

# Appendix 13E. The financing factor in arms sales: the role of official export credits and guarantees

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## I. Introduction

On 10 October 2002 the United States Congress authorized the Department of Defense (DOD) to offer Poland a loan of up to \$3.8 billion on 15-year repayment terms pursuant to the US Arms Export Control Act.<sup>1</sup> The loan was unusual, given its large size and the fact that there had been a substantial reduction in the number and value of US Government loans issued to support arms sales during the 1990s. Tucked into a continuing resolution, it was approved only days before the deadline to meet a request by Poland for proposals on a package of 48 new multi-role combat aircraft, missiles and associated equipment. The authorization was presented to Congress as a critical element needed to complete a bid package which included 48 Lockheed Martin F-16 combat aircraft, Pratt & Whitney engines, and Raytheon and Textron Systems missiles.<sup>2</sup> Financing by the US Government was deemed essential to counter competing financing offers from Sweden and the United Kingdom on behalf of the JAS-39 Gripen combat aircraft, jointly manufactured by Saab and BAE Systems, and a French consortium on behalf of the Mirage 2000 combat aircraft, manufactured by Dassault Aviation.<sup>3</sup> Poland awarded the contract to Lockheed Martin for the F-16 on 27 December 2002.<sup>4</sup>

Many issues are raised by the supply of aid and trade credits in support of arms sales. One immediate question is whether the type of loan package to support the F-16 bid in Poland was a one-off event induced by unusual circumstances or whether it signals the US Government's resolve to use export financing more aggressively to win military contracts abroad. A second issue is the level of subsidization that is associated with government-backed credits and guarantees. Another fundamental question is whether military-related export credit competition between supplier countries can be controlled. Comprehensive statistics are not publicly available, but a

<sup>1</sup> Morgan, D., 'House passes new stopgap funding bill: defense, military construction measures passed; other spending fights continue', *Washington Post*, 11 Oct. 2002, p. A20. Public Law 90-629, the Foreign Military Sales Act of 1968, was amended by Public Law 94-329, the International Security Assistance and Arms Export Control Act of 1976. Together, they are commonly referred to as the Arms Export Control Act.

<sup>2</sup> For a full description of the package offered to Poland see US Defense Security Cooperation Agency, 'Poland-F-16 fighter aircraft', News Release, transmittal no. 02-49, 22 July 2002.

<sup>3</sup> Few details of the competing European offers are publicly available but they both involve substantial government support through the provision of export credit. Sweden's Exportkreditnämnd (EKN) and the UK's Export Credits Guarantee Department (ECGD) jointly offered 100% cover for 15-year loans provided by a consortium of European banks at an interest rate of 4.5% to support the bid from Gripen International. Private communication from an official of Gripen International, 18 Nov. 2002. See also 'Dassault Aviation says France would guarantee 85 pct of Polish Mirage deal', *AFX European Focus*, 5 Sep. 2002; and later reports that the French Government had agreed to increase its financing support to back the full 100% value of Dassault's bid at a low interest rate of 3.4%. See, e.g., Jaxa-Malakowski, R., 'Proposals issued for Poland's fighter contest', *Flight International*, 19 Nov. 2002.

<sup>4</sup> Busvine, D., 'Lockheed wins \$3.5 billion F-16 tender', Reuters (Warsaw), 27 Dec. 2002.

rough estimate suggests that aid and trade credits for military goods and services provided by supplier states now exceed \$10 billion annually.<sup>5</sup> Owing to the lack of comprehensive statistics, cross-country comparisons in the level and desination of supplier financing is not easily made. This appendix focuses on the financing programmes operated by the USA.

A state's decision to provide export financing may combine security and economic considerations. As a result, it has proved especially difficult in the military sector to secure international constraints designed to control export credit competition. There are two international agreements that seek to control export subsidization—the 1994 World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM Agreement)<sup>6</sup> and the more specific 1978 agreement negotiated within the context of the Organisation for Economic Co-operation and Development (OECD).<sup>7</sup> The latter agreement—the Arrangement on Guidelines for Officially Supported Export Credits (commonly known as the Arrangement or Consensus)—sets the terms and conditions of official export credits offered by OECD countries.<sup>8</sup> Neither the WTO SCM Agreement nor the OECD Arrangement rules cover export subsidies for military sales. A particular irony of the competition in Poland is that in 1993 Sweden had proposed that international trade finance disciplines established through the OECD be extended to cover military equipment. At the time, the US DOD and State Department opposed such disciplines.<sup>9</sup> Without the support of the USA, an international agreement to control export credit subsidization had little chance of succeeding and was dropped.

This appendix addresses the financial role that arms supplier states play in facilitating international arms transfers. Section II examines the US financing package offered to Poland, and section III reviews the demand and supply pressures that create mixed incentives for supplier states to offer export financing. Section IV examines the role of the Export–Import Bank, and section V takes a more detailed look at the evolution of the US export financing programmes for military equipment and where they stand today. Section VI reviews efforts at the international level to apply export credit financing disciplines to the military sector, the limitations of data collection and reporting, and the implications of the recent policy initiative to ensure that export credits to the world's poorest countries are not used for 'unproductive' purposes. The final section offers some conclusions.

<sup>5</sup> This estimate is based on a figure of \$3.8 billion for the USA (Foreign Military Financing plus the Military Assistance Program plus the Export–Import Bank) in fiscal year 2001 and private communications from and annual reports of major export credit agencies which give recent annual averages of \$2.9 billion for France, \$2.2 billion for the UK, \$600 million for Canada, \$600 million for the Netherlands, and \$500 million for Sweden. See also US Government Accounting Office (GAO), *Military Exports: A Comparison of Government Support in the United States and Three Major Competitors*, GAO/NSIAD-95-86 (US Government Printing Office: Washington, DC, May 1995); and Broek, M., 'Paper on export credit agencies and arms trade', *Campagne Tegen Wapenhandel*, Amsterdam, Sep. 2000.

<sup>6</sup> See the WTO Internet site at URL <<http://www.worldtradelaw.net/uragreements/scmagreement.pdf>>.

<sup>7</sup> Organisation for Economic Co-operation and Development (OECD), *Arrangement on Guidelines for Officially Supported Export Credits* (OECD: Paris, 1998), available at URL <<http://www.oecd.org/pdf/M00035000/M00035551.pdf>>. For the members of the OECD see the glossary in this volume.

<sup>8</sup> As of 2001, the members of the OECD Arrangement included: Australia, Canada, the European Community (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK), Japan, South Korea, New Zealand, Norway, Switzerland and the USA.

<sup>9</sup> Private communication from a US Treasury Department official, 12 Nov. 2002.

## II. Export financing competition in Poland

Financing has emerged as an important factor—together with offsets<sup>10</sup>—in winning large military equipment orders arising from the enlargement of the North Atlantic Treaty Organization (NATO). US manufacturers and DOD officials claim that the lack of competitive financing was one reason for the string of lost contracts in Eastern Europe, where they faced European competitors with government-backed financing packages.<sup>11</sup> This lack of competitive financing was cited in relation to the September 2001 decision by Hungary to lease 14 JAS-39 Gripen fighters from the Swedish Air Force for a period of 10 years starting in 2004. It was considered to have been a factor in the Czech Republic's December 2001 decision (cancelled in 2002) to buy 24 new Gripens rather than leasing used Lockheed Martin F-16s.<sup>12</sup> Finally, it was implicated in Austria's decision in July 2002 to buy 24 Typhoon fighters from the Eurofighter consortium over competing offers of F-16s and JAS-39 Gripens.

The loan authorization for Poland resulted from an effort by the administration of President George W. Bush to overcome the limitations imposed by existing US Government financing programmes.<sup>13</sup> In contrast to its European competitors, the USA did not have a competitive export credit facility that could issue government loans or guarantees for this type of sale. The Export–Import Bank of the United States (see section IV) does not provide financing for most military sales. In addition, the Defense Export Loan Guarantee (DELG) programme, which was set up within the DOD in 1996 to 'mirror' Export–Import Bank loans for military equipment and services, is subject to conditions which make its financing terms expensive and therefore uncompetitive (see section V).

The special loan terms for Poland overcame these limitations by tapping the little-used permanent borrowing authority under Section 23 of the Arms Export Control Act to borrow money directly from the US Treasury. This permitted the DOD's Defense Security Cooperation Agency (DSCA), which manages the Pentagon's Foreign Military Sales (FMS) programme (see section V), to provide 100 per cent of the loan instead of the 85 per cent guarantee of commercial bank loans permitted under the DELG programme. It also permitted the DSCA to offer an interest rate based not on market rates but on the more favourable 10-year US Treasury note. The 15-year term authorized by Congress allowed the DSCA 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 US Government man-

<sup>10</sup> Hagelin, B., Wezeman, P. D., Wezeman, S. T. and Chipperfield, N., 'International arms transfers', *SIPRI Yearbook 2002: Armaments, Disarmament and International Security* (Oxford University Press: Oxford, 2002), pp. 390–95; and Hagelin, B., Wezeman, P. D., Wezeman, S. T. and Chipperfield, N., 'Transfers of major conventional weapons', *SIPRI Yearbook 2001: Armaments, Disarmament and International Security* (Oxford University Press: Oxford, 2001), pp. 334–40.

<sup>11</sup> Private communications from officials at Lockheed Martin, Washington, DC, 25 Oct. 2002. Also illustrative are the comments of Air Force Lt-Gen. Tome Walters, Director of the US Defense Security Cooperation Agency (DSCA), in early 2002: 'Our inability to compete with financing is a major problem for us . . . The absence of an effective defense-export loan program from the US really disadvantages us. It is time for us to begin that discussion with the administration and Congress to point out to them that we are losing out on a generation of air force to air force relationships because we can't be more financially competitive'. Quoted in Baumgardner, N., 'Walters concerned about EU pressure in Central European fighter competitions', *Defense Daily International*, 4 Jan. 2002.

<sup>12</sup> Baumgardner, N., 'Gripen International sees 10-year window for orders before JSF arrives', *Defense Daily International*, 26 July 2002.

<sup>13</sup> See, e.g., Whittle, R., 'US helps Lockheed Martin market fighter plane to Poland', *Dallas Morning News*, 8 Oct. 2002.

aged 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.<sup>14</sup>

The loan offer also significantly reduced the cost of fees associated with other US Government support programmes. The DELG guarantees require buyers to pay exposure fees to insure against potential losses. For a country in Poland's risk category, this exposure fee could cost as much as \$570 million on a loan of \$3.8 billion.<sup>15</sup> The special, Congress-approved loan authorization allowed the DSCA to structure a financing package in a way that not only substantially reduced the financing fees but also allowed Poland to meet the default subsidy requirement by obtaining a letter of credit from a commercial bank to serve as a performance bond. Export credit agencies (ECAs), by contrast, normally charge risk exposure fees to cover default risk and therefore impose a higher cost on the borrower, unless they are subsidized.

A further effort was made to reduce the total cost by permitting Poland to 'buy down' the total cost of the loan by paying more up-front in what the bid package called a 'loan interest rate reduction fee'.<sup>16</sup>

The loan authorization for Poland was also noteworthy given recent trends (see table 13E.1). While the USA continues to maintain a sizeable grant programme, loans for military exports have been in decline. The last loan was issued by the DSCA in 1998 and totalled only \$100 million.<sup>17</sup> Larger loans were made available in the early 1990s but never exceeded \$860 million in any given year. Turkey has been the largest loan recipient over the 10 years since 1992, receiving a total of \$1.7 billion. The loan authorization to Poland was therefore not only larger than the total for any previous year or any other country; it was larger than all the loan authorizations for the preceding decade.

### III. Mixed motivations and concerns

#### Motivations

The majority of global arms transfers are financed by purchasing governments, either through defence 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. Official export financing takes several forms, ranging from the highly concessional to near-market terms. Concessional financing can take the form of tied aid grants or subsidized loans. More market-based financing is generally provided by the exporting country's ECA

<sup>14</sup> To conclude the terms of the commercial (non-FMS) sale of F-16s to the United Arab Emirates in 2000, Lockheed Martin was required to post a performance bond of nearly \$2 billion. Calamba, S., 'Lockheed's credit seen intact from performance bond', *Capital Market Report*, 28 Mar. 2000.

<sup>15</sup> In Oct. 2002 Poland was considered a category C country under the Export-Import Bank's Inter-agency Country Risk Assessment System (ICRAS). The ICRAS, established to comply with the Credit Reform Act of 1990, is used to 'score' loans, i.e., to determine the amount (or 'default subsidy') that must be set aside against estimates of the contingent liability (pure default risk) associated with a loan. In the normal course of agency lending, these default subsidies are appropriated by Congress as part of the lending agency's programming budget. However, because Congress did not appropriate these funds for the F-16 package, this constraint would be overcome by charging the subsidy cost directly to Poland.

<sup>16</sup> Private communication from an official of the DSCA, 13 Nov. 2002.

<sup>17</sup> US Defense Security Cooperation Agency (DSCA), 'DSCA (facts book): Foreign Military Sales, Foreign Military Construction Sales and Military Assistance facts', 26 Sep. 2002, URL <[http://www.dsc.osd.mil/programs/Comptroller/2001\\_FACTS/default.htm](http://www.dsc.osd.mil/programs/Comptroller/2001_FACTS/default.htm)>.

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, also known as 'cover', from an ECA or other official source. This is particularly true in developing country markets owing to perceptions of risk, foreign exposure ceilings, and the potential adverse publicity associated with support of military goods and services. Even 'commercial' export transactions therefore generally involve some type of cover from an ECA or other official source.

A combination of factors motivates governments to offer export financing to support arms sales. Some of these pressures arise from the conditions affecting buyers. The value of government-supplied export financing is greatest in markets that are the least credit worthy and pose the greatest risk of default.<sup>18</sup> Export financing is therefore particularly valuable for countries with limited or unreliable defence budget allocations or which are facing significant political and economic instability. Thus financing is particularly valuable in the arms markets of much of Africa, Asia, Eastern Europe and Latin America, and the non oil-producing countries of the Middle East, such as Egypt, Israel, Jordan and Turkey. From the perspective of buyers, the cheaper and more secure the credit terms the better, since lower fixed interest rates and extended-term rates relieve repayment pressures and reduce financing costs. In an over-supplied market, buyers are often able to demand and obtain these favourable financing terms.

Pressures on the supply side are also at work. Although international conditions have changed from the height of the cold war, security goals continue to serve as a rationale for the supply of financing. This is the principal rationale offered by the USA to justify an average of \$3.5 billion a year in grants and loans provided to buyers to purchase military goods and services from US suppliers. This includes financing to meet commitments associated with the 1978 Egyptian–Israeli–US Camp David accords on the Middle East<sup>19</sup> and other peace and security objectives, to fight drugs trafficking, to suppress counter-insurgencies and more recently to fight terrorism.

However, other sources of pressure are also evident. One stems from the well-documented pressure to export in order to contain unit costs of particular weapon systems or simply to keep production lines open.<sup>20</sup> Export credits are a direct measure that governments can offer to help manufacturers market major weapon platforms abroad. Domestic manufacturers also value grants, loans and/or guarantees as a way of offsetting the high risks associated with exporting. Employment is another consideration. Calls for export credit financing for arms sales to be reduced or eliminated have failed in the face of political concerns that this would lead to the loss of jobs linked to exports.

<sup>18</sup> Bosworth, B. P., Carron, A. S. and Rhyne, E. H., *The Economics of Federal Credit Programs* (Brookings Institution: Washington, DC, 1987), chapters 2 and 4.

<sup>19</sup> For the accords see URL <<http://www.mfa.gov.il/mfa/go.asp?MFAH00ie0>>.

<sup>20</sup> For a discussion of the importance of international orders for the economic viability of the JAS-39 Gripen see Sköns, E. and Wetterqvist, F., 'The Gripen and Sweden's evolving defense industrial policy', ed. Randall Forsberg, *The Arms Production Dilemma: Contraction and Restraint in the World Combat Aircraft Industry* (MIT Press: Cambridge, Mass., 1994), p. 231. On the USA see Opall, B., 'Pentagon sides with industry on export financing', *Defense News*, 30 May–5 June 1994. For a broader discussion of the post-cold war capacity 'overhang' and the political incentives that work against shutting down excess plant capacity despite defence industry mergers see Gholz, E. and Sapolsky, H. M., 'Restructuring the US defense industry', *International Security*, vol. 24, no. 3 (winter 1999/2000), pp. 5–51.

**Table 13E.1.** US military-related export financing programmes, 1992–2001  
 Figures are in US\$ thousand.

Fiscal year (FY)	Export financing programmes administered by the Department of Defense						US Export–Import Bank loans and guarantees <sup>e</sup>
	Foreign Military Financing (FMF)		Military Assistance Program <sup>b</sup>	Debt forgiveness <sup>c</sup>	Guaranteed Reserve Fund sources <sup>d</sup>		
	Grants	Loans					
1992	3 929 476	345 000	–	116 269	85 154	34 138	30 826
1993	3 368 505	855 200	–	551 910	–	63	34 555
1994	3 147 703	769 500	–	320 900	94 629	50	79 300
1995	3 154 561	557 685	–	117 000	–	39	24 072
1996	3 292 343	544 000	–	330 340	–	24	184 329
1997	3 232 786	297 500	16 700	71 627	–	17	23 170
1998	3 319 707	100 000	–	95 000	–	28	40 116
1999	3 370 240	–	–	267 700	–	38	316 564
2000	4 332 802	–	–	84 600	–	38	31 200
2001	3 535 429	–	–	41 000	–	38	217 536
<b>Total</b>	<b>34 583 552</b>	<b>3 468 885</b>	<b>16 700</b>	<b>1 996 346</b>	<b>179 783</b>	<b>34 471</b>	<b>981 668</b>

<sup>a</sup> DELG = Direct Export Loan Guarantee: this programme was established pursuant to the National Defense Authorization Act for fiscal year (FY) 1996. <sup>b</sup> Includes Military Assistance Services Funded (MASF), emergency drawdowns, and other grant assistance; excludes training. <sup>c</sup> Debt forgiveness was undertaken for Egypt (FY 1991) and Jordan (FY 1995). <sup>d</sup> This ceased as a Guaranty Reserve Fund as of FY 1992. As of that date, it became the Foreign Military Loan Liquidating Account. In FY 1992 as a result of credit reform, the undisbursed loan balances (\$1.87 billion) in the FMF Account were transferred to this account. In FY 1996 the final disbursements of loan balances were made. From that time, only default payments to the Federal Financing Bank have been made from this account. <sup>e</sup> Includes transactions having potential military implications, including anti-narcotics-related transactions requiring a Presidential Determination and/or Leahy clearance from the US State Department to verify the human rights record of the end-user, dual-use items, and equipment procured by national police for public order and safety purposes.

*Source:* US Defense Security Cooperation Agency (DSCA), 'DSCA (facts book): Foreign Military Sales, Foreign Military Construction Sales and Military Assistance facts', 26 Sep. 2002; US General Accounting Office, Letter to Congressional Committees, *Export–Import Bank: The US Export–Import Bank's Financing of Dual-Use Exports*, GAO/NSIAD/00–23 IR, 1 Sep. 2000, p. 7, and GAO-01-1110R, Eximbank's Financing of Dual-Use Exports, 31 Aug. 2001, p. 6; and Private communications from the US Export–Import Bank.

Finally, there are the pressures that arise from exporters to match financing offers from competitor countries. As the US loan authorization to Poland shows, governments may go to considerable lengths to piece together a competitive financing package in order to win a tender. International rules have been established both through the WTO SCM Agreement and the OECD Export Credit Arrangement to control below-market export financing. However, neither agreement covers military equipment.<sup>21</sup>

## Concerns

Critics have raised a variety of concerns about the provision of export credits and guarantees by arms supplier states. One is the lack of transparency associated with the practice. In the case of France, military equipment averages 20 per cent of the annual export activity of the French export credit agency, the *Compagnie Française d'Assurance pour le Commerce Extérieur* (COFACE), but specific data on military transactions are not made publicly available.<sup>22</sup> Not only do the relevant ministries withhold this information, but the French Government and exporting firms enter into confidentiality covenants which prohibit both parties from disclosing credit terms and conditions.<sup>23</sup> Similar non-disclosure rules apply with the Dutch, German, Italian and Spanish ECAs. Somewhat more information on arms-related export financing is available from Sweden, the UK and the USA. However, even here the figures tend to be highly aggregated, with little or no reporting by country or individual contract. Under considerable public pressure, the British Export Credit Guarantee Department (ECGD) has recently begun publishing information on individual deals on a *post hoc* basis.

A second concern arises from the subsidy cost associated with providing official export credits and the market distortions this creates. These subsidies arise when suppliers charge interest rates that are below market rates or fail to charge risk premium fees sufficient to cover the full default risk associated with loans or guarantees.<sup>24</sup>

A third concern is the potential 'crowding out' effect on civilian exports. To manage risk, export credit agencies establish ceilings on the amount of total exposure they

<sup>21</sup> Export credit agencies are required by WTO rules to break even over time as established by Item (J) of the Agreement on Subsidies and Countervailing Measures. However, ECAs often escape even these minimal subsidy constraints by keeping 2 sets of books, with 1 carrying 'national-interest' transactions that include military sales. In this way governments avoid compromising the minimal subsidy constraints that may be caused by military transactions. In the case of the USA, the problem is avoided since defence export subsidies are funneled through DOD agencies rather than the US Export-Import Bank.

<sup>22</sup> Private communication with officials of the French Ministry of Economy and Finance, Economic and Trade Department, Paris, 7 Mar. 2002.

<sup>23</sup> Defence manufacturers have conflicting incentives when it comes to releasing information on the official export cover they may be receiving. It is often in their interest to reveal this information to the financial press in order to demonstrate to the market that they are not taking direct balance-sheet risk. However, concern about provoking accusations of 'corporate welfare' (associated with receiving publicly supported export credits) or the opponents of arms exports more generally, which might threaten government support programmes, creates countervailing incentives to withhold this information.

<sup>24</sup> A number of efforts have been made to estimate the subsidies associated with defence exports. For estimates of the subsidy cost of military-related export credits provided by Britain's ECGD, see Ingram, P. and Davis, I., *The Subsidy Trap: British Government Financial Support for Arms Exports and the Defense Industry* (Oxford Research Group: Oxford, July 2001); and Chalmers, M. *et al.*, *The Economic Costs and Benefits of UK Defense Exports* (University of York, Centre for Defence Economics: York, Nov. 2001). For an analysis of the US situation see Hartung, W. D., 'Corporate welfare for weapons makers: the hidden costs of spending on defense and foreign aid', *Policy Analysis* (Cato Institute), no. 350 (12 Aug. 1999).

**Table 13E.2.** US Department of Defense military aid, loan and loan guarantee programmes, ranked by country totals, fiscal years 1992–2001<sup>a</sup>

Countries are ranked by size of grant. Figures are totals for the 10-year period, in US\$ thousand.

Rank/Country	Grant	Rank /Country	Grant	Rank/Country	Grant
1 Israel	19 255 644	39 Eritrea	6 023	73 Gambia	1 400
2 Egypt	12 997 140	40 Argentina	5 548	74 Namibia	1 370
3 Jordan	521 295	41 Honduras	5 317	75 St Vincent and the Grenadines	1 312
4 Turkey	475 000	42 Cambodia	5 050		
5 Portugal	100 000	43 Russia	4 500	76 Rwanda	1 225
6 Colombia	91 700	44 Haiti	4 475	77 Niger	1 200
7 Poland	81 636	45 Malta	3 743	78 Chile	1 198
8 Morocco	69 995	46 Ecuador	3 619	79 Zimbabwe	1 140
9 Romania	59 337	47 Dominican Rep.	3 544	80 Kenya	1 000
10 Czech Rep.	56 318	48 Benin	3 450	81 Zambia	950
11 Hungary	52 218	49 Botswana	3 397	82 Fiji	850
12 Bolivia	50 638	50 Guinea	3 250	83 Paraguay	847
13 Philippines	44 779	51 Mali	3 247	84 Guyana	679
14 Macedonia	41 274	52 Antigua and Barbuda	3 177	85 Bahamas	649
15 Bulgaria	39 345			86 Mozambique	600
16 El Salvador	32 250	53 Trinidad and Tobago	2 895	87 Thailand	598
17 Greece	30 000			88 Panama	590
18 Slovakia	29 885	54 Turkmenistan	2 849	89 Laos	500
19 Estonia	26 892	55 Mongolia	2 682	90 Malaysia	348
20 Lithuania	26 442	56 St Lucia	2 233	91 São Tome and Príncipe	290
21 Latvia	24 544	57 Bangladesh	2 050	92 Cape Verde	225
22 Ukraine	22 089	58 Angola	2 000	93 Seychelles	150
23 Georgia	21 490	59 Grenada	1 929	94 Djibouti	100
24 Tunisia	20 493	60 South Africa	1 900	95 Tanzania	100
25 Nigeria	20 000	61 Uruguay	1 900	96 Suriname	75
26 Albania	18 556	62 Nepal	1 897	97 Sierra Leone	60
27 Slovenia	13 987	63 Belize	1 810		
28 Senegal	13 965	64 Guinea-Bissau	1 800		
29 Uganda	10 320	65 East Timor (UNTAET)	1 796		
30 Bosnia and Herzegovina	9 986			<b>Rank by loan</b>	
31 Kazakhstan	8 946	66 Barbados	1 702	1 Turkey	1 703 050
32 Moldova	8 545	67 Côte d'Ivoire	1 700	2 Greece	1 494 635
33 Uzbekistan	8 395	68 St Kitts and Nevis	1 557	3 Portugal	171 000
34 Croatia	7 991			4 Poland	100 000
35 Ethiopia	7 130	69 Dominica	1 508		
36 Kyrgyzstan	6 546	70 Bahrain	1 500	<b>Rank by loan guarantee</b>	
37 Jamaica	6 522	71 Oman	1 500	1 Romania	16 700
38 Ghana	6 185	72 Malawi	1 469		

UNTAET = UN Transitional Administration in East Timor.

<sup>a</sup> Excludes \$2 million in Military Assistance Service funded, emergency drawdowns, training and other grant assistance between 1992 and 2001.

Source: Calculated from US Defense Security Cooperation Agency (DSCA), 'DSCA (facts book): Foreign Military Sales, Foreign Military Construction Sales and Military Assistance facts', 26 Sep. 2002, URL <[http://www.dsca.osd.mil/programs/Comptroller/2001\\_FACTS/default.htm](http://www.dsca.osd.mil/programs/Comptroller/2001_FACTS/default.htm)>.



will take in any given country. Large military orders can quickly breach these limits, thereby crowding out the provision of ECA cover for civilian goods and services.<sup>25</sup>

Another set of concerns relates to the potential negative impact on buyer countries, particularly the developing countries, which rely most heavily on export credit financing to purchase weapons. The provision of export credits has been criticized for distorting development priorities by shifting resources away from economic development and basic human needs. Easy credit has also been blamed for aggravating already high levels of developing country debt. These concerns led Michel Camdessus, at the time Managing Director of the International Monetary Fund (IMF), to call for the abolition of export credits for military purposes.<sup>26</sup>

One final concern is that weapons obtained with the support of export credits may be used for internal repression. This is primarily a question of export licensing systems and codes of conduct. However, ECA-backed sales to Indonesia and other countries in the 1990s drew attention to the role public monies can play in supporting controversial sales.<sup>27</sup>

Despite the criticisms and concerns, the incentives to establish programmes to protect domestic arms producers from the high financial risks associated with exporting or to ease the credit terms for potential buyers remain strong and extend beyond the USA and European suppliers. As a result of a more competitive international market and declining military orders, Russia has tried to consolidate and strengthen its military export institutions. One step in this direction was the creation of a single state intermediary to manage military exports—Rosoboronexport. It has also expanded the range of export credit and insurance. In December 2001 Rosoboronexport announced that it had acquired a controlling stake in the Russian Insurance Center in order to provide its suppliers with a full guarantee against losses on exported military and dual-use goods.<sup>28</sup>

Little is known about the programmes of other weapon exporters such as China and Israel. Many of their export deals are likely to be on a cash basis. However, given that they sell primarily into higher-risk developing country markets, it is likely that they also face a variety of pressures to supply financing to facilitate sales and cover the financial risks that companies face in exporting arms.

<sup>25</sup> The British Government attempted to overcome this problem by establishing a special £1 billion (\$2.5 billion) fund that would be made available to extend country limits where needed. Poole, T., '£1 billion ECGD scheme to aid defence sales', *The Independent*, 29 June 1988.

<sup>26</sup> 'Address by Michel Camdessus, Chairman of the Executive Board and Managing Director of the International Monetary Fund to the Board of Governors of the Fund', Washington, DC, 28 Sep. 1999, available at URL <<http://www.imf.org/external/np/speeches/1999/092899.htm>>.

<sup>27</sup> One of the better-documented cases is the controversial sales of arms and dual-use items to Iraq in the 1980s and to Indonesia in the 1990s financed by the British ECGD. Phythian, M., *The Politics of British Arms Sales Since 1964* (Manchester University Press: Manchester and New York, 2000); and Jackson, B., *Gunrunners' Gold: How the Public's Money Finances Arms Sales* (World Development Movement: London, May 1995).

<sup>28</sup> Miledin, P., 'Roseoboronexport has purchased an insurer', *Defense and Security*, 14 Jan. 2002; and 'Russia's Rosoboronexport-growth prospects', Canada Newswire, 28 Nov. 2001. However, the lack of competitive government loan facilities continues to be a problem. Indonesia reportedly abandoned plans to obtain Russian helicopters for its navy because the supplier was unable to obtain the required export credit loan. Karniol, R., 'Indonesia drops helicopter plan', *Jane's Defence Weekly*, 16 Jan. 2002. See also Khozyainov, Y., 'Russian arms exports: possibilities, problems and prospects', *Ekspert Vooruzhenii*, vol. 32, no. 4 (July/Aug. 2002), p. 2.

#### IV. The Export–Import Bank of the United States<sup>29</sup>

The Export–Import Bank’s role in supporting military sales has evolved significantly over the years. At one time it was deeply involved in financing military sales. In 1962 the bank began financing military exports to creditworthy allies. In the mid-1960s, Congress amended the Foreign Assistance Act to allow the DOD to guarantee credits provided by the bank for military sales to developing countries. Subsequently, an arrangement was worked out whereby the Export–Import Bank would provide loans that were then guaranteed by the DOD. Under this arrangement, the Export–Import Bank provided the financing but did not deal with the buyer and was not informed of the buyer’s identity. These transactions become known as ‘country X loans’.<sup>30</sup> Between 1962 and mid-1967 the Export–Import Bank supported approximately \$1.9 billion-worth of military exports to both developed and developing countries. Although military activity over this period accounted for less than 10 per cent of total bank authorizations, in some years the amount rose to as much as 45 per cent of all loan activity.

Growing concerns about military sales led Congress to prohibit the Export–Import Bank from supporting military equipment sales to developing countries in 1968. However, this did not immediately halt support. Between 1968 and 1974, the bank 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 Corporation for a sale of 80 F-14 Tomcat fighter aircraft to Iran. This contract had an estimated value of \$2.2 billion. The Export–Import Bank skirted the congressional ban on providing support to developing countries by determining that Iran was a developed country and therefore eligible to receive Export–Import Bank financing.<sup>31</sup>

After disbursements associated with the Iranian transaction were completed in 1974, the Export–Import Bank restricted military support to all countries. Although Congress did not pass explicit legislation against the Export–Import Bank supporting military transactions to developed countries, congressional sentiment against the bank’s role in military financing hardened further in the 1970s. That policy stance was strongly reinforced within the bank by the Iranian Revolution in 1978, not long after the last F-14 fighter financed by the bank was delivered to Iran’s Khatami Air Force Base.

#### **Restrictions combined with exceptions**

Ever since 1974, when the Export–Import Bank adopted a policy restricting military sales, there have been efforts to rescind or modify this policy. Political pressure for its restrictions on military support to be relaxed began in earnest in the late 1980s. The pressure arose from growing complaints from the industry about the limited availability of competitive financing to promote exports of military and military-related items. The lack of competitive financing was cited as a factor in the loss of export

<sup>29</sup> Information about the bank is available at URL <<http://www.exim.gov>>.

<sup>30</sup> US General Accounting Office (GAO), *Eximbank Financing Support for Exports of Defense-Related Products*, GAO/NSIAD-84-66 (US Government Printing Office: Washington, DC, 13 Apr. 1984).

<sup>31</sup> Private communication with an official of the Export–Import Bank, 29 July 2002.

sales. Some companies also cited the lack of financing as a factor in their decision to move military production outside the USA.<sup>32</sup> These complaints arose in an environment of more general concern about declining US competitiveness and accusations of unfair trade practices, including the use by foreign governments of mixed credits and other financing techniques in order to win export sales.<sup>33</sup> In addition, the Export–Import Bank had \$1.5–3 billion in unused loan guarantee authority. Defence exporters argued that this unused authority could be used to support military-related exports.

These pressures ultimately failed to fundamentally change the Export–Import Bank’s policy or the congressional ban on financing military sales to developing countries. They did, however, lead to a number of exceptions being introduced.

The first exception was made in 1988, when Congress amended the Export–Import Bank’s charter to permit the bank to use its guarantee and insurance authority to support counter-narcotics efforts. This allowed the bank to support sales of small aircraft, helicopters, patrol boats, surveillance radar and other equipment to Colombia, Guatemala, Mexico and Venezuela. A second exception was made shortly before the 1991 Persian Gulf War. In August 1990 the Export–Import Bank approved two military-related guarantees totalling \$1.4 billion. The most significant of these was to support the \$1.6 billion export of 200 Sikorsky UH-60L helicopter kits<sup>34</sup> to Turkey in competition against Aérospatiale of France, Messerschmitt-Bolkow-Blohm GmbH of Germany and Agusta of Italy. A separate transaction provided a \$47 million guarantee to support the \$55.4 million export sale of modular control and automatic tracking system equipment for Turkish surveillance radars.

Following this sale, the 1989–93 administration of President George H. W. Bush attempted to re-establish the Export–Import Bank’s ability to offer guarantees of commercial bank credits for military exports to members of NATO and to Australia, Israel and Japan. The goal was to establish a market-oriented programme that would extend to US defence firms the same terms as were given to civil-use exporters and create a more level playing field for them vis-à-vis foreign competitors. Presenting the proposal as a pilot programme, the administration sought authority of up to \$1 billion each year for this purpose. The plan sparked considerable controversy and bipartisan opposition.<sup>35</sup> The proposal was passed by the Senate but was eventually defeated by the House. It failed in part because of the objections of civilian users of the bank, who were concerned not only about the competition for a limited amount of loans and guarantees but also about the risk that controversial arms deals could

<sup>32</sup> E.g., Bell-Textron decided to move part of its helicopter production facility from Fort Worth, Tex., 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 rather than US subcontractors in order to obtain access to financing requested by the Turkish Government to buy Patriot missiles in 1990.

<sup>33</sup> Farnsworth, C. H., ‘\$1 billion annual export loss seen’, *New York Times*, 21 Apr. 1989; Lachica, E., ‘Ex-Im Bank says US exports are hurt by other countries’ ‘tied’ aid credits’, *Wall Street Journal*, 9 May 1989; and ‘Export finance war’, editorial, *Journal of Commerce*, 15 Sep. 1989.

<sup>34</sup> Dunne, N., ‘Military sale to Turkey changes Eximbank policy’, *Financial Times*, 23 Aug. 1990. Manufacturers in this transaction included Bell Helicopter Textron, United Technologies, MBB Helicopter Corp. and Agusta Aerospace. ‘Eximbank supports military sales to Turkey’, *Exim News*, 1 Oct. 1990.

<sup>35</sup> Cloud, D. S., ‘Members question proposal to boost weapons sales’, *Congressional Quarterly*, 23 Mar. 1991; Burgess, J., ‘Arms export loan plan draws fire in Congress’, *Washington Post*, 3 May 1991; and ‘Bush plan to apply Eximbank program to arms exports attracts criticism’, *Inside the Pentagon*, 18 Apr. 1991.

undermine the political support needed to sustain the Export–Import Bank when it came up for reauthorization.

A third exception was instituted in 1994, when Congress gave authority for the bank to provide financing for the export of non-lethal military articles and military services the primary end-use of which would be civilian purposes. The law also modified Export–Import Bank policy to allow non-lethal dual-use items intended primarily for civilian purposes to be used partly for military purposes as well.<sup>36</sup> This was largely to permit the bank to support US companies which were competing in the rapidly expanding international market for air traffic control and radar systems. The total amount the bank could provide for these transactions was capped at 10 per cent of the bank’s annual subsidy appropriation. The measure gained the support of congressmen normally opposed to government financing for arms sales as a way for industry to use military technology in commercial applications.<sup>37</sup>

The anti-narcotics and dual-use exceptions made to the Export–Import Bank’s military financing policy had a relatively minor impact on overall US defence-related exports. If the large package of credits to Turkey in 1990 is excluded, Export–Import Bank financing supported just over \$1 billion in exports having potential military implications. This is less than 1 per cent of total US arms-related exports over the 10 years 1992–2001.

## V. Financing US military exports

It is instructive to examine the defence-related export financing programmes of the USA, the world’s largest arms exporter, in greater detail. Their structure has an impact on global arms transfers and on the competitive position of US arms manufacturers even where the government does not provide direct financing. The amount of financing which the US Government provides is fairly large compared to that provided by other major arms-exporting countries.<sup>38</sup> However, these funds are concentrated on relatively few countries. Little or no US Government financing is available either through the DOD’s FMS programmes or elsewhere to facilitate sales to most of the countries that would meet the terms and conditions of the US Government’s export licensing regime.

Buyers finance the majority of weapon purchases from US manufacturers. Between 1992 and 2001, approximately 72 per cent of total US arms exports (\$104 billion) was paid for on a ‘cash’ basis, that is, the buyer financed the sale. Even so, over this period, total US Government-supplied financing for arms sales was significant, totalling over \$41 billion (see table 13E.1).

### Department of Defense Foreign Military Financing

The principal source of US Government financing for weapon purchases is through the Foreign Military Financing (FMF) programme administered by the DOD.<sup>39</sup> Until

<sup>36</sup> Public Law 103-428, 31 Oct. 1994.

<sup>37</sup> ‘House unanimously passes export–import bill allowing dual-use exports’, *Inside the Air Force*, 19 Aug. 1994.

<sup>38</sup> Busvine (note 4).

<sup>39</sup> Funding for the Military Assistance Program (MAP) was consolidated under the Foreign Military Financing programme beginning in FY 1990. The MAP consisted of the portion of the DOD’s security

the 1990s, a significant share of this export financing consisted of loans issued by the US Federal Financing Bank (FFB) and backed by guarantees from the DOD. These funds were then transferred to country accounts to pay for weapon sales, offering repayment terms that were much more advantageous than commercial terms. This was possible because the FFB could borrow funds at approximately the same rate as that obtained by the US Treasury.<sup>40</sup> However, this mechanism ran into trouble when some of the largest users experienced a payments crisis in the 1980s. Credits to Egypt, Israel, Turkey and several other countries were eventually converted to grants in order to avoid the negative impact on their credit ratings if they defaulted.

During the 1990s the greater part of US military financing took the form of grants, with no repayment obligation. Between 1992 and 2001, the USA provided \$34.6 billion in grants to purchase US military goods or services. A total of 97 countries received grants; however, just two—Egypt and Israel—received over 93 per cent of these funds (see table 13E.2). Other major grant recipients included Jordan, Poland, Portugal and Turkey. The majority of countries received very limited funds: 68 received less than \$10 million each, and of these 40 received \$2 million or less. With the exception of approximately \$500 million a year in flows to Israel, these grants are tied to the purchase of US military goods and services.

Since the early 1990s, direct loans have accounted for a declining share of the military financing programme. Between 1992 and 2001, loans totalled \$3.5 billion, or less than 9 per cent of export financing supplied by DOD. Direct loans peaked in fiscal year (FY) 1993 at \$855 million and tapered off to \$100 million in 1998. After 1998 no new loans were authorized until the loan authorization for Poland.

The shift from loans to grants also coincided with a more general effort to tighten federal accounting rules and provide a more accurate measure of the true subsidy cost of government credit. The Federal Credit Reform Act of 1990 required the DOD, like other federal agencies, to set aside funds for each loan as security against default. The size of the 'default subsidy' varies by country and depends on its 'score' assessed through the confidential Interagency Country Risk Assessment System (ICRAS). The new credit system, coupled with the legacy of payment problems in the 1980s, reduced much of the former attractiveness of issuing loan guarantees.

### Foreign Military Sales

Sales under the FMS programme make up approximately 85 per cent of total US military exports. They are distinguished by the direct role the DOD plays as a procurement agent between the buyers and sellers.<sup>41</sup> A portion of FMS sales is financed by the US Government. Over the past decade, this was approximately 28 per cent of FMS sales. Transactions which do not receive financing are referred to as 'cash' sales. These are transactions where the buyer agrees to finance an FMS transaction from national funds, either through a dependable undertaking for sales from procurement or by cash payment prior to delivery for sales from DOD inventories. The purchasing government pays all costs that may be associated with the sale. US law pre-

assistance programme authorized by the Foreign Assistance Act of 1961 to pay for weapons and services on a non-reimbursable (grant) basis.

<sup>40</sup> Johnson, J. L., 'Financing the arms trade', *Annals of the American Academy of Political and Social Science*, vol. 535 (Sep. 1994), pp. 118–19.

<sup>41</sup> A detailed description of the FMS system can be found in Defense Institute of Security Assistance Management, *The Management of Security Assistance*, 18th edn (Wright-Patterson Air Force Base: Dayton, Ohio, June 1998).

vents 'cash-financed' government-to-government sales from imposing any cost on the US taxpayer. Buyers are therefore assessed a fee which is intended to cover the estimated administrative costs of managing these contracts.

Both buyers and manufacturers selling the equipment derive important benefits from the system even when the US Government does not supply financing. First, buyers receive the same prices as those paid by the DOD and therefore benefit directly from the significant economies of scale and bargaining leverage that the Pentagon enjoys as the largest buyer of military goods and services produced in the USA. Second, buyers benefit from the Pentagon's experience in managing defence contracts, which can range widely 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 US Government is generally in a better position than a manufacturer to enforce contracts with overseas buyers if payment problems arise. This helps to reduce risk and therefore the cost of these transactions. As a result, the FMS system provides a source of competitive advantage for US arms manufacturers in international arms sales. By serving as a market intermediary the US Government plays a significant role in managing price risk for buyers and payment risk for sellers. At the same time, buyers have complained about the high cost of the administration fees. In response to these criticisms and a more general effort aimed at reforming the programme, the DSCA reduced the administration fee to 2.5 per cent in 1999.<sup>42</sup>

The FMS system is most advantageous to buyers from OECD countries which face less difficulty in self-financing purchases from the USA. However, it can also be attractive for countries that have other means of financing purchases. Alternative undertakings most commonly take the form of loans on oil export revenues; however, they can be tied to other resource exports that earn hard currency. Chile's decision in 2002 to purchase 10 Lockheed Martin F-16 combat aircraft worth approximately \$660 million is a recent example. The sale was supported by an off-budget allocation from Chile's state-owned enterprise, CODELCO (Corporación Nacional del Cobre), the world's largest copper producer.<sup>43</sup> This secure undertaking made it possible for Chile to enter into an FMS agreement to buy the F-16s.

<sup>42</sup> In 1977–99 the FMS administrative surcharge was set at 3%. In 1999 the DSCA received congressional approval to reduce the fee to 2.5%. The fee reduction was 1 element in a broader effort launched in 1998 by the Deputy Secretary of Defense to streamline the FMS programme and respond to complaints from customers that the programme was too expensive. Although this fee reduction was approved, concerns were raised that the DOD lacked adequate cost information to manage the FMS programme and ensure full cost recovery. An evaluation by the Government Accounting Office found that there was not sufficient analysis of either the need for or the impact of the reduction. US General Accounting Office, 'Defense trade: decision to lower FMS administrative fee is premature', Letter to the Hon. William S. Cohen, Secretary of Defense, 13 May 1999; and US Government Accounting Office (GAO), *Foreign Military Sales: Efforts to Improve Administration Hampered by Insufficient Information*, GAO/NSIAD-00-37 (US Government Printing Office: Washington, DC, Nov. 1999).

<sup>43</sup> 'Copper-bottomed: Chile's strange way of paying for defence', *The Economist*, 9 Feb. 2002; and 'Lagos approves F-16 purchase, but frigates will wait', *Santiago Times*, 31 Jan. 2002. By law, 10% of CODELCO's exports revenues are deposited in a special account which the armed forces use to purchase new weapon systems. For information on CODELCO see Rojas Aravena, F., 'Chile', ed. R. P. Singh, SIPRI, *Arms Procurement Decision Making, Volume II: Chile, Greece, Malaysia, Poland, South Africa and Taiwan* (Oxford University Press: Oxford, 2000).

## Commercial programmes

Buyers of weapon systems may choose to buy them directly from US manufacturers. These transactions, known as Direct Commercial Sales (DCS), accounted for approximately 14 per cent of military exports (\$20.4 billion) over the past decade, 1992–2001.<sup>44</sup> The largest users of DCS over that period were Japan, South Korea, Taiwan, Turkey and the UK. These exports are still subject to US military licensing procedures, but the sales are not administered by the DOD and do not involve a government-to-government procurement agreement. Instead, they involve financing arrangements worked out privately between the buying country, the defence contractor and commercial banks. Buyers sometimes prefer DCS sales because they can be more flexible, quicker and cheaper to transact than FMS sales. They also permit different weapon configurations from those that can be obtained through FMS purchases.

Other aspects of the DCS approach to purchasing US-made weapon systems are less attractive. Payment schedules are generally more ‘front-loaded’ than under FMS. There may also be additional costs associated with the risks of commercial sales. Buyers may require manufacturers to post performance bonds to guarantee contract compliance. This was, for example, one of the conditions the United Arab Emirates imposed when it placed a commercial order for 80 F-16s in 2000.<sup>45</sup> Performance bonds can help to ensure contract compliance for buyers but are disliked by exporters because they create a contingent liability, which can place a strain on a company’s balance sheet and impinge on its bank credit capacity.

## The Defense Export Loan Guarantee Program

The inability to expand the Export–Import Bank’s programmes significantly in the early 1990s caused a push for an alternative government military export financing. As mentioned above, this led to a proposal to establish a programme within the DOD that would mirror financing programmes offered to civilian exporters. The effort took several years but eventually led Congress to authorize the DOD to establish the DELG programme in 1995. Supporters argued that this legislation was necessary to put US defence contractors on a level playing field with foreign competitors, protect jobs and protect the US military industrial base.<sup>46</sup> The legislation authorized the DOD to issue guarantees against possible losses of principal and interest for loans provided by private banks, with a contingent liability not to exceed \$15 billion. A total of 39 countries were eligible for guarantees, including NATO members, major non-

<sup>44</sup> Statistics on these sales are less readily available than statistics on FMS sales. The destinations of one-third of these sales over the past decade, amounting to \$7.1 billion, are classified information. Once an exporter receives a commercial licence authorization to sell (which is valid for 4 years) there is no requirement that the exporter provide the US Government with comprehensive details regarding any sales contract that results from the licence, including any reduction in scope or cancellation of such a contract. Grimmett, R. F., *Conventional Arms Transfers to Developing Nations, 1993–2000*, CRS Report to Congress (Library of Congress, Congressional Research Service: Washington, DC, 16 Aug. 2001), p. 15.

<sup>45</sup> See Whittle (note 13).

<sup>46</sup> Department of Defense Appropriations Act, 1996, *Congressional Record–Senate*, 104th Congress 1st Session, 141 Cong. Rec. S 11227, vol. 141 no. 128, 3 Aug. 1995 (legislative day of Monday, 10 July 1995).

NATO allies, non-communist Asia-Pacific Economic Cooperation (APEC) countries,<sup>47</sup> and Central European countries.

However, the programme was not passed before opponents inserted a provision which rendered it ineffective. The ‘poison pill’ was an amendment offered by Senator Dale Bumpers which prohibited the financing of exposure fees that reflected the risk of default as part of the DELG programme.<sup>48</sup> This condition, coupled with user fees set at levels expected to cover the estimated programme costs, made the programme more expensive than competing alternatives for potential users. Greece, South Korea, New Zealand, Spain, Thailand and Turkey made enquiries but ultimately decided against using the DELG.<sup>49</sup>

The DELG programme 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 per cent, requiring an up-front fee of \$3.5 million. Depending on the country’s risk rating, this could require a fee of up to 15–22 per cent of the total contract price. Given the high cost of the programme and the inability to ‘wrap’ the exposure fees into the loan, it has not been used since. For this reason, the DELG has not been an effective vehicle for supporting US military exports.

‘Fixing’ the DELG is a priority of US defence companies. They have sought among other things to remove the prohibition against including the exposure fee in the loan.<sup>50</sup>

The net result is that US Government export programmes favour US manufacturers in countries which have strong credit ratings or can self-finance weapon sales, but tend to hurt their competitive position in countries with poor credit ratings and limited or unstable military budgets—unless the US Government steps in with a special financing package, as it did in Poland in 2002.

## VI. International trade finance disciplines

In contrast to civilian goods, international agreements provide few checks on the subsidization of military exports. The OECD Arrangement on Guidelines for Officially Supported Export Credits is the principal regime designed to control export credit competition.<sup>51</sup> The purpose of the arrangement is to provide a framework for an orderly export credit market and thus to prevent an export credit competition in which exporting countries would compete on the basis of officially supported financing terms instead of on the basis of the highest quality and the best service for the lowest price. The OECD Arrangement sets basic credit terms as well as notification procedures. Members are required to give details on each transaction for which they are

<sup>47</sup> For the membership of APEC see the glossary in this volume.

<sup>48</sup> The amendment 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’. Debate on amendment no. 2397, Department of Defense Appropriations Act, 1996 (note 46).

<sup>49</sup> US Government Accounting Office (GAO), *Defense Trade: Status of the Defense Export Loan Guarantee Program*, GAO/NSIAD-99-30 (US Government Printing Office: Washington, DC, Dec. 1998), pp. 5–7.

<sup>50</sup> Aerospace Industries Association, ‘Improve Defense Export Loan Guarantee program’, Unpublished position statement, Washington, DC, 14 Nov. 2000.

<sup>51</sup> OECD (note 7).



supplying official support. These procedures are designed to enhance transparency and facilitate peer group enforcement.<sup>52</sup>

Military equipment has been excluded from the OECD Arrangement since it was formally established in 1978.<sup>53</sup> Civilian aircraft, nuclear power plants and ships were also excluded from the original agreement; however, they were eventually subject to disciplines through special sector agreements negotiated by participants in the OECD Arrangement. The exclusion of military items has meant that domestic measures, where they exist, remain the only constraint against competitive subsidization.<sup>54</sup>

Proposals to bring the military sector under the terms of the arrangement have failed for lack of support. In 1993 Sweden voiced its concern that a number of countries were subsidizing military exports through favourable credit terms, subsidized prices and tied aid.<sup>55</sup> To address this problem, Sweden proposed that participants begin work on broadening the arrangement by establishing a working sector understanding on military equipment.<sup>56</sup> As part of such an agreement, Sweden proposed that members establish a ban on governmental support other than pure cover (guarantees or insurance without loans) and the use of market rates. It also suggested banning tied aid credits and developing guidelines on repayment terms such as existed in other sector agreements. With the exception of derogations (officially notified departures from the terms of the OECD Arrangement), this would ban any concessionary financing or aid for military sales tied to the purchase of equipment or services among participants in the arrangement.

Sweden's proposal made little headway among the participants and was subsequently dropped. The USA opposed the proposal on several grounds. First, it argued that the proposal raised security issues which it did not think the OECD, as an economic forum, could properly address. Second, it argued that military assistance was—at least for the USA—a matter of national security policy. Third, it pointed out that no international disciplines exist on production and research and development (R&D) subsidies for military goods. The USA 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 pos-

<sup>52</sup> The arrangement provides that any participant may question any other participant about whether or not the terms and conditions it has offered or plans to offer for a specific transaction are in accordance with the rules. Members can also request 'common lines' designed to set the conditions and terms of support to a specified project. Common lines may provide for harder or for softer terms than those in the arrangement's guidelines. Ray, J. E., *Managing Official Export Credits: The Quest for a Global Regime* (Institute for International Economics: Washington, DC, July 1995), pp. 40–42.

<sup>53</sup> OECD (note 7), p. 6.

<sup>54</sup> Governments are generally reluctant to impose unilateral constraints, fearing that this will place them at a competitive disadvantage with countries that do not impose similar measures. Evans, P. C. and Oye, K. A., 'Conflict and cooperation in export financing', eds G. Hufbauer and R. Rodriguez, *US Ex-Im Bank in the 21st Century: A New Approach?* (Institute for International Economics: Washington, DC, 2001), pp. 113–58.

<sup>55</sup> Sweden's proposal appears to have been motivated by neighbouring Finland's decision in May 1992 to purchase F/A-18 Hornet fighter aircraft from McDonnell Douglas rather than the new JAS-39 Gripen. The loss of this order, for 64 aircraft and valued at \$2–3 billion, was a significant setback for the Swedish military and Sweden's Saab-Scania AB, which had been counting heavily on this contract to supplement domestic orders. Sweden's sudden interest in controlling military export financing competition appears to have arisen from an assessment of the challenges it faced in marketing the JAS-39 Gripen internationally, including export credit subsidies from rivals. This was also 2 years before Saab announced its alliance with British Aerospace (BAe) to market and support export versions of the JAS-39 Gripens.

<sup>56</sup> Private communications from officials of the Department of Export Promotion and International Markets, Ministry of Foreign Affairs, Sweden, 11 Oct. 2001.

sible subsidy problem. Finally, the USA pointed out that major producers of military equipment outside the OECD would not be covered by an agreement.<sup>57</sup>

Other countries have also expressed their view that a sector understanding may be unworkable, at least in the context of the OECD Arrangement. In addition to China and Russia not being parties to the arrangement, France has pointed out that the US Treasury and the Export-Import Bank represent US interests in export credit negotiations. The US DOD is not represented and therefore, according to French officials, may not feel bound by any measures adopted by that group.<sup>58</sup>

### **Limitations of the Creditor Reporting System**

Leaving military transfers outside the OECD trade finance disciplines means that military transactions are not recorded in official statistics. This has important consequences. In the case of civilian capital goods, OECD countries have used financial information on transactions to analyse and enforce existing trade finance disciplines. Any participant of the OECD Export Credit Arrangement contemplating official credits to an eligible country must notify the terms to all participants. This provides a mechanism for other governments to determine whether the credits are in compliance with existing rules and to challenge any that are not. The information that surfaces through notification enhances transparency and the ability to verify and ultimately enforce trade finance disciplines. The reluctance of governments to report the financial terms of military transactions means that the preliminary requirement for establishing viable controls on military export credit subsidization is currently lacking.

The principal data collection mechanism for export credits, guarantees, grants and other official financing is the Creditor Reporting System (CRS), which has been operated jointly by the OECD and the World Bank since 1967. One function of the CRS is to collect, analyse and report data on grants and concessional loans (guaranteed or not) to developing countries. This information is made public on an annual basis and through special reports prepared by the OECD's Development Assistance Committee (DAC).<sup>59</sup> However, governments are under no obligation to include information on financial commitments or flows associated with military equipment, nor are they required to report on training of military personnel, even when this involves non-military matters such as civil engineering, surveying or human rights law. Thus the information collected and reported as overseas development assistance (ODA) or other official flows (OOF) does not include military tied aid or other arms-related financial flows. 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 OOF.<sup>60</sup> Military grants are generally also excluded from IMF reporting on balance-of-payments transactions.

<sup>57</sup> US Department of the Treasury, Office of International Trade Finance, 'Swedish proposal on export credit support for military sales', 28 June 1993.

<sup>58</sup> Private communications from officials at the French Ministry of Economy and Finance, Economic and Trade Department, Paris, 7 Mar. 2002.

<sup>59</sup> Most of this information is available on the Internet site of the OECD Development Assistance Committee at URL <<http://www.oecd.org/EN/statistics/0,,EN-statistics-notheme-2-no-no--no,00.html>>.

<sup>60</sup> Organisation for Economic Co-operation and Development (OECD), Development Assistance Committee (DAC), Development Co-operation Directorate (DCD), 'DAC statistical reporting directives', DCD/DAC(2000)10, OECD, Paris, 23 May 2000, p. 71.

Another function of the CRS is to collect and report data on export credits and other non-ODA official support. OECD members are required to submit financial information on two types of official credit. One is loans and credits (including lines of credit, revolving credits and leasing arrangements) of more than one-year maturity extended by exporters or financial institutions to foreign borrowers and guaranteed or insured by an official agency. The other is lines of credit for military transactions of over one year maturity extended directly by national official export credit financing institutions to foreign borrowers.<sup>61</sup> Data reported in the CRS on officially supported export credits are classified as confidential and are made public only in a highly aggregated form.

The only official statistics where the financing of military equipment does appear are the external debt statistics published jointly by the OECD, the Bank for International Settlements (BIS), the IMF and the World Bank.<sup>62</sup> CRS data are combined with data on bank claims collected by the BIS to derive total bank and trade-related non-bank external debt owed by borrowing countries. These data are published twice a year. However, 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. Anecdotal information suggests that military equipment can represent a significant share of a country's debt burden.<sup>63</sup>

As a result of the limitation on military aid and export credit transactions, studies that have tried to examine military-related financial flows have had to rely on statistical guesswork and, as one researcher expressed it, a resort to 'heroic' assumptions.<sup>64</sup>

### **Constraints on credits to the world's poorest countries**

One area where OECD countries have announced steps to potentially restrict arms-related financing is to the world's very poorest countries. In 1998 the UK urged other countries to follow its lead and provide export credits only for 'productive' purposes. This followed a unilateral announcement that the UK would only provide export credits to the world's 42 heavily indebted poor countries (HIPC) if they supported productive expenditure.<sup>65</sup> The UK made this policy permanent in January 2000, while extending it to the 63 'IDA only' countries, which make up the group of countries eligible for concessional lending from the World Bank's International Development Agency (IDA). The issue was also taken up in the context of Group of Seven (G7) meetings, largely at the UK's request. At the 2000 G7 summit meeting in Okinawa, Japan, finance ministers called on the OECD to 'review through its export credit

<sup>61</sup> These are known as Form 3A reports under the CRS.

<sup>62</sup> 'Joint BIS-IMF-OECD-World Bank statistics on external debt', URL <<http://www1.oecd.org/dac/debt/>>.

<sup>63</sup> In the aftermath of the Asian financial crisis of 1997-98, the UK agreed to reschedule £260 million (\$4.2 million) of Indonesian debt guaranteed by the ECGD. Over £100 million of this amount was associated with Indonesia's purchase of Hawk aircraft. 'Britain: addicted to the arms trade', *The Economist*, 18-24 Sep. 1999.

<sup>64</sup> For one of the attempts to estimate military-related financing for developing countries see Brzoska, M., 'The financing factor in military trade', *Defense and Peace Economics*, vol. 5 (1994), p. 79.

<sup>65</sup> Brown, G. (Rt Hon., MP), 'Debt 2000: the Mauritius mandate', Statement to Commonwealth Finance Ministers meeting, 16 Sep. 1997, available at URL <[http://www.hm-treasury.gov.uk/newsroom\\_and\\_speeches/](http://www.hm-treasury.gov.uk/newsroom_and_speeches/)>; and British Treasury, Press Office, 'UK bans export credits for unproductive expenditure to 63 countries', Press release, 11 Jan. 2000, available at URL <[http://www.hm-treasury.gov.uk/newsroom\\_and\\_speeches/](http://www.hm-treasury.gov.uk/newsroom_and_speeches/)>.

group strengthened measures toward ensuring that export credit support to HIPCs and other low income developing countries is not used for unproductive purposes'.<sup>66</sup> The effort to restrict the provision of export credits to productive expenditures was widely reported in the press as an effort to stop poor countries from using export credits to buy weapons.<sup>67</sup>

Participants in the OECD export credit arrangement began discussions on the British 'productive expenditure' proposal in 1998. As a first step, participating governments agreed to share information on their official support to HIPCs on a voluntary and *ex-post factum* basis. Some countries argued that principles to guide the provision of credits to HIPCs were unnecessary since the concept of productive expenditure was already implicitly taken into account in existing credit appraisal procedures. These and other reservations led to important modifications to the final statement of principles that was issued by the OECD in July 2001.<sup>68</sup> Some countries argued that the statement of principles on official export credits support should be recast in the negative, that is, in terms of discouraging unproductive expenditures rather than encouraging productive expenditure.

The other major objection concerned military goods. Some countries insisted that the principles make it clear that there was no intention *a priori* to exclude support for defence-related items. As a result, the final text was amended to read: 'It is understood that the adoption of these Principles does not automatically preclude support for equipment deemed essential to the debtor country's national security or required to combat e.g. the drug trade, smuggling, piracy'.<sup>69</sup>

The productive expenditure criteria are likely to have only a very modest effect on arms transfers to developing countries. HIPCs represent a small fraction of total medium- and long-term official export credit activity, currently averaging less than 1 per cent of approximately \$70 billion in medium- and long-term export credits associated with developing country trade each year.<sup>70</sup> Moreover, because of their high debt levels, most are 'off cover', that is, ineligible to receive export credit support. Compared to other developing countries, HIPCs are insignificant buyers of military equipment.

The narrow application of the principles to HIPCs has been criticized. In 2000, South Africa signed contracts for combat aircraft in a deal worth \$1.16 billion backed with export credits from Sweden and the UK. Given South Africa's high debt levels, mounting health care costs associated with the AIDS epidemic, and lack of regional security threats, critics have questioned whether this sale could be considered productive expenditure. However, because South Africa is not an HIPC country, neither the British nor the OECD's principles applied. To have a significant impact on the

<sup>66</sup> 'Poverty reduction and economic development, Report from G7 Finance Ministers to the heads of state and government', Okinawa, 21 July 2000, section C14, available at URL <<http://www.mof.go.jp/english/if/if024.htm>>.

<sup>67</sup> 'G7 calls for arms credits clampdown', *Financial Times*, 2 Aug. 2000.

<sup>68</sup> Organisation for Economic Co-operation and Development (OECD), 'OECD export credit group discourages official support for unproductive expenditures in heavily indebted poor countries: a statement of principles', News release, Paris, 19 July 2001, available at URL <<http://www1.oecd.org/media/release/nw01-69a.htm>>.

<sup>69</sup> Organisation for Economic Co-operation and Development, Trade Directorate, 'Unproductive expenditures and officially supported export credits: statement of principles', Paris, 18 Apr. 2001, available at URL <<http://www.oecd.org/EN/document/0,,EN-document-356-10-no-27-22749-356,00.html>>.

<sup>70</sup> Organisation for Economic Co-operation and Development, Trade Directorate, 'Productive expenditure 2000: review of the voluntary exchange of information on official export credit support in highly indebted poor countries, and next steps', TD/ECG(2000)13, Paris, 30 Mar. 2001.

arms trade, some argue that the productive expenditures criteria would need to be applied to all developing countries.<sup>71</sup>

## VII. Conclusions

The lack of public information regarding the provision of military aid and trade credits presents significant analytical challenges. At present it is not possible to construct a comprehensive picture of their role in international arms transfers. There is insufficient transparency regarding financing terms and conditions at the level of individual contracts or even at a more aggregated level of countries or regions. As a result it is not possible to determine the level of debt associated with arms purchases, which in the case of developing countries may be substantial. It is also not possible to accurately calculate the level of subsidies and thereby the cost borne by taxpayers in the majority of arms supplier states. It is difficult to determine to what degree, if any, the provision of export credits may be crowding out civilian exports through competition for loans and guarantees. The lack of transparency also has consequences for any international effort to control export credit competition.

The willingness of governments to share information on credit terms in advance has been an essential element in the success of the OECD Arrangement on Guidelines for Officially Supported Export Credits and its ability to control export credit competition in civilian aircraft and other capital goods. Similar information exchanges would be needed in any international effort to control military export subsidies. The 1998 decision among OECD countries to share information on military transactions with HIPC countries is a positive step. However, it remains extremely limited and would have to be significantly expanded to have any impact on international arms transfers.

Other factors compound the challenges of managing arms-related export credit competition. Security considerations create incentives for states to retain maximum flexibility with regard to external military policy and to avoid any constraints on the ways in which they pursue these security goals, including the subsidization of arms exports. This was the principal reason the USA gave for its rejection of Sweden's proposal to extend export credit disciplines to the military sphere. The problem, of course, is that an arms supplier state's motivation for offering financing is rarely purely a security matter but is usually mixed with economic and political considerations.

Another difficulty in establishing international disciplines arises from the structural differences between major supplier states. With a few important exceptions, the USA does not offer competitive export credit financing to its arms manufacturers. However, the DOD confers important competitive advantages on US suppliers through the FMS programme by managing market risk. Countries competing against US manufacturers recognize this and have designed their export financing programmes to counter this advantage. Indeed, countries competing against the USA are unlikely to agree to place constraints on ECA financing as long as the DOD indirectly subsidizes US arms exports through the position it has taken on as a market intermediary between buyers and US manufacturers.

<sup>71</sup> Greenhill, R., 'Recommendations for the Export Credit Guarantee Department (ECGD) on debt and export credits', Paper for UK NGO Seminar on Export Credit Agency Reform, House of Commons, 23 May 2002, available at URL <<http://www.jubileepius.org/analysis/articles/debt290502.htm>>. This also explains why the criteria were not an issue with regard to the 1998 European Union Code of Conduct on Arms Exports. The Code is available at URL <<http://projects.sipri.se/expcon/eucode.htm>>.

Finally, there is the jurisdictional problem associated with the OECD Arrangement as a forum for establishing rules for military credits. The membership of the arrangement covers the world's capital goods-exporting countries reasonably well.<sup>72</sup> The same cannot be said for arms exporters. Not only are important countries not members of the OECD, but key institutions among the participants are not represented. The arrangement is a grouping represented by export credit agencies, treasuries and trade ministries. Greater input from defence ministries would be required if the arrangement were chosen as a forum to renew efforts to control military-related export credit competition. At the very least, a strong mandate from the heads of state of the major arms-exporting countries will be required in order to put this issue on the international negotiating agenda.

The challenges associated with extending international trade finance disciplines to the military sector are formidable. The competition witnessed in Poland is notable for the size of the contract but should be considered illustrative of a broader phenomenon. Easy credit for buyers induced by the competition between suppliers is the norm rather than the exception in the international arms market. US DOD officials have claimed that: 'For the time being we do not intend to grant government loans to any country except Poland'.<sup>73</sup> However, the USA reserves this right and has demonstrated its willingness to offer grants, loans and/or guarantees when financing is an obstacle to winning what it considers on security, economic or political grounds to be critical international sales.

<sup>72</sup> For the list of members see note 8.

<sup>73</sup> 'US defense official views bid for contract to supply planes to Poland: Interview with General Tome Walters, Director of the US Defense Security Cooperation Agency', *Rzeczpospolita* (Warsaw, Internet edn), in Foreign Broadcast Information Service (FBIS), *Daily Report-East Europe (FBIS-EEU)*, FBIS-EEU-2002-1115, 5 Nov. 2002.