New OECD Tied Aid Agreement Expected to Benefit U.S. Exporters Says Deputy Assistant Secretary for Trade and Investment Policy William E. Barreda

On February 15, 1992, a new agreement on tied aid credits was implemented within the Organization for Economic Cooperation and Development (OECD).

"The new rules are an innovative attempt to reduce trade distortions that arise when aid financing crowds out commercial financing in certain types of development projects," said Treasury Deputy Assistant Secretary for Trade and Investment Policy William E. Barreda in an exclusive interview. The new agreement encourages competition based on price, quality, and service rather than financing subsidies.

"The problem we had in the past is that it was possible to use an aid program as an export promotion device," said the Deputy Assistant Secretary, who has negotiating the new agreement over the past 2 1/2 years. "Export subsidies are generally prohibited, except in agriculture, but aid is widely applauded," he said. "But if you gave aid to certain countries for one third of a plant and required that they buy the remaining two thirds from you commercially, prior to this agreement, you were within accepted trade rules."

The new agreement prohibits tied aid funds, except those funds having at least an 80 percent subsidy, from competing with private financing and official export credits for projects that can pay their own way. The market should be financing these kinds of projects, unless the donor is prepared to virtually give away the equipment," he said. Other's use of aid funds to "sweeten" commercial deals has hurt U.S. exporters and distorted trade. "What we've tried to do is draw the line between the types of projects that can be financed by tied aid and those that should get commercial financing," he continued. "A very good example of a purely aid project is a road. A road usually doesn't pay for itself, but it's good for the country as a whole. But an electrical power plant in an urban center can pay for itself--users can, and should pay the cost. That project should be left for the market. Market competition should determine which firm wins the contract.

"Another key discipline is to draw a line as to which countries are eligible for tied aid in the first place," the Deputy Assistant Secretary said. Countries with higher per capita income, including Mexico, Brazil, and Venezuela, are able to attract and afford sufficient private capital flows and are ineligible for tied aid credits under the new rules. Negotiations on the transition mechanism for these countries were underway at press time. The new agreement also sets up a dispute settlement mechanism.

"We hope by the application of these new rules, private capital flows will be maximized in the promotion of development and aid money will go to the best use. We expect that financially viable projects will be bid and awarded efficiently without financing subsidies," he said. "Our goal is that aid will no longer substitute for private capital and distort trade."

NEW TIED AID RULES

For projects below a minimum concessionality level of 80 percent and credit above SDR 2 million the new rules would:

•Ban tied aid to countries whose annual per capita income would make them ineligible for 17 or 20 year loans from the World Bank (per capita income $2,465 or above) with automatic graduation after 2 years above the line.

•Attempt to draw a line between projects that can support financing on commercial terms and those that legitimately require aid funds that may be tied for those below $2,465 per capita income, but excluding the poorest countries (LLDCs). Financial viability at appropriate market-based prices and availability of market-related financing are tests;

•Provide special consultation procedures for large projects (over SDR 50 million) with special weight to the availability of financing on commercial terms, for all countries where tied aid is not prohibited (including LLDCs).

•Require 30 days prior notification to OECD export credit management participants for all tied, partially untied, and untied aid or concessional credits.

(Existing minimum concessionality levels required for all tied and partially untied concessional and aid credits.)

Dispute resolved within a comprehensive prior notification and consultation procedure that would:

•Allow a participant to challenge a notification as not meeting the new rules. In cases where commercial viability is at issue, require the aid agency to show that the project would not be viable even if market prices were applied;

•Require substantial support from other OECD members (the EC has one vote) validate the new view that project is not commercially viable and appropriate for tied aid;

•Require for any subsequent derogation public explanation (on non-trade grounds absent such substantial support. Derogations expected to be unusual and infrequent at subject of a special annual report to OECD Ministers.

Subsidies reduced in standard export credits by:

•Eliminating of eligibility of intermediate countries for arrangement average interest (matrix) rates;

•Increasing the matrix interest rate for the relatively poorest countries by 30 basis points;

•Setting the maximum 120 days hold on interest rate offers at a cost of 20 bp.

Work program will:

•Examine matrix with view toward elimination for relatively poor countries and examine the appropriate discount rate (ODR) for meeting the minimum concessionality rules by the end of 1993;

•Work with the Development Assistance Committee to develop targets for aid untied by the end of 1992;

•Attempt to develop a better definition for de facto untied and partially untied aid;

•Examine premiums and fees charged for official export credit insurance to minimize any subsidies that may exist.
Director of the Office for Trade Finance William L. McCamey
Explains New OECD Agreement to Congress

December 18, 1991, William L. McCamey, Director of the Office for Trade Finance, addressed the House Subcommittee on International Economic Policy and Trade and the Committee on Foreign Affairs on the new agreement reached by the Organization for Economic Cooperation and Development (OECD). The agreement will reduce both the scope of tied aid as well as subsidies in standard export credits. The 22 countries that participated in the Arrangement on Guidelines for Officially Supported Export Credits confirmed it December. The following was taken from Director McCamey’s statement.

The new OECD agreement is another important step in the direction of encouraging competition on the basis of price, quality, and service rather than financing subsidies.

This agreement is the culmination of more than 2 years of intensive negotiations initiated by the United States. These negotiations responded to Eximbank’s 1989 report to Congress on the tied aid practices of others, a similar Commerce department report last year, and concerns in the business community, Congress, and the Administration itself.

We began efforts to initiate negotiations in late 1989. A considerable portion of last year was devoted to gaining international agreement on the negotiating mandate and securing needed support at the political level, including that of both the OECD Ministerial and London Economic Summit.

Tied Aid Credit Problem

Tied aid is defined as concessional financing linked to procurement of goods and services in the donor country. Tied aid credits can stand alone or be mixed with commercial financing or standard official export credits. The latter are called mixed credits. The purpose of tied aid is to assist developing economies through softer financing terms while prompting or maintaining an adequate constituency in support of aid budget allocations in donor legislatures.

The trade distortion issue most often arises when tied aid is used in whole or part to finance capital projects. The availability of tied aid credits puts exporters from countries without equivalent access to such concessional financing at a distinct disadvantage in bidding on projects.

Once tied aid enters the picture, contract awards are often based not on the price or quality of the goods or service, but rather on the availability of subsidized financing. U.S. exporters utilizing commercial or Eximbank financing often cannot compete effectively with foreign firms that benefit from financing that includes tied aid credits. Eximbank estimated in its 1989 report to Congress that U.S. capital goods exporters lost annual sales of $400-800 million as the result of the tied aid practices of others.

The New Agreement

The agreement confirmed recently sets up rules and procedures to determine when tied and partially untied concessional and aid credits are likely to distort trade and should not be extended. It also reduces subsidies in standard export credits.

Tied Aid Rules

The tied aid credits that potentially distort trade are defined for purposes of the new tied aid rules as those with a concessionality level less than 80 percent. Projects below a de minimis level of SDR 2 million are similarly excluded from the new disciplines.

One basic restraint of the new agreement provides that relatively wealthier countries will no longer be eligible for any tied aid credits. The new rules use World Bank categories to define relatively wealthy countries as those having an annual per capita income in excess of $2,465 in 1990. Furthermore, as middle-income countries grow, the agreement includes a provision to graduate them from eligibility for tied aid credits.

This new agreement exempts the very poorest countries (LLDCs) from the new disciplines because of their urgent
need for concessional assistance, whether tied or untied. A
high minimum concessionality level (50 percent) is already
required when providing tied aid credits to them.

For countries in between the wealthier countries and
LLDCs, the key rule limits tied aid credits for projects that
should, with market-oriented pricing, be commercially viable
and, therefore, able to be financed on commercial terms.

Such projects will, under the new rule, not normally be
eligible for tied aid credits with a concessionality level below
80 percent unless financing—including official export
credits—is not available on market-related terms.

Limiting tied aid for commercially viable projects is an
attempt to replicate the efficient financing patterns of market
economics. Projects inherently productive enough to service
debt on market terms should be allocated capital on market
terms, thereby saving scarce concessional assistance for
projects that cannot attract and support such financing.

The availability of aid funds should not crowd out
commercial financing. With strict adherence, this strategy
should maximize the total flow of capital available for
development and allocate it more efficiently.

The concept that tied aid credits should not finance
inherently commercially viable projects was developed by
the OECD’s Development Assistance Committee (DAC).
Since tied aid credits affect both trade and aid policies, the
U.S. initiated parallel efforts in the Export Credit Arrange-
ment forum and the DAC.

A third new rule provides for consultations on large
projects. Tied aid offers for projects in excess of SDR 50
million will be subject to a special international consultation
process aimed at maximizing the use of official export credits
available on market-related terms.

Tied Aid Procedures

In addition to the new rules, the agreement institutes a
comprehensive reporting and consultation process to
increase the transparency of aid credit offers, and to interpret
and enforce the rules.

All offers of tied aid, partially untied aid subject to the
new rules, and untied aid, must be prior notified 30 working
days before the earliest date—the bid closing date, or
extending the financing offer. Any OECD Export Credit
Arrangement participant may then challenge a notification as
not meeting the new rules and/or not being effectively untied.

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replicate the efficient financing patterns of market economics.

This will initiate a consultation procedure that will involve
canvassing all Export Credit Arrangement participants as to
whether the project should be permitted tied aid credits. The
procedure can, at the discretion of the challenging par-
ticipant, include a face-to-face meeting. If there is not
"substantial support" for the use of tied aid, the country
wishing to offer the credit will be asked not to go forward.

If the country decides to extend the offer anyway, it must
notify the OECD Secretary General in writing as to the
non-trade related imperative that requires such action. Such
derogations from the rules are expected to be unusual and
infrequent, and will be the subject of an annual report to
OECD Ministers.

While some consultations may turn on political impera-
tive, we expect consultations to occur primarily where there
are differing views as to the commercial viability of an
individual project.

The consultation process will thus be utilized to
reconcile technical differences on borderline cases on a
project-by-project basis. In so doing, a body of case law is
expected to be developed that will guide aid agencies and
official export credit agencies in the future toward projects
that are suitable for their respective financing roles.

Standard Export Credits

The agreement also reduces remaining subsidies in
standard export credits. Lending to middle-income countries
(Category II countries in OECD Export Credit Arrangement
terms) will be restricted to market-related interest rates
(called commercial interest reference rates or CIRRs) rather
than the matrix rates established in the Arrangement. The
latter, which are based on an average of interest rates in
major countries, may be below market rates, particularly for
concurrency of high interest rate countries.

Matrix rates were earlier eliminated for wealthier (Cat I)
countries. The matrix rates that remain available for the
relatively poor countries (Cat III countries) will be increased (up to 30 basis points) to further reduce subsidies pending conclusion of a review to see whether market-related interest rates should be used for these countries also.

Future Work

The new agreement also includes a program for future work. As mentioned, the participants will be reviewing the arrangement matrix with a view toward its total elimination and placing sole reliance on market-related rates. The work program will entail development of a better definition of de facto untied aid. This should permit assessment of whether some untied aid should be subject to new rules as well.

Premiums and fees charged for official export credit insurance and guarantees will also be examined to eliminate any subsides that may exist.

However, a major focus of our efforts in the next year or two will be on implementation of the new agreement. As we did following the 1987 agreement, we plan to use available War Chest funds in a defensive manner to ensure effective implementation of the agreement.

Central and Eastern Europe

In parallel with the tied-aid-credit negotiations, we pursued a separate agreement to keep Central and Eastern European countries (CEEC) a tied aid-free zone.

That region emerged from communist control untainted by tied aid and with a large potential need for capital goods. In the absence of an agreement, economic and political pressure for tied aid inevitably would have built. Given the orientation of our own aid program, the introduction of tied aid credits would have put U.S. exporters at a severe disadvantage. At the instigation of the United States, Ministers at the June 1991 OECD meeting agreed to “try to avoid tied aid credits other than outright grants, food aid, and humanitarian aid into Central and Eastern Europe.”

The new aid agreement recognized the separate Ministerial agreement. The Ministerial agreement has been holding, and we believe it important to U.S. industry to maintain it. We addressed the special needs of two countries in the region, Yugoslavia and Albania, in the agreement. It was agreed that Yugoslavia would not be graduated from eligibility for tied aid credits. When reliable per capita income statistics become available, it will be reclassified. Similarly, Albania is so poor, it remains eligible for tied aid.

Conclusion

The new tied aid/export credit agreement, which builds on and complements past agreements to reduce trade distortions from tied aid and further squeeze financing subsidies from official export credits:

- Graduates wealthier countries from eligibility for tied aid.
- Institutes a standard for extending or not extending tied aid credits and procedures for resolving differences.
- Provides for scrutiny of untied aid credits.
- Eliminates matrix interest rates for standard export credits to middle income developing countries in favor of market-related rates and initiates a review aimed at eliminating matrix rates altogether.
- Reinforces the Ministerial agreement to refrain from spoiling the markets of Central and Eastern Europe with tied aid credits.

This provides a framework for making substantial progress on a complex issue made more difficult by virtue of divergent national views on the appropriate role of, and techniques for, extending aid. This is important in reconciling these views. It is our hope that over time, with experience, aid and export credit agencies will be able to distinguish, with increasing confidence and comfort, between the types of projects appropriate for aid financing and those that should be able to support commercial financing.

We believe this agreement will significantly reduce the disadvantage faced by U.S. exporters who have had to compete against foreign firms with access to concessional financing. It will not eliminate trade distorting aid practices. But it is our hope that it will permit U.S. business to compete more effectively by returning the emphasis of competition to price, quality, and service rather than financing subsidies.

The ultimate success of the agreement will depend on its implementation.

We will be working closely with Eximbank, AID, and other interested agencies to implement the agreement aggressively. In addition, we have been consulting closely with the business community during these negotiations and will continue to do so during implementation. Implementation, however, depends not only on the United States. We found during the negotiations a very considerable degree of acceptance that the new rules provide a sensible basis for allocating concessional resources that have become increasingly scarce. We expect to work closely with like-minded governments during the implementation process.