Foreign Military Sales (FMS) Concessional Interest Rate Loans: Determination of Country Eligibility

By

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The United States cannot safeguard the Free World's security interests alone. When a country has a strong national defense, it reduces the probability of a local or regional conflict developing to the point whereby U.S. interests are threatened. It is to the advantage of the United States to enhance the ability of other nations to provide for their own defense. If a country, whose security interests parallels ours, is unable to pay cash but is financially capable of assuming debt obligations for the purchase of U.S.-origin defense articles and services, FMS financing will assist the country in sharing the burden of collective security. Consequently, the likelihood of U.S. interests being threatened or the U.S. military becoming directly involved in regional conflicts will be reduced.

The present FMS financing program originated in the Mutual Security Act of 1954. Since 1954 other legislation concerning financing has been enacted. Today, the primary acts are the Foreign Assistance Act (FAA) of 1961, as amended, and the Arms Export Control Act (AECA) of 1976, as amended. During Fiscal Years 1977-1984 most FMS financing was in the form of AECA, Section 24 guaranteed loans through the Federal Financing Bank (FFB). Interest rates for guaranteed loans were fixed at the time of disbursement of the loan funds at rates equal to the cost of money to the U.S. Treasury plus a one-eighth of one percent administrative surcharge. The requirement to repay high interest rate Section 24 guaranteed loans has contributed in several cases to certain Third World countries' difficulties in the repayment of loans and the servicing of their national debt.

Section 23 of the AECA authorizes the President to finance procurements of defense articles, defense services, and design and construction services by friendly foreign countries and international organizations. Historically, Section 23 direct loans have been used for two purposes: as U.S. Treasury rate loans to assist those FMS countries in the process of economic development; and as the vehicle for implementing "repayment waived" loans as authorized by the Congress. In addition to the normal treasury rate and "repayment waived" loans, FY 1986 and 1987 legislation referencing AECA, Section 23, authorizes concessional interest rate loans. U.S. Government policy has set the interest rates on these loans at one-half of the U.S. Treasury interest rate (but no lower than 5%) at the time of loan issuance.

The FY 1986-1987 FMS Financing Program contains no Section 24 guaranteed loans but, within the auspices of Section 23 direct loans, includes both treasury and concessional interest rate loans. The interest rate on treasury loans is fixed at the equivalent U.S. Treasury rate at the time of loan issuance. Within concessional rate loans there are two categories: loans for which repayment (principal and interest) is forgiven, and loans where the interest rate is fixed at a concessional rate. Some countries receive a combination of treasury rate loans and concessional rate loans. Other countries receive either treasury rate or concessional rate loans. For example, the *FY 1987 Congressional Presentation for Security Assistance Programs* proposal is for four countries to receive both treasury rate and concessional rate loans (Jordan, Portugal, Thailand, and Turkey). Eight countries are to receive only treasury rate loans (Cameroon, Gabon, Greece, Korea, Malaysia, Oman, Pakistan, and Spain), and twelve countries are to receive only concessional rate loans (Botswana, Colombia, Dominican Republic, Egypt, Indonesia, Israel, Morocco, Panama, Peru, Philippines, Tunisia, and Yemen).

One determinant of a country's eligibility for concessional interest rate loans is its annual per capita income. However, per capita income is not the only indicator of a country's ability to service additional debt. Another such indicator is the country's debt service ratio. The debt service ratio is determined by a country's export earnings. For example, if 30% of a country's export earnings is used to finance loans (principal and interest), the country is considered to have a 30% debt service ratio. A ratio of 30% or above, absent mitigating circumstances, is usually taken as evidence of a strained balance-of-payments position. However, ratios may be misleading. A recent rescheduling of a country's outstanding loans may cause a low current ratio. [Rescheduling has been discussed in a previous *DISAM Journal* article entitled "Debt Rescheduling," Volume 6, Number 3 (Spring 1984), pp. 39-44.] Since rescheduling prolongs loan repayments and increases the amount to be repaid in future years, it would be erroneous to use only the present debt service ratio to determine a country's ability to repay loans in the future. Projected ratios are only as good as the assumptions used, for example, estimates of growth of a country's Gross National Product (GNP) and estimates of the demand for a country's exports. However, debt service ratios, as projected by the World Bank and the International Monetary Fund, in conjunction with per capita income, are generally good indicators of a country's ability to repay current and future loans. In the final analysis, however, U.S. national security and political criteria are the dominant factors.

Loan recipients are divided into four categories, according to criteria used by the World Bank to determine eligibility for various levels of concessionality.

- **Category I.** Countries with annual per capita GNPs of less than $790 (1983 World Bank figures) can be deemed eligible for all concessional programs, unless other factors indicate so strong an ability to repay as to make this unnecessary. Category I includes the countries of Indonesia, Morocco, and the Philippines.

- **Category II.** Countries with annual per capita GNPs between $791 and $1635, can be deemed eligible to receive part of their FMS loans at concessional rates and part at treasury rates. In some cases, countries might be eligible for an all concessional program if "ability to repay" (as indicated by a current or projected debt service ratio of 30% or higher) is considerably in doubt. Category II includes the countries of Botswana, Cameroon, Colombia, Dominican Republic, Ecuador, Guatemala, Peru, Thailand, Tunisia, and Turkey. The Dominican Republic, Ecuador, and Peru are also considered for Category I (all concessional loans) because of balance of payments problems.

- **Category III.** Countries with annual per capita GNPs between $1636 and $2850 are deemed ineligible for concessional FMS loans unless there is a strong indication of repayment problems (debt service ratio over 30%). However, countries in this category are eligible for treasury rate loans. If Category III countries, such as Jordan, Panama, Portugal, and Uruguay, have considerable balance of payments difficulties, they may be eligible for concessional FMS financing.

- **Category IV.** Countries with annual per capita GNPs above $2850 are not eligible for concessional FMS loans based upon economic criteria. (This is the same figure used by the World Bank in determining the cut-off of eligibility for World Bank loans). However, countries in this category are eligible for treasury rate loans. Examples are Oman and Spain. Greece would normally fit into this category, but that country is made eligible for concessional interest rate loans by specific authorizing legislation.

Realizing the world's present economic problems, especially those concerning Third World countries, the USG has continued to take steps to assist not only economically but militarily those countries who have defensive needs. From World War II through the decade of the 1960s, the USG provided grant military materiel to friendly governments through the Military Assistance

Program (MAP) as authorized by the FAA of 1961. During the 1970s, as world economic conditions improved, the USG switched primarily to an FMS financing program under the auspices of the AECA of 1976. During the late 1970s and early 1980s, the oil crisis, recessions, droughts, and other depressed economic factors caused economic conditions to deteriorate. FMS financing through concessional interest rates will assist numerous countries in the improvement of their national defense capability and enhance regional stability.

ABOUT THE AUTHOR

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