Will OECD Governments Avoid the Path Towards a New Credit War?

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Abstract

After 50 years of successfully avoiding a costly credit war, OECD governments find themselves back at a "race to the bottom" crossroad. Will OECD governments succeed in maintaining a level playing field? Or will the allure of promoting national interests in this new world order with new global political priorities, increasing competition and a complex globalized world lead governments to restart a race to the bottom and ultimately towards a new credit war? To avoid the path towards a credit war not seen since the 1970s, a renewed commitment is required. Securing a level playing field for OECD exporters and business should have high-level political priority. The OECD Arrangement for export credits is in need of modernization, but governments must also recognize that securing a level playing field in terms of government financing goes beyond export credits and export finance. Official government involvement in international finance can be trade distortive regardless of the primary purpose of financing. A whole-of-government approach to the provision of official international financing, regardless of whether the primary purpose of financing is exports, development or climate, is necessary if OECD governments wish to avoid starting down a costly and destructive path.

These are troubling, confusing and exhilarating times for a practitioner in the field of official export credit policy working for the interests of a small, open economy. The job description has hitherto been relatively simple: maintain a transparent, responsible and operational framework for the provision of public money and guarantees, promote free and fair cross border trade, and avoid crowding out the private financial sector. Times are *troubling* because a system that has functioned well and delivered as intended is at risk of disintegrating. It is *confusing* because 'threats' to the system come from multiple directions, including from within OECD governments, and it is difficult to know which path to follow. Nonetheless, it is also *exhilarating* because being at a crossroads means that we can choose a path that may deliver something better than what we had.

Diminishing US hegemony, increasing competition from China and the increasing number of global official export credit providers increase multipolarity and complexity. Institutional inertia arises when discussions touch upon the need for systemic change, and fragmentation is visible in the increasing number of institutions, public and private, dealing with international finance and global capital flows. The four signs of 'gridlock', multipolarity, complexity, institutional inertia and fragmentation (Hale and Held, 2017) have appeared gradually over the past few years. A race to the bottom in the use of public funds for national exports and interests should be in nobody's interest (Laurent, 2015) and it makes sense to deal with the changing balance of power and loss of the US as hegemon by working to modernize the existing export credit communities (Vassard, 2015). Unfortunately, however, this view is not reflected in higher level political interests. The interest in the OECD for maintaining and adapting the regulatory framework for export credits has weakened, and business involving international trade with government financing outside the regulatory framework is increasing together with a more strategic use of the export financing (WTO, 2018).

In other words, the path towards a new credit war is not as unlikely as one could hope. The contention of this article is that discussions within the existing framework on export credits alone are not enough to avoid OECD countries going down this path. OECD governments need to reconsider the basic pillars of the technical framework for financing of trade (export credits) and more importantly re-establish common ground on how to use official financing for different international policy purposes.

1. The re-emergence of the 'race to the bottom' crossroad

Official agencies providing loans and financial guarantees in support of trade i.e. export credits, have existed since the beginning of the last century. The international framework for export credits was, however, formed in a time of an oil crisis, a surge in global capital flows and unchecked public support for national exporters (Lubin, 2018; West, 2011). A common interest in controlling the use of public financing emerged in the OECD led by the US as the hegemonic power. The primary aim was avoiding unfair competition between exporters and nations but the wish to control capital flows added two distinct features of the export credit framework: (1) export credits should be 'lending of last resort'; and (2) access to foreign exchange through export credit financing of local expenditure should be restricted.

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The political mandate for the export credit framework has, therefore since the 1970s, been to achieve control of official financing, set restrictions and monitor transactions. Fast forward to 2019 and competition and trade wars are back on the agenda. Interestingly enough despite the fear of a trade war and the focus on competition from non-OECD countries, there is little *high-level* political focus in the OECD on avoiding unfair use of subsidies and distortion of markets. Instead we see *high-level* political interest in scaling up the use of official financing tools to mobilize financing for specific policy purposes with very little consideration of the consequences this may have on trade distortion and capital flows.

The key to the success of the OECD regulatory framework on export credits has been the continuous adaptation of the rules to global economic and financial changes and stakeholder interests (Drysdale, 2015). The OECD Arrangement on Officially Supported Export Credits (The Arrangement) has kept trade subsidies to a minimum (Horlick and Clarke, 2016); limited trade disputes and complaints bearing witness to this. Further, the export credit framework has been adapted to meet political and civil society demands to address sustainability and good governance issues as well as the latest global challenge of climate change.

The economic drive for achieving trade surpluses and growth after World War II ultimately led to the crossroad of the 1970s: implement disciplines or continue the race to the bottom. A similar scramble for economic global positioning is taking place today. In the 1970s, the US took the lead. Who, if anyone, will take the lead this time? And if non-OECD countries like China are not willing to participate in stopping the scramble, how should OECD countries react towards each other? The following will discuss the challenges facing export credit regulation and identify what lessons can be learnt.

2. Learning from the experience of export credit regulation

The challenges facing export credit regulation can be described in terms of four main forces: globalization, new global political priorities, modernizing development finance and increased global competition.

Globalization

Globalization has brought two major challenges to the existing export credit framework: (1) global supply chains; and (2) cross-border ownership. Traditional export credit regulation builds upon simple export transactions from a nationally owned company in country X (perhaps with some content/sub supply from country Y) to country Z, either as delivery of goods or built into a project. This simple structure is becoming rare both as regards sourcing as well as 'national ownership'. Further, as supply chains become more complex, technical solutions and interpretations within the existing boundaries have not always been possible, and the rules have had to be adapted.

Adaptation to the effects of globalization has been visible both at institutional level as well as in the OECD's regulatory framework. National ECAs (export credit agencies) have gone from requiring national content to national interest (from 'made in' to 'made by') and the OECD limitation on financing for local sourcing in the buyer country was loosened in 2007. Nonetheless business demands further changes if the OECD regulatory framework is to remain relevant (BIAC, 2018).

These discussions are difficult as they touch on the fundamentals of an export credit. Not only has the restriction on financing of local content been a fundamental and original part of the framework; if a transaction includes very little or no export, but mostly local sourcing, is the financing provided still an export credit? Or if we are dealing with exports, but the company exporting is not 'national' or the exports come from a subsidiary in another country, is this national? Is this exports? If we are no longer regulating the financing of national exports, what are we regulating? And more importantly, what should we be regulating to avoid trade distortion?

Lessons learned: globalization has complicated the definition of export and national interest and a new look on how to avoid trade distortion through the use of official financing instruments is needed. And to cater for complex supply chains and changing business models, the regulatory framework must be simpler, transparent and more flexible than the existing.

New global political priorities

The first wave of new political priorities, that of good governance, included consideration of environmental and social impact of the financing provided, protecting and respecting human rights, working against bribery and supporting the IMF and World Bank debt sustainability frameworks for low income countries. These issues were taken onboard with a backdrop of also having to achieve a level playing field. The negotiations on good governance, whether environmental due diligence or debt sustainability have included ECAs and export credit practitioners. Their involvement is what has made the export credit agreements on good governance work (Bonucci, 2011). While the mandates of ECAs may not be to promote the application of high environmental standards in international business, in reality that is what has happened thanks to focus on comparable implementation, and indeed official financing can distort markets but if done properly it can also contribute to setting standards of doing business.

Implementation of good governance has benefited from the strong culture of international cooperation to ensure fair trade. However, it must be recognized that this culture is fragile in the sense that it depends on strong technical cooperation and trust among ECAs and their export credit authorities. If the framework for levelling the playing field of

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financial support for exports and cross border activity in the OECD starts to crumble, competition will increase, trust will disappear and not only will the OECD level playing field be lost, all the work done on good governance in the provision of official financing for cross-border activity may be lost too.

In 2005 OECD governments catered to the increasing political focus on climate change by agreeing to adapt the export credit framework to allow for longer and flexible repayment terms for projects that mitigate climate change such as renewable energy. In 2012, this was expanded to include additional climate friendly technologies. The 2005 agreement was delivered 10 years before the political drive to deliver US$100 billion a year by 2020 in the 2015 Paris Accord. The primary driving for export credits was technical and bottom up from technological and market developments in the green energy sector. Renewable energy projects became financially viable and export-ready in a few countries, and the OECD Arrangement needed adapting to accommodate the new sector.

The high-level political interest in climate finance that emerges in 2013 exposed a systemic and structural challenge facing OECD governments as regards use and regulation of official financing. Discussions took a 'restriction' path and a 'mobilization' path. The restriction path delivered an OECD agreement restricting export credit finance for coal projects. The mobilization path delivered seven ideas on how export credit instruments could mobilize additional financing for climate finance. However, once presented at the Climate Finance Ministerial in Copenhagen in 2013 (EKF, 2014), the mobilization track for export credits never gained traction in international discussions.

It became clear that OECD governments face an obstacle in the structural and operational division applied to the two main disciplines of official financing: trade finance and international development finance. In practice ideas on mobilization fail in the export credit community as export credits policy authorities do not have political mandate to discuss mobilization of finance, and similarly trade concerns are ignored in the development finance community as their political mandate is mobilization, not control and restrict.

In most OECD countries, the official financing landscape is fragmented by many institutions with different mandates operating under different jurisdictions. Export credits falling mainly under the jurisdiction of Ministries of Finance, Business or Trade. Financing for Climate has been delegated to the jurisdictions dealing with Development Finance, mostly in the Ministries of Foreign Affairs. This is a problem when two systems begin to overlap and decisions are taken unilaterally without considering the effect on other parts of the system; and it is a problem if governments want to achieve both more mobilization of commercial financing, introduce a new range of political objectives for official financing and maintain a level playing field at the same time.

The next wave of political priorities is the high-level political push for financing the Sustainable Development Goals (SDGs). As the SDGs are so broad and basically touch upon all of the business supported by export credits (either negatively or positively), there is no specific technologically driven push to simultaneously secure both mobilization of extra financing and a level playing field as was achieved with renewable energy and climate technology in the export credit framework. SDG financing is pure policy financing, and unless the structural and systemic divide is handled this could easily lead to a trip down an unfortunate and costly path.

Lessons learned: involvement of technical financial experts in good governance agreements ensure comparable implementation; securing a level playing and good governance are mutually beneficial objectives; technical adaptation of agreements can lead to early delivery of political objectives; and delivering a level playing field in the use of official financing requires breaking down the systemic and structural silos in OECD countries.

Modernizing development finance

In 2012, OECD governments *recognized that the context for development cooperation has now irrevocably changed* (OECD, 2012) and the modernization of development assistance was launched. From a trade and sustainable finance perspective, the agreed changes to the statistical and conceptual structure of development finance, including the concept of commercial financing having a grant equivalent, poses a problem. The clear quantitative demarcation lines that existed between export credits and development financing have been removed with no consideration of the impact this may have on other financial flows such as export credits (Mudde, 2017).

With modernization of Official Development Assistance (ODA) OECD governments incentivize the use of officially supported commercial instruments such as loans and guarantees through national development banks. ECAs and development banks are thus both providing commercial financing in other countries. Both have good governance requirements to live up to and if the project involves cross-border trade or national business interests, the financial support given and the parties involved may be the same. With no common regulation on what these new commercial development finance instruments may be used for and no transaction-based transparency, there is nothing to prevent these instruments from potentially having a trade distorting effect.

Unfortunately, there is no consensus on how to avoid that development finance becomes a way to support national interests. In some cases, unregulated development finance through strengthened development banks is seemingly considered the only way to match Chinese competition, best exemplified in the new US BUILD act to strengthen development finance to gain 'influence in countries that might otherwise be a danger to US national security or commercial interest' (Gordon, 2018).

Lesson learned: with the removal of the qualitative demarcation line between aid and trade in the OECD a new consensus has to found on how also to deliver on a level playing field for trade.

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The force of increasing competition and the change in power balance

Increasing competition from China and other non-OECD exporting nations is the largest game changer for OECD export credit regulation. In 2012, the US succeeded in bringing China into talks on global export credit regulation in the International Working Group on Export Credits (IWG) with the aim of creating a new global agreement on export credits. However, the power imbalance where half of the members are committed to a common set of restrictive rules, while the others are not, plus a lack of common intent are proving to be major obstacles to reaching an agreement.

The hope of higher political pressure or that the economic risks of excessive public finance would become clear to China have not yet come to play. Why would China be interested in limiting its possibilities to provide public support when clearly the unlevel playing field is to its advantage? As to common intent, OECD countries come to the negotiating table with the export credit mindset of the 1970s, wanting to restrict official financing. The ambition of Chinese policy-makers is to place the state at the centre of capital markets and to 'reassert the value of policymakers discretion: to these inflows yes please; to those no thanks' (Lubin, 2018, p. 113).

While there are clear benefits in the IWG as a technical group that can keep discussions alive and 'combat multilateral dysfunction' (Klasen, 2017), with no incentive for China to change its approach, the onus is on the OECD countries to rethink their strategy.

Lessons learned: OECD countries are at a disadvantage with antiquated rules and a 'siloed' approach to official finance. However, losing the level playing among OECD countries will not help the power equilibrium. The OECD needs to regroup and take a whole of government approach to official financing. China already has.

Conclusions

To conclude, while OECD export credit authorities are hoping for success in the technical discussions with China, many OECD countries are also ramping up business outside the traditional, regulated export credit playing field, and the OECD has to make some choices as regards its regulation of official financing.

The export credit framework and the structures regulating trade finance and official finance for other purposes are no longer adequate but moving outside the framework is not the answer. OECD governments have successfully maintained the framework for official financing of trade for over 50 years and they have the policy and technical expertise to do so.

The overall political mandate to modernize and adapt the rules, systems and structures for official financing in the OECD is, however, lacking. Based on the challenges facing the export credit framework discussed above, a few recommendations can be made for the future:

First, broad government recognition that any government financing, regardless of purpose, institutional mandate and level of national content or interest may have a trade and market distorting effect. Supporting national exports is a political objective. Supporting development of other countries, combatting climate change or promoting sustainable development are also political objectives. The 'purpose of financing' does not change the underlying distortive potential of government financing of international activity.

Second, good governance and fair trade are mutually supportive. The combination of political will, stakeholder pressure and practical focus on fair trade, transparency and peer pressure can deliver both. Remove fair trade, however, and good governance may become nothing more than empty promises.

Third, OECD governments need to adopt a 'whole of government' approach to all official financing. The discussion of official international commercial financing for new political objectives should build on the experience of the OECD in securing the level playing field for trade and debt management. This is after all what the export credit community has successfully been mandated to manage and control for the past 50 years.

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