120389

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Unrealistic Use Of Loans To Support Foreign Military Sales

To finance foreign military sales, the United States has shifted from an on-budget grant and low-interest direct loan program to an off-budget high-interest loan program. This shift is not entirely realistic because

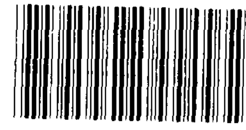
--off-budget loans do not show the total expenditure for foreign military assistance and require the United States to charge the recipient a high interest rate;

--some countries cannot afford the high interest charges associated with these off-budget loans;

--the Guaranty Reserve Fund used to guarantee these off-budget loans (financed through the Federal Financing Bank) is under-capitalized in relationship to the risks undertaken so that a future Congress may need to appropriate billions of dollars to fund a program authorized by a prior Congress; and

--loans only delay rather than resolve the question of how to fund military imports for less developed countries.

GAO recommends that the foreign military sales program be put on-budget; financing programs be tailored to the ability of countries to repay their loans; and the funding levels of the Guaranty Reserve Fund be commensurate with the size and nature of its contingent liability.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report analyzes whether security assistance programs are tailored to the ability of recipient countries to pay for their military imports. We found that, due to concerns over the size of the budget, the executive branch and the Congress are keeping as much of the program off-budget as possible. On-budget loans can be at flexible interest rates tailored to the countries' abilities to repay. However, the off-budget approach requires many countries to pay the same interest rate charged to the Treasury plus a fee to acquire the funds. But, many countries may not be able to afford these loans.

Because debt servicing problems have an effect on the political and economic stability of recipient countries, we believe the executive branch and the Congress should reconsider how they will finance military sales in the future. We believe that until foreign military sales financing arrangements are included in the budget, it may not be possible to design a program that is tailored to the ability of countries to repay their obligations.

We are also sending this report today to the Director, Office of Management and Budget; and to the Secretaries of State, Defense, and the Treasury.

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

UNREALISTIC USE OF LOANS TO
SUPPORT FOREIGN MILITARY SALES

DIGEST

Since 1975 the guaranteed loan program has financed more than $16 billion of military exports to some countries facing severe economic problems. These loans are not included in the Federal budget; rather they are made out of the Federal Financing Bank (FFB). Under this program, countries agree to pay the same interest rate charged the Treasury plus a fee to acquire the funds. This review was initiated because of congressional concern over the ability of security assistance program recipients to repay defense loans.

In some cases, it will be many years before recipient countries are affected by the full impact of the loan commitments because the principal payments are deferred during the first 10 years. Some of these countries are already experiencing extreme difficulties in making their required interest payments and have been granted relief through debt rescheduling. Other countries may soon follow with requests for debt relief. (See p. 10.)

GAO recognizes that program levels are based upon many foreign policy considerations and these levels are not assessed in this report. However, if these levels are maintained or increased, it is only realistic that some countries will need increased assistance in the form of grants or low-interest loans which will need to be added to the budget. (See pp. 6 and 19.)

FOREIGN MILITARY SALES (FMS) FINANCING PROGRAM: A PROBLEM FOR THE UNITED STATES

When a major recipient of FMS financing fails to meet its guaranteed loan obligations, it is a problem for the United States Guaranty Reserve Fund--a fund established by the Congress to cover late payments and reschedulings of interest and principal payments of guaranteed loans. The Fund

is not being funded with annual appropriations and its balance is not adequate to cover possible reschedulings by recipients of guaranteed loans. (See p. 7.)

The Congress appropriated 25 percent of the annual FMS guarantee program to capitalize the Fund until fiscal year 1975 when it reduced the required appropriations to 10 percent. In December 1980, the Congress eliminated the annual appropriations requirement. (See p. 8.)

With the balance of the Guaranty Reserve Fund falling from a 1980 high of $1.1 billion to a projected $860 million by the end of fiscal year 1983 and with additional defaults likely, the Fund is already over-extended. Although its balance is decreasing, the amount of guaranteed loans which the Fund is expected to cover is increasing to the point where the Fund's balance will be equal to only 4.6 percent of the $18.9 billion loans guaranteed by the end of 1983. (See p. 10.)

Additional factors increasing the probability of the Fund's need for replenishment appropriations include the

--concentration of guaranteed loans in a few high- and moderate-risk countries that may require several years of debt rescheduling.

--extension of maturity periods for guaranteed loans from 12 years to 30 years for some of the poorest FMS recipients which results in the accumulation of large outstanding principal balances, and

--doubling of interest rates between 1975 and 1982 on guaranteed loans which require large annual interest payments during principal repayment grace periods. (See p. 7.)

GAO believes that Congress should increase the funding of the Guaranty Reserve Fund. However, the precise level of additional funding will vary depending on the countries provided guarantees and the amount of these guarantees. If corrective actions are not taken now to provide increased funding for contingencies, other actions may be needed if FFB payments are due and neither the recipient country nor the Fund has the money to cover the payments. The

Congress would then need to appropriate funds to fulfill the Government's pledge to pay FFB if debtor countries fail to pay interest and principal payments on their FMS debts. The need to possibly reschedule billions of dollars of FMS guaranteed loans will have political, economic, and foreign policy repercussions for the United States as funds required for replenishment of the Guaranty Reserve Fund cut into future budgets. (See p. 16.)

In the past, the Congress and the administration have preferred the FFB guaranteed loan program because this program requires no new budget authority and does not show up in the Federal budget deficit. However, FFB receives all of its funds to make foreign military sales loans from the Department of Treasury. Therefore, there is no actual difference in terms of the level of Federal borrowing whether the program is a direct loan or an FFB guaranteed loan. Further, GAO has consistently opposed the use of off-budget loans by the FFB because this practice leads to an incomplete picture of Federal assistance. (See p. 15.)

FMS FINANCING PROGRAM: NOT RESPONSIVE TO SOME RECIPIENT COUNTRIES' ECONOMIES

In the case of the foreign military sales program, the use of guaranteed FFB loans also results in less flexibility in designing assistance programs tailored to the ability of recipient countries to repay their loans without damaging their development prospects. This is the result of the statutory requirement that FFB loans must charge the borrowing country the same interest rate charged the Treasury plus a small fee.

For example, the FMS financing programs for some large and small recipients do not reflect the recipients' capabilities to service their debts in the short-, medium-, and long-term. FFB interest rates of 13 to 16 percent on guaranteed loans to such countries as Sudan, Turkey, and Egypt are not realistic because these countries are likely to have extreme short- and medium-term debt service burdens. Sudan and Turkey, for the last several years, were unable to make required payments and are currently at different stages of International Monetary Fund (IMF)-supported austerity programs. Also Egypt continues to get very high levels of guaranteed loans despite its declining economy.
(See pp. 19 and 20.)

If more of the financing program were on-budget through low-interest direct loans, it would be more responsive to the economic situations of several countries. GAO believes that some of the FMS loan program should be shifted to an on-budget direct loan program as the administration has proposed. If this were done the following problems should be addressed:

--The proposed low-interest direct loans' 12-year maturity period instead of a 30-year maturity period as is the case for some guaranteed loans worked against the goal of softening the repayment burden on some recipients. Authority to make direct loans with maturities up to 30 years would require an amendment to section 23 of the Arms Export Control Act.

--The proposals lacked specifics on interest rates and grace periods. (See p. 21.)

If more of the program is placed on-budget, GAO believes components are available with which to design a more flexible and responsive FMS financing program. Mixed packages of direct loans--forgiven, low-interest, and at market rates--have been and could be designed to reflect the capabilities of recipients to repay their FMS debts on schedule. (See p. 24.)

AGENCY COMMENTS

The Department of State agrees that the ability of guaranteed loan recipients to repay these debts should be of major concern to the administration and the Congress. However, State believes the administration has been attentive to this need. Additionally, State believes the GAO view of the status of the Guaranty Reserve Fund is overly pessimistic. (See pp. 17 and 26.)

GAO believes this report shows that security assistance programs proposed by the administration for countries like Sudan, Turkey and Egypt are not tailored to the ability of these countries to repay their FMS obligations without damaging their development prospects. With respect to the assertion that GAO is overly pessimistic concerning the Guaranty Reserve Fund, GAO believes that the economic uncertainty facing

major recipients of guaranteed loans increases the risk that the Fund's balance could be insufficient to cover a rescheduling in the future. (See pp. 17 and 26.)

The Departments of Defense and Treasury did not provide comments. (See p. 18.)

RECOMMENDATIONS TO THE CONGRESS

GAO recommends that the Congress:

--Place the entire FMS program on-budget in the International Affairs account to reflect the true budgetary costs and eliminate the present incentive to make loans through the guaranteed loan approach which requires a high-interest charge. This would also allow for a more flexible security assistance program that recognizes the potential financial burden placed on the economies of developing countries by military equipment imports. To develop a flexible program, the Congress should require the administration to provide specifics on interest rates and maturities when the program is submitted to the Congress. (See pp. 18 and 27.)

--Provide funds for the Guaranty Reserve Fund that establishes funding levels based on the nature and size of the current contingent liability covered by the fund. One way to increase the balance of the fund is to allow interest earned as well as the principal repayments on rescheduled loans to be deposited in the Fund. If the program remains off-budget, the level of the Fund's balance should increase to cover future loans. (See p. 18.)

--Amend the Arms Export Control Act to allow for low-interest loans to have maturities up to 30 years for those countries facing short and medium term economic problems. (See p. 27.)

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ABBREVIATIONS

AID Agency for International Development
DSAA Defense Security Assistance Agency
FFB Federal Financing Bank
FMS Foreign Military Sales
GAO General Accounting Office
IMF International Monetary Fund
MAP Military Assistance Program
DOD Department of Defense

CHAPTER 1

INTRODUCTION

To assist selected Foreign Military Sales (FMS) recipient countries finance their U.S. arms purchases in fiscal years 1982 and 1983, the executive branch proposed that a portion of its FMS financing package be low-interest rate loans geared to the recipients' ability to repay. Primarily, this proposal is based on two factors. First, the administration concluded that due to the worldwide economic downturn, few countries could afford to finance the procurement of defense equipment at commercial or Federal Financing Bank (FFB) interest rates.1/ Second, the administration wanted to be able to offer some form of compensation during negotiations for base rights and facility access agreements in areas strategically critical to U.S. defense needs.

There are three methods available for qualified countries to obtain military exports from the United States when they are unable to pay cash. These are grants under the Military Assistance Program (MAP), direct U.S. Government loans with maturities up to 12 years, and federally guaranteed loans. Since 1975, all guaranteed loans have been financed through FFB. Direct loans for some countries may be forgiven (no principal or interest payments collected, similar to a grant) or may be low-interest loans. Guarantees may cover loans with maturities up to 12-year or 30-year maturities with specific statutory authorization.

An overriding consideration in the decision as to which financing method is used is its impact on the U.S. Government budget. Does it require new budget authority? Guarantees for foreign military loans require no new budget authority and now require no annual appropriations for the Guaranty Reserve Fund. All other ways to pay for the equipment require dollar for dollar appropriations and will increase the size of the budget.

It is important to recognize that FFB guaranteed loans are the same as a direct government loans but have an interest rate equal to the Treasury borrowing rate plus a small fee. In this regard, the FFB receives all of its borrowing from the Department of Treasury. Accordingly, the Federal Government's borrowing requirements do not change when the FFB guaranteed loan approach is used as a substitute for a direct loan. In both cases, the Department of Treasury remains the source of the funds. The exercise of going through the guaranteed loan approach only serves to remove this program from the official budget deficit totals and allows the administrations to avoid going through the appropriations committees.

1/The Federal Financing Bank was created in 1973 to function as a financial go-between, purchasing the different kinds of debt and guaranteed obligations of Federal agencies and private borrowers and substituting its own borrowing for that of the agencies.

In summary, the problem between U.S. budgetary and recipient financial needs creates a dilemma for the United States in foreign military sales. To lighten the recipients' financial burden for defense imports, grants and forgiven loans followed by low-interest direct loans are preferred over guarantees. On the other hand, to hold down the size of the budget authority, guarantees are preferred over all other forms of financing.

The administration's fiscal year 1982 proposal for FMS financing included $500 million in forgiven loans, $1 billion in guarantees with maturities up to 12 years, $1.5 billion in guarantees with extended 30-year maturities, and $981.8 million in low-interest direct loans. The administration also mixed the forms of assistance in developing country programs. Israel was to receive forgiven loans and extended guarantees; Turkey and Egypt were to receive extended guarantees and low-interest direct loans; five recipients were to receive only low-interest direct loans; seven recipients were to receive guarantees and low-interest direct loans; and 24 recipients were to receive only guarantees.

The Congress rejected the administration's 1982 proposal for low-interest direct loans but not the premise that countries could not afford regular guaranteed loans. The Congress approved an alternative consisting of a mix of grant aid and guarantees. This alternative shifted some of the proposed direct on-budget low-interest loans to off-budget guarantees. The shift resulted in the administration's allocation of funds as can be seen in the chart below.

ORIGINAL FISCAL YEAR 1982 PROPOSED AND APPROVED SECURITY ASSISTANCE PROGRAM FOR SELECTED COUNTRIES

(000,000 omitted)

	Original Proposed By Administration				Approved Security Assistance Program			
Country	(On-budget) Grants/forgiven	(On-budget) Low interest	(Off-budget) Guarantees	Total	(On-budget) Grants/forgiven	Low interest	(Off-budget) Guarantees	Total
Thailand		$ 50	$ 30	$ 80	$ 4.5	0	$ 62.5	$ 67
Egypt		400	500	900	200 a/	"	700	900
Israel	$500 a/		900	1,400	550 a/	"	850	1,400
Yemen		10	5	15	1	"	10	11
Portugal		50	10	60	10	"	45	55
Turkey		250	150	400	57	"	343	400
Kenya		51		51	10	"	22	32
Liberia		12.3		12.3	5	"	7	12
Somalia		20		20	10	"	10	20
Sudan		100		100	25	"	75	100
Zaire		7.5	3	10.5	3	"	7.5	10.5
Dominican Republic		4	3	7	1	"	4	5
El Salvador		17	8	25	8.5	"	16.5	25
Honduras		4.5	5.5	10	1	"	9	10
Jamaica		1		1	1	"	1	2
Eastern Caribbean b/		4.5	1	5.5	1	"	4.6	5.6
Total	$500	$981.8	$1,615.5	$3,097.3	$888	0	$2,167.1	$3,055.1

a/These are forgiven credits.

b/Eligible countries in the Eastern Caribbean are Antigua, Barbados, Barbuda, Dominica, Montserrat, St. Kitts-Nevis, St. Lucia, St. Vincent, and the Grenadines. In this report we have counted the Eastern Caribbean as a single recipient.

The overall budgetary impact for the 16 recipient programs was to reduce budget authority by $593.8 million. This figure is the difference between the proposed low-interest loans and forgiven loans ($981.8 million and $500 million respectively) and the approved forgiven and grant aid combined ($888 million). The Congress expressly delineated $750 million forgiven credits for Israel and Egypt. The Congress did not, however, allocate the grant aid. The final allocations were made by the administration and then reported to the Congress.

The Congress also authorized $917 million for the 25 countries receiving only guarantees. These countries, not included in the above schedule, presumably can afford the high FFB interest rates better than the 16 recipients listed. The larger recipients of only guaranteed loans include Korea ($166 million), the Philippines ($50 million), Tunisia ($85 million), Greece ($280 million), and Spain ($125 million).

The administration's original fiscal year 1983 FMS financing proposal includes $789 million in direct low-interest loans, $950 million in forgiven loans, and $3,928.8 million in guaranteed loans.1/ For example, changes made in six FMS financing programs from the fiscal year 1982 program (not including changes resulting from supplemental appropriations)2/ would be as follows:

--Egypt's total program would increase by $400 million to $1.3 billion. Of that amount, forgiven loans would rise from $200 to $400 million and guaranteed loans would rise from $700 million to $900 million.

--Israel's total program would increase by $300 million. Forgiven loans would decline from $550 million to $500 million and guaranteed loans would rise from $850 million to $1.2 billion.

--Sudan's total program would remain at the $100 million level but program content would change to $100 million direct loans with half forgiven.

--Turkey's total program would increase by $65 million to $465 million. Guaranteed loans would decline

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1/The fiscal year 1983 program had not been approved as of November 1982. The program operated under a continuing resolution that was scheduled to expire December 17, 1982.

2/The fiscal year 1982 assistance supplemental appropriations, which included $25 million in reprogramming funds, added $52 million in grants to the following countries: Honduras ($10 million), Costa Rica ($2 million), Portugal ($10 million), Somalia ($5 million) and Sudan ($25 million).

from $343 million to $165 million and $300 million in direct loans would be offered instead of $57 million in grants.

--Portugal's total program would increase by $35 million to $90 million. Guaranteed loans would decline from $45 million to $15 million and $75 million in direct loans would replace $10 million in grants.

--Thailand's total program would increase by $24 million to $91 million. Guaranteed loans would decline from $62.5 million to $41 million and $50 million in direct loans would replace $4.5 million in grants.

BUDGETARY CONSIDERATIONS

If the Congress approves the administration's fiscal year 1983 request, it will have authorized since 1975 guaranteed loans totaling $21.6 billion. These guaranteed loans do not require new budget authority. However, the resulting long-term budget implications are hidden.

An important long-term implication is the proper funding level of the Guaranty Reserve Fund. This Fund is the only mechanism available short of an act of Congress to honor the Government FMS guarantees if a country defaults or has its debt rescheduled.

Prior to December 16, 1980, the Guaranty Reserve Fund was capitalized in proportion to its authorized loans as required by the Arms Export Control Act. The Congress, before fiscal year 1975, appropriated funds equal to 25 percent of the Fund's authorized loans; for fiscal years 1975 to 1979, 10 percent of the authorized loans was appropriated. If a country did not make a required payment, the Fund would pay the lender the interest and principal due. The country would then owe the payment to the Department of Defense (DOD) which would deposit the interest and rescheduled payments into the miscellaneous receipts of the U.S. Treasury when received.

After December 16, 1980, requirements under the Act were changed to make the Fund a revolving fund. Thus, the Fund's balance no longer bears a relationship to its contingent liability, and is no longer supported by annual appropriations. Instead, rescheduled payments from foreign governments are made to the Fund. Interest earned on these rescheduled payments continues to be deposited into the miscellaneous receipts of the U.S. Treasury.

The Act, however, provides a trigger mechanism so that if the Fund's balance falls below $750 million, the President must report this decline to the Congress along with possible recommendations for authorization for replenishment appropriations. On September 30, 1980, the closing balance of the Fund stood at $1,170 million. Chapter 2 discusses these short- and long-term

budgetary factors and whether the Guaranty Reserve Fund is adequately capitalized to cover likely claims arising from borrower defaults and loan reschedulings.

OBJECTIVE, SCOPE, AND METHODOLOGY

The central factor addressed in this report is the ability of guarantee recipients to repay their FMS loans under the current program. There is, however, no single or group of economic indicators which can be used to accurately predict ability to handle debt service obligations. Although there are problems associated with all forms of debt service analysis, most economists agree that an evaluation of a country's current external and internal economic trends and policies yields the best results for interpreting a country's economic position. Long-term projections, by nature, are more prone to change than short- to medium-term projections because of the changing conditions both within and outside the studied country. In an interdependent world, for example, all countries can be affected by war and instability in their region, fluctuating petroleum prices can change economic forecasts for producers and buyers, and world-wide recession can dampen demand for the exports of the developing countries.

Another problem with projecting a country's ability to service its debts is the general reluctance to conclude that a particular country may need debt relief in the future. The fear is that this prediction may lead to a self-fulfilling prophesy. People who make these projections hope that countries can change the direction of their faltering economies. This hope exists even for countries undergoing debt rescheduling or negotiating debt relief.

Despite these limitations, this report is generally based on studies of 6 of the 16 recipients included in the administration's original fiscal year 1982 FMS direct credit proposal. The countries studied were Israel, Egypt, Turkey, Portugal, Sudan, and Thailand. They were selected because of the wide variation in their economic conditions. The specific factors considered in our country selections include the size of the FMS program already authorized for these countries, per capita income levels, and default and rescheduling records.

We reviewed the ability of the six countries to service their FMS debts. The bulk of the statistical information was taken from published reports of the World Bank and the International Monetary Fund (IMF). Our observations on the financial outlook for these countries paralleled the views of assessments made by the Agency for International Development (AID), the Central Intelligence Agency, and the Departments of State and the Treasury.

The results of these studies were reviewed by country desk officers from AID, State, and Treasury. In addition, offices having responsibility for program content and policy decisions

from these agencies as well as the Defense Security Assistance Agency (DSAA) were given an opportunity to comment on our results. We have considered these comments in preparing this report.

We recognize that, in addition to a country's own political and military needs, U.S. political interests are also considered in determining the size and types of FMS assistance given. However, we have not addressed U.S. political and military interests nor the levels of the program. Such an analysis, we believe, would be beyond the scope of our review and not necessary to address the basic question as to what methods could best be used by the Congress to provide financing for the FMS program. Our review was performed between August 1981 and August 1982 in accordance with generally accepted government auditing standards.

CHAPTER 2

FOREIGN MILITARY SALES FINANCING:

A PROBLEM FOR THE UNITED STATES

The large growth rate of federally guaranteed FMS loans, particularly to some high-risk countries, has jeopardized the Guaranty Reserve Fund so that the present or future Congress may need to appropriate money to support the Fund. Although the Fund was established to cover delinquent FMS payments, it is not at a level adequate to cover potential claims given the changing size and nature of its contingent liability.

The Guaranty Reserve Fund is under-capitalized because of the

--cessation of a relationship between the Fund's balance and its contingent liability,

--increased amount of guaranteed loans authorized for high-risk countries,

--use of extended loan maturities for some high-risk countries, and

--high interest rates which, by law, must be charged on FFB loans.

Now, if a major FMS guaranteed loan recipient cannot make payments to the FFB that exceed the balance of the Fund, the Congress will need to appropriate funds to fulfill the U.S. Government's promise to guarantee payment. 1/ This situation could have been avoided if these factors could have been foreseen prior to the 1980 changes to the Fund.

Also, the $750 million trigger mechanism does not provide sufficient warning to the Congress because the Fund may not cover a rescheduling by a major recipient. For example just one country, Egypt, has $2.8 billion in loans guaranteed by the Fund.

FUND'S BALANCE NO LONGER TIED TO ITS LIABILITY

In December 1980, the Congress changed the Fund from one in which the Congress kept the Fund's balance proportional to its contingent liability to a revolving fund, which in theory should

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1/We did not consider an alternative that would involve FFB sustaining the loss through additional borrowing or by passing on the loss to the U.S. Treasury by non-payment of its obligation to Treasury.

be self-supporting. Before December 1980, the Fund's balance was kept at 10 percent of its authorized loans through annual appropriations--25 percent prior to 1975. This approach allowed the Fund's balance to rise proportionately to its liability. For example, in December 1980, the amount of authorized FMS guaranteed loans was $12.27 billion and the Fund's balance was $1.12 billion.

The revolving fund was to be maintained by FMS recipients' defaulted payments for which the Fund paid the FFB. In addition to the Fund's $1.12 billion balance, repayment of DOD loans totaling $158 million, which had been owed to DOD on pre-1981 rescheduled and defaulted payments, will now be made to the Fund. Thus the Fund's total assets in December 1980 were approximately $1.3 billion. The Fund does not retain interest earned on defaulted or rescheduled payments which, instead, is transferred to Treasury's miscellaneous receipts. Hence, the maximum level of the revolving fund would be nearly $1.3 billion unless the Congress decided to increase it.

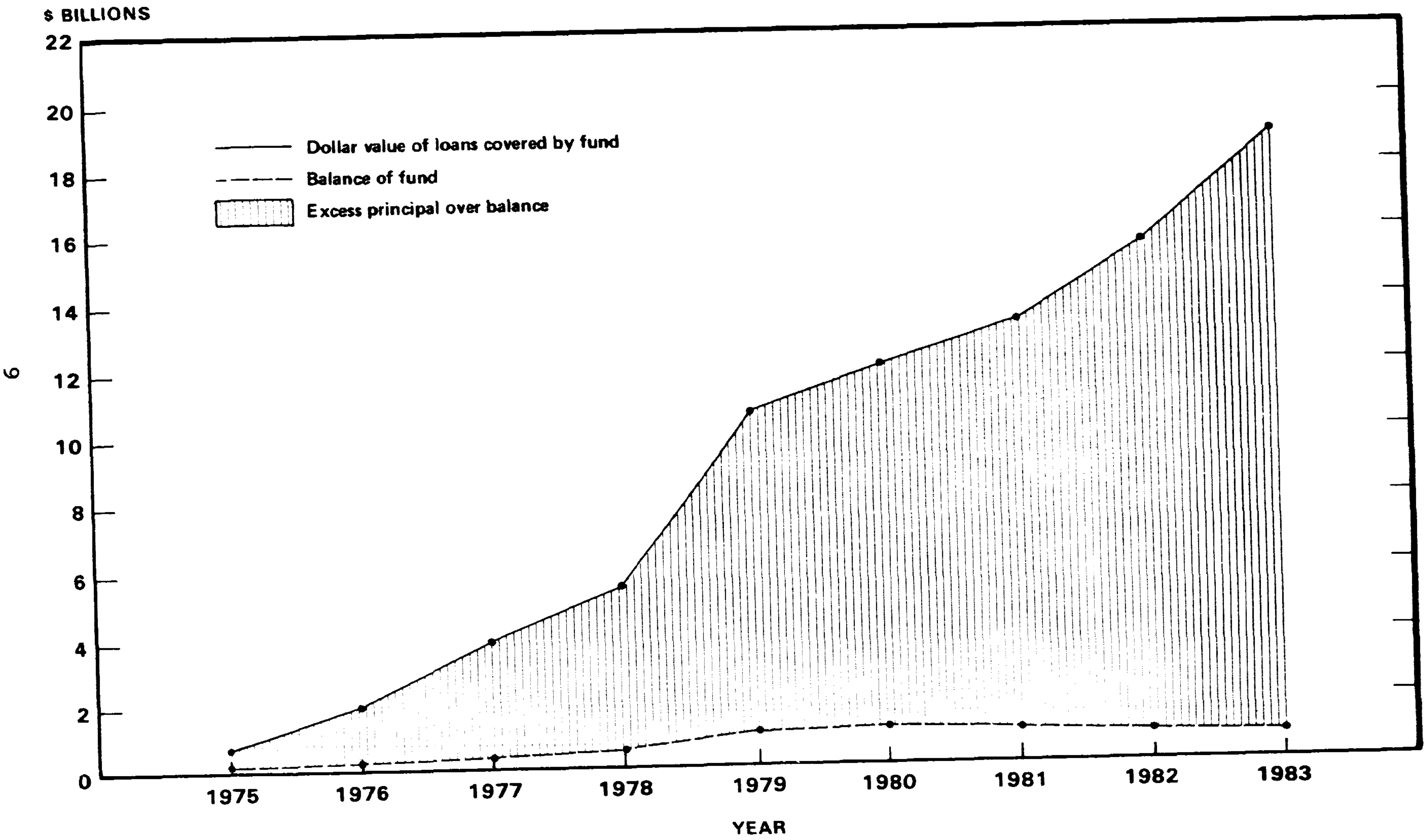
Prior to December 1980, very limited debt rescheduling of guaranteed loan payments had taken place. From the time the Fund became a revolving fund to the end of fiscal year 1983, the amount of authorized loans is expected to grow from $12.3 billion to $18.9 billion, but the balance of the Fund available to make payments on defaulted loans (which will be referred to in this report as liquid balance) is expected to fall from $1.12 billion to $860 million (see chart I). 1/ The major reason for the projected $260 million decline in the liquid balance is due to the Fund's payments to cover debt rescheduling of FMS guarantees by Peru, Turkey, and Liberia.

Our concern about the Fund's instability is money that has and potentially will be flowing out of the Fund compared to the limited inflows for replenishment. Repayments during the next several years will not significantly increase the Fund's liquid balance. For example, the terms of the $468 million of Turkish rescheduled loans provide for final payment to be made after 1992. Grace periods on these rescheduled payments range from 3 to 5 years so that few, if any, payments will be made to replenish the Fund by 1983. If Turkey is used as an example for the other countries in debt to the Fund, some of these outstanding rescheduled loans may be rescheduled a second time, further delaying replenishment of the Fund's balance.

1/The amount of authorized loans outstanding shows only part of the potential claims against the Fund. Interest payments are also guaranteed and for many countries, interest, not principal, is the major portion of the contingent liability covered by the Fund.

CHART I

GUARANTY RESERVE FUND'S PRINCIPAL LIABILITY 1975-1983



As chart I clearly demonstrates, the cumulative contingent liability (for principal only and without the very substantial amount due in interest payments) has risen significantly compared to the Fund's balance. The ratio is projected to drop to 4.6 percent in 1983 as opposed to the required 10-percent ratio before 1980. If the 10-percent ratio was still required, $750 million in new appropriations would be required to reach the 10 percent balance. (See app. I.)

INCREASED LOANS FOR MODERATE- TO HIGH-RISK COUNTRIES

Another way of looking at the changing nature of the Fund's contingent liability is to review the countries with payments covered by the Fund. Since 1980, the Fund has increased its coverage to 13 of 17 countries which have either defaulted on FMS guaranteed loans or had their non-military debts rescheduled or both. 1/ Newly authorized loans to these countries covered by the Fund from 1976 to 1979 totaled $1,185.1 million. However, newly authorized loans to these countries from 1980 to 1983, which have demonstrated financial problems, may increase to as much as $2,204.4 million. A comparison of authorized FMS guaranteed loan programs to these countries from fiscal years 1976 to 1979 with FMS guaranteed loan programs for fiscal years 1980 to 1983 is provided in appendices II and III.

The following summarizes the risk of potential rescheduling by Turkey, Egypt and Israel, the three largest guaranteed loan recipients which the Fund would have to cover. If these countries fall behind in making payments, the Fund's revolving nature could be jeopardized.

Turkey

Turkey has not paid FMS financing obligations since 1978, having already undergone four reschedulings of more than $400 million in FMS loan obligations owed to the United States. Since 1973, Turkey's balance of payments position has deteriorated to a point where the country is suffering severe cash flow problems. Export growth had been particularly weak, growing at an average rate of 1.5 percent during the 1975 to 1980 period. Turkey's total debt burden reached $17.8 billion in 1980 due to the rapid buildup of short-term borrowing to finance large current account

1/These countries are Bolivia, Costa Rica, El Salvador, Indonesia, Jamaica, Lebanon, Liberia, Morocco, Nicaragua, Pakistan, Peru, the Philippines, Senegal, Sudan, Tunisia, Turkey, and Zaire.

deficits. 1/ As a result, debt service ratios reached 46 percent in 1979 and 76 percent in 1980, before declining to an estimated 23 percent in 1981 because of rescheduling. 2/

Despite improvements made through a series of economic stabilization plans during 1978 to 1980, the economic outlook is uncertain. Reschedulings have considerably reduced Turkey's debt burden and enabled Turkey to postpone making principal and interest payments on the debt owed to the United States between 1978 and 1983. However, after 1983, Turkey's debt service payments will climb due to the bunching of rescheduled payments and new debt obligations. According to U.S. officials, Turkey will probably continue to have difficulties making payments after the rescheduling periods. One unknown factor is what will happen to Turkey's economy once civilian government returns.

Egypt

If its domestic economic problems are not resolved through reforms, Egypt will probably experience serious debt service problems which may require rescheduling of its FMS loan obligations sometime in the future. In 1983, Egypt's military debt service payments on its $2.8 billion in guaranteed loans are projected to reach 65 percent of its $318 million debt service to the United States. With the approval of $900 million of proposed guaranteed loans in 1983, Egypt's interest payments on defense loans may reach $500 million annually by 1985. In effect, the adequacy of the Guaranty Reserve Fund's balance might depend on Egypt's successful implementation of economic reforms, because a potential rescheduling on just 1 year's FMS payment owed by Egypt would endanger the Guaranty Reserve Fund's balance.

Between 1975 and 1980, because of domestic opposition and government reluctance to make changes, Egypt missed an opportunity to reduce government subsidies, increase taxes, devalue the Egyptian pound, and control consumer demands. During this period, Egypt's foreign exchange earnings increased dramatically because of increased petroleum exports, Egyptians working outside of Egypt sending back earnings, tourism, and Suez Canal earnings. These economic improvements, however, were short-lived.

U.S. Government officials believe that unless Egypt can successfully reduce consumer demands or find additional ways to earn foreign exchange, it is likely to fall into a deep debt servicing

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1/Current account balance is the difference between (1) exports of goods and services plus inflows of unrequited official and private transfers and (2) imports of goods and services plus unrequited transfers to the rest of the world.

2/Debt service ratio is the percentage of principal and interest payments to exports. The debt service ratio is a common indicator used to measure a country's debt burden.

problem. Reducing consumer demands means reducing food and energy subsidies, increasing taxes, and devaluing the Egyptian pound. Past efforts to bring about these reforms have resulted in protests and public disorders. In 1981, the current account deficit increased significantly forcing Egypt to use its international reserves to finance this deficit.

Israel

For the next several years, Israel appears likely to be able to repay its FMS obligations (mostly interest) but could encounter debt servicing problems when it also begins to pay large principal payments after the expiration of its grace periods. Principal payments will continue to mount as the grace period for each succeeding year's program expires. In 1983, Israel's FMS debt is projected to be 84 percent of its total debt to the United States. The sheer size of Israel's FMS guaranteed payments (over $900 million annually) combined with factors affecting its balance of payments prospects could alter Israel's ability to service its debts. Such factors were identified by AID in its 1982 report on Israel's economy and debt repayment prospects as

--the price of imported energy,

--economic conditions in the countries with which Israel trades,

--political and military developments in the Middle East and their impact on Israel's defense spending, and

--the rate and pattern of growth in the Israeli economy.

USE OF EXTENDED MATURITIES FOR GUARANTEED LOANS

In addition to its increased coverage of moderate- to high-risk countries, the inadequacy of the Fund's capitalization level is further compounded by extended maturity terms for some high-risk countries. Israel was the first country to be given extended repayment terms followed, from 1979 to 1982, by Egypt, Turkey, Sudan, Somalia, and Greece. These countries pay less on an annual basis because their principal loan repayment terms have been extended from 12 to 30 years. After the grace period, annual principal payments on extended loans are only 5 percent of the total debt obligation compared to 10 percent on 12-year loans. 1/

The problem with this approach is that principal payments are not made until the eleventh year and countries will likely accumulate new and larger debts without having retired any principal on their earlier loans.

1/We used a 10-year grace period for extended loans and a 2-year grace period for 12-year loans.

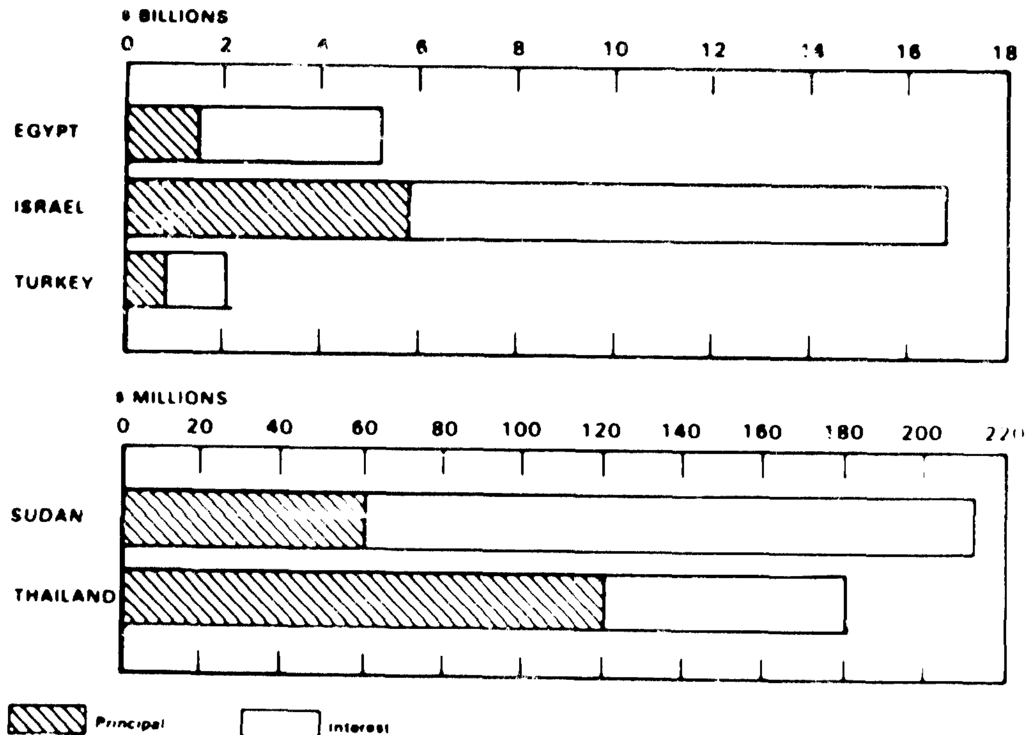
Egypt's situation illustrates the potential build-up of loans during the grace period. In 1979, Egypt received a $1.5 billion loan in accordance with the Camp David Accords. Although Egypt was not authorized any new military loans in 1980, it did receive $550 million in 1981, $700 million in 1982, and may receive $900 million in 1983. Assuming the levels of newly authorized loans are kept at $900 million annually, in 1989--the time the 1979 grace period expires--Egypt's FMS guaranteed loans may total $9 billion.

HIGH INTEREST RATES ALSO RAISES FUND'S LIABILITY

An additional problem for the Fund is the high interest rates that must be charged for guarantees. By law, FFB interest rates must be the Treasury borrowing rate plus a nominal administrative fee. Since 1981 interest rates have ranged between 13 to 16 percent. This high-level of interest is particularly burdensome for some of the countries getting extended maturities. Chart II shows the importance of interest payments in terms of the Fund's contingent liability. Interest will be 71 percent, 65 percent. 55 percent, and 72 percent of Egypt's, Israel's, Turkey's, and Sudan's total payments respectively on their loans covered by the Fund, much of which is on extended terms. In contrast, interest will only be 33 percent of Thailand's total payments on its 12-year loans.

CHART II

CONTINGENT LIABILITY OF VARIOUS RECIPIENTS' FFB GUARANTEED LOANS (as of fiscal year 1980)



At 13.5-percent interest rates, these extended maturities require a country to pay $2.50 in interest for every $1 of principal disbursed over the life of the loan. This means that, using the same assumptions used above to project Egypt's principal liability, Egypt's interest payments over the life of the authorized loans through fiscal year 1988 will total $22.6 billion. In other words, the Fund's total contingent liability for Egypt alone, may reach $31.6 billion. In terms of annual payments, Egypt's interest payments would be $1.2 billion assuming an average interest rate of 13.5 percent or $900 million if the average interest rate should fall to 10 percent.

TRIGGER MECHANISM INADEQUATE

The trigger mechanism created to recapitalize the Fund if it is drawn down below $750 million provides the Congress with insufficient warning about the danger to the Fund regarding potential defaults by major recipients. It would be adequate only if the Fund had to make payments to the FFB for its smaller liabilities, such as Peru and Liberia, countries which have already had reschedulings of their debt to official creditors. In this case the Fund's balance would only gradually be drawn down and the $750 million trigger would probably be adequate.

On the other hand, if a major recipient were to default in the next several years, the impact on the Fund would be more serious. These countries will be accumulating more debts annually and each year's payments will be increased. Thus any debt rescheduling exercise for major recipients could lead to diminishing the Fund balance. As previously shown, a country's interest payments under certain assumptions could reach $1.2 billion by fiscal year 1989.

The $750 million trigger might have been appropriate in 1980, but it is now too low to cover the rising payments due to the FFB. In fiscal year 1980, when the trigger mechanism was fixed at $750 million, DOD's Congressional Presentation Document projected the highest Israeli interest and principal payment of $451 million in fiscal year 1982; the same document projected no Egyptian interest and principal payments.1/

The fiscal year 1983 Congressional Presentation Document, however, based on loans approved through September 1981, showed Israeli loan repayments ranging from $714 million to $900 million between fiscal years 1982 and 1991 and Egyptian payments ranging from $287 million to $358 million. Israel and Egypt received $850 million and $700 million, respectively, for FMS guaranteed loans in fiscal year 1982. And, with proposals of $1.2 billion

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1/From fiscal years 1981 to 1983 (1983 based on proposed programs), Israel and Egypt were the recipients of more than half of all FMS guaranteed loans.

and $900 million for Israel and Egypt for fiscal year 1983, respectively, the 1991 payments will increase substantially. Therefore, not only could the Fund fall below $750 million if one of these later payments is not made, it could also become insolvent. We believe for the trigger mechanism to be effective, at a minimum, it should reflect the value of the contingent liability covered by the Fund.

GUARANTEED FMS TRANSACTIONS VIA FFB NOT ADEQUATELY SCRUTINIZED

FMS guaranteed loans are made by the FFB. Under existing law, FFB is authorized to purchase loans guaranteed by Federal agencies (12 U.S.C. 2285), in this case, DOD. Under usual budget concepts, the disbursement of funds by the Federal Government (FFB is a Federal entity) to a private individual or firm is a Federal budget outlay. However, the transactions by FFB of this sort are excluded from the budget totals by law (12 U.S.C. 2290). Thus, these transactions escape the discipline of the budget process. Taken together, however, these transactions--the DOD guarantee plus the FFB purchase--amount to a direct loan. In addition, the FFB receives all of its funds for foreign military sales loans from the Department of Treasury. Therefore, this guarantee program is one in name only because the Federal Government is not guaranteeing a loan made by a private institution but is only guaranteeing a loan made by another Federal entity.

There is little dispute that direct loans should logically be reflected in the budget totals. However, the special budget treatment accorded to FFB loans having DOD guarantees creates a situation in which it is possible to make direct loans without ever going through the normal discipline of the budget process--a discipline which is applicable to most proposals to spend the taxpayer's money.

This anomaly is inconsistent with sound budgetary principles. We believe FFB should not engage in transactions of this sort so long as its activities are not fully reflected in the budget.

In an earlier report to the Congress 1/, we recommended that FFB receipts and disbursements be included in the Federal budget totals. This report concluded that off-budget FFB transactions combined with questionable budget practices produced an inadequate and incomplete picture of Federal credit assistance and outlays. In addition, this report stated that unwarranted growth of off-budget guarantees provided the potential for a poorly designed assistance program because there was a potential for increased use of full guarantees where partial guarantees or more direct forms of Federal assistance are more appropriate.

1/"Government Agency Transactions With the Federal Financing Bank Should Be Included On the Budget" (PAD-77-70, Aug. 3, 1977).

Continuing in this vein, we believe the FMS guaranteed loan program is not getting the necessary administration and congressional scrutiny it deserves. Off-budget loans do not get reviewed as attentively as on-budget grant aid and direct loans. The 1983 proposal to offer guaranteed loans to Pakistan is a case in point. Pakistan, a country which has undergone numerous reschedulings, is to receive a larger FMS guaranteed loan program than that being provided to some proposed direct-loan recipients which are economically stronger. An implication of this proposal is to use guaranteed loans in the first year of a new military relationship to improve the chance of getting the package through the Congress. If Pakistan is unable to make the required payments, the payments will actually be financed through the Guaranty Reserve Fund and will become a direct loan owed to the Fund.

CONCLUSION

If corrective actions are not taken now to provide increased funding for contingencies, other actions may be needed if FFB payments are due and neither the recipient country nor the Fund has the money to cover the payments. The Congress would then need to appropriate funds to fulfill the Government's pledge to pay FFB if debtor countries fail to pay interest and principal payments on their FMS debts. 1/ The need to possibly reschedule billions of dollars of FMS guaranteed loans will have political, economic, and foreign policy repercussions for the United States as funds required for replenishment of the Guaranty Reserve Fund cut into future budgets.

We believe that sound budgetary principles would place the entire FMS financing program on-budget. If FFB loans and hence FMS guaranteed loans were placed on-budget, there would be no need for the Guaranty Reserve Fund because there would be no guarantees. If a country could not meet its scheduled payments, a rescheduling of the loan would not require a new appropriation.

Alternatively, action could be taken to develop a guaranteed loan program which would bring the Guaranty Reserve Fund's balance in line with the size and nature of its contingent liability. The way to accomplish this depends on whether the Fund's balance is to be based on the revolving fund concept or on a set percentage of the authorized loans outstanding at the end of each fiscal year. In any event, the Fund will have to be increased just to cover its current liabilities.

1/We did not consider an alternative that would involve FFB sustaining the loss through additional borrowing or by passing on the loss to the U.S. Treasury by non-payment of its obligation to Treasury.

If the Fund remains as a revolving fund, the trigger mechanism to replenish the Fund needs to be flexible, i.e., increased as the obligations of the major recipients are increased. If the revolving fund concept is used, we believe the revolving fund should retain all interest earned on defaulted and rescheduled payments in keeping with its revolving nature. If a fixed percentage of the outstanding balance of guaranteed loans is used to govern the Fund's balance, the percentage selected should reflect the fact that guaranteed loans are concentrated in a few moderate-to high-risk countries which may require not one but several years of debt reschedulings. Once the Fund's balance is adjusted to provide for its contingent liability, then the amount of future appropriations would not have to be as large if the Fund's exposure was limited to covering lower risk countries. The Fund's balance could, therefore, be maintained at a smaller level than for higher risk countries. We have not determined what the amount of the fund should be.

AGENCY COMMENTS AND OUR ANALYSIS

Guaranty Reserve Fund

The Department of State agreed with the following observations:

1. They also have concern that a few high-risk countries receiving large amounts of guaranteed loans may require reschedulings.

2. The use of extended maturities and high interest may add the risk of default for these countries.

3. If interest earned is provided to the Fund rather than to the Treasury, greater stability and possible growth in the Fund could result.

Unless there were a complete breakdown in the world economy, the Department of State does not foresee the Congress having to appropriate billions of dollars to save the guarantee fund. In our opinion, this comment does not recognize the very nature of the Guaranty Reserve Fund's contingent liability, which is that over half of the authorized loans are for only two countries--Egypt and Israel.

As previously indicated on page 12, if Israel were to reschedule its debt for more than 1 year, then the Congress would have to appropriate $1 billion in the second rescheduling year to cover the guaranteed interest and principal payments. Also, because most of the Israeli loans are still in the 10-year grace period, Israel's annual interest and principal payments will continue to rise as new guaranteed loans are disbursed to Israel. The same pattern is developing in the Egyptian guaranteed loan

program which is running about 4 years behind Israel in terms of the amount of authorized guaranteed loans. Thus, it is not necessary to predicate increased capitalization of the Fund on a prediction of a total collapse of the world economy or the need for multi-country reschedulings.

The Department of State believes the report has not substantiated that Egypt or Israel will require a rescheduling. However, in our opinion, the level of Fund capitalization should not rest on the need to show that particular countries will definitely require a rescheduling. Instead, our recommendations are based on showing that debt servicing prospects are uncertain enough for any of several large borrowers that prudence requires increasing the Fund's balance.

The Departments of Defense and the Treasury did not provide comments.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress:

--Place the entire FMS program on-budget in the International Affairs account to reflect true budgetary costs.

--Provide funds to the Guaranty Reserve Fund that establishes a level based on the nature and size of its current contingent liability covered by the Fund. One way to increase the cash balance of the Fund is to allow interest earned as well as the principal repayments on rescheduled loans to be deposited in the Fund. If the program remains off-budget the level of the Fund's balance should increase to cover future loans.

CHAPTER 3

FOREIGN MILITARY SALES FINANCING:

A PROBLEM FOR SOME RECIPIENT COUNTRIES

The Arms Export Control Act mandates that activities undertaken under the Act should not cause an undue burden on recipient country economies. These activities are to be consistent with "the economic and financial capability of the recipient country, with particular regard being given * * * to the impact of the sales programs on social and economic development * * * ." This mandate was the administration's basis for seeking greater low-interest loans in helping FMS recipients finance their military imports.

Despite the legislative mandate, approved programs do not reflect the ability of some recipient countries to repay their FMS loans. Neither do they reflect the wide differences in the severity of economic problems being faced by various FMS recipients.

We believe that greater attention must be given to the ability of the recipient countries to repay their loans in designing FMS financing programs. If the levels of FMS assistance are maintained or increased, it is only realistic that some countries will need increased assistance in the form of grant or low-interest loans.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSALS

Despite the introduction of low-interest loans in the administration's fiscal years 1982 and 1983 FMS financing proposals, these proposals did not fully address the recipient's ability to repay low-interest direct loans or guaranteed loans. For example, the fiscal year 1982 proposal did not give adequate weight to the economic problems of Sudan and Turkey which would have difficulty repaying interest and amortization payments because of current reschedulings and IMF-supported austerity programs.

We also believe the proposed program was deficient because it did not propose extending the maturity periods for the low-interest direct loans and lacked specifics on interest rates and grace periods.

The fiscal year 1983 proposal only corrected some of the above problems. Proposed direct loans at reduced rates were increased from $1.5 billion in the fiscal year 1982 proposal, to $1.7 billion. The fiscal year 1983 proposal added low-interest financing for five recipients and increased the amount of forgiven

or low-interest loans to six other FMS financing recipients over the fiscal year 1982 program levels. 1/

Nevertheless, the 1983 proposal repeated some of the fiscal year 1982 problems and introduced new ones. The following cases illustrate the continuing problems contained in the proposals.

--Sudan needs its limited foreign exchange to buy necessary imports and will be hard pressed to divert those resources to payment of either direct low-interest loans or guaranteed loans. In 1981, Sudan experienced negative gross national product growth, a large current account deficit, had no international reserves, and was implementing an International Monetary Fund reform program after rescheduling its debt service obligation. In light of these economic developments, Fiscal Year 1982 and 1983 proposals that included $100 million and $50 million in direct loans respectively even at low interest rates, appear not to be responsive to the capabilities of Sudan to handle new debt.

--In light of Egypt's deteriorating balance of payment situation, it is difficult to rationalize increasing the amount of guaranteed loans proposed in fiscal year 1983 to $900 million. In fiscal year 1982, when Egyptian prospects were more favorable, the administration proposed only $500 million in guaranteed loans. Egypt also illustrates that when program levels are increased (from $900 million in 1982 to $1.3 billion in 1983), guaranteed loans may increase notwithstanding the actual performance of the recipient countries' economy.

Our analysis of some other countries showed additional contradictions between the executive branch's stated objective of not placing an undue burden on those countries experiencing severe economic problems. For example, Pakistan, a proposed new recipient of FMS financing, may receive $275 million in fiscal year 1983 guaranteed loans. These loans would be the first installments in a substantial multi-year program to improve Pakistan's self-defense capabilities. Pakistan, however, has been a country granted debt rescheduling and has experienced persistent economic problems.

The opportunity to increase the benefits of the low-interest loans was lost because maturity terms were restricted to 12 years instead of the 30-year maturities extended to some guaranteed loan recipients. If loan recipients are in the midst of, or entering a balance of payments crisis, 12-year loans at any interest rate would siphon off needed resources from an already suffering economy. Therefore, limiting repayment of low-interest loans to 12 years, does not recognize that some countries may need extended repayment

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1/The five countries proposed to receive the low-interest rate loans were Morocco, Tunisia, Niger, Senegal, and Haiti; more concessionality was proposed for Sudan, Turkey, Zaire, Egypt, El Salvador, and Honduras.

periods regardless of the interest rate. The Arms Export Control Act, Section 23, states that credit sales must be repaid "within a period not to exceed twelve years" for most countries. In contrast, however, 30-year terms were given to Egypt, Greece, Israel, Sudan, Somalia, and Turkey for guaranteed loans. Extended terms on low-interest loans were not contained in the proposals for Sudan, Turkey, or Egypt--three countries which our analysis showed would probably have problems repaying principal in the short-, medium-, or long-term.

The lack of specifics on interest rates and maturity terms made it difficult for congressional reviewers to understand the extent of added benefits proposed for the recipients. The Congressional Presentation Document did not propose specific maturity periods or interest rates to be used for direct loans. Administration officials did not respond uniformly when questioned about these issues during congressional hearings. Confusion arose over whether the administration was proposing an interest rate which would vary for each proposed recipient or a uniform interest rate which would not provide any flexibility based on an individual recipient's economic status. A DSAA official indicated to us that a 3-percent rate was to be applied to all direct-loan recipients. Although most administration officials agreed that the maximum time limit for repayment would be 12 years, including a grace period, they disagreed on the length of the grace period within the 12-year period.

The confusion over the interest rate could have been avoided if the administration would have closely followed the spirit of Section 23 of the Arms Export Control Act. This section requires the President to identify the specific rate of low interest required when the President certifies and justifies that the national interest requires the lesser rate. The administration's answers to congressional questions about interest rates should have been more uniform, so that Congress would have had a clearer notion of the administration's intent, i.e., to provide flexible terms based on the recipient's ability to repay its debts.

Potential budgetary impacts influenced the composition of the administration's FMS financing proposals. Administration officials, testifying before the Congress, stated that their FMS program was drafted in line with the need for "budgetary stringency," and resisted alternatives that would add to their proposed global budget levels. A Deputy Assistant Secretary of State testified before the Senate Foreign Relations Committee that "if we raised the forgiveness proportion for the Israeli program, each dollar raised would be added to the direct budgetary impact and requirements for budget authorization this fiscal year." Since increased low-interest loans or grant aid would require increased appropriations while increased guaranteed loans would not, the administration was reluctant to recommend increasing low-interest loans or grants but did not have similar concerns about increasing guaranteed loans.

The disadvantange to this approach is that guaranteed loans require the United States to charge the borrowing country the same interest rate (plus a small fee) that the Department of Treasury must pay in obtaining the funds which are transferred to the FFB. Thus, the exclusive use of guaranteed loans or even a mix of grants and guaranteed loans means that the United States has to charge the recipient a high rate of interest notwithstanding its ability or lack of ability to pay for these loans without damaging its development prospects.

CONGRESSIONALLY APPROVED PROGRAM DOES NOT RECOGNIZE CONCESSIONAL NEEDS

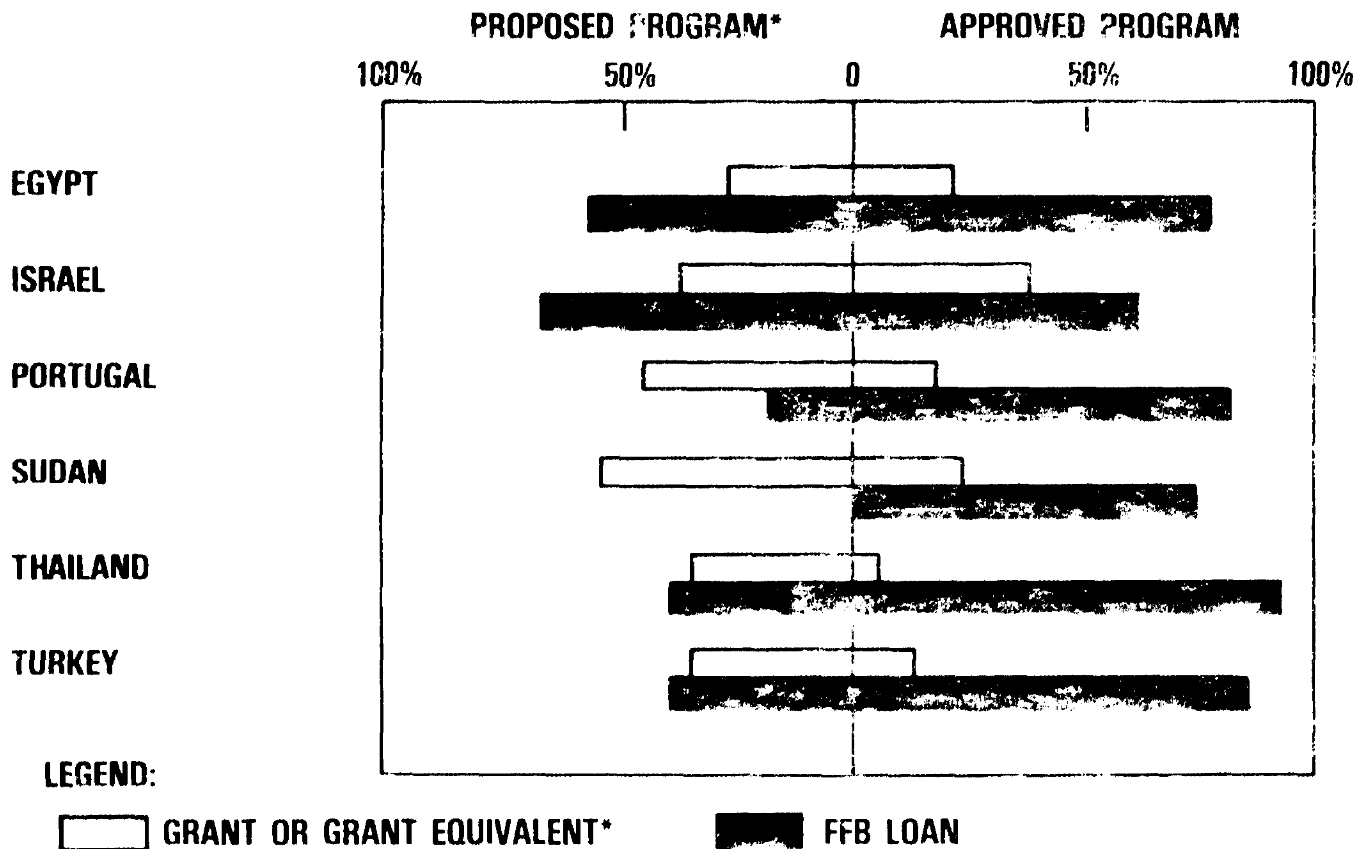
Budgetary concerns were repeatedly mentioned during congressional hearings on the administration's direct credit proposal. The Chairman of the House Foreign Affairs Committee opposed the use of direct loans and noted the significant budgetary impact of an increase of approximately $1 billion which the direct loan proposal would have on the fiscal year 1982 Federal deficit. The Chairman also noted that not including direct loans would enhance enactment of the authorization bill. Accordingly, the fiscal year 1982 program does not include any low-interest direct loans. Instead, each country would receive a portion of its financing program at FFB interest rates.

The allocation of the congressionally approved grant and forgiven loans by the administration was uneven and particularly hard on some countries. The Congress set the levels of forgiven loans to Israel at $550 million--an increase over the administration's proposed $500 million in forgiven loans--and Egypt at $200 million in lieu of the administration's proposed $400 million low-interest direct loans. In lieu of direct loans for the other 14 recipients, the Congress approved $138 million in MAP grants to be allocated by the administration. Under the administration's proposal, these 14 countries would have received a grant equivalent of $308.4 million. Thus the Congress reduced the grant portion (grant element) by more than 50 percent for these countries. 1/

Of the six countries we reviewed in detail, Sudan and Turkey will have the most difficulty handling the reduction in their programs' grant element. The grant element in Sudan's program fell from 53 percent in the proposed direct-loan plan to 25 percent, while its FFB loans increased from zero to 75 percent. Sudan will probably be unable to service its 3-percent direct loans and hence would be equally unable to service FFB rate guaranteed loans. The grant element in Turkey's program fell from 33 percent to 14 percent while its FFB loans rose from 38 percent to 86 percent. The situation for the six countries follows:

1/By definition, grant element is the principal amount of the loan less the present value (discounted value) of the interest and principal payments made over the life of the loan. In effect the grant element is the present value of the interest subsidy.

PERCENTAGE OF GRANTS (OR GRANT EQUIVALENT) AND GUARANTEES IN PROPOSED AND APPROVED FY 82 FMS PROGRAMS



*PROPOSED PROGRAM DOES NOT TOTAL 100 PERCENT BECAUSE GRANT EQUIVALENT IS BASED UPON CALCULATIONS, NOT ACTUALLY PROPOSED GRANTS. THESE FIGURES WERE COMPUTED BY COMPARING DIRECT LOANS AT TREASURY BORROWING RATES OF 14 PERCENT AND DIRECT LOANS AT 3 PERCENT. HENCE, 53 PERCENT OF DIRECT LOANS AT 3 PERCENT IS EQUIVALENT TO DIRECT GRANTS.

Another point is that the unresponsiveness of the administration's proposal for certain countries continued in the finally approved program. For example, we believe that Egypt may have difficulty servicing the amount of guaranteed loans offered by the administration, i.e., 56 percent of its total package or $500 million. The approved program, however, increased Egypt's guaranteed loans to 78 percent of its total package or $700 million. Although the congressional program provides forgiveness of $200 million in lieu of $400 million in low-interest direct loans, in the long run, Egypt will be burdened with higher payments than under the administration's plan. According to our analysis, Egypt may have difficulty making these payments.

DESIGNING A MORE FLEXIBLE FINANCING PROGRAM

A decision should be made by the administration and the Congress as to when low-interest or market rate loans best facilitate the common defense of the United States and its allies. Current and former officials in the executive branch have testified on the needs of some countries for direct loans at low-interest rates. The former Director, DSAA, noted his concern about creating an impossible loan burden on some countries which the United States would probably have to forgive in the long run. The former and current Directors, DSAA, both said in testimony before congressional committees that

> "***we should be vigilant about the possible side effects of our foreign military sales programs and should not, however unintentionally, help create the pre-conditions for economic calamity while working to improve the pre-condition for national security and stability."

We concur with this view. Furthermore, we believe that a more flexible approach might include a mixed program of (1) low-interest direct loans at rates more in line with the recipients' ability to repay, (2) forgiven loans, and (3) FFB rate loans. These components could be used in various mixed packages depending on the recipients' ability to repay FMS loans. Policymakers need to decide when these components, either individually or in a mixed package, are most appropriate.

We recognize that designing an FMS financing program according to a country's economic conditions would be impeded by the interrelationship between some country programs either in levels of assistance or in the amounts of grant assistance provided. For example, the Egyptian and Israeli programs are politically intertwined. Therefore, it would be difficult to give greater assistance to Egypt without giving Israel greater assistance. Another complex similar situation exists between Greece and Turkey. However, the economic positions of these recipients differ greatly. There is, therefore, the possibility of providing interest and principal payments which are too high for the poorer countries or too low for countries with stronger economies. In addition, although economic factors show that a country, such as Sudan, may

need all grant aid, providing a 100-percent grant program could be difficult politically since other countries, considering themselves also deserving, might demand the same.

CONCLUSION

The desires of the administration and the Congress for budgetary stringency have resulted in an FMS financing program which is not responsive to some countries' economies. This is due to the use of off-budget guaranteed loans, which require the United States to charge the recipient a high rate of interest, notwithstanding its ability to repay loans. If a more flexible program--including low-interest loans or grants--is to be adopted, these costs will have to be on-budget.

We believe greater attention should be given to the impact of military loans on the recipient country. This is not likely to happen until the entire FMS financing program is placed on-budget eliminating the present incentive to make loans through the guaranteed high-interest loan approach. As indicated in chapter 2, the desire for the Congress and the administration to go off-budget does not change the actual borrowing requirement of the Federal Government. Moreover, an on-budget program would accurately show the true cost of these loans to the United States.

Based on the Arms Export Control Act, recipient countries' economic conditions should receive strong consideration in establishing individual financing packages. Economic indicators--past trends, current conditions, and projected figures--should be reviewed to design an FMS financing program which meets the needs of the United States and the recipient countries. In addition to these indicators, the relative size of the recipient's financing package in comparison to its economy should also be considered. Countries such as Turkey, Sudan, and Egypt are already spending a large portion of their foreign exchange on military needs. Additional interest payments on FFB rate loans will burden these economies to a greater extent than they are likely to be able to handle without damaging their economic and social development prospects.

We believe the proposed and already available mechanisms--low and market interest rate loans, and varying maturity periods--could be utilized more effectively in line with the countries' ability to pay. We agree with the bases of the administration's proposals which were meant to increase the flexibility of FMS financing to keep it more in tune with the countries' abilities to repay. However, low-interest rate direct loans should be at extended maturity terms at least for most countries eligible for extended maturities for guaranteed loans. This would make direct loans less burdensome on countries in immediate need of foreign exchange for developmental purposes such as Turkey and Sudan. Also, we believe that the applied interest rates should be more in line with a recipient's ability to repay. These interest rates should be determined prior to submission of the financing proposal

early determination by the administration of the appropriate interest rates would enable the Congress to more clearly understand the administration's proposal and facilitate knowledgeable debate about the responsiveness of the FMS program to the needs of its recipients.

AGENCY COMMENTS AND OUR ANALYSIS

The Department of State commented that:

--The record shows that the State Department is cognizant of the debt servicing problem and has tailored the administration's security assistance program accordingly.

--The Congress has consistently reduced the administration's request for grant aid.

--A flexible financing program is desirable and additional grant funds are required to meet the security threats to less economically advanced countries.

Although it is true that the Congress has reduced the administration's request for grant aid, we believe the Department of State over-emphasized this point. For the countries included in our review, we noted the following exceptions to the State Department's position that programs are tailored to the recipients' ability to pay.

--Continued high levels of high-interest rate guaranteed loans proposed for Turkey when it was undergoing a series of debt reschedulings. In 1982, the administration's fiscal year 1982 supplemental request also included an $82 million increase in guaranteed loans. This request came on the heels of congressional action that reduced the grant element of Turkey's fiscal year 1982 program from 33 percent to 14 percent.

--Proposed direct loans for Sudan at a time when Sudan showed no ability to repay these obligations.

--Increased levels of guaranteed loans for Egypt at a time when Egypt's economy experienced significant deterioration.

--The introduction of guaranteed loans for Pakistan, a country that has experienced persistent economic problems.

The record shows that country programs are somewhat based on the ability of countries to pay. However, the programs are also based on the administration's and the Congress' desires to keep as much of the program off-budget as possible. The administration appears to be understating the amount of low-interest loans and grants needed. The Congress is then taking these under-

by switching direct loans to a mix of on-budget forgiven loans (grant) and off-budget guarantees. If the administration believes more grant aid is needed, it should propose it.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress:

--Approve a flexible security assistance financing program that recognizes the potential financial burden placed on the economies of developing countries by military imports. To develop this program, the Congress should require the administration to provide specifics on interest rates and maturities when the program is submitted to the Congress.

--Amend the Arms Export Control Act to allow for low-interest direct loans to have maturities up to 30 years for those countries facing short- and medium-term economic problems.

GUARANTY RESERVE FUND

Fiscal year	The Fund's balance	Cumulative principal authorized	Percent
	-----(dollars in thousands)------		
1977	$ 389,430	$ 3,894,300	10.0
1978	547,780	5,477,800	10.0
1979	1,064,280	10,642,800	10.0
1980	1,116,590 a/	12,289,699	9.1
1981	1,060,445 b/	13,233,000	8.0
1982	960,445 c/	15,666,000 c/	6.1
1983	860,445 c/	18,910,000 c/	4.6

a/The Fund's balance after all outlays as of December 16, 1980. This total represented 25 percent of the outstanding loans issued in FY 1974 and prior, and 10 percent of outstanding loans issued subsequent to 1974. After December 16, 1980, Public Law 96-533 was passed.

b/Declines are the result of agreed debt reschedulings for Turkey and Liberia.

c/DOD Estimated.

FMS GUARANTEED LOANS TO COUNTRIES ALREADY IN DEFAULT ON PRIOR FMS GUARANTEED LOANS (note a)

Countries	1976-1979	1980-1983 b/	Percentage change
	----(dollars in millions)---		
Bolivia	$ 15.0	$ 0	- 100.0
Costa Rica	5.0	0	- 100.0
El Salvador	0	42.2	-
Lebanon	67.5	67.0	- .7
Liberia	3.9	14.2	+ 264.0
Morocco	148.0	138.4	- 6.5
Nicaragua	5.0	0	- 100.0
Senegal	8.0	2.0	- 75.0
Sudan	5.0	130.0	+2500.0
Tunisia	95.0	185.0	+ 95.0
Turkey	600.00	960.9	+ 60.0
Zaire	0	19.6	-

a/As of February 1982.

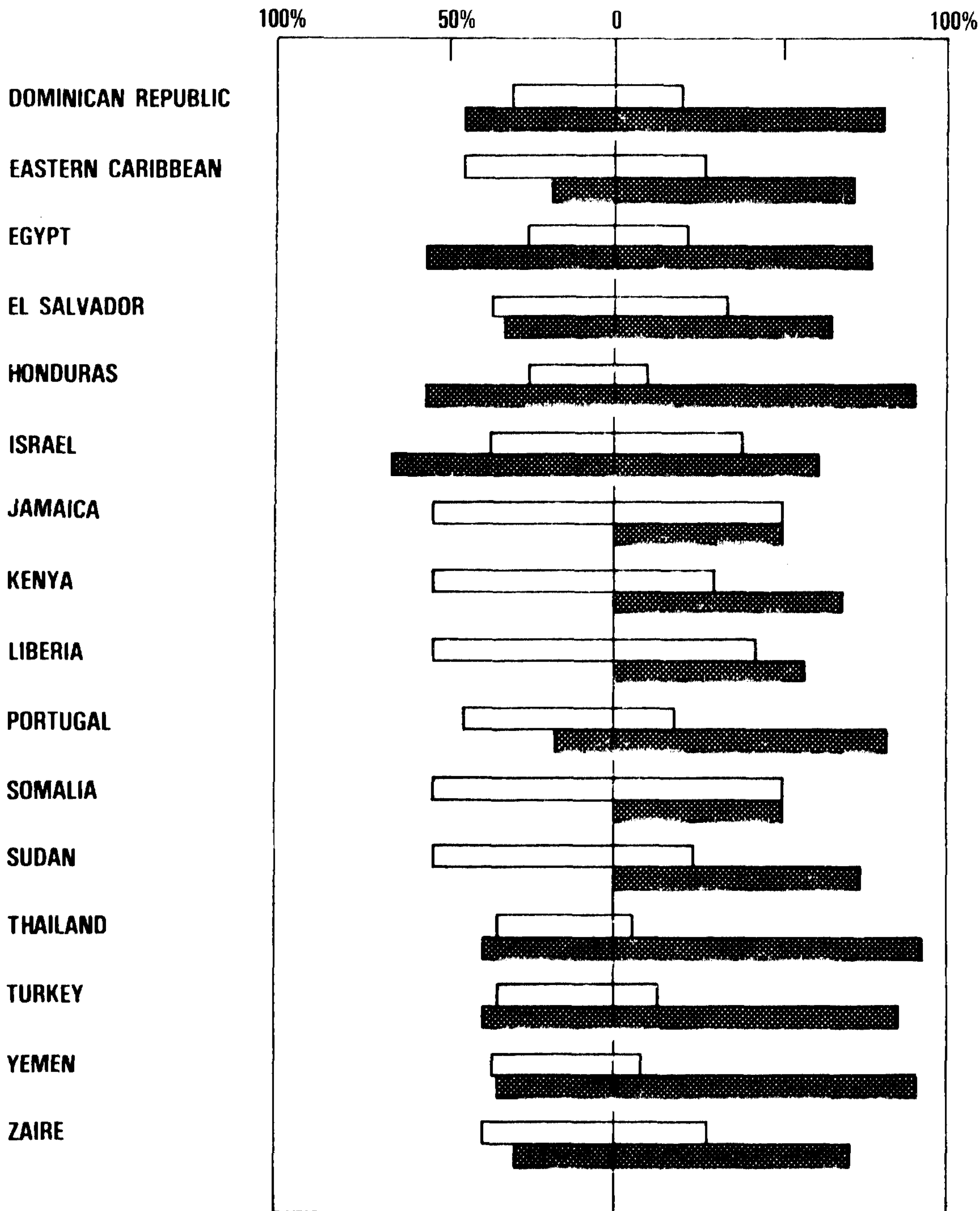
b/Figures for 1983 are those in the administration's proposed program.

FMS GUARANTEES TO COUNTRIES WHICH HAVE UNDERGONE DEBT RESCHEDULINGS OF NON-MILITARY DEBT TO U.S.

Countries	1976-1979	1980-1983 a/	Percentage change
	----(dollars in millions)---		
Bolivia	$ 15.0	$ 0	- 100.0
Costa Rica	5.0	0	- 100.0
Indonesia	118.2	150.0	+ 26.9
Jamaica	0	2.6	-
Liberia	3.9	14.2	+ 264.0
Nicaragua	5.0	0	- 100.0
Pakistan	0	275.0	-
Peru	43.0	17.5	- 59.3
Philippines	71.5	200.0	+ 179.7
Senegal	8.0	2.0	- 75.0
Sudan	5.0	130.0	+2500.0
Turkey	600.0	960.9	+ 60.0
Zaire	0	19.6	-

a/Figures for 1983 are those in the Administration's proposed program.

PERCENTAGE OF GRANTS (OR GRANT EQUIVALENT) AND GUARANTEES IN PROPOSED AND APPROVED FY 82 FMS PACKAGES



LEGEND

☐ GRANT OR GRANT EQUIVALENT*

■ FFB LOAN

*PROPOSED PROGRAM DOES NOT TOTAL 100% BECAUSE GRANT EQUIVALENT IS BASED UPON CALCULATIONS, NOT ACTUALLY PROPOSED GRANTS. THESE FIGURES WERE COMPUTED BY COMPARING DIRECT LOANS AT TREASURY BORROWING RATES OF 14 PERCENT AND DIRECT LOANS AT PERCENT. HENCE, 53 PERCENT OF DIRECT LOANS AT 3 PERCENT IS EQUIVALENT TO DIRECT GRANTS.

DEPARTMENT OF STATE
Comptroller
Washington, D.C. 20520

8 OCT 1982

Dear Frank:

I am replying to your letter of September 2, 1982, which forwarded copies of the draft report: "Unrealistic Use of Loans to Support Foreign Military Sales".

The enclosed comments on this report were prepared by the Deputy Director in the Bureau of Politico-Military Affairs.

We appreciate having had the opportunity to review and comment on the draft report. If I may be of further assistance, I trust you will let me know.

Sincerely,

Roger

Roger B. Feldman

Enclosure:
As Stated.

Mr. Frank C. Conahan,
Director,
International Division,
U.S. General Accounting Office,
Washington, D.C.

GAO DRAFT REPORT: "UNREALISTIC USE OF LOANS TO SUPPORT FOREIGN MILITARY SALES"

We begin with comments on the major subject areas covered in the GAO report.

GUARANTEED LOANS. The Department of State agrees that the central issue addressed in the report -- the ability of guaranteed loan recipients to repay these debts -- should be of major concern to the Administration and Congress. The record shows that the Department of State has been cognizant of this problem and has tailored the Administration's security assistance budget request accordingly. Congress has consistently reduced Administration requests for grant aid or other concessional assistance. In FY 1982 for example, the Administration originally asked for $981.8 million in concessional ("direct loan") FMS financing. When it became clear Congress would not approve this proposal, the Administration amended its budget request, as per the Senate Foreign Relations Committee's recommendation, with the expectation of receiving $490.9 million in grant assistance under the Senate formula. Congress appropriated instead only $138 million of grant (MAP) which compelled the Administration to switch to guaranteed credits to compensate for decreased amounts of FMS concessional funding for some countries (e.g. Turkey, Egypt, Sudan, etc). The problem is not the planned use of FFB guaranteed loans or that such loans are off-budget, but rather the lack of concessional (on-budget) funding provided by the Congress in relation to the security needs of countries which are of strategic interest to the United States.

GUARANTY RESERVE FUND. While there are a few countries that are late in making payments on their FFB loans, most recipients do repay their loans on time and no country has yet defaulted in a literal sense. The term "default" used in the report actually means "arrearage" or late payment. We believe the report is overly pessimistic in this regard as well as in its treatment

of the Guaranty Reserve Fund. The statements in the report that the Guaranty Reserve Fund may become insolvent are based on a worst possible case scenario (e.g. large defaults/reschedulings by Egypt, Israel, Turkey, etc.) but no substantiation is provided that this will occur. The projection in the GAO report that the Guaranty Reserve Fund is on the way to depletion is, and will be, more appropriately addressed by the Departments of Defense and Treasury.

The law requires that the President keep the Congress informed as to the status of the Guaranty Reserve Fund and permits additional requests for appropriations to the fund when warranted. The appropriate question at this point is whether additional appropriations should be requested now or in subsequent years. The fund could only be considered undercapitalized if one foresaw a total default by several major recipients. While extended loan maturities and high interest rates may add to the risk of default, inflation in the U.S. has historically lightened the burden. This is not to say that we should not be concerned about the total amount of outstanding FFB guaranteed loans to high-risk countries, but we do not foresee Congress having to appropriate billions of dollars to save the Guaranty Reserve Fund unless there were to be a complete breakdown in the world economy, in which case, the impact of FMS credits would address only a small part of the problem. Currently of concern are a few high risk countries receiving large amounts of guaranteed loans that may require rescheduling. We agree that if interest earned by the use of Guaranty Reserve Fund money were returned to the fund rather than to the Treasury, greater stability and possible growth in the fund could result.

Other comments follow:

TITLE OF REPORT. "Unrealistic Use of Loans to Support Foreign Military Sales".

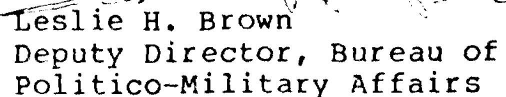
COMMENT. The title is misleading and prejudges the inquiry. The original study title, "Review of the Need for Concessional Interest Rates in Financing Security Assistance" is also not descriptive. A general title, "Financing U.S. Foreign Military Sales" appears more appropriate.

GAO FINDING. The Administraton's foreign aid propsals, as modified by Congress, do not reflect the ability of some recipient countries to repay their FMS loans.

COMMENT. In developing its integrated security assistance Program, the Administration considers each recipient's ability to repay. At the direction of the president, the FY 1983 (and FY 1984) budget requests integrated all resources -- security, development, food, multilateral assistance institutions, and others -- to ensure that they would be used effectively to attain essential U.S. foreign policy objectives. The FY 1983 International Security and Economic Cooperation request provided for a $1.4 billion net increase in the budget authority over the appropriated FY 1982 level (exclusive of the supplementary financing bill - PL97-257), including major increases for FMS concessional credits ($989 million) and ESF ($310 million). This functional (i.e. military and economic) and financial (i.e. grants and loans) balance of assistance is designed to meet our foreign policy and strategic objectives without severely overburdening the economies of several critical countries. The key phrase, of course, is "as modified by Congress".

GAO FINDING. In designing a FMS financing program, a more flexible approach might include a mixed program of (1) concessional direct credits (interest rates and terms), (2) forgiven credits, and (3) guaranteed loans; related to the recipient's ability to pay.

COMMENT. The Department of State agrees in principle with the finding that a flexible financing program is desirable. The most important requirement, in our view, is for additional grant funds to help meet the security threats to less economically advanced countries.



Leslie H. Brown
Deputy Director, Bureau of
Politico-Military Affairs

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