



## **European Export Credit Agencies and the Financing of Arms Trade**

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Export Credit Agencies (ECAs) are collectively the single largest class of public financial institutions. They finance around ten percent of world trade and are the most important source of developing countries' debt. One of the sectors benefiting most from ECA support is the arms industry. Probably, around a quarter of the long-term credits and guarantees provided by European ECAs goes to military exports. Military export credits are not coherent with European and national development policies which aim at reducing poverty through the Millennium Development Goals, reducing the global debt burden and combating bribery.

This paper, based on European wide research on ECAs and Arms Trade<sup>1</sup>, further examines the relationship between development coherence, arms trade and development. First, an explanation on the function and methods of Export Credit Agencies is given. Then the relationship between three important barriers for development - military expenditure, debt burden and corruption - and military export credits is examined. After that, this paper will further elaborate on export credits for arms trade, transparency, corruption and on the so-called 'security exceptions' concerning arms exports within international treaties on Export Credit Agencies.

### **Export Credit Agencies**

Export Credit Agencies are mostly national, public or publicly mandated agencies. They support companies from their home country exporting to developing countries that are considered too risky (commercially or politically) for conventional corporate financing. Many ECAs provide direct loans, or when commercial banks or exporters provide the loans or the credit, ECAs provide guarantees or insurances. In this way, they are essentially covering potential losses for banks or exporters. In return for the payment of premium and/or interest for ECA support, a company gets the certainty of obtaining the anticipated revenues from its business. In case the counterpart in the developing country does not pay, the ECA will compensate the company. Because of the ECA support, the private risk of the company is effectively transferred to the public sector ECA. After the company has been compensated, the ECA will try to recover

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payment from the developing country.<sup>2</sup> If that does not work, the debt is transferred to the national government.

### How ECAs hamper development

In the Human Development Report of 2003, the United Nations Development Program (UNDP) points out several barriers to attain the Millennium Development Goals. One of those barriers is military expenditure.<sup>3</sup> Worldwide military expenses average ten percent of the public expenditure. For developing countries military expenses even amount to fifteen percent of public expenditure.<sup>4</sup> This very often equates several times the amount spent on education and healthcare. According to the UNDP, attaining the Millennium Development Goals is not possible without reducing military expenses. The UNDP pointedly states that 'without reforms [of the arms export policies] by exporters and recipients, commitments to the Goals seem questionable on both sides.'

The second barrier, according to the UNDP, is the indebtedness of many developing countries, not only the so-called Heavily Indebted Poor Countries (HIPC). Again, in many developing countries, debt discharges by far exceed spending on healthcare and education. According to different estimations, between fifteen and twenty percent of the total global debt is related to military expenses.<sup>5</sup> At this point Export Credit Agencies come in. The World Bank, The International Monetary Fund and other International Financial Institutions do not fund military transactions. ECAs however, do give loans or guarantees for arms sales. Without these, there would *be* no finance, and most of the time no arms sale. As a Midland Bank executive in charge of arms deals, once described: "You see, before we advance monies to a company, we always insist on any funds being covered by the [UK] Export Credit Guarantee Department...We can't lose. After 90 days, if the Iraqis haven't coughed up, the company is paid instead by the British Government. Either way, we recover our loan, plus interest of course. It's beautiful."<sup>6</sup>

According to the World Bank, corruption is one of the greatest barriers to development, especially severely effecting the poor.<sup>7</sup> Transparency International states: "bribing foreign officials in order to secure overseas contracts for their exports has become a widespread practice in industrial countries, particularly in certain sectors such as exports of military equipment and public works. Normally these contracts are guaranteed by government-owned or -supported Export Credit Insurance (ECI) schemes (HERMES in Germany, COFACE in France, DUCROIRE in Belgium, ECGD in the UK)."<sup>8</sup>

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2 A key characteristic of ECA support for an export or investment deal is the so-called counter-guarantee from the government of the developing country pledging payment in case of default. If the receiving company fails to pay for the exported equipment, the exporter and its bank will submit a claim with the ECA. The ECA will provide compensation under the insurance scheme on behalf of the domestic government. This government will claim the full nominal amount of the original transaction from the government of the receiving country, and add this to other export credit claims on that country. For arms exports the situation is different, since the receiver already is a government.

3 Human Development Report 2003, UNDP, p. 93.

4 'Worldwide Military Expenditures and Arms Transfers, 2003, Military Burden and Other Relative Indicators,' U.S. State Department, p.1.

5 Bleeding the poor: Arms versus development', International Broadcasting Trust, 1994, cited in: Oxfam International / Amnesty International: Guns or growth, Assessing the impact of arms sales on international development, 2003. Adams: Odious debts, cited in: 'Defining illegitimate debt and linking its cancellation to economic justice', Joseph Hanlon, Norwegian Church Aid, June 2002.

6 Quoted in Killing Secrets, ECGD: The Export Credit Guarantee Department, Killing Secrets, 1998, cited in 'Export Credit Agencies, Corporate Welfare and Policy Incoherence,' Nicholas Hildyard (Corner House), June 1999.

7 <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPUBLICSECTORANDGOVERNANCE/EXTANTICORRUPTION/0,,me nuPK:384461~pagePK:149018~piPK:149093~theSitePK:384455,00.html>

8 'Export Credit Insurance and the Fight against International Corruption,' Dieter Frisch, Transparency International working paper, 1999: 2.

As will be shown in this paper, these three barriers are all closely related to military export credits. By supporting arms trade through guarantees, loans and insurances, Export Credit Agencies hamper the development of countries receiving development aid from the European Union and its member states.

### Export credits for arms trade

#### ***Textbox 1***

##### **Arms in the portfolio of European ECAs**

1. The United Kingdom (ECGD): between 38 and 50 % in 2002-2005.
2. The Netherlands (Atradius-DSB): on average 27 % since July 2002, with a peak of 57% in 2004.
3. France (COFACE): one third (estimation based on information from the ministry of Finance).
4. Germany (Hermes): between 0,2 and 9.4 % of all -long and short term-credits.
5. The Belgian ECA guaranteed twenty percent of all the exported arms for which an export licence has been provided.

In most European countries, there is not much information available either on the policies of ECAs or on the export of military goods. Only for The Netherlands, Germany, the United Kingdom, Belgium and France there are (some) data available (see textbox 1). **The Austrian ECA (OeKB) does not guarantee any military goods,<sup>9</sup> the Swiss ECA excludes lethal weapons from its support.<sup>10</sup>**

Due to the lack of information, using figures on the share of military goods within the portfolio of the European ECAs can only be indicative. However, the data available show that ECA support is of great importance for arms trade. Probably between twenty to thirty percent of all long term credits and guarantees are military. In the meantime, arms exports make up for a relative

small proportion of overall export. Only in four European countries, the arms export covers more than 0.5 percent of the total exports. Old figures from two major European arms exporters show the importance of the export credit insurances and guarantees for the arms trade. In the nineties the British ECA (ECGD) used thirty percent of its budget (1998/99: 2,5 billion Euro) to cover for military exports. Roughly one fifth of the contracts (1998: 79 billion Euro) concluded by the France ECA (COFACE) during the same period were for military purposes. During this period, the value of French military exports was 6,3 billion Euro and the British 1,3 billion Euro.<sup>11</sup> In both countries, the ECA support for military equipment is almost twice the amount of all the military exports.

British data also show that ECA support for military exports is far from cost effective. The ECGD is the only ECA for which separate data concerning premium income, claims and recovered claims on military and civil credits are available. It turns out that over a period of eleven years 976 million Euro was lost on arms trade. The premiums generally cover one third to half of the claims for damages. For military goods, premiums only cover twenty to twenty five percent. Therefore, the ECGD's losses on military guarantees are higher than on the civil ones.<sup>12</sup>

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<sup>9</sup> This policy has been in place since 1994. OeKB's General Business Conditions states: the guarantee does not cover claims arising from the delivery of goods, which are subject to the regulations of the Federal Statute on the import, export and transit of war materials or to those of the Statute on security control.

<sup>10</sup> This means the company does not guarantee tanks or weapons, but would give a guarantee to a specially designed police car with Swiss technology or something similar.

<sup>11</sup> 'Rapport No 1861, Assemblée Nationale; Économie, Finances et Industrie; Commerce Extérieur', 18/11/99 annexe No 12; 'Rapport au Parlement sur les exportations d'armement de la France, Résultats 1998, Table le Livraisons de l'année 1998; Laurence Cockroft and David Murray (ed), 'Corruption in the Official Arms Trade', Transparency International Policy Paper; Britain Strategic Export Controls; Report 199; Table 4: 'Statistics on Exports of Military Equipment between 01/01/99 and 31/12/99. All cited in: Martin Broek, 'Paper on Export Credit Agencies and Arms Trade', Campagne tegen Wapenhandel, March 2003.

<sup>12</sup> House of Commons Written Answers, Ms Hewitt to Mr Stinchcombe MP, 4 February and 21 June 2002.

## Textbox 2

### Arms to South Africa

One of the more controversial arms deals in recent years is the sale of 24 British Aerospace Hawk fighter jets and 28 Gripen fighters to South Africa, worth almost four billion Euro, announced in 1999. This deal has led to several graft allegations in South Africa, involving the minister of Defence's change of the bid evaluation process that awarded the contract to British Aerospace for 616 million Euro more than an Italian competitor's offer. Meanwhile, South African ngo's have argued that the country's massive weapons procurement program directly contradicts its development needs. The deal was guaranteed by the British and Swedish ECAs (ECGD and EKN).

*Sources: Aaron Goldzimer, 'Globalization's most Perverse Secret: The Role of Export Credit Agencies and Investment Insurance Agencies', paper presented at the Alternatives to Neoliberalism Conference, May 2002; Ann Feltham 'The Case for Removing Arms from the ECGD's Portfolio', Campaign Against Arms Trade.*

Michael Woerfel, the German former head of European Aeronautic and Defence and Space Company (EADS) and DASA in South Africa "wined and dined his way into the lives of five South African government officials, who all played a key role in deciding the country's biggest arms deal," as the South African Sunday Times stated. One of the key South African suspects was sentenced to four years in prison, others lost their jobs. Among those Tony Yengeni, leader of the ANC in Parliament.<sup>13</sup>

### Corruption

According to the American Chamber of Commerce, fifty percent of the bribes paid worldwide between 1994 and 1999 relate to arms trade.<sup>14</sup> The CIA estimates forty to forty five percent.<sup>15</sup> This is remarkable, since arms trade only makes up one percent of the world trade. This link still exists,<sup>16</sup> as the South African example described above shows. Several OECD regulations aim to combat bribery.<sup>17</sup> However, payments of commissions worth five percent of the total value of the contract are generally accepted and no ECA has consistent debarment procedures in place when a company is convicted for corruption. Since the contents of the policies made by ECAs are not published, it is impossible to judge whether the commissions paid are in proportion with the delivered goods or services.<sup>18</sup> According to Dieter Frisch, former Director-General of Development at the European Commission, 'it is obvious that this practice [of including commissions in the amount covered by the export credit guarantee] constitutes an indirect encouragement to bribe.'<sup>19</sup>

### Security exceptions

The available figures, although not complete, make clear that arms are a major part of the business of ECAs and the other way around, that ECA support is important for the arms industry, or at

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13 *Arms Boss Wined and Dines Yengeni*, *Mzilikazi wa Afrika*, Jessica Bezuidenhout, 19 May 2002.

14 'International Trade Administration: National Export Strategy 2000', Trade Promotion Co-ordinating Committee, March 2000.

15 'Parallel Markets: Corruption in the International Arms Trade', Joe Roeber, Campaign against Arms Trade, 2005, p. 12.

16 Transparency International states in its yearly update that: "Despite a great deal of effort, particularly in seeking to put in place strong procurement processes, fighting corruption is still viewed by the public and by many in government and the military as a top priority. 'Update note 1: Preventing Corruption in the Official Arms Trade: Defence Integrity Pacts', 27 June 2005.

17 'Convention on Combating Bribery of Foreign Public Officials in International Business' (1999) and 'OECD Working Party on Export Credits and Credit Guarantees: 2006 Action Statement on Bribery and Officially Supported Export Credits' (May 2006)

18 More on the strength and weaknesses of the OECD anti-bribery policy: [http://www.eca-watch.org/problems/corruption/ecaw\\_oecd\\_bribery\\_press\\_advisory\\_16may06.htm](http://www.eca-watch.org/problems/corruption/ecaw_oecd_bribery_press_advisory_16may06.htm)

19 'Export Credit Insurance and the Fight against International Corruption', Dieter Frisch, Transparency International, 1999, p.23.

least for arms exports to developing countries. International agreements on ECAs facilitate this by making exceptions for arms trade. The Knaepen Package (the OECD agreement on premium rules), the European Council Directive and the WTO agreement on cost effectiveness all exempt the defence industry. Cost effectiveness means that premiums and repaid claims suffice to compensate the losses and pay the costs of the facility.<sup>20</sup> This exemption implies that it is allowed to subsidize the defence industry through the export credits.

The Dutch and British examples show that Atradius and ECGD are far from cost effective. The UK Treasury now accepts that the ECGD is subsidised to the tune of 205 million Euro a year from public funds. In the Netherlands the repaid claims mainly consist of debt cancellation within the framework of the Paris Club. Without this - partly official Development Assistance (ODA) - money<sup>21</sup>, the export credit facility would be far from cost effective. ECA-backed arms transfers are debt-producing transactions because they are "non-productive expenditures", which do not generate means that contribute to debt repayment. The OECD members have agreed not to borrow money to Heavily Indebted Poor Countries (HIPCs) for unproductive expenditures, but its Statement of Principles 'does not automatically preclude support for equipment deemed essential to the debtor's country's national security or required to combat e.g. the drugs trade, smuggling, piracy, etc.'<sup>22</sup> This means that subsidizing the defence industry through export credits is allowed, even to the poorest or most severely indebted countries.

### Textbox 3: Indonesia

Although Indonesia does not have an HIPC status, the controversial sales of the Scorpion tanks and Hawk fighter aircraft to Indonesia in the nineties are good examples of the effects of the exemptions. London paid the price for the sale, which ECGD made possible. Late 2004 Indonesia owed 127 million Euro to ECGD for this deal. At the same time, The Guardian unveiled that: "In the last six years, the taxpayer has paid 883 million Euro to arms firms for failed deals with Indonesia." The ECGD still hopes to get some of its money back.

Meanwhile, by now severely indebted Indonesia continues to borrow money for defence procurements. In 2004, between 15 to 20 percent of the concluded debts were for arms deliveries. Recently Russia borrowed Indonesia 742 million Euro for updating its army with Russian fighter planes, Poland lend the country over 193 million Euro for transport planes and the Netherlands more than one billion euro for four navy vessels (corvettes). According to an American defence official, weapon deals like these are not possible without a flexible financing program and loans with low interest rates. In the meantime, Indonesia spends almost 15 percent of its government budget on the military, worldwide this averages ten percent. Debt repayments cost the country twice as much as it spends on health care and education together.

Sources: Rob Evans, 'Taxpayers paid £400m to BAE for failed arms deals,' *The Guardian*, 20 December 2004. 'Defence Procurement and Military Related Debt', Andi Widjajanto, *The Jakarta Post*, 13 June 2005, 'Guns or Growth. Assessing the Impact of Arms Sales on Sustainable Development', *Oxfam International/Amnesty International*, 2003, footnote 37, 'Indonesia Inks Deal to Purchase 10 Skytruck Planes from Poland', 6 June 2006 and 'Air Force to Buy Six more Sukhois', *The Jakarta Post*, 6 June 2006.

Those ECAs, which do have corporate social responsibilities policies, very often exclude military deals from these policies, just as arms are excluded from transparency policies (e.g. France and Italy). Within the OECD-DAC however, OECD members have agreed not to register the

20 The European Council Directive 98/29/EC of 7 May 1998 on harmonisation of the main provisions concerning export credit insurance for transactions with medium and long-term cover, WTO Agreement on Subsidies and Countervailing Measures

21 In the period 2002-2008 between five to twelve percent of the ODA budget -which is 0,8 percent of the Dutch BNP- will be spent on cancellation of export credit debt.

22 'OECD Export Credit Group Discourages Official Support for Unproductive Expenditure in Heavily Indebted Poor Countries: A Statement of Principles, 19 July 2001. In fact, this is quite a symbolic measure, since these countries are already heavily indebted, they are off cover because the risk of non-payment is too high.

cancellation of military debts as ODA 'since military transactions are not contributing to the development of developing countries'. Unfortunately, all the information necessary to see to the implementation of this arrangement lacks.

### **Arms export policies**

The European Union has a Code of Conduct on Arms exports.<sup>23</sup> This Code aims to prevent arms exports to countries violating human rights, involved in (impending) conflicts or for which the procurement of (expensive) arms would be a heavy burden on the national budget. The national governments of the European Union implement this Code of Conduct at the national level. However, once a public or publicly mandated Export Credit Agency backs an arms deal –this often happens long before the export licence is issued- the government becomes a financially interested party. For example, the Netherlands plans to export four corvettes to Indonesia (see textbox 3). If however, the human rights situation in Indonesia deteriorates and granting an export license would be inappropriate, the Dutch government is exposed to the risk of losing one billion euro<sup>24</sup>. Financial involvement is conflicting with the government's role as an independent supervisor.

### **Conclusions and recommendations**

Due to a lack of transparency in many countries, a lot of information on ECAs and arms trade is still lacking. Even most countries that do provide information on the projects and goods they guarantee, do not provide information on export credit support for strategic goods. Information on the policies backed by ECAs is needed to gain more insight in the amount of military export credits, to prevent corruption and to make sure that the cancellation of military debts is not booked as ODA. A higher level of transparency will also create a level playing field for European ECAs since several ECAs already provide information per policy.

### **Recommendation**

**European Export Credit Agencies and national governments should publish information per policy. This should at least include value of the policy, exporter, exported goods or services, financier and commissions.**

As is described above, industrialized, arms producing countries promote their home country's arms exports through export credit loans, insurances and guarantees. In this way, they stimulate military expenditure in developing countries, facilitate corruption and contribute to new – unsustainable- debts. This practice is not coherent with development policies, which aim at reducing indebtedness, stimulating good governance and combating bribery.

### **Recommendation**

**European Export Credit Agencies should stop lending support for the export of strategic goods.**

*For more information on export credit agencies and arms trade, see [www.stoparmstrade.org](http://www.stoparmstrade.org) and [www.eca-watch.org](http://www.eca-watch.org). You can also contact [m.peperkamp@stopwapenhandel.org](mailto:m.peperkamp@stopwapenhandel.org). Late September, the ENAAT Research Group will publish a report on ECA support for military transactions, [www.enaat.org](http://www.enaat.org).*

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<sup>23</sup> <http://ue.eu.int/uedocs/cmsUpload/08675r2en8.pdf>

<sup>24</sup> 'Exportkredietverzekering, sondages en wapenexportvergunningen', letter from the Ministry of Economic Affairs to Parliament, 27 June 2005.