PAST ACHIEVEMENTS OF THE ARRANGEMENT AND FUTURE CHALLENGES

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The OECD Working Party on Export Credits and Credit Guarantees (ECG) was, in the early and mid-1970s, the unique forum for discussing and setting out the original rules limiting individual government supported export credits. The OECD Arrangement on Officially Supported Export Credits, established in 1978, focused on rules for levelling the playing field among OECD members in order to avoid trade distortions. From the mid-1980s to the 1990s, I participated in OECD meetings on behalf of JBIC (then the Export-Import Bank of Japan), working with other export credit agencies (ECAs) to establish the basic structure of the Arrangement framework – from the Wallén Package on interest rates to the Knaepen Package on risk premium.

The pricing system of the Arrangement

During the 1970s, just before the birth of the Arrangement, intensive competitions developed among exporting countries, *i.e.* the Member States of the European Union, the United States and Japan. Under the different national export credit systems, each country provided subsidies to support lower interest rates for financing its exports resulting in increased budget burdens. In the early 1980s, the world economy suffered from inflation caused by the second oil crisis and some OECD countries adopted high interest rate policies to restrain inflation. Moreover, one recalls that world politics were still dominated by the cold war between the Western and Eastern Blocs and the United States was confronted with a serious financial problem caused by the expansion of its military budget. Inevitably, this environment was reflected in the negotiations of provisions in the Arrangement for the pricing of official export credit support which focused on two elements, interest rates and risk premium fees.

Birth of the fixed interest rate regime

With regard to the current interest rate system, the first discussions focused on the fixed interest rate to be applied to financing supported by ECAs. The concept of setting a common interest rate among the competing ECAs originated from the Agreed Minutes on Export Credit Support signed by six countries in Washington in 1974. After establishing the Arrangement in 1978, discussion on a common fixed interest rate heated up. Some countries suggested higher interest rates for export credits in order to eliminate subsidy elements from official export credit support; subsidy meant lower interest rate assistance with taxpayers' money and the intention was to avoid allowing official financing support to exacerbate the serious budget deficits of governments. At that time, political compromise took precedence over consistency with market practice and as a result, an unusual situation developed: the interest rate applied to official support under the Arrangement exceeded that of the market in some countries, like Japan, where commercial credit was available at relatively low interest rates. Due to the politically-motivated high interest rates imposed by the Arrangement, in addition to the heavy burden of accumulating government debts in Eastern Europe and developing countries, the volume of export credits supported by JBIC in 1984 decreased to a level of 40% of the peak recorded in 1981.

Throughout 1986, there were some long and hard discussions on the minimum interest rate to be applied under the Arrangement. In the early stages, several methods were proposed, such as a uniform moving matrix system and a differentiated rate system. Another proposal was made by the then Chairman of the Participants to the Arrangement, Axel Wallén (Sweden), who suggested that the applied interest rate should be tied to the market rate in each currency; this proposal defined the applied interest rate as the commercial interest reference rate (CIRR) which consisted of a base rate, a global margin, a fee and a premium fee. Further discussions on the CIRR proposal followed and, after eight years, it was developed under the auspices of Chairman Kurt Schaerer (Switzerland), and became part of the Schaerer Package agreed by the Participants to the Arrangement in 1994. Under the Schaerer Package, the CIRR system generally applied to all countries, whereby CIRR was set at a fixed margin of 100 basis points above each currency's base rate and adjusted monthly.

Birth of the risk premium regime

In the meantime, the discussions on the second element of the pricing system commenced. In 1986 the GATT started to strengthen its regulations on subsidies by governments. Fuelled by this trend in international trade policy, as well as concerns about serious budget deficits due to the export credit activities of several export insurance institutions, the OECD discussions moved towards requiring a risk premium which would cover long-term operating costs and loses and foster a convergence on risk premium charged by the ECAs. Intensive negotiations were undertaken, beginning in 1994, when the Participants to the Arrangement set up a group of their premium experts, chaired by Pierre Knaepen (Belgium). What made the discussions particularly difficult for the negotiators was the absence of a common practice for charging premium by ECAs and their different financing tools: *e.g.* insurance, guarantees and direct lending. However, in 1997, the Participants to the Arrangement agreed the Knaepen Package (named after the Chairman of the premium experts) which established the guiding principles for charging risk-based premium for official support for export credits. To facilitate wider acceptance of the Knaepen Package, the guiding principles focused on setting premium for sovereign and country credit risk.

The Schaerer and the Knaepen Packages marked the establishment of the current pricing system of official support for export credits. Throughout the processes outlined above, the Participants to the Arrangement consistently worked to level the playing field under the slogan of avoiding trade distortions and reducing subsidies. Thirty years have passed since the inception of the Arrangement in 1978 and although the pricing system has worked well for many years it may now be the time to take a step to the next stage.

Changes needed in ECA practices

Over the past 30 years, the Participants to the Arrangement have had to tackle two big issues at the same time: the first, to continue to exclude subsidy elements from the official support system for export credits in line with WTO regulations and the second, to promote the export credit system while maintaining a level playing field. As a result, a system was established which removed subsidy elements from officially supported export credits. In the meantime, reflecting the amazingly rapid changes in the world economy, some new and unexpected developments were introduced, such as “market window” operations and project finance activities. The Arrangement faces the never-ending challenge of coping with new developments affecting the business of ECAs. This challenge cannot be avoided, as everyone knows that the current economic and political circumstances are far different from those prevailing 30 years ago.

Financial institution of last resort

In recent years, ECAs have reconfirmed and expanded their role in international trade and business. The global financial crisis originating with the shock of the collapse of Lehman Brothers in 2008 proved to all that private markets alone cannot ensure steady flows of credit to support international business. In order to ease the adverse effect of such global financial turmoil, ECAs have provided medium- to long-term trade finance to developing as well as developed countries, have monitored the macro-economies of those countries carefully and have exchanged information with international financial institutions. Even in times of economic boom, private banks and multilateral development banks may face pressure to decrease their loans to developing countries; for private banks this pressure may arise from the BIS (Bank for International Settlements) capital adequacy requirements and for multilateral banks it may arise from concerns about the level of indebtedness of developing countries. With the object of ensuring sources of sustainable financial support for international trade and business, ECAs must be the "financial institution of last resort".

Considering that the world economy and the political situation have changed drastically since the 1980s, ECAs may no longer be able to perform the functions currently required of them based on a system constituted 30 years ago; a level playing field among the Participants to the Arrangement is now almost established. Over several decades, ECAs have been excessively absorbed in combating subsidies and competition among the Participants and somewhat less careful about adapting to the changes occurring in the outside world.

Can the current pricing system last forever?

Now that the subsidy element has been almost eliminated from the pricing system for officially supported export credits, it is time to reconsider the appropriateness of the strict regulations on the terms and conditions imposed under the Arrangement. The CIRR and risk premium systems may require change.

Observations on the CIRR regime

As an initial step, a wider array of options should be allowed in determining the CIRR rates quoted to borrowers. Some argue that the additional 100 basis points margin included in the calculation of the CIRR is intended to take account of both the spread between the borrowing costs incurred by domestic first-class borrowers, plus the warehousing costs for the period from the commitment of the financing to disbursement. Considering the development of new financial techniques, such as the option and swap markets, which had not matured at the time the CIRR regime was agreed in the 1990s, as well as the low interest rates prevailing in developed countries like OECD members, the spread of 100 bps may in some cases be regarded as unduly high and rigid compared to current market practice. It may not bode well for the ability of ECAs to meet current needs and fulfil their changing roles that the CIRR conditions imposed under the Arrangement have remained more or less the same over a quarter century, while the financial markets have experienced, and may continue to experience, drastic and rapid changes in response to short-term economic developments.

In addition, a further issue should be considered with regard to the current CIRR regime. The discussion on the appropriate CIRR has so far been limited to the fixed interest rate regime; the status of floating rate loans has been left open. No subsidy element is contained in a floating rate loan when the rate covers the fund-raising cost of the ECA or other lending institution. A key point to keep in mind is that warehousing costs would be almost negligible in a floating rate loan, as the funds are always available in the market at an interest rate based on LIBOR (the London Inter Bank Offered Rate) and there is, therefore, no need to impose a spread or premium to reflect such warehousing costs.

Observations on the risk premium regime

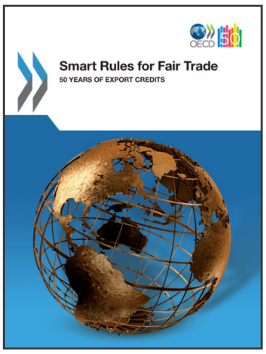
With regard to the risk premium system introduced in April 1999, in my personal view, the overall level of the risk premium is too high in various ways. The level of the minimum risk fee (minimum premium rate) is based on the arithmetic average of the premium imposed by all ECAs at the time the system was developed; this is somewhat inflexible and arbitrary. Under the current procedure, in the event that a country is downgraded (decided by consensus of the participating ECAs in the Arrangement in the context of a borrowing country's ability to service its external debt), it takes too long to restore its previous rating. Therefore, the risk premium required to be charged by an ECA tends to be higher than the market level. In order to minimise such distortions, it may be necessary to examine a new flexible method which enables ECAs to make suitable adjustments to the risk premium level.

Early in 2010, remarkable progress was achieved in respect of the current premium regime. After accepting the Knaepen Package, in 1997, and cementing this in the Arrangement, the Participants discussed for over a decade an alternative risk premium system based on the credit risk of the buyer. This finally bore fruit in the form of a compromise on buyer risk premium (*i.e.* the Malzkuhn-Drysdale Package); what should be appreciated is that this regime was constituted on the basis of the experience of ECAs as well as market trends. I look forward to watching carefully the implementation of this newly agreed risk premium system which will be put into practice in the autumn of 2011 and which responds to my concerns about aligning better the Arrangement's rules to the market and global developments.

The role of the Arrangement in the 21st century

Over the past decades, JBIC has engaged in negotiating and implementing the Arrangement rules as an active ECA operating in Japan. The Arrangement must continue to evolve to reflect the development of the world economy, but recently its rules have become somewhat complex and inflexible in light of current conditions. Consequently, ECAs have been gradually forced to become customer-unfriendly institutions, in contrast to their originally intended role. Further, such troublesome and rigid procedures for official support also have the unfortunate effect of discouraging non-member countries from participating in the Arrangement. The current tendency of negotiations for the Arrangement seems to go far beyond its original objective of not using taxpayers' money to support exports through ECAs. Labelling as a "subsidy" an ECA interest rate that is lower than the market rate is a misinterpretation of the word; this is an issue which the Participants to the Arrangement need to address. As a result of applying over adjusted CIRRs and premium fees, all ECAs have earned considerable profit lately. It is time for the Participants to examine seriously what a public financial institution should be. The highest priority for a financial institution of last resort is to provide steady flows of credit; break-even profit may be sufficient for such institutions.

In order to support private business through export credit finance, sensitivity to market trends and flexibility in providing financing packages for export industries will be an important future theme for the Arrangement. Now, in the 21st century, the world economy is characterised by emerging markets outside OECD member countries which are not regulated by the Arrangement. The Participants cannot allow themselves to be stuck in their own world, admiring the achievements of the past and ignoring the present. The Arrangement must continue to accommodate new and flexible frameworks in order to remain abreast of the ever-changing business of ECAs. This is a new challenge which the Participants should now address with the same dedication and spirit of co-operation that they have demonstrated in the past.



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