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Trade Finance in Crisis

Should Developing Countries Establish Export Credit Agencies?

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Abstract

New data on export insurance and guarantees suggest that publicly backed export credit agencies have played a role to prevent a complete drying up of trade finance markets during the current financial crisis. Given that export credit agencies are mainly located in advanced and emerging economies, the question arises whether developing countries that are not equipped with these agencies should establish their own agencies to support exporting firms and avoid trade finance shortages in times of crisis. This paper highlights a number of issues requiring attention in the decision whether to establish such specialized financial institutions. It concludes that developing countries should consider export credit agencies only when certain pre-requirements in terms of financial capacity, institutional capability, and governance are met.

This paper—a product of the International Trade Department, Poverty Reduction and Economic Management Network—is part of a larger effort in the department to better understand the role of trade finance in the current global economic crisis. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org.

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Trade Finance in Crisis:
Should Developing Countries Establish Export Credit Agencies?

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1. Introduction

International trade has plunged in the latter half of 2008 and the course of this year (Baldwin, 2009). The global financial meltdown has not only led to a substantial drop in economic activity in both emerging markets and the developed world, but has also made it increasingly difficult for potential trading partners to gain access to external finance. While trade finance - due to its self-liquidating character - is generally on the low risk and high collateral side of the finance spectrum, as well as underwritten by long standing practices between banks and traders, developments have shown that it has not been spared by the global 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 - itself driven mainly by the fall in the demand for trade activities, but at least partly also by liquidity shortages - is likely to have further accelerated the slowdown. Surveys conducted by the IMF in cooperation with the Bankers' Association for Finance and Trade (BAFT) and by the World Bank suggest that some emerging markets have been impacted severely by the lack of available trade financing options (IMF/BAFT, 2009 and Malouche, 2009). The anecdotal evidence from banks and traders reinforces this view; as does the sharp increase in short-term trade credit spreads and the sheer size of the drop in trade volumes. Reliable statistics on trade finance are scarce, which poses major problems for the analysis of the underlying reasons driving the collapse in world trade. But available evidence suggests that trade credit was the number two cause of the trade collapse after demand (Mora and Powers, 2009).

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. At two BAFT trade finance summits in January and April of 2009 the international community pledged to "*enhance the secondary market for trade finance risk with ECAs*" and to "*adjust ECA programs to facilitate and accelerate trade financing in emerging markets*".[2] At their September 2009 summit in Pittsburgh, leaders of the G20 welcomed the swift implementation of the $250 billion trade finance initiative that was agreed at their April 2009 meeting in London to support trade finance, including through their export credit and investment agencies.[3]

Most ECAs have been founded with the stated objective of promoting foreign trade and/or alleviating financial sector related constraints in providing the necessary financial sector products to domestic firms involved in foreign trade. Given the renewed interest in these institutions and the fact that such institutions have for decades been part of the financial sector landscape in many countries, including many developed countries with relatively large foreign trade sectors, the question arises whether developing countries should follow suit and establish their own agencies to support exporting firms and to avoid complete trade finance shortages in times of crisis.

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[2] www.baft.org.

[3] http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf and http://www.g20.org/Documents/final-communique.pdf .

The purpose of this paper is to discuss a number of issues that require attention when deciding whether a country should establish a specialized financial institution to support exports as well as what shape, form and modus operandi it should have. We discuss 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 the real sector of the economy. In addition, the choice of a sustainable business model for the specialized financial institution is crucial. This paper does not seek to provide definitive answers as to whether, when and how developing countries should establish ECAs. Yet, it tilts towards extreme caution in setting up such institutions in a low-income context and highlights a range of factors that policymakers should consider in deciding whether such an institution is warranted or not.[4]

Before discussing these factors, we analyze data from the International Union of Investment Insurers (Berne Union) on the export credit insurance industry, a spectrum of trade financing that has proven critical in the current environment. The data suggest that, although overall insurance volumes fell due to the sharp drop in trade volumes, medium to long-term insurance volumes have expanded during the crisis. Given that ECAs are dominant players in these markets, this finding indicates that public financial institutions, specialized at financing exports, have been helpful in backing longer-term credit arrangements during the crisis.

The remainder of this paper is organized as follows. Section 2 analyses data on export insurance and guarantees provided by the members of the Berne Union. It further discusses the perceived ability of publicly backed ECAs to influence the export insurance volumes during the crisis. Section 3 discusses issues that require attention when deciding whether a country should establish a specialized financial institution to finance exports. Section 4 concludes.

2. Export Credit Insurance and Guarantees: Any Support from Public Agencies?

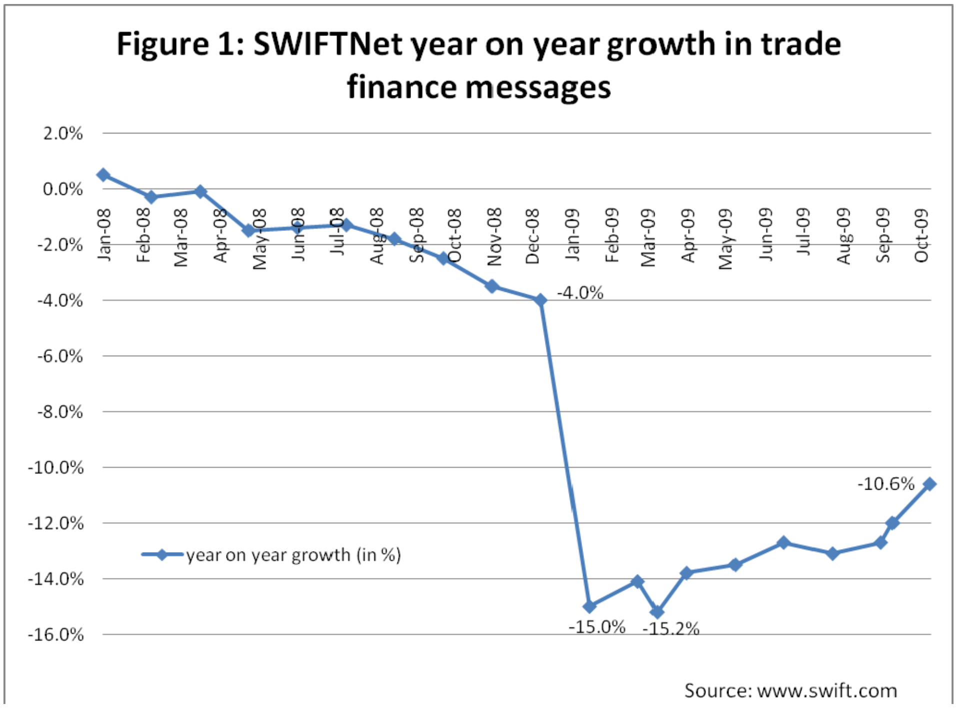
In order to understand better why trade finance has been so high on the international policy agenda since the onset of the crisis, we begin this section by reviewing developments in volumes of trade financing during the financial crisis. Given the scarcity of comprehensive data on the subject, we largely rely on surveys conducted by, among others, the World Bank and the IMF/BAFT. In the second subsection, we analyze data on export credit insurance volumes during the financial crisis and draw some conclusions as to the role ECAs have played in alleviating shortages in this important spectrum of trade financing.

Recent Trade Finance Developments

Statistics on trade finance volumes are generally scarce. Data available from Dialogic capturing all disclosed transactions in structured trade finance products indicate that medium to long-term finance instruments fell by about 40 percent by the last quarter of 2008. Although structured finance products only cover a fraction of the market for overall trade finance, there is additional evidence from various sources that points in the same direction. As Figure 1 illustrates, the Society for Worldwide Interbank Financial Telecommunication (SWIFT) reports a fall of 15

[4] The paper focuses on an ECA's relative merits from the point of view of the country in which it is to be founded but does not address issues related to the international regulation of ECAs in detail.

percent in the number of trade finance messages in January 2009 compared with a year before. A modest recovery (year-on-year) is underway since April 2009.



Three surveys of 88 major banks in 44 countries conducted by the IMF in cooperation with BAFT in December 2008, March 2009 and August 2009 support the view that the cost of trade finance has increased and that the supply of trade financing instruments has dried up in late 2008-early 2009 (IMF/BAFT, 2009). Whereas total trade finance activities appear to have increased slightly in value between Q4 2007 and Q4 2008 (4 percent), a marked fall in trade finance volumes (-11 percent) is detected for the period Q4 2008 – Q2 2009. During the same period, the value of Letters of Credit (L/C) business declined by 8 percent and the value of export credit insurance business by 12 percent. Although the survey finds that the demand for trade activities is the major driving factor behind these developments, 41 percent of respondents acknowledge that the lower availability of trade finance instruments in their institution has played a notable role in the fall of trade finance volumes. In general, the impact of the financial crisis on developing country exporters has not been uniform. Banks indicated that guidelines tend to be stricter for countries with weaker sovereign credit ratings. Regions most affected initially were the industrial countries and Latin America and, then, emerging countries in Eastern Europe. In the most recent survey, respondents suggested that recovery was underway in some regions, but the trade finance markets that fuel global trade have not fully bounced back. Compared to the previous survey, notably fewer respondents thought the value of transactions had declined due to credit availability at the banks.

A survey undertaken by the International Chamber of Commerce (ICC, 2009) on a sample of 122 banks in 59 countries from March 2009 (updated in September 2009) confirms that trade has decreased both as a result of the recession and tighter credit conditions, although the peak of the impact of the financial crisis on trade finance appears to have been reached in the first half of 2009.

A 14-country World Bank survey launched in early 2009 examines how and whether changes in trade finance have affected firms and banks in developing countries (Malouche, 2009). The survey covers 402 firms and 75 banks and other financial institutions. It confirms that trade finance has become more expensive and less available although the drop in demand is still the key concern for firms. Moreover, small and medium enterprises (SMEs) as well as larger firms with high exposure to international markets are most strongly affected by the squeeze in trade finance. The banks surveyed do not seem to have suffered from lack of liquidity but became more risk averse and selective, and have therefore been tightening trade finance conditions. Last but not least, the survey detected an increased need for more guarantees and insurance to facilitate the release of trade finance funds.

The Berne Union and the Export Credit Insurance Industry

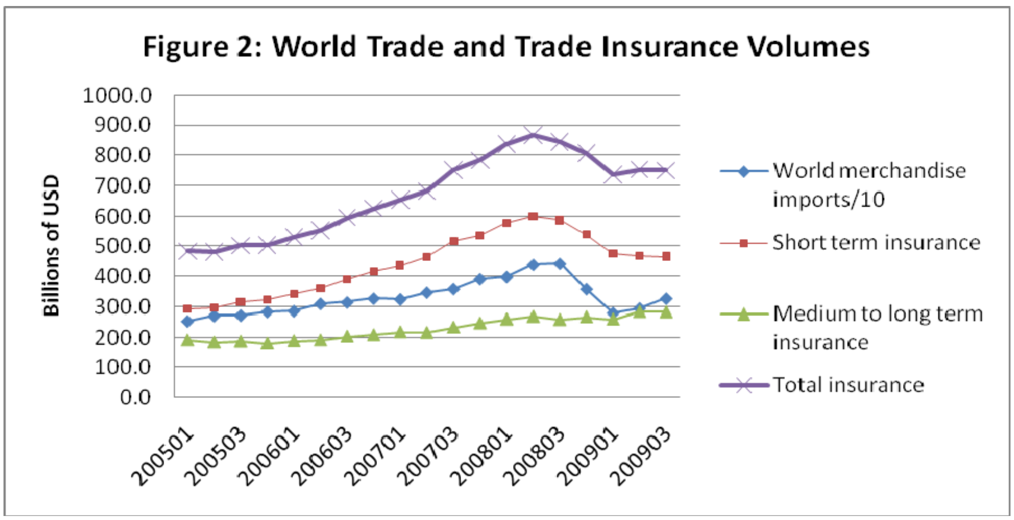
Export credit insurance is a financial instrument whereby exporters insure themselves directly against the risk of buyers' default. The insurer reimburses the firm in case of non-payment. An export credit guarantee provides a guarantee to banks or other financial institutions that are willing to lend either to the exporting or the importing firm. The guarantor takes responsibility for a financial obligation if the primary liable borrower fails to perform. It is common to distinguish short-term (credit terms of up to and including 12 months for the purpose of this paper) and medium to long-term export credit insurance. Medium to long-term insurance is typically used for large transactions such as those related to capital goods, large machinery and turn-key plants. In some cases (e.g. Three Gorges Dam), this type of insurance has been used in the financing of large scale projects as a floating collateral against current and future receivables, a type of insurance that perhaps not necessarily qualifies as trade finance in the stricter sense.

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 is dominated by private agencies (some 80 percent of overall business), ECAs underwrite the wider majority of medium to long-term commitments. An agency will typically aim at alleviating the risks inherent to international trade by providing adequate insurance to domestic exporters. Such risks are likely to be more significant in relation to medium and long-term credit arrangements.

The issuance of export credit insurance and guarantees is an important spectrum of trade finance, reducing credit risks and allowing exporters to offer open account terms in competitive markets. It is a spectrum of trade financing that is of crucial importance in the current environment of high systemic risk; with a declining secondary market to offload loans, as well as an increase in bank counter-party risk, demand for export credit insurance and guarantees is high. Indeed, export credit insurance may enable increased financing of foreign receivables on more favorable terms and amounts than otherwise available. Moreover, risk management tools such as export credit insurance and guarantees can be critical to access financing, both because of the higher risks of cross-border trade and the fact that less creditworthy exporters can use insured receivables from high-quality foreign customers to guarantee domestic credit.

Insurance or guarantees on export credit can be issued by both private insurers and public agencies. The Berne Union is the leading association for export credit and investment insurance worldwide, and is providing a forum for professional exchange among its members. Berne Union's members represent all aspects (private and public) of the export credit and investment insurance industry worldwide. The organization regularly asks its members to provide information about their provision of short as well as medium and long-term export insurance to trading partners around the globe. Recent data was made available to the World Bank's International Trade Department that spans the period 2005 (Quarter 1) to 2009 (Quarter 3) on a country by country basis. The data cover a total of 41 countries, 9 of which are classified as high-income countries, 22 as middle-income countries and 10 as low-income countries.[5] For a given country, the data set includes information on the total value of insurance offers and insurance commitments on its imports.[6]

Figure 2 shows the evolution of both global trade and (Berne Union) export credit insurance volumes from Q1 2005 to Q3 2009. Merchandise trade volumes dropped between Q2 2008 and Q1 2009 and have been recovering gradually since then. Mirroring trade volumes, total insurance commitments of Berne Union's members have also grown at a steady pace during the past few years before dropping between Q2 of 2008 and Q1 of 2009. Total insurance volumes have recovered side by side with trade volumes since Q1 2009.



Intuitively, a growing volume of trade will produce an increase in the demand for trade finance, insurance and guarantees, independently of any change in the risk environment. This is likely to be the main reason why the export insurance business has grown steadily over the past years. Similarly, the fall in trade volumes during Q2 2008 - Q1 2009 can be seen as a proximate factor explaining the drop in overall insurance commitments. It is striking, however, that insurance

[5] The sample includes Argentina, Australia, Bangladesh, Bolivia, Brazil, Cambodia, Canada, Chile, China, Costa Rica, Egypt, France, Germany, Ghana, Hungary, India, Indonesia, Italy, Japan, Jordan, Kenya, Korea, Malaysia, Mexico, Nigeria, Pakistan, Panama, Peru, Philippines, Poland, Russia, Senegal, South Africa, Tanzania, Thailand, Turkey, Ukraine, United Kingdom, United States, Venezuela and Vietnam.

[6] It is important to notice that the sample, albeit representative in its composition, does not cover all countries the imports of which are insured by the Berne Union.

volumes have fallen by much less (-15 percent) than global merchandise trade volumes (-36 percent) during this period.[7]

The finding that insurance volumes fell by less than trade volumes during the most severe period of the crisis (Q2 2008 – Q1 2009) is consistent with earlier anecdotal evidence suggesting that trading partners have resorted to more formal, bank intermediated instruments to finance trade since the outbreak of the financial crisis in order to reduce the high probability of default in open account financing. In addition, the increase in bank counter-party 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 premia and the cost of insurance, thus reflecting the increasingly important role of insurance and guarantees during times of crisis.

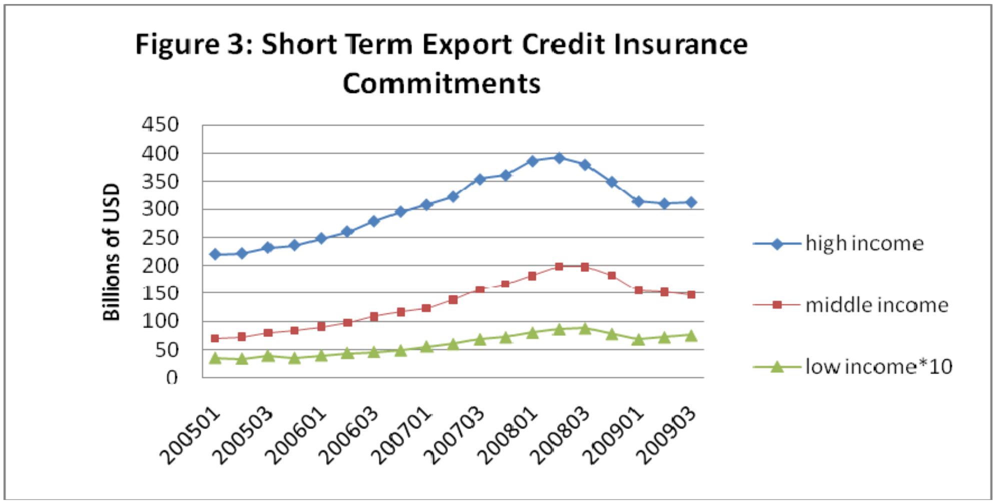
Figure 2 also illustrates the evolution of the composition of export credit insurance volumes over time. Short-term insurance commitments have almost doubled in value up until the beginning of the financial crisis, yet dropped strongly between Q2 2008 and Q1 2009 (-22 percent) and have kept falling at a slower pace thereafter (-2 percent). Medium to long-term commitments, on the other hand, remained almost constant in volume during the period of the strongest impact of the crisis (-3 percent) and have recovered strongly ever since (9 percent increase since Q1 2009).

How may these findings be explained? As mentioned earlier, medium to long-term insurance is typically used for large scale transactions. The upswing in medium to long-term insurance commitments relative to short-term commitments since Q2 2008 is therefore likely due to the fact that demand for insurance for large scale transactions typically 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 in need to recapitalize and to off-load their balance sheets from liabilities whose risk is difficult to assess, short rather than medium or long-term commitments are more easily terminated or reduced on short notice.

However, given that insurance premia for longer-term insurance are particularly expensive in an environment of high systemic risk, and given that capital expenditure has been dropping rapidly during the crisis, the magnitude of the divergence between short and medium to long-term volumes is difficult to explain solely on the basis of 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 a majority of collected premiums and disbursed claims in export credit insurance. This suggests that ECAs stepped in to ease financing terms and increase insurance supply in order to alleviate market tensions when spreads widened and markets began drying up. In other words, governments and multilateral institutions have followed through on their pledges to boost their trade finance programs.[8]

[7] The data also suggest that the recovery of insurance volumes after Q1 2009 is weaker than the trade recovery. This may be due to the fact that conditions are improving and the need for trade finance has decreased.
[8] For a detailed account of trade finance measures taken by governments and multilateral institutions to mitigate the impact of the crisis as of July 2009, see Chauffour and Farole (2009).

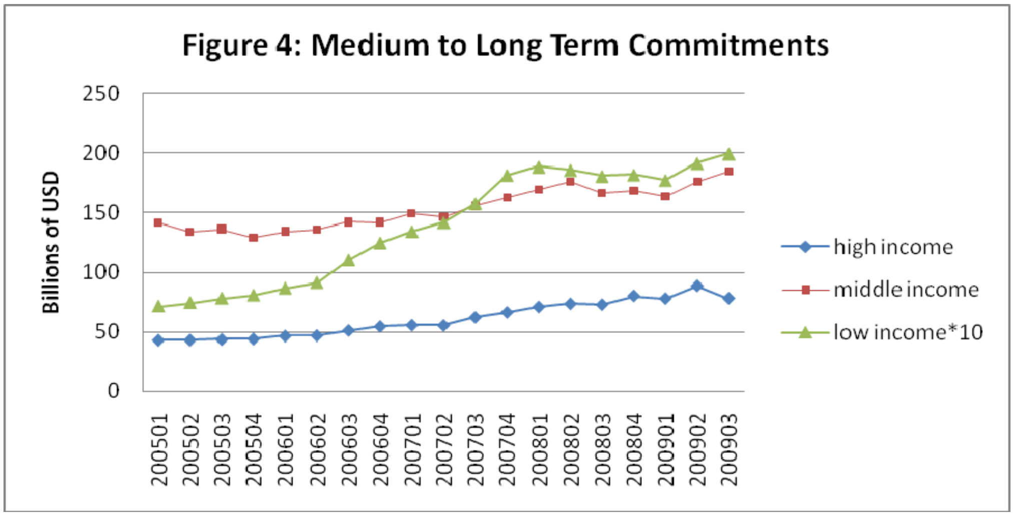
In this respect, it is interesting to consider the change in insurance commitments as well as their composition across income groups (Figure 3 and Figure 4). Here, it is important to note that the data takes the importer's point of view in providing information on the volume of insurance commitments on a given country's imports rather than its exports. Figure 3 shows that the drop in short-term commitments until Q1 2009 was rather evenly distributed across income groups, with volumes falling by 20 percent for high-income economies and by 21 percent for middle and low-income economies since Q2 2008. The recovery after Q1 2009 has been slightly stronger for low and highincome economies than for middle-income economies.



The change in medium to long-term commitments has been less evenly distributed (Figure 4). Between Q2 2008 and Q1 2009, medium to long-term commitments grew by a healthy 6 percent for high-income economies compared to negative growth rates of -7 percent and -4 percent for middle and low-income economies. These numbers likely partly reflect the growing need for export insurance and guarantees for trade flows to industrialized economies 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. This reinforces the finding of surveys discussed previously, namely that exporters in emerging markets have been impacted severely by the general shortage in trade finance (although these surveys focused on exports rather than on imports as we do here).[9]

Figure 4 shows that efforts to keep trade finance flowing for exports to emerging markets when the crisis reached its peak were not fully successful. This is undoubtedly worrying, since in times of crisis, a lack of insurance supply for trade flows to developing countries can have dramatic consequences: it remains indeed crucial that developing countries be supplied with imports of raw materials and intermediate goods to continue to export and grow.

[9] In the light of this argument, it is important to note that insurance volumes had been growing strongly for low income economies prior to the recent drop. An alternative explanation of the recent fall in volumes may thus be that volumes are coming back to normal levels after a boom period during which the risk environment was (mis)perceived to be particularly benign.



Yet, Figure 4 also shows a strikingly different picture in the period after Q1 2009: medium to long-term insurance volumes have rebounded strongly in both low- and middle-income economies (by about 12 percent), whereas they remained more or less constant for high-income economies. This suggests that ECAs have been more successful in supporting trade flows to developing countries during the recovery part of the crisis.

3. Supporting Exports through Specialized Institutions

The previous section has analyzed data on export credit insurance volumes extended to firms by publicly backed ECAs or private institutions. The numbers confirm that trade finance volumes have declined significantly during the current financial crisis. The data also suggests that the decline in short-term insurance has been far greater than the fall in medium to long-term commitments. This finding is important given that public ECAs are minor players in the market for short-term insurance while they dominate the market for medium to long-term contracts. It suggests that these specialized public financial institutions may, in line with recent pledges, indeed have expanded their operations during the financial crisis to keep trade finance markets from drying up.

We begin this section by briefly discussing institutional characteristics and products of ECAs as well as their international regulation and then proceed to discussing specific issues that require attention when deciding whether to establish an institution to support exporting firms in the domestic economy.

Institutional Characteristics and Products of an ECA

An ECA is usually set up as a statutory institution that aims to facilitate foreign trade primarily between private parties. In reality, a government, through the ECA's operations, directly or indirectly becomes party to a private trade transaction. A range of countries have established one or more such specialized financial institutions, each of which may have a distinctive organizational structure and business model. At a broader organizational level, ECAs can be set up in various ways such as government departments, agencies or independent financial institutions which may be partly or entirely owned by the state. ECAs can also be set up as private institutions administering an account on behalf of the government that is separate from their own commercial business (Gianturco, 2001).

Depending on the mandate the government gives to the institution, it can provide export credits or insure (or guarantee) export credits extended to buyers by exporters and private financial institutions.[10] The risk on each of these financial products is borne by the ECA and, ultimately, by the sponsoring government. In fact, the effectiveness and the sustainability of an ECA depend on how well these risks are managed.

International Regulation of ECAs

Due to their frequent use as instruments of mercantilist trade policies, ECAs have long been a cause of concern in the international trading system. Criticism has centered on their role in distorting international and domestic markets (Baldwin, 1970; Hufbauer and Erb, 1984; de Meza 1989) as a result of their support of domestic exporting firms in their international operations. The alleged frequent use of ECAs for this purpose is the reason why some observers view their involvement in financial markets as nothing more than ‘export subsidies under a different name’. Concerns have also frequently been voiced as regards the involvement of ECAs in aid projects which may lead to a problematic mix of trade and aid policy (Preeg, 1989; Morrissey, 1993).

At the international level, initiatives have been undertaken to regulate government-backed ECAs since the 1950s. The various purposes for which ECAs can be used and the ambiguous effects of their operations on trade competitors have severely complicated the international regulation of these agencies (Evans, 2005). Attempts to enact a comprehensive regulatory agreement have been undertaken via various institutions including the WTO, the Berne Union and the OECD. The “Arrangement on Guidelines for Officially Supported Export Credits”[11] has - in spite of its limited membership (22 members) and the fact that it is neither a formal agreement nor a legally binding treaty (Ray, 1998) - been the most influential in recent years as regards its involvement in enacting and enforcing rules. The ‘arrangement’ regulates many aspects of ECAs’ operations although its strength varies across sectors and different modes of financing. Having initially concentrated on efforts to minimize interest rate subsidies, the coverage of the arrangement currently includes various more specialized regulations (Evans and Oye, 2001) and has evolved into a comprehensive regulatory scheme, affecting most export credit activities, with an impressive compliance record (Levit, 2004).

Evans and Oye (2001) identify three fundamental justifications for a public role in export financing from the perspective of an international regulator. First, ECAs may provide support to exporting firms in order to offset possible market failures such as the absence of appropriate

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[10] There are two forms of export credit: the more common type supplier’s credit, extended to the exporter, and the less common type buyer’s credit, extended to the importer. A supplier’s credit is a credit provided by the supplier to the buyer in the form of a deferred payment. The ECA (or another financial institution) intervenes by providing the financing for the deferred payment. A buyer’s credit is a loan to a foreign buyer of domestic goods. The ECA extends a loan to the foreign company or intermediary to allow the buyer to finance the transaction. An export credit guarantee provides a guarantee to banks or other financial institutions that are willing to lend either to the exporting or the importing firm. The guarantor (the ECA) takes responsibility for a financial obligation if the borrower fails to perform. Export credit insurance is a program whereby exporters insure themselves directly against the risk of default. The ECA reimburses the firm in case of non-payment.

[11] See http://www.olis.oecd.org/olis/2009doc.nsf/linkto/tad-pg(2009)21 for the July 2009 Arrangement.

financing option for exports to high risk destinations. Second, ECAs may have an important role in adjusting credit terms for non-financial externalities (domestic economic spillover effects, national security costs, environmental externalities) arising from the failure of non-financial domestic markets. Third, there is a rationale for offsetting perceived unfair support of foreign exporters via their respective governments and ECAs. All three of these rationales are heavily disputed, especially with respect to the analysis of particular cases in which they may or may not be valid. It is, however, apparent that an improved code of conduct has developed that, in spite of limited coverage, regulates much of ECAs' activities in international markets successfully.

Some Issues That Require Attention When Setting up an ECA

Many countries both in the developed and developing world have set up ECAs to finance exports and alleviate market failures and market imperfections. Whether these specialized financial institutions are useful and on balance add value is debatable. While it is easy to take sides in this debate, especially on ideological grounds, it is arguably difficult, if not virtually impossible, to make a conclusive statement which could apply to all circumstances as to the need for, and the most appropriate shape and form of these institutions. Given the fact that restructuring, reforming or abolishing a public institution is more difficult than establishing one, the decision to set up an ECA should come as a result of a comprehensive evaluation process.

While 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. The question of 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.[12]

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 it is located in. First, it 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 result of this influence depends on many factors ranging from the structure of the real economy and its competitive position to the overall governance environment in the country. In addition to these two main dimensions, it is crucial to put forward a sustainable business model for the new institution (*Business Model Dimension*).

Financial Sector Dimension

There are at least two key questions that should be addressed as regards the financial sector when considering the establishment of an institution to support exporting of domestic firms. The first question inquires whether the ECA can provide additionality through additional trade finance related products and services and/or additional volumes of such products given the financial sector conditions in the country. The answer to this question will give a fairly good idea of

[12] State intervention in financial markets has been discussed by many and from various perspectives in the literature (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.

whether there is a need for such an institution. The second question deals with 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.[13]

Is there a need for an Export Finance Institution?

Public intervention in financial markets, like any intervention in a market place, can be justified when significant and persistent externalities or market failures are present. Among others, Ellingson and Vlachos (2009) argue that public support of trade finance volumes can be more effective than is the case for other types of credit. Menichini (2009) emphasizes the particular nature of inter-firm trade finance and discusses policy options to support inter-firm financing volumes during times of crisis. The principles for effective intervention to support trade finance have been examined by Chauffour and Farole (2009).

The starting point of examining the need for a specialized export finance institution requires comprehensive analysis of the current conditions and trends within the financial sector of the domestic economy. The analysis of the financial system should aim to detect any market failures and imperfections that may be present and adversely affect the volume of exports. In this regard, it is important to assess how capable the financial system is in terms of attracting both domestic savings and foreign flows of capital, and carrying out its intermediary functions. In other words, the depth of financial system and actual lending practices should be examined carefully.[14] The lack of financial depth is an important factor and usually presents itself as a resource constraint for the financial sector and, in turn, as inadequate supply of credit to the real sector.

In order to be able to take an informed decision as to whether sufficient externalities or market failures are present to justify intervention, it is 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; and
- 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. As it is difficult to expand exports to markets where buyers face significant financial sector related constraints, both in terms of the availability and the pricing of financial products (especially trade related), such market failure can have a similar impact on the domestic economy as a genuinely domestic

[13]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 subject of many debates. See A. de la Torre, Gozzi and Schmukler (2006) and Beck and Honohan (2006).

[14] Financial depth usually refers to the relative size of the financial sector with respect to the economy. The ratio of broad money (M2) to GDP is the most commonly used measure of financial depth. In addition to M2/GDP ratio, other ratios such as the ratio of private sector credit to GDP or ratios of total banking assets to GDP, or total deposits to GDP are frequently used.

market imperfection. It may thus equally require intervention by the domestic government. In fact, the origins of many export finance institutions lie in this argument.

Another interesting dimension of export financing is the availability of special financing schemes offered by other countries supplying investment goods and raw materials. The export sector can utilize these facilities for both working capital and investment finance purposes. 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.

What would be the type and magnitude of the distortions in the financial sector that could be caused by an export finance institution to be established under the sponsorship of the state and/or owned and managed by the government?

Interventions into financial markets by way of funds earmarked for special purposes and/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.[15] This could have a considerable impact on the competitive pricing of credit. The magnitude of this impact depends on both the size of the additional funds as well as on the relative amount of credit demand.

Specialized financial institutions undoubtedly influence the composition of the loan books of banks. The nature of this influence is highly dependent on the business model of the specialized institution (Ascari, 2007). For example, an ECA involved in retail lending and loans directly to final beneficiaries usually reduces lending by the rest of financial sector to the targeted activities. On the other hand, the financial sector usually increases its lending to targeted activities if the specialized financial institution 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 (or, alternatively could be tolerated) is an important question that needs to be answered and should be taken into account when taking a decision on an appropriate business model for the ECA.

Furthermore, state-backed export finance institutions can potentially undermine the development of the financial sector. The presence of such institutions may discourage private banks to develop export related financial products. The credit culture in the country may suffer if the exports finance institution becomes susceptible to political influence.

Publicly backed export finance institutions can also de-link certain types of activities and/or borrowers from the commercial banking system if their influence becomes large. This will limit the banking system's understanding and information about the activities and the borrowers engaged in the export sector. As a result, the banking system will not only reduce its exposure to

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[15] 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 on the impact of government owned institutions see Barth, Caprio and Levine (2001) and Caprio and Honohan (2001).

these activities but it would also be hesitant to engage in additional business with the same borrowers as the system might not be able to properly assess underlying risks.

Finally, relying on export finance institutions primarily for borrowing purposes may cause exporters to incur larger costs for other transactions. Commercial banks typically provide a wide array of services which cannot be matched in their entirety by a specialized financial institution. A commercial bank may require higher fees from a client that maintains only limited business with the bank than from a client demanding 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 issuing of a performance bond from a customer that does not borrow from it and does not do business with it otherwise. In order to avoid such situations and to endorse close relations between exporters and the country's financial system, ECAs should utilize existing financial institutions to a maximum extent for the channeling of its products. 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 understanding that a change in the behavior of the real sector is warranted. In fact, an export finance institution is viewed as one of the main elements of a broader incentive framework to increase exports. In order to properly assess the need for and the feasibility of an export finance institution, it is therefore important to understand why an increase in export volumes is desired by policymakers and whether specific export products and/or markets are to be targeted. These questions are crucial in designing the broader incentive framework, including the financing element, as well as in determining the appropriate business model for the ECA.

Why is the policymaker interested in increasing export volumes?

An increase in export volumes is often desired for one or more of the following reasons:

- dealing with balance of payment problems;
- pursuing export-led growth strategies;
- diversifying economic activities including the export base; and
- expanding the political influence of the country.

ECAs typically support various types of firms operating in different sectors of the economy. However, driven by the same objectives that lead to its founding, an ECA's activities are often biased towards a specific sub-set 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 export levels, including the export finance element, is effective, the composition of real sector activities as well as the composition of exports and export markets may change. Such changes will inevitably alter the structure of the economy and its macro balances in the long run. Benefits from such changes as well as the sustainability of the emerging structure are crucial factors that need to be examined.

Different policy objectives as regards the real economy point to different types of export finance institutions. For example, an export finance institution with wider reach may be better if balance of payment related concerns are dominant. If, on the other hand, 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 threshold in terms of size.

The 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 necessitate working capital loans with at least nine months maturity while a three-month facility would be sufficient for the most manufacturing processes. If the country is mainly concerned with providing credit to buyers of its export products, 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.

While defining the ECA's product range, it should be kept in mind that real sector conditions evolve over time, both domestically and globally. Hence, sufficient flexibility should be built into the product range as well as objectives to allow an ECA to adjust in line with the changing conditions. For example, an ECA which starts out solely supporting the country's domestic export base can over time evolve into a global underwriter of trade risk and/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 the biggest challenge for public sector entities. These challenges are especially large for financial institutions owned directly by the state. Beck and Honohan (2006) present a comprehensive summary of governance challenges facing development finance institutions more generally.

A well functioning financial sector is an important precondition to embarking on a sustainable path of economic development. Strong financial systems are built on good governance, both of the intermediaries and their regulators. As discussed previously, an ECA is 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 a large number of firms and financial institutions in the private sector. A satisfactory governance record is therefore crucial not only for an efficient fulfillment of an ECA's role in the economy; given its tight relationships with both the government and the private sector, an ECA may also have an influence on the quality of governance in the economy as a whole (Beck and Honohan, 2006). This role is arguably enhanced the stronger is the ECA's position in the economy and the larger are the resources dedicated to its business.

When specifying a business model for an ECA, its governance structure should thus be among the most important considerations. In particular, the nature and quality of the Board of Directors deserve special attention as they could be potential destabilizing factors of the ECA. Good governance cannot be achieved if the senior management and the Board of Directors are not properly configured.[16]

Care should also be taken in specifying a legal form for the ECA that is consistent with its business model. Furthermore, at least two interlinked quality characteristics are desirable in achieving an efficient functioning of the institution as well as a strong governance record.

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 since the independence of an export finance institution cannot realistically be achieved if the institution fails to generate income sufficient to meet its operational expenses and produce 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 of export finance institutions vary widely depending on the specific business model of the ECA. For example, an institution involved in retail lending will need to have more staff, branches and a more expansive IT platform than a second-tier organization. A small guarantee scheme that underwrites specific portfolios of commercial banks could technically be operated by very few people. If sufficient funds are not available, the potential outsourcing of some functions such as payroll, IT, utilizing specialized consultancy services, should be considered as an option.

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 due to resource constraints. In order for the export institution to meet its objectives, the ECA should thus be a relevant player in the country it is located in, both in terms of its resource base and its operational footprint.

A strong governance structure and the availability of a sufficiently large capital stock for the ECA to be able to act independently and to have a strong enough operational footprint to achieve its objectives are two preconditions which are unlikely to be met in many low-income countries. Low-income countries typically 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 promotions agencies (EPAs) in developing countries have long been criticized for lacking strong leadership and client orientation, being inadequately funded, and suffering from government involvement (Lederman, Olareaga 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

[16] There are various governance models to ensure independence of the Board of Directors. The OECD provides useful guidance on this.

in various low-income countries. The relative merits of establishing such an institution, however, would go beyond the scope of this paper.

4. Conclusion

The results of recent trade finance surveys conducted, among others, by the World Bank and the IMF suggest that emerging markets have been impacted severely by the lack of available trade financing options during the financial crisis. Both bankers and the international community have since called upon state-backed ECAs to expand their operations to mitigate credit risk and keep trade finance markets in developing countries from drying up.

Most ECAs have been founded with the stated objective of promoting foreign trade and/or alleviating financial sector related constraints in the provision of the necessary financial products to domestic firms involved in foreign trade. Given the renewed interest in these institutions and the fact that such institutions have long been part of the financial sector landscape in many advanced and emerging countries with relatively large foreign trade sectors, the question arises whether less developed countries should follow suit and establish their own agencies to support exporting firms and to shield their economies against complete trade finance shortages in times of crisis.

A number of issues require attention when deciding whether a country should establish a specialized financial institution to finance exports as well as what shape, form and modus operandi it should have. Any decision to establish such a specialized financial institution to finance exports should be made only after a careful evaluation of its potential impact on both the financial and the real sector of the economy. In addition, the choice of a sustainable business model is shown to be crucial. We argue that 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.

ECAs are institutions that can – under the right circumstances, rules, and discipline – help alleviate market failures in the effective provision of export credits as well as insurance and guarantees. This is especially true in times of crisis. However, conditions for an ECA to be effective are demanding in terms of economic environment, institutional design, and governance structure. Such pre-requirements make ECAs more suitable for more matured economies than for low-income countries that are still often confronting many basic development challenges.

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