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# EXPORT FINANCING BY DEVELOPMENT FINANCE COMPANIES[1]

by

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**Development banks[1] and balance of payments**

Balance of payments problems originating from a shortage of foreign exchange earnings are one of the crucial issues of both developing and developed countries.

The export of processed staple goods or refined raw materials and, still more, of semi-manufactured or manufactured articles is considered to be a decisive means of coping with the foreign exchange problem.

The process of industrialization in developing countries is to a great extent promoted, assisted or reinforced by industrial development financing institutions, or development banks.

Historically, development banks have undertaken their activities mainly with a double motive: promoting the internal development and increasing the independence from the overriding and ambivalent problem of the balance of payments. The policies of development banks have always taken into account the foreign exchange situation of their country.

It is therefore logical to consider the financial role of development banks in promoting exports in general.

**Definition of "export financing"**

The term " export financing" is generally used in a restricted sense. It refers to financing specific export transactions concluded on deferred payment terms, by bank loans, given either to the seller or to the buyer.

There is another, widely used meaning of "export financing". It describes the totality of instruments for short-term financing, current export transactions, as used by commercial banks. Used in this sense the term should be "commercial export financing".

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1/ Development Finance Companies will hereinafter more shortly be referred to as "Development Banks" or, in abbreviation, as "[illegible]" ("[illegible]").

Apart from the type of export financing referring to individual transactions, there is the financing of export-oriented enterprises as such, with regard to a foreign selling line of products or an "export programme", or just because the firm to be financed is export-oriented. This is an indirect type of export financing.

It would be convenient to combine export financing in the sense of one particular transaction, and financing of export-oriented enterprises u under one common term, such as "financial export promotion". It should also comprise "commercial export financing" in so far as it is of a promotional character. It would exclude the non-promotional short-term commercial bank activities on the one hand, and all kinds of non-financial or non-banking promotional instruments on the other, such as tax exemptions, product or price subsidies or traning and consulting services of specialized bodies.

The resulting scheme of definitions would thus be:

Export promotion

Non-financial or general export promotion

Services (training, consulting, market surveys, advertising etc.)

Subsidies (tax exemptions, price stabilization, interest subsidies)

Financial export promotion (through credits)

Export financing (financial export promotion of individual transactions)

Financing of export-oriented industries (indirect financial export promotion)

**A preliminary overview of the subject**

An initial survey reveals that export financing proper is still rare in developing countries, owing to the relatively small activities in exporting heavier equipment on deferred payment terms. Examples, however, show that export financing is already practised, even on an insured basis.

Export financing proper i[illegible], [illegible] the other hand, [illegible] with export credit insurance, [illegible] ta[illegible] of exporters in [illegible] countries in [illegible] the Third World. It is an activity that is subsidized by the governments. Developing countries that enter into this competition will have a heavy burden.

In spite of the importance of the phenomenon in developed countries, its historic evolution is of no great significance - experience gained there can hardly serve as a guideline for developing countries, since the role of DBs is entirely different in various environments and at various stages of industrial development.

Indirect financial export promotion, however, is an activity in which most development banks have gained experience. In the course of industrial growth, there will be increasing pressure for export financing proper.

This paper will develop the issue along the following lines:

(a) Describe the prevailing types of financial export promotion and their relationship to DBs (Chapter I);

(b) Discuss the implications of DBs adopting financial export promotion and especially export financing proper.

<u>Chapter I. The prevailing types of financial export promotion and their relationship with development banks</u>

<u>[illegible]</u>

It will prove useful to go beyond the definitions outlined above and work out more distinctly the most important types of financial export promotion.

<u>Type one: [illegible]</u>

This type includes financing of individual export transactions of greater importance, characterized by deferred payment over more than five years, concerning heavy equipment or turn-key contracts. The exporter's claims are insured, thus reducing the risk for the bank financing the operation either by a credit to the supplier or to the foreign buyer.

Type two: Light export financing

It differs from the preceding category in that it is for lighter equipment, smaller contract values and shorter repayment periods than five years. Insurance may be involved, but is no necessary ingredient.

Type three: Financing of export-bound working capital on special terms

This type helps an export-oriented firm to finance its rolling stock of short and medium-term export claims when it attains a certain importance with which the firm cannot cope without cutting itself off from further credit supply for normal current requirements. It is no longer an individual type of financing, and in this sense it is indirect. But is is direct in the sense that it finances the export claims and not an investment that helps to earn foreign exchange. It is commercial export financing under promotional auspices.

Type four: Export-oriented development banking

With this type a new element is introduced: no longer is an individual operation financed as in types one and two, nor a multitude, or a revolving aggregate, of export claims as in type three, but the enterprise as a whole receives a long-term development loan that is ear-marked for investments that will produce foreign-selling goods and equipments. These goods may possibly be defined in a programme of the DB, or in a priority list issued by the government. Such a list contain capacity ceilings that the DB shall not exceed when sanctioning investment projects. This is the first of two types in which the ingredient of development banking is contained.

Type five: Development banking under balance of payments criteria

It differs from type four in so far as the balance of payments considerations are more smoothly, and more scientifically, introduced into the policy of the DB. Instead of following rigid lists, the DBs carefully evaluate the foreign exchange saving effect of a project, including the foreign debt service. Evaluation

procedures may incorporate shadow foreign [illegible]
to introduce elements of a cost-benefit analysis.

<u>Type six: Allocation of foreign exchange on credit terms under balance of payments criteria</u>

This type represents a policy of distributing scarce foreign exchange to potential investors for the purchase of investment equipment abroad. The guiding principle for distribution is again, as in type five, the balance of payments criterion or a priority list of export goods as in type four.

In short: foreign exchange sunk into investments must again help earn foreign exchange. But the volume of applications is so extreme in comparison to the available foreign exchange that only a small fraction of applicants can be selected.

The DB, in applying additional criteria such as creditworthiness, reflected by low debt/equity ratios etc., ends up in selecting firms that, while urgently interested in a foreign exchange allocation, do not required long-term credit at all: they would be in a position to pay in cash for the foreign allocations.

Being a DB, the bank under its normal procedures has, however, to insist on long-term repayment. That is why this type, which is of wide importance, can be called an "administration of foreign exchange resources, disguised as development banking".

It is, or has been, typical for countries that suffer under a lack of foreign exchange and where, on the other hand, foreign-exchange-earning investments can only be made with equipment that has to be bought abroad.

<u>Experience of development banks with financial export promotion</u>

It may be tempting to interprete the types in the sense of phases of development that follow each other. A few historical examples and some remarks in the introduction may suggest that type six should be at the beginning, followed by types four and five, upon which then follow the other "phases".

There is, however, an overlapping of the types, even a reversed order of sequence: one or the other may be left out or be unknown. Some interrelations are typical:

(a) Insurance supported heavy export financing normally follows the phase of light export financing.

(b) Export-oriented development banking (priority lists) and the one under balance of payments criteria are closely linked to each other and may often be practised jointly by a DB. Under interregional economic co-operation a DB that has evaluated projects so far under the balance of payments criteria may switch to outright promotion of investments that yield certain products for exports to countries of the group.

(c) Financing of export-bound working capital is an activity that many DBs do not undertake, simply because their statutes do not allow this. DBs with a wider scope of services will consider this an ideal component of package financing offered to a customer. When evaluating the experience gained with these different types, the following observations can be made.
Type six, i.e. foreign exchange allocation under criteria of export promotion, has certainly passed its summit. It has recently been made subject to hard criticism. DBs have, without doubt, helped to save or earn foreign exchange but they may have kept away from financing many a project that may have had great merits under developmental or employment aspects, but did not show sufficient financial solidity. However, this was not so much due to the application of the balance of payments criterion, but is rather the result of over-emphasizing profitability or security standards. It seems that whenever DBs have to work under similar conditions, they should be very vigilant to avoid the inherent difficulties of this type.

Type five, i.e. investment financing under general balance of payments criteria is an experience shared by nearly every DB, naturally more by banks in those countries where the foreign exchange problem is especially important. Within the two standards of viability, or profitability and economic justification the consideration of balance of payments, which is only a partial aspect of the latter, has increasingly gained an autonomous value and has developed into one of the main yardsticks by which the merits of a credit application are measured. To that extent, development banking has helped to improve a country's balance of payments. The problem of whether DBs could have done better is one of weighing this criterion against the other criteria of "economic justification". In applying shadow prices the different criteria can be merged into one consistent and commensurate analysis, and arbitrary decision thus be eliminated.

Type four, i.e. investment financing with a view to promoting production of well-defined export goods is in many respects comparable to the preceding type. One of the outstanding examples is the Pakistan campaign of the early 1960s of boosting investments in the textile industry with the aim of substituting for imports and gaining on exports. At the same time, the Bangladesh jute industry heavily pushed into processing and transforming the cheap raw material into better selling yarn and carpet backings.

For the DBs in the numerous countries that rely to a great extent on export of staple goods, this type of financial promotion remains vital. One must continually watch whether increments in foreign exchange earnings through higher prices really offset, and surpass, the incremental foreign exchange cost originating from the necessary investments.

Type three, i.e. financing export-bound working capital seems to have been too often neglected by DBs, which exclusively embark on long-term operations. Here, a short-coming of the statutes of many DBs becomes evident. Of course, in many cases the abstinence from

financing marketing, [illegible] arguments are motivated by considering the role of commercial banks. These, often shareholders of a DB, watched over a strict separation of the two domains. It seems debatable why marketing of products, which is a major concern in project appraisal of a DB, is not taken care of financially by the same bank.

Types one and two, i.e. heavy, insurance-backed, and light export financing in the proper sense, find hardly any mention in the statutes of DBs in developing countries throughout the world.

Many statutes may allow for such operations, in the absence of a formal exclusion. But little need has so far arisen for such operations, except in countries like Brasil, India, Mexico, which compete in the Third World's light and heavy equipment markets.

General observations are not possible, but examples may be cited. The Industrial Development Bank of India (IDBI), a central discount bank of banks, more than a DB in the sense of this paper, refinances other DBs or commercial banks that do export financing. In Mexico, Nacional Financiera finances the foreign trade bank of the country.

At this point, a vast field of experience gained in the[2] developed countries offers itself for consideration. A number of solutions have been adopted there. But prior to any attempt of evaluating experience, a description would be required which would exceed the limits of this paper. Chapter 11 will implicitly draw on the experience in developed countries.

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2/ Reference can be made here to existing United Nations documentation, such as:

Export Credits and Development Financing
Part One "Current Practices and Problems", United Nations publication, Sales No. 67.II.D.1.
Part Two "National Export Credit Systems", United Nations publication, Sales No. 67.II.D.1.
Suppliers' Credits from Industrialized to Developing Countries
A Study by the staff of the World Bank requested by UNCTAD, Washington D.C., 1967. (See United Nations publication, Sales No. 68.II.D.17)p.148.
Export Promotion
"Promotion of Export-oriented Industries" United Nations publication Sales No. 69.II.39 Vol. 19

## Chapter II. Some basic considerations [illegible] of development banks in financial export promotion

From experience, one may state that the abovementioned six types can be grouped into three categories. The following scheme may help to make the grouping more apparent:

6: Exchange allocation on credit terms

5: Development banking/balance of payments criteria

4: Development banking/priority lists

3: Loans for export-bound working capital

2: Light export financing

1: Heavy export financing

(a) The "hard core" is made up by types four and five. Here, DBs have gained wide experience, and achievements are predominantly positive.

(b) Type six seems to be a type of export promotion that can no longer be acknowledged as useful, though it may still be practised.

(c) The third group comprises export working capital financing, and the two types of export financing proper. In developing countries is a field of experiment rather than of experience. In any case, the amount of experience decreases towards the bottom of the graph.

As a consequence, it seems of primary importance to concentrate on the third group in trying to develop basic considerations and to formulate principles that should be observed when DBs consider export financing activities.

Problems with regard to each of the three types rather than types themselves are discussed below.

A general consideration appears at this point, i.e. it can be anticipated that many problems will suggest different answers according to the type of the DB concerned: a government-dependent institution, a privately-owned DB with widespread services, or a super-institution with not only financing but also planning and co-ordinating functions, etc.

Banking structure of a country

It is apparent that nearly each country seeks an individual solution, to export financing. A few common problems, however, are evident:

(a) Working capital financing is a touchy matter for a DB streamlined on long-term financing. If the commercial banking sector offers good services, a private DB should not endeavour to assume this task. But closer co-operation should be envisaged. A government-owned DB in a private commercial banking environment could give guarantees for working capital loans, thus enabling the commercial banks to forego securing their credit lines. The question should be considered whether it should be made a strict rule that such credit lines (or guarantees) are issued only in favour of firms that have applied for a long-term investment loan.

(b) The question remains who should handle export financing proper. Any banking structure can absorb any solution. The funds will most probably come from the Government, as it is the case in most developed countries. In a smaller financial community a separate institution handling exclusively export credits seems out of place. A good practice in many circumstances may be to offer the export credit funds to all banks and institutions on a competitive basis.

Conflict of interests

It should be considered whether a DB would, when expanding into working capital and export financing, tend to divert part of its attention and loyalty owed to development financing? It may be

tempting to apply the funds rather to financing the export requirements of a running, well-established customer than to sink them into a grass-root venture with appraised, but still uncertain risks. A DB from its own cannot cope with this conflict impartially. But there are answers to this problem - statutes or policy statements must be drafted accordingly, special funds can be created or ear-marked, separate departments could balance the diverging interests.

On the other hand, financial promotion of sales, on the domestic market or abroad, must not be neglected. Complementary financing of investments should, therefore, be handled by the same institution. Otherwise a specialized export financing institution may tend to over-emphasize its activity to the detriment of the DB.

Financing

The basic problem is to what extent an economy can rationally divert funds from development purposes to financing exports or export-bound working capital.

The appropriate method to deal with this question would be a cost-benefit analysis which would have to ponder the net benefit arising from additional export financing as against the net cost arising from the putting off of investments in industry or even in basic infrastructure.

If we take it for granted that there is a need for export financing and assume that the Government is prepared to procure the necessary funds, the question is in which form financing is made available.

(a) Should the Government increase its equity participation in institutions, such as DBs that are able to do export financing?

(b) Should the funds be lent to these institutions, leaving it to them to increase their risk capital accordingly?

(c) Should the institutions manage the funds for the account of the Government, thus avoiding any risk?

(4) Should the Government simply subsidize the activities by providing interest income and paying [illegible] risk premium?

The questions reveal that, whichever form a Government chooses, most DBs would be able to respond to any of them, except where public shareholders are not welcome.

**Risk problems**

Export financing in the form of a credit to the purchaser involves a DB directly in a foreign risk. A supplier's credit or working capital loan does so in an indirect way: the exporter's portfolio gets stuffed with more foreign assets.

Risk appraisal is something the DB should normally be familiar with. As it appraises a domestic investment, it should be able to appraise the risk involved in a foreign project to which its customer is supplying equipment. The purchasing firm in a neighbouring developing country will often be itself a customer of the DB of its country. The two DBs involved could even exchange information and agree on formalized procedures for doing so in all cases.

In the case of a short and medium-term portfolio of an exporter, split up among hundreds of debtors in several dozens of countries, risk appraisal becomes more difficult, if not impossible, and it is alien to a DB's current activities. But a commercial bank would be in no better position. In a number of countries firms that produce consumer goods for export are guided in their foreign activities by public export promotion entities. These marketing boards have linked the commercial relations between exporter and buyer. It may be a worthwhile proposition that these promotional entities issue guarantees to the banks in favour of the firms whose exports were sponsored by them. Their apparent lack of financial standing must be balanced, supported by governmental backing, or in other words, they would issue their guarantees for the Government's account.

The risk problem changes completely if export credit insurance is available. Again any substantial activities in this field can be undertaken only by the Government. The Government either assumes foreign portfolio risks more or less directly through a DB of its own, or, if it wants these portfolios to be financed by private banks, it insures them.

**Package dealings versus specialisation**

Specialization in the field of financial export promotion, as it is practised in the Federal Republic of Germany, can have the following result: an export-oriented medium-sized machinery manufacturer

- obtains a long-term investment loan from Industriekreditbank;
- finances his current export transactions by a credit line of his commercial banker;
- sells a larger plant to a foreign buyer and requests financing of the pre-shipment phase from Ausfuhrkredit-Gesellschaft (AKA), a private bank-sponsored export credit bank;
- induces Kreditanstalt für Wiederaufbau (KW) to give a purchaser's loan to his customer abroad. This loan is disbursed one year after commissioning of the plant and may run over five or eight years;
- insures, as a necessary prerequisite for AKA and KW financing, his export claims with "Hermes", the German government-sponsored export credit insurance

As opposed to the concept of unilateral financing from one source, this five fold set up can be looked upon as a nightmare. Naturally, specialization also has its merits. There are, however, great advantages in pooling the different services. The main problems that can be thus eliminated are:

- Competition between banks for securities;
- Accumulated financing and insurance costs;

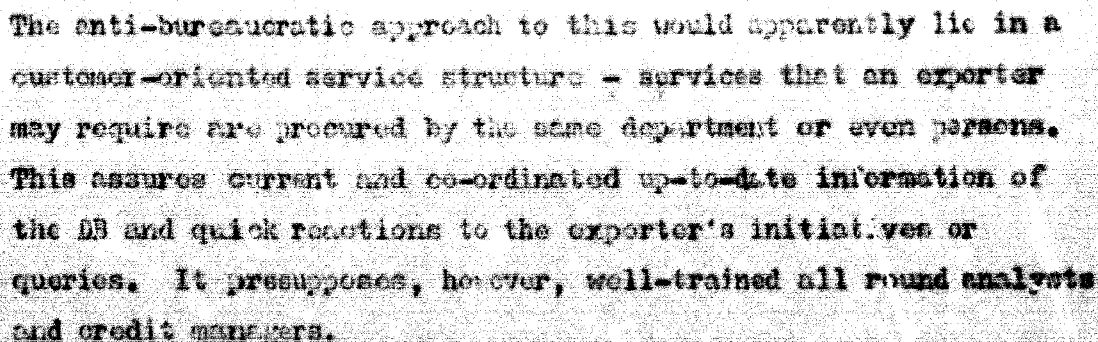
- Time-consuming processing of applications
- Divergences of opinion in appraising the project in question.

The two last-mentioned problems may turn up even within one institution, provided two distinct departments are handling the different services

**Organisational questions**

If the different services, or types, of financial export promotion are integrated in one institution, the chances may still be great that the splitting up of responsibilities between several departments revives the problem of specialisation as outlined in the preceding paragraph.

The anti-bureaucratic approach to this would apparently lie in a customer-oriented service structure - services that an exporter may require are procured by the same department or even persons. This assures current and co-ordinated up-to-date information of the DB and quick reactions to the exporter's initiatives or queries. It presupposes, however, well-trained all round analysts and credit managers.



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