International trade plunged in the latter half of 2008 and throughout 2009 (Baldwin 2009). The global financial meltdown not only led to a substantial drop in economic activity in both emerging markets and the developed world, but also made it increasingly difficult for potential trading partners to gain access to external finance. Although trade finance—due to its self-liquidating character—is generally on the low-risk, high-collateral side of the finance spectrum and underwritten by long-standing practices between banks and traders, developments have shown that it has not been spared by the credit crisis (Auboin 2009; Chauffour and Farole 2009).

The sharp drop in trade volumes was driven primarily by a contraction in global demand. Yet the decline in trade finance—its own driven mainly by the fall in the demand for trade activities but also, at least partly, by liquidity shortages—is likely to have further accelerated the slowdown. Reliable statistics on trade finance are scarce, but available evidence suggests that trade credit was the second-biggest cause of the trade collapse (Mora and Powers 2009). Anecdotal evidence from banks and traders reinforces this view, as do the sharp increase in short-term trade credit spreads and the sheer size of the trade volume decline.

Both bankers and the international community have since called upon state-backed export credit agencies (ECAs) to expand their operations to mitigate credit risk and keep trade finance markets from drying up. Given the renewed interest in
ECAs, the question arises whether a larger number of developing countries should follow suit and establish their own agencies to support exporting firms and to avoid severe trade finance shortages in times of crisis.

This chapter discusses some issues that require attention when deciding whether a country should establish an ECA as well as what shape, form, and modus operandi it should take. It also discusses why any decision to establish an ECA should be made only after a careful evaluation of the impact of such an institution on both the financial and real sectors of the economy. In addition, the choice of a sustainable business model for the ECA is crucial. The chapter does not seek to provide definitive answers as to whether, when, and how developing countries should establish ECAs. However, it tilts toward extreme caution in setting up such entities in low-income countries with weak institutions and highlights a range of factors that policy makers should consider in deciding whether an ECA should be established.

Export Credit Insurance and Guarantees: Public Agency Support?

Opening the discussion is an analysis of data from the International Union of Investment Insurers (the Berne Union) on the export credit insurance industry. The issuance of export credit insurance and guarantees is an aspect of trade finance that is of crucial importance, especially in a crisis environment of high systemic risk. In the context of a declining secondary market to offload loans, along with an increase in bank counterparty risk, demand is high for export credit insurance and guarantees.

The market for export credit insurance and guarantees comprises not only private but also public players, namely ECAs. Whereas the market for short-term insurance (credit terms of up to and including 12 months, for the purposes of this chapter) is dominated by private agencies (some 80 percent of overall business), ECAs underwrite the wider majority of medium- to long-term commitments.

The Berne Union is the leading association for export credit and investment insurance worldwide. Its members represent all aspects (private and public) of the export credit and investment insurance industry worldwide. The Berne Union made recent country-by-country data available to the World Bank’s International Trade Department that span 2005 through the third quarter of 2009. The data cover 41 countries, 9 of which are classified as high-income countries, 22 as middle-income countries, and 10 as low-income countries. For a given country, the dataset includes information on the total value of insurance offers and insurance commitments on its imports.1

Figure 16.1 shows the evolution of both global trade and export credit insurance volumes from the first quarter of 2005 through the third of 2009. Mirroring
trade volumes, total insurance commitments of the Berne Union’s members grew steadily during the past few years before dropping between the second quarter of 2008 and the first of 2009. Total insurance volumes have since recovered side by side with trade volumes. Intuitively, a growing volume of trade will increase the demand for trade finance, insurance, and guarantees independent of any change in the risk environment. This is likely the main reason why the export insurance business has grown steadily over the past years.

Similarly, the fall in trade volumes from the second quarter of 2008 through the first of 2009 can be seen as a proximate factor explaining the drop in overall insurance commitments. It is striking, however, that insurance volumes fell by much less (15 percent) than did global merchandise trade (36 percent) during this period. This observation is consistent with anecdotal evidence suggesting that trading partners resorted to more formal, bank-intermediated instruments to finance trade since the outbreak of the financial crisis to reduce the high probability of default in open-account financing. In addition, the increase in bank counterparty risk may have led to a substitution of export credit insurance for other
trade finance products such as letters of credit. Such developments would lead to a greater relative demand for external credit insurance and guarantees despite the substantial increase in risk premiums and the cost of insurance, thus reflecting the increasingly important role of insurance and guarantees during times of crisis.

Figure 16.1 also illustrates how the composition of export credit insurance has evolved. Short-term insurance commitments almost doubled in value until the beginning of the financial crisis but dropped strongly (by 22 percent) between the second quarter of 2008 and the first of 2009 and kept falling at a slower pace thereafter (by 2 percent). Medium- to long-term commitments, however, remained almost constant in volume during the period of the strongest impact of the crisis (falling by 3 percent) and have recovered since then (increasing by 9 percent since the first quarter of 2009).

How may these findings be rationalized? Medium- to long-term insurance is typically used for large-scale transactions. The surge in longer-term relative to shorter-term commitments since the second quarter of 2008 was therefore likely because demand for insurance for large-scale transactions increases in an environment of high systemic risk. Given the need to recapitalize in a timely manner, supply-side factors may also have affected the composition of different maturities in insurance commitments. Indeed, with insurers and banks needing to recapitalize and offload their balance sheets from liabilities whose risk is difficult to assess, short-term commitments are more easily terminated on short notice.

However, given that insurance premiums for longer-term insurance are particularly expensive in an environment of high systemic risk and given that capital expenditures dropped rapidly during the crisis, the magnitude of the divergence between short-term and medium- to long-term volumes is difficult to explain solely based on the perspective of private market participants. Indeed, a likely factor that could explain these findings is the active intervention of the public sector. Whereas ECAs backed by state guarantees underwrite only about 10 percent of overall policies, this share is much higher for medium- to long-term insurance and historically accounts for most of the collected premiums and disbursed claims in export credit insurance. In other words, governments and multilateral institutions followed through on their pledges to boost trade finance programs.

It is interesting to consider the change in the composition of medium- to long-term commitments across income groups. Figure 16.2 shows that between the second quarter of 2008 and the first of 2009, medium- to long-term commitments grew by 6 percent for high-income economies, compared with decreases of 7 percent and 4 percent for low- and middle-income economies, respectively.

These numbers likely partly reflect the growing need for export insurance and guarantees for trade flows to industrialized economies that were previously at the low end of the risk spectrum. However, the figures may also indicate a shortage in
insurance supply for trade flows to developing, as opposed to developed, markets when the crisis reached its peak.\(^2\) In the period after the first quarter of 2009, however, medium- to long-term insurance volumes rebounded strongly in both low- and middle-income economies (12 percent), suggesting that ECAs were more successful in supporting trade flows to developing countries during later stages of the crisis.

**Key Issues When Setting Up an ECA**

These findings suggest that ECAs, in line with recent pledges, may indeed have expanded their operations during the financial crisis to keep trade finance markets from drying up. The natural question to ask is whether more developing countries should follow suit and establish their own agencies to alleviate market frictions and support exporting firms. This section highlights specific issues that require attention when deciding whether to establish such an institution.

Many countries in both the developed and the developing worlds have set up ECAs to finance exports and alleviate market failures. However, it is difficult to make a generalized statement about the need for, and the most appropriate shape
and form of, these institutions. Given that restructuring, reforming, or abolishing a public institution is more difficult than establishing one, the decision to set up an ECA should result from a comprehensive evaluation process.

Although the main motivation to establish an export finance institution may differ from one country to another, the creation of a public financial institution—the main task of which is to direct credit to a specific set of economic activities—always represents an intervention into the resource allocation process of the domestic economy. Whether such intervention is warranted or adds value should be carefully examined and satisfactorily answered during the decision process. The issues involved in this regard are complex and have been at the core of an ongoing debate.3

Any type of financial institution that aims to play a part in the financing of exports has an impact on two main dimensions in the country where it is located. First, the financial institution’s activity changes the structure of the financial sector and influences the behavior of other financial institutions (financial sector dimension). Second, it changes the incentive framework in the real sector (real sector dimension). The net impact on the economy as a whole depends on many factors—ranging from the structure of the real economy and its competitive position to the overall governance environment in the country and the business model for the new institution (business model dimension).

Financial Sector Dimension

At least two questions should be addressed regarding the financial sector when considering the establishment of an ECA. The first question is whether the ECA can provide additionality through more trade finance-related products and services or greater volumes of such products, given conditions in the country’s financial sector. The answer to this question will give a fairly good idea of whether such an institution is needed. The second question concerns the impact of an ECA on the equilibrium level of prices and quantities in financial markets as well as on the growth dynamics of the financial sector.4

Public intervention in financial markets, like any marketplace intervention, can be justified when significant and persistent externalities or market failures persist. The principles of effective intervention to support trade finance have been examined by Chauffour and Farole (2009). Ellingsen and Vlachos (2009), among others, argue that public support of trade finance volumes can be more effective than support for other types of credit. Menichini (2009) emphasizes the particular nature of interfirm trade finance and discusses policy options to support interfirm financing volumes during times of crisis.
Examination of the need for a specialized export finance institution needs to start with comprehensive analysis of the current conditions and trends in the domestic financial sector. The analysis of the financial system should aim to detect any market failures and imperfections that may adversely affect the volume of exports. In this regard, it is important to assess the financial system’s capability of (a) attracting both domestic savings and foreign flows of capital and (b) carrying out its intermediary functions. In other words, the depth of the financial system and actual lending practices should be examined carefully. The lack of financial depth is an important factor and usually takes the form of a resource constraint for the financial sector and, in turn, inadequate supply of credit to the real sector.

To make an informed decision about whether sufficient externalities or market failures are present to justify intervention, one finds it instructive to pay close attention to the following issues:

- The levels and terms of working capital and investment finance
- The mechanisms to obtain working capital and investment finance
- The presence of any peculiar constraints for exporting firms to obtain finance
- The capacity of the banking system to handle cross-border transactions.

In addition to the analysis of the domestic financial sector, the financial systems in export markets as well as in competitor countries warrant closer attention. Because it is difficult to expand exports to markets where buyers face significant financial sector-related constraints—in terms of both the availability and the pricing of financial products (especially trade-related)—such market failure can have an impact on the domestic economy similar to a genuinely domestic market imperfection. Market failures in partner countries may thus equally require intervention by the domestic government. In fact, the origins of many export finance institutions lie in this argument.

Another important dimension of export financing is the availability of special financing schemes offered by other countries that supply investment goods and raw materials. The export sector can use these facilities for both working capital and investment finance. However, while these facilities can potentially be important sources of funding for exporting firms, especially for exporters of manufactured goods, the same institutions may work against the interest of the country’s exporting firms if they support the competition in export markets.

Interventions into financial markets by way of funds earmarked for special purposes or specialized financial institutions, if they are not additional to the existing pool of funds within the financial sector, serve as mechanisms of credit directing and rationing. This could have a considerable impact on the competitive
pricing of credit. The magnitude of this impact depends on both the amount of the additional funds and the relative amount of credit demand.

Specialized financial institutions undoubtedly influence the composition of banks’ loan books. The nature of this influence is highly dependent on the ECAs business model (Ascari 2007). For example, an ECA involved in retail lending and loans directed to final beneficiaries usually reduces lending by the rest of the financial sector to the targeted activities. However, the financial sector usually increases its lending to targeted activities if the ECA issues guarantees or acts as some sort of second-tier institution. Hence, following an intervention, the composition of final lending occurs either by choice of banks or by choice of borrowers. Which of these paths creates more distortion is an important question that must be answered.

ECAs can also potentially undermine the development of the financial sector. The presence of such institutions may discourage private banks from developing export-related financial products or may delink certain types of activities or borrowers from the commercial banking system if their influence becomes large. This result will limit the banking system’s understanding and information about the activities and borrowers engaged in the export sector. In turn, the banking system may not only reduce its exposure to these activities but individual banks may also become hesitant to engage in additional business with the same borrowers because the system might not be able to properly assess underlying risks.

Likewise, a heavy reliance on ECAs primarily for borrowing may cause exporters to incur larger costs for other transactions. Commercial banks typically provide a wide array of services that an ECA cannot match in their entirety. A commercial bank may require higher fees from a client that maintains only limited business with the bank than it requires from a client that demands a variety of products and services. For example, a commercial bank may require higher fees for the opening of a letter of credit or the issuance of a performance bond from a customer that does not borrow from it and does not do business with it otherwise. To avoid such situations and to endorse close relations between exporters and the country’s financial system, ECAs should channel their products to existing financial institutions as much as possible. The ECA’s charter must, moreover, be clear enough to prevent competition between the ECA and the financial sector.

Real Sector Dimension

The main motivation behind the decision to establish an export finance institution is usually the judgment that a change in the behavior of the real sector toward export-related activities is warranted. In fact, an export finance institution is viewed as one of the main elements of a broader incentive framework to increase
exports. It is therefore important to understand why policy makers desire an increase in export volumes and whether specific export products and markets are to be targeted. These questions are crucial in designing the broader incentive framework, including the financing element, and in determining the appropriate business model for the ECA.

ECAs typically support various types of firms operating in different sectors of the economy. However, driven by the same objectives that led to its founding, an ECA’s activities are often biased toward a specific subset of sectors of the domestic economy. Consequently, export finance institutions may end up serving a narrow set of economic activities. If the broader incentive framework to boost exports (including the export finance element) is effective, the composition of both real sector activities and exports may change. Such changes will inevitably alter the structure of the economy and its macro balances in the long run.

Different policy objectives regarding the real economy point to different types of ECAs. For example, an ECA with wider reach may be preferable if balance-of-payment concerns are dominant. If, however, export-led growth policies are to be pursued, an export finance institution could be useful to promote economies of scale by dealing only with firms above a certain size threshold.

The financial products of an export finance institution should be shaped by the founding objectives. For example, providing credit to a cotton outgrower scheme for export purposes may require working capital loans with at least nine months’ maturity, although a three-month facility would be sufficient for most manufacturing processes. If the country is mainly concerned with providing credit to buyers of its exports, the nature of the financial products needed would differ from those needed to support exporting firms with credit or guarantees directly. In particular, longer terms and lower interest rates may be necessary if the objective is to provide credit to purchasers of exports.

Finally, it should be kept in mind that real sector conditions evolve over time, both domestically and globally. Sufficient flexibility should be built into the product range and the ECA’s objectives to allow it to adjust. For example, an ECA that starts out solely supporting the country’s domestic export base can evolve into a global underwriter of trade risk or a facilitator of international projects that works with different suppliers from various countries, some of which may be competing with domestic firms.

**Business Model Dimension**

Specifying business models and governance structures as well as their implementation have proven to be important challenges for public sector entities. These challenges are especially formidable for financial institutions owned directly by the state.
A well-functioning financial sector is an important precondition to a sustainable path of economic development. Strong financial systems are built on good governance—of both the intermediaries and their regulators. An ECA is typically strongly linked with the government, although there are various options for the precise structure of the relationship. The institution is also designed to interact with many firms and financial institutions in the private sector. A satisfactory governance record is therefore crucial not only to efficient fulfillment of an ECA’s role in the economy, but also to its influence on the quality of governance in the economy as a whole, given its tight relationships with both the government and the private sector (Beck and Honohan 2006). The stronger the ECA’s position in the economy and the larger the resources dedicated to its business, arguably the more enhanced its role will be.

In the specification of an ECA business model, its governance structure should thus be among the most important considerations. In particular, the nature and quality of its board of directors deserve special attention because they could be potential destabilizing factors. Good governance cannot be achieved if the ECA’s senior management and board of directors are not properly configured.

Care should also be taken in specifying a legal form for the ECA that is consistent with its business model. At least two interlinked quality characteristics, described below, are desirable in achieving efficient functioning of the institution as well as a strong governance record: operational independence and a sustainable mandate.

**Operational independence**
First, the ECA should be given operational independence. Good governance is difficult to achieve in the absence of an entity’s operational independence and without a supporting legal form. In this respect—and because the independence of an export finance institution cannot realistically be achieved if the institution fails to generate enough income to meet its operational expenses and produce a surplus—it is important to equip the ECA with sufficiently large resources from the outset to efficiently fulfill its role in the economy.

The amount of operational expenses varies widely, depending on the ECA’s specific business model. An institution involved in retail lending will need to have more staff, more branches, and a more expansive information technology (IT) platform than a second-tier organization would require. A small-guarantee scheme that underwrites specific portfolios of commercial banks could technically be operated by just a few people. If sufficient funds are not available, the potential outsourcing of some functions such as payroll and IT, using specialized consultancy services, should be considered as an option.
A sustainable mandate
Second, an ECA must be given a mandate that is both sustainable and compatible with the objectives of the institution. Sufficient financial resources are again important in fulfilling this condition. An export finance institution will likely fail to achieve its objectives if it cannot dispose of sufficient and sustainable resources from the outset. Many developing countries have established various export finance schemes and structures, but these institutions have failed to be relevant because of resource constraints. For the ECA to meet its objectives, it should be a relevant player in the country where it is located, in terms of both its resource base and its operational footprint.

A strong governance structure and the availability of a sufficiently large capital stock for the ECA to act independently and to have a strong enough operational footprint to achieve its objectives are two preconditions that are unlikely to be met in many low-income countries. Low-income countries often suffer from sovereign debt problems, weak institutional capacity, lack of good governance practices, and, more broadly, difficulties in applying the rule of law. These concerns are reminiscent of those related to the functioning of other types of public-backed institutions to support exports. For instance, export promotion agencies in developing countries have long been criticized for lacking strong leadership and client orientation, being inadequately funded, and suffering from government involvement (Lederman, Olarreaga, and Payton 2009).

A possible way to circumvent these issues may be the foundation of some form of a global ECA—in other words, an ECA designed as an international institution to support exporting firms in various low-income countries. The relative merits of establishing such an institution, however, would go beyond the scope of this chapter.

Conclusions
A number of issues require attention when deciding whether a country should establish an ECA as well as what shape, form, and modus operandi it should have. Any decision to establish such a specialized financial institution should be made only after a careful evaluation of its potential impact on both the financial and the real sectors of the economy.

In addition, the choice of a sustainable business model is crucial. A sustainable business model involves a strong governance structure as well as the availability of a sufficiently large capital stock for the institution to be capable of acting independently and to have a strong enough operational footprint to achieve its objectives. These are two preconditions that are seldom met in low-income economies,
which often suffer from sovereign debt problems, weak institutional capacity, poor governance practices, and difficulties in applying the rule of law.

Notes

1. It is important to notice that the sample, albeit representative in its composition, does not cover all countries whose imports are insured by Berne Union members.
2. Insurance volumes had been growing strongly for low-income economies before the recent drop. Thus, an alternative explanation may be that volumes are returning to normal levels.
3. State intervention in financial markets has been discussed by many in the literature (addressing concerns such as principal-agent problems, information asymmetries, and regulation). Stiglitz (1994) and Besley (1994) provide good generalized discussions of state intervention in the financial sector. See also Zingales (2004) for a critique of endorsements of state intervention based on Coase’s (1960) arguments applied to financial regulation.
4. The issues mentioned here are valid for a broader set of development finance institutions (DFIs) in developing countries, of which ECAs can be regarded a subset. DFIs are also the subject of many debates (Beck and Honohan 2006; De la Torre, Gozzi, and Schmukler 2007).
5. The impact of government intervention in financial markets on the equilibrium level of prices and quantities has been subject to close examination from a wide range of perspectives. For theoretical treatments of historical arguments, see Stiglitz (1994); Hoff and Stiglitz (2001); and Murphy, Shleifer, and Vishny (1989). For an empirical study of the impact of government-owned institutions, see Barth, Caprio, and Levine (2001) and Caprio and Honohan (2001).

References


