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Report to the Chairman, Subcommittee on Criminal Justice, Committee on the Judiciary, House of Representatives

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LOAN GUARANTEES

Export Credit Guarantee Programs' Long-Run Costs Are High

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National Security and
International Affairs Division

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April 19, 1991

The Honorable Charles E. Schumer
Chairman, Subcommittee on
Criminal Justice
Committee on the Judiciary
House of Representatives

Dear Mr. Chairman:

As you requested, we examined program costs of the Commodity Credit Corporation's Export Credit and Intermediate Export Credit Guarantee Programs in the Department of Agriculture. We also reviewed the regulations governing the participation of foreign-owned, U.S.-based financial institutions in these programs. These programs are also known as the GSM-102/103 programs. You specifically asked us to (1) estimate the programs' long-run costs[1] due to loan payment delinquencies and (2) determine if program regulations effectively prohibit foreign-owned, U.S.-based financial institutions from receiving credit guarantees for financing agricultural commodity sales to their owner countries.

Results in Brief

We estimate that long-run costs for the programs will be about $6.7 billion, or 60 percent of the $11.2 billion in loan guarantees and accounts receivable[2] outstanding as of May 1990. The cost is high because the Corporation provided guarantees to high risk countries, including Iraq. On the average, the GSM-102/103 programs are slightly more risky than the highly concessional P.L.-480[3] food-aid loan program that is targeted to high risk countries.

Commodity Credit Corporation regulations have not prevented financial institutions owned by foreign governments and located in the United States from receiving credit guarantees for financing sales to their owner countries. We identified three financial institutions that (1) were directly or indirectly owned, at least in part, by the borrowing foreign

[1]These long-run costs are the expenses the Corporation incurs over the long run, e.g., the next 18 years, because its guaranteed credits and accounts receivable will not be fully repaid.

[2]Accounts receivable includes delinquent payments and rescheduled debt not yet due.

[3]P.L.-480 is a commonly used term that refers to the Agricultural Trade Development and Assistance Act of 1954 (P.L. 83-480). Until fiscal year 1991, titles I and III of the act provided food loans with very low interest rates for foreign countries. Title II continues to provide food donations and grants to foreign countries.

country and (2) received GSM credit guarantees for sales to that country. The Commodity Credit Corporation plans to issue regulations that will prohibit financial institutions from receiving credit guarantees under such circumstances.

Background

To expand exports of U.S. agricultural commodities, the U.S. government, through the Department of Agriculture's Commodity Credit Corporation, guarantees repayment of bank-financed credits to foreign buyers under the Export Credit Guarantee Program (GSM-102) and the Intermediate Export Credit Guarantee Program (GSM-103). (See app. I.) Since the programs began in the late 1970s, through May 1990, about $29.9 billion in credit guarantees has been provided to countries where such guarantees are generally necessary to secure financing for commodity purchases. Often guarantees have been given to further U.S. foreign policy goals as well as to encourage agricultural market development. Outstanding export credit guarantees averaged $6.7 billion during the last 9 years and had an average life of 2.1 years.

The Programs' Long-Run Costs Are High

As of May 31, 1990, the Corporation had approximately $8.6 billion outstanding in credit guarantees and $2.6 billion in accounts receivable resulting from guarantee payouts on delinquent loans. We estimate that the GSM programs will cost the Corporation about $6.7 billion in the long run, or about 60 percent of the $11.2 billion face value of the outstanding credits and receivables. (See table 1.) This estimate assumes that the outstanding loans and guarantees remain at the same level for about 18 years and that their average risk remains unchanged as new guarantees replace old ones. If the level of the outstanding loans and guarantees continues to grow and the average risk of the new guarantees is not substantially reduced, then we expect that the long-run costs will be even higher.

Table 1: GSM Programs' Estimated Long-Run Costs (Based on May 1990 Balances Outstanding)

Dollars in billions

GSM costs	Loan guarantees	Accounts receivable[a]	Total
Loan amounts outstanding	$8.58	$2.63	**$11.21**
Long-run costs	4.66	2.06	**6.72**
Long-run costs/outstanding loan amounts (percent)[b]	54.3	78.5	**60.0**

[a]Includes delinquent payments and rescheduled debt not yet due.

[b]Numbers may not equal percentages due to rounding.

Source: GAO's analysis of Agricultural Stabilization and Conservation Service data.

We should point out that in its most recent financial statement—for the period ending September 30, 1989—the Corporation recognizes a much lower percentage cost estimate. It estimates the percentage cost for all of its foreign loan programs, including P.L.-480, at about 36 percent. Our long-run percentage cost estimate of 60 percent is higher principally because we assume that GSM amounts outstanding will remain constant for 18 years, i.e., as loan guarantees are repaid, new ones are provided with the same average risk. (See app. II for more details.) The Corporation, like others in their financial statements, assumes that as loans and guarantees are repaid, new loans and guarantees will not be forthcoming, even though experience indicates otherwise. Our estimate also uses "mark-to-market" techniques so that value estimates are more closely tied to secondary market prices. The Corporation does not use this technique.

Corporation officials believe our estimate of the programs' cost is too high and does not take into consideration actual repayment histories and the high priority that foreign governments place on repaying food loans. They stated that the Corporation has paid out only 10.4 percent (approximately $3.1 billion) of the total $29.9 billion in guarantees issued over the 10-year life of these programs—a much smaller percentage than we estimated as long-run costs. We do not believe that the Corporation's method for portraying the historical rate of payout contributes to a clear understanding of the issue. We calculated that the Corporation's historical rate of payout over the last 9 years is approximately 47 percent of its $6.7 billion average outstanding balance of guarantees, a rate that is quite high. Furthermore our view is that the assessment of risk in the current portfolio is the correct way to estimate future costs, not past experience when risks were different. The Corporation's views, and our evaluation, are discussed in appendix III.

The average long-run cost of outstanding GSM loans and guarantees is high because the Corporation provided guarantees to high risk countries, including Iraq. On the average, the GSM-102/103 programs are slightly more risky than the highly concessional (or below-market-interest-rate loan) P.L.-480 food aid loan program, which is targeted to high risk countries. We compared the average risk of outstanding GSM-102/103 loans and guarantees as of May 31, 1990, to the average risk of outstanding P.L.-480 loans as of June 30, 1990, using secondary market prices for commercial bank loans in October 1990. Secondary market prices for commercial bank loans are inversely related to the debtor's risk—the higher the debtor's risk, the lower the loan's price. A commercial bank loan portfolio comparable to the outstanding GSM loans and guarantees has a lower average price than a commercial bank loan portfolio comparable to the outstanding P.L.-480 loans. This slightly lower average price reflects the slightly greater average risk of outstanding GSM loans and guarantees.

This result was unexpected because a number of factors led us to believe that recipients of GSM-102/103 loan guarantees would typically be more creditworthy than recipients of P.L.-480 loans. For example, countries receiving GSM loans have to meet creditworthiness standards, whereas countries receiving P.L.-480 assistance do not. Prior to 1991, P.L.-480 targeted high risk countries by requiring that 75 percent of each year's commodity allocation go to countries that met poverty standards. Also, an Agriculture official told us that, in general, the least poor countries are supposed to receive GSM loans while the most poor countries are supposed to be provided P.L.-480 assistance.

The increase in total annual allocations of the GSM programs, as mandated by the Food and Security Act of 1985 for fiscal years 1986 through 1990, caused the Corporation to allocate more guarantees to high risk countries. In August 1986, GSM-102/103 program officials told us that the Corporation was having difficulty finding creditworthy countries for that year's larger allocation. They stated that the larger allocations would require that guarantees be made to less stable countries, thus increasing (1) the chance of nonpayment and (2) the Corporation's cost.

The Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624) keeps the GSM-102 program allocations at the same level as the Food and Security Act of 1985, e.g., "not less than $5,000,000,000 in credit guarantees" for each of the fiscal years 1991 through 1995, and changes the GSM-103 program allocation from not more than $1 billion for each of fiscal years 1989 and 1990 to "not less than $500,000,000" for each of the fiscal years 1991 through 1995. The act also requires that, in addition to those amounts, the "Commodity Credit Corporation, for the fiscal years 1991 through 1995 shall make available not less than $1,000,000,000 of export credit guarantees for exports to emerging democracies...."

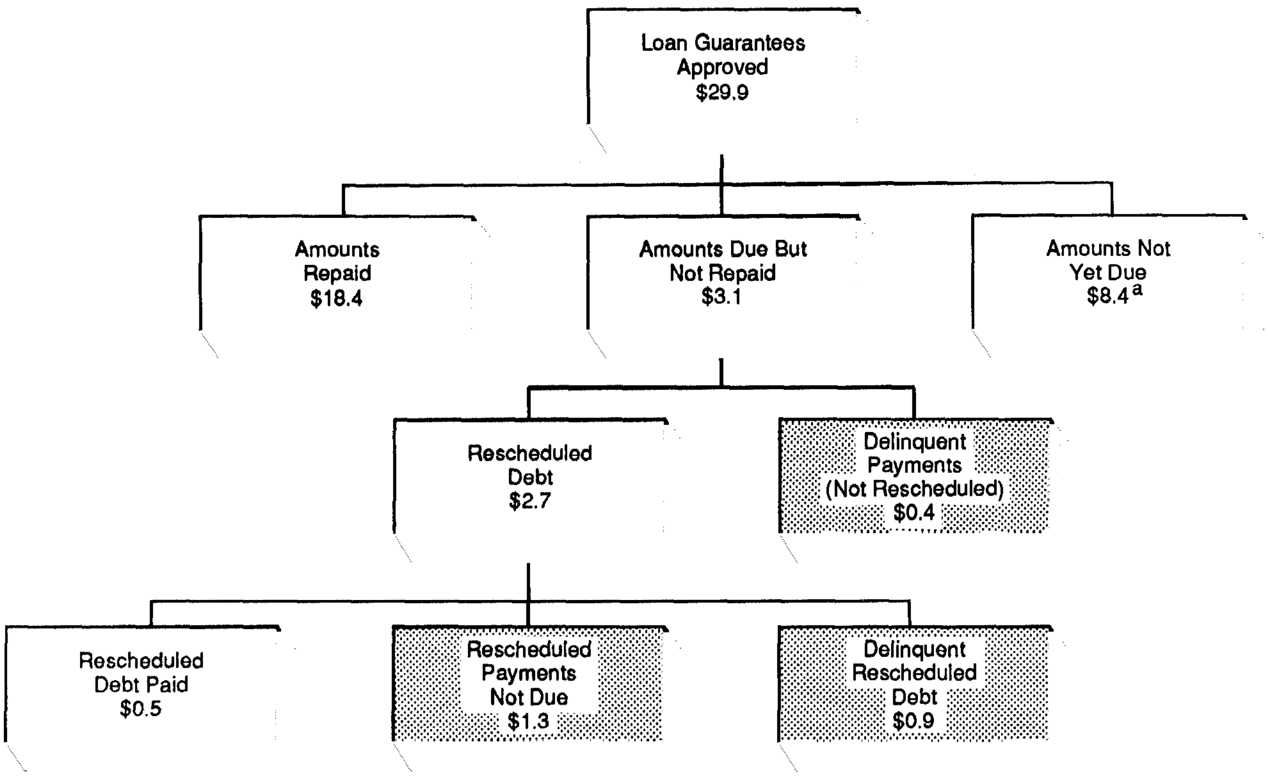
Credit guarantee allocations to countries are based on a country's agricultural needs, its market development potential, and the likelihood that the country's financial sector (or government) will repay the guaranteed loans. In 1986, a high level program official told us that political considerations had also frequently influenced GSM country allocation decisions. For example, Iraq has received about $5 billion in loan guarantees since the programs began, making it the third largest program participant following Mexico and South Korea.[4] The Food, Agriculture, Conservation and Trade Act of 1990 (P.L. 101-624), signed into law on November 28, 1990, now prohibits the GSM programs from being used for foreign policy purposes. In December 1990, the Secretary of Agriculture for the first time authorized credit guarantees—$1 billion in GSM-102 loan guarantees—to the Soviet Union for use during fiscal year 1991. The Soviet Union's credit rating by major international banks had deteriorated rapidly over the past year, the second greatest 1-year decline for a country in the past decade.

Another factor confirming the high risks of the Corporation's allocation of guarantees has been that the Corporation has experienced difficulty when collecting on debt. The Corporation's strategy in handling GSM-102/103 loan payment delinquencies has been to suspend further program activity with a country until payment is made or rescheduled and to use diplomatic channels to encourage the country to repay. The Corporation, via the U.S. government, uses the Paris Club[5] to negotiate debt rescheduling. Of the $2.7 billion in rescheduled GSM debt (as of May 1990), $1.4 billion has come due. Most of that amount, or $900 million, is delinquent. (See fig. 1.)

[4]In August 1990, the U.S. government established economic sanctions against Iraq in response to its invasion of Kuwait. Iraq responded to the U.S. action by not servicing the debt it owed the United States, including approximately $2 billion of debt outstanding under the GSM programs. As of March 1, 1991, the Corporation had paid out over $160 million because of Iraqi loan delinquencies and stands to pay out the remainder of the $2 billion as payments come due and are delinquent.

[5]The Paris Club is an organization composed of creditor governments that meets in Paris, France, and negotiates loan rescheduling for debtor countries.

Figure 1: Status of GSM Loan Guarantees as of May 1990 (Dollars in billions)



Represents $2.6 billion of Corporation's accounts receivable as of May 1990.

[a]This amount, plus $0.2 billion estimated interest, represents $8.6 billion in outstanding credit guarantees as of May 1990.

Source: Amounts obtained from reports prepared by the Agricultural Stabilization and Conservation Service. The reports covered slightly different time periods. However, according to Corporation officials, these amounts fairly present the status of loan guarantees as of May 1990.

Program Regulations for Financial Institutions to Be Revised

The Corporation has traditionally viewed GSM loan transactions as "commercial transactions," and therefore subject to the controls that exist in normal commercial business transactions. Consequently, the Corporation has established few program restrictions governing the participation of U.S.-based financial institutions, which are almost always commercial banks. Instead, the Corporation has assumed that arm's-length business transactions between the financial institutions and the borrowing government would ensure that GSM loan transactions were properly conducted. However, we found three cases in which U.S.-based financial institutions were directly or indirectly owned, at least in part, by the borrowing foreign government. In these cases the foreign government also owned or controlled its local bank that had issued the letter of credit. Under these circumstances, the U.S.-based financial institution may base its decision to participate on factors other than strictly commercial interests (i.e., the fact that it is owned by the foreign country.) For these three cases, the Corporation issued more than $1 billion in program guarantees and paid out $128 million for delinquencies.

The legislative history of the Food, Agriculture, Conservation, and Trade Act of 1990 indicates that Congress was concerned that transactions under the export credit guarantee programs should be arm's length. To this end, the act prohibits a financial institution from participating in the programs if it is owned or controlled by an "entity" that also owns or controls the financial institution providing the letter of credit. Based on discussions with GAO representatives, Corporation officials agreed that this prohibition covers the type of transactions we identified; therefore, they plan to issue implementing regulations.

Recommendations

We recommend that the Secretary of Agriculture direct the Administrator of the Foreign Agricultural Service to

- lessen long-run program costs by reducing the average risk of new guarantees and
- issue regulations specifying that financial institutions in the United States that are owned or controlled by a foreign country that also owns or controls the local bank issuing the letter of credit are ineligible to receive credit guarantees.

Scope and Methodology

To estimate long-run GSM-102/103 program costs, we examined the Corporation's receivables and guarantees as of May 31, 1990. We analyzed the secondary market for commercial loans to less developed countries and applied the results of our analysis to the GSM-102/103 loan and credit guarantee portfolio. We examined the Corporation's GSM-102/103 program regulations and discussed them with appropriate officials of the Corporation and several financial institutions that have participated in the programs.

We conducted the majority of our work at the U.S. Department of Agriculture, Washington, D.C. Because the Corporation relies on the Federal Reserve to monitor U.S.-based, foreign-owned financial institutions that participate in the programs, we discussed relevant oversight and monitoring issues with Federal Reserve officials in Washington, D.C.

We performed our review from April 1990 through March 1991 in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Chairmen of the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture; the Chairmen of the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs; and the Secretaries of Agriculture and the Treasury. We will also make copies available to others upon request.

Please contact me on (202) 275-4812 if you or your staff have any questions regarding this report. The major contributors to this report are listed in appendix IV.

Sincerely yours,

Allan I. Mendelowitz

Allan I. Mendelowitz, Director
International Trade, Energy,
and Finance Issues

Contents

Abbreviations

GSM-102	General Sales Manager Export Credit Guarantee Program
GSM-103	General Sales Manager Intermediate Export Credit Program
LDC	less developed country

The Export Credit and Intermediate Export Credit Guarantee Program Operations

There are two programs in the U.S. Department of Agriculture that provide export credit guarantees. The GSM-102 (General Sales Manager) program is a short-term export loan guarantee program for transactions with repayment periods of 6 to 36 months. The GSM-103 program is an intermediate loan guarantee program for transactions with repayment periods of more than 3 but not more than 10 years.

Since inception of the GSM programs in the late 1970s, through May 1990, the Corporation provided approximately $29.9 billion in loan guarantees. Outstanding export credit guarantee loans averaged about $6.7 billion during the last 9 years and had an average life of 2.1 years. The Corporation has paid out approximately $3.1 billion for loans due but not repaid.

Over the past few years Congress has required that the Corporation make available at least $5 billion in loan guarantees annually under GSM-102 and not more than $1 billion annually under GSM-103. New legislation requires similar amounts be made available each year over the next 5 years, plus an additional minimum amount of $1 billion over 5 years for countries with emerging democracies.

The Commodity Credit Corporation, with advice from the National Advisory Council on International Monetary and Financial Policies,[1] controls the total amount of loan guarantee exposure through an annual allocation process in which the Corporation announces available guarantees for specific agricultural commodities and countries. Allocations are based on an individual country's agricultural needs, its market development potential for U.S. commodities, and the ability and likelihood that the country's financial sector (or government) will repay the guaranteed loans.

Decisions to provide loan guarantees to countries have often been influenced by foreign policy considerations. Principal recipients of guarantees have often been countries that have had significant foreign policy relationships with the United States. However, the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624) signed into law on

[1]The National Advisory Council is an interagency group that gives advice and recommendations to government agencies, such as the Commodity Credit Corporation, on international financing matters. Council members include the Departments of the Treasury, State, and Commerce, and the Federal Reserve Board, U.S. Export-Import Bank, U.S. Trade Representative, and International Development Cooperation Agency. Council members discuss GSM-102/103 proposals from each of their perspectives, highlighting issues dealing with foreign policy, financial risk, trade, and development considerations.

November 28, 1990, now prohibits the GSM programs from being used for foreign policy purposes.

Since the GSM-102/103 programs began, Mexico, South Korea, and Iraq have received the largest allocations of all participating countries, getting $10.6 billion, $6 billion, and $5 billion in allocations, respectively. In December 1990 the Secretary of Agriculture for the first time authorized credit guarantees—$1 billion in GSM-102 loan guarantees—for the Soviet Union for use during fiscal year 1991.

The GSM-102/103 programs work as follows:

- A foreign buyer (generally a foreign government agency), through its local bank, negotiates interest rates and arranges for a line of credit from a financial institution in the United States desiring to participate in the GSM-102/103 programs.
- The U.S. exporter negotiates a firm sale with the foreign buyer and then applies to the Commodity Credit Corporation for a credit (or loan repayment) guarantee. The Corporation generally guarantees repayment of 98 percent of the value of the sale plus some of the interest.
- After obtaining the guarantee, the exporter almost always assigns the account receivable and the guarantee to the financial institution in the United States that agreed to finance the deal. The financial institution then pays the exporter in full for the sales transaction and collects the principal and interest payments from the foreign buyer's bank.

The U.S.-based lending financial institution earns interest on the loans. It also earns fees for advising the foreign buyer's local bank on issuing letters of credit and for providing other services related to the transaction.

Should a foreign buyer's bank fail to make repayments on the loan, the U.S.-based financial institution looks to the Corporation to fulfill the repayment guarantee. In the event the Corporation pays a claim under its repayment guarantee, the Corporation seeks recovery from the foreign buyer's bank or government. (The Corporation seeks, and often obtains, assurances from foreign governments that GSM loans will be repaid.) If the foreign government does not repay the loan, the debt may be rescheduled with the U.S. government. In that event, the rescheduling usually results in longer repayment terms and allows for a grace period on principal repayments. Also, as long as the foreign government is current on its rescheduled loans, it is eligible for consideration to receive additional guaranteed loans. As of May 1990 there was

$2.7 billion in rescheduled loans owed the Corporation by 14 countries. Five of these countries were allocated $1.7 billion in new loan guarantees for fiscal year 1990.

Corporation and U.S. financial institution officials told us that during rescheduling negotiations, countries are encouraged to make good on the unguaranteed portions of the GSM loans. To the extent that this payment occurs, U.S. financial institutions are accepting risk on less than 2 percent of the loan.

Estimate of Long-Run Program Costs

A secondary market exists for trading debt owed by less developed countries (LDC).[1] Our analysis of this market's prices concludes that they are realistic risk-based valuations of LDC debt and that they are the best basis for estimating the long-run GSM-102/103 programs' cost.

Most debt traded on the secondary market, like GSM-guaranteed loans, is variable interest rate debt and, thus, its price does not change because of general interest rate movements. Prices are discounted from face value in the secondary market to reflect investors' assessments of the risk associated with these loans or because there are other factors present that impair the value of the loan.

If there were no market forces present other than the evaluation of risk by investors, then a loan's price would be an unbiased predictor of its value. Under these circumstances, for example, if commercial bank loans owed by a country have a price of 40 percent of face value, then the market expects that the loan would, on average, pay only about 40 percent of the loan's face value. Therefore, investors in this market, on the average, expect that an institution that had obtained this loan at face value will, over the long run, incur expenses that exceed payments received by about 60 percent of face value. Thus, 60 percent of face value is this institution's expected long-run cost of owning this loan.

In addition, if there were no other market forces present, or these other forces remained unchanged, prices would respond only to changes in investors' perceptions of risk. For example, if investors believed loans to a country were less risky than their price indicated, investors would have an incentive to buy these loans and, as a group, cause the price of these loans to increase. Similarly, if investors believed a country's loans to be more risky than their price indicated, then investors would have an incentive to sell these loans and, as a group, cause the price of these loans to be lower.

Our analysis of the LDC loan market for October 1990 indicates that secondary market prices are based almost exclusively on investors' perceptions of the loans' risk because other market forces which were present

[1] This secondary market is an over-the-counter market in which dollar debt owed by foreign governments or private enterprise is traded. Volume has grown quickly and was approximately $2 billion (face value) in 1985, $5 billion in 1986, and $70 billion in 1990. Prices for loans owed by LDCs are often substantially discounted from face value. Many market transactions involve swaps of securities rather than sales strictly for cash. A transaction in this market often consists of a number of loan swaps and cash sales that close simultaneously.

over the last 4 years now appear to be minimal.[2] Consequently, we believe that our reliance on the unbiased secondary market price of loans indicates that our $6.7- billion estimate of the GSM programs' long-run cost is sound, provided the programs' $11.2 billion of outstanding loans and guarantees remains constant over the next 18 years, and, as loan guarantees are repaid, new ones are provided with the same average risk.

[2]In earlier reviews of appropriate reserve levels for LDC debt, we obtained estimates of appropriate reserves based on the secondary market for LDC debt. We found that market forces other than investors' risk evaluation had caused market prices to be too high and market-based reserves too low for investors' perceptions of market risk. See, for example, International Banking: Supervision of Overseas Lending Is Inadequate (GAO/NSIAD-88-87, May 5, 1988) and International Trade: Commodity Credit Corporation's Export Credit Guarantee Programs (GAO/NSIAD-88-194, June 10, 1988).

Agency Views and Our Evaluation

Corporation officials believe our long-run GSM-102/103 program cost estimate ignores the programs' loan repayment history. They stated that the Corporation has paid out only 10.4 percent (approximately $3.1 billion) of the total $29.9-billion guarantees issued over the 10-year life of these programs—a much smaller percentage than we estimated as long-run costs.

We determined that the Corporation's historical rate of payout over the last 9 years is approximately 47 percent (or 4.3 percent per year) of its $6.7-billion average outstanding balance of guarantees, a rate that is quite high.[1] We believe that the Corporation's portrayal of payouts understates the programs' likely long-run costs for three reasons. First, the Corporation's presentation does not recognize that on the average, during the past 10 years, a guarantee was outstanding for only about 2.1 years. Second, we believe that even comparing payouts to the average outstanding balance, as we computed, understates the GSM programs' rate of long-run costs because the programs' high growth[2] created special incentives for participants to remain current on their debt service. The typical borrower under this program is a high risk LDC with large debt and very limited access to external funds; it must remain current on the programs' debt service payments in order to receive additional loans under these programs. Therefore, it has been in the participating LDC's interest to make preferential repayments, relative to other debt, so that new loans under these programs would be forthcoming, as indeed they have been. We expect that when these programs are no longer such a ready source of funds, the Corporation will incur a higher payout rate. Third, we expect that additional payouts should be expected for some guarantees that have already been issued to countries such as Iraq. Since payouts often have been limited to individual delinquent loan payments and not the entire delinquent loan, additional payouts for these delinquent loans are likely. Corporation officials stated that GSM program loan guarantees and rescheduled loans are more likely to be repaid than other guarantees and loans for the following reasons:

[1]The average outstanding balance of guarantees is much less than the total issued because many of the guarantees were for short-term loans, requiring multiple guarantees to a given level of loans over the last 9 years.

[2]For the period September 30, 1981, to May 31, 1990, the total amounts outstanding under the programs grew an average of 18.7 percent annually, loan guarantees grew annually at an average of 15.4 percent, and accounts (loans) receivable grew annually at an average of 54.4 percent.

- Loan guarantees to more risky LDCs are tranched, or parceled out, so that further guarantees for the year are made available only if repayments are current.
- Recipient governments place a higher priority on repaying GSM-guaranteed loans than other loans because GSM-guaranteed loans are used for food, and the borrowing countries want to keep their food credit lines open.
- Most GSM-guaranteed loans are cosigned by the foreign government and become obligations of that government if rescheduling occurs.

We believe that withholding further loan guarantees if debt service payments are not current has effects similar to those of continuing high program growth. Both actions provide incentives for a borrowing country to remain current only as long as sufficient new guarantees are forthcoming. Corporation officials were unable to provide any specific examples of when recipient governments have placed a priority on repayment of food loans. Finally, assigning the host government responsibility for repaying GSM debt does not make the debt any less risky than secondary market debt because the vast majority of that debt is also guaranteed or owed by foreign governments.

Corporation officials questioned our use of the secondary market as a basis for estimating long-run program costs. They stated the following:

- Secondary market prices are good measures of liquidation value, but the Corporation does not plan to liquidate its holdings.
- The secondary market is thin and lacks standardized products.
- Secondary market prices are frequently affected by problems in a few countries.
- Debt owed governments, such as rescheduled debt owed to the Corporation, is not traded on the secondary market.
- Debt of some GSM borrower countries is not traded.

We continue to believe that the secondary market is the appropriate vehicle to use in estimating these programs' long-run costs. Many transactions in this market are not solely for cash, but are exchanges of one type of LDC debt for another. Market prices adjust when professionals who evaluate and manage country risk change their collective opinion concerning a loan or bond's risk or there are changes in other market forces. Over the past few years we have seen these other market forces become less important, and our most recent analysis concludes that there is very little net effect on prices by these other forces.

Whether or not the secondary market is thin is not the relevant issue. What is important is whether the market tends to underprice these loans relative to their long-term value. Although a loan's price may differ because it has qualities different from other loans from the same LDC, the key question is whether the characteristics contained in program loans tend to be priced systematically higher (or lower) than the prices we used. Because we do not know of any characteristics with this quality, we did not modify our cost estimate.

While it is true that factors in one debtor country can affect the price of other countries' debt, market professionals believe these effects are short-lived, cause prices to be either higher or lower and, most importantly, were not present on the day on which we based our cost estimates.

Although official government-to-government debt may not be traded on the secondary market, debt owed by many LDC governments to major banks is traded on the secondary market.

In order to obtain implied secondary market prices for countries whose debt is not traded on the secondary market, we statistically estimated the relationship between a risk-rating consensus of major international banks, compiled and published by Institutional Investor, and secondary market prices for countries whose debt is traded. We then used this relationship, along with the Institutional Investor risk rating, to obtain statistically valid estimates of secondary market prices for countries whose debt is not traded but whose risk is rated by Institutional Investor. This is a statistically valid method because the Institutional Investor risk rating is very highly correlated with actual secondary market prices.

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Related GAO Products

Iraq's Participation in the Commodity Credit Corporation's GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-91-13, Mar. 14, 1991).

International Trade: Iraq's Participation in U.S. Agricultural Export Programs (GAO/NSIAD-91-76, Nov. 14, 1990).

Report on the Commodity Credit Corporation's GSM-102/103 Export Credit Guarantee Programs and Iraq's Participation in the Programs (GAO/T-NSIAD-91-01, Oct. 16, 1990).

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Status Report on GAO's Reviews of the Targeted Export Assistance Program, the Export Enhancement Program, and the GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-90-53, June 28, 1990).

Status Report on GAO's Reviews of the Targeted Export Assistance Program, the Export Enhancement Program, and the GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-90-02, Feb. 21, 1990).

Status Report on GAO's Reviews of the Targeted Export Assistance Program, the Export Enhancement Program, and the GSM-102/103 Export Credit Guarantee Programs (GAO/T-NSIAD-90-12, Nov. 16, 1989).

Commodity Credit Corporation's Export Credit Guarantee Programs (GAO/T-NSIAD-89-41, June 14, 1989).

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International Banking: Supervision of Overseas Lending Is Inadequate (GAO/NSIAD-88-87, May 5, 1988).

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