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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL

SECURITY AND SCIENTIFIC AFFAIRS

COMMITTEE ON FOREIGN AFFAIRS

HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to discuss our report entitled "Unrealistic Use of Loans to Support Foreign Military Sales" (GAO/ID-83-5, January 8, 1983). Our discussion will cover:

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--The ability of countries to pay for their military imports.

--The implications of FMS financing on the Federal budget.

--The solvency of the FMS Guaranty Reserve Fund.

To finance foreign military sales after 1975, the United States has shifted, for the most part, 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 undercapitalized in relationship to the risks undertaken so that a future Congress may need to make appropriations 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.

The Arms Export Control Act states that activities undertaken by 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 emphasis on the impact FMS financing has on social and economic development.

This mandate is not being met because debt troubled countries are required to divert scarce foreign exchange from development to servicing their military debt. Internal structural problems and changes in the world economy may cause a country to experience a debt servicing problem; large military loans add to the debt servicing problem, especially if they carry high interest rates.

Sudan provides an example where foreign military sales financing during 1978 to 1983 was not consistent with the economic and financial capability of the recipient. During this period, the United States approved $117 million in high-interest FMS loans to Sudan. These loans were approved at a time when 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 obligations. The fiscal year 1984 Security Assistance Program does not contain a request for new high-interest loans for Sudan.

If the United States continues to provide $850 million annually in loans to Egypt through fiscal year 1989, Egypt's military debt will approach $9 billion at that time. Unless Egypt can successfully reduce consumer demands, it is likely to fall into a debt servicing problem. Adding to Egypt's problem is the potential fall in oil prices. As a petroleum exporter, Egypt may not increase foreign exchange earnings as earlier predicted. Moreover, foreign exchange earnings from Egyptians working outside of Egypt could decline if other Arab petroleum exporters cut back on development projects.

Turkey provides another example of the United States giving high-interest FMS financing when a country could not afford it. From 1973 to 1980 Turkey's balance of payments situation deteriorated to a point where it suffered a severe cash flow problem. Export growth was particularly weak. By 1980, Turkey's total debt reached $17.8 billion due to the rapid buildup of short-term borrowing to finance large current account deficits. Notwithstanding these conditions, the United States provided Turkey with more than $900 million in high interest FMS loans during this period.

Why is the United States providing countries high-interest loans through the Federal Financing Bank (FFB)? The answer to this question brings us to the second area--budget implications of FMS financing.

An overriding consideration in the decision as to which financing method has been used, has been its impact on the U.S. Government budget. Guarantees for FFB foreign military loans require no new budget authority and now require no annual appropriations for the Guaranty Reserve Fund. 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 and on-budget direct government loans have the same impact on the

U.S. Treasury. The FFB receives all of its money 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. The essential differences are that the guaranteed loan approach removes the loans from the official budget totals and does not require an appropriation before the loans can be made.

Transactions by FFB are excluded from the budget totals by law (12 U.S.C. 2290). Thus, these transactions escape the 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. We believe the entire FMS financing program should be placed on-budget to reflect the true budgetary costs.

The budget advantages of the guaranteed loan approach may be short lived if these countries are unable to repay their loans on time. This brings us to the final area of concern, the solvency of the Guaranty Reserve Fund.

In December 1980, the Congress changed this Fund from one in which the balance was kept proportional to its contingent liability through annual appropriations, to a revolving fund. At that time, the amount of guaranteed loans authorized was \$12.2 billion and the Fund's balance was \$1.1 billion or 9.1 percent. By the end of fiscal year 1983, authorized guaranteed loans will rise to \$18.9 billion and the Fund balance will fall to $860 million or 4.6 percent. The major reasons for the projected decline in the fund's balance are the termination of the annual appropriations and the need to make payments to the FFB as a result of debt reschedulings by Peru, Turkey, and Liberia.

The Department of State said that the Fund should only be considered undercapitalized if one foresees a total default by several major recipients. We believe the debt servicing prospects for several large borrowers are uncertain enough that the adequacy of the Fund is called into question.

Egypt and Israel, along with several others, are granted 10-year grace periods on principal repayments. This allows countries to build large principal balances. In addition, because of high interest rates on long-term maturities, interest payments also begin to rise quickly.

By 1989, Egypt may be paying $1 billion in annual interest payments, the same position Israel is likely to face at the end of fiscal year 1984. If the Israeli fiscal year 1984 request for $1.1 billion in guaranteed loans is approved, Israel will have received guaranteed loans totaling $9 billion by the end of 1984 and its annual interest payments will likely be over $1 billion beginning in fiscal year 1985.

Egypt and Israel may not be the only countries which could place the solvency of the Guaranty Reserve fund in doubt. Turkey provides another illustration. During the period 1978 to 1983, Turkey avoided payments on its military debt through international rescheduling exercises. The fund was able to cover these reschedulings because they took place before Turkey had a chance to incur a substantial liability. During these rescheduling periods, Turkey continued to receive new guaranteed loans. Thus, each succeeding rescheduling resulted in a larger drain on the fund's balance--$12 million in 1978 compared to $100 million in 1982.

If proposals currently before the Congress are approved, Turkey's guaranteed loans outstanding will rise to over $2 billion and a future Turkish rescheduling for a single year's payment will be in the quarter billion dollar range. The Turkish case shows that the longer the Guaranty Reserve Fund escapes a major rescheduling, the more serious the impact on the fund's solvency when one does occur.

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, then the Congress would need to appropriate funds to fulfill the Government's pledge to pay FFB.

This concludes our prepared statement, Mr. Chairman. We would be happy to answer any questions the Subcommittee may have.