CHAPTER III

FACTORS AFFECTING OFFICIALLY SUPPORTED EXPORT CREDITS

The decisions of the OECD governments to further reduce subsidies and to downsize government-supported businesses in the early 1990s were key factors in setting in motion the retreat of official agencies as suppliers of short-term export credits in industrial countries. Both national and international policies have also had a direct impact on the level, destination, and sectoral allocation of officially supported export credits. The subsequent rise of the private sector represents a fundamental force reshaping the landscape of international trade finance, with long-term implications for official agencies.

There are other factors that are affecting official export credit agencies' core market—which is the financing of capital goods exports to developing countries. On the supply side, these factors include the availability of trade finance from local sources in emerging markets, innovations to attract capital market financing, and the emergence of trade finance facilities in multilateral development banks. Demand-side factors include changes in the importer countries.

The evolution of this core market also has implications for the role of official agencies in the years ahead. Although these changes suggest an increasing marginalization of the official agencies relative to their traditional core business, the number of such agencies has continued to grow as developing countries follow the lead of most OECD countries.

Government Policies

Reduction of Explicit Subsidies

The sharp reduction of explicit subsidies as a result of the OECD Arrangement and the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM) has been one of the key reasons for the decline in ECA activity relative to exports in OECD countries.[1] During the 1970s, expensive subsidy competition in export finance among major industrial countries not only distorted the market but also became an increasing drain on government budgets, as evidenced by the large cash outflows from the ECAs. The OECD Arrangement, established in April 1978, has played an important role in promoting free and fair trade by reining in government subsidies on export credits.[2]

Over time, the scope and coverage of the OECD Arrangement have expanded from disciplines on interest rates and repayment terms of export credits to, among other things, risk premiums on credit insurance and tied aid credits. In April 1999, the so-called Knaepen Package of the OECD Arrangement went into effect, providing a new discipline on minimum premium rates for the country credit risk for medium- and long-term officially supported export credits, irrespective of whether the importer or borrower is a private or public entity.[3] The package applies to all OECD member governments that are participants in the Arrangement. It recognizes the need to

[1]WTO rules permit the use of development assistance but preclude the use of subsidies that distort international trade and are more for the benefit of domestic exporters than poorer countries.

[2]The Arrangement set minimum fixed rates of interest, minimum down payments, maximum lengths of credits, and standard repayment terms on export credit facilities.

[3]Pierre Knaepen was the chairman of a Working Group of Experts mandated by the participants in the OECD Arrangement in 1994 to develop proposals on guiding principles for setting premiums and related conditions (see OECD, 1998 and 2004).

converge on risk premiums so as to level the playing field and to meet the Item (j) provision of the WTO Agreement on SCM (see Appendix III). Item (j) requires export credit agencies to break even over the long term, that is, to charge premiums at adequate levels to cover long-term operating costs and losses. It applies not only to OECD countries but also to all other members of the WTO, further dissuading the use of subsidies in trade financing.[4]

More recently, reviews of the disciplines governing export credits have focused on the consistency between the WTO and the OECD Arrangement, and have examined, among other things, issues relating to export credits with a floating interest rate provided by private banks under ECA insurance cover.[5]

Privatization of ECA Short-Term Activity

The U.K. government began the privatization trend in 1991 with the sale of the short-term credit insurance business of its Export Credits Guarantee Department to NCM of the Netherlands. The U.S. government followed suit with termination of its exclusive underwriting relationship with the Foreign Credit Insurance Agency (FCIA) in 1992.[6] COFACE of France was privatized in 1994. While sales or transfers (e.g., Sweden and Finland) directly moved the export credit agencies' short-term business to private hands, there has also been silent privatization in which private insurers, acting as an agent of the government, have insured more and more business on their own accounts, leading to a declining share of government account business in total business (e.g., NCM of the Netherlands, and COFACE since 1994). Outside the OECD area, South Africa terminated the arrangement under which the government reinsures the country's export credit agency in 2001, while Singapore has recently privatized its official export credit agency.

Competition Policies

The retreat by official ECAs from the short-term market in OECD countries has also been a direct consequence of government actions that provide more room for private companies. The European Commission set guidelines in 1997 discouraging governments in the European Union (EU) from insuring "marketable risk" (short-term commercial credit risk contestable in the private market) in OECD countries (excluding Mexico and Turkey), while allowing private insurers and reinsurers within the EU to underwrite any risks they are willing to cover.[7] The U.S. Export-Import Bank has shifted its short-term business focus to small and medium-sized exporters who cannot find cover in the private market, based on a general policy of not competing with the private sector in this area. More recently, the government of Japan announced the end of the monopoly on short-term export credit insurance by the state-owned company, Nippon Export and Investment Insurance (NEXI), as of 2005.

Private Sector Competition

Globalization and Intrafirm Trade

Net foreign direct investment in emerging markets has risen dramatically since the early

[4]As specified in Articles 1 and 3, and Annex 1 of the WTO Agreement on SCM.

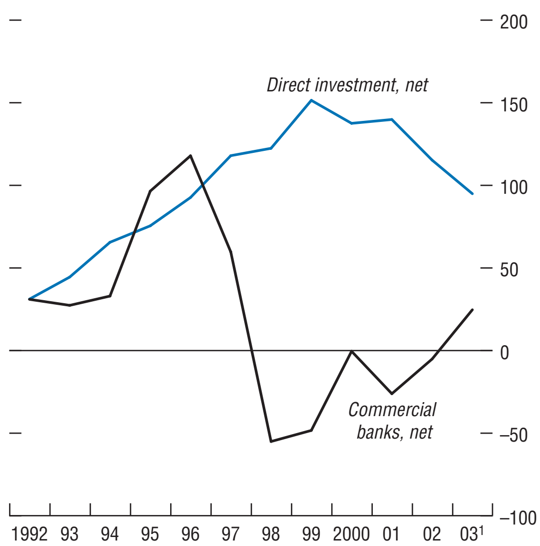
[5]The WTO Agreement on SCM considers official support for export credits provided in conformity with the interest rate provisions of the OECD Arrangement as not being prohibited subsidies (the "safe haven" clause). However, recent case law in the WTO found that the OECD Arrangement, as it stands, does not "protect" export credit practices taking the form of floating interest rate arrangements. Reaching consensus on official support under floating interest rate arrangements would help ensure effective regulation of subsidies provided in this area of export finance. The recent WTO rulings on disputes over regional jet aircraft financing between Canada (an OECD Arrangement participant) and Brazil (a nonparticipant) have underscored the importance of resolving these remaining issues.

[6]The U.S. Export-Import Bank's book of short-term business was split. The FCIA as a private entity took what it wanted for its account, with the U.S. Export-Import Bank assuming the rest.

[7]See Godier (2001).

1990s (Figure 3.1). As a result, the share of international trade occurring through cross-border production networks, where multinational corporations produce each stage of a final good in a different location, has grown significantly.[8] The long-term relationships required for network production reduce the need for many of the traditional security arrangements for trade finance (e.g., letters of credit), and hence the demand for ECA services.[9]

Figure 3.1. Foreign Direct Investment and Commercial Bank Lending to Emerging Market Economies
(In billions of U.S. dollars)



Source: Institute of International Finance.
Note: For a group of 29 emerging market countries, including China, India, Brazil, and Indonesia.
[1]2003 figures are estimates.

Private Insurers

Private trade credit insurance has registered strong growth since the mid-1990s and now dominates the short-term market. In political risk insurance (medium- and long-term), new players have entered the markets (e.g., Sovereign and Zurich, as shown in Figure 3.2), and others have returned with a strong presence (e.g., Chubb). The number of insurers in the market almost doubled during the 1990s. Some insurers (e.g., AIG, Sovereign, Zurich) have pushed out the tenor of their cover to 15 years and per risk capacity.[10] Some large private insurers have established a presence in major emerging markets (e.g., COFACE and AIG) and used their financial strength and high credit ratings to package and securitize trade risk for large customers. Increased private sector participation reflects an improvement in the ability of private insurers to analyze and manage trade credit and investment risks. Since the late 1990s, large private reinsur-

[8]OECD data show that during the 1990s, the share of intrafirm trade in goods exports increased slightly in the United States (from 32 percent in 1992 to 36 percent in 1999), but rose sharply in Japan (from 17 percent in 1992 to 31 percent in 1999).

[9]For instance, letters of credit are not commonly used in China's "export processing trade," which, according to China Customs Statistics, accounted for 55 percent of the country's exports of more than $430 billion in 2003. Export processing trade refers to certain transactions in which a foreign entity purchases Chinese manufactured goods, or has raw materials and components processed on a consignment basis in China. In addition, foreign direct investment (more than $50 billion a year) has provided financing for a large part of China's capital goods imports, dampening the demand for ECA financing.

[10]See James (1999) and Mackie (2003).

ers, such as Munich Re, Swiss Re, and others, have also provided political risk support.

Other Factors

Trade Finance Facilities of Multilateral Development Banks

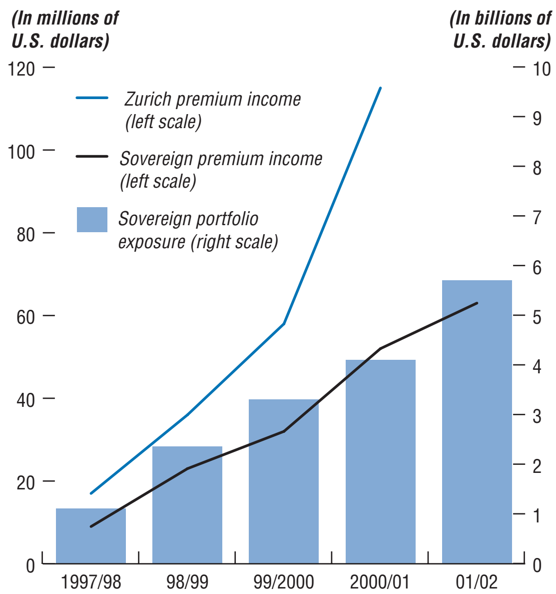
Multilateral development banks are relatively new to trade finance, although the World Bank's Multilateral Investment Guarantee Agency (MIGA) has long been in the business of promoting foreign direct investment in developing countries through political risk guarantees or insurance as well as advisory services (Box 3.1). Major regional development banks have set up trade financing facilities over the past several years, and while their size is still modest compared with financing provided by official ECAs, these facilities constitute an additional source of trade finance to developing countries. The facilities have been designed to be part of the multilateral banks' tool kits for development financing, but some of them have played an important role in mitigating the impact of a generalized loss of access to trade finance in recent financial crises.[11]

Local Banking Capacity in Emerging Markets

The development of local banking capacity in emerging markets has eclipsed the ECAs' role as the main financier of capital equipment imports, particularly in Asia. The volume of medium- and long-term activity (excluding project and aircraft financing) in China and other Asian emerging markets by export credit agencies in OECD countries has been stagnant since the mid-1990s, notwithstanding rapid import growth in these countries.[12] Available data from the Bank for International Settlements (BIS) indicate that, while cross-border lending by OECD-based commercial banks to developing countries increased by about 40 percent between 1990 and 2001, local bank lending in developing countries

[11]See International Monetary Fund (2003).
[12]See Chang (2002).

Figure 3.2. Selected Private Export Credit Insurers: Premium and Exposure



Sources: Sovereign Risk Insurance Limited and Zurich Emerging Markets Solutions.

Box 3.1. Multilateral Development Banks and Trade Finance

The **International Finance Corporation (IFC)**, which is part of the World Bank Group, offers trade financing through a variety of instruments, including partial guarantees of bank financing related to confirming letters of credit, purchase of trade-related notes issued or guaranteed by local banks and extension of trade credit lines to local banks, and financing to exporters. Trade financing support by the IFC to crisis-affected countries totaled about $1 billion in 2003 (World Bank, 2004).

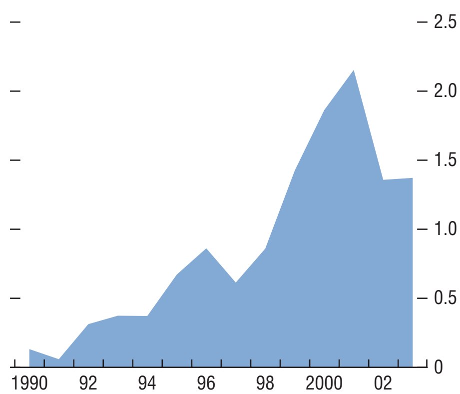
The **Multilateral Investment Guarantee Agency (MIGA)**, also part of the World Bank Group, provides political risk insurance to investors and lenders. It frequently acts as a syndicate leader for large transactions and is an important player in investment insurance and the reinsurance market, accounting for about 5 percent of investment insurance worldwide.

The **European Bank for Reconstruction and Development (EBRD)** provides trade finance to private sector firms through its Trade Facilitation Program (TFP). Started in 1999, the TFP offers guarantees against both commercial and political risks. Instruments covered by EBRD guarantees include letters of credit, trade-related promissory notes, and advance payments guarantees and bonds. In 2003, the TFP financed close to 500 transactions totaling more than 900 million euros. Transactions supported by the EBRD are mostly short term (within a year).

The **Asian Development Bank (ADB)** has its own trade finance programs, which consist of a guarantee facility and a revolving credit facility, each covering commercial and political risk. The former allows local banks access to short-term trade credit from international and regional banks and covers up to 80 percent of the trade instruments (letters of credit, standby letters of credit, and bankers' acceptances). The short-term lending facility provides credits to local banks that on-lend to private enterprises engaged in international trade. During the Asian financial crisis, the ADB made trade financing available to a number of countries, including Thailand, Pakistan, and Indonesia.

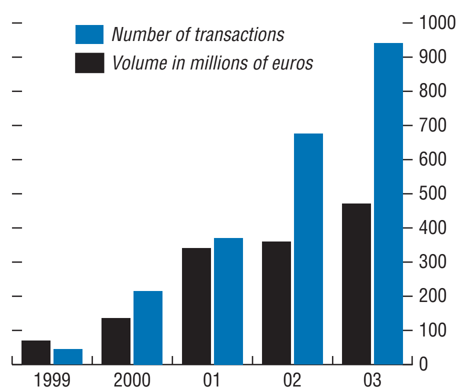
The **Inter-American Development Bank (IDB)** approved $1 billion for a Trade Finance Reactivation Facility in March 2003 to finance private firms engaged in international trade. The facility follows the EBRD model and offers guarantees covering trade finance instruments (such as letters of credit) issued by local commercial banks, thereby providing comfort to international banks.

Investment Guarantees Issued by the Multilateral Investment Guarantee Agency
(In billions of U.S. dollars)



Source: Multilateral Investment Guarantee Agency.

Trade Facilitation Program Transactions by the European Bank for Reconstruction and Development



Source: European Bank for Reconstruction and Development.

increased by a factor of 11, with the volume of local bank lending exceeding cross-border lending by a large margin. This structural shift reflects strategic refocusing by international banks to reduce cross-border exposure and risk after the financial crises in the late 1990s, and the fact that many of these banks established subsidiaries and expanded operations in emerging market countries.

Capital Market Financing

During the past decade, capital market financing has gained ground vis-à-vis other forms of debt financing to emerging markets.[13] Access to capital markets, which includes securitization, factoring, and forfaiting, has provided emerging market economies with an opportunity to diversify their trade finance sources. Countries with market access are therefore likely to use these alternative sources of financing where available at terms comparable to those offered by official ECAs. In addition, given attractive yields, capital market investors have been drawn to emerging markets' trade and project finance—especially to investment grade countries—by the ability of structured finance to minimize risk.

Changes in Importer Countries

It also seems axiomatic that official ECAs' core markets—subinvestment grade developing countries—become less reliant on officially supported export credits as their per capita income grows and creditworthiness improves. Unless countries currently relying primarily on concessional development assistance move up the development ladder to become substantial users of official export credits, ECAs' core market could continue to shrink. Available data suggest that this may well be the case—the top 10 recipients of officially supported export credits have not substantially changed over the past 10 years, but at the same time, official ECAs' exposure to some large users has fallen (see Figure 2.6). With the increased availability of local financing capacity (e.g., in China, Brazil, Mexico, Russia), the market presence of ECAs in these countries may become smaller.

[13]Cline (2001) notes that net bank lending to emerging markets fared significantly worse than net lending through bonds and other nonbank sources (e.g., supplier credits and nonresident purchases of domestic treasury bills) following the financial crises of the late 1990s. The share of bonds and other nonbank lending in total external debt held by emerging markets rose from 23 percent in 1992 to 39 percent in 2002, whereas the share of commercial banks declined from 35 to 26 percent and that of official bilateral creditors fell from 27 to 19 percent.