A Pre-export Guarantee Facility in Moldova

Mitigating political risk in transition

Moldovan firms wanting to export face severe financing constraints. The local banking system has neither the capital base nor the technical capacity to finance their working capital requirements. And export credit agencies either are not willing to provide cover or, if they are, require a full government counterguarantee covering both commercial and political risks. Thus, to enable viable local firms to attract private working capital, the government of Moldova asked the World Bank to help design a pre-export guarantee facility, but with the proviso that the facility should not require the government to assume commercial risks. Under this facility, which became operational on October 30, 1995, the Moldovan government guarantees financiers against political risk, and the World Bank provides a backstop guarantee of the government's claim payment obligations. A similar approach could be used in other transition economies, where firms face much the same constraints.

This Note briefly describes the development of the facility and offers suggestions for designing a "line of guarantee" modeled on it as a way to help attract private finance for a relatively large number of small projects.

Catering to risks and opportunities

Although local and international banks are unwilling to provide pre-export finance to Moldovan enterprises, many foreign trading companies and input suppliers have indicated that they would be willing to bear the commercial risk of supplying inputs on credit. But these nonbank financiers need assurance that the Moldovan government would not impose retroactive changes in rules and regulations that would prevent their being paid. Discussions with a wide range of input suppliers, trading companies, and commercial lenders suggested that an effective program to mitigate political risk could do much to boost private finance for commercially viable pre-export transactions. Political risk coverage would also encourage many trading companies and input suppliers...
not now active in Moldova to look into the possibility of doing business there.

These factors defined the basic design issues. First, the noncommercial risks inhibiting the private sector from financing viable pre-export transactions in Moldova had to be identified and mitigated. Second, the risk coverage, risk definitions, and claim adjudication procedures had to have sufficient credibility in the private financial community. Finally, the design had to be flexible enough to accommodate the diverse pre-export financing structures expected to emerge in Moldova in the short to medium term.

The facility is designed to be an instrument of transition. Its potential catalytic effect would be especially strong during the early stages of the economic transition, when political and economic uncertainty is greatest and the government’s commitment to trade liberalization and private initiative relatively untested. It is during this period that a favorable enabling environment—in the form of a liberalized trade and foreign exchange regime—may not suffice to assuage the concerns of private lenders. The reason is not that the proposed policy environment is “wrong,” but that potential lenders are not confident that the new, more liberal rules and regulations will survive the underlying input supply transaction. Once these rules and regulations have achieved some traction, investor perceptions of political risk will diminish, and the guarantee facility can give way to more mainstream financing techniques.

The architecture

The pre-export guarantee facility was designed to work in the following way:
- A foreign trading company, input supply company, or commercial bank would agree to finance working capital inputs for a Moldovan enterprise. The local firm would repay the working capital advance with a portion of the revenues from exporting the resulting outputs. To ensure repayment, input suppliers would act as a marketing agent for the Moldovan enterprise, arranging for the sale of the output to a creditworthy buyer outside Moldova. In this way, input suppliers would also help Moldovan enterprises develop new markets and restore old markets ruptured by the breakup of the Soviet Union.
- A government-owned guarantee administration unit would sell political risk coverage on a first-come, first-served basis to any foreign creditor willing to bear the commercial
risk of financing a pre-export transaction in Moldova.

- A framework guarantee contract outlining the terms and conditions of the political risk guarantees would protect the holders against losses arising from retroactive government interference with a guaranteed pre-export transaction. The contract would cover such risks as currency inconvertibility or inability to transfer foreign exchange out of Moldova, government seizure of inputs or outputs, government expropriation of the local enterprise, the retroactive revocation of import or export permits, the retroactive imposition of other import or export restrictions, and political force majeure related to war and civil disturbance on the territory of Moldova. All but the last risk are entirely within the control of the government, which simply has to refrain from retroactive interference with a transaction to avoid liability. Thus, the government accepts responsibility only for risks at least partly within its control. It bears no financial responsibility for any of the commercial risks typically associated with pre-export transactions, such as an unexpected decline in world market price, the failure of the local enterprise to deliver goods of acceptable quantity or quality, or the failure of the foreign buyer to fulfill the purchase contract.

- Under the terms of the framework guarantee contract, the government would pay only for damages caused by government actions or inactions specified in the contract. The guarantee holder would be required to notify the guarantee administration unit thirty days before filing a claim. During this thirty-day “cure” period, the government would have an opportunity to correct the actions that triggered the potential claim. If the problem is corrected, no claim would be filed and no payment made to the guarantee holder.

The World Bank’s role

Because political risk guarantees issued by the government of Moldova do not yet have sufficient credibility in international markets, a World Bank contingent loan facility was designed to backstop the government’s claim payment obligations on up to US$30 million of outstanding guarantees. The facility works as follows: An agent bank employed by the guarantee administration unit issues standby letters of credit to accompany each guarantee contract sold by the unit. If a claim must be paid and the government does not remit funds to the agent bank by the payment deadline, the agent bank can draw funds from the World Bank loan facility, to which it has irrevocable access. Under the terms of the World Bank facility, funds used to pay claims on guarantees would be permanently deducted from the facility, reducing the amount of future government guarantees that could be issued with World Bank support.

The World Bank facility is available for back-stopping new guarantees for five years. Thus, the guarantee unit could potentially support US$150 million of pre-export transactions, assuming that the average length of each transaction is one year and that the unit’s guarantee issuance capacity is fully utilized. Guarantees issued during the five-year period would remain valid for the remaining life of the private transaction, which could be up to three years.

Using the design in similar Bank operations

Other transition economies also face problems in financing private firms’ pre-export transactions. For these countries, it would be relatively straightforward to develop a pre-export guarantee facility similar to Moldova’s, adapting it as needed. Preparation would be relatively quick, since a generic framework guarantee contract and an operating manual for a guarantee administration unit already exist and would require only minor modification. Efforts to develop such facilities are under way in Ukraine, Russia, and possibly Armenia.

To be feasible, such a facility requires a relatively open trade and foreign exchange regime, to give the private sector confidence that there
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WORLD BANK SUPPORT

No existing World Bank Group guarantee instruments were appropriate to support the Moldovan project. The Multilateral Investment Guarantee Agency is not permitted to guarantee loans with a maturity of less than three years. And the International Finance Corporation is prohibited from obtaining a government guarantee—a prohibition that applies in this case even though the guarantee facility's credibility derives from the government's commitment to pay for losses directly resulting from retroactive changes in government rules and regulations.

Furthermore, the World Bank's then-new policy of mainstreaming guarantees did not envisage the use of guarantees for this type of project. The Bank therefore provided support to the Moldovan project in the form of a contingent loan with a ten-year bullet maturity, meaning that any repayment is due ten years after the loan becomes effective, no matter when disbursement took place. Yet discussions during preparation of the project and the discussion of the project by the Bank's Executive Board acknowledged that it was very much in the spirit of the mainstreaming policy: the government and the Bank bear only those risks the government can control, and the project allows the country to attract private foreign capital for productive purposes.

Thus, future projects of this type are likely to be supported by a World Bank guarantee. But the contingent loan design could still be used in countries that borrow from the International Development Association and for which the guarantee option is not available.

is scope for viable pre-export transactions. World Bank support would help assure the private participants in pre-export transactions that the relatively open regime will remain in place for at least the life of a transaction.

Using the “delivery mechanism” for capital investment or infrastructure projects

While Moldova’s guarantee facility is designed to support pre-export transactions, the general approach could also be used to deliver a government “line of guarantee” with World Bank backstop for a large number of relatively small projects. For example, a framework guarantee contract could be developed to promote fixed capital investments in small or medium-scale enterprises, or to support a large number of relatively small private municipal infrastructure investments or small hydropower investments. In either case, a government unit would sell a World Bank-backed guarantee contract covering the discrete government compliance risks—but none of the commercial risks—associated with private investment in the sector.

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