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Honor Among Nations: Enforcing the "Gentlemen's Agreement" on Export Credits

Daniel F. Kohler, Peter H. Reuter

December 1986

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Prepared for
The Office of the Under Secretary of Defense for Policy

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PREFACE

This Note is one in a series prepared for the Office of the Under Secretary of Defense for Policy, under RAND's National Defense Research Institute, a Federally Funded Research and Development Center supported by the Office of the Secretary of Defense. It is a product of RAND's research program on international economic policy and should be of interest to policymakers concerned with international resource flows. It analyzes the workings of the major international agreement intended to restrict the volume of support subsidies provided through export credit programs, known as "the gentlemen's agreement."

Other RAND publications from this project include:

Daniel F. Kohler and Kip T. Fisher, *Subsidization of East-West Trade Through Credit Insurance and Loan Guarantees*, N-1951-USDP, January 1983.

Daniel F. Kohler, *Incentives and Insurance in International Financial Markets*, N-2117-USDP, June 1984.

Keith Crane and Daniel F. Kohler, *The Effect of Export Credit Subsidies on Western Exports to the Soviet Bloc*, N-2106-USDP, June 1984.

Stephen W. Salant, *Export Subsidies as Instruments of Economic and Foreign Policy*, N-2120-USDP, June 1984.

Daniel F. Kohler et al., *Economic Cost and Benefits of Subsidizing Western Credits to the East*, R-3129-USDP, July 1984.

Daniel F. Kohler, *Economic Cost and Benefits of Subsidizing Western Credits to the East: Executive Briefing*, R-3129/1-USDP, February 1985.

Donald Putnam Henry, *The Financial Costs of Export Credit Guarantee Programs*, R-3491-USDP, forthcoming.

SUMMARY

Most major manufacturing nations have created schemes by which the government offers subsidies for exports of manufactured goods through direct and indirect credit subsidies. Many COMECON and less developed countries therefore receive considerable subsidies on their manufactured imports.

OECD members account for most of these subsidies and have created an agreement intended to reduce export competition based on them. That arrangement, generally known as "the gentlemen's agreement," has been in existence since 1976, despite considerable tension among its members with widely varying economic interests and policies.

The United States objects to export subsidies on two grounds. First, U.S. policymakers believe, quite correctly in our judgment, that export subsidies involve higher economic costs than are justified by their benefits. Second, the U.S. government is concerned by the fact that Eastern Bloc countries are among major beneficiaries of export subsidies. A curtailing of export subsidies in general would reduce substantial unintended resource flows to our strategic adversaries.

The United States has been a strong supporter of the gentlemen's agreement as a mechanism for reducing export credit subsidies. This Note analyzes the workings of the agreement, particularly problems of maintaining discipline among members and the extent to which it is threatened by the growth of nonmember exporters. The framework for this analysis is provided by a brief examination of why governments operate these export subsidy schemes, in light of powerful economic arguments that the same economic goals can be attained more efficiently through other means.

The agreement appears to have restrained competition through direct credit subsidies. However, it has failed to deal with indirect credit subsidies, provided through insurance and loan guarantees, probably because at least until recently, such subsidies had little budgetary effect. The agreement has predictably led to the growth of indirect subsidies as a share of total export credit subsidies.

The agreement has had only modest problems of maintaining discipline among members. In part this may reflect the fortunate configuration of interest rates among members, which allow for widely varying subsidies within the constraint of uniform nominal floor rates for loans. However, the disciplinary sanctions available within the agreement are fairly weak and the Note suggests some changes that may improve their effectiveness.

Apart from internal tensions, the agreement faces an increasing threat from nonmember exporters, particularly the Newly Industrialized Countries (NIC) who have become aggressive providers of subsidies to their exporters. Improved internal discipline may be necessary for the arrangement to withstand such competition.

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I. INTRODUCTION

All the major exporting countries of the Organization for Economic Cooperation and Development (OECD) have created systems by which the government supports credits extended to foreign purchasers of export goods. The support may be in the form of direct interest rate subsidies. The government can lend to foreign importers directly at rates below its own marginal cost of funds, or subsidize such loans made by private banks. It may also grant particularly favorable refinancing facilities for export credits to banks. In all of these cases, the subsidy is revealed in the government budget as an expenditure or deficit.

An indirect form of credit subsidy is the provision of guarantees at prices below what a private insurer would charge for assumption of the same risk. Such guarantees enable foreign borrowers to avoid incurring the high rates that the market would normally require to compensate for the risk of late (or non) payment. Such indirect subsidies may be quite substantial in total value, especially on exports to countries considered to have an impaired credit rating, such as some East European countries and many in the third world (Kohler, 1984).

The United States subsidizes export credits through several institutions, but mainly through credits and guarantees provided by the U.S. Export-Import Bank (EXIM Bank), and the Commodity Credit Corporation (CCC). The EXIM Bank has been providing subsidized export finance since 1934. In some respects, American programs are even more generous than those of other OECD countries; for example, the United States requires no coinsurance by the exporter for political risks, whereas the vast majority of its rivals require 5 to 10 percent coinsurance.

Despite the generosity of its own program, the United States is opposed to export credit subsidies, for two main reasons: The first is a belief that the potential benefits, to the exporting countries as a group, of subsidized export finance (e.g., increased export sales) do not outweigh the costs of the subsidies.[1] The second is strategic.

[1]See Salant (1984) for a discussion of the economic welfare consequences of export subsidies.

Export credit subsidies transfer resources to the importing countries;[2] their indiscriminate application to all exports, including those to such strategic adversaries as the Soviet Union, is incompatible with a rational strategic posture.

Neither of these arguments has apparently carried much weight in discussions among the OECD countries on reducing export subsidies. These discussions began in 1963 but produced no agreement until 1976. What finally brought about some willingness to limit at least direct subsidies was their effect on government budgets. Subsidized export credits were usually extended as long term loans with very low fixed interest rates. The escalation of market interest rates, including government bond rates, in the late 1970s sharply increased the budget burdens of such loans. The U.S. Treasury, using a confidential OECD study, estimated the direct subsidy costs to the budgets of OECD countries to be between $5.5 and $7 billion annually in the early 1980s.[3]

Although the sharp increase in interest rates dramatized the budgetary costs of subsidized export credits, concern about cost had led to some action earlier. In 1976, several major exporting nations entered into an arrangement to restrict competition through such subsidies. The result is what is commonly referred to as "the gentlemen's agreement," officially the *Arrangement on Guidelines for Officially Supported Export Credits*, run by the secretariat of the OECD.

That agreement, although subject to much internal dissent as to the choice of rules, sanctions and expansions, has survived for over a decade, even though the Arrangement does not have the status of international law, as does the General Agreement on Tariffs and Trade (GATT). Its enforcement is solely in the hands of the signatory governments. In particular, there is no supranational authority empowered with enforcement of the terms of the agreement. The OECD secretariat merely acts as a facilitator.

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[2]And are not covered by the General Agreement on Tariffs and Trade (GATT), which restricts direct price subsidies.

[3]U.S. Treasury news release, November 2, 1981.

The gentlemen's agreement groups borrowing countries into three categories, from category I (relatively rich) to category III (relatively poor, qualifies for International Development Assistance--IDA--loans). It is built around a matrix of minimum interest rates applicable to these categories of countries and to loans of different maturity; richer borrowing countries receive loans with a higher minimum interest rate, longer loans have a lower minimum interest rate.

The United States has been one of the most active proponents of the gentlemen's agreement. The U.S. government has consistently attempted to tighten the rules of the agreement to further reduce subsidies in export finance. In that respect it has enjoyed some success.

One of its major successes has been the reclassification of certain East Bloc countries in 1982. All East Bloc countries had been considered category II or III countries and had enjoyed reductions in interest rates that were originally intended as an explicit form of foreign aid, even though on income criteria alone some should have been placed in higher categories. As of July 1982, this policy was reversed. The Soviet Union, Czechoslovakia, and East Germany were reclassified as "relatively rich countries," and thus could receive loans with interest rates no lower than those of countries with similar per capita incomes, such as Greece and Israel. The remaining East Bloc countries still enjoy the lower floor interest rates available to category II and III countries, as befits their per capita income level.

Although there is a large journalistic literature on the operation of the gentlemen's agreement, there is apparently no academic analysis.[4] This Note attempts to partially fill this gap. It has two purposes. The first is to examine the welfare consequences of the arrangement, in theory and practice, focusing particularly on its effectiveness in restraining certain forms of subsidy competition. The second is to identify possible threats to the working of the agreement and remedies to deal with these threats.

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[4]Rand conducted a data base search using the "Economic Literature Index"; apart from Wallen (1984), it yielded only journalistic references.

The Note begins with an analysis of why governments offer export subsidies, a question that arises because of the considerable weight of economic argument that such subsidies are always a suboptimal means of attaining a given economic goal. The next section describes the evolution and scope of the agreement and briefly considers its welfare consequences. This is followed by an analysis of the agreement's success in obtaining compliance with its rules and by suggestions for improving its performance in this respect. The final section examines impending threats to its continued effectiveness.

Information sources in this are very limited. Most governments involved in export subsidies do not see fit to provide more than skeletal information about them; the detailed reports provided by the EXIM Bank are a lonely exception to that rule. We can obtain only gross estimates of the scale of supported loans for most OECD members; very little detail is available concerning these programs.

This secrecy applies also to most aspects of the gentlemen's agreement. The very text of the agreement is not a public document, although enough copies have been distributed that no great ingenuity is required to obtain one. However, detailed information about the actual operation of the agreement is extremely difficult to find. This Note relies heavily on the journalistic literature about individual transactions, which provide some evidence concerning the actual operation of the agreement and about policy discussions among the members. We also interviewed a few officials involved in the negotiation and operation of the agreement. They did provide useful additional information, although they were generally rather guarded.

II. WHY ARE EXPORT CREDITS SUBSIDIZED?

The weight of economic doctrine against export credit subsidies is substantial.[1] Except under rather special and unlikely conditions, there are always other economic instruments that can more efficiently accomplish the same economic end. Nonetheless, governments routinely offer such subsidies. In this section we offer some rationalizations for their behavior, because a restraint can be evaluated only in terms of how it changes behavior. Hence we need some model of what leads governments to offer these apparently nonoptimal subsidies.

We start by assuming that governments are rational; their behavior is intended to maximize an objective function, given their knowledge about the consequences of their actions. Governments would not extend export credit subsidies if they did not believe that they or their constituencies derive benefits therefrom. Subsidies are not desired in themselves, because they impose at least the transaction costs of collecting taxes and disbursing the subsidies, in addition to the deadweight losses that arise from any distortions in incentives to economic agents, of which any OECD government is undoubtedly aware.

The situation may be slightly different for indirect subsidies. The attractiveness of indirect subsidization through government guarantees and insurance may be precisely the fact that these costs do not appear overtly in government accounts but are borne indirectly by the economy. Many individuals and, more important, governments may be unaware of the cost of indirect subsidies. Some European officials we interviewed were highly skeptical as to the economic costs of government guarantees, and many flatly denied that such guarantees "cost the taxpayer anything."

Several arguments may be offered to justify export subsidies despite their economic costs.

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[1]For a review and critique of the different agreements justifying export subsidies, see Salant (1984).

- Redistribution

Subsidies may be offered to particular groups with political power so as to redistribute wealth in their favor. The redistribution may be to a particular region, industry, or other subgroup. This is an incomplete rationale, because there is always a means of accomplishing the same redistribution less expensively. However, other redistributive mechanisms make the subsidies more visible and hence *politically* more expensive. Thus redistribution may be one of the goals of the export credit subsidy program.

For example, it is an explicit EXIM Bank policy to favor small manufacturers of U.S. products (EXIM Bank Program Survey, April/May 1982). At a conference for potential clients in 1983, EXIM officials indicated that one of the factors they considered was the economic situation in the area where the plant was located. Plants located in areas with chronic unemployment problems would be favored over others. Indeed, traditional manufacturing industries, which are mostly located in the "Rust Belt," see a much larger proportion of their exports supported by the EXIM Bank. In the case of power production and distribution equipment, over 40 percent of exports in 1980 benefited from EXIM Bank subsidies (Salant, 1984; p. 8).

One group that is a frequent recipient of export credit subsidies consists of industries faced with high unemployment. The EXIM Bank Program Survey states that for the U.S. applicant "it is helpful . . . to describe the effect of the [export] sale upon unemployment in the particular plant or facility from which the goods and services are to be provided, including any impact on major subcontractors, and small and minority owned enterprises if known." The implication is that loans that would prevent large job losses to the direct and major subcontractors are more likely to be granted than are loans that merely expand employment.

Some governments maintain that export credit subsidies are effective as tools in macroeconomic management. Indeed, because such subsidies reduce the price a foreign borrower has to pay for the purchase of subsidized exports, they maintain economic activity and

employment in the subsidized sector. Furthermore, they appear to do so at very low cost.

A more complete accounting of the economic costs and benefits would take into account that the resource costs of the subsidy have to be borne by other productive sectors and that this burden will probably reduce economic activity and employment in those sectors. However, lay-offs and plant closures are considerably more visible, and hence politically less acceptable, than a slowdown in the expansion of productive sectors.

- Resource Transfers

The benefits of export subsidies go at least in part to the importing country. Export subsidies could be understood as a conscious effort to transfer resources to the importing country, a form of foreign aid. This argument provides some rationale for the practice of mixing export credits with economic development funds to lower the average (blended) interest rate.

The classification of borrowing countries based on per capita income clearly recognizes that export credit subsidies are one form of foreign aid, one that is particularly attractive to governments because aid generally is not politically popular. By tying it to exports that benefit particular regions or industries, the government is able to create a constituency for such aid.

- Dynamic Arguments

The above two arguments are political; they concern distribution and not efficiency. At least one dynamic argument for export subsidies cannot be dismissed on efficiency grounds. Some governments, particularly that of the United States, assert that they provide export credit subsidies primarily for the purpose of discouraging others from doing so; they raise the export subsidy cost to other countries by requiring them to provide even higher subsidies to win contracts. The president of the EXIM Bank has referred to this as "raising the threshold of pain.[2]

[2]Cited in *Euromoney,* Juanuary 1985, p. 141.

The United States has used this argument in its efforts to limit the mixing of foreign aid funds and government supported export credits. The U.S. government is intent on maintaining a distinction between aid and international commercial competition. Although the United States finds it acceptable that commercial policy, such as export subsidies, should have some foreign aid side benefits, it objects to the use of foreign aid funds for essentially commercial purposes. It also objects to the indiscriminate extension of foreign aid in this manner because some of the recipients of this aid are our strategic adversaries, whom it does not believe deserving of subsidies from the western alliance.

In its efforts to obtain an effective agreement limiting the use of mixed credits, the administration has sought, and the House of Representatives has approved, a "war chest." This consists of a $300 million fund earmarked for selectively targeting and undercutting mixed export credits offered by other OECD countries. "No grants could be made unless the Treasury determined that it would help bring about an international agreement on tied aid."[3]

These rationales or motivations for export credit subsidies are not mutually exclusive. Any government has a multitude of goals and chooses among different policies with respect to these multiple goals (variables in the objective function). Moreover, governments differ with respect to the weighting of their goals (parameters in the objective functions). Hence the optimal level and distribution of such subsidies are likely to be different for different governments.

We would like to go beyond such general statements and specify enough about the governmental objective functions to be able to determine some characteristics of the preferred export subsidy policy, to predict, for example, what kinds of governments are likely to be most aggressive in their subsidy policy and what levels of subsidies they might seek to attain.[4] However, those objective functions are unobservable and we can only hope to make some broad statements.

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[3]*Wall Street Journal,* September 23, 1986, p. 64.

[4]Perverse effects are possible. If the purpose of subsidies is to redistribute income to a particular group, and if there is resistance to such redistribution by other politically powerful groups, then the government may prefer to face aggressive competition from other governments so that it may justify higher levels of subsidy, assuming that some share of the subsidy remains with the exporters rather than the customers.

It is likely that governments for whom the net budget costs of export subsidies are low tend to engage more aggressively in export subsidization. One possibility is that governments with higher levels of social insurance, particularly unemployment benefit subsidies, prefer higher levels of subsidy.[5] Export subsidies may impose a lower budget cost than do unemployment subsidies for the maintenance of a given level of unemployment. This is a very incomplete economic accounting, but it may reflect the incentives and constraints under which governments act.

It may be argued that there is a doctrinal consistency between export credit subsidy attitudes of a government and other aspects of its economic policy. Governments that are highly interventionist in their domestic economic policy are also likely to have a greater propensity to intervene in international transactions. Export credit subsidies thus are merely a rational extension of the government's subsidization policy.

The net costs of an export subsidy also depend on the market conditions that exporters face. A small country that is largely a price taker in international markets will see a larger portion of its subsidies being rationed by the exporting industry and a smaller portion accruing to the foreign importer than a country with a large share of the export market. Thus, the country whose exporters have little or no market power might be more prone to subsidize its exports than a country whose actions influence world market prices.

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[5] It is necessary to distinguish between unemployment insurance provided through employer/employee taxes and direct subsidies out of general revenues; the latter may be the only payments that enter into the government's objective function.

III. THE ARRANGEMENT

The Arrangement on Guidelines for Officially Supported Export Credits (the gentlemen's agreement) has its origins in the U.S. government concern in the early 1970s that the major Western nations were spending very large sums in subsidizing exports and that this competition yielded no net benefits to the exporting countries. The United States was particularly concerned about subsidies for exports to the Soviet Union. An interim agreement including six nations was reached in 1976 and formalized in 1978, with 20 signatories. Today, 22 of the 24 OECD countries are members of the agreement (see Table 2); the exceptions are Iceland and Turkey.

As drafted, the agreement covers a wide range of government programs and a modest number of dimensions of those programs. It includes all export transactions that are "officially supported by way of direct credit, refinancing, eligibility for an interest subsidy, guarantee or insurance." Aspects of these programs covered by the agreement are the minimum allowed interest rate, the maximum length of loan, the minimum share of direct aid permitted in a subsidized transaction, and minimum downpayment and grace period. In addition, it specifies procedures for dealing with violations. The arrangement includes no rules concerning insurance and guarantees, except that these may not cover more than the value of the credit itself.

From its inception, the agreement has covered interest rates on all officially supported export credits of more than two years maturity. The signatories agreed that no foreign borrower could receive an official loan at a rate below the level set by the agreement. Each importing country was placed into one of three categories, depending on its per capita income. The lowest allowed interest rate on a subsidized export credit to a given country was determined by which of the three categories it fell in. Table 1 presents the consensus rates that have been set at different times since the agreement began. In addition, limits were placed on the minimum percentage of the transaction that had to be paid by the importer and on the maximum lengths of the loans.

The Arrangement does not cover all goods and explicitly excludes services, in part because the trade in the latter does not generally involve the offer of export credits and long term financing. The major excluded goods are commercial aircraft, shipbuilding, power plants (all covered by separate agreements), and agricultural products. The last of these are subject to such a maze of other government interventions that controls on export credits could easily be circumvented by increasing other subsidies.

The agreement specified nominal interest rates for the consensus levels, which served as a weak restraint in the following five years as interest rates rose throughout the world. The consensus rate of 7.25 percent for the poorest borrowers permitted very large subsidies when the government borrowing rate reached 13.72 percent in the United States in 1981. The direct interest subsidy delivered through export credits by signatories of the arrangement was estimated to have reached $7 billion in 1981 (Wallen, 1984).

Table 1

OECD CONSENSUS RATES

(Finance charges in percent per year)

	Country Categories and Maturities					
Effective Dates	I 2-5yrs	I >5yrs	II 2-5yrs	II >5yrs	III 2-5yrs	III >5yrs
04/01/78-06/30/80	7.75	8.00	7.25	7.75	7.25	7.50
07/01/80-11/15/81	8.50	8.75	8.00	8.50	7.50	7.75
11/06/81-07/05/82	11.00	11.25	10.50	11.00	10.00	10.00
07/06/82-10/14/83 (a)	12.15	12.40	10.85	11.35	10.00	10.00
10/15/83-07/14/84	12.15	12.40	10.35	10.70	9.50	9.50
07/15/84-01/14/85	13.35	13.60	11.55	11.90	10.70	10.70
01/15/85-07/14/85	12.00	12.25	10.70	11.20	9.85	9.85
07/15/85- present	12.00	12.25	10.70	11.20	9.85	9.85

SOURCE: EXIM Bank.

(a) Until 12/31/82, countries newly placed in category II were granted intermediate rates of 10.50 and 10.75 percent.

The consensus rates were raised in 1980 and again in 1981. The first increase was very slight, leaving the highest consensus rate at 8-3/4 percent. Even though the second increase, in November 1982, was more substantial, with the highest rate at 11-1/4 percent, the consensus rates were still very far below the market rates for government securities in some nations. This can be seen in a comparison of the interest rates in Table 1 with those in Table 2, which are the government borrowing rates during the same period for some of the major members of the OECD agreement.

Although the consensus rates still allowed substantial subsidies, there were major violations of the rules of the agreement in the early days. The EXIM Bank reported that in one six month period in 1980-1981 it had made loans totaling $1.8 billion, which had maturities longer than the maximum length of 8-1/2 years allowed under the agreement.[1] In each case it was responding to foreign competitors that had violated the rules in their initial offers on particular contracts; in the case of one loan, $200 million to the Mexican railroads, the maturity of EXIM's winning offer was 22 years.

Major revisions occurred in 1983, when a formula was agreed upon for automatic semiannual changes in the minimum interest rate. Instead of a fixed interest rate for an indeterminate period, the minimum rates were to be based on a weighted average of the interest rates for six major currencies. Changes were to be made every January 15 and July 15, based on the new weighted average of the rate prevailing on the previous December 31 or June 30. There was also more careful statement of the terms of lending by nations whose government borrowing rate fell below the formula determined minimum. These governments were now permitted to supply credits at approximately 0.5 percent above their borrowing costs.

The key operational aspect of the arrangement is the scheme of prior notification of any intended violation, called "derogation" in the official documents. Each member must provide all other members with

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[1]Maturities of up to 10 years are allowed for the poorest countries.

Table 2

GOVERNMENT BOND YIELDS FOR SIGNATORIES
TO THE OECD CONSENSUS ARRANGEMENT

Country	1978	1979	1980	1981	1982	1983	1984	1985
Australia	9.06	9.76	11.64	13.96	15.35	14.33	13.84	NA
Austria	8.21	7.96	9.24	10.61	9.92	8.17	8.02	8.01
Belgium	8.45	9.51	12.04	13.71	13.56	11.86	11.98	11.42
Canada	9.30	10.26	12.49	15.22	14.26	11.79	12.75	11.46
Denmark	14.54	15.82	17.66	18.92	20.39	14.46	13.93	13.14
Finland	9.80	9.51	10.42	10.97	10.99	10.76	11.10	10.66
France	8.96	9.48	12.99	15.66	15.56	13.61	12.41	11.18
West Germany	5.80	7.40	8.50	10.40	9.00	7.90	7.80	7.24
Greece	11.00	11.04	NA	NA	NA	NA	NA	NA
Ireland	12.83	15.07	15.35	17.26	17.06	13.90	14.59	13.51
Italy	13.70	14.05	16.11	20.58	20.90	18.02	14.95	12.90
Japan (a)	6.09	7.69	9.22	8.66	8.06	7.42	NA	6.56
Luxembourg	6.64	6.78	7.50	8.68	10.50	9.83	10.22	9.74
Netherlands	7.74	8.78	10.21	11.55	10.10	8.61	8.33	7.69
New Zealand	9.97	12.04	13.29	12.83	12.91	12.18	12.57	17.81
Norway	8.45	8.59	NA	12.31	13.20	12.86	12.16	12.36
Portugal	16.17	16.68	16.68	16.71	16.79	NA	21.50	21.02
Spain (b)	10.00	12.00*	12.83	12.58	16.73	17.63	16.50	10.50
Sweden	10.09	10.47	11.74	13.49	13.04	12.30	12.28	13.03
Switzerland (a)	3.33	3.45	4.77	5.57	4.83	4.52	4.70	4.86
United Kingdom	12.40	12.99	13.79	14.74	12.88	10.81	10.69	10.87
United States	8.49	9.33	11.39	13.72	12.92	11.34	12.48	11.47

SOURCE: International Monetary Fund, *International Financial Statistics*, various years.

(a) Figures for Japan and Switzerland are first quarter 1985 only.

(b) Spain 1978-79 is bond yield at issue. 1980-85 is secondary market rate.

notification of an intended commitment for a medium or long term loan involving some subsidy that might produce a violation of the Agreement. In this event, other members are allowed, with some restrictions, to match or even underbid the offender's offer.

The United States remains the leading source of pressure for expansion of the agreement. Although it claims to be pleased with the continuing tightening of terms, the United States government presses for elimination of subsidies (*EXIM Annual Report*, 1984). It argues that

importers should be making choices on the basis of product quality, price, etc. and not on the basis of the level of government subsidy. France leads the nations seeking to prevent further tightening of subsidy restraints. An excellent discussion of the tensions within the agreement over its lifetime is provided in Wallen (1984).

Perhaps the most controversial aspect of the agreement in recent years has been the "mixed credit" issue. Some governments extend export credit combined with direct aid; the result is a hybrid with much lower interest rates (called blended) than allowed under the consensus. The U.S. position, strongly resisted by the French, has been that aid and export credits should not be mixed. Within the context of the Arrangement, this has taken the form of specification of a minimum share of the total credit that can be financed through aid. Currently every transaction that includes aid must contain at least 20 percent aid, and any transaction with the aid element between 20 and 25 percent is subject to the Arrangement's notification requirements.

This rule makes it expensive for governments to include aid as a method for winning export orders. Such aid cannot be thrown in as the marginal inducement but must represent a substantial amount of the total. The United States continues to press for an increase in the minimum aid element allowed, to 50 percent. The French resist this effort, arguing that mixed credits are a legitimate method for delivering aid to developing countries.

This disagreement continues to mar the working of the agreement. In late 1985, the President of the EXIM Bank announced that the United States was going to match French mixed credits with respect to six major contracts, claiming that these were a "predatory practice." He also stated, "It's a skirmish, not an all-out war with France. We want to bring about a successful peace in this war of mixed credits."[2]

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[2]*Washington Post*, November 13, 1985. The complexity of this kind of warfare is revealed by a later comment in the same article. The largest of the contracts involved Algeria, to which the United States, but not the French, were offering mixed credits. The U.S. justification for this was, "The French look at Algeria as a country that is very French-oriented in its purchasing program. . . . We felt that this was a good place to attack."

In general, it appears difficult to develop an agreement that can take account of all the techniques used to subsidize exporters. For example, the French for some years had a program that provided insurance for capital goods exporters against unexpected increases in the domestic rate of inflation. The cost of this program, as measured by the difference between premium income and payments, reached $500 million in 1979 (*The Economist*, February 14, 1981, p. 79). Yet because this was a subsidy to the exporting firm and not tied to the extension of credit, it was not covered under the terms of the Arrangement. Similarly, repayment risk insurance can be provided at particularly favorable terms without violating the Arrangement.

Inducements of a less direct kind can be provided--e.g., the chauffeur driven limousine for the visiting importer provided by the export credit agency (*Wall Street Journal*, September 19, 1985). To cover all such forms of subsidy and inducement would require an enforcement mechanism, particularly monitoring, that is likely to involve an unacceptable degree of interference into the affairs of sovereign nations.

The noninclusion of indirect subsidies in the Arrangement can probably be ascribed to their budgetary invisibility. We suggested earlier that the incentive for forming the agreement was the rising budgetary costs associated with direct subsidies. It is not surprising then to find that subsidies without visible budgetary consequences are not included.

This might be changing. The recent *de facto* default by Poland and similar near defaults that could be averted only by costly rescue operations (reschedulings) have forced official credit risk insurers to acknowledge their losses and begin writing off some of the bad loans. The chickens have come home to roost, and in the foreseeable future the budgetary costs of indirect subsidies may become sufficiently apparent to cause the OECD governments to focus on them.

These flaws do not imply that the arrangement has not had an effect on competition among the member nations. It simply points to the

difficulty of obtaining a comprehensive restraint. The more refined the rules, the more expensive and inefficient it may be to find means of violating them; incompletely effective rules may nonetheless restrain competition.

IV. CONSEQUENCES OF THE AGREEMENT

A CARTEL?

The agreement is intended to restrict competition, the defining characteristic of a cartel. But this agreement is among governments, not among such profit-oriented entities as corporations. Is it then restraint of trade?

We ask the question not for semantic reasons but as a means of directing attention toward the economic welfare implications of the gentlemen's agreement. Cartels usually reduce economic welfare in addition to redistributing it because the cartel will tend to restrict output and raise prices, compared with the outcome under unrestrained competition.

But in this case there is no reason to believe that we are dealing with entities that make profit maximizing calculations. Government decisions about the level of subsidy to be offered in export transactions are determined, as already suggested, by various considerations, both economic (often incorrect) and political. Governments are not constrained by markets to make the economic calculations of marginal costs and revenues that determine the competitive outcome in markets. Thus there is no reason to believe that, absent an agreement, there would be a welfare maximizing level of export subsidies.

Salant (1984) has shown that export subsidies are likely to be welfare-enhancing only under very implausible conditions with respect to demand and supply elasticities. We infer then that lower levels of export subsidies are, except in those special cases, to be preferred to higher levels of subsidies. If the effect of the gentlemen's agreement is to reduce the total flow of export subsidies, then the agreement increases global welfare.

Of course, the Agreement also affects the distribution of income. To the extent that the populations of poorer nations capture the subsidies rather than the elites of those nations or the exporting firms, then we would assume that the distributional consequences of subsidies are desirable.[1]

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[1]Again we note that direct transfers constitute an economically more efficient means of achieving this redistribution.

HOW WELL DOES THE AGREEMENT WORK?

Why have the signatories to the Arrangement not created a formal third party enforcement mechanism such as that provided in the GATT agreement? We suggest that there are four main reasons:

1. The "injury" is not recurring but concerns a past transaction; discipline would be punitive rather than deterrent with respect to an ongoing violation of the Arrangement.

2. The injured party is not well defined. In the case of GATT, the violation typically involves a discriminatory tariff that injures a particular exporter. Violations of the gentlemen's agreement mean that the customer receives a higher subsidy from an exporter and that some other nation's exporter was not awarded the contract because of this subsidy. The latter's basis for complaint is at best argumentative.

3. The cost of discipline is borne by the disciplinarian. Presumably discipline would take the form of allowing the nation whose exporter had lost out to provide higher subsidies in some future export competition against the derogating nation. That may not be the preferred position of the disciplining government, which incurs increased budgetary subsidy costs as a consequence. In GATT, the injured party's remedy (e.g., imposing a countervailing tariff) has a positive effect on the budget.

4. Governments want to be able to derogate from time to time. Under the gentlemen's agreement, any government can derogate, provided it announces the derogation in time so that potential competitors can match the subsidy provided. In effect, any government can suspend the agreement whenever it chooses.

We propose to evaluate the agreement initially in terms of compliance with its own restrictions: To what extent do the signatory nations conform to the stated conditions with respect to interest rates, length of loans, grace periods, etc? We shall then speculate about the extent to which the agreement, if complied with, would actually restrict competition among member governments in the provision of subsidies. Analysis of this second question is limited by the absence of a well-developed model of government subsidy behavior.

In discussing the workings of the gentlemen's agreement, it is useful to treat the (dis)agreements on mixed credits separately. It seems at first counterintuitive to have an agreement on *minimum* levels of subsidies, as is the case for mixed credits, when the overall professed goal of the agreement is to *reduce* subsidies. Foreign aid that is tied to particular products and transactions is an export subsidy like any other. The only difference is in the intent that motivates the subsidy. The U.S. position is that small amounts of foreign aid tied to officially supported exports are not intended primarily as foreign aid, but are offered as a marginal inducement to win contracts and are therefore a means of circumventing the spirit of the agreement.

The part of the gentlemen's agreement dealing with mixed credits should therefore be viewed as an enforcement mechanism, rather than as a component of the agreement proper. Its primary intent is not to reduce subsidies directly but to make it more expensive for signatories to use mixed credits to circumvent the intent of the agreement. As a disciplining measure it is intended to reduce the total level of subsidies indirectly, through better discipline and a reduction in the number of mixed credit transactions, even though those mixed credits that are still extended contain a higher subsidy component.

This tactic of improving discipline by making a loophole popular with many signatories more expensive has itself been very controversial. Most of the derogations observed under the gentlemen's agreement today do involve the creative use of mixed credits.

Nations vary in the extent and method of derogation. Japan and France both tend to offer mixed credits that include less than the allowed aid element. The Canadians are reputed to evade some of the terms of the Arrangement by using their development agency as the source of loans including a very low aid element (Knight, 1980).

Japan has also been imaginative in finding other ways of getting around the constraints of the agreement. For example, in 1980, Japan granted Malaysia 4 percent credit with 25 years term, a grant with a sufficiently large aid element to avoid derogation. But Japan also made clear that it expected to receive contracts for the construction of a

major power plant (Knight, 1980). In the same year, the Japanese discussed making available 6.25 percent financing to the Chinese for a five year loan. Japan claimed that this was not export finance but import finance, because it was to be used by the Chinese to purchase equipment for the production of export items to Japan. If the Chinese decided to purchase Japanese equipment for this purpose, so much the better.

The arrangement does not have means for dealing with such indirectly related transactions. Nor, given the profusion of such possible tie-ins and the multitude of purposes that they serve, is it conceivable that the OECD could be empowered to control them all.

Another problem is that nations may find it profitable to develop "bad" reputations. Consider a nation that is known to be a frequent derogator. Any other nation facing it in a competition for a given contract will have to raise its estimate of the cost of winning that contract by taking into account that success will require provision of a subsidy higher than allowed under the consensus.

This may discourage competition against the notorious derogator. The latter will not have to increase the frequency of its derogation overall, because it should experience fewer instances in which others engage it directly.

It would be misleading to convey the impression that such derogations are the norm. Those officials who were interviewed believed that most officially supported export credit transactions did meet the letter, if not always the spirit, of the agreement. Efforts to obtain a list of violations from organizations with an interest in policing conformity with agreement rules were uniformly met with the statement that such violations were sufficiently rare that no such list was maintained.

The apparent efficacy of the agreement (in terms of obtaining conformity with its own strictures) is readily explained. It has some characteristics that make it almost self-enforcing with respect to direct derogations. Offering a loan that is more favorable to the importer than a loan meeting the terms of the guideline is not in itself a violation of the agreement, provided the exporting government alerts the other signatories to the intended derogation at least ten days prior

to the signing of the contract.[2] But even without such an announcement, the importer has an incentive to disclose the terms of this offer to competing exporters to encourage them to offer still better terms. The fact that the agreement is known to permit matching of derogations encourages importers to make these disclosures. Thus, any derogation is likely to be disclosed to at least one other member of the agreement,[3] which reduces the expected reward to derogation. In this sense, and to this extent, the agreement is self-enforcing.

Without the prenotification requirement, exporters could be tempted to offer subsidized interest rates with very short commitment periods. By making an attractive offer that is valid for only 24 hours, for example, the exporter might forestall the importer's attempt at obtaining better deals from competing exporters, thus preempting any possible competition. The prenotification requirement is designed to proscribe such business practices and assure that any derogating offer is open to competition from all interested parties. This significantly reduces the attractiveness of a derogation from the consensus rates.

Failure to meet the notification requirements constitutes a clear violation of the agreement and, according to the officials interviewed, is a major problem in its operations. In some instances, the derogator did not file any information; more typically the information was filed so late that the other governments were unable to respond. The fact that such violations occur, and that this is a matter of concern to other participants, suggests that prenotification does have its intended effects. Otherwise, given the almost zero cost involved in notification, all governments would, except through negligence, meet this requirement.

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[2]The reporting of intended derogations prior to the execution of a contract may lead to negotiations by one of the other signatory governments to dissuade the intending derogator from completing the transaction. We were unable to learn about the frequency or success of such efforts.

[3]If a member country firm is competing only against nonmember country firms, then no such disclosure is guaranteed. However, members of the agreement are likely to be less concerned about the precedential value of violations in a situation in which the result of conforming would be the loss of the order to a nonmember. Moreover, given that the members account for 70 percent of all manufactured exports, there are relatively few situations in which only one member will be competing for a major contract against one or more nonmembers.

THE COSTS OF DISCIPLINE

The effectiveness of a cartel is partly determined by the cost of monitoring compliance and sanctioning noncompliance (Stigler, 1964). As suggested above, the costs of monitoring Arrangement noncompliance with the consensus rates is likely to be minimal, because customers are generally motivated to report such events in the hope of obtaining still better terms.[4] Discipline, when violations do occur, presents a more complex problem.

Given that these credits, unlike commodities, are not fungible, it is possible to devise highly selective sanctions. For example, the agreement might allow undercutting of the violator in his next transaction. Such sanctions provide an efficient method for maintaining discipline, because their imposition does not directly threaten the terms of other transactions by agreement members. This contrasts with, for example, a retail cartel, in which the offer of a lower price, for purposes of disciplining cartel violators, cannot easily be restricted to a subset of customers, such as those serviced by the violating member.

Selective sanctions may well have a deterrent effect, given the mixed objectives of the governments in their subsidy programs. Subsidizing governments seek to raise their share of export markets while reducing the level of subsidies. Successful violations of the agreement clearly raise both export shares *and* the level of subsidies, while a derogation does not necessarily lead to an increase in export shares.

Assuming each government is a rational actor, we can infer that the initial violator prefers to win the contract and pay the nonconforming subsidy, because it made that offer. A workable disciplinary action

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[4]There are circumstance that in theory would motivate customers (importers) not to report violations even if they have sufficient time to do so. Assume that the customer expects to be a repeat buyer in this market. The violator offers to continue to derogate in future deals with the same customer if the current derogation is not reported. If the violator is a credible source for future purchases, then the customer may choose not to report the derogation, trading potential current gains for potential future gains.

will raise the resulting subsidy cost to a derogating government to the point where it no longer pays to win the contract. That will to discourage future nonconforming offers.

For the nonaggressive governments administering discipline, the offer of matching bids in situations of derogation may push them to nonpreferred situations. This simply states that discipline is costly to the government that provides it.

One method for lowering the cost of discipline to individual members is the creation of a "war chest." Member governments would be required to make payments, perhaps proportional to their total subsidies (which has the condign effect of raising the cost of subsidies) or their total exports, into a fund that is available to subsidize matching derogations. A member government that matches a derogation would receive some compensation from the fund, related to the difference between the cost of the winning offer and the maximum subsidy that would have been allowed under the terms of the agreement. This ensures that the violator pays part of the cost of his own discipline, not an unattractive feature.

The size of the war chest might be determined by the frequency and severity of known violations in the previous, say, 12 months. This also has the condign effect of raising the tax rate for the successful violator, because the more often he violates, the larger the war chest that needs to be collected.

This would also deal with one weakness of the current system, that there is no retroactive discipline. Derogating governments frequently do not provide sufficient notification for other governments to match or beat their offers--i.e. to discipline them. If each government's contribution to the war chest depends on its total subsidies granted,[5] some retroactive discipline would then be built into the system, because its payment will be higher as a result.

It can be argued that the success of the agreement at least partly depends on the continued ability of some governments to evade its strictures. A system of discipline that completely bound governments to

[5]This could be computed by multiplying the spread between a lender country's government bond rate and the consensus rate by the volume of officially supported loans granted.

conformity would lead some members to exit from the agreement. For each nation there may be contracts that have a particular significance, perhaps as a consequence of their timing in the political cycle. Some member governments may highly prize the ability to win a few major contracts, through derogation if necessary, in the quarter preceding a national election. Conceivably those are highly prized enough to outweigh the benefits the government receives from conforming with the agreement at other times.

Other contracts may be particularly important not just for their political timing but for their industrial or regional allocation. The West German government, for example, might value export credit subsidies to the ailing steel industry more highly than subsidies to other sectors. As a result, they will be willing to incur both the expense and the disapproval associated with noncompliance to win steel industry export orders.

Imperfect discipline may thus be optimal. However, it should also be possible to design systems of discipline that raise the cost of nonconformity when it does occur. Members will derogate only when they particularly value a contract, so this may still allow the minimal flexibility necessary for maintenance of the agreement.

V. POTENTIAL PROBLEMS

The continued success of the agreement is a matter of speculation. Two potential problems seem important. The first is the growing share of manufactured exports coming from nonmember nations. The other is less readily described but arises from a combination of the use of nominal interest rates in the specification of the consensus and the skewed distribution of nominal rates among member countries.

THREATS FROM NONMEMBERS

The signatories to the agreement hold a dominant share of exports of the products covered by that agreement. However, the share of some nonmembers has grown considerably since 1978. Non-OECD members, outside of the East Bloc, accounted for 27 percent of manufacturing exports in 1983 compared to 24 percent in 1974. The NICs (Newly Industrialized Countries)[1] have set up programs to support export credits, as have some other non-OECD nations. Little quantitative information is available about these programs, but exporters of those nations are reputed to use them aggressively.

The optimal strategy for the nonmembers is to offer interest rates just below the consensus rates. This increases their market shares without greatly raising the amount expended as subsidies. If the nonmembers' share of manufactured exports grows, then, to the extent that they deviate from the consensus terms, they will threaten the viability of the agreement. Just as the Organization of Petroleum Exporting Countries (OPEC) has been weakened by the growth in nonmember production, both in terms of the price it can set as the cartel price and its ability to maintain discipline among its members, so Arrangement members may be inclined to break the agreement in order to meet growing competition in export markets from nonmember countries. Given GATT restrictions on other export subsidies, the NICs are likely to emphasize export credit subsidies.

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[1]Brazil, South Korea, Singapore, Republic of China, Hong Kong.

One means for dealing with this problem is to admit these countries as new members of the Arrangement. The terms of the agreement allow for such expansion, if ratified by the current signatories. However, there is likely to be considerable unease about admitting these countries into the Arrangement. They are, after all, recipients of considerable amounts of export credit from the current members. Cartels are not eager to have customers privy to their negotiations.[2]

It would of course be interesting to observe whether the NICs are more concerned with obtaining low consensus rates as importers or with maintaining high rates to ease their own export credit subsidy burdens. However, as exporters their interests are best served by the continuation of the Arrangement without their having to make the sacrifice of joining.

THE STRUCTURE OF NOMINAL INTEREST RATES

As of this writing, nominal interest rates continue to vary greatly among the member countries. The government borrowing rate for France in 1985 averaged 11.2 percent, compared with 7.2 percent for West Germany. Arrangement rules regarding the provision of export credits in countries with government borrowing rates below the consensus figures exacerbate these differences. The French government is, in effect, permitted to offer a very large direct subsidy; the West Germans can offer none.[3]

These differences among members probably enhance the stability of the Arrangement. France is, by all accounts, the most aggressive tester of the consensus terms; certainly it is the country most frequently named in published reports as seeking to prevent changes that would further restrict its ability to subsidize (e.g., *Washington Post*, November 23, 1985). Thus to ensure continued cooperation by the French government, the other governments are willing to accede to a practice

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[2]Leeper (1979) makes a similar point, suggesting the possibility of a two-tier membership system as a solution.

[3]Differences in interest rates between nations are related to exchange rate expectations. A currency whose exchange rate is expected to fall carries a higher nominal free market interest rate, which equalizes the expected real cost to the borrower.

that permits France and similar countries to offer higher subsidies without violating the terms of the agreement.

A decline in the nominal interest rates in France might put the agreement under severe strain. However, at least on the basis of casual observation, there is a correlation suggesting that the problem is not very likely. The distribution of nominal interest rates among nations is very much affected by the distribution of deficits; high deficits are correlated with high nominal interest rates, for obvious reasons. But governments that are willing to aggressively subsidize exports are also likely to be governments that run high deficits. Thus, there should be a positive correlation between nominal interest rates and the aggressiveness of export subsidy programs.

A correlation is not enough to ensure that the aggressive governments will always be able to offer higher subsidies under the current terms of the agreement. If the configuration of interest rates changes in the near future, it may increase the tension among members. If the effective subsidy rates continue to vary greatly among nations, however, the obvious inequity of the agreement may come to pose a serious threat as well. It may be necessary to develop a more flexible arrangement that takes better account of interest rate differentials, although past efforts to do so have been unsuccessful (Wallen, 1984).

VI. CONCLUSIONS

The gentlemen's agreement has endured since 1976 and has grown in strength in terms of both the lowering of the subsidy element and expansion of the number of signatories. Despite tensions among members it has apparently managed to constrain competition in the provision of export credit subsidies.

It has clear limitations in this respect. The failure to include indirect subsidies, notably insurance and guarantees, means that one of the two major elements of government subsidies, in fact the more insidious of the two, remains unconstrained. It is no surprise that these indirect subsidies seem to be a growing share of the total.

On their own, some countries have begun limiting the indirect subsidies somewhat, primarily by increasing the fees charged for political risk cover and government guarantees. Hermes, the German provider of officially backed export credit subsidies, raised its rates in 1984 and again in 1985, and the British export credits guarantee department, facing a shortfall of several billion pounds sterling, raised them in 1985. The United States, however, has kept constant its charges for EXIM guarantees and insurance against political risks, and still does not even require any coinsurance.

To achieve further reductions in direct subsidies, the gentlemen's agreement would need a disciplinary mechanism to discourage derogations. At present, sanctions are confined to the specific transaction where a derogation occurs. In essence, the only risk a lender faces when contemplating a lower than consensus rate loan is that his derogating offer will be matched by other competitors. If he postpones the required announcement of the derogation long enough (a violation of the agreement), the competitors may not have an opportunity to counter the offer. Currently then, the only sanction is the ire of other signatories. This is a modest threat. It is not difficult to conceive of circumstances under which certain countries would find it in their interest to violate the agreement routinely. Improving the ability of the agreement to discipline violators and discourage derogators could substantially enhance its long term stability.

But the major threat must be the growth of subsidized exports by nonmembers. With increased pressure on the major debtor nations, such as Mexico and Brazil, to increase their hard currency export earnings, the share of export subsidies originating in nonmember countries is likely to grow sharply. The ability of the agreement to continue to restrain its members in face of such pressures is difficult to determine.

One of the specifically American concerns about export subsidies has been the treatment of the Communist Bloc. The Soviet Union and its allies expanded their imports and borrowings through the 1970s. From 1971 to 1980 Eastern Europe, including the Soviet Union, increased its officially backed hard currency foreign debt more than fivefold. In some markets, for example pipe and pipeline equipment, the Soviet Union has enjoyed considerable market power; and anecdotal evidence suggests that the Soviet importers have been able to use it.[1]

Because of its significant market power, the Soviet Union was able to demand, and usually obtain, very low interest rates on OECD export credits. The Soviet import bank simply refused to accept any credits with interest rates exceeding a specific limit.[2] In 1976 with the introduction of the three tier system of categorizing the borrowing countries according to their per capita income, the category limits were drawn so as to place the Soviet Union and its allies in categories II and III. The United States pushed for and in 1982 succeeded in obtaining a change in the category limits. That resulted in the Soviet Union being placed in category I, along with East Germany and Czechoslovakia. Although the transition did not go very smoothly, France having secretly signed a series of large long term accords with the Soviet Union at the old rates just before the effective date of the

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[1]See for example Gordon Crovitz, "Europe Pays for Its Pipe Dream," *The Wall Street Journal*, December 13, 1983.

[2]This is still the case today and has led to a practice of "cosmetic" interest rates whereby a lender agrees to an artificially low interest rate and then tries to recoup his losses through higher prices. It is, of course, impossible for outsiders to verify whether the subsidy on a cosmetic interest rate is indeed recovered through a price increase.

new rates, this reclassification must be considered a success for U.S. policy. It also demonstrated that the gentlemen's agreement has the potential of leading to significant reductions of subsidies in areas of particular concern to the United States.

Even if the lending governments apply the higher consensus rates, the Soviet Union and its allies are the beneficiaries of substantial export subsidies, especially indirect subsidies. An analysis of risk spreads applied in international lending reveals that communist countries are considered inherently more risky than comparable noncommunist countries and thus would have to pay higher risk surcharges if the exporting government would not assume the repayment risks.[3] The indirect subsidies imparted through government guarantees and officially backed insurance are therefore proportionately larger for communist countries than for noncommunist ones.

The gentlemen's agreement would be a useful mechanism for limiting these indirect subsidies by establishing standards for cover, coinsurance, and fees. The only rule currently in effect states that the amount covered cannot exceed the amount of the loan. A tightening of insurance terms would be in the interest of all signatories to the consensus. Given that the the agreement on minimum interest rates appears to be working, in spite of occasional difficulties, one has reason to hope that a parallel agreement on insurance terms could be similarly successful.

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[3]Kohler and Fisher (1983).

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