shipbuilding, the conditions within the industry were not auspicious for forming a stable cartel agreement in the 1970s. This was a period of significant turmoil for nuclear reactor manufacturers. For two decades after the Eisenhower Administration announced the Atoms for Peace program, U.S. suppliers dominated the global commercial market as the sole supplier of reactors, enrichment services and reprocessing. However, the monopoly position

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collapsed in the 1970s as several countries gained independent technological capability. France and Germany emerged as the most determined to gain a foothold in the international market, but Canada, Sweden, Japan and the U.K. also achieved export potential.\textsuperscript{343} In just four years, from 1974 and 1978, U.S. market share fell from well over 90 percent to below 50 percent.\textsuperscript{344}

Several factors caused the new entrants to fight hard for export business and to count on government support in the fight. In the first half of the decade, there were strong expectations of a large and potentially lucrative market. As an increasing number of countries launched nuclear power programs, surveys pointed to a rapidly growing market. A 1973 study by The International Atomic Energy Agency suggested that as much as 75 percent of new capacity additions in key developing country markets would be dedicated to nuclear investment in the 1980s, with a total cumulative value of over $200 billion.\textsuperscript{345} Countries competing against the U.S. viewed government support as necessary to win a foothold in this booming market in the face of unusually high barriers to entry. In the second half of the decade, market conditions took a dramatic turn. Orders expected in the wake of the oil shocks and rising energy consumption did not materialize. Billions of dollars in orders were cancelled or postponed. Between 1976 and 1979,

\textsuperscript{343} France’s Framatome produced pressurized water reactors through a license from Westinghouse, which was eventually bought outright by the French government. Germany’s Kraftwerk Union (KWU) largely marketed pressurized water reactors of indigenous design independent of U.S. company licenses. Canada’s Atomic Energy of Canada (AECL), a Federal crown corporation, marketed the CANDU reactor, which was based on a combination of technologies (namely GE, Westinghouse and Babcock & Wilcox). Japan’s Mitsubishi (Westinghouse license), Hitachi (GE license) and Toshiba (GE license) built significant technological capacity to produce boiling water and pressurized water reactors but like the U.K. did not aggressively assert independence of U.S. technology and therefore generated less trade friction.


annual average reactor orders fell to just 12 gigawatts compared to average annual orders of 33 gigawatts in the first half of the 1970s. If estimates of total industrial capacity at the time were correct (approximately 50-60 gigawatts per annum), then the industry was only operating at 24 percent of capacity by 1977-1978.\textsuperscript{346} Government support was viewed as necessary to support a struggling industry in winning at least a share of the rapidly shrinking international market.

There were also several factors that caused new entrants to use bilateral export financing as a way to gain competitive advantage. First, the role of trade finance grew as sales opportunities gravitated to the untapped markets of the South. The new customers for nuclear power plants—almost always state-owned utilities—were not only higher risk but had less capacity to raise long-term investment capital from the domestic market. Second, the size and capital intensity of nuclear reactors were considerable. At more than $1 billion a unit, the decision to place an order represented a major financial commitment, especially for countries with limited foreign exchange.\textsuperscript{347} Due to the size of the deals, manipulation of financing terms could result in hundreds of millions of dollars in savings to buyers.\textsuperscript{348} Third, bilateral OTF was often the only source of financing available since the World Bank and other regional development banks declined to participate in nuclear sales. Commercial banks would only participate in deals protected by government guarantees. Finally, volatile macroeconomic conditions induced by the oil

\textsuperscript{346} William Walker and Mans Lönroth, p. 47.
\textsuperscript{348} For example, in the competition for the sale of two units to Taiwan in 1981, the press reported that French companies were offering a financial package that cost $300 million less than U.S. vendors could offer based on more favorable government export credit support. See Sandy Cannon, “U.S. to Exact Toll on French, Germans in Taiwan Reactor Competition,” \textit{Nucleonics Week}, vol. 22, no. 33, p. 1.
shocks caused buyers to demand fixed rate financing to contain the cost of nuclear
investments.

The emergence of determined competitors, weakening demand, and buyers, eager
to secure favorable fixed rate financing to hedge against cost escalation in an inflationary
environment, made it difficult to include nuclear power within the general terms of the
Arrangement. In 1975 the major suppliers negotiated a special “standstill” agreement that
attempted to freeze the financial terms offered by competing export credit agencies in
support of nuclear sales. 349 However, the agreement had significant limitations. It
specified that there be a minimum cash down payment of 10 percent and a maximum
repayment of 15 years, but left a major loophole by setting no minimum interest rate.
France, Germany and Canada exploited this loophole. As interest rates rose to historic
highs in the late 1970s, they began offering fixed interest rate loans that were as much as
800 basis points below those governments’ cost of borrowing. Competition was depleting
U.S. Ex-Im’s budget. 350 By the end of the 1970s, the U.S. Treasury Department
estimated that every percentage point below market terms offered by ECAs cost as much
as $200 million over the life of a typical loan. 351 This represented a windfall for buyers
but an increasing burden for sellers.

Although the nuclear club remained small, the growing international competition
also raised proliferation concerns. A number of controversial sales triggered a crisis in

349 John M. Duff, Jr., “The Outlook for Official Export Credits,” Law and Policy in International Business,
351 “OECD Sector Understanding on Export Credits for Nuclear Power Plants,” Treasury News, United
the existing non-proliferation regime and concern that nuclear programs in the developing world would evolve into military programs. Between 1975 and 1976, West Germany entered into an agreement with Brazil’s military government for eight reactors and the facilities required to produce enriched uranium and plutonium. Not long afterwards, France agreed to sell plutonium reprocessing equipment to Pakistan and South Korea. In the effort to halt the negative dynamics and reestablish market stability, several members of the U.S. Congress advanced the idea of establishing a market sharing agreement among the leading suppliers. This proposal was predicated on the belief that unless the United States was prepared to enter into such an arrangement—and implicitly to accept a smaller share of the world reactor market as the price of achieving nonproliferation objectives—the other suppliers would continue to see U.S nonproliferation proposals as way to promote the sale of American reactors and to preserve American domination of the nuclear marketplace. However, the conditions for such an arrangement were not favorable. As one commentator argued: “The general economic incentives to export these advanced technologies together with the current overcapacity in the market are not conducive to any kind of cartel arrangement to restrict supplies of conventional reactors among the five or six major countries involved.”

Free trade norms were generally weaker in the nuclear sector, which eased pressure on supplier states to accept constraints on export financing. As one analyst

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quipped: “Nuclear trade is the neoclassical economist’s nightmare.” Challengers could rationalize export subsidies in any number of ways. Subsidies could be justified as necessary to offset the historic advantage that U.S. vendors held in the market. Challengers lacked the large domestic market, the commercial ties with foreign utilities that U.S. vendors had built up over the years, or the legal control accorded to the U.S. through the NPT regime. Energy security provided another set of justifications that competed with free trade norms. By supporting domestic reactor manufacturing capability, international sales contributed to domestic energy security goals. A small flow of orders could help to ensure technological capability was maintained, ensure economies of scale in design and manufacturing, and place the industry in a better position should the market turn up again. Even in the U.S. there were few who believed that the nuclear trade could or should be subject to normal trade. Nuclear power was widely considered a strategic industry and one that could not be left to the market. These ideas worked to limit the degree to which governments considered it reasonable to regulate ‘unfair’ trade practices in the sector. These considerations also help to explain why the nuclear power sector was accorded special status and subject to few, if any, restrictions on government intervention in trade regimes. For other sectors, these restrictions ranged from the GATT to regional trade arrangements put forth in Europe’s Treaty of Rome, which, among other things, restricted state aid.

355 Walker and Lönnroth, Nuclear Power Struggles, p. 93.
The stabilization of the export market in the early 1980s, albeit at a much lower volume of orders, improved the conditions for the six major supplier states to negotiate stricter export credit rules. Another contributing factor in this improvement was the fact that nuclear sales generally made up a small portion the industry leader’s total sales. Most of the firms producing nuclear components were industrial conglomerates selling a wide range of products and services. For the largest Western heavy electrical equipment manufacturers, such as Westinghouse, General Electric, Siemens, reactors rarely constituted more than 10 percent of total power production exports in a given year.\textsuperscript{358} The industry also employed a smaller number of workers with more transferable skills than did the shipbuilding industry. Because adjustment costs were not as acute as they were for shipyards, these firms put less pressure on their home states to defend international market share at all costs. The exception was France, which confronted greater difficulty in “adapting its nuclear enterprises to a lower level of activity in the domestic market.”\textsuperscript{359} Not only was nuclear power a centerpiece of France’s industrial policy and energy security policy, but Framatome was the only global player in the market totally dedicated to nuclear business. For these reasons, France had more reasons to resist subsidy constraints.

The mounting losses that ECAs were experiencing as a result of subsidized terms in their nuclear-related business made negotiating stronger rules a priority for all the principle exporting states by the end of the 1970s.\textsuperscript{360} Still, the competing states

\begin{footnotes}
\textsuperscript{358} Daniel Poneman, \textit{Nuclear Power in the Developing World}, p. 204. \\
\textsuperscript{359} William Walker and Måns Lönnroth, pp. 59-60. \\
\textsuperscript{360} See elaboration on losses and the collective motivation this created in the negotiation of stronger rules in this sector in Duff, “The Outlook for Official Export Credits,” p. 925 and Lisa B. Barry, “International
bargained hard once negotiations commenced to set more stringent rules. Deeper capital markets provided the U.S. with a source of bargaining leverage. U.S. negotiators began by proposing a system based on market rates and maximum repayment terms of 20 to 25 years. U.S. negotiators pressed their European counterparts to raise the minimum interest rate from 7.6 percent to a rate closer to market levels (at the time, U.S. long-term treasury notes were 13.6 percent, whereas French Treasury bonds were about 15.8 percent). European negotiators rejected this proposal. A key objective of France and Germany was to prevent the US Ex-Im Bank from offering terms longer than 15 years and, if possible, to shorten repayment to 12 or even 10 years. European ECAs’ access to long-term capital was more limited than the U.S.’s (typically 10 years on European financial markets). However, European ECAs generally faced a softer budget constraint than did U.S. Ex-Im Bank and could counter Washington’s ability to offer longer term financing by offering interest rates that U.S. Ex-Im found difficult to match. The advantage of deeper bond markets gave the U.S. leverage, but this advantage was not sufficient to dictate the terms of the negotiations.

A compromise among the competing supplier states was eventually reached in August of 1984. In the end, the U.S. agreed not to offer terms beyond 15 years, while France, Germany and other parties agreed to link minimum interest rates to the cost of

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361 U.S. negotiators justified these terms as reflective of the U.S. market in which nuclear power plants were financed by utility bond issues that carried a maturity of up to 30 years. They also noted that these repayment terms were well within the 40-year estimated project life of nuclear plants.

money to government (using the CIRR rates as a proxy). Special exceptions were made for low interest rate countries such as Japan. In addition, a special CIRR rate was devised for countries providing credits for periods longer than 12 years. Exempting nuclear plant orders then under negotiation—including fiercely fought deals in China, Finland, Egypt and Turkey—further facilitated agreement. Once concluded, the Sector Understanding on Export Credits for Nuclear Power Plants was incorporated into the Arrangement as an Annex.

The act of bringing the sector more formally within the scope of the Arrangement facilitated the process of negotiating additional rules in subsequent years. Since 1984, a variety of issues have been addressed including the practice of deferred interest payments accrued during construction, special subsidies for uranium enrichment services, and appropriate terms for decommissioning nuclear power plants. There have been no significant breaches of the agreement. The more stringent terms and conditions in addition to the weaker international market meant that the sector was no longer the flash point that it was in the 1970s and early 1980s.

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364 The minimum interest rate was based on a Special Commercial Interest Reference Rate (SCIRR), which added a markup to reflect the longer than standard repayment terms for countries with low interest rates. These conditions required that countries add 75 basis points to the CIRR for the currency of the transaction, except for Japanese yen. The maximum CIRR term was to be applied for countries with more than one CIRR rate.
Civilian Aircraft

Reaching a special sector agreement covering export financing subsidies for civilian aircraft also proved to be difficult and contentious. The first attempt to restrain credit competition in this sector occurred in the 1970s. In 1975, Britain, France, Germany and the U.S. concluded a standstill agreement for large civil aircraft along the lines of the one concluded for nuclear power plants. The private agreement included a pledge not to offer OTF for aircraft at lower interest rates than was then being charged at the time.367 The agreement also set the maximum length of credit that would be permitted for different sized aircraft. Three categories were established: Category A: repayment terms up to ten years, included large turbo-jet aircraft; Category B, with a maximum repayment term of 7 years, included large turbo-prop aircraft, large helicopters, all executive jet aircraft and other medium-sized aircraft; and Category C, with a maximum repayment term of 5 years, included all other subsonic aircraft and helicopters.

However, the effort to freeze existing export financing practices did not hold. One chronicler of the period aptly described the growing acrimony thusly: “As the struggle between American companies and Airbus Industrie developed, accusations of ‘predatory financing’ were hurled back and forth across the Atlantic; Americans and Europeans continue to charge each other, not unreasonably, with lacking restraint and flouting the so-called standstill agreement—the few officially agreed rules, such as a

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limit on duration of loans, that are supposed to bound the terms and conditions of financing new airplanes.\textsuperscript{368}

Some of the most contentious transactions involved deals in the U.S. In one instance, Airbus offered a $788 million deal for twenty-three A300 aircraft to financially troubled Eastern Airlines. Boeing claimed that it could not match the financing package offered by European ECAs supporting Airbus' offer. U.S. Ex-Im was not available due to restrictions in its charter that prevented it from undertaking transactions within the U.S. market.\textsuperscript{369} Another controversial deal involved the sale of Rolls-Royce engines worth $210 million sold to Pan American World Airways in a complex deal backed by Britain's ECGD. The U.S. officials argued that this deal violated the standstill agreement by exceeding the 10-year maximum term for repayment and breaching terms of local cost by requiring no cash payment, 100 percent cover of credit risk and 15 year repayment period.\textsuperscript{370} But there were also complaints about the terms of deals outside the U.S. market. For example, Boeing claimed publicly that it lost sales to Pakistan International Airlines in 1977 due to support of French and German governments in providing long-term financing that it could not match with commercial financing or financing from the US Ex-Im.\textsuperscript{371}

\textsuperscript{369} U.S. Ex-Im financing was not available to Boeing because of restrictions written into its charter that prohibited financing for domestic sales. This "home market" restriction was rescinded in 1978 to permit Ex-Im to match the financing provided by ECAs in the U.S market.
\textsuperscript{371} "Export Boost" Aviation Week & Space Technology, May 1, 1978.
The problem of securing compliance even with the relatively weak terms of the standstill agreement can be traced to the widely divergent preferences that the parties brought to the sector in the 1970s. The U.S. had a strong preference for restricting all subsidized export finance. U.S. aircraft manufacturers dominated the civilian aircraft market in the 1970s and therefore had little need for marketing inducement such as low-cost financing in order to secure orders for new aircraft. During the period from 1971 to 1975, the three U.S. manufacturers producing planes at the time—Boeing, McDonnell-Douglas and Lockheed—secured 88 percent of the world’s aircraft deliveries.\(^{372}\) The launch of Boeing’s 747 in 1969 gave American manufacturers complete control of the large volume, long-haul segment of the market.

As a new entrant in the market, the situation looked very different for the Airbus consortium and the governments that backed it.\(^{373}\) Concerned about continued American dominance in a strategic industry but unable to compete alone effectively, led by Aerospatiale of France, Messerschmitt-Bölkow-Blohm of West Germany, Fokker-VFW of the Netherlands and CASA of Spain and Hawker Siddley of the Britain joined in a collaborative venture to design, develop and produce large capacity, short to medium range transport aircraft.\(^{374}\) In September 1967 the governments of France, Britain and

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\(^{373}\) For a history of the collaboration and how it emerged see Keith Hayward, *International Collaboration in Civil Aerospace* (London: Pinter, 1986).

Germany gave Airbus Industries authority to produce the consortium’s first model: the Airbus A300.375

Airbus’s entry into the market could not have been more poorly timed. The A300’s commercial debut in 1973 coincided with the Arab oil embargo. The oil shocks that followed and the fears that it generated about global energy shortages not only sent aircraft fuel prices soaring but also drove down demand for air travel as economies throughout the world contracted.376 Airlines reacted by cancelled pending aircraft deliveries and placing new orders on hold. To fill the breach, European national flag carriers were enlisted to purchase Airbus’ new planes.377 The first launch order came from Air France. This purchase was followed by sales to Lufthansa the following year. However, despite the support Airbus received from European national carriers, sales continued to be alarmingly low. Only two A300s were sold between December 1975 and April 1977.378

Even more fundamental than unfortunate market timing was the array of market barriers that a new entrant faced. Analysis of the challenges confronting new entrants in the aircraft industry has tended to focus on special production factors that characterize the industry. These include the huge development costs, very high fixed cost of production,

378 Thornton, Airbus Industrie, p. 100.
significant learning effects associated with producing highly complex assembly, as well
economies of scope and scale that must be achieved to compete successfully in the
market.\textsuperscript{379} However, Airbus also faced an array of barriers on the demand side of the
market associated with the buying behavior of airlines. Aircraft are expensive and
therefore represent a significant outlay of capital for airlines seeking to upgrade or
expand their fleets.\textsuperscript{380} The useful life of aircraft is relatively long—as much as 25
years—leading to relatively low replacement rates. When Airbus entered the market, the
average annual worldwide demand for aircraft was less than 350 units, intensifying the
stakes involved in each sale. Airlines are naturally conservative. Given the flying
public’s concerns over safety, airlines treat equipment purchases with considerable care.
Few airlines are willing to purchase untested aircraft. Airbus’ seemingly unwieldy
corporate structure heightened these concerns. Customers feared having to deal with not
one manufacturer but several who would be tempted to engage in buck passing amongst
themselves should a problem arise.\textsuperscript{381} These reputational considerations strongly favor
incumbent producers. Airbus Industrie was therefore under considerable pressure to win
orders, ideally from established airlines operating in the U.S. market, the world’s largest
and most important aviation market.


\textsuperscript{380} Depending on their size, large commercial aircraft range anywhere from $20-30 million for the McDonnell-Douglas 80 series (172 seats) to $130-152 million for the Boeing 747 (up to 550 seats). The Airbus A300 and its derivative the A310 (336-375 seats) cost approximately $75 million (in 1991). See Pitt and Norsworthy, \textit{Economics of the U.S. Commercial Airline Industry}, p. 35.

Economies of scope are also among the demand side factors that inhibited entry. Airlines naturally preferred manufacturers that offered a family of planes. A common fleet can significantly reduce maintenance, pilot training and other operational costs.\(^{382}\) In the early years, Airbus only had one model to offer. The A300 was specifically designed to serve a niche in the market for an economical, twin-engined, 250-seat, wide-bodied aircraft not then served by other manufacturers. However, this was often not enough to offset the disadvantage of being limited to only a single model in the eyes of airlines. Finally, because aircraft involve significant financial commitments, airlines often turned to manufacturers to arrange financing. This became even more so as production capacity outstripped demand in the 1970s and a buyer’s market emerged.

The combination of market entry barriers on both the supply and demand side of the market was one factor that caused the European governments to resist stringent international export finance rules. Another important set of factors were more directly finance related. One factor concerned the convention of financing aircraft in dollars. Since the vast majority of aircraft sold world-wide were based in dollars, Airbus faced exchange rate risk that its American counterparts did not.\(^{383}\) This risk was used to justify export credit support that offset this disadvantage. Another factor concerned the insurance model that characterized the leading European ECAs. Many believed that the insurance-based instruments offered by COFACE and Hermes that backed commercial bank syndicates were not as well suited to aircraft financing as the direct lending


\(^{383}\) Klepper, p.781
available from Ex-Im Bank. The ability to provide flexible state export financing support was essential. In the early years, establishing a foothold in the market and building market share were more important to European governments than the general interest they may have had in preventing unintentional wealth transfers flowing to buyers.

Although the U.S. government had a preference for restricting government financial interventions, it also had strong incentives to support its own national firms once the threat was recognized. American aircraft manufacturers generated a producer surplus that was highly beneficial to the U.S. Commercial jet aircraft was one of America’s most successful industries. Airframe and engine manufacturers stood at the apex of a network of suppliers. The industry was an important source of employment for skilled production workers, as well as for highly trained scientists and engineers. It was also the leading export industry in the country. At a time when America’s overall trade balance was steadily worsening, aerospace was a star performer. Between 1977 and 1981, the aerospace sector logged a $50 billion trade surplus. There were also significant positive economic and technological externalities associated with the aircraft manufacturing industry that could be consumed and internalized by the United States through upstream and downstream linkages throughout the economy, which generated

benefits far greater than the industry’s relatively small proportion of gross national product would suggest.\textsuperscript{387}

Initially, U.S. policy leaned in the direction of tolerating differences in the export financing practices of France and Germany on behalf of Airbus. In the mid-1970s, U.S. Ex-Im’s management was reluctant to worsen the bank’s already weakening financial position by offering softer financing terms. In an article in \textit{Aviation Week and Space Technology} critical of the lack of U.S. government intervention on behalf of the industry, the chairman of the Ex-Im was quoted as saying: “If we were the captive of the aerospace industry, we’d go broke.”\textsuperscript{388} However, after losing an increasing number of orders to Airbus beginning in 1977, U.S. policy quickly changed course. Despite the cost to its balance sheet, Ex-Im adopted a much more aggressive aircraft lending policy.\textsuperscript{389} A new Chairman was put in charge of the Ex-Im and given a mandate to meet international export competition.\textsuperscript{390} Already a large portion of the bank’s portfolio, aircraft became even larger. By the end of the 1970s, nearly half of the Bank’s direct lending was devoted to aircraft sales, with a subsidy rate on each transaction ranging from 7.8 percent to 40.2 percent.\textsuperscript{391}

\textsuperscript{387} The economic externalities associated with the aerospace industry are documented by Mark Busch, \textit{Trade Warriors}, pp. 37-48.
\textsuperscript{388} Cecil Brownlow, “Tighter Exim Bank Loan Policies Hit,” \textit{Aviation Week & Space Technology}, October 18, 1976, p. 16.
\textsuperscript{389} “Between fiscal 1977 and the end of 1980, Ex-Im drastically increased its loan cover from 30-45 percent to 65-70 percent. Larger provisions of direct credit lending pressed the Bank’s resources, which was one of the reasons the Ex-Im requested Congress to increase its lending authority from $25 billion to $40 billion in the 1978 reauthorization.” Becker and McClenahan, Jr. \textit{The Market, the State, and the Export Import Bank of the United States, 1934-2000}, p. 191.
\textsuperscript{390} Ibid., pp. 189-195.
\textsuperscript{391} Analysis of Ex-Im’s aircraft portfolio had a total subsidy value of approximately $1.25 billion from fiscal 1979 to 1981. During this period Ex-Im authorized 95 credits for $5.9 billion, which had a total export value of $11.4 billion. See David P. Baron, \textit{The Export-Import Bank: An Economic Analysis} (New York: Academic Press, 1983), pp. 234-235.
Officially, the U.S. adopted a policy of matching only European export credit financing terms. However, cases emerged which indicated that this policy was not always honored. The most serious accusation arose over the sale of 25 aircraft to the Australian carrier Ansett Airlines backed by $290 million in financing from U.S. Ex-Im. The European ECAs backing Airbus offered a package of credits for 10-12 years at a blended interest rate of 7.99 percent. The deal generated considerable controversy for several reasons. First, the deal provided additional fodder for those who were already critical of what they considered to be excessive corporate welfare. One Congressman charged that the terms Ex-Im offered amounted to a $3 million windfall for the buyer at the expense of U.S. taxpayers. Second, it generated accusations that export credits were being used to curry political favors related to the presidential primaries. Finally, the deal raised concerns that it undercut U.S. credibility in its effort to tighten finance terms at the international level. Until the Ansett deal, it was easier to paint the Europeans as violator of free trade norms. Evidence that the U.S. was doing more than just matching European practices made this more difficult.

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393 Ansett Airlines, a domestic Australian airline, was controlled by Rupert Murdoch. Murdoch also owned the *New York Post*. Critics charged that there was a connection between the *New York Post*’s endorsement of President Carter in the New York primary contest against Edward Kennedy and the subsidized credits provided by Ex-Im Bank to finance Ansett’s purchase of Boeing aircraft. In testimony to Congress organized to investigate the matter, Ex-Im’s Chairman testified that the soft credits were offered to counter subsidies financing arranged by European ECAs on behalf of Airbus not to secure political favors. See John F. Berry, “Ex-Im Chief Pushed Loan for Murdoch: Loan for Murdoch Pushed After White House Visit,” *Washington Post*, March 19, 1980, p. E1; and John F. Berry, “No Political Impropriety Seen in Loan to Murdoch,” *Washington Post*, May 13, 1980, p. A7.
Cartel theory anticipates the difficulty in securing cooperation on subsidies in a sector like civil aircraft. The theory predicts that collusion will be more difficult when members have different production costs and produce different products. "When firms are symmetric, reaching agreement is relatively easy... In other cases, however, unless side payments are possible, joint-profit maximization may not be a reasonable goal. Reaching agreement is therefore more difficult when firm heterogeneities are introduced." 395 This was clearly the case for aircraft in the 1970s. One measure of the cost differentials between Boeing and Airbus was the learning effects associated with large aircraft. Economic analysis suggested that large aircraft have a learning elasticity of 0.2. In other words, production costs decrease by 20 percent with a doubling of output. 396 If correct, this means that Airbus was at a significant relative cost disadvantage to Boeing has it climbed the production learning curve with A300 in the 1970s and subsequent models in the 1980s.

In addition, cartels depend on parties voluntarily supplying information to monitor pricing arrangements if they are to be successful. In these early years, aircraft was not subject to the same reporting requirements that applied to other capital goods. Supplier states were under no obligation to provide information on the terms and conditions of particular deals. As a result, the standstill agreement did not provide an institutional basis to police violations effectively. During this period, U.S. and European officials relied heavily on information provided by their respective manufacturers.

However, reliability of this information was questionable, since the firms had a vested interest in exaggerating the financing terms offered by competitors. States did not have the information required to monitor and enforce restraints on competition. As one observer noted: “Whereas the monitoring functions of the Arrangement worked fairly well for other sectors, aircraft as an excluded sector was not subject to the same rules.” Lacking adequate information, suppliers were not able to achieve the degree of cooperation achieved for other capital goods.

American officials did their best to enlist free trade norms in their campaign to secure more stringent rules. According to American officials, the civil aircraft industry should operate on the basis of “commercial competition” free from government intervention. In Congress and other public forums, European practices were consistently portrayed as unfair and in violation of the international community’s effort to establish a free and open world trade system. However, European officials rejected these appeals as self-serving. They did not reject free trade theory per se, but they did not see free trade norms as having particularly useful prescriptive value for the aircraft sector. From the European perspective, since America had a virtual monopoly on international aviation, interventions were not market distorting but rather market correcting. Even prominent American economists came to acknowledge that Airbus

397 Baron, The Export-Import Bank, p. 211.
could not have entered the market without large-scale development, production and marketing support.\(^{402}\) Because the sector was rife with market failures, free trade norms offered limited guidance for how international trade finance rules should be constructed for the sector. Inappropriately stringent rules held the potential of not only making Europeans worse off but also of making the world worse off.\(^{403}\)

Despite persistent effort, U.S. negotiators were unable to convince competitors that free trade norms should apply to civil aircraft. Records of the export finance negotiations are not available.\(^{404}\) However, the tenor of the discussions can be discerned from the more public discussion associated with the negotiations leading to the 1979 Agreement on Trade in Civil Aircraft. In addition to seeking controls on export financing, the U.S. also placed aircraft on the agenda in the late stages of the Tokyo Round. The special character of the global aircraft industry was codified in the negotiation as a special sector agreement in the Tokyo Round. Article Six, entitled Government Support, Export Credits and Aircraft Marketing stated: “They [signatories] also shall take into account the special factors which apply in the aircraft sector, in particular the widespread governmental support in this area, their international economic


\[^{404}\] In the course of researching this dissertation, I was unable to obtain access to minutes or other documentation of the aircraft negotiations.
interests, and the desire of producers of all Signatories to participate in the expansion of the world civil aircraft market."^{405}

While differences over a wide range of direct and indirect subsidy practices would intensify over the next decade, the U.S. and Europe were able to tighten progressively international subsidy rules (see Figure 6). The first step in this direction was the Common Line on Aircraft Export Credit Financing reached in 1981. The agreement raised the minimum interest rate to 12 percent for credits denominated in U.S. dollars, 11.5 percent for credits denominated in French francs and 9.5 percent for credits denominated in German deutschmarks. The agreement was significant because it marked

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\(^{405}\) Agreement on Trade in Civil Aircraft, Article Six, Government Support, Export Credits, and Aircraft Marketing, paragraph 1. available at: http://www.wto.org/english/docs_e/legal_e/legal_e.htm#civil.

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the first time that supplier states were able to secure agreement on fixing minimum
interest rates for large commercial jet aircraft. It also set an interest rate floor that was
closer to the cost of borrowing that the competing ECAs faced at the time than for
general capital goods.406

Three years later, the U.S. and European states backing Airbus concluded the
Large Aircraft Sector Understanding (LASU). This represented a more comprehensive
agreement designed to restrict predatory financing and force buyers to pay at least the
supplier ECA’s cost of financing plus a margin.407 LASU applied to aircraft over seventy
seats. This agreement extended repayment to a maximum of 12 years and bound the
parties to the use of CIRR rates. It also included a number of other restrictions, including
a commitment to avoid predatory financing in “home” markets and a prohibition against
mixing aid and export credits for aircraft. The following year an agreement was reached
on small aircraft. The two agreements were folded into the Arrangement as an Annex in
1986.

A number of factors explain why European states eventually submitted to stricter
financing rules. First, U.S. matching reduced the competitive advantage gained through
export finance subsidies. As one observer noted: “After a series of competitive

407 Annex IV, Chapter 1.2 states: The objective of this Chapter is to establish a balanced equilibrium that,
on all markets: equalizes competitive financial conditions between participants; neutralizes finance among
participants as a factor in the choice among competing aircraft; and avoids distortions of competition. See
Organization for Economic Cooperation and Development, Arrangement on Guidelines for Officially
transactions, some of which were won by the United States despite strong competition by the Europeans, the Europeans for the first time showed an interest in mitigating the cost of this competition. They appeared to have begun to find some value in the notion that if each side intended to match the other, the matching might better occur at interest rates which would not be excessively costly.” The official US policy was to “neutralize” the effect of European financing offers. Under pressure from Boeing and other manufactures, Ex-Im agreed to provide financing that matched European offers. Aircraft related credit competition had become expensive for all the states involved. An economic analysis of the period estimated that the U.S. spent $1.25 billion in aircraft related export credit subsidies between 1979 and 1981. The level of export credit related subsidies that European states paid out were at least at this level and probably much higher.

Once the U.S. pursued an active policy of emulating European export financing practices, the strategic value of this approach diminished. It simply led to mounting budget costs for supplier states and a windfall for buyers. In some cases, such as the sales to Eastern and Pan Am, some of these buyers were domestic. However, the international aviation market was undergoing significant change. Whereas the U.S. and Europe were the dominant markets in the 1950s and 1960s, by the 1970s demand for aircraft outside these traditional markets was growing dramatically. Developing countries in Latin America, Africa and particularly Asia became the fastest growing markets. These shifting sources of demand increased the interest of the producing

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408 Baron, The Export-Import Bank, pp. 235-236.
industries and countries in applying interest rate floors and other conditions export finance.\textsuperscript{409}

A second reason for Europe’s adoption of stricter financing rules was that, as time progressed, Airbus’ need for special marketing aids declined.\textsuperscript{410} By the 1980s, Airbus had gained commercial market acceptance, as suggested by its growing customer base. In 1975 Airbus had only sold planes to eight airlines. In 1980 Airbus had sold planes to a total of thirty-seven airlines. By 1985 the number had climbed to fifty-two.\textsuperscript{411} Sales in the US market established Airbus’ reputation as a reliable supplier. The advantage of government financing particularly in the North American market was also mitigated by the emergence of alternative methods of aircraft financing. In particular, the growing role of leasing companies reduced some of the pressure on manufactures to arrange financing to secure aircraft purchases.

Third, building economies of scope became more important for Airbus. Although Airbus sold fewer A300s than it had hoped, it had still made significant inroads into the market. The consortium’s priorities shifted in the 1980s to the expansion its complement of planes. The first step in this direction was the launch of the A310, which was a derivative of the A300. This plane made its first flight in 1982. Over the next ten years, Airbus developed a family of aircraft targeted at different segments of the market, including the A320, the A330 and A340, and the A321. To offset the cost and risk

\textsuperscript{409} See Piper, “Unique Sectoral Agreement Establishes Free Trade Framework,” p. 239.
\textsuperscript{410} McGuire, \textit{Airbus Industrie}, pp. 60-61.
\textsuperscript{411} Thornton, \textit{Airbus Industrie}, Figure A.5 Order Buildup, p. 187.
associated with fielding these new models, development and production funding became much more important than subsidized export finance.\textsuperscript{412}

Finally, concerns on both sides of the Atlantic that the dispute over subsidies would feed a protectionist backlash that benefited neither side. Airbus wanted and needed access to the American market. Likewise, Boeing wanted and needed access to the European market. Boeing declined to file trade action even though it was under public pressure to do so. European officials did not want to give the U.S. an excuse to impose restrictive measures. Boeing also wanted to keep open the option to sell into the European market (the company declined to file anti-subsidy petitions against Airbus). Placing limits on export subsidies made sense if they helped to mitigate trade tension and stave off more protectionist measures.

There is little evidence that the U.S. unilaterally imposed its preferences in the aircraft sector. The Common Line on Aircraft Export Financing and the Large Aircraft Sector Understanding are better understood as truces than as capitulations and the result of changing market conditions. Moreover, the agreements served more to contain than to eliminate disputes over aircraft financing. While they foreclosed competition in some areas, others were discovered, leading to pressure to further extend the scope of rules. One area that was discovered concerned the lack of rules regarding the risk premium rates charged. Airbus benefited from the fact that some European ECAs were willing to offer officially supported insurance at relatively low premiums. U.S. aircraft

\textsuperscript{412} Hayward, "Airbus: Twenty Years of European Collaboration," p. 16.
manufacturers complained that these offers amounted to subsidies that gave Airbus an unfair competitive advantage. Another area addressed by the agreements concerned so-called “mismatch loan structures” used to finance large aircraft orders, such as the Latin Trio case discussed in Chapter 2. As will be recalled, a mismatch loan structure refers to a two-part credit transaction, the first 12-year portion fined by one or more ECAs according to the terms set by LASU, and a second portion by commercial lenders with either residual values guarantees or commitments to refinance. By combining these elements together, the repayment period can be extended to as much as 18 years, with significant savings to buyers, and well beyond the 12 years permitted by LASU. These techniques were not an outright violation of the aircraft sector agreement but rather took advantage of loopholes and ambiguities in the agreement.

Thus, the aircraft sector became subject to rules, but only imperfectly so. When preferences were strongly opposed during the period in which Airbus was seeking initial market entry, only the most limited agreement was possible. As the budgetary cost of unrestricted competition rose and market conditions changed in ways that made market failures less pronounced, more restrictive rules became acceptable. In addition, applicability of free trade norms made more sense to Europeans under an oligopoly than when they faced a situation of unambiguous American monopoly. The result is that the U.S. and Europe were eventually able to submit the aircraft sector to the same cartel-like arrangements that made it possible to restrict predatory subsidization in other sectors.

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413 Ray, Managing Official Export Credits, p. 113.
Unregulated Sectors

While supplier states have been able to establish collusive agreements to fix credit terms for the majority of manufactured goods, with special agreements for particularly difficult sectors, there are some sectors where similar efforts have failed. Despite proposals, the Arrangement has continued to exclude agriculture and military goods. This has been the result of heterogeneity in the interests of supplier states, market structures that made cartel formation more difficult, and weaker norms against subsidies and free trade in these sectors, which produced deadlock.

Agriculture

Agricultural markets differ from capital goods markets in important ways. Agricultural production is not overwhelmingly concentrated in OECD countries as is the case for capital goods. Developing countries are also major producers of agricultural commodities. International trade in agriculture is significant but plays more of a residual role in filling market gaps. Exports from OECD countries often compete directly with local producers in developing countries, which is less often the case for large capital goods. From the early 1970s through the end of the 1990s, the volume of agricultural trade, including fishery and forestry products, grew by about 75 percent, and its value expanded from $148 billion to $650 billion (in nominal prices). The value of the food commodity trade was approximately $412 billion in 2000. However, the sector’s share of total merchandise trade has fallen relative to trade in manufactured goods, declining from around 20 percent to approximately 10 percent between 1970 and 1997.

There is also greater diversity in the trade position within the agricultural market among developed and developing countries. Some OECD countries are net exporters while others, such as Japan, are major net importers. The same is true of developing countries, which include some important net exporters such as Argentina, but also include many large net importers, especially in North Africa, the Middle East and parts of Asia. As a group, OECD countries control approximately 70 percent of world agricultural export market, a share that has held relatively constant over the past three decades. As a percentage of export earnings, agricultural trade is less important for OECD countries than for developing countries. This said, agricultural exports have been a significant source of export earnings for certain countries including Australia, France, New Zealand, and the United States, collectively earning these countries an average of nearly $110 billion per year in worldwide sales during the 1990s.415

The nature of agricultural commodities has also meant that state-backed export finance has played a more limited role than has been true for capital goods. Since the expected life of agricultural goods is usually very short, as the products are often used or consumed within weeks after purchase, the majority of agriculture commodities are transacted on a cash basis or with short-term commercial credits that typically do not exceed 180 days. These short terms create a risk profile that is normally acceptable to the private sector, so commercial banks are active participants in financing agricultural trade. Exporting states have justified the supply of official credits on a variety of market failure

415 Ibid.
grounds, including foreign exchange shortages and food security concerns among importers. However, there can also be a strategic aspect as well, since buyers face switching costs.\textsuperscript{416} Studies of wheat markets show that an exporting country and the exporting firm clearly benefit from any increase that an importer faces in switching to a rival’s product. Because of these benefits, exporting countries have an incentive to adopt trade policies that increase switching costs. Loans, guarantees and insurance credit offer a way to increase switching costs, since they are only available for wheat from the county, which provides the credit guarantees. Credit can therefore be a tactical device that creates additional costs for the importing country to switch away from that exporting country’s wheat in the future.\textsuperscript{417} Some studies suggest that the availability of favorable credit is second only to price in importance when determining import decisions.

Disagreement exists on how best to characterize international agricultural markets. Some argue that there are strong empirical and theoretical reasons to believe these markets are fundamentally oligopolistic in nature. As evidence, they point to the dominance of a handful of large multinational enterprises, such as Cargill Continental, Bunge and Born, Louis Dreyfus and André Garnac, which account for roughly 75 percent of the total grain shipped worldwide. They also point to the presence of State Trading

\textsuperscript{416} Switching costs refer to the transaction costs that buyers face in changing between functionally equivalent brands of a product. The degree of switching costs that buyers face can explain unusual competitive pricing behavior. Paul Klemperer, “Price Wars Caused by Switching Costs,” Review of Economic Studies, vol. 56, no. 3 (July 1989), pp. 405-420.

Enterprises (STE), which often have exclusive authority to export agricultural products.\footnote{See Michelle Veeman, Murray Fulton, and Bruno Larue, \textit{International Trade in Agricultural and Food Products: The Role of State Trading Enterprises}, Agriculture and Agri-Food Canada, April 1999; and Michael T. Roberts, “The Unique Role of State Trading Enterprises in World Agricultural Trade: Sifting Through Rhetoric,” \textit{Drake Journal of Agricultural Law}, vol. 6 (Fall 2001), pp. 287-315.} The claim is that exporter STEs, such as the Canadian Wheat Board and the New Zealand Dairy Board, can provide an implicit export subsidy “by being able to sell at different prices in markets with different elasticity and redistribute the revenues to producers through a higher pooled price.”\footnote{Jana Hranaiova, Harry de Gorter and Merlinda Ingco, “Perspectives on Agricultural Export State Trading Enterprises in the WTO Trade Negotiations,” Agriculture and Rural Development, World Bank, August 15, 2002, p. 4.} A common view is that STEs exercise market power to countervail against the market power of processors, wholesalers and traders and practice price discrimination to benefit producers.\footnote{Ibid. p. 3.} The picture that emerges is a market with imperfect competition among exporting countries and price taking behavior among the importing countries.

Others have drawn the opposite conclusion by pointing to features of import markets. Many importing countries have established mechanisms to enhance their own bargaining power. Import tariffs and strict food safety regimes are two common ways of effecting discrimination. Importing countries have also organized STEs that control access to import markets.\footnote{Karen Ackerman, “State Trading Enterprises: Their Role As Importers,” \textit{Agricultural Outlook}, Economic Research Service, US Department of Agriculture, November 1997, pp. 31-37.} Many of the largest food importers such as Japan, Indonesia, Korea, Mexico, Turkey and Tunisia all have import-oriented STEs. This fact points to a market that places exporters in the position of being price-takers due to the monopolistic behavior of importing countries. Despite a large amount of research, a definitive characterization remains contested. What is clear is that international trade in agricultural
goods tends toward imperfect competition, with large multinational firms acting in consort (and sometimes in conflict) with heavy government intervention on both the exporting and importing sides of the market.

One of the most controversial aspects of government intervention has been the role of domestic price supports and other subsidy mechanisms that artificially reduce export prices. The Common Agricultural Policy (CAP) launched by the EU in 1968 has been among the most visible and long-standing targets of criticism. This program contributed to stimulating the overproduction of food that increasingly found its way into international markets. In the case of wheat, CAP-related subsidies contributed to Western Europe’s shift from being a net importer until 1974 to becoming a major competitor of the U.S. in the 1980s. The program provoked retaliatory action by the United States through the establishment of the Export Enhancement Program in 1985. This program provided a subsidy (in kind or in cash) to the U.S. exporting firm after they delivered products to the targeted country at a reduced price. The bitter trade war that developed was only partially ameliorated by measures accepted under the Agreement on Agriculture in the Uruguay Round of multilateral trade negotiations concluded in 1994. This agreement introduced restrictions but did not eliminate the ability of signatories to continue to engage in direct export subsidization or the provision of export credits, which were provided in part to counter their competitive effects (see Figure 7). These complex

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market conditions are the backdrop against which the ECG took up and ultimately failed to address the issue of official agricultural export credits.

Agriculture became a part of the ECG’s agenda shortly after the Arrangement was concluded in 1978. In 1981, New Zealand and Australia proposed that rules be developed to regulate official credits supporting agriculture commodity exports. Because
of the widely differing terms of trade between agriculture products and capital goods, they argued that agricultural products should be brought within the Arrangement as a separate sector agreement without formal links to the existing provisions on capital goods. The proposal suggested that officially supported agricultural export credits be subject to the following terms:

a) normal cash terms to be recognized as being cash or 180 day credit;

b) credits with terms in excess of 180 days and up to two years should be listed and reported retrospectively every six months;

c) credits with terms in excess of two years should be subject to Arrangement guidelines and prior notification;

d) a list of agricultural products covered by the Arrangement should be compiled in the event of special terms or requirements being negotiated for agricultural credits.\footnote{Organization for Economic Cooperation and Development, “Agricultural Credits: Note by the Secretariat,” Trade Directorate, OECD/TD/Consensus/81.10., September 22, 1982.}

The proposal met with a chilly response from the United States. Negotiators from Washington announced in the ECG that while the U.S. would welcome negotiations on disciplines concerning all agricultural subsidy practices, it could not discuss export credit subsidies in isolation. This position emerged from an interagency meeting held in 1981 to discuss the New Zealand/Australia proposal. At the interagency meeting, the U.S. Department of Agriculture (USDA) argued that the U.S. government should oppose the inclusion of officially supported agricultural credits in the Arrangement, since the U.S. had nothing to gain by way of leverage over direct export subsidies if it were to move closer to the New Zealand position. A consensus emerged that that the issue would most
likely receive relatively low priority and that discussion would be limited, thereby not providing an adequate opportunity for New Zealand and Australia to pressure the U.S. to compromise.\textsuperscript{425} The USDA’s resistance to accepting limits on export credits, while direct export subsidies remained a much larger uncontrolled problem, carried the day in the interagency process and formed the basis of Washington’s negotiating stance.

Negotiating instructions prepared for the April 25-27 meeting in Paris put officials on notice that the “U.S. del should not repeat not support the EC proposal to negotiate on export credit arrangement for agriculture.”\textsuperscript{426} This stance was to hold, basically unchanged, for two decades.

Despite the resistance of the U.S. delegation, the Secretariat proposed that members of ECG complete a survey to compile more comprehensive data on each member’s agricultural credit policies and programs, including statistics on agricultural credits provided through specialized programs broken down by products, markets and credit terms. The results were complied by the Secretariat and distributed to ECG members the following year in June 1983. The results showed that short-term official credits (repayment periods of 180 days or less) rose from $5.4 billion to $6.1 billion. These figures were based on information supplied by only 12 countries and excluded important countries such as France, which did not submit information on its agricultural credits. Total medium-term credit supplied during the 1980-81 period was $5.9 billion. However, even fewer countries supplied information regarding these longer term credits.

\textsuperscript{425} “Agricultural Credits in the Arrangement,” Memorandum of Interagency Meeting, September 22, 1981, U.S. Department of Treasury, Office of the Assistant Secretary for International Affairs, Office of Trade Finance.

Without complete reporting, the Secretariat claimed that it was difficult to gain an accurate picture of the role played by official export credits, where they were directed or the degree to which they were subsidized. The Secretariat concluded, "since many countries provided either inadequate statistics or none, it was not possible to distinguish with certainty regular from unusual practices."\textsuperscript{427}

By the end of 1983, the positions of the major negotiating parties had solidified. Australia continued to voice its concern over the spreading of credit practices beyond what could be considered normal commercial practice. Several months earlier, Australia had circulated a paper which concluded that "circumstances are being created that will lead to widespread and disruptive competition on credit levels in the agricultural sector."\textsuperscript{428} However, the U.S. maintained its position that the issue of official export credits needed to be addressed as part of the larger issue of export subsidies. EU and Canada stated that if any agreement was reached on agricultural export credit it should also be subscribed to by the U.S. Canada and Australia voiced the need for participation of major non-OECD agricultural exporters including Argentina, Brazil and South Africa.\textsuperscript{429}

\textsuperscript{427} Organization for Economic Cooperation and Development, "Summary of Replies to the Questionaire on Export Credits for Agricultural Commodities," Trade Directorate, TD/Consensus/83.31, June 10, 1983, p. 4.


All representatives except for the United States requested that the Secretariat proceed with a detailed draft framework for a sector understanding. A group was formed for this purpose and worked through 1984 and into the beginning of 1985. At the 27th meeting of the ECG, the working group announced that the technical work had been completed and it was time move beyond the expert level to political negotiations. At this stage, the position of the U.S. had, if anything, hardened further against separating export credit negotiations from direct subsidy negotiations. The U.S. delegation asserted that the United States would be ready to start parallel discussions on export credits once negotiations on agricultural subsidies had started in the GATT. The U.S. delegate stated that the Arrangement would provide the proper forum for these discussions once they had begun.\footnote{TD/CSUS/86.66.}\footnote{TD/CSUS/85.88 paragraph 4.} In the absence of a major player, ECG members stated that further negotiations would be meaningless.\footnote{TD/CSUS/85.88 paragraph 4.}

Washington’s stand reflected the deepening domestic farm sector crisis. In a period of only four years, U.S. agricultural export revenues had plummeted by 34 percent from $44 billion in 1981 to $29 billion in 1985.\footnote{Keith Schneider, “Congress Votes Sweeping Change in Government Support for Farms,” \textit{New York Times}, December 19, 1985.} There were critical problems in the structure of the domestic programs including, losses of over $2 billion per year in farm credit banking system in 1985 and 1986.\footnote{Gordon C. Rausser, “Predatory Versus Productive Government: The Case of U.S. Agricultural Policies,” \textit{Journal of Economic Perspectives}, vol. 6, issue 3 (Summer 1992), p. 139.} Price support expenditures became the fastest rising part of the Federal budget. European export subsidies received much of the blame. Exports from Europe were gaining market share, which the U.S. considered to be the
result of heavy subsidization, not of superior cost or productivity advantages. The unwillingness of European countries to negotiate reductions in direct export subsidies created the political basis for the U.S. to create a retaliatory export subsidy program. The Export Enhancement Program (EEP) was initiated in May 1985 to help U.S. exporters meet competitors’ subsidized prices in targeted markets. Under the EEP, exporters are awarded cash payments on a bid basis, enabling them to sell wheat to specified countries at competitive prices. Over one-half of U.S. wheat exports were facilitated by the EEP from fiscal 1986 through fiscal 1995. The goal of the program was to prevent further declines in U.S. exports, challenge unfair practices of other countries, and pressure the EU to negotiate restrictions on agricultural export subsidies.

Washington’s opposition to developing separate agricultural disciplines held firm through the Uruguay Round negotiations. During this period, the U.S. focused on ensuring that its hard line on agriculture did not undermine progress on tied aid and other aspects of trade credits that were reaching a critical juncture. Negotiators focused on fending off efforts by other countries to link other negotiations taking place in the ECG on aspects of credit financing that the U.S. was pushing hard to secure. The Treasury department instructed negotiators that they were to maintain the link between negotiations on agricultural export credits in the OECD and the UR outcome, as well as

avoid an impasse in the ongoing tied aid credit negotiations. In the case of agriculture, Treasury counseled negotiators to take a passive position in the ECG:

“to ensure that issues on agriculture export credits do not move more quickly than will permit us to evaluate the utility of actual negotiation of a ‘consensus’ on agricultural export credits and guarantees, the U.S. will not initiate any proposals or attempt to facilitate progress. Our role will be a reactive one, leaving the onus on the EC, or others, to frame the issues for discussion.”

The 1990 Farm Bill contained a “GATT trigger” which required spending $1 billion annually on EEP if no Uruguay Round agreement had been reached by June 30, 1992. Since no agreement was reached by that time, the additional EEP funding was authorized. In a bit of bravado, the head of the USDA declared that the U.S. was prepared to “bankrupt the European Union with a trade war” if the Community continued to refuse to negotiate reductions in agricultural subsidies in the Uruguay round.

A breakthrough was finally achieved in the GATT in December 1993 with the conclusion of an Agreement on Agriculture. Among the most significant measures was the establishment of a cap on the expenditures a country was permitted to use to subsidize exports. The agreement required developed countries to reduce expenditures for export subsidies by 36 percent and to reduce their volume of subsidized exports by 21 percent.

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over 6 years (1995-2000) based on the 1986-90 base period. The agreement was hailed as a victory in the U.S. and Europe but was criticized for exacerbating inequalities between developed and developing countries. While prohibiting the introduction of new subsidies, the Agreement institutionalized the unfair competitive advantage held by developed country producers by permitting past users of export subsidies to maintain those subsidies, subject to certain reduction obligations. Consequently, the WTO Agreement on Agriculture, far from promoting liberalized trade in the agricultural sector, merely established permissible levels of market distortion.

The Agreement on Agriculture also did nothing to resolve the export credit issue. Export credit programs were not specifically listed as subsidies subject to the reduction commitments. Signatories simply agreed to “work towards the development of internationally agreed disciplines to govern the provision of export credits, export credit guarantees or insurance programs.” It was a best-effort commitment. Although a timetable was not specified, the implicit assumption and the preference of the US and the EU was that export credit subsidies discussions would be taken up in the OECD. With this mandate, the ECG assembled a second working group on agriculture chaired by Japan to draft a set of rules.

Disagreements quickly emerged on several fronts. One concerned the scope of the proposed sector understanding, especially whether it should include fish, fish products and forestry. Disagreement also emerged over which institutions would be

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439 World Trade Organization, Agreement on Agriculture, Article 10.2.
covered and whether the rules would be limited to ECAs or also cover STEs. There was also disagreement over data collection and how important it was in moving the negotiations forward. The U.S. complained that the data was “not sufficiently disaggregated by recipient country so as to allow proper analysis and development of a sector understanding.” Others took the U.S. position as evidence of continued stonewalling. French representatives demanded to know precisely the intent of this exercise, feeling that it was just an exercise in statistical analysis rather than a true effort on the part of the U.S. to commence negotiations on an international agreement. The French view was supported by Italy, Australia, and Germany.

By 1996, the working group on agriculture had completed its work and passed a draft understanding to the full ECG membership for consideration. However, the longstanding impasse between the U.S. and EU remained. U.S. negotiators complained that requests for U.S. restrictions on export credits were not being matched by willingness among EU countries to tighten their non-export credit subsidy practices. Specifically, EU demanded that the U.S. limit terms on export credits, while the U.S. demanded that Europe and Canada: 1) promise not to use its allowed subsidy funds for production to be used as a ‘rolling’ fund; and 2) to be more transparent on activities of their STEs. USDA continued to argue that the U.S. required longer terms to compensate for advantages that European exporters gain through direct subsidies. However, its position had softened somewhat, indicating a willingness to reduce the use of 7-year

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441 Ibid, p. 4.
During this period, major farm legislation was passed in the U.S. The U.S. Federal Agricultural Improvement and Reform Act (FAIR Act) reduced domestic price support programs, and export subsidies channeled through the EEP were zeroed out. However, ECG members found to their consternation that the legislation reauthorized previous export guarantee programs and food aid programs through 2002. The legislation authorized a total of $5.5 billion for export credits. EU and Argentina complained that the FAIR Act was at odds with Uruguay round, which obligated all governments to negotiate new disciplines on export credits. With differences among the governments too wide to breach, the ECG negotiations on agriculture languished.

In 2000, efforts were made to revive the export credit negotiations. That year the OECD Economic Ministers issued a Communiqué stating that they “regretted the failure of the Participants to the Export Credit Arrangement to reach an agreement on an Understanding covering agriculture as mandated in the Uruguay Round,” and went on to state a need “for negotiations to be resumed and successfully completed by the end of July 2000 if possible and by the end of 2000 at the latest.” By this time, evidence was beginning to confirm suspicion that the caps on direct export subsidies were simply spilling into unregulated areas including export credits. A study commissioned by the OECD found that between 1995 and 1998, export credits by fifteen OECD countries increased by $2.4 billion or 44 percent. The U.S. was identified as the largest supplier with 46 percent of the total, followed by Australia with 25 percent. The study challenged

442 Email communication, official, U.S. Export Import Bank, March 17, 1997.
the common justification for the export credit programs—namely, that they may help developing countries overcome liquidity constraints to purchase food, since the majority official credit backed trade between OECD countries. The study also found that while the volume of export credits was large, totaling $7.9 billion in 1998, the amount of subsidy associated with these credits was relatively small totaling just $216 million. By contrast direct export subsidies totaled 6.2 billion in 1998 and therefore a much large source of market distortion than export credits.

The 79th meeting of the ECG In April 2001, at the 79th meeting of the ECG attempted again but ultimately failed to bridge their disagreements. The one unexpected development is that the U.S. agreed to accept the provisions as drafted. However, Canada and Argentina refused to accept the agreement. Canada argued that that the substance of the Understanding was weak with respect to credit tenors and the text would need to be legally precise as to which entities it applied to and how. Argentina argued that the repayment terms continued to be too generous particularly for cereal and oil seed potentially placing Argentina at a competitive disadvantage in light of its higher cost of borrowing.

Previously unreceptive to the talks, agricultural interests in the U.S. began to press for an agreement on export credits. In particular they were interested securing the same type of safe harbor that had been achieved for official export credits deployed to

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446 Ibid, p. 4.
assist the export of manufactured goods. Speaking before the Senate Committee on Agriculture, Nutrition and Forestry shortly after the ECG failed to reach agreement, Charles O’mara stated:

We need to successfully conclude the discussion on the OECD agreement on agricultural export credits as soon as possible. Such an agreement would protect our oilseed, corn, cotton and other producers who benefit from export credits from a WTO challenge.\(^\text{447}\)

Europe and the United States have been characterized as two noncooperatively behaving “super-powers” whose actions in the market have an influence on each other’s agricultural policies, as well as on world prices.\(^\text{448}\) The U.S. was ultimately unwilling to accept restrictions on its agricultural export credit practices as long as the EU maintained direct export subsidies. Export credits were part of Washington’s arsenal that it was unwilling to give up without comparable restrictions on direct subsidies. The persistence of government subsidies in the agricultural sector, especially by Europe, has been explained by the asymmetry of political interests among domestic interests. The farm lobby within the EU consistently blocked moves by the EC to dramatically change the CAP. This was possible, as John Keeler explains, by “its asymmetrical interests,

\(^{447}\) Statement of Charles J. O’mara on behalf of the American Oilseed Coalition before the Senate Committee on Agriculture, Nutrition, and Forestry on the Trade Title of the Federal Agriculture Improvement and Reform Act of 1996, April 25, 2001 at URL: http://agriculture.senate.gov/Hearings/Hearings_2001/April_25_2001/0425oma.htm. The American Oilseed Coalition (AOC) includes the American Soybean Association, the National Cottonseed Products Association, the National Oilseed Processors Association, the National Sunflower Association, and the U.S. Canola Association. Charles J. O’Mara, President of O’Mara & Associates, was previously Counsel for International Affairs to the U.S. Secretary of Agriculture and Special Trade Negotiator for Agriculture.

\(^{448}\) Ibid, p. 36.
extraordinary organization, and remarkably biased enfranchisement. Some economists estimated that if price supports were ended, the net income losses per agricultural working EC-wide would be more than 9.5 times higher than the income gains per nonagricultural worker. This meant that farmers’ stake in retaining subsidies was far higher than the consumers/taxpayers’ stake in eliminating them. These distributional asymmetries, coupled with strong organizations and decision rules of EC policymaking, gave agriculture a privileged position that made it possible for the farm lobby to block significant reductions in CAP subsidies.

As long as direct subsidies remained an issue, it was impossible to reach an agreement within the ECG. Producers that did not actively subsidize exports like Australia, pressed for an agreement, but were not able to secure a sufficient level of market concentration to achieve a workable agreement without the participation of the United States in the 1980s and 1990s, and of Canada and Argentina in 2001.

Military Equipment

Military equipment was excluded from the Arrangement when it was formally established in 1978. Members concluded no standstill agreement or other provisions that would have regulated the terms or conditions for OTF backing arms sales. To this day, supplier states have made no substantive progress in bringing the sector within the Arrangement’s scope. Domestic policies regarding export subsidies are the only

450 Ibid, 131.
451 Arrangement on Guidelines for Officially Supported Export Credits (note 7), p. 6.
constraint against competitive subsidization in the sector. For the most part, these constraints are weak, leading to continued credit races, as witnessed recently in the competition in Poland for 48 multi-role combat aircraft. In this contest, Poland awarded the contract to Lockheed Martin for the F-16 on December 27, 2002 in a deal worth over $3.5 billion, but only after the U.S. government met competing financing offers from European competitors with its own financing package on subsidized terms.

The majority of global arms transfers are financed by purchasing governments, either through defense budget allocations or through a dependable undertaking such as oil or other hard currency revenue streams. There is, however, a significant subset of arms transfers that rely on financing provided by supplier countries. State-backed export financing takes several forms, ranging from the highly concessional to near market terms. Market-based financing is generally provided by the exporting country's ECA in the form of official guarantees and/or insurance, which protect the commercial banks providing the loans security against losses. A limited number of commercial banks are willing to finance military transactions but almost always require loan security from an ECA or other official source. Therefore, even 'commercial' export transactions generally involve some type of cover from an ECA or other official source. Comprehensive statistics are

453 Douglas Busvine, "Lockheed Wins $3.5 billion F-16 Tender', Reuters (Warsaw), 27 Dec. 2002. The 15-year term authorized by Congress permitted the Defense Department to offer Poland an attractive fixed rate 13-year loan, with the option to defer payments of the principal for eight years. As this was a direct government-to-government FMS sale, the U.S. Government managed payment risk and therefore eliminated the need for Lockheed to post a performance bond, which has been required by foreign buyers in the past for large commercial transactions. It also permitted Defense Department to offer an interest rate not based on market rates, but the more favorable 10-year US Treasury note. Personal communication with staff of Defense Security Cooperation Agency and Office of Management and Budget, November, 2002.
not publicly available, but a rough estimate suggests that aid and trade credits for military goods and services exceed $10 billion annually.454

For over four decades, global defense exports were shaped by the Cold War bipolar international order, which made constraints among the leading supplier states, if not unthinkable, at least unworkable.455 The collapse of the Soviet Union and the end of the Cold War created a new international environment and expectations that commercial factors would come to rival ideology and geopolitical considerations in driving the global arms market.456 However, the intensity of the competition surprised many. Global demand for all types of armaments was already in decline. In the space of a decade, the export market dropped by half, declining to $21.9 billion in 1993 and from $42.4 billion in 1984.457 Defense budget cuts in the U.S., Europe and Russia brought on by the Cold War’s end further squeezed demand. One effect that the cuts had was to spur a wave of industry mergers and rationalization.458 Another effect was to increase the pressure the

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454 This estimate is based on a figure of $3.8 billion for the U.S. (Foreign Military Financing + Military Assistance Program + Export Import Bank) in FY2001; and interviews and annual reports of major export credit agencies, giving recent annual averages of $2.9 billion for France; $2.2 billion for United Kingdom; $600 million for Canada; $600 million for the Netherlands; and $500 million for Sweden. See also, U.S. Government Accounting Office, Military Exports: A Comparison of Government Support in the United States and Three Major Competitors, GAO/NSIAD-95-86, May 1995; and Brock, Martin, ‘Paper on Export Credit Agencies and Arms Trade’, Campagne Tegen Wapenhandel, Amsterdam, Sep. 2000.


world’s suppliers of conventional weapon systems to export. While policy makers were considering how to spend the “peace dividend” created by reduced military expenditures, the industry was experiencing severe excess capacity, heightened pressure to export, and a shift in bargaining leverage to buyers. As one commentator summarized the situation: “The severe decline on the demand side and overcapacity on the supply side of arms markets have created the worst case for both exporters and nonproliferation: a buyers market.”

The new market engendered a pattern of firm lobbying common to the other sectors reviewed in this chapter. U.S. firms competing in the market claimed to be at a growing competitive disadvantage due to inferior government financing programs. U.S. defense firms cited the lack of competitive financing as a factor in the loss of export sales. Some even cited the lack of financing as a factor in their decision to move defense production outside the U.S. In response, they organized a lobbying effort that included calls for the U.S. government to establish or reestablish financing programs comparable to those available from European competitors. Among the policy changes that the industry sought was the removal of restrictions that prevented Ex-Im bank from offering export loans and loan guarantees. Concerns about military sales had caused Congress to

461 E.g., Bell-Textron’s decision to move part of its helicopter production facility from Fort Worth, TX to Canada. According to Bell officials, the availability of export finance assistance from the Canadian Export Development Corporation was one of a number of factors that encouraged them to relocate. In another example, Raytheon reportedly turned to European subcontractors rather than US to obtain access to financing requested by the Turkish government to purchase Patriot missiles in 1990.
prohibit Ex-Im from supporting military equipment sales to developing countries in 1968.\footnote{This did not immediately halt support. Between 1968 and 1974, Ex-Im extended support for another $1.6 billion in arms exports. The largest transaction during this period was $620 million in loans and $400 million in guarantees to Grumman Corp. for a sale of 80 F-14 Tomcat fighter planes to Iran. This contract had an estimated value of $2.2 billion. Ex-Im skirted the Congressional ban on providing support to developing countries by determining that Iran was a “developed” country and therefore was eligible to receive Ex-Im financing. Private communication with an official of the US Export-Import Bank, 29 July 2002.}

The defense industry’s lobbying effort led to some minor concessions between 1990 and 1994, one of which was made shortly before the 1991 Persian Gulf War. In August 1990, Congress directed Ex-Im to back two defense-related guarantees totaling $1.4 billion. The most significant of these was to support the $1.6 billion export sale of 200 Sikorsky UH-60L helicopter kits\footnote{Nancy Dunne, “Military sale to Turkey changes Eximbank policy,” \textit{Financial Times}, 23 August 1990.} to Turkey in competition against Aerospatiale of France, Messerschmitt-Bolkow-Blohm Gmbh of Germany and Agusta of Italy.\footnote{A separate transaction provided $47 million guarantee to support a $55.4 million export sale of modular control and automatic tracking system equipment for Turkish surveillance radars.} A second guarantee was secured in 1994, when Congress gave Ex-Im authority to provide financing for the export of non-lethal defense articles and defense services, intended primarily for civilian use. The law also modified Ex-Im policy to allow non-lethal dual use items intended primarily for civilian purposes to be used partly for military purposes, as well.\footnote{This was largely to permit Ex-Im to support US companies, which were competing in the rapidly expanding international market for air traffic control and radar systems. See Cloud, David S., ‘Members question proposal to boost weapons sales,’ \textit{Congressional Quarterly}, 23 March 1991; Burgess, John, “Arms Export Loan Plan Draws Fire in Congress,” \textit{Washington Post}, 3 May 1991; ‘Bush plan to apply Eximbank program to arms exports attracts criticism,’ \textit{Inside The Pentagon}, 18 April 1991.} However, these exceptions fell far short of industry demands.
Unable to secure satisfactory policy changes at Ex-Im, defense export supporters turned their attention to establishing a separate $5 billion loan guarantee program.\(^{466}\)

Arguing that it was necessary to put U.S. defense contractors on a level playing field with foreign competitors, protect jobs; and protect the US military industrial base, supporters drafted legislation that would establish an export financing program within the Department of Defense (DOD), which would mirror export financing available to civilian exporters.\(^{467}\) Eventually, Congress approved legislation establishing the Defense Export Loan Guarantee (DELG) program in 1995. That year, the Congressional Research Service's annual report on arms transfers to the developing world showed that France surpassed the U.S. as the leading exporter of arms. In 1994, France secured 45 percent of all new arms agreements to $11.4 billion. This was nearly twice the level secured by the U.S. ($6.1 billion), the lowest level in eight years. U.S. military contractors seized on the data as further evidence of the need for the U.S. government to increase assistance to American companies competing against subsidies provided by European competitors.\(^{468}\)

The DELG program authorized the DOD to issue guarantees against possible losses of principal and interest for loans provided by private banks, with a total contingent liability not to exceed $15 billion. A total of 39 countries were eligible for guarantees, including NATO members, major non-NATO allies, non-communist members of Asia-Pacific Economic Cooperation (APEC), and central European countries. However, the program did not provide the benefits that defense manufacturers

\(^{467}\) See statement of Senator Kempthorne Congressional Record-- Senate, Thursday, August 3, 1995 (104th Congress 1st Session).
sought. Before the legislation was passed, opponents inserted a provision that rendered it uncompetitive. The poison pill was an amendment that prohibited the program from financing exposure fees levied on each transaction to cover estimated default risk.\textsuperscript{469} This condition, coupled with user fees set at levels expected to cover the estimated program costs, made the guarantees more expensive than competing alternatives for potential users. Greece, New Zealand, South Korea, Spain, Thailand and Turkey made inquiries but ultimately decided against using the DELG.\textsuperscript{470} Therefore, the program was at best a pyrrhic victory.

While Congress resisted the defense industry’s demands to establish a full complement of military export financing programs, the U.S. did not actively seek out international rules to constrain credit competition. In stark contrast to other sectors, the U.S. made no effort within the ECG to control export credit racing in the military sector. Indeed, the U.S. blocked these measures proposed by another state. In 1993, Sweden notified the Export Credits Group of its concern: a number of countries were subsidizing military exports through favorable credit terms, subsidized prices, and tied aid. To

\textsuperscript{469} The amendment offered by Senators Dale Bumpers (D-Arkansas) read: ‘That the exposure fees charged and collected by the Secretary for each guarantee, shall be paid by the country involved and shall not be financed as part of a loan guarantee by the United States.’ See debate on amendment no. 2397, Department of Defense Appropriations Act, 1996, \textit{Congressional Record—Senate, Congress 1\textsuperscript{st} Session, 141 Congressional Record S 12166, vol. 141 no. 134, Thursday, 10 Aug. 10, 1995 (Legislative day of Monday, 10 July 1995).}

\textsuperscript{470} The DELG program only issued one loan guarantee valued at $16.7 million to support a direct commercial sale to Romania for an unmanned aerial vehicle and moving target simulator. The exposure fee for this transaction was assessed at 21.23 percent, requiring an upfront fee of $3.5 million. Depending on the country’s risk rating, the program could require a fee of up to 15-22 percent of the total contract price. Given the high cost of this program and the inability to wrap the exposure fees into the loan the program, it has not been used since. See Government Accounting Office, \textit{Defense Trade: Status of the Defense Export Loan Guarantee Program}, GAO/NSIAD-99-30, Washington, DC, Dec. 1998, pp. 5-7. Fixing the DELG became a priority for the defense industry, which was seeking, among other things, to remove the prohibition against including the exposure fee in the loan. See Aerospace Industries Association, ‘Improve Defense Export Loan Guarantee Program,’ unpublished position statement, Washington, DC, 14 Nov. 2000.
address this problem, Sweden submitted a confidential proposal for a sector understanding on military equipment.\textsuperscript{471} As part of such an agreement, Sweden proposed that members agree to permit only pure cover (guarantees or insurance) with appropriate fees or the use of CIRR rates on official loans. It also suggested restricting the use of tied aid credits associated with military sales.

Sweden’s plan appears to have been motivated by its own competitiveness concerns related to the challenges it faced in marketing its new fighter jet the JAS-39 Gripen. In May 1992, Finland announced that it would not purchase the new JAS-39 Gripen but would instead purchase the F/A-18 Hornet fighter aircraft from McDonnell Douglas.\textsuperscript{472} The loss of this order, for 64 aircraft in a deal valued at $2–3 billion, was a significant set-back for the Swedish military and Sweden’s Saab-Scania AB. Both the military and the manufacturer had been counting heavily on this contract to supplement domestic orders. Sweden’s sudden interest in controlling military export arose from the challenges it faced in marketing the JAS-39 Gripen beyond its immediate neighbors.\textsuperscript{473}

The U.S. rejected Sweden’s proposal to broaden the scope of the Arrangement on several grounds.\textsuperscript{474} First, it informed Sweden and other members that the proposal raised security issues, which it did not believe the ECG, as an economic forum, could properly

\textsuperscript{471} Private communications from officials of the Department of Export Promotion and International Markets, Ministry of Foreign Affairs, Sweden, October 2001.


\textsuperscript{473} This was also two years before Saab announced its alliance with British Aerospace to market and support export versions of the JAS-39 Gripen to foreign customers.

\textsuperscript{474} U.S. Department of Treasury, Office of International Trade Finance, ‘Swedish proposal on export credit support for military sales’, October 30, 1992.
address. Second, U.S. officials argued that military assistance was a matter of national security policy and opposed any restrictions on its policy options in this area. The official talking points written to rebut the Swedish proposal stated: “Our government values flexibility in this area and we assume others do also.” 475 Third, it pointed out that no international disciplines exist on production and research and development (R&D) subsidies for military goods. The U.S., therefore, questioned whether it made sense to discipline export credit subsidies in a sector where other forms of export subsidies were not disciplined and where export credits were a relatively small part of the possible subsidy problem. Finally, the U.S. questioned the effectiveness of a sector agreement, pointing to the fact that major producers of military equipment outside the OECD would not be covered by an agreement.

Other countries have also expressed the view that a sector understanding would not work in the context of the Arrangement. In addition to China and Russia not being parties to the arrangement, French officials have pointed out that the U.S. Treasury and the Export-Import Bank represent U.S. interests in export credit negotiations. As long as DOD is not represented, according to French officials, the U.S. might not feel bound by any measures adopted by that group. 476

Cartel theory predicts some but not all of the challenges of expanding the scope of the Arrangement to cover military goods. Although U.S. officials argued that a sector agreement was not possible because Russia, China and other arms exporters stood outside

475 Ibid.
476 Private communications from officials at the French Ministry of Economy and Finance, Economic and Trade Department, Paris, March 2002.
the Arrangement, these exporters in fact made up a relatively small fringe. During the five-year period between 1994 and 1998, total global arms deliveries averaged $41.3 billion a year. The U.S. was the dominant supplier with a market share of 43 percent. Just four Arrangement members—the U.S., France, UK and Germany—made up 75 percent of these deliveries. If third-tier European arms suppliers are included, such as the Netherlands, Switzerland, and Sweden, then Arrangement members controlled 85 percent of the global arms trade (see Figure 8). While Russia had been a major exporter in the 1980s, its arms exports had dwindled to only 7 percent of world arms deliveries, less than half of average sales of the UK.477 Even if China and other non-Arrangement suppliers are combined, they still constituted a fringe of only 15 percent. Thus, an important condition of collusion was met. Cartel theory predicts that collusion will be more difficult when producers are chasing a dwindling number of orders; however, collusion is not unknown under such conditions. As shown by the creation of “recession cartels” at various periods, over capacity and weak demand can also create strong incentives to limit cutthroat competition and resist the market power of buyers. Thus, the argument made by U.S. officials regarding the competitive threat from outside suppliers is not convincing.

As noted in Chapter 2, cartel theory predicts that collusion among producers will be more difficult to establish and enforce when non-price factors play a significant factor.

in contract competition. In the military sector, where government-to-government sales are the norm rather than the exception, and power and diplomatic influence are significant factors in concluding contracts, this is clearly the case. As one scholar stated: “The argument that arms transfers are tools of power and influence is a leitmotif in the arms transfer literature.”

Arms sales can provide a means of gaining access to

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political and military elites. \footnote{Pierre, The Global Politics of Arms Sales, p. 15.} Arms sales may serve a supplier state’s interests by helping to maintain regional military balances favorable to the supplier state; strengthen the internal security and stability of the recipient; and build the quality and commonality of the capabilities of major allies. Arms transfers may also be promoted to address a variety of other security-related externalities, including fighting drug trafficking as a means of suppressing counter-insurgencies and, most recently, fighting terrorism. \footnote{Andrew Hurrell, “Security in Latin America,” International Affairs, vol. 74, no. 3 (July 1998), pp. 529-546}

In addition to these non-price factors, differences in the way suppliers organize their export programs make cooperation in this sector difficult. Western European governments rely heavily on their ECAs to support export contracts in what may be considered an export guarantee model of promoting arms exports. For example, Britain relies on ECGD to finance the majority of its military sales by guaranteeing commercial bank loans. The French government also relies heavily on COFACE to finance export sales. The U.S., by contrast, relies more heavily on government-to-government contracts arranged by the Department of Defense in what may be considered an agent model of promoting arms exports. The U.S. does permit defense firms and foreign buyers to arrange sales. As illustrated in Figure 9, these so-called Direct Commercial Sales (DCS) made up an average 14 percent of military exports between 1992 and 2001. However, the majority of sales are government-to-government transactions. \footnote{A detailed description of the FMS system can be found in: The Management of Security Assistance, Defense Institute of Security Assistance Management, Wright-Patterson Air Force Base, Ohio, 18th edition, June 1998.} Foreign Military Sales (FMS) made up approximately 85 per cent of total US military exports ($122 billion).
They are distinguished by the direct role that DOD acts as a procurement agent between the U.S. exporter and the foreign buyer. The U.S. government finances a portion of FMS sales through loans, guarantees and grants.\textsuperscript{482} However, the majority of FMS sales receive no direct financing support from the U.S. government. Transactions that do not

\textsuperscript{482} Over the past decade, this was approximately 28 per cent of FMS sales.
receive financing are referred to as ‘cash’ sales. These sales totaled $82.1 billion dollars between 1992 and 2001. U.S. law requires that ‘cash-financed’ government-to-government transactions impose no direct cost on U.S. taxpayers. Buyers are assessed a fee, which is intended to cover the estimated administrative costs of managing these contracts, but this fee does not necessarily cover the full economic value of DOD’s role as market intermediary.

Even when the U.S. program does not provide direct financing, exporting firms and buyers can derive significant economic benefits from the agent procurement model. First, foreign buyers receive the same prices paid by the DOD and therefore directly benefit from the significant scale economies and bargaining leverage that the Pentagon enjoys as the largest buyer of defense goods and services produced in the U.S. Second, buyers benefit from the Pentagon’s experience in managing defense contracts, which can range widely in structure from relatively straightforward fixed price arrangements to more complex cost-plus-incentive-fee contracts. On the other side of the transaction, sellers benefit from significantly reduced payment risk. The U.S. Government is generally in a better position than a manufacturer to enforce contracts with overseas buyers if payment problems arise. By serving as an agent for the transaction, the U.S. Government manages price risk for buyers and repayment risk for sellers, lowering risk and therefore the cost of these transactions. Competitors view this program as a source of competitive advantage and design their own export promotion programs to overcome or at least attempt to neutralize this advantage. As one policy brief written by staff at Ex-Im

483 Cash sales are transactions where the buyer agrees to finance a transaction from national funds, either through a dependable undertaking for sales from procurement, or by cash prior to delivery for sales from DOD inventories. The purchasing government pays all costs that may be associated with the sale.

484 Personal communication with staff of U.S. Aerospace Industries Association, December 2002.
explained: “...most competitors’ view FMS as a twofold program with both commercial and political goals, and, therefore tailor their programs to combat it.”

The ability of supplier states to constrain export credit competition in the military sector has also been undermined by the unwillingness of states to share information on military transactions. Supplier states participating in the Arrangement have refused to share information about financial commitments or flows associated with military equipment. The only exceptions are the additional costs of military personnel in delivering humanitarian aid, which are reportable as part of ODA, and forgiveness of military debt, which may be reported as “other official flows” (OOF). Arrangement members are required to report lines of credit for military transactions of over one year in maturity extended directly by national official export credit financing institutions to foreign borrowers. However, this data is combined with data on bank claims collected by the Bank for International Settlements to derive total bank and trade-related non-bank external debt owed by borrowing countries. The military component of these debt figures is combined with credits and other claims for non-military items, making it impossible to determine the level of official financing support for military purchases either on a country-by-country basis or on a more aggregated basis.

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487 These are known as Form 3A reports under the CRS.
Free trade norms had little effect in promoting agreement in the military sector. There is little evidence that Sweden framed its proposal to regulate export subsidies in the military sector in these terms. The proposal was kept secret and only discussed within the context of the ECG. Sweden did not publicize its efforts or seek to build support from sympathetic non-state actors. As noted in Chapter 2, international actors can intentionally choose and promote certain norms, thereby constructing a focal point around which actors’ expectations can converge. While U.S. regularly appealed to free trade norms in other sectors to advance the formation of OTF rules, U.S. officials made no such appeals in the military sector. The Arrangement offered an institutional basis to do so. By the 1990s, the ECG was well established as a forum for discussing a wide range of export financing practices, suggesting that it could have become as basis for discourse, knowledge exchange and persuasion on military financing. Although Switzerland, the Netherlands and other third-tier suppliers were sympathetic Sweden’s proposal, it had no chance without the backing of U.S., the UK or France.488

It is important to note that the case for ending supplier state financial interventions in support of weapons sales is not unknown. A diverse group of peace, non-proliferation and church groups, on both sides of the Atlantic, have actively advanced the idea.489 Restraints based on an appeal to free trade principles have also been made in defense sector policy circles. This case was made most prominently by a

special Advisory board to the president impaneled by President Clinton in January 1995. One of the Advisory Board's core recommendations was not only that arms exports should be free of subsidized financing but also that the U.S. should take a leadership role in eliminating such distortions internationally. In advancing these recommendations, the Advisory board appealed directly to free trade norms:

"As a matter of principle, the Board believes that free trade without the price distorting mechanisms of government subsidies is a desirable goal. Excessive government involvement frequently inhibits free trade and reinforces unhealthy special-interest relationships between governments and industries within their jurisdiction, particularly with government owned or subsidized companies. In the case of arms sales, this can lead to strong domestic pressures to make sales of weapons or technologies that may be unwise form an international security perspective... The Board believes that the Administration and the Congress should work together to develop and implement a strategy to gain multilateral restraint on all manner of price distortion and unfair trade practices."  

While the normative case has been made that free trade norms should apply in military sector, they have rarely translated into binding rules at the international level. Applying Legro’s concept of concordance—that is, how widely a norm is accepted as measured by its institutionalization in laws, treaties or communiqués—we find that free trade norms are weak. Trade agreements have routinely excluded the military trade.

Every trade agreement since the GATT was established in 1947 has a 'security

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490 President’s Advisory Board on Arms Proliferation Policy, Executive Order 12946 of January 20, 1995, Federal Register, vol. 60, no. 15, January 24, 1995.  
491 United States, Presidential Advisory Board on Arms Proliferation Policy, Report of the Presidential Advisory Board on Arms Proliferation Policy, Jane E. Nolan, Chair (Santa Monica, CA: Rand, 1996), pp. 16-17.
exemption' clause, which allows governments to subsidize production, promote sales, and impose any trade embargoes that they deem necessary to maintain national security.492 Article XXI of the General Agreement and Trade and Tariffs (GATT) exempts military activities, including massive government research and export subsidies, ostensibly to protect "essential security interests." These exclusions shield weapons producers from possible WTO challenge.

The factors presented above explain why the military sector has not been brought under the terms of the Arrangement. Since the end of the Cold War, Arrangement members have controlled an overwhelming share of the export market, indicating that an important criterion for extending the scope of the export credit cartel was met. However, other important conditions were not met. The fact that non-price factors and major structural differences existed between competing suppliers made cooperation difficult. Further, state preferences did not favor international rules. The U.S. was not only willing to tolerate heterogeneous export financing practices, but it also resisted proposals that would have established common terms and conditions. The U.S. stance was particularly important in this sector, given its dominant market share. Finally, free trade norms were not sufficiently robust to overcome competition from security norms. Together, these factors explain why the military sector continues to remain unregulated.

Conclusion

This chapter began by asking two questions relevant to the scope of the OTF regime: 1) Why supplier states were able to negotiate and enforce rules on general manufactured goods but faced more difficulty in certain sectors, specifically ships, nuclear plants, and civil aircraft? 2) Why, despite calls to do so, have supplier states been unable effectively regulate OTF backing agriculture and military equipment?

The evidence presented in this chapter confirms that models that combine the concept of institutional costs with the hegemonic power of the United States are inadequate to explain the construction of rules across sectors. I proposed that stringent rules are more likely to be established when the preferences of supplier states converge, the institutional and market structure requirements necessary for a stable cartel hold and the norms encouraging free trade and discouraging subsidies are clear, durable and widely accepted. In the regulated sectors this was found to be the case. Free trade principles also dovetailed with supplier states interest in halting unintentional wealth transfers to buyers. By asserting that competitive subsidization distorted markets, supplier states were able to justify applying the terms and conditions negotiated through the Arrangement to a wide range of capital goods exports. Members of the Arrangement controlled a dominant share of the market for both the credits and the product being exported. These market structural features made it easier for the largest suppliers of OTF to meet an important requirement for establishing and maintaining a stable cartel-like institution.
I also proposed that stringent rules were less likely when the preferences of supplier states are heterogeneous, the institutional requirements of a cartel are not realized, and prescriptive norms regarding subsidies and free trade are narrowly accepted, if at all. These outcomes where found to hold in the more difficult to regulate sectors. Imperfect competition, particularly difficult exit (e.g. shipbuilding) or entry (e.g. civil aircraft), was one of the most important factors in creating heterogeneous preferences toward collusion. When preferences were highly divergent supplier states were unwilling to share information and therefore met a key condition necessary for a cartel to be effective. As shown most clearly in the case of aircraft, industries characterized by imperfect competition also provided arguments that free trade norms did not apply.

Finally, export finance is only one of several types of intervention practiced by states. The most challenging cases for rule construction involved instances in which export credits subsidies were used to counter the effects of other forms of government intervention. Agriculture is one instance where the US used the export credits to counteract distortions caused by the European CAP program. Military equipment is another instance where European states used export credits to counteract the distortions caused by the U.S. FMS program. Free trade norms were less applicable in these sectors as well as they competed with other legitimating principles that justified subsidies—namely, food security and national security. In contrast to general capital goods sectors, supplier states not only have more divergent preferences, they also lacked a clear focal point around which to establish agreement. Thus, even though the
institutional arrangements to restrict competition were well established by the 1980s, supplier state could not use them effectively to constrain competition.
CHAPTER FIVE: SCOPE OF RULES BY FINANCIAL INSTRUMENTS

The previous two chapters explained the institutional arrangements governing export finance and the sectors covered by international rules. This chapter turns to the scope of rules that govern different forms of state-backed export finance. As noted in Chapter 1, there is a range of financial instruments that governments provide to support exports and investment abroad. These instruments include export credit loans, export insurance, and investment credits, as well as foreign aid and combinations of foreign aid and export credits. The institutional vehicle through which the financing is provided can also be significant, depending on whether the financing is provided through an “official window” — typically a government owned and funded agency — or a “market window” — typically a government corporation that is only indirectly financed by the government.

The terms on which governments provide OTF are always highly contested. Two sets of games, which take place simultaneously, condition the outcome. One is the struggle between supplier states and buyer states. For example, suppliers of financing typically try to shift the risk to the borrower by lending at floating rates. Borrowers, in turn, typically seek to avoid the risk that interest rates will increase in the future by seeking out fixed rates. A similar situation is found in the case of foreign aid. To limit budget costs, donors have an incentive to provide aid on harder terms (e.g. loans rather

493 Other authors use the terms “creditor” and “borrower” and/or “donor” and “recipient” to identify these actors.
than grants) and to retain control of where the money is spent. Recipients, on the other hand, generally prefer softer terms and the greatest degree of flexibility possible in making procurement decisions. At the same time, there is a parallel contest, which takes place between competing supplier states. In a competitive export environment, supplier states are under strong pressure to offer the most competitive financing available to their own exporters while at the same time defending their exporters against the “predatory” financing of others.

International rules governing OTF offer an opportunity for supplier states to intercede and set terms for the two contests described above. If they are sufficiently robust and well enforced, the rules can have a significant effect on the terms and conditions on which state-backed financing is offered. However, supplier states have been more effective in regulating some modes of financing than others. This chapter explains the variation found in the strength of rules across different forms of OTF financing over the past 30 years. Two regulated (export credits and mixed credits) and two unregulated (untied aid and market windows) modes of finance are examined. As in the case of sector based rules examined in the last chapter, the evidence suggests that state preferences, the satisfaction of cartel conditions, and the role of free trade norms provide a compelling explanation for the variation found in the scope of rules adopted by supplier states.
Regulating Export Credit Interest Rates

A core function of a cartel is to detect and punish price-cutting behavior. But before this can take place, cartel members must agree on a standard against which to judge deviant behavior. A mutually acceptable methodology for fixing prices is necessary. In the case of the Arrangement, one of the top agenda items during the 1970s and 80s was to reach an agreement on how to set interest rate prices. This proved to be a long and difficult journey, lasting over three decades. Figure 10 shows the evolution of the three basic price fixing methodologies since the early 1970s. The first approach

Figure 10. Evolution of Market-Proxy Interest Rate Methodology for Export Credits

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<td>MMI</td>
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<td>CIRR</td>
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Note: MMI = Matrix Minimum Interest rate; UMM = Uniform Moving Matrix; CIRR = Commercial Interest Reference Rate.

supplier states adopted was the matrix minimum interest (MMI) rate. This pricing system lasted for nine years from 1974 to 1982. The second approach was the Uniform Moving Matrix (UMM). Most Arrangement members used this formula for three years from 1983 to 1986; however, it continued to be used by some members up until 1995. The Commercial Interest Reference Rate (CIRR) methodology was introduced in 1983. It became the primary approach in 1986, but it was another nine years before it became the standard for all members. The evolution of these price-fixing guidelines cannot be understood without reference to the preferences of supplier states, the formation of a cartel-like institutional arrangement that served as a bargaining forum, or the norms that informed the negotiation process.

The MMI rate was a key outcome of secret negotiations that took place from 1974 to 1976. As noted in Chapter 2, negotiations among supplier states began in earnest after a side gathering of finance ministers at an IMF meeting in Nairobi, Kenya. This meeting launched a series of closed-door negotiations that took place in Rome, Bonn, Washington, Brussels and Paris. By 1974, the effects of the oil shocks and the collapse of the fixed change system had created strong incentives for supplier states to shift from attempting to control export credit subsidies through a general prohibition, as found in

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495 The applicability extends beyond Arrangement members, because the WTO’ Agreement on Subsidies and Countervailing Measures recognizes the interest rate provisions established by the Arrangement (Annex I. (k)). Annex I. Item K of the Uruguay Round SCM Agreement stipulates that if a measure is entered into consistently with the interest rate provisions of the OECD Arrangement, such a practice cannot be challenged as an export subsidy. Item k of the Uruguay Round SCM Agreement is unchanged from the paragraph k in the illustrative list of the Tokyo Round subsidy code.

GATT Article XVI 4, to a more specific agreement that fixed minimum interest rates. Spurred by fear that international economic crisis and growing surplus industrial capacity would further aggravate the incentive to export at all costs, OECD Ministers provided a political mandate to take more concrete measures as part of “trade pledge” issued in May 1974. In late 1974, the Swedish delegation presented a study to the ECG, which concluded that an agreement on minimum interest rates would be useful if not necessary. By this time the Exchange of Information System (EIS), which supplier states had directed the ECG secretariat to establish in 1972, was ready to operate. An agreement on interest rates was crucial to providing a benchmark against which deviant behavior could be judged; otherwise, the emerging export credit cartel was unlikely to function effectively as a means of policing behavior.

By the 1970s, there had also been progress in clarifying the distinction between development finance and export credits. Through the 1950s and 1960s there had been considerable inconsistency regarding the relationship between these two modes of OTF. Even though it was standard for supplier states to consider export credits commercial, these transactions were, nevertheless, often subsidized. Research conducted by the

499 For a description of the information sharing system see U.S. House, Committee on Banking, Finance and Urban Affairs, To Amend and Extend the Export-Import Bank Act of 1945: Hearings before the Subcommittee on International Trade, Investment and Monetary Policy, 95th Congress, 2nd Session, March 13, 15, 16 and 17, 1978, p. 95.
OECD in the late 1960s suggested that “commercial credits” were subsidized anywhere from five to over twenty percent.\textsuperscript{500} Likewise, foreign aid was often difficult to distinguish from trade promotion. The inconsistencies were found even in the U.S. programs, which had sought to maintain a more rigid line between the two types of financing than had most governments. For example, Ex-Im Bank’s legislative charter encouraged commercial business practices and annual dividend returns to the U.S. Treasury by requiring the Board to approve loans only when transactions “offer reasonable assurance of repayment.”\textsuperscript{501} However, in the 1950s and 1960s, Ex-Im regularly issued soft “developmental loans” and, for a time, created considerable friction with the World Bank by directly competing with the fledgling institution for business.\textsuperscript{502} At the same time, USAID’s pursuit of development goals looked to many like trade promotion as the agency became heavily involved in providing long term financing for power plants and other capital goods exports.\textsuperscript{503}

Finally, in 1969, after protracted discussions, supplier states adopted the concept of Official Development Assistance (ODA), which more clearly separated foreign aid from “Other Official Flows”, including export credits.\textsuperscript{504} ODA was defined as official

\textsuperscript{500} The results of this study are reported in Nathaniel McKitterick and B. Jenkins Middleton, \textit{The Bankers of the Rich and the Bankers of the Poor: The Role of Export Credit in Development Finance} Washington, DC: The Overseas Development Council, monograph No. 6, 1972, p. 31
\textsuperscript{501} \textit{The Export-Import Bank Act of 1945} (P.L. 173, 79\textsuperscript{th} Congress).
\textsuperscript{502} This friction continued until policy changes introduced by the Eisenhower administration more clearly delineated the spheres that each institution would serve. See Mason and Asher, \textit{The World Bank Since Bretton Woods}, pp. 502-503; and Becker and McClenahan, Jr., \textit{The Market, the States and the Export-Import Bank of the United States}, 1934-2000, pp. 95-96.
\textsuperscript{504} OOF are transactions by the official sector with countries on the List of Aid Recipients which do not meet the conditions for eligibility as Official Development Assistance or Official Aid, either because they are not primarily aimed at development, or because they have a grant element of less than 25%.
transactions that had as their primary objective the promotion of the economic and social
development of developing countries and were supported on financial terms that were
“intended to be concessional in character.” The Development Assistance Committee,
through which these technical discussions took place, refined this definition further in
1972. To be considered ODA, the DAC announced that a transaction must meet the
following test: “a) It is administered with the promotion of the economic development
and welfare of developing countries as its main objective, and b) it is concessional in
character and contains a grant element of at least 25 percent (calculated at a rate of
discount of 10 percent).”

Rules that explicitly sanctioned subsidy interventions for developmental purposes had the effect of further lessening the legitimacy of subsidies
associated with export credits. A more clearly defined channel for aid subsidies created
the expectation that other financial interventions by a state would be subsidy free.

Codifying separate categories for export credits and foreign aid also conformed to
a growing body of economic literature that counseled against the provision of subsidies in
“normal” trade. Free trade ideas already had a long intellectual history extending back to
the seventeenth-century. However, important advancements were made in economic
reasoning regarding export subsidies in the two decades between 1950 and 1970s,
including influential work by James Meade, Gottfried Haberler, Jagdish Bhagwati, and

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Assistance Committee and the Development Cooperation Directorate in Dates, Names and Figures,”
Organization for Economic Cooperation and Development, OCDE/GD(94)67, 1994, p. 27.
University Press, 1996) and William Allen, “International Trade Theory, Commercial Policy and the
Robert Baldwin, among others. In general, this literature argued that unless justified by clear market failures, subsidies created distortions that threatened to reduce both national and world income. These ideas influenced policy advice on the question of whether commercial credits should be used to promote development goals as well as trade. This question grew in salience as the number of developing countries experiencing international payment difficulties grew from the mid-1960s onward. Responding to criticisms that export credits had harmful effects and that their terms should be softened, international trade economists generally argued that all trade—including north-south trade—should be free of distortions. A 1970 IMF study commissioned by UNCTAD to explore the relationship between export credits and external indebtedness was typical of these views. In addition to rejecting controls on the volume of export credit flows from developed to developing countries, the study concluded: “Deliberate action to reduce interest rates and insurance charges, while possibly alleviating the foreign debt servicing burden, would require direct or indirect subsidization and would run contrary to the efforts of the international community to avoid the use of subsidies in export trade.”


510 International Monetary Fund, “The Use of Commercial Credits by Developing Countries for Financing Imports of Capital Goods,” p. 34.
Still, how free trade norms should translate into specific interest rate pricing rules was not entirely clear. ECAs provided financing in areas where private sector financing was inadequate, or, as one British official suggested in testimony before Parliament, “a facility which no banker in his right mind would introduce.” The U.S. in particular argued that export credit interest rates should be raised to reflect market rates. But what did “market prices” mean in this context? Welfare economics offered an answer, or at least a theoretical ideal. The range of options available to supplier states in pricing credits and their varying welfare consequences are illustrated notionally in Figure 11.

The vector 0-0' represents an idealized price outcome under the conditions of perfect competition, or what J.E. Meade referred to as the point of “utopian efficiency.” This vector represents the point at which the price of an export credit equals its marginal cost. Interest rates priced along this line would therefore be considered economically efficient, meeting the criteria of Pareto efficiency, where it is no longer possible to make one additional person better off without anyone else being worse off.

The ideal price vector defines welfare outcomes. A pricing methodology that yields interest rates above the price vector would be a collusive tax, which would shift rents from borrowers to creditors. By contrast, a pricing methodology that results in credit terms below this vector means that rents are transferred from creditors to

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511 Quoted in Joan Pearce, *Subsidized Export Credit*, p. 17.
512 Figure 11 plots interest rates (y axis) against repayment period (x axis). These are important determinants of the cost of financing but not the only determinants. Other factors include the size of the downpayment, the amount of local cost financing, and repayment terms and the amount of interest charged during construction.
Figure 11. Interest Rate Pricing Options for Export Credits

Note: Vector 0-\(O'\) indicates the point at which the price of official trade finance is equal to marginal cost. It is the theoretical Pareto efficient point where world income is maximized. This point is can be difficult if not impossible to locate (indicated by being increasingly broken) as the repayment period and therefore the risk of the transaction is extended. \(S=\text{Supplier state; } B=\text{Buyer State. The plus sign (+) indicates a gain in economic rents while the minus sign (-) indicates a loss of economic rents. Vector } B-B' \text{ indicates the subsidy equilibrium that prevails when supplier states are unable to cooperate in setting higher export credit interest rate prices.}\)

The problem that confronted supplier states—if they were truly interested in eliminating distortions associated with export credits—was finding this vector. These

borrowers. Vector \(B-B'\) illustrates competitive subsidy equilibrium that results when supplier states are unwilling or unable to cooperate to raise prices to the “market rate.”
ideal price points are less difficult to identify for short-term credits, since risks are lower and commercial banks are more likely to compete in this segment of the market (indicated by the solid line). The ideal price point is more difficult, if not impossible, to identify for medium to long-term credits since private capital is less likely to operate in that segment of the market (indicated by the progressively broken line in Figure 12). Thus, while economic reasoning provided the framework that demonstrated that “market prices” were the ideal that supplier states should strive for in devising an international pricing policy, it did not resolve the practical problem of how to find such prices where a private banker would not “in his right mind” offer financing.515

As will be recalled from Chapter 2, the leading supplier states agreed to proscriptive guidelines on export credits as part of the early GATT negotiations aimed at eliminating subsidies on manufactured products. This effort not only failed institutionally by not creating an effective cartel to monitor and police the provision of credits, but it also failed as an effective pricing standard. It barred “the grant by governments (or special institutions controlled by governments) of export credits at rates below those, which they have to pay in order to obtain the funds so employed.”516 This methodology was a cost-to-government standard not a true market standard. It was also highly ambiguous in that it did not specify whether it referred to individual transactions, a

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515 As noted in Chapter 2 (pp. 86-87) there is controversy over why private banks avoid certain market segments. One explanation is that markets are failing due to inadequate information, the limited number of actors or transactions or some other imperfection that inhibits the efficient allocation of resources. However, another explanation is that the lack of participation is a signal regarding the true risk of backing a particular transaction or class of transactions. For a discussion of the point that “the lack of longer-term or fixed-interest-rate finance is a market characteristic, not necessarily an imperfection,” see James J. Emery, Norman A. Graham, Richard L. Kauffman and Michael C. Oppenheimer, *The U.S. Export-Import Bank: Policy Dilemmas and Choices* (Boulder, CO: Westview Press, 1984), pp. 54-55.

portfolio of transactions, or the entire range of business in which an ECA might engage. It also did not specify the period of time over which the accounting would be done and whether it would be quarterly, yearly, or over some other span of time. If states only had to ensure that their export credit agencies operated at no net cost to public funds, including administrative, the standard still would have left considerable leeway for price-specific transactions.

The negotiations launched by the six largest supplier states in Nairobi reflected the realization that unrestricted competition could only be contained through a collective agreement to fix minimum credit terms. One issue that became controversial during the effort to construct the MMI was whether the interest rate floor set by supplier states should acknowledge different classes of buyers. Two views predominated among supplier states. One view was that financing should be based solely on the features of the goods being exported, such as the size of the transaction and the expected life of the good. U.S. negotiators took this position and opposed an approach that would incorporate any geographical considerations into the repayment methodology.517 U.S. officials maintained that interest rates should relate exclusively to the nature of the projects being financed and rejected the idea that any accounting of the ability to pay should be part of the standard. Another view was that export credit terms should be based not only on the features of the goods being exported but also the economic conditions of the importing country. European negotiators held this position, arguing that

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interest rate rules should take into account not only the nature of the project, but also the
financing capacity of the importing country. The U.S. position did not prevail. In
order to secure an agreement, the U.S. eventually dropped its opposition. Buyer states
were divided into three categories of states depending on their per capita income data
published by the World Bank.

Although the need for minimum interest rates was commonly accepted among
supplier states, agreement on what these specific rates should be was only settled through
a process of hard bargaining. No supplier state was willing to accept interest rates that
would place them at significant competitive disadvantage in export markets. According
to media reports from the period, the U.S. began by demanding a minimum rate of 9
percent, although some argued that prevailing market rates were in the range of 9.5 to 11
percent. The U.S. demand was later dropped to 8.5 percent. Europe and Japan initially
started at 7 percent but would go no further than 7.5 percent for most of the
negotiations. The negotiations continued in fits and starts through 1975 and into early
1976. Finally, the original six supplier states plus Canada agreed to abide by a
common MMI in July 1976. As shown in Figure 12, the matrix of country categories and
tenor ranged from 8 percent to 7.25 percent. The highest interest rate applied to

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518 Ibid.
519 Faul Kemezi, “Brussels Meeting Can’t Reach Agreement on Export Credits,” New York Times,
September 12, 1974.
520 For an account of these negotiations see Harry Terrell, “Three Initiatives in Export Credit,” The Banker,
pp. 1497-1498; Geberth, “The Genesis of the Consensus,” p. 28; and Ray, Managing Official Export
Credits, pp. 48-58.

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Figure 12. Matrix Minimum Interest (MMI) Rates, 1976 and 1981

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<tr>
<th></th>
<th>July 1976 Agreement</th>
<th>November 1981 Agreement</th>
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<tr>
<td><strong>Relatively Rich</strong>*</td>
<td>7.75% 8.00% N/A</td>
<td>11.00% 11.25% N/A</td>
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<tr>
<td><strong>Intermediate</strong></td>
<td>7.25% 7.75% N/A</td>
<td>10.50% 11.00% N/A</td>
</tr>
<tr>
<td><strong>Poorest Countries</strong>*</td>
<td>7.25% 7.50% 7.50%</td>
<td>10.00% 10.00% 10.00%</td>
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* Category I Country: defined in July 1976 agreement as per capita GNP over $3,000 in 1973; revised in 1982 to annual per capita GNP over $4,000 in 1979. ** Category II Country: defined in July 1976 agreement as per capita GNP from $1,000 to $3,000 in 1973; revised in 1982 to annual per capita GNP between $625 and $4,000 in 1979. *** Category III Country: defined in July 1976 agreement as per capita GNP below $1,000 in 1973; revised in 1982 to annual per capita GNP below $624 in 1978.


relatively rich countries (Category I). The rates for intermediate (Category II) and relatively poor countries (Category III) were set between 25 to 50 basis points lower depending on the length of the repayment period.

Despite the rapidly rising cost of borrowing in the later part of the 1970s and early 1980s, it was another five years before the rates were meaningfully adjusted again.

Finally, in November 1981, supplier states agreed to raise MMI sharply by 2.25 percent for credits over 5 years for relatively poor countries and 2.5 percent for all other
categories. This bought the MMI medium term credits to 11.25% for relatively rich countries, 11.00% for intermediate countries, and 10.00% for relatively poor countries. The following year, country categories were adjusted as well. The definition of a relatively rich country was raised to $4,000; the intermediate country category was revised to an annual per capita GNP between $625 and $4,000, and relatively poor countries were redefined as those with an annual per capita GNP of less than $625.

The difficulty in reaching agreement was the result of internal disagreements among supplier states, most notably between the U.S. and France. “The United States, which originally had been the naysayer against multilateral discipline, had by 1976 become the strongest proponent for strengthening the Consensus’s rules. On the other hand, France, which had originally expressed the greatest satisfaction with the Arrangement, was opposed to changes that would have limited its ability to subsidize interest rates on export credits. This set a pattern that would hold for more than a decade: the United States led the participants who wanted stronger rules, while France was the strongest spokesman for maintaining the status quo.”

As a means of controlling competition, the MMI contributed to stemming unintentional wealth transfers to buyer states, but it had significant drawbacks. Some of these drawbacks were more easily overcome than others. One was its limited reach. At first, the agreement only included seven countries: Canada, France, Germany, Italy, Japan the United Kingdom and the United States. These were by far the largest suppliers of

\cite{Ray1986}

\cite{Zysman1978}
export finance, but this still left a large fringe of suppliers that were under no obligation to meet the minimum terms. To ensure the stability of the agreement, the core members actively worked to include all members of the OECD. In May 1977, all the OECD countries except Austria, Greece, Portugal, New Zealand and Spain had agreed to follow the MMI rates. By the following year, most of these states had joined. Greater participation helped to reduce the risk that fringe would undercut the floor set by Arrangement members. The agreement was facilitated by not applying it to all state-backed financial transactions. Significant sectors, including nuclear power, civil aircraft, shipbuilding, agriculture and military equipment, were exempted as discussed in the previous Chapter.

Other drawbacks were more were more difficult to resolve. One was the fact that the MMI was undifferentiated by different categories of buyer states. A uniform rate was not a major problem when the cost of borrowing was similar among supplier states. However, these renegotiations became more difficult as the cost of raising funds among supplier states grew more disbursed. In some cases, the differences in long-term government bond rates were dramatic. At one point, Italy’s cost of borrowing was as much as 1,000 basis points higher than Japan’s.522 Another problem was the lack of an automatic adjustment mechanism. Because supplier states found establishing consensus about a single matrix so difficult, the MMI fell increasingly out of step with the cost of their export financing programs operations.

But by far the greatest weakness of the MMI from a supplier’s perspective was that the rates remained too low. The MMI established a check on the ability of buyer states to play one supplier off of another but did not eliminate subsidies. This was particularly a problem for countries with high domestic interest rates. In an increasingly competitive international environment, supplier states were under constant pressure from their exporters to subsidize credit offers down to the MMI. This undermined the profitability of all supplier states. An external audit by the U.S. General Accounting Office revealed that net income had fallen from $147 million in 1972 to just $80 million in 1975. The GAO warned that Ex-Im’s financial position would continue to worsen if the Bank continued to pay more interest for borrowed funds than it was earning on the loans for which the funds were borrowed. Government audits of the UK’s export credit agency, ECGD, revealed similar problems caused by lending internationally at rates lower than the domestic Public Works Loan Rate, which, before flexible interest rates were introduced in the 1980s, tracked the Bank of England’s Minimum Lending Rate. The total cost of ECGD’s losses that was attributed to direct cost for refinancing of fixed rate export credits and interest rate support costs was 1.11 billion pounds in fiscal 1974/75 and 1.04 billion pounds in fiscal 1975/76 (1979 prices). France incurred by far the largest losses. In 1980, Ex-Im Bank staff estimated that total French government export credit subsidies to ranged from $2 to $2.5 billion.

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523 Pearce, *Subsidized Export Credit*, p. 11.
526 The figures are from the UK’s *The Government’s Expenditure Plan* are cited in Pearce, *Subsidized Export Credit*, p. 20.
However, for a time at least, these losses were viewed as necessary to improve France’s market position, which in turn would contribute to the nation’s growth. Historically, French government had provided a range of export support programs during the post-World War II reconstruction period. These interventions increased particularly after the 1974 balance-of-payments crisis, when the government embraced export credit support as an integral part of this export led growth strategy. Extending loans to Tunisia, Morocco, India, Turkey, Indonesia, and Pakistan among others was embraced as an effective strategy for boosting French exports. French officials pointed to the fact that exports grew two to three times faster than investments or consumption in the early 1970s. However, France was widely blamed by other supplier states, if not for starting the credit war, then at least for making it more difficult to control. This put France in direct conflict with the U.S., whose dominant competitive position internationally led it to favor free trade commercial policies. As one French official sought to explain: “Essentially, you have a clash of economic philosophies. We basically believe in government support for private business until these commercial enterprises prove that they don’t need it, while the Americans believe in not intervening until it is proven that a company needs help.”

Thus, the MMI contributed to the stabilization of the export credit war but it did not end subsidization. Looking back on the period, one participant in the negotiations

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observed: “In those days, one could really ask whether the purpose of the Arrangement was to give free way for bigger and bigger subsidies, instead of the contrary.”

Dissatisfaction with the MMI generated demand for a more effective pricing methodology. ECG commissioned a study to search for alternatives in 1979. The secret study was undertaken by Axel Wallen, director general of the Swedish export credit agency EKN (later chairman of the ECG), to devise a system that would further harden interest rate pricing rules. In May 1980, two proposals were presented to the ECG. The first was a differentiated rate system that would base minimum interest rates on domestic market rates in each country. It would also adjust these interest rate limits at regular intervals. This differential rate system laid the groundwork for the CIRR system. The second proposal was a uniform moving matrix, which would establish a single matrix of minimum rates that would move automatically as market rates move and that would apply to all currencies used by participants to extend export credits. UMM adopted a blended rate based on the International Monetary Fund’s Special Drawing Right (SDR), a weighted average of government bond rates for five different currencies calculated biannually.

532 See Ray, Managing Official Export Credits, p. 56.
533 At first, these adjustments were made annually; however, in 1983 supplier states agreed to adjustments every six months beginning in January 1984. For a published list of the actual interest terms used by the Arrangement members through 1990, see Blair, Trade Negotiations in the OECD, p. 54.
Neither system won unanimity from the group. The UMM was preferred by states with the high interest rate, because it gave them the chance to subsidize their exports, while requiring states with low interest rates to lend at rates above their domestic market rates. However, low interest rate states such as Japan, West Germany and Switzerland refused to go along with this system. The states with low interest rates only saw disadvantages to being forced to lend at the higher rate the UMM would impose. Because they had a comparatively low cost of borrowing, states with low domestic interest rates had a strong preference for the differentiated system, since they all had a cost of borrowing below the new matrix. The latter approach allowed them to take advantage of their comparatively low cost of borrowing to offer competitive export financing.

The differences between high and low interest rate countries were only reconciled by the introduction of a hybrid system. In 1983, high interest rate countries agreed to abandon the MMI in favor of the UMM. This new methodology for setting interest rate floors for the three buyer country categories was embraced by most supplier states from 1983 to 1986, although it continued to be used by some through as late as 1996. States with low interest rates chose to price their export credits on the differentiated price system that was eventually formalized at the CIRR. Thus, states could choose which pricing system to adopt. The solution is one common to cartels, which regularly provide side-payments to compensate higher cost producers in order to keep them from

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The hybrid system was not an optimal solution from a free trade perspective, since it permitted states with high interest rates to continue to offer subsidized export credits. However, it served the general interest of supplier states by further hardening credit terms and was clearly superior to the alternative of no agreement at all.

The hybrid system, although complex and inconsistent with a strict interpretation of free trade doctrine, represented an advance for supplier states in their struggle to contain competitive poaching of contracts. It also served to counteract the bargaining power of buyer states under conditions of global surplus capacity. By more closely aligning the prices charged to buyers with the supplier state's costs of extending export credits, the system was more effective in preventing unintentional wealth transfers than the MMI. The UMM and CIRR operated in tandem for over a decade (1983 to 1995). In 1986, a standard formula was adopted for CIRR in which rates are calculated monthly and are based on government bond issued in the country's domestic market in the country's currency. For all countries except the U.S., this formula was defined as the secondary market yield on government bonds plus 100 basis points.

By the end of the 1980s, most members of the Arrangement had adopted the CIRR methodology. This shift was made easier by the decline in domestic interest rates throughout the OECD and by the narrowing of the interest rate differential between currencies. Eventually, all members of the Arrangement embraced the CIRR as the

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common approach for setting a market-proxy interest rate. The process of gaining
acceptance took time. While participants agreed to a standard formula for fixing CIRR, it
was not until 1994 that the CIRR methodology was made universal. By this time, interest
rate differentials that had become dramatic during the late 1970s had narrowed
substantially among the largest supplier states.

The CIRR methodology was not without flaws. It did not fully eliminate the
potential for supplier states to subsidize and therefore gain competitive advantage. This
flaw became more apparent in the early 1990s when long-term interest rates, as well as
the CIRR, did not track the market rates as closely as some states had expected. This
interest rate differential again created conflict as U.S. accused Europe of taking
advantage of these opportunities. For example, ECAs base all CIRRs on a 5-year
government borrowing rate—whether the repayment term is under 5 years, 5 to 8.5 years
or over 8.5 years. The U.S. bases its calculation of dollar loans over 8.5 years on a 7-year
treasury, so in normal case of positively sloping yield curves, its long term CIRR is
priced relatively higher than the Europeans’ when they use their own currency (when
using dollars they must use US dollar CIRR). The lower European CIRR enables them
also to swap into dollars at rates, which could beat the OECD dollar CIRR. The U.S. Ex-
Im calculated that if all these potential CIRR subsidies were exploited, its financing was
at a relative disadvantage using the U.K. pound as reference case. Ex-Im estimated that

UK exporters benefited on direct loans by 55 to 80 basis points and 105 to 150 basis points for pure cover (insurance and guarantees of private sector bank loans).  

Through a long and sometimes tense search for a proxy for true market interest rates, supplier states moved from a fixed, undifferentiated approach to a system that limited interest rates differentiated among currencies and adjusted automatically at predictable intervals. The result did not completely eliminate export subsidies, but it did serve to harden progressively export credit terms and restrict unintentional wealth transfers from supplier states to buyer states. The history of the negotiations suggests that no single supplier state had overwhelming bargaining strength or forced another party to adopt export credit practices that it viewed to be contrary to its national interests. Far from dictating terms the U.S. was forced to accept compromises throughout the process. Cartel theory predicts that collusion will be more difficult when production cost functions differ widely.  

This phenomenon was clearly reflected in the negotiations when domestic interest rates diverged widely and supplier states were only able to secure agreement by first accepting a relatively weak agreement and then by adopting a hybrid system that provided special treatment for high cost suppliers. At the same time, free trade norms helped to move supplier states toward agreement by holding up market pricing as a focal point for the negotiations. However, free trade doctrine acted more as a framework than as an exact template. For example, European states pressed for and won recognition of the ability to pay over straight market efficiency. This recognition

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539 See discussion on cartels in Chapter 2.
introduced a progressive element, albeit a small one, to the interest rate pricing rules that have been a feature of the Arrangement ever since. Most importantly, collectively, the MMI, the MMU and, eventually, the CIRR did provide an all-important benchmark against which deviant behavior could be judged and punished.540

**Tied Aid and Mixed Credits Battle**

The question of tied aid and mixed credits is one of the most divisive and difficult issues that supplier states attempted to address through the Arrangement. Because they yield similar effects from the perspective of credit competition, the terms “tied aid” and “mixed credits” are often used interchangeably. “Tied aid” refers to aid that is offered on the condition that the recipient purchase goods or services from the state supplying the financing. What is of particular concern in the context of credit competition is tied aid is offered at low concessionality levels (i.e. limited subsidy). “Mixed credits” refers to the practice of combining tied aid credits with standard export credits to reduce the overall cost of the financing offer. The result in both cases is an offer that is more attractive than a standard export credit based on CIRR or other market interest rate proxy, but that is on significantly harder terms than an outright grant.

An issue of growing significance during the 1960s and 70s, low concessionality tied aid emerged as a major source of conflict between supplier states in the 1980s. The conflict centered on different interpretations of the proper role of aid and trade finance

and the commercial advantage that could be gained from blending the two. Critics charged that low concessionality tied aid amounted to little more than predatory trade financing masquerading as aid. U.S. officials, in particular, sought to frame mixed credits as a violation of free trade norms and a form of cheating in the context of the Arrangement. They regularly referred to countries such as Egypt, Morocco, Indonesia and India, where mixed credits offers were prevalent, as “spoiled” markets.\textsuperscript{541} Advocates argued that tied-aid credits reduced the cost to developing countries of projects with a high developmental content and stretched the development impact of scarce foreign aid funds. They also claimed that such credits permitted developing countries to finance needed imports, particularly when commercial flows were in decline.\textsuperscript{542}

The tied aid/mixed credits controversy revealed that export credits were not the only form of OTF that was susceptible to a negative competitive dynamic. But, unlike standard export credits, the competitive dynamic generally yields harder rather than softer financing terms. One cause of this dynamic is the incentive supplier states have to reduce the real cost of aid; states may accomplish this by restricting procurement to the supplier’s national firms, thereby retaining part of the transaction value. For example, in the 1960s, supplier states with balance of payments deficits found that they faced a loss of real income if the aid transfer did not result in a matching demand for imports. In this case, supplier states would have to adjust their payments accounts, which in turn

\textsuperscript{541} See, for example, Kenneth J. Stier, “Export-Import Bank Aims to Boost Asian Presence,” \textit{Journal of Commerce}, March 12, 1990, p. 5A.
threatened to weaken the terms of trade, and hence reduce real income.\textsuperscript{543} Tying became a popular solution to this problem.\textsuperscript{544} However, tying by one state created incentives for others to do the same. Once one state succumbed to the pressure to tie procurement, exporters from other supplier states soon demanded their governments do the same lest their markets abroad be jeopardized.

Although they are often portrayed as the victims of aid-tying and low concessionality, recipients are rarely passive actors in the competitive dynamic. Before supplier states adopted more stringent rules, buyer states often intensified the competition in their own search for the cheapest and most stable financing available. There are numerous cases of buyer states seeking out mixed credits to finance domestic projects.\textsuperscript{545} If one supplier state offered concessional financing, it was not uncommon for these terms to be used by buyer states as a standard by which to judge all competing offers. Supplier states that established a reputation for offering concessional terms became the target of extortion from buyers seeking easier financing terms. France faced this dilemma in the 1980s as it developed a reputation among buyer states as the leading supplier of mixed credits. Indonesia imposed pressure on France improve its credit terms.\textsuperscript{546} Domestic rent-seeking within the recipient state also tended to reinforce supplier states’ interest in offering financing for private goods over public goods. Factories, power plants, and

\textsuperscript{543} Bhagwati, “The Tying of Aid,” p. 251.
\textsuperscript{544} In addition, aid tying was embraced by those who believed that it could assist industries with excess capacity (e.g. manufacturing) or surplus stocks (e.g. agriculture), and those who believed that aid funds should not go third country competitors.
\textsuperscript{546} See, for example, “France Encounters Stiff Indonesian Financing Demands,” \textit{International Trade Finance}, September 24, 1986.
telecommunications equipment tended to win out over health, education and other social projects, which generally had lower commercial interest and fewer opportunities for lining pockets.\textsuperscript{547}

The tendency for intentional wealth transfers to devolve toward commercially driven "hard" aid has been criticized on a variety of fronts. Drawing on neoclassical economic theory, economists have associated these practices with distortions both in the exporting country and the recipient country. Empirical studies support the contention that non-competitively priced aid is economically inefficient and more costly for recipients.\textsuperscript{548} On the domestic front, economists argue that mixed credits are little different from other subsidies that reward inefficient producers. Finally, this mode of financing has been criticized for its potential to divert trade and induce the type of "beggar-thy-neighbor" outcomes that run contrary to the principles of an open world trade system. Writing in the early 1960s, VB Bandera summarized the view of many free trade advocates regarding the cost of tied aid when he wrote: "The policies of the economically advanced free-world countries are self-contradictory and unfair when they promote multilateralism with respect to buying and selling 'for cash' and, at the same time, enhance 'one-way bilateralism' making international governmental loans not freely convertible."\textsuperscript{549}


\textsuperscript{549} Bandera, "Tied Loans and International Payments Problems," p. 301.
The development community also attacked low concessionary tied aid and mixed credits as contrary to sound development.\textsuperscript{550} At the macro level, this mode of finance is blamed for diverting scarce aid resources from the poorest countries to more commercially attractive but arguably less needy, higher income countries. At the micro level, it is blamed for the diversion of aid from developmental projects to projects that are more commercially attractive to the supplier state’s exporting industries. While more recipient-focused in their critique, development specialists generally agree with trade economists that hard aid is contrary to the interests of recipient countries.

Figure 13 illustrates four of the dimensions that the debate over mixed credits has brought to the fore.\textsuperscript{551} One dimension is the type of good that is financed, which can range from private to public. Generally, subsidies for public goods are considered more defensible than private goods given the failure of private markets to supply them. A second dimension is the developmental level of the recipient country. Generally, subsidies to the poorest developing countries are considered more defensible than subsidies to higher income developing countries. A third dimension is the concessionality level of the subsidy, measured in percent by the grant element. Generally, transactions with a high grant element are preferable to those with a low grant element. Procurement conditions constitute the final dimension. Economic theory posits

\textsuperscript{550} Morrissey, Oliver, "The Mixing of Aid and Trade Policies," \textit{The World Economy}, Vol. 16, No. 1, January 1993, pp. 69-84.

\textsuperscript{551} Figure 14 provides a further refinement of the lower right hand quadrant of Figure 5, "Economically Optimal Regulation of Official Trade Finance," presented in Chapter 2.
that subsidies will be used more efficiently if they are open to competitive tender. Together, these dimensions provide a set of normative ideas about what constitutes quality aid and what does not. Economic reasoning suggests that the highest quality aid is found in the upper right hand corner of box B and D. This aid is 1) orientated toward public goods; 2) provided to the poorest countries; 3) provided with a high level of concessionality; and 4) fully untied. Left unchecked, competition between suppliers tends toward the competitive equilibrium found in the lower left hand corner of box C.
Aid in this category is provided to higher income countries, for private goods, with restrictive procurement conditions and a low grant element.

It took years before ideas regarding what constituted high quality aid were transformed into operational rules that could be used by supplier states to police hard aid. It was nearly three decades after the debate began that the first proposal to regulate tied aid and mixed credits was adopted as the Helsinki rules in 1991. Five years later, the Helsinki rules were further clarified through a document called *Ex Ante Guidance for Tied Aid* (1996). Some commentators have attributed the tightening of mixed credit rules to the leadership and hegemonic power of the U.S. However, a careful analysis of the mixed credit battle suggests a much more complex picture, which involves changing preferences among the major suppliers, improvements in monitoring and detection that took advantage of the cartel-like features of the Arrangement, and broader acceptance of ideas regarding what constituted legitimate aid.

The Netherlands presented the first proposal to regulate mixed credit in 1964. The proposal was motivated by concerns in Europe about changes in procurement rules instituted by the U.S., which was by far the largest aid donor at the time. As shown in Figure 15, the U.S. was responsible for nearly 60 percent of total foreign aid transfers in the 1950s and 1960s. Claiming a need to correct the widening balance of payments deficit, the U.S. began progressively to tie its aid procurement beginning in

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552 Organization for Economic Cooperation and Development, *Ex Ante Guidance for Tied Aid*, OECD/DG(96)180, 1996. A significant drawback of this publication is that it provides almost no context or background for understanding how and why Participants chose this final set of guidelines.
1959.553 This action prompted other supplier states to do the same as they established aid programs in the 1960s, despite widespread criticism of the practice by economists and development specialists. The Dutch proposal was discussed during the period 1964-66 in the OECD, but no agreement was reached.554 The next effort to seek a multilateral agreement on progressive untying was made in 1969 by Sweden with strong support from Germany, the Netherlands and Norway. Initially, Japan objected but then reversed course. Japan announced that it would progressively untie its aid program but did not provide a clear timetable. At a High Level Meeting of the DAC hosted by Japan in 1970, the U.S. announced that it would consider abandoning its requirement that its foreign aid be spent on American goods if other supplier states agreed to do the same.555 However, this meeting ultimately failed to secure an agreement.556 France, Italy, Canada and the

553 In the early years, U.S. aid program was heavily orientated towards capital project lending. USAID was established in 1961 by taking over and expanding the administration of the Development Loan Fund (DLF), established in 1957 to promote Third World economic development within the mutual security program. These loans funded infrastructure projects including highways, electric power plants, railroad locomotives, hydroelectric dams, ports and harbor development, factories, irrigation, telecommunications, and other "directly productive" investments. The primary difference between DLF and Ex-Im was that loans were repayable in local currency and therefore offered on softer terms than Ex-Im. In 1963 the DLF was amended so that it would only support projects that promoted economic development. The changes also required "appropriate participation" of private enterprise. USAID was directed to make use of U.S. firms in financing its capital projects. For a history of the establishment of the Development Loan Fund see Burton I. Kaufman, Trade and Aid: Eisenhower's Foreign Economic Policy 1953-1961 (Baltimore, MD: The Johns Hopkins University Press, 1982), Chapter 6; and V. N. Bandera, "Tied Loans and International Payments Problems," Oxford Economic Papers, New Series, vol. 17, no. 2 (July 1965), pp. 300-303.

554 Briefly, the Netherlands proposed that there be a maximum repayment period of 5 years for all export credits with industrialized countries and for small export credit transactions with developing countries; the latter would enjoy a ceiling of 8 years for contracts exceeding $1.5 million and of 10 years for contracts exceeding $5 million. The normal rules for credit terms, i.e., those pertaining to percentage of downpayment, local costs, equal installments, and percentage of insurance cover, would be applied to such credits and credit guarantees. Tied-aid credits would have a minimum maturity of 15 years. In sales to developing countries, there would be a "buffer" or "neutral" zone stretching from 5 to 15 years for small contracts, from 8 to 15 years for contracts of more than $1.5 million, and from 10 to 15 years with official aid funds in a single package prohibited. Matching commercial credits with aid credits also would not be permitted. See International Monetary Fund, "The Use of Commercial Credits by Developing Countries for Financing Imports of Capital Goods," (prepared under the supervision of Azizali F. Mohammed) IMF Staff Papers, vol. 17, no. 1 (March 1970), pp. 64-65.


United States withdrew support for untying. The U.S. would have been the largest loser if aid had been truly untied, since it was by far the largest aid supplier, while its firms were not necessarily the most cost competitive. Economists estimated that anywhere from 30 to 35 percent of U.S. aid contracts would “leak” to rival supplier states if fully open to international competition. 557

When the tied aid and mixed credit issue resurfaced in the 1980s, the U.S. had emerged as the leading proponent of tighter restrictions on the use of low concessionality tied aid and mixed credits. A number of factors explain the change in policy preference. One of the most significant was the reorientation of U.S. aid programs away from investment loans aimed at infrastructure and private goods and more toward public goods. The U.S. program remained heavily tied but concessionality levels were also high, with most U.S. aid subsidies being offered in the form of grants. In the two and a half decades since WWII, while the U.S. spent $143 billion in aid subsidies to rebuild Western Europe and support economic development in the Third World, its relative share of global aid was shrinking. By the 1970s, its share of global aid had fallen to 32 percent of net transfers provided by supplier states (see Figure 14). Domestic political support for aid had faded in the face of mounting criticism from the left and the right. 558

558 For criticisms on the left that viewed aid as part of a system of neocolonialism see Teresa Hyter, Aid As Imperialism (Baltimore: Penguin, 1971) and Susanne Bodenheimer, “Dependency and Imperialism,” in K.T. Fann and Donald Hodges, eds., Readings in U.S. Imperialism (Boston, MA: Peter Sargent, 1971). For critiques on the right, which viewed aid as contributing to encourage corruption and laziness, as well as the growth of the public sector and the inefficiencies that resulted, see P.T. Bauer, Dissent on Development (Cambridge, MA: Harvard University Press, 1971).
1973 New Directions Mandate was an important turning point in the reorientation of U.S. aid towards “basic human needs.” Reformers intent on sustaining U.S. global engagement through aid found that targeting assistance to areas such as food, education, and health was effective in winning back liberal internationalists who had threatened to join fiscal conservatives in Congress in slashing U.S. aid commitments. From the mid

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1970s onward, sustaining basic human needs was the only formula that consistently won bi-partisan support for wealth transfers abroad, apart from U.S. military and agricultural subsidies.

While the shift to a focus on basic human needs helped to gird sagging domestic support for aid transfers, it also left the U.S. without resources to compete with low concessionary tied aid or mixed credits from competing supplier states whose relative share of intentional wealth transfers climbed significantly from 1973 onward. At first, U.S. officials treated the issue as minor but important to monitor. In 1977, officials in the Carter Administration formed a Working Group on Mixed Credits to study complaints from U.S. exporters that mixed credits were widely available to most of their major foreign competitors. U.S. embassies were enlisted to gather more specific data since at the time, the Arrangement provided insufficient information about hard aid credit offers (a grant element of less than 50 percent). The results, presented in a confidential report presented to the National Advisory Council on International Monetary and Financial Affairs (NAC), revealed that the number of supplier states offering mixed credits was relatively low.\textsuperscript{561} France and Japan were found to be the only major global suppliers. The total volume of mixed credit transactions was also found to be relatively small. Over the two-year period between 1976 and 1977, the subsidy value (i.e., the aid portion of the mixed credit) of French offers totaled $399 million, primarily to ex-colonies, Vietnam and Syria. Over the same period, Japan provided $604 million in mixed credits with a somewhat higher subsidy value; Japan’s mixed credit offers were targeted at oil, resource

processing and industrial projects in Iran, Indonesia and Iraq. The report presented a number of different options for U.S. action, including targeted matching to send "the message that the U.S. will not stand by and allow the use of mixed credit financing to take away business from U.S. exporters." Further, the report predicted that if no action was taken "it would permit a highly emotional issue to fester and possibly result in undesirable developments."

This is, indeed, what happened. The number of mixed credit offers grew dramatically between 1980 and 1984. Data obtained by the U.S. government from notifications submitted through improvements to the Arrangement showed that mixed credits rose over 200 percent from 37 offers worth $2.1 billion in 1980 to 305 offers worth $6.5 billion in 1984. This amount represented a total of $16.4 billion in subsidies that could leverage export orders with a contract value of $65 billion or more. Nearly half of the mixed credits were allocated to just three sectors: energy, telecom and transport. U.S. officials judged that the available data most likely underestimated the extent of the problem since notifications to the Arrangement tended to under-report mixed credits offers, especially from Japan and Canada. The largest source during this period was France ($7.4 billion), followed by Germany ($2.2 billion), UK ($1.1 billion) and Austria ($1.1 billion).

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562 Ibid. p. 4.
563 Ibid. p. 5.
565 The $65 billion figure assumes that each export transaction was financed at 25 percent concessionality, the lowest level permissible at the time. The actual figure could be larger since it does not take into account follow-on orders generated by the original subsidized transaction.
566 Telesca, Chapman and Harbaugh, "Mixed Credit Presentation: Introduction and Overview," Table XI.
From the perspective of the U.S., not only was the total value of mixed credits worrisome, but other developments were troubling, as well. First, other supplier states had joined France and Japan as major suppliers of mixed credits, including Germany and the UK, which had earlier voiced support for controlling this mode of finance. Second, evidence of large mixed credit offers in Brazil ($55 million) and Mexico ($250 million) indicated that the practice was spreading to areas that the U.S. considered under its sphere of influence. As one Treasury Department official complained in a memo: “Even though Mexico and Brazil are our backyard, French intrusions are as irritating as French cornering of the Francophile market.”

The U.S. government had always faced domestic factions that believed export credit and development finance should be combined to further U.S. trade interests in the developing world. Although it was eventually deleted from the final legislation as being duplicative of programs offered by US Ex-Im and the World Bank, there was even a proposal floated during the debate over the New Directions Mandate to establish an Export Development Credit Fund. As the mixed credit competition grew in the early 1980s, pressure from industry groups to emulate foreign financing practices grew

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569 A 1972 study by the Overseas Development Council argued that a mechanism should be established to permit joint operations between USAID and Eximbank, involving the mixing of export credit and development finance. Such a mechanism, the study argued, would help to repair America’s lack of competitiveness in low-income markets. See Nathaniel Mckitterick and B. Jenkins Middleton, The Bankers of the Rich and the Bankers of the Poor: The Role of Export Credit in Development Finance, Washington, DC: The Overseas Development Council, monograph No. 6, 1972.
570 Ruttan, United States Development Assistance Policy, p. 103.
stronger. General Electric, Westinghouse, Bechtel Corp. and other exporters joined with industrial unions as well as several governors to form a crop of new lobby groups including the LICIT (Labor Industry Coalition for International Trade), the CEE (Coalition for Employment through Exports) and CITE (Coalition for International Trade Equity). 571 Established trade lobby groups like the National Foreign Trade Council and the U.S. Chamber of Commerce also weighed in with strategy papers and demands for more forceful U.S. government action.

Despite its strong preference for tightening the rules on mixed credits, the U.S. was unable to persuade other supplier states to go along. The French government continued to insist that its mixed credit program was “an integral element of the French aid program,”572 which was provided to support developmental goals of poor countries or to countries with which France had a special interest. While a consensus had been reached on the goal (though not on the procedures) for regulating standard export credits, positions on tied aid and mixed credits remained far apart. France rejected the contention that it was cheating on the Arrangement or engaged in predatory trade practices. As one French official said in an interview: “It is impossible for aid and trade to be totally separate. Where do you draw the line? As soon as aid can be used to buy, in a sense it is trade.”573 The U.S. position implied that a supplier state’s motivation could be inferred from concessionality level could be inferred on where to draw the line between

573 Ibid.
“commercially-motivated” and “aid” motivated subsidies and therefore legitimate. The debate over tied aid during this period suggests that the norm proscribing hard aid was still poorly defined and not universally accepted by relevant actors.

When persuasion failed, the U.S. attempted to retaliate in order to force other supplier states to accept more stringent rules. However, a number of factors hobbled the U.S. effort. One factor was lack of resources at U.S. Ex-Im. The bruising competition over export credits for aircraft and nuclear power left the bank weakened and with little appetite to compete against foreign tied aid offers without budgetary support. Its resources were significantly depleted by the interest rate competition on standard export credits (aircraft). There was strong Congressional pressure to rebuild its depleted reserves. A second factor was the policy agenda of the first Reagan Administration. Ex-Im was singled out as a symbol of the new Administration’s determination to cut corporate welfare as forcefully as it cut other wasteful government spending. Explaining his decision to cut Ex-Im’s budget by three-quarters of a billion dollars in 1981, David Stockman, Director of the Office of Management and Budget later explained: “It’s my impression that most of the money goes to a handful of big corporations, and if we are ever caught not cutting this while we’re biting deeply into social programs, we’re going

574 For further discussion of this point see Amiel, Oran D. International Regulation of Government-backed Export Financing: Subsidized Export Credits Under the OECD Arrangement and the GATT-MTN System, Ann Arbor, University of Michigan, doctoral dissertation, 1991.
575 For example, in 1984 concerned with the erosion of the Ex-Im’s capital base. Senator William Proxmire (D-Wisconsin) proposed the “EximBank Capital Restoration Act of 1984,” which would have required the Bank to “maintain at all times a minimum level of capital stock and retained earnings in an amount not less than $2,000,000,000.” See Congressional Record, August 6, 1984, p. S97234.
to have big problems." Successive cuts to Ex-Im's direct lending authority over the next three years left the bank with few resources with which to fight.

As a consequence, the U.S. negotiating leverage was widely viewed as weak at home and abroad. Observing the situation in 1984 on the eve of a meeting of the Arrangement, the Financial Times was led to comment: "Thanks to Mr. David Stockman, the U.S. budget director, the U.S. Export-Import Bank is riding towards a showdown on mixed credits this week in Paris like a gunslinger with wet ammunition." The situation was little different at the end of the decade. An official with the National Foreign Trade Council captured the mood of the export community when he characterized the proposals offered by the first George Bush Administration to address the mixed credit problem as "a feeble response to an enormous problem."

In 1978, the National Advisory Council approved a policy of matching competitor mixed credit offers. As a stop-gap measure, U.S. officials tapped USAID's budget for funds. The source of funding for retaliation suffered from a variety of weaknesses. First, only countries eligible for Commodity Import Programs (CIP) could be targeted, which represented less than half of the countries where tied aid competition was considered

most problematic. Second, there was also considerable resistance to using these funds in this way at home and abroad. Earmarking funds was resented by many within USAID and the development community who did not see defending large U.S. multinational corporations as a part of its mission. Tapping the CIP was also resented by recipient states. For example, while the Egyptian government agreed to the diversion of funds in 1982 to support two Westinghouse and General Electric transactions involving generator sales, it ignored a subsequent request by the U.S. to use CIP funds to counter other tied aid offers from French, Canadian and Japanese suppliers. In 1983, Congress responded to industry lobbying by seeking to establish a more effective mixed credits program to defend U.S. exporters and advanced negotiations in Paris. The 1983 Trade and Development Enhancement Act mandated the establishment of a USAID tied-aid credit program, but no funding was appropriated.

Meanwhile, the economic conditions worsened. By 1984, the unemployment rate climbed to 9.6 percent for all civilian workers and to 19.5 percent for blacks. At the same time, the U.S. trade deficit was mounting rapidly. It jumped from $52 billion in 1983 to $102 billion in 1984 to $114 billion in 1985. Many blamed the tight monetary policy adopted by the Reagan administration to fight inflation and its inability to gain control of the federal deficit, which drove up interest rates and the value of the dollar. The dramatic rise in the value of the dollar was the most significant change from the perspective of U.S. exporters. In a matter of 5 years (1980-1985), the dollar rose in real terms by 56

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582 AID provided $5.9 million in grant funds and Ex-Im $34.5 million on standard export credit terms to finance exports valued at $53 million.
percent against ten major currencies on a trade-weighted basis. All of this made the export environment increasingly difficult for U.S. manufacturers.

With criticism of its domestic economic policies at a high pitch and little to show for its negotiating efforts in Paris, combined with obligations to the business community for its backing in the 1984 election campaign, the Reagan administration, now in its second term, agreed to support a more aggressive response. In the summer of 1985, Treasury Department officials prepared legislation appropriation for a special fund. Not knowing when Congress would make the Bank whole, officials took the risk of authorizing Ex-Im to begin aggressively matching competitor projects in the fall of 1985 out of its own reserves. To rally Congress behind the measure, reassure domestic business constituencies, and send a message to trade partners, the White House agreed to make the mixed credit issue the centerpiece of what turned out to be Ronald Reagan’s only major trade policy speech during his two terms as President. On September 23, 1985 the President began his speech by asserting America’s commitment to free and fair trade: “Our trade policy rests firmly on the foundation of free and open markets, free trade.” He then followed this specific action items. The most prominent action item was a proposal to fund retaliatory measures for predatory use of mixed credits:

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584 This turned out to be longer than the Administration anticipated. Congress did not approve the request for supplemental Ex-Im War Chest appropriations until FY 1987.
I have directed the Secretary of the Treasury to work with the Congress to establish a $300 million fund that will support up to a billion dollars in mixed-credit loans. These funds will counter our loss of business to trading partners who use what, in effect, are subsidies to deprive U.S. companies of fair access to world markets.\textsuperscript{587}

The request was much less than the $1 billion mixed credit fund originally considered by the Presidential Task Force International Private Enterprise a year before.\textsuperscript{588} Still, the Administration did its best to build up the significance of the fund by christening it the "War Chest".\textsuperscript{589} The Administration also let it be known that it would be used strategically, both initiating and overmatching existing mixed credit offers in order to "inflict maximum damage" against unfair financing practices.\textsuperscript{590} Further, the Administration communicated through the press that targets for retaliation would be picked under the overall supervision of an interagency Cabinet level 'strike force' under the chairmanship of Treasury Secretary James A. Baker.\textsuperscript{591} U.S. officials attempted to

\textsuperscript{587} Ibid. p. 3.
\textsuperscript{588} The Task Force was chaired by Dwayne O. Andreas, Chairman of the Archer-Daniels-Midland Co. Mr. Andreas, an active fund raider, may have been one of the business interests that President Reagan was obligated to after winning the 1984 presidential campaign. On Andreas’ role in advocating more aggressive action on mixed credits see Bruce Stokes, “Latest Trade Enticement Combines Government-Financed Loans with Grants,” National Journal, December 29, 1984, pp. 2433-2435. On Andreas’ lobbying activities more generally, see James Bovard, “Archer Daniels Midland: A Case Study in Corporate Welfare,” Cato Institute, September 26, 1995 available at http://www.mindfully.org/Industry/ADM-Corp-Welfare.htm.
\textsuperscript{589} The War Chest was initially funded for $300 million to be used over fiscal year 1987 and 1988 period. Congress directed that decisions over the funds be made by Ex-Im Bank with the concurrence of the U.S. Department of Treasury. The funds provided grants that were then combined with existing Ex-Im resources to create subsidized tied aid credits. The cost of the program was included in the overall U.S. government budget. See Export-Import Bank of the United States, "Report to the U.S. Congress on Tied Aid Credit Practices," U.S. Export-Import Bank, Washington, D.C., April 1989, p. 23.
\textsuperscript{590} Boyd France, “The Ex-Im to Foreign Governments: Back Off,” Business Week, November 18, 1985, p. 50.
exert additional pressure by concentrating retaliation on a series of projects just prior to French elections in an effort to gain maximum leverage.

U.S. officials insisted publicly that the strategy was a success, but, in fact, changes made to the Arrangement from 1982 to 1988 fell well short of U.S. negotiating goals. The most significant policy change during this six-year period was an increase in the minimum permissible grant element. U.S. demands were for a minimum rate of 50 percent, but only a 35 percent increase was secured. In 1982, Arrangement members collectively agreed to prohibit tied aid with a grant element under 20 percent. This was raised to 25 percent in 1985, to 30 percent in 1987 and finally to 35 percent in 1988 for Category II countries. In 1987, tied aid credits with a grant element of less than 50 percent for Category III countries were prohibited, but because these countries were among the world’s very poorest, this measure was of limited consequence for commercial competition. The U.S. also called for extending the prior notification requirements to 60 days on the grounds that the existing 10-day time frame was not sufficient to prepare a matching offer. However, the most that other supplier states were willing to accept was to extend notification to 20 days and to face-to-face consultation procedures for highly contested projects. Finally, the U.S. also proposed changing the discount rate for calculating aid from 10 percent to a differentiated discount rate (DDR) based on government bond rate plus a margin or CIRR rates.

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592 At the time there were a total of 40 states were classified as Category III or Least Developed Countries. These states included 27 African states, eight Asian states, four Pacific Ocean states and Haiti. See “Aid, Official Finance Division Now Sharper,” *International Trade Finance*, August 26, 1987.
An internal study conducted by Ex-Im bank staff helps to explain why there was such resistance to changes in Arrangement rules. The study revealed that U.S. demands would have increased the real cost of providing aid, in some cases significantly. Several scenarios were studied, including the effect of imposing a 40 percent minimum grant element and DDR. This requirement was estimated to raise Germany’s aid budget cost by 12 percent, France’s by 39 percent, Italy’s by 36 percent and the Netherlands’ by 100 percent. By far the greatest impact would have been experienced by Japan, which was estimated to face a cost increase of 490 percent. The impact would have been high on Japan, because its aid program was heavily geared toward low concessional loans, and because its domestic interest rates were low. Japan benefited considerably from the arbitrary 10 percent discount factor that had been agreed to in the DAC years before. Given these costs, and the fact that the U.S. was not willing to reciprocate concessions and untie its own development assistance, it is not surprising that U.S. demands were resisted.

Despite the fanfare surrounding the War Chest, the resources that the U.S. actually expended on retaliation were relatively small compared to the more than $1 billion spent in direct subsidies to defend aircraft, nuclear power and other sectors during the interest rate battles of the late 1970s. The amount spent on retaliation was also small in comparison to the amount spent by other supplier states engaged in matching through the Arrangement. Even as late as 1985, the U.S. was not the largest matcher. Both Japan

and the UK spent two and a half to three times more that year alone on matching.

Longer trends reveal even more dramatic differences. Between 1984 and 1990, the U.S. ranked not first but fourth among the 22 members of the Arrangement in matching expenditures. As shown in Table 3, the U.S. spent only a little over eight percent of all matching expenditures. Collectively, Japan, Canada and the UK spent nine and a half times what the U.S. spent between 1984 and 1990. The costs of retaliation were clearly distributed across the Arrangement.

At the end of the 1980s, there continued to be dissatisfaction with rules on mixed credits. The rules increased the cost but did not stop countries from granting mixed

Table 3. Total Expenditures on Matching (1984 – 1990)

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
<th>Amount (million SDR)</th>
<th>Percent Spent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>1</td>
<td>3,905</td>
<td>34.5%</td>
</tr>
<tr>
<td>Canada</td>
<td>2</td>
<td>2,565</td>
<td>22.7%</td>
</tr>
<tr>
<td>UK</td>
<td>3</td>
<td>2,487</td>
<td>22.0%</td>
</tr>
<tr>
<td>United States</td>
<td>4</td>
<td>928</td>
<td>8.2%</td>
</tr>
<tr>
<td>France</td>
<td>5</td>
<td>507</td>
<td>4.5%</td>
</tr>
<tr>
<td>Italy</td>
<td>6</td>
<td>320</td>
<td>2.8%</td>
</tr>
<tr>
<td>Germany</td>
<td>7</td>
<td>304</td>
<td>2.7%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>8</td>
<td>138</td>
<td>1.2%</td>
</tr>
<tr>
<td>Other</td>
<td>9</td>
<td>114</td>
<td>1.0%</td>
</tr>
<tr>
<td>Spain</td>
<td>10</td>
<td>39</td>
<td>0.3%</td>
</tr>
</tbody>
</table>

11,307 100.0%

Source: Organization for Economic Cooperation and Development, Trade Secretariat, Participants Notifications various years.
credits. A study undertaken by the Arrangement secretariat found that the 1987 rules had not succeeded in reducing the volume of hard aid offers.\footnote{Organization for Economic Cooperation and Development, “Experience with the New Rules of the Arrangement on Tied and Partially United Aid Financing,” Trade Directorate, TD/Consensus/89.24, September 20, 1989.} The rules eliminated the hardest credits, but supplier states continued to offer the majority of aid at a grant element below 50 percent. In 1988/89, 52 percent of aid notifications were in the 35-40 percent range. The total volume of these credit offers was increasing, rising by 40 percent just after the 1987 rules were adopted. In April 1989, US Ex-Im issued its own study of mixed credits, claiming that U.S. exporters continued to lose an estimated $400 to $800 million a year in telecommunications, railroad, electric power and heavy earthmoving equipment as a direct result of low concessional tied aid offers by competing states.\footnote{Eduardo Lachica, “Ex-Im Bank Says U.S. Exports Are Hurt by Other Countries’ ‘Tied’ aid Credits,” \textit{Wall Street Journal}, May 9, 1989.} Industry groups countered that these figures were far too conservative and put the estimated losses at $2.4 billion to $4.8 billion.\footnote{“Industry Groups Charge That Eximbank Report Misrepresents Tied Aid Effects on U.S. Firms,” \textit{International Trade Reporter}, May 17, 1989.} That year, Congress pressed the Administration to take more aggressive measures to address the problem. It also authorized additional funds to replenish the War Chest but this time with an authorization of only $100 million.\footnote{“House Eyeing Bold Actions to Finance Exports if Administration Falters,” \textit{Inside U.S. Trade}, May 12, 1989; and United States Congress, Senate, “Hearings on the Tied Aid Credit War chest of the Export-Import Bank of the United States,” Subcommittee on International Finance and Monetary Policy, Committee on Banking, 101st Congress, September 13, 1989.}

At the end of the 1980s, economic and political conditions were more conducive to a collective settlement. First, the effectiveness of mixed credits as a form of export promotion had deteriorated. The ability of other members of the Arrangement to match...
and overmatch created a windfall for buyer states but reduced the strategic commercial value of mixed credits for supplier states.\textsuperscript{600} As long as rules were weak, there was also the possibility for extortion. While few buyer states went as far as Indonesia in codifying specific financing demands in national decrees, exporters faced constant pressure to ease financing terms to the terms permitted by the Arrangement or even better if possible.

Second, economic conditions were improving. While a core group of countries remained in financial trouble, economic conditions were improving for others, prompting fresh new investment spending, noted in the popular press by the shift from “debtor nations” to “emerging markets.”\textsuperscript{601} As a result, the buyer’s market that had dominated in the early part of the decade shifted to a seller’s market. Cartel theorists have noted that cartel arrangements are more easily negotiated when prices are rising and demand is increasing. This was the case for mixed credits. With the collapse of the Soviet Union, there was also a collective concern among supplier states that mixed credit competition not spill over into the newly opened markets of Eastern Europe.\textsuperscript{602} Finally, internal and external factors were changing France’s determination to offer low concessional tied aid. These factors included deeper economic integration with Europe and the opportunities this opened for French firms, budget pressures, and growing acceptance in policy circles that export subsidies were creating distortions both internationally and at home.\textsuperscript{603} This created new resistance within France to the rent-seeking activities of French state-owned firms, which had largely monopolized the country’s mixed credit system.

\textsuperscript{601} See “Go South, Yong Man,” \textit{The Economist}, April 16, 1988, p. 93.
The intellectual case for restricting hard aid was also stronger. In the U.S., perhaps the most significant impact was in making the intellectual case for restricting hard aid. Through persistent dialogue carried out through the Arrangement, U.S. officials helped to transform ideas about the negative effects of hard aid into a proscriptive norm. Whereas only a few supplier states viewed low concessional tied aid credits as a violation of the Arrangement, by the end of the 1980s, a majority had shifted to this position. Hard aid was not only coming into disfavor because of its potential to distort trade, but also because of its potential to distort developmental priorities by creating a bias toward projects with a larger import content in areas of particular export interest to the supplier state, as well as a bias against projects and programs with low import content such as rural development projects.

By 1989, when the negotiations leading to the Helsinki agreement commenced, supplier states understood what was needed. John Ray, chairman of the export credits group during this period, later wrote that supplier states were in general agreement on what was needed: “firm rules that were easily understood and that would permit an export credit agency or a potential exporter to know, beforehand and rapidly, whether or not a specific project was of the sort where tied-aid rules were allowed.” Several different approaches were considered during the subsequent negotiations, but each was found wanting.\footnote{Detailed critiques of the various approaches were undertaken by the U.S. government. See Memorandum, Edwin L. Barber, “U.S. Negotiating Objectives and Strategy,” EPC Working Group on Tied Aid Credits, U.S. Department of Treasury, August 24, 1989.} One proposal was to set rules on aid quality, but supplier states were unable to devise a simple and easily usable list of indicators of aid quality. Another
proposal advanced by the Japanese was to require all aid credits to be untied. However, general untying was generally considered politically infeasible because supplier states favored untying sectors in which their industries were particularly competitive but resisted sectors in which they were not. A third approach was to prohibit mixed credits in particularly problematic markets and problematic sectors. The sector approach was rejected because supplier states differed on which markets were in fact “spoiled”. There was also a concern that resources would simply shift to unrestricted sectors.

Eventually, supplier states settled on what has become known as the Helsinki Package. These rules have several parts (see Table 4). First, the rules regulate what states are eligible for tied concessional financing. The rules prohibit most tied aid credits in higher income countries, while allowing continued flows to middle income and low-income developing countries. Second, the rules raised the minimum levels of concessionality for tied aid to 35 percent. Finally, the rules establish a commercial viability test designed to ensure that aid subsidies do not flow to projects that could otherwise be financed on commercial terms. The commercial viability test was the most important innovation of the Helsinki Rules. The Helsinki rules sought to restrict aid to the following conditions:

605 Higher income countries are defined as countries with a Gross National Income per capita sufficient to make them ineligible for 17-year loans from the World Bank for at least two consecutive years. This figure was $2,465 in 1990 and $2,995 in 2000. In Latin America, this bars Argentina, Brazil, Mexico, and Venezuela from most tied aid but allows it in Colombia, Dominican Republic and El Salvador. In Asia, Hong Kong, Korea, Malaysia, Singapore, and Taiwan are largely barred, but China, India, Indonesia, Philippines, Sri Lanka, Thailand and Vietnam are eligible. In Africa, Botswana and Gabon are barred, but Algeria, Angola, Egypt, Ghana, Morocco, Namibia, Nigeria, South Africa and Tunisia are permitted. In the Middle East, Bahrain, Israel, and Saudi Arabia are barred, but Jordan, Turkey and Yemen are eligible. Russia and most countries in Eastern Europe are largely barred from tied aid; however, Azerbaijan, Tajikistan, and other countries in the Caspian region are eligible.

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1) The project lacks the capacity (with appropriate pricing based on market principles) to generate cash flow sufficient to cover its operating costs and debt flow. Such a project would be considered commercially non viable (CNV).

2) The project is financially viable, but commercial or export credit financing is not available.

Supplier states use cash flow analysis to determine financial viability within the credit repayment periods permitted by the Arrangement. Financial viability is interpreted strictly in terms of a project’s debt service capacity—that is, whether the cash flow is

Table 4. Arrangement Rules for Tied Aid Financing (Helsinki Package)†

<table>
<thead>
<tr>
<th>Recipient</th>
<th>Type of Project</th>
<th>Eligibility for Tied Aid</th>
<th>Minimum Grant Element</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD/Countries in Transition</td>
<td>All projects</td>
<td>Prohibited</td>
<td>−</td>
</tr>
<tr>
<td>Higher Income* (Category I)</td>
<td>Commercially viable</td>
<td>Eligible</td>
<td>80%</td>
</tr>
<tr>
<td></td>
<td>Commercially non viable</td>
<td>Eligible</td>
<td>80%</td>
</tr>
<tr>
<td>Middle Income (Category II)</td>
<td>Commercially viable**</td>
<td>Eligible</td>
<td>80%</td>
</tr>
<tr>
<td></td>
<td>Commercially non viable</td>
<td>Eligible</td>
<td>35%</td>
</tr>
<tr>
<td>Low Income (Category III)</td>
<td>All projects***</td>
<td>Eligible</td>
<td>50%</td>
</tr>
</tbody>
</table>

† Projects with a value in excess of SDR 2 Million (SDR = Special Drawing Rights).
** A special exception is made in the rare case that ECA or market financing is not available for a commercially viable project. This is case, donors may provide tied aid with a minimum concessionality level of 35 percent.
*** Helsinki rules exempt these countries from financial viability tests. All tied aid offers must, however, have a minimum concessionality level of 50%.
sufficient to repay borrowed funds and cover interest charges using the Arrangement’s
credit rates and terms as the reference point. Traditional cost/benefit analysis operates at
a marginal level, measuring the economic impact of a project proposal as the difference
between net economic benefits when the project goes forward (“with”) versus cases
where it does not (“without”). In contrast, the Helsinki rules establish a financial based
analysis that takes a time-slice approach of the “smallest complete productive entity” to
determine whether a project is commercially viable. 606

The guidelines developed to implement the Helsinki rules are as important as the
basic rules themselves. Implementation of the rules generated its own set of conflicts,
requiring supplier states to establish a special forum for resolving disputes and other
challenges created by the new rules. This took place through the Tied Aid Consultations
Group, which met in Paris under the auspices of the Arrangement. Between 1992 and the
end of 2000, a total of 126 transactions were challenged by one or more supplier states. 607
In the first four years, on average, more than 25 projects a year were challenged. After
1996, the number of challenges fell significantly to just 3 or 4 a year as supplier states
gained experience with the rules, and definitional and methodological problems were
resolved. The largest number of disputes occurred over energy projects, which made up
43 percent of the cases brought before the group, followed by telecommunications (26

606 Anthony Owen, “Final Report (Phase II) on the Body of Experience Gained under the Helsinki
Disciplines,” Trade Secretariat, Organization for Economic Cooperation and Development, December
1995, pp. 31-32.
percent) and manufacturing (15 percent).\textsuperscript{608} These generally involved transactions proposed for China, with the next largest number of disputes taking place in Indonesia.

One of the most controversial issues raised in implementing the Helsinki rules concerned the interpretation of “appropriate pricing based on market principles.” The choice of project input prices has the potential to shift a project from being considered financially non-viable to being financially viable if “appropriate prices” are applied. Participants differed on whether shadow (i.e. willingness to pay) prices should be used in the analysis in place of actual local prices if the latter were significantly distorted.\textsuperscript{609} Eventually, participants agreed that evaluations based on local prices would only perpetuate economic inefficiencies. Ex Ante Guidance leaves it to the state sponsoring the project to decide whether or not to adjust local prices.\textsuperscript{610} It also left open the right for others to challenge these assessments, which they have.

Another difficulty supplier states faced in implementing the Helsinki rules was determining what constituted a project. Like pricing, defining “project” was controversial because it could influence whether or not the project was considered to be financially viable. Eventually, supplier states agreed to define a project as:

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{609} This was less of a problem for projects that involve internationally traded commodities, where the international trade prices at the border provided a clear benchmark. However, it proved more challenging with respect to internally traded goods such as domestic coal. If no adjustment is made to account for the presence of subsidies in domestic coal fuel input prices, then a project may be declared financially non-viable when “correct” pricing would have made it financially viable.
\item \textsuperscript{610} \textit{Ex Ante Guidance for Tied Aid}, p. 20.
\end{itemize}
\end{footnotesize}
The smallest complete productive entity, physically and technically integrated, that fully utilizes the proposed investment and captures all the financial benefits that can be attributed to the investment.611

This definition was designed to prevent equipment that may not have produced revenue itself (such as pollution control equipment) from being considered commercially non-viable. The definition required that the financial test be made with reference to the larger productive entity to which the project was connected (e.g. the paper and pulp mill, power plant, etc.) and not the retrofit itself. The productive entity could be a distinct division of the enterprise undertaking the investment and did not have to be the complete legal or accounting unit.

Several challenged transactions forced supplier states to consider whether environmental projects should be given special treatment. The debate began in response to two tied aid credits brought before the Consultation Group in 1992.612 One was a Spanish tied aid credit for decontamination equipment for a copper smelter in Chile. The other was for an Austrian tied-aid credit for steel dedusting equipment in Indonesia. Both Spain and Austria argued that their projects were environmental in nature with no revenue generating ability. Austria held to the view that tied aid should be universally permitted for environmental projects in developing countries. The U.S. and Canada strongly supported the application of the “polluter pays principle” and strongly opposed treating environmental projects as exceptions to the Helsinki rules. Both countries

611 Ex Ante Guidance for Tied Aid, Appendix I, p. 15.
pointed to the significant problems associated with defining “environmental” and expressed the fear that any project that improved on existing conditions could claim an exemption, which could significantly reduce the effectiveness of stronger tied aid rules.

In subsequent discussions, the Spanish and Austrian projects were deemed to be commercially viable and therefore ineligible for tied aid. Through the consultation process, it was revealed that the copper smelter was owned by ENAMI, Chile’s second largest exporter. It was a well-capitalized, profitable state-owned company. The majority of the participants found these facts sufficient to deem the smelter commercially viable and therefore ineligible for tied aid financing. Austria’s proposed tied aid credit proposal was less clear-cut. The Indonesian steel company, Krakatau, was a public enterprise, which did not publish financial statements and, as a steel company, its financial profitability could not be taken for granted. Austria’s prepared financial analysis of the project assumed “world prices” for natural gas and steel and indicated a significant loss for the company’s accounts. However, the U.S. argued that there should be a strong presumption of commercial viability for the steel mill, given that gas supplies in Indonesia were plentiful and cheaply priced for the domestic market, and that domestic steel producers likely benefited from high priced steel imports, given relatively high transportation costs. This view eventually prevailed, and this project was also found to be commercially viable. This meant that Austria would have to raise the minimum concessionality level to 80 percent instead of 35 percent or abandon its tied aid offer.
Based on these and other cases, supplier states also agreed that environmental projects should not receive special treatment. Supplier states decided it was best to apply the "polluter pays principle," which holds that environmental costs should, to the greatest degree possible, be incorporated in the actual cost of production. Supplier states agreed to apply this principle when considering tied aid offers not only for new industrial plants, but also for environmental retrofits to existing facilities. However, the methodology adopted by the group did not permit the internalization of environmental costs where government regulatory measures are absent, a common occurrence in developing countries. Given the apparent bias, an economist hired to evaluate the methodology for
screening projects tied aid projects recommended adopting criteria for appraising
environmental projects under the Helsinki rules that more explicitly consider financially
non-tangible costs and benefits. Such a move would help to remove the contradiction
between the requirement for "appropriate pricing determined on market principles" and
the "polluter pays principle" since the commercial viability test does not require that the
polluter actually pay the full private and social cost of production.613

The Helsinki rules had a number of different consequences that supplier states
generally viewed positively and in line with their intended goals. Analysis conducted by
the ECG secretariat found that rules encouraged supplier states to direct their tied aid
offers towards commercially non-viable projects. The rules also contributed to a shift in
the composition of transactions toward more public goods, like education and health care,
and away from more commercially orientated projects (Figure 15). These effects were
particularly significant in the energy sector. Figure 16 shows the trends in tied aid offers
offers ranged from $2.2 to $2.8 billion. By the end of the decade, tied aid offers in the
energy sector had dropped significantly to less than $500 million, due in large part to the
decline of tied aid offers for power plants, transmission and large hydroelectric power
projects.614

613 As the report to the Tied Aid Consultations group stated: "The Environment receives no special
consideration under the Helsinki disciplines. The problem stems from the fact that environmental
degradation is not being regarded as a private market cost. In other words, the cost of remediation is not
being internalized by the market. Or, more bluntly, although the polluter pays principle has been embraced,
in reality the polluter (who, ultimately, is the consumer of the good) does not pay!" Anthony Owen, "Final
614 For further analysis see Peter C. Evans, "Export Finance and Sustainable Development: Do Export
Credit Subsidy Rules Require Revision?" Center for International Studies, Massachusetts Institute of
By its own account, the U.S. is a major beneficiary of the new rules. According to the 1998 *U.S. National Export Strategy*, the $30 billion decline in tied-aid offers between 1993 and 1997 boosted U.S. capital goods exports by an estimated $1 billion annually. The report further estimated the same $1 billion of exports would have required a U.S. government expenditure of approximately $300 million a year in subsidies. These gains were made at the expense of supplier states that had the largest tied aid programs, including France, Italy, the UK and Spain.

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Supplier states could still offer tied aid under Helsinki rules but only under more restrictive conditions. An example of the consequences of such conditions is illustrated by a package for three sulfur scrubbers financed by Germany at coal-fired power plants in Beijing. Banshan and Chongqing implemented the package during China’s Ninth Five Year Plan (1997-2002). In order to comply with the Helsinki rules and still tie procurement to its national firms, the German government forced the concessionality level to above 80 percent, since sulfur scrubbers are generally considered commercially viable.616 The project therefore ended up taking $100 million from Germany’s aid budget allocation to China. Such a practice is expensive to sustain, and German officials have indicated that it is unlikely to be repeated, at least for sulfur scrubber projects in China.617 By expanding the scope of the Arrangement, the Helsinki rules limited the ability of buyer countries to play one supplier state off another to obtain concessional financing for such projects. As one US official put it, “we can not allow China to demand a bribe to clean up [its environment].”618

Thus, through a long and often tense search, Arrangement members eventually established a mutually acceptable set of rules to regulate another mode of official finance. The result did not completely eliminate commercially driven aid, but did establish significant controls. The history of the negotiations suggests that no single supplier state had overwhelming bargaining strength or forced another party to adopt export credit practices that that country viewed as contrary to its national interests. The U.S. had a strong preference for rules and aggressively used the Arrangement as a forum to press its

616 The project was notified 84.6% grant element. OEDC CRS database, 2003.
617 Interview with German aid officials, Frankfurt, Germany, January 1998.
618 Interview with U.S. Treasury Department official, Washington, DC, June 1998.
case. However, the U.S. was forced to accept compromises throughout the process. There is little to indicate that its bargaining power won the day. Whatever cost the U.S. may have imposed on France and other states that resisted more stringent rules during the 1980s, it was much less than the costs imposed through matching by other members of the Arrangement. A more significant contribution was the role the U.S. played, along with other states sympathetic to establishing stricter rules, in translating the intellectual case against hard aid into operational rules. Again, the U.S. and its allies in the Arrangement drew on free trade doctrine and the tools of welfare economics to find a solution to the problem of identifying bone fide aid. The commercial viability test was eventually hit upon as a practical way to judge tied aid projects that all supplier states could agree upon.

Unregulated Modes of Official Finance

Measures to contain competition in certain modes of finance have given rise to concerns about other forms of OTF. For example, as rules governing tied aid were tightened, some supplier states raised concerns about untied aid. Beginning in the 1980s, exporters in the U.S. and elsewhere began to complain that untied aid may in fact not be truly untied, creating a loophole through which supplier states can continue to provide “hard aid” without restraint. Likewise, stricter rules governing standard export credits have raised concerns about predatory financing available from market window institutions (MWI). Supplier states that run these facilities through their ECAs claim that they operate on market terms and are therefore exempt from interest rate and procedural
rules set through the Arrangement. Despite calls for stricter regulation, members of the Arrangement have been unable to agree on rules regarding these modes of finance. This section explains why the combination of heterogeneous supplier state interests, missing ingredients crucial to cartel formation, and the inability of free trade norms to provide a salient solution produced this outcome.

Untied Aid

From both a trade competition perspective and a developmental perspective, untied aid has long been considered superior to tied aid. However, there has long been concern about whether aid that is officially untied is in fact truly open to competition.\textsuperscript{619} Studies of untied aid and anecdotal cases over the years suggest that there are often biases in outcomes favoring a high percentage of contracts awarded to the firms of the donor country. Whether or not these patterns are intentional is a matter of debate. Countries offering untied aid contend that if their firms happen to win contracts through untied aid offers, this is a consequence of superior price, above services or other factors. The officials and firms of competing countries contend that the outcomes are rigged. An alternative explanation points to the interests and strategies of recipient countries who usually manage the tender process. Foreign aid is often an important source of financing for the buyer state’s infrastructure development, and levels of support are certainly not

harmed by awarding contracts to the donor’s firms. Even if contracts are not rigged, unspoken reciprocity may explain these outcomes.\textsuperscript{620}

Data collected through notifications to the Arrangement revealed an upward surge in the volume of untied aid credits after the Helsinki rules were put in place. From 1995 to 2003, untied aid credits totaled more than $66 billion – almost double the $34 billion of tied aid over the same period. This contrast would have been larger if Japan’s budget problems had not begun to dampen its untied aid program in the late 1990s and tied aid programs had not been introduced in 1999. Over the period from 1995 to 2000, Japan’s untied aid program alone totaled $58 billion, or over $10 billion a year.\textsuperscript{621} Japan accounted for 95\% of global untied aid notifications (Figure 17). Germany was the next largest supplier of untied aid, but supplied only an average of 4 percent of total untied aid.\textsuperscript{622} Japanese untied aid fell to about $2.1 billion in 2002, when total untied aid fell to about $2.8 billion. However, it rebounded thereafter. Notification to the Arrangement indicated that Japanese untied aid reached $5.1 billion in 2003, an increase of over 80 percent from 2002.

Data collected through notifications to the Arrangement also revealed patterns in the type of projects funded with untied aid credits. Between 1995 and 2000, untied aid


\textsuperscript{622} Japan began untying ODA loans in the late 1970s, and they are now nearly all officially untied. A major recent exception, however, was the establishment of the Special Yen Loans fund totaling ¥600 billion (approximately $5 billion) for the 1999-2002 period. Japanese official used the Asian crisis and Japan's recession to justify these funds to procurement from Japanese firms. See “DAC Peer Review of Japan,” \textit{The DAC Journal} 2004, vol. 5, no. 2, p. 102. Untied loans have an average grant element of 74 percent, with some as low as 44 percent.
credit financing worth over $15 billion was notified for projects in sectors that are
normally considered commercially viable and therefore ineligible for tied aid credits.
This includes power generation, transportation, telecommunications, and manufacturing.
Because these industries are unregulated, untied aid is not subject to Helsinki’s
commercial viability test or other rules. It also means that untied aid offers can avoid the
scrutiny to which tied aid offers are subject through the Tied Aid Consultation group.
A related finding was that untied aid is used much less frequently than tied aid to finance education, health, water and sanitation, and general social infrastructure, which are generally considered commercially non-viable. Over the period from 1995 to 2003, 32 percent of tied aid was directed toward these types of aid projects compared to only 17 percent of untied aid. In addition, because there are no rules governing untied aid, there are no requirements for international competitive bidding. There is also no advanced public notice for untied aid-financed projects to facilitate open bidding, and there are no reporting requirements that could reveal if contract awards correspond to what might be expected under open and fair bidding procedures. Unlike the restrictions imposed under the Helsinki rules, there are no minimum grant element requirements to prevent untied aid from gravitating towards harder terms or financial tests that prevent untied aid from being allocated to projects that could otherwise be financed by the commercial lenders.

In a report to Congress, the US Treasury Department argued:

Current untied aid practices not only threaten to create trade distortions in their own right and contribute to higher debt burdens in developing countries, but they also threaten the continued success of the tied aid disciplines. Without agreed disciplines over the use of untied aid, our trading partners/competitors can simply announce that all or a part of their existing tied aid programs no longer require a contract to procure from a domestic firm and those programs would immediately escape the tied aid rules. Donors would then be free to implement these aid programs as they see fit.\footnote{Report to Congress on the U.S. Treasury Department’s Efforts to Advance Multilateral Negotiations to Discipline Untied Aid, Office of Trade Finance, U.S. Department of Treasury, July 14, 2004, p. 15.}
The Treasury further claimed that U.S. exports would have been almost $5 billion higher over the 1995-2003 period if these projects were subject to full transparent competition and if U.S. firms had won their global share of this business.624

To support its contention that untied aid could be used to circumvent the goals of the Arrangement, the U.S. government cited loan projects supported by Japan in China.625 In 2001, Japan notified the Arrangement of its intent to provide tied aid for three large hydropower projects in China with loans totaling $277 million.626 The U.S. challenged these projects in the Arrangement's Tied Aid Consultations Group as being commercially viable and, therefore, ineligible for tied aid financing. After the U.S. analyzed the projects and convinced other members of the group that the projects were, in fact, commercially viable and therefore not eligible for tied aid under Helsinki rules, Japan faced two choices. It could either withdraw official financing support for the projects or have its exporters compete for the projects on a commercial basis with no guarantee that they would win. Instead, according to the U.S., Japan announced that the three projects would be financed with untied aid credits rather than tied aid credits, even though they were found to be commercially viable. By doing so, the U.S. argued, Japan circumvented the tied aid rules in order to finance these projects with aid. In the U.S. view, this uneven scope in the Arrangement created incentives for supplier states to switch from regulated tied aid to unregulated untied aid.

625 Ibid., pp. 15-16.
626 The three projects and loan amounts are: Shandong Tai’an Pumped Storage Power State ($148 million); Hubei small-scale hydropower project ($75.3 million); and Gansu small-scale hydropower project ($53.9 million). OECD Creditor Reporting System, 2002.
Washington's approach toward Japanese untied aid has shifted over the years. Initially, Japan's agreement to untie its aid procurement was applauded. The measure was announced as part of the 1978 Strauss-Ushiba agreement designed to improve access to the Japanese market and reduce Japan's mounting trade surplus with the U.S.\(^\text{627}\)

During the 1980s, the fact that aid could be untied in name only became apparent but, given the focus on controlling mixed credits, it was not considered a high negotiating priority. As a U.S. Treasury Department official explained: "While [Japanese] aid was untied *de jure*, none of us believed that it was untied *de facto*. But there was nothing we could do about that except, WATCH and complain, if no one but a Japanese company won the bidding on a contract awarded by the Japanese government."\(^\text{628}\) In general, there was little support among supplier states for the development of rules regulating untied aid.

During the 1990s, the U.S. and other governments focused their efforts on helping their firms obtain more and better information about Japanese aid contracts. Much of the effort focused on publicizing specific projects in the hope that this would give U.S. firms a better chance of bidding and winning untied aid projects. This was largely done through the work of commercial attaché in foreign embassies. One of the largest and most public efforts was undertaken by the U.S. Department of Commerce. In 1995, the agency established the Japanese Untied Aid program, which was intended to improve


\(^{628}\) Email communication from John Lange, May 11, 2001. Emphasis original.
U.S. firms’ access to the $10 billion in untied aid contracts Japan awarded each year.\textsuperscript{629} The program aimed to collect and disseminate information on Japanese firms necessary for U.S. exporters to prepare competitive bids for projects funded with untied aid. Information was collected by U.S. Embassies in China, India, Indonesia, Japan, Philippines, Thailand, and Vietnam and then disseminated to U.S. firms through the Department of Commerce’s internet web site.\textsuperscript{630} This initiative was not considered very successful, and the Commerce Department’s effort lost steam and was eventually halted.

In 2001, the U.S. strategy shifted to pressing Arrangement members to accept much more restrictive untied aid rules. The U.S. presented a proposal calling for untied aid to be subject to rules similar to those that govern tied aid as set by the Helsinki Package, including country eligibility, project eligibility, minimum concessionality, and transparency. This would bar higher income countries that are ineligible for 17 to 20 year World Bank loans from receiving untied aid. It would also mean that projects found to be commercially viable following Helsinki and\textit{ ex ante} guidance would be ineligible for untied aid financing. On the other hand, untied aid flows to the poorest developing countries would be exempt from the commercial viability test as they are for tied aid under Helsinki rules.\textsuperscript{631}


\textsuperscript{630} Over 300 projects located mostly in Asia totaling more than $22 billion before the initiative was disbanded.

\textsuperscript{631} Personnel communication with officials at U.S. Department of Treasury, Washington, DC, March 5, 2003.
Since Japan was by far the largest provider of officially untied aid, this proposal was largely directed toward it. The increased pressure on Japan came at the same time that pressure was mounting at home to make Japan’s aid more nationally orientated. The prolonged recession prompted a domestic reassessment of aid. There was growing support for revising Japan’s aid policy towards a more overt “national interest” approach.\(^{632}\) As a result, untied aid remains an unregulated mode of finance, and, in the view of some, it is one of the most significant remaining loopholes in the Arrangement.

After two years of negotiations, the U.S. did win some small concessions. In 2004, Japan, along with other members of the Arrangement, agreed to a temporary two-year pilot program focused on procedural changes.\(^{633}\) The agreement called for public notification of at least 30 days before the start of bidding for projects larger than 5 million SDR. It established a minimum bidding period of 45 days or 90 days in the case of large projects over $70 million. The agreement also included a provision for annual post hoc reporting of the results of the bids. Since most supplier states, including the U.S., do not provide large amounts of untied aid, the proposal had little effect on their aid programs. Indeed, most supplier states backed the U.S. in order to help their firms capture more of the aid contracts flowing from Japan’s intentional wealth transfers.

Untied aid remains largely unregulated, continuing to be exempt from the commercial viability and concessionality requirements that apply to tied aid. The untied


aid case reveals the problems that can arise when a supplier state adopts policies that are consistent with free trade norms. First, cartel enforcement depends on the ability of members to agree on standards for cheating and to establish information systems that reveal instances of defection. Japan’s official position was consistent with free trade norms, which made it possible for the Japanese government to resist calls for improved verification. Second, cartel enforcement depends to a considerable degree on the willingness of individual members to supply information on their practices. In the case of untied aid, the U.S. and other members of the Arrangement could attempt to persuade Japan to open its procurement more fully or reorient its aid away from large infrastructure projects, but Japan could not be forced to do so. For their part, buyer states also have little incentive to surface information and alter the status quo if they can expect to benefit from skewed patterns of contract awards. For buyers, it may be worth it to award contracts to the firms of particularly generous donors if doing so continues the flow of subsidized funds.

Market Windows

A Market Window Institution (MWI) is a financial institution that is government owned or directed, that benefits directly or indirectly from government support, and that claims to operate on a commercial basis. Government support may include tax exemptions, equity capital supplied through government budgets, or funding obtained from private sources with full or partial government guarantees. Countries that use MWIs maintain that these institutions do not fall under the disciplines of the OECD.
Arrangement on Guidelines for Officially Supported Export Credits (the Arrangement), because they operate on a commercial basis. MWIs came under increasing scrutiny in the 1990s because of their potential to distort international trade and investment patterns while skirting provisions of the Arrangement. Some supplier states have suggested that MWIs are of concern to the United States, because they may divert export contracts and shift production to countries with MWI operations. Over the long term, international competitive pressures may cause MWIs to proliferate, distorting trade and investment and reducing the effectiveness of the OECD Arrangement.

Table 5. Key Distinctions between Commercial Banks, MWIs and ECAs

<table>
<thead>
<tr>
<th>Recipient</th>
<th>Commercial Banks</th>
<th>Market Windows</th>
<th>Export Credit Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mandates</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Serve as lending of last resort</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Meet foreign subsidized competition</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Promote national trade interests</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Be profitable</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Funding Structure</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual government appropriations</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Equity capital from government</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Government guarantees</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax exemptions</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Retain earnings</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

*Tax treatment of market windows varies. While most are tax exempt some may be subject to taxation, such as the recently restructured KfW.*
To gain a clearer understanding of where MWIs fit in the provision of export financing, it is useful to compare and contrast them with ECAs and private sector banks. As shown in Table 5, the differences and similarities occur across several different dimensions, including mandates, legal status, ownership, and board composition, as well as the elements that make up their funding structure.

One way in which MWIs can be distinguished from ECAs and commercial banks is by their lending mandates. ECAs are mandated to focus on business segments, where private market failures may arise from scale effects and information asymmetries that contribute to incompleteness of private financial markets. MWIs do not face these lending limitations. MWIs are permitted by their governments to compete directly with commercial banks, not only in developing countries where the market failure rationale is strongest, but also in industrial country markets where there may be few if any substantial gaps in financial markets. Freedom from these lending constraints also means that market windows can pursue a broader range of profitable transactions. The ability of MWIs to operate in OECD countries as well as developing countries provides greater flexibility in developing a diversified portfolio than is the case for traditional ECAs. It also offers the potential for higher revenues and less risk than if its mandate were limited to being a lender of last resort. Further, it has given these institutions a large share of

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634 This alternative funding model has been advanced most clearly by EDC. Executives at that bank reject the “last resort” model, arguing that it is unrealistic for a trade finance institution to work on the basis of springing back to life only during times of financial crisis (i.e. when private capital markets have dried up). As one EDC publication suggests; “ECAs who attempt the ‘Sleeping Beauty’ routine will end up costing their nations’ taxpayers dearly, and perhaps even undermine the efficient operations of the market more than if they were to participate as legitimate, continuous players in the market.” Export Development Canada, Creating Capacity: An Evaluation of EDC’s Role in Canada’s Export Credit System, brief submitted to: Gowling, Strathy & Henderson for the Export Development Act Review, March 1999, p. 30.
each country’s export financing market. The association between market windows and pure commercial entities part company under the third mandate—trade promotion.

Commercial banks are obligated only to make a profit for their shareholders and seek the best clients, regardless of country of origin. ECAs, as publicly owned institutions, are expected to support national export and employment interests. They generally have restrictive domestic content policies with clear quantitative limits. MWIs sit between ECAs and commercial banks. MWIs tend to limit financing to transactions deemed to support national interests, including transactions that provide benefits to national firms or that attract investment and production by foreign firms. Their content policies are flexible. Finally, MWIs are subject to financial mandates. MWIs, like commercial banks, are expected to be profitable. The difference is in the strength of this orientation. Commercial banks have a mandate to maximize profits for their shareholders. MWIs, on the other hand, are generally described as being profit oriented rather than profit maximizers. This suggests that they may be under less pressure and have greater leeway than commercial banks in determining whom they finance and in shaping the terms they offer.

Another distinguishing feature of MWIs is their funding structure. In contrast to ECAs, MWIs do not receive regular annual governmental appropriations. However, the

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635 By some accounts KfW held more than 50 percent share of the $12-15 billion German export and project finance market during much of the 1990s. Personal communication, German private bank official, March 20, 2003. The figure is even higher for Canada. Commercial banks operating in Canada claim that EDC holds as much as 80 to 90 percent of the country’s medium and long-term export finance business. Personal communication, Canadian private bank officials, April 3, 2003.

636 In early 2001, U.S. Ex-Im adjusted its foreign content policies in an effort to make them more flexible. However, there was a long-standing requirement that foreign content be capped at 15 percent of export value. All content must be shipped from the United States. See Export-Import Bank of the United States, “Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States, for the period January 1, 2001 through December 31, 2001,” Washington, DC, July 2002, pp. 19-20.
funding structure of these institutions can give them significant cost advantages over commercial banks. MWIs often benefit from equity capital contributed by their governments.\footnote{For example, a portion of KfW's funding for export financing originates from concessionary European Recovery Program (ERP) monies accumulated by the German government during the immediate postwar years. In 1953, all postwar economic aid funds including funds dispersed under the Marshall Plan were combined in the Federal Republic of Germany under the European Recovery Program (ERP) Special Fund. See J. Andrew Spindler, The Politics of International Credit: Private Finance and Foreign Policy in Germany and Japan, p. 53.} Even more valuable than equity capital are government guarantees, which can be direct or indirect. Government guarantees allow the MWI to borrow with full faith and credit of the government without paying fees for this funding arrangement.\footnote{In the case of EDC, these guarantees are direct. EDC is permitted to borrow up to a maximum of 15 times the aggregate of its current paid-in capital and retained earning. As an agency of the Government of Canada, EDC's bond issues are fully backed by Canada, permitting EDC to borrow with the same credit rating as Canada, or AAA for domestic and AA+ for foreign debt.} Another advantage over commercial banks flows from the treatment of dividend payments. In general, MWIs have limited or no obligation to pay dividends.\footnote{EDC's payment of dividends has been sporadic. In 2001, EDC paid dividends to the Canadian Department of Finance of Cdn$95 million. This was only the third dividend paid out in since EDC was established in 1969 and the first since its dividend payment of Cdn$25 million in 1993. Email correspondence with EDC official, April 9, 2003.} Market windows typically enjoy various tax advantages.\footnote{EDC is exempted from paying corporate income tax on profits but not from other governmental taxes. KfW also has been exempt from paying most taxes, although this has changed as a result of reforms introduced in 2004.} Together, the elements that make up the funding structures provide MWIs with potentially significant cost advantages over commercial banks and regulatory advantages over ECAs.

Supplier states have been relatively ineffective in resolving the market windows issue to the satisfaction of all participants. A key problem stems from the original agreement on which the Arrangement was based when it was formalized in the 1970s. At that time, drafters of the agreement left the critical question of what constituted “official”
financing support unresolved. The failure to clearly define official financing support has allowed supplier states to self-define what financing institutions and practices are covered under the Arrangement.

Two problems have resulted. First, the lack of a clear definition permitted a transparency problem to arise. Because market windows operate outside of rules established through the Arrangement, it is not possible for other members to verify the terms and conditions on which they provide support. Financing offered through these windows may be beyond the terms of the Arrangement, or it may not be. First, in contrast to official export credits, there have been no reporting obligations in place which could generate the information necessary to verify terms. Second, incomplete coverage leaves open the possibility that MWI may proliferate, given the competitive pressures that exist in the export arena. There was growing concern that there was a loophole in the Arrangement that countries could exploit. As rules are tightened in one area, there is a tendency for competition to reemerge in other areas.

Since the mid-1980s, members of the Arrangement have collectively agreed to a number of exercises designed to elicit information about the structure and practices of MWIs. These peer review exercises sought to clarify the degree of government ownership and control over decisions taken by market windows and the role of government in the market window decision-making process. They also sought to establish what opportunities existed for supplier states to switch from one window to

\[64\] Ray, *Managing Official Export Credits*, pp. 54-55.
another during the original terms of the credit and whether or not the public window
could refinance the market window in any way. Finally, they sought to improve
information on the role that governments play in funding market windows and how the
cost of funds compares with wholly private borrowers.

Ultimately, these exercises failed to resolve differences among supplier states
regarding the potential for market distortions or the regulatory measures needed to
regulate MWIs. Countries were generally forthcoming in explaining the broad legal and
institutional arrangements that underpin their MWI operations during the peer review
process. However, the reviews undertaken within the framework of the Arrangement
were unsuccessful in two important respects. First, they failed to achieve a consensus
around a common definition of official support and therefore remained outside of the
Arrangement disciplines. Second, the exercise was unsuccessful in improving
transparency on specific transactions. Countries with market windows refused to provide
information on the credit terms offered through these facilities on either an *ex ante* or
*post hoc* basis. The peer review process, which took place over several years during the
1990s, was not effective in altering that position.\(^{643}\)

In 1999, supplier states agreed with a U.S. request to develop a list of market
window characteristics, with the aim of meeting the Arrangement’s requirement that
states define official support and market windows. There was broad support but no
consensus. Canada opposed the suggested concentration on the “institutional” issues of

\(^{643}\) "Report to Congress on Market Windows," Office of the Assistant Secretary for International Affairs,
ownership, control, and relationship to government, preferring instead to concentrate on
whether the institutions were conferring a “benefit” as understood in the context of the
WTO Subsidies and Countervailing Measures Agreement. Canada argued that
government ownership and control per se were not evidence of trade-distorting practices.
Canada further argued that where private sources of capital are becoming available to
support trade and investment, the OECD disciplines may be either more or less generous
(depending on the market and timing) than the terms which the commercial markets are
offering. In such cases, Canada claimed that Arrangement rules in and of themselves
may become trade distorting by preventing a state operating a market window ECA from
providing the same kinds of terms and conditions that are available from the private
sector in another country.

In response, Canada offered the following definition of official support:

For the purposes of applying the Arrangement, the term official support
means the grant by governments, or special institutions controlled by
and/or acting under the authority of governments, of export credits on
terms and conditions more favorable than those available in international
capital markets. This support can take the form of direct credits/financing,
refinancing, interest rate support, aid financing (credits and grants), export
credit insurance and guarantees. Direct credits/financing, refinancing and
interest rate support are referred to as official support.644

The lack of rules governing market window transactions means that the Export
Credits Group is not notified about these transactions. As a result, other supplier states

644 This statement was provided to the author by EDC.
lack a reliable mechanism for determining whether the credits are in compliance with existing rules and for challenging any that are not. Supplier states concerned about MWI activity must rely on alternative forms of intelligence, which may or may not be reliable.

During this period of debate, there was an upsurge in complaints by U.S. firms about being placed at a competitive disadvantage by MWI financing. In 2000, GE pointed to a contract won by General Motors-Canada to claim that EDC was facilitating predatory pricing. The complaint was prompted by GE’s loss of a major locomotive order in 1999 and concerns about losing additional orders as a result of cut rate financing offered by EDC. In October 1999, Union Pacific Corporation, the largest railroad in the US, awarded an order of 1,000 locomotives worth more than $2 billion from Electro-Motive, the Canadian division of General Motors. The order, the largest ever for the company, reversed proposed layoffs and ensured stable employment for the plant’s 2,700 employees located in Ontario Province. GE asserted that by providing below market rate financing for Electro-Motive, EDC had adversely impacted GE Transportation Systems and threatened to do so again in the future if permitted to continue. GE maintained that ECD’s financing was predatory and was designed to take market share away from GE. GE alleged that EDC’s financing tactics were putting as many as 1,250 jobs at stake and undermining the profitability and viability of GE Transportation Systems. GE officials urged that Ex-Im call ECD immediately to request the withdrawal of ECD support for deals that it was supporting in the US. The company also called on the U.S. government to negotiate an immediate “home markets” financing agreement for locomotives similar

to the agreement that had been established between Airbus and Boeing. This agreement restricts ECA support in each other’s home markets.

As noted in Chapter 2, the WTO rulings also has implications for evaluating the practices of MWIs. The rulings arose from a dispute between Canada and Brazil over aircraft sales supported with export credits. The trade conflict relates to aircraft financing in support of two competitors in the Regional Jet market, Bombardier and Embraer. Normally, such matters would be addressed through the Arrangement; however, because Brazil is not a party to the OECD Arrangement, Canada turned to the WTO to challenge Brazilian export credit practices. In response, Brazil counter-challenged Canada’s support, including the use of EDC’s Canada Account. In hearing the case, the WTO panel and appellate body had to interpret the meaning of item (k) and define precisely what “interest rate provisions” meant in reference to the Arrangement. To address these issues, the WTO panel sought information on the terms and conditions of a series of EDC transactions. According to the Canadian Ministry of Finance, the WTO panel found “only a few” transactions that could be construed as being beyond market. The panel ruled that export credits can benefit from the safe haven of item (k) if they are in the form of direct credit financing, refinancing, or interest rate support, and if they apply the Arrangement CIRR requirement for setting interest rates.

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648 Private communication, officials, Department of Finance, Canada, February 14, 2003.
649 Commercial Interest Reference Rates (CIRRs) are the official lending rates used by export credit agencies. They are calculated monthly and are based on government bonds issued in the country’s domestic market for the country’s currency.
The ruling also had implications for evaluating the practices of MWIs by shifting the burden of proof onto complainants. MWI transactions would first be tested against the definition of a subsidy to determine whether a benefit has been conferred. If no export subsidy has been given, there would be no requirement for a safe haven. Therefore, in WTO terms, the validity of a market window operation should be defined by whether the institutions that provide such financing are truly acting as market players from the perspective of borrowers.

As a result, the WTO panel decisions have had direct bearing on the debate over how to define official export credit support. Countries with market window activities have always argued for transaction-based definitions of official support (i.e., transactions on market terms are exempt from the rules). Other countries have argued for an institutional definition of official support (i.e., if a government owned or supported institution offers official export credits, then every export credit offered must comply with the Arrangement). The Brazil/Canada WTO decisions supported the transaction-based definition. If non-Arrangement export credits are not on market terms, then they can be challenged in the WTO. But the burden of proof is on plaintiffs to provide information on the terms and conditions of loans that may be in violation of the subsidies code.

Canada interpreted the WTO ruling regarding the definition of official support as excluding MWI activity from scrutiny under the Arrangement. From this perspective, MWIs are under no obligation under the Arrangement to provide information on credit
terms, even though ECAs are obligated to provide information on official credits. In a 1999 submission to the OECD, Canada offered the following definition of official support:

For the purposes of applying the Arrangement, the term official support means the grant by governments, or special institutions controlled by and/or acting under the authority of governments, of export credits on terms and conditions more favorable than those available in international capital markets. This support can take the form of direct credits/financing, refinancing, interest rate support, aid financing (credits and grants), export credit insurance and guarantees. Direct credits/financing, refinancing and interest rate support are referred to as official support.\(^{650}\)

WTO panel rulings have also modified the legality of matching in a broad array of trade financing situations. The question of whether the Arrangement’s “matching” clauses are covered by the safe haven of item (k) was the subject of extensive examination in the second Canada-Aircraft case. In support of its position that the matching provisions are covered by the exception of item (k), Canada put forward an array of arguments and analysis from the text of the Arrangement, its context, and its objectives and purposes. Canada argued that “matching” was an indispensable tool necessary to ensure that the disciplines of the Arrangement are followed. Canada also insisted that it would use self-restraint when considering matching. The panel rejected these arguments.

\(^{650}\) Statement provided to author by EDC.
In the second Canada-Aircraft case, the panel recognized that Canada Account financing to Air Wisconsin matched an Embraer offer to Air Wisconsin that was not in conformity with the OECD Consensus. Canada again defended the position that matching should be covered by the safe haven of item (k) in relation to EDC’s offer to Air Wisconsin. Its arguments were once again rejected by the panel, which found the findings of the Canada-Aircraft I panel persuasive. A key rationale for limiting the scope of the item (k) reference to the Consensus, and in particular for excluding certain matching transactions from the exception, appeared to hinge on the Panel’s need to limit an exception designed only for the use of a select group of WTO members to an agreement that is binding on and benefits all WTO members. The WTO panel expressed concern about the effects that matching could have on financing, essentially creating “a race to the bottom.” However, it also raised the question as to which institution had ultimate authority to regulate official trade finance. Supplier states participating in the Arrangement interpreted the WTO’s critique of “self-help” in the area of export finance as an effort to assert authority over export finance for the first time.

This decision is significant, because it has the potential to remove matching as a possible response to beyond market behavior by MWIs. In 2002, Congress granted the U.S. Ex-Im authority to match market window transactions. However, this practice could be found in violation of WTO rules, if this interpretation of the WTO Panel decision holds. This raised concerns among member of the Arrangement, because it effectively removes self-help remedies that have been the hallmark of the Arrangement for almost 25

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651 Check WTO file
652 Check WTO file
years. In short the decision requires countries with complaints about MWI to be brought before the WTO and not the Arrangement. Given the cost, time, and information required to bring a case to the WTO, some members of the Arrangement complained that the Panel decision may reduce effective oversight of MWIs and perhaps other subsidy disciplines carried out through the Arrangement. This has sparked resistance by supplier states who see the Arrangement as vital to achieving their interests and therefore as an institutional arrangement that needs to be protected. While supplier states were unable to reach agreement on regulating MWIs, they did agree to redraft parts of the Arrangement in order to better protect it from legal challenges through the WTO.

MWIs continue to elude regulation through the Arrangement. Like the case of untied aid, MWIs illustrate the problem that supplier states face in establishing rules for OTF practices that are not boldly inconsistent with free trade norms. MWIs have the potential to be market distorting but are not necessarily so. The ability of supplier states to use the Arrangement to police predatory behavior is confounded when members are unable to agree on what constitutes cheating. Canada and, to a lesser extent, Germany’s claim that their MWIs operate on market terms, which made it possible for the Japanese government to resist calls for improved verification. The effectiveness of the Arrangement is also limited when one or more supplier states refuse to cooperate. Cartel enforcement depends to a considerable degree on the willingness of individual members to supply information on their practices. Thus far, the U.S. and other members of the Arrangement have been unable to persuade Canada and other supplier states that operate

653 Personal communication, U.S. Treasury Department official, March 2003.
MWIs to fully report financial transactions. As in the case of untied aid, buyer states also have few incentives to provide this information if it could lead to a reduction in favorable financing.

Conclusion

This chapter examined the variation in the strength of rules across different forms of OTF financing over the past 30 years. Two regulated (export credits and mixed credits) and two unregulated (united aid and market windows) modes of finance were examined.

The evidence presented in this chapter confirms that models that combine the concept of institutional costs with the hegemonic power of the United States are inadequate to explain the construction of rules across sectors. This was found to be the case for both regulated and unregulated modes of financing. Beginning in the 1970s, the U.S. became a vocal proponent of stricter export financing rules. However, U.S. preferences were often not fully realized. The U.S. consistently had to compromise to accommodate the preferences of other supplier states. This was seen when it was forced to accept a hybrid system for setting minimum interest rates that addressed the distributional concerns of supplier states with particularly high interest rates. It was also seen in compromises that emerged in the battles over low concessional tied aid, where the U.S. was forced to accept minimum concessionality levels far lower than it demanded.
and was unable to win approval for its plan to move rules on discounting to a differentiated system.

I also proposed that stringent rules were less likely when the preferences of supplier states are heterogeneous, the institutional requirements of a cartel are not realized, and prescriptive norms regarding subsidies and free trade are narrowly, if at all, accepted. The empirical analysis revealed that all but the last condition hold. One surprising finding with respect to unregulated modes of finance was that the applicability of free trade doctrine was not rejected, but embraced. Japan (in the case of united aid) and Canada (in the case of market windows) fully accepted the primacy of free trade doctrine but then used it to claim that they need not provide other members of the Arrangement with information, because they were in full compliance. Without their cooperation, it was difficult for the Arrangement to police credit activities. When supplier states were unwilling to share information, a key condition necessary for a cartel to be effective was not met.

In most cases, however, the appeal to free trade principles helped supplier states develop principles designed to halt predatory financing and unintentional wealth transfers to buyers. It provided a basis for supplier states to find mutually acceptable criteria for setting minimum interest rates. It also provided a basis for supplier states to establish the commercial viability test adopted as part of the Helsinki agreement and resolve the problem of hard aid transactions. Thus, while preferences mattered, free trade norms
provided a common framework that helped supplier states establish standards against which to judge and punish deviant behavior.
CHAPTER SIX: CONCLUSION

I set out in this dissertation to explain how states have sought to reconcile the regulation of state-backed export finance with the goals of an open world trade system. As noted at the outset, the regime governing official trade finance has a number of puzzling features. The Arrangement’s legal basis is ambiguous. Its proceedings are secret. Its membership is restricted to a relatively small number of states. Finally, its rules vary in strength across different modes of financing. Some sectors and modes of finance are more tightly regulated than are others. Some are not regulated at all. My research goal was not only to explain the unusual institutional features and scope of the regime as it stands today, but also to explain how it emerged and evolved over time.

I argued that the Arrangement is not best understood as a product of U.S. hegemony or through the lens of conventional regime theory, but as the result of collusion between supplier states. The history of the Arrangement does not support the assertion that the U.S. alone forced other supplier states to converge toward its policy preferences. The U.S. was part of a bargaining process among the twenty-two members of the Arrangement. In order to secure an agreement that was enforceable, the U.S. was often forced to accept terms and conditions that often fell far short of its negotiating objectives. The history of the Arrangement also does not support an interpretation of the Arrangement in the Keohanian functionalist sense of reducing the costs of making international agreements. The Arrangement does more than improve the efficiency of
cooperation by facilitating information sharing and reducing transaction costs. The Arrangement serves the interest of supplier states in redistributing economic rents.

The Arrangement encompasses not one, but two redistributive conflicts. One conflict involves the struggle among supplier states to contain the use of export finance subsidies to shift rents from one supplier state to another. The other conflict involves the broader struggle between supplier states as a group and buyer states over the allocation of rents: Buyers have an interest in securing the softest, most flexible financing terms possible; whereas the supplier states have an interest in providing export credits on the hardest terms possible and in minimizing the cost of foreign aid.

The need for a theory of collusion and redistribution to explain the rules constructed around these dueling cleavages is illustrated by the empirical analysis presented in this dissertation. Cartel theory specifies the conditions under which self-help aimed at the redistribution of wealth is likely to succeed. For example, secrecy and selective membership are important aids that supplier states have used in the effort to stop beggar-thy-neighbor export financing practices that result in buyers receiving windfalls (in the case of export credits), or harder, more trade-oriented terms (in the case of foreign aid). The cartel framework also clarifies the scope of the rules that supplier states have constructed. This is because collusion is likely to be more successful when certain market structures and institutional features are satisfied.

Four findings deserve elaboration:
Weak and disorganized buyer states

The ability of supplier states to establish a cartel to regulate export finance has been facilitated by the weak and disorganized state of buyers. There have been some exceptions. One example discussed early in the dissertation was the case of the “Latin Trio,” where three buyer states secured a substantial reduction in financing costs by joining together to purchase aircraft. However, instances of pooled purchases and other joint tactics that enhance buyer bargaining power are rare in the history of export finance, probably due to the coordination problems involved in trying to organize joint purchases of power plants and other capital goods. More common are individual efforts to improve bargaining leverage by playing one supplier off another, establishing specific finance-related policy guidelines and other measures. These strategies generally have been most successful for the very largest buyer states, such as the Soviet Union in the 1970s-1980s, Indonesia in the 1980s and China in the 1990s. But even these large states have been forced to accept harder financing terms in the face of agreements reached collectively by supplier states.

The broader historical context of North-South relations is also worth noting. The Arrangement came into existence in the 1970s at a time when advanced industrial states expressed growing resistance to the New Industrial Economic Order and other political and economic demands arising from the Third World. It is therefore not surprising to find an official like Fred Bergsten, who was at the forefront in the mid 1970s in raising the alarm about the threat that third world commodity cartels posed to the U.S. and the
industrial world, become, in the later half of the decade, chief proponent of using the Arrangement to counter the market power of buyer countries through the cartelization of official export finance as a ranking U.S. Treasury Department official.654

Market Share

A cartel’s need to control a large market share contributes to the contours of the Arrangement. Tightening financing terms on capital goods exports has been the primary focus and area of success for the Arrangement. The concentration of capital goods production in advanced industrial countries has favored the establishment and operation of a cartel-like institution. The sectors brought under the terms of the Arrangement were the ones in which supplier states controlled a dominant share of the market. This was true in the 1970s when the Arrangement was established. In the intervening years, developing countries have dramatically increased their production of textiles and light manufacturing. However, few have established globally competitive capital goods export industries, in particular ones that are aimed at South-South trade, which would require significant volumes of medium to long-term finance. As a result, the fringe of competitors that could disrupt the Arrangement was relatively small during the 1970s, 80s and 90s.

There have been a number of exceptions, which are instructive from the perspective of regime scope. The sectors where supplier states have not controlled a

dominant market have been problematic for extending the coverage of the Arrangement. Regional jets provide one example. In the 1990s, Brazil, a non-Arrangement member, became the world’s second largest producer of regional jets. The regional jet case is not unlike the Airbus/Boeing rivalry of the 1970s, which pitted a determined new entrant willing to use a variety of means including subsidized export finance to build market share against incumbents satisfied with the status quo.

The agricultural sector provides another example. The fact that the existing twenty-two members of the Arrangement did not control a dominant share of the world market is not the only reason that an agreement was not reached in this sector. Domestic rent seeking and differences between supplier states over whether free trade doctrine was applicable to the sector played significant roles. However, it is instructive that agriculture is the only sector in which a developing country was permitted to join the negotiations. Argentina is an important exporter of agricultural products and therefore could have posed a threat if left outside an agreement. Neither hegemonic stability theory nor standard regime theory can satisfactorily explain why supplier states would bring Argentina into these negotiations and not others.

Finally, the market share hypothesis explains an anomaly of the original shipbuilding sector agreement concluded in 1969. The absence of the U.S. from the original agreement to constrain export credit competition in the shipbuilding industry is problematic for hegemonic stability theory, which proposes that large states are necessary to facilitate international agreement. However, the absence is easily explained by cartel
theory. At the end of the 1960s, the U.S. held an insignificant market share of ship exports, and therefore its presence was not necessary to reach an agreement.

Production Costs and Product Characteristics

The cartel literature predicts that price fixing and other measures to control competition will be easier if cartel members have similar production costs and produce like products. This is because heterogeneity between cartel members causes different preferences and compounds the problems of reaching a mutually acceptable agreement on how to divide the gains of collusion. The history of the Arrangement shows this to be the case. The search for a market interest rate proxy was greatly complicated by wide spreads in interest rates among members of the Arrangement beginning in the mid 1970s. Supplier states only resolved the problem by adopting a hybrid system, in which supplier states with high interest rates adopted UMM, while low interest rate countries adopted CIRR. The solution is one common to cartels, which commonly agree to side-payments to compensate higher cost producers in order to keep them from defecting.

Provision of Information

Finally, the cartel framework highlights the way information influenced the contours of the regime. Because ECAs run by supplier states are susceptible to the exaggerated claims of exporters and developing country buyers, supplier states needed a reliable, confidential source of information supplied on an *ex ante* basis to improve monitoring and discourage cheating. The cartel framework explains why neither the Berne Union nor the GATT/WTO was able to do this. The Berne Union lacked
credibility and authority. The GATT/WTO was inappropriate because it would have risked releasing key credit information to all contracting parties, including those who were major users of export credits. Loosely situating the Arrangement in the OECD’s trade directorate better served the redistributive interests of supplier states.

In addition to shedding light on the choice of institutional arrangements, cartel theory also explains how information has limited the construction of OTF rules. Sectors in which states willingly provided information correspond with tighter rules. This was true for rules applied to general capital goods, as well as special sectors like civil aircraft. Cartels are most effective when members voluntarily supply pricing and other critical information. Control over information has also been used by states as a way to resist the extension of rules. Japan in the case of untied aid and Canada in the case of market windows have effectively withheld information as a way to resist the extension of rules. Since information is crucial to successful enforcement, countries have been able to resist the expansion of regulation by refusing to supply complete and accurate information.

**Future of Official Trade Finance Regulation**

What does the future hold for the regulation of OTF? Since cartels tend to be unstable, it is worth asking what could threaten the regulatory framework established through the Arrangement.

One potential challenge is to the legitimacy of the Arrangement’s decision making structure. Exclusive and non-transparent approaches to setting rules for money
and trade, or what some call the “club model,” have come under increasing criticism in recent years.\textsuperscript{655} Given its exclusive and secretive nature, the Arrangement represents in many respects an extreme form of the club model. At present, twenty-two countries set OTF rules and regulations that apply to all 140 member of the WTO. Supplier states have attempted to legitimize and defend the Arrangement as a “market reflective instrument.”\textsuperscript{656} Supplier states commonly refer to OTF conforming to the Arrangement as market interest rates or commercial credits. In practice, the rules governing export finance are the result of political bargains struck between suppliers of export finance not the market mechanism. Although they are likely to be less distorting than the rates that would prevail under conditions of unrestricted competition, the terms they have struck, including CIRR rates, are not true market rates. One threat to the stability of the Arrangement arises from demands to increase transparency and broaden participation in setting OTF rules. The problem, of course, is that those currently excluded from the Arrangement are buyer states. As this dissertation makes clear, the interests of buyers diverge sharply with those of suppliers. Not surprisingly, supplier states have resisted recent calls broaden participation in the Arrangement or transfer more authority over OTF to the WTO.

A second challenge arises from future macroeconomic shocks. Over the last decade and a half, supplier states have operated in an environment of historically low


interest rates. These macroeconomic conditions have reduced the competitive pressure facing supplier states to provide subsidized export finance. Compared to the high interest rate environment of the 1970s and early 80s, the domestic interest rate spreads between supplier states and the spreads between official sources and commercial sources have declined significantly. Competitive pressures are likely to reemerge if a high interest rates return. The cartel advanced in this dissertation suggests that the stability cartel could be thrown in jeopardy under these circumstances. A significant rise in interest rates or surplus industrial capacity within supplier states would increase the incentives to defect. Indeed, the foundations of the current regime may not be as solid as many expect.

A third potential challenge to the stability of the Arrangement arises from the emergence of new suppliers. Over the next two decades, traditional buyer states like China, India, Russia and Brazil are likely to become more important suppliers of large capital goods. A question that such a shift will engender is whether these states will join the traditional twenty-two supplier states or form a competitive fringe. From the standpoint of supplier states, Korea presents a successful model. With the important exception of shipbuilding, this state was brought into the framework of subsidy constraints as it moved from a buyer to an increasingly important supplier in the 1980s. Brazil presents a more problematic model. It has refused to join the Arrangement under the conditions set by the existing members. It is important to ask which case is most likely for rising supplier states. Of course, if new challenges emerge we can expect that the existing suppliers will respond to any subsidized financing they may offer by

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aggressive matching and overmatching. At present, it is difficult to imagine non members posing a broad challenge to the Arrangement. A more likely scenario is one raised by Brazil’s emergence as a leading aircraft manufacturer. Challenges from a rising fringe are likely to be industry specific.

The other question to consider is the impact of the Arrangement on bilateral flows in support of global public goods. The Arrangement’s overriding concern is with policing the negative trade effects of OTF. In the early years, supplier states used the Arrangement to control the use of export financed for predatory purposes. As progress was made in this area in the 1980s and 1990s, attention shifted to applying rules to regulate the terms and conditions of foreign aid. The Helsinki package was justified as a means of improving the quality of aid flows by restricting hard aid. The total volume of intentional wealth transfers has been lower ever since. This sequence of events does not prove that there is a causal relationship between tighter Arrangement rules and the recent decline in the total volume of bilateral ODA. It does, however, illustrate the need for further research on the relationship between trade rules aimed at controlling subsidies and the incentives to finance public goods.

Finally, this dissertation shines a more critical light on U.S. policy toward OTF. Many have commented on the meagerness of America’s intentional wealth transfers.\textsuperscript{658} This is true whether one measures these transfers as a percentage of gross national income, as the relative contributions of other supplier states, or against the daunting need

\textsuperscript{658} See, for example, Jeffery D. Sachs, “The Development Challenge,” \textit{Foreign Affairs}, vol. 84, no. 2 (March/April 2005), pp. 78-90.
for greater financial flows to the world’s neediest regions. What this dissertation reveals is that while the U.S. dramatically scaled back on foreign aid over the past three decades, U.S. officials worked double-time to police the intentional wealth transfers of others. Viewed charitably, the U.S. played a vital role in eliminating finance related trade distortions and increasing the quality of foreign aid. Viewed less charitably, U.S. policy has been beholden to protecting the narrow commercial interest of U.S. exporters in “leveling the playing field.” The result is a lopsided stance toward OTF: aggressive measures to restrict rent shifting through targeting financing subsidies, but little in the way of initiatives to expand the supply of subsidies that seek to correct pressing non financial market failures ranging from chronic poverty to progressive environmental deterioration. With the exception of military equipment, U.S. policy has been more intent on policing potentially predatory trade practices of rival supplier states and reducing the transfer of rents to developing countries than in cajoling additional contributions to the global common good.

659 In 2003, the U.S. contributed only allocated 0.15 percent of gross national income to foreign aid, which was the absolute lowest within the OECD. See Organization for Economic Cooperation and Development, “Final ODA Data for 2003,” available at URL: http://www.oecd.org/document/22/0,2340,en_2649_33721_34285782_1_1_1_1,00.html
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