CHAPTER V

CHALLENGES FACING OFFICIAL EXPORT CREDIT AGENCIES

Complementing the Private Sector

Over the past decade, the private sector has grown to become capable of providing trade financing adequately and competitively in certain markets previously dominated by official export credit agencies. Official ECAs also have to deal with two other sources of competition originating from economic development in recipient countries: the expansion of domestic banking capacity, and improved access of borrowing countries to other sources of international financing as their income level and creditworthiness rise. The current top markets of ECAs may eventually become self-sufficient in meeting the financing needs for their capital goods imports and even in large project financing. (For instance, such was the case in Spain in the 1960s, Korea in the 1980s, and Mexico and possibly China more recently.) If these factors continue to develop, official ECAs' share in world trade may decline further. Especially in OECD countries, official ECAs are facing the challenge of private sector competition and an associated adverse selection problem—how to break even while covering the riskiest segments of the market.

Some official export credit agencies have reacted to these developments by entering into risk sharing arrangements with other public and private insurers on the assumption that political risks would be underwritten by official agencies and commercial risks would be underwritten by the private insurer or commercial banks, or even the project sponsor.[1] In recent years, official export credit insurers have increasingly taken part in reinsurance agreements with other official agencies and private reinsurers, especially for political risk. A recent survey of Berne Union members shows that official ECAs reinsure about 70 percent of their short-term business (see Appendix VIII). There may also be a trend, especially in OECD countries, for the public agencies to act as a reinsurer. Several European governments have moved partially in this direction by providing a political reinsurance window for their chosen underwriting agencies. Some governments, such as the United Kingdom and Denmark, have maintained backstop national interest account reinsurance facilities after withdrawal from short-term business.[2]

Representatives of official ECAs and private insurers broadly share the view, as evidenced in recent surveys and discussions with staff from the International Monetary Fund, that governments should not do what the private sector is capable of doing and that national agencies should complement, rather than compete with, the private sector. This could be achieved by:

- Fostering private sector development by providing room for private creditors and insurers, where the private sector is capable, to do more, including in medium- and long-term export credit and investment insurance markets. In this regard, periodic review of private sector capacity and public agencies' services would facilitate adjustment when needed.
- Standing behind the private sector by acting as a reinsurer of qualified private underwriters.[3] This would encourage competition among private sector insurers and allow public agencies to focus on public policy objectives. It would also allow public agencies to retain the necessary means to influence private trade financing flows.

[1]See Wilkinson (2004).

[2]See Export Finance and Insurance Corporation (2001).

[3]There is a widely shared view in the market that private reinsurance capacity, as well as private sector lending, is cyclical, drying up when the market becomes riskier (National Economic Research Associates, 2000).

- Working alongside private underwriters by sharing risks as a coinsurer or coguarantor.
- Filling in market gaps when the private market retreats, including meeting possible additional demand arising from implementation of the Basel II Accord on banking regulation.

The Basel II Accord is expected to strengthen the links between risk assessment and capital requirements of commercial banks. This may have an impact on the appetite of international banks for cross-border lending, including trade finance to emerging markets. Because ECA guarantees from OECD countries will continue to carry a zero- or low-risk rating, ECA-supported assets should remain attractive and could be in greater demand. Developments in insurer capital adequacy rules, such as the European Union's Solvency II, may also increase demand for underwriting risks by official ECAs.

Financing for Low-Income Countries

Many low-income countries have seen their share in world trade decline.[4] Yet foreign trade and investment represent a key engine of growth that could pull these countries out of persistent poverty. Trade finance may be a constraint to many low-income countries increasing their participation in the world economy. Indeed, there is a sizable amount of exports from developing countries that has little or no access to trade credits.[5] There also are large gaps in terms of the risk mitigation tools available, as well as between the perception and reality of low-income countries, especially in Africa. Official export credit agencies could play a useful role in filling in these gaps, thereby facilitating foreign trade in low-income countries, including intraregional or South-South trade. The challenge is how to provide such support while helping to maintain external debt sustainability in these countries.

To achieve external debt sustainability, many low-income countries have benefited from various debt relief initiatives, including the HIPC Initiative. In addition, many of these countries have adopted policies to restrain public sector borrowing on nonconcessional terms under economic programs supported by international financial institutions. Under these circumstances and against the general backdrop of a lack of creditworthiness in many poor countries, official export credit agencies could:

- Target viable private sector borrowers and projects that do not require sovereign guarantee, particularly in countries with improved creditworthiness.
- Participate in public-private risk sharing arrangements such as the Africa Trade Insurance Agency as a reinsurer or coinsurer. Coinsurance is an area that attracts private interest and could be further explored to facilitate trade financing to developing countries.[6]
- Explore ways to make the best use of the competitive advantages of ECAs in markets with little or no access to private market financing, including processing traditional trade finance, arranging financing for projects, and supporting local currency financing where warranted,[7] while maintaining prudent risk management.

Providing cover without a sovereign guarantee exposes export credit agencies to the risk associated with the operation of domestic bankruptcy systems in low-income countries. These poorer nations, and developing countries in general, therefore need to pay particular attention to developing creditor rights, including the legal framework and enforcement mechanisms for insolvency, as well as to building a credit culture and creditworthiness, in order to attract externally provided trade financing.

[4]See World Trade Organization (2004).

[5]According to *International Trade Finance* (December 2003), cash-in-advance is the recommended or preferred payment arrangement for about 20 developing countries. Exports from these countries amounted to $80 billion in 2003.

[6]See Mudde (2003).

[7]Many ECAs already offer cover for local currency financing. See Hodgson (2003).

Trade Finance in Financial Crisis

In the context of an international effort, with crisis country authorities adopting the appropriate macroeconomic and structural reform measures to address the root causes of the crisis, official export credit agencies could play a constructive role in crisis resolution and in the subsequent recovery by helping to restore confidence and supporting or providing financing where warranted. The challenge is how to do this in the face of the technical and financial constraints discussed earlier in this report (see Chapter IV), and in a way that minimizes the risk of moral hazard on the part of private lenders.

Because most short-term trade finance is now provided by the private sector, the direct extension of short-term trade credit by governments may not be feasible. Accordingly, an ECA intervention to provide cover would need to be crafted to fit the contours of financial markets. Specifically, an effective approach would probably use the established business relationships and expertise of banks and private credit insurers, but shift some of the risk from the private sector to ECAs, so as to encourage banks to maintain exposure without assuming more credit risk or needing to accumulate loan provisions. Official export credit agencies and their guardian authorities could:

- Strengthen the ability of ECAs to act as a reinsurer and coinsurer.
- Explore ways for export credit agencies in noncrisis countries to play more of a countercyclical role, especially in the recovery from crises, by playing a signaling role, facilitating medium- and long-term financing for investment in emerging markets, and, where possible, rolling over or expanding short-term credit lines, including the expiring maturities of originally longer-term credits.
- Complement multilateral development bank trade finance facilities in a concerted effort to restore confidence and facilitate the resumption of private sector financing.

Export Credit Agencies in Developing Countries

For developing countries that set up export credit agencies to promote exports and development, an additional challenge is to use the limited resources to fill in the market gap in risk mitigation and trade financing, rather than to serve subsidy or commercial policy purposes. The experience of the ECAs in industrial countries from the 1970s through the 1990s has clearly shown that international subsidy competition is costly and ultimately counterproductive. It has also shown that individual countries have much to gain by joining multilateral efforts to eliminate export subsidies. The OECD Arrangement on Guidelines for Officially Supported Export Credits provides a framework of rules that has helped strengthen the WTO discipline on subsidies. Already, some emerging market ECAs have opted to follow the OECD Arrangement in their operations. More countries joining such an effort would help promote a level playing field in international trade and increase the efficiency of official export finance.

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