Private Sector Export to Emerging Market Economies During Times of Crisis: How Can Export Credit Agencies Help?

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Abstract

In an increasingly globalized world, economic growth depends much on openness of economies and trade among nations. The current economic and financial crisis has severely affected trade flows in the world that dropped sharply in the second half of 2008 and 2009. During the crisis, export credit agencies (ECAs) have played an increasing role in maintaining and stimulating cross border trade to emerging market economies. The article discusses the role and risk mitigation instruments of ECAs. It also provides examples of cross border trade and illustrates how the instruments of ECAs have been applied in real world situations to mitigate against commercial and non-commercial/political risks in emerging market economies.

Keywords: *Cross border trade and investment, emerging markets, financial crisis, export credit agencies (ECAs), commercial and non-commercial risks, and risk mitigation instruments.*

JEL classification: F14, F21, G01, G24, G32

Introduction

In an increasingly globalized world, continued economic growth depends much on openness of economies and trade among nations. The current economic and financial crisis has severely affected trade flows. A recent IMF Working Paper shows that exports of advanced, emerging, and developing nations were all growing strongly through mid-2008 but then dropping sharply in the second half of 2008 and 2009 (Asmundson, et al., 2011). During such crisis firm response of the international community is important. This article will focus on the role of export credit agencies (ECAs) in maintaining and stimulating cross border trade to emerging markets. It will also demonstrate how private sector companies who wish to engage in cross border trade to emerging market economies can utilize the instruments provided by ECAs to manage risks when exporting.

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But what is an ECA and what do they do? According to the OECD governments provide official export credits through ECAs in support of national exporters competing for overseas sales. ECAs provide credits to foreign buyers either directly or via private financial institutions benefiting from their insurance or guarantee cover. ECAs can be government institutions or private companies operating on behalf of the government (OECD, n.d.).

During the current times of crisis and economic turbulence ECAs role is increasingly important. According to the IMF working paper mentioned above the prompt action by the G-20 and ECAs likely helped keep trade flowing during the worst of the disruptions (Asmundson, et al., 2011). A recent column published by two World Bank staff members, titled "Export credit agencies to the rescue of trade finance" argues that export credit agencies played a key role in stabilizing the trade finance market. They also refer to surveys that have detected an increased need for more guarantees and insurance to facilitate the release of trade finance funds (Chauffour & Saborowski, 2010). Furthermore, according to Steve Tvardek at the OECD, when discussing trade flows in the aftermath of the economic and financial crisis that started in the fall of 2008, "ECAs not only became more important than ever as a source of trade finance, they actually became one of the principal policy tools governments used to cushion the real economy from the chaos in the markets" (Tverdek, 2011, p.1).

The demand for the services of many ECAs has increased during the crisis. For example according to EKN, the Swedish Export Credit Agency, the volume of guarantees issued increased from more than SEK 20 billion in 2007 to more than SEK 115 billion in 2010 (EKN, 2010). This evidence unequivocally illustrates that risk mitigation instruments are in high demand in a country like Sweden.

The structure of this article is as follows. The next chapter discusses the risks associated with private sector engagement in emerging market economies, including both commercial and non-commercial risks. The following chapter discusses risk mitigation instruments offered by ECAs. This will be followed with a chapter discussing cases that demonstrate the application of ECAs risk mitigation instruments. The final chapter will briefly discuss the preliminary findings from a research conducted by the authors in co-operation with a large Icelandic company, Marel, in Vietnam. Marel is engaged in manufacturing food processing equipment and has production facilities in a number of countries in Europe, America and Asia. The objective of this research is to answer the research question: How can private companies use the funding and risk mitigation instruments offered by Export Credit Agencies in emerging markets during times of crisis?

1. The risks associated with private sector engagement in emerging market economies

Companies that engage in trade and investments in emerging markets are both faced with commercial risks and non-commercial/political risks. Political risks are normally higher in emerging markets than in developed countries. There are many definitions of political risk. MIGA[2] defines political risk as "the probability of disruption of the operations of MNEs by political forces or events, whether they occur in host countries, home country, or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also of minority groups, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment" (MIGA, 2009, p. 28). When discussing the reasons why a country needs to set up an ECA, Stephens[3] states that "political risks are those relating to the actions of governments in importing countries to prevent payment being made to the foreign exporter, for instance problems with transferring foreign currency. Default by government or public sector buyers or guarantors in another example, as is civil war" (Stephens, 1996). Beside political risk, commercial risk is also a concern of companies when they enter or expand their business to emerging markets. Commercial risk is defined by the OECD (in the context of export credits) as "the risk of nonpayment by a non-sovereign or private sector buyer or borrower in his or her domestic currency arising from default, insolvency, and/or a failure to take up goods that have been shipped according to the supply contract" (OECD, 2003). And Stephens has a quite similar definition on commercial risk, "the principal commercial risks are insolvency of the buyer, default on payment by the buyer and repudiation of or refusal to accept the goods or services ordered" (Stephens, 1996). Commercial risks can be high in emerging markets where the financial system is still immature as compared to developed countries. The lack of financial information and the quality of information in these markets partly institutes the threats of commercial risk. Credit rating agencies and the exporters themselves cannot always assess credit worthiness comprehensively and sufficiently based on the limited financial information of their buyers. As Nerouppos et al. emphasized in a study the lack of data in emerging markets can lead to tremendous difficulties for risk management. "Another problem, equally important from a risk management point of view, is that there is a startling scarcity of available data. Often, the institutional mechanisms that lead to the plethora of data in advanced markets do not exist (e.g. derivatives exchanges, secondary markets, and even regular auctions of a standard set of government bonds). Furthermore, those data that are available are contaminated for many reasons. Since many emerging markets have gone through some period of crisis, the history of local financial variables is of questionable value in calibrating mathematical models for assessing future risks. Any current price data that are available must be viewed in light of the volumes and liquidity of local markets. All of these factors lead to tremendous difficulties for risk management" (Nerouppos et al., 2006, pp. 180-181).

[2] The Multilateral Investment Guarantee Agency, MIGA, is part of the World Bank Group.

[3] Malcolm Stephens occupied key positions such as the Secretary-General of the International Union of Credit and Investment Insurers (Berne Union) and as the Chief Executive of the Export Credits Guarantee Department in the United Kingdom.

In spite of the high level of risks in many emerging markets, companies continue tapping into those markets because of potentially high profit margins. In order to mitigate against political and commercial risks the use of risk mitigation instruments has become more important for companies exporting to and doing business in emerging markets. This is especially true during times of crisis. These instruments are provided mostly by export credit agencies (ECAs), multilaterals and private insurers. Most ECAs are members of the Berne Union[4] (the International Union of Credit and Investment Insurers).

2. Risks mitigation instruments offered by export credit agencies

When private companies engage in cross border trade in emerging markets, the risks they face is a key concern. Not only small and medium sized companies need to evaluate and assess the risks they are faced with carefully, but also large corporations with stronger financial capabilities need to protect their business from risks. In order to meet this existing demand the political and commercial risk insurance industry has been formed. The leading association in this industry is the Berne Union (founded 1934) with 73 members including mainly ECAs, multilaterals, and private insurers (MIGA, 2010). ECAs are either public-sector institutions in their respective countries, established to provide support for the exports of that country, or private-sector companies that act as a channel for government support for exports from the country concerned (Yescombe, 2002).

In general, these ECAs will charge a premium to those companies who use their products. According to MIGA the "OECD country ratings are designed to set guidelines to price the default risk on export credit and to set minimum premium rates charged by participating ECAs" (MIGA, 2010, p. 63). The ratings known as the Knaepen Package came into effect in 1999, is a system for assessing country credit risk and classifying countries into eight risk categories, from 0 to 7 (OECD, n.d). Basically, ECAs will assess political risk and commercial risk when they issue guarantees to exporters or foreign buyers. ECAs use country ratings by OECD as platform to assess political risk or country risk while commercial risk is assessed based on each individual corporate´s information such as operation and background information, financial and audited annual reports, project feasibility studies, etc. Companies who are eligible to use products or services provided by an ECA must have their operations relevant to national interest of the country where the ECA is located. In other words, the companies must contribute to national economic development of that country in a direct or indirect way. For instance, a company must have production facilities located in the home country of the ECA.

[4] "The Berne Union (BU) was founded in 1934 in order to promote international acceptance of sound principles in export credit and investment insurance and to exchange information relating to these activities. Today, the BU has 73 members (including Prague Club members) comprising mainly export credit agencies (ECAs), multilaterals and private insurers. The BU plays an important role in bringing together the public and private insurers to enhance cooperation and information sharing. Members meet on a regular basis to discuss industry trends and challenges" (MIGA, 2010, p. 53).

The ECA can also support a home company who has production facility in a host country.

There are various products or risk mitigation instruments offered by ECAs and these products can be the same or very similar from one ECA to another. Products of ECAs include, for example: Bond Guarantee, Investment Guarantee, Project Financing Guarantee, Financing Guarantee, Project Delivery Guarantee, Working Capital Guarantee or Reinsurance.

The products that this article focuses on and analyzes are: (i) Buyer Credit Guarantee, (ii) Supplier Credit Guarantees and (iii) Export Loans. The authors of this article chose those three products based on their research of a large European company in connection to its business expansion in Vietnam. These products seem to be the most suitable in terms of risk mitigation when companies export goods or services to their buyers in emerging markets. However, companies need to find what product suits them best on a case by case basis.

A Buyer Credit Guarantee is basically a guarantee issued by an ECA to a bank that lends money to a foreign importer to pay for an order of goods or services from an exporter in the country where this ECA is located (see figure 1). In emerging economy countries, both local and international banks are cautious when deciding to lend capital to companies. A research[5] among the largest fisheries processors (ranked by VASEP[6]) in Vietnam conducted by the authors in November 2011 found that when companies applied for medium or long-term loans (up to 5 years) to invest in their processing equipment they usually only got 50 to 55 percent of the amount requested. If a company has good working experience and good relations with a local bank and the feasibility study of their project is highly assessed, the amount of loan could be increased to 70 percent of the total loan requested. The companies had to use their own funds for the rest of the investment. Some processors said that they could hardly obtain any medium or long term loan if the size of the loan is up to few millions US dollars. This has been one of the companies´ main constraints and it prevents companies from investing intensively in comprehensive and modern processing lines.

Buyer Credit Guarantee can help foreign buyers in emerging markets to obtain larger loans from international banks with longer lending term and at more favorable interest rates. This can also be done through a local bank but it would normally take longer time as the ECA is more likely to know the international banks. The bank will then be covered from buyer´s default in repayment due to commercial or non-commercial risks.

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5 In co-operation with Marel Food Systems, the authors selected, visited and interviewed 4 of the largest Vietnamese pangasius processors in order to understand their difficulties and constraints in modernizing their processing lines. Export value of these processors on a yearly basis varied from USD 17 million to USD 61.7 million in 2010 (according statistic from VASEP sent via email July 22, 2011). These companies are thus an important source of foreign exchange for Vietnam.

6 Vietnam Association of Seafood Exporters and Producers (VASEP) is a non-governmental organization, established on June 12th 1998, based on the principles of volunteer, autonomy and equality. VASEP members include leading Vietnamese seafood producers and exporters and companies providing service to the seafood sector.

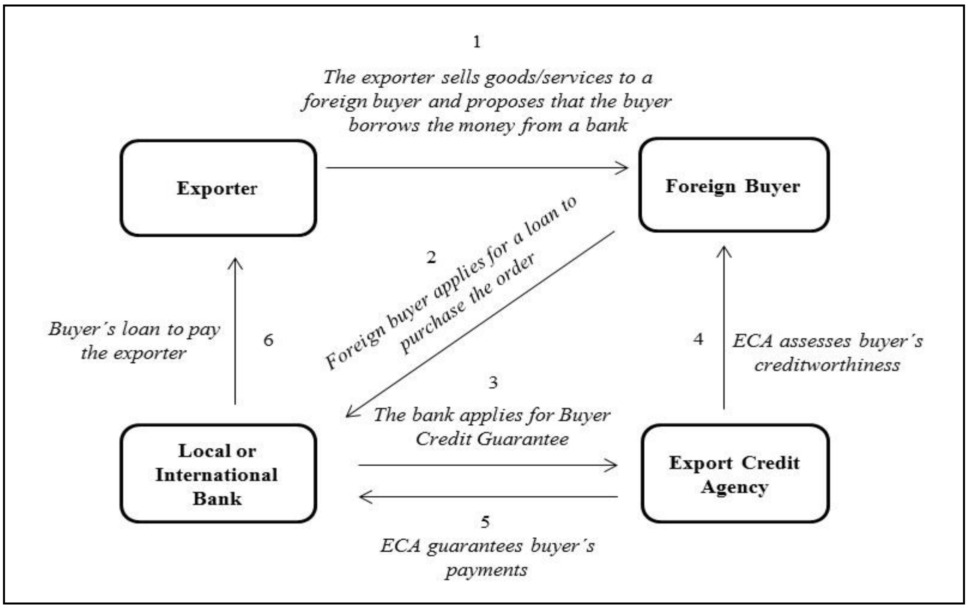

Figure 1. Model of Buyer Credit Guarantee of the Danish ECA – EKF

A Supplier Credit Guarantee is a guarantee issued by an ECA to the supplier or the exporter and this exporter can then grant the foreign buyer extended credit on amounts payable for the order. The supplier or the exporter will be protected against the risk of not being paid by the buyer or the importer due to political or commercial risks. The exporter can take advantage of supplier credit guarantee to lend the foreign buyers in an emerging market where an extended credit period may be the key incentive for the buyers to select the most competitive supplier over the others. Supplier Credit Guarantee helps the buyer or the importer repay the order in a longer period (see figure 2). This can be very advantageous for a buyer who may have limited cash flow and has difficulty in accessing funds. During a research conducted by the authors of this article among 20 largest Vietnamese fisheries processors in August 2011, a questionnaire was sent out. All of those who answered indicated that they have to pay the supplier within 3 to 6 months after the equipment has been fully installed and checked. This short term repayment period for the equipment from the supplier is one of their main constraints especially for companies who lack working capital and have difficulty in obtaining loans. The field research conducted by the authors in November 2011 found that these companies have not been offered an extended credit period from any supplier. They have to apply for loans from local banks with high interest rates. Most loans lent to them are both short term loans (less than 12 months) and the amount allocated is far lower than the amount they requested. This constraint appears to be one of the reasons why Vietnamese fisheries processors could not purchase sophisticated processing equipment from European manufacturers on a large scale.

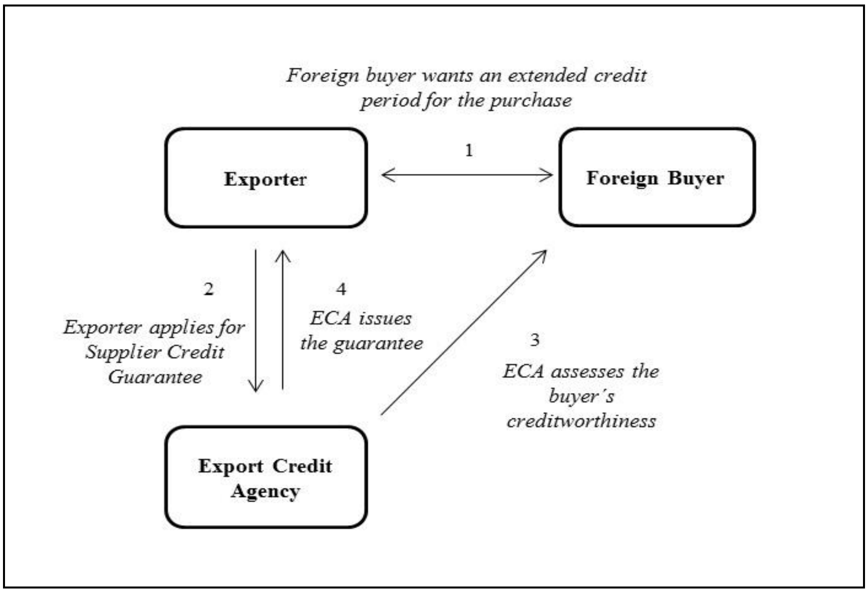

Figure 2. Model of Supplier Credit Guarantee of the Danish ECA – EKF

They only purchased a small part of the equipment needed from these manufactures and the rest of processing lines were locally made or imported from more affordable Asian manufacturers like China, Korea or Japan. This suggests that if buyers from an emerging market like Vietnam were offered an extended credit period, it might affect their investment decision which means that they would perhaps invest more sophisticated processing equipment on a larger scale. Some of the processors in Vietnam indicated that if they were granted a longer repayment period from the supplier and at reasonable cost they would consider to invest and modernize their processing lines more comprehensively. See figure 2 for the description of how Supplier Credit Guarantee works.

An export loan is a lending scheme to help the exporter´s foreign buyer when this buyer is unable to secure credit facilities from banks for purchasing products and services from the exporter (see figure 3). In the case of EKF, the Danish Export Credit Agency, they would facilitate the export loan through a bank, and the loan is based on the bank´s lending terms. It depends on each individual ECA whether or not they offer the export loan product and how long the lending term will be. But this product is very important during financial crisis when banks are unable to provide loans to companies. The EKF offers export loans as a result of the crisis and application for an export loan from EKF can be made until end of 2015.

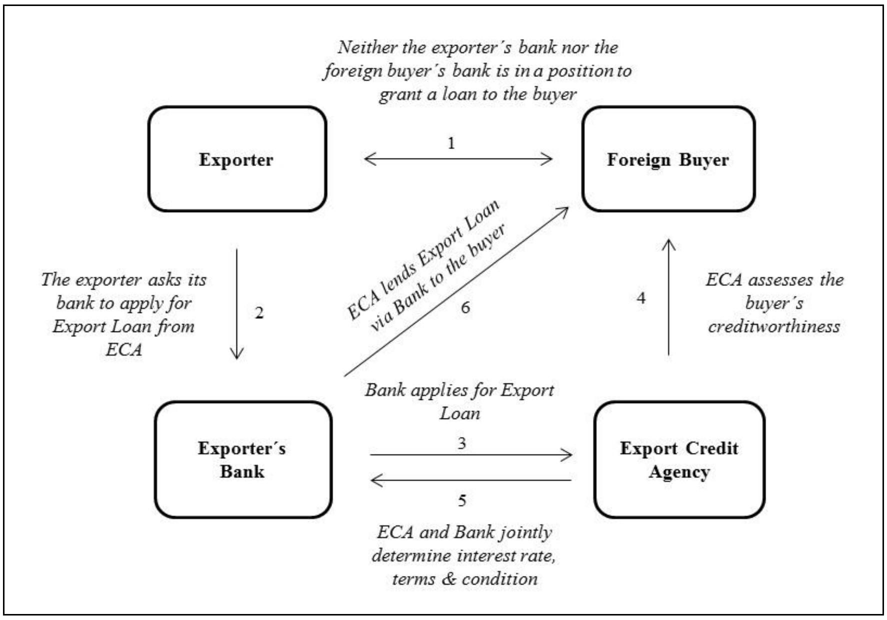

Figure 3. Model of Export Loan of the Danish ECA – EKF

However, the costs associated and premium for this Export Loan scheme is not necessary cheaper than other traditional lending schemes because the export loan is granted jointly by a bank (usually the exporter´s bank) and an ECA to the foreign buyer on a commercial basis and market conditions. Export loan can be even more expensive but it also can be critically important in international trade especially during financial crisis time where many banks are unable to provide funds to companies. The next chapter will illustrate how this produce is applied with a case in Jordan.

3. Cases. How are ECAs' risk mitigation instruments applied?

This chapter discusses some success stories of companies who used products of the Danish Export Credit Agency, EKF. These cases are quoted directly from cases published on the EKF´s website.

3.1 Olam International Limited and the use of Buyer Credit Guarantee from Danish ECA - EKF – for a manufacturing facility in Vietnam (2009)

Olam is a leading global supply chain manager and processor of agricultural products and food ingredients. With direct sourcing and processing in most major producing countries for various products, with the headquarters in Singapore, Olam has built a global leadership position in many businesses, including cocoa, coffee, cashew, sesame, rice, cotton and wood products. Olam operates an integrated supply chain for 20 products in 65 countries, delivering these products to over 11,000 customers worldwide (Olam, 2011).

The Challenge

In the year 2009, Olam was looking to invest in equipment for its new coffee manufacturing facility in Vietnam. Olam chose a Danish company namely GEA Process Engineering A/S as the supplier. Unfortunately, the global economic and financial crisis made it difficult for Olam to secure the financing it needed to buy the equipment. At the same time, Olam´s bank was reluctant to secure long term financing. "Owing to the lack of liquidity in the financial market in February 2009 it would in all probability have been impossible to secure financing with a repayment term beyond 2-3 years for Olam," says Antero Ranta from Olam's bank, ANZ Structured Asset and Export Finance, in Singapore

The Process

Thanks to long standing working relations between GEA and EKF, GEA proposed that EKF be involved in the process of procuring financing for Olam´s project in Vietnam. "I was convinced that EKF would be able to assist in putting the financing in place. For our part, it was all plain sailing, as, right from the start, our customer and ANZ were keen to take over and deal with EKF directly," says Jesper Duckert, Project Finance Manager, GEA Process Engineering A/S. In order to implement the financing negotiations, EKF decided to send its representatives to Vietnam and had a meeting with representatives from Olam and ANZ Structured Asset. After the visit to Vietnam, EKF had better basis for assessing the actual credit risk entailed by the project.

The Solution

After the meeting and negotiation EKF came up with a detailed assessment of the project and was able to offer a buyer credit guarantee. This guarantee meant that EKF assumed a share of the risk of extending a loan to Olam, and therefore, ANZ could secure financing for Olam as they needed. "With an export credit guarantee from EKF we were able to offer Olam a loan with a repayment term of 8.5 years," says Antero Ranta from ANZ Structured Asset and Export Finance in Singapore. "In spite of the financial crisis we were able to secure long-term financing for our activities on a growth market," says Arun Sharma, Senior Vice President, Coffee Division, Olam (EKF, 2009a).

3.2 A Jordanian company namely Modern Cement & Mining Company, and the use of Export Loan and Buyer Credit Guarantee from Danish ECA – EKF (period of credit: 2010 to 2017)

The Challenge

In July 2008 the Jordanian company Modern Cement & Mining Company chose a Danish company namely FLSmidth as an equipment supplier for its new cement plant in the south of Amman. The first deliveries were already paid by the Jordanian company but the main part of the order was to be financed by a local bank. However, due to the global economic and financial crisis, the bank turned down applications for new loans. This threatened the progress of the construction and the order of FLSmidth. FLSmidth decided to contact EKF in the spring of 2009 because FLSmidth had previously been assisted by EKF with guarantees for financing solutions.

The Process

EKF had meetings with a number of international and local banks who expressed their interest in taking on the risks of the project provided that EKF would guarantee most of the loans. Furthermore, through the export lending scheme EKF was able to offer a loan to the buyer of FLSmidth services. Then EKF quickly endorsed the project. "EKF's endorsement was conditional to the approval of the risks and terms in the transaction, its environmental impact and the extent of the Danish economic interest in the transaction – aspects which all needed further examination and subsequent negotiation with the parties involved" (EKF, 2010).

The Solution

Finally the solution came into place in May 2010. "Half of the FLSmidth contract was financed with equity from the owners of the cement plant while the other half was financed with loans. More than half of the debt financing came from the Danish export lending scheme administered by EKF, while the remainder was provided by a group of local banks" (EKF, 2010). HSBC London arranged the EKF financing. HSBC London is also acting as agent bank on behalf of EKF. Thanks to EKF's loan and guarantee, the construction of the cement plant in Jordan could continue as planned. And the plant is expected to be ready for production start-up at the beginning of 2012 (EKF, 2010).

3.3 Grain and seed exporter Nibulon Company in Ukraine used EKF´s Buyer Credit Guarantee to borrow money from a European Bank at a far lower interest rate than in Ukraine

The Challenge

In 2009, a Danish company, Cimbria Unigrain received the first of two large orders worth EUR 20 million from Nibulon, Ukraine's largest grain and seed exporter and a high-growth company. This order consisted of eight silo facilities for storing, drying and loading grain and seed. And Nibulon uses this equipment to extend and standardize its storage and transportation facilities by the rivers of Ukraine and the Black Sea. However, the Ukrainian buyer´s constraint was that they had to borrow at a high interest rate in Ukraine to pay Cimbria Unigrain. And this might create uncertainty regarding the order from the Danish manufacturer.

The Process

Cimbria contacted EKF and EKF agreed to assess the viability of the export order and work on the financing options via a guarantee from EKF. ”Even allowing for the premium payable to EKF, Nibulon is making a big saving," says Sales Director Henning Roslev Bukh. He adds that Nibulon regards Cimbria Unigrain and EKF as important and regular business partners.

The Solution

Finally EKF offered a buyer credit guarantee to Nibulon. This meant that Nibulon was able to secure a loan from a Western European Bank at a far lower interest rate than in Ukraine. ”Nibulon is very pleased that it was possible to arrange a Danish guarantee for this order. We might well have got the order anyway, as Nibulon has ordered from us for many years and is very satisfied with our products. Nibulon could perhaps have financed the purchase with equity, but it is often cheaper to borrow the money than to use equity, and equity is greatly needed in a growth-oriented company such as Nibulon,” says Henning Roslev Bukh. And in 2010. Nibulon made another order for eight silo facilities – and once again, EKF provided a guarantee for the buyer’s payments. Thanks to this order Cimbria Unigrain has hired 30 employees in 2010 (EKF, 2009b).

4. Marel Food Systems expansion in Vietnam. Can ECAs help?

Marel Food Systems is one of the leading manufactures in food processing equipment. Marel is headquartered in Iceland[7] and has production facilities for processing lines in fish, poultry, and meat in numbers of European countries, USA, Brazil and in Asia. Marel is ambitious to expand their business in emerging markets where food processing industry is becoming more important like for example in China, Thailand and Vietnam. However, the purchasing volume of buyers from these markets remains low especially in Vietnam. The research conducted by the authors in cooperation with Marel, mentioned earlier, among largest pangasius processors in Vietnam, found that Vietnamese buyers bought some limited number of equipment rather than investing in comprehensive processing lines. During in-depth interviews with 4 of the largest Vietnamese processors, the authors were told that most of the equipment made by European manufacturers is very sophisticated and advanced, however, this equipment is too expensive for them to purchase on a large scale. Instead, they needed to select some equipment which is most important for them. The remaining equipment they bought from more affordable manufacturers from China, Korea or Japan and some other equipment is locally made. When asked, these processors said they were aware of the fact that having advanced equipment in their processing lines would enable them to export more of their products to high income markets like USA, Europe and Japan. The critical issue is lack of funding which prevents them from investing intensively. The issues here include low amount of loan allocation from local banks, limited availability and accessibility to long term loans especially in foreign currency like USD, high interest rates, short repayment period to the equipment suppliers etc. At the same time, the authors visited and interviewed some ECAs in Europe like EKF (Denmark), EKN (Sweden) and Atradius (Netherlands), and ECICS in Asia (Singapore). In response to the question what products offered by ECAs they thought would be most suitable for Marel and its

[7] Iceland has an ECA called TRÚ. This agency has so far been inactive and has never processed a transaction. Since Marel Food Systems has production facilities in several countries the company can use the services of the ECAs in those countries. Iceland, like several small states, also has limited membership in international financial institutions (IFIs) and is not member of the regional development banks (see, for example, Hilmarsson, 2011). This limits the access of Icelandic companies to the risk mitigation instruments of IFIs.

buyers in Vietnam given the constraints mentioned above, these ECAs thought that two products should be suitable which are Buyer Credit Guarantee and Supplier Credit Guarantee. The recommended products of ECAs could help Marel achieve its goal which is to expand its business in Vietnam. However, the ECAs also said that in order to be supported by ECAs´ instruments, the Vietnamese buyers need to fulfill requirements in terms of being able to provide sufficient and transparent information about their companies, especially financial information, including audited annual reports. The readiness and good "home-work" of Vietnamese buyers will help the process of ECAs in assessing their creditworthiness and making decision on their request quicker. Most of the Vietnamese fisheries processors now are working with local banks both state owned and private, however, ECAs indicated that if foreign buyers work with international banks it will normally make the process faster because ECAs have more working experience with large international banks than local banks in a specific country.

Conclusions

In an increasingly globalized world, economic growth depends much on openness of economies and trade among nations. The current economic and financial crisis has severely affected trade flows in the world that dropped sharply in the second half of 2008 and 2009. During the crisis, export credit agencies have played an increasing role in maintaining and stimulating cross border trade to emerging market economies.

When companies engage in cross border trade and/or investment they are likely to face higher risks than in domestic markets. These risks can be political and commercial risks and the level of risk is also different in different markets. In order to cover the existing demand and to promote the export of its home products, ECAs worldwide provide various risks mitigation instruments. Through the research done by the authors and the real cases described in this article, we can see that there are real possibilities for companies to have risks covered thus enhance their business development especially when they tap into emerging markets.

Among the key factors for success is the ability of ECAs to assess the creditworthiness of companies involved especially the foreign buyers. Therefore, in response to this issue, foreign buyers should provide full and transparent financial information to help the process move faster, including audited annual reports. Besides that, ECAs prefer working with international banks that they know and already have a business relationship with so it would be advantage for foreign buyers to seek loans from international banks like ANZ, HSBC, Standard Chartered Bank or international organizations like the Asian Development Bank and the International Finance Corporation of the World Bank Group, etc. The products offered by ECAs show that the risks associated with political and commercial risks in emerging markets can be managed, and the cases discussed in this paper are tangible evidence of recent success during a global economic and financial crisis.

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