Export Credit Guarantees in a Globalised World

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Introduction

On 24 January 2014 Sigmar Gabriel, the Federal Minister for Economic Affairs and Energy, announced that the federal government provided export credit guarantees – also known as Hermes cover – worth 27.9 billion euros in 2013. Small and medium-sized enterprises (SMEs) accounted for around 70 percent of the companies applying for cover under the scheme. Emerging markets such as Turkey (2.47 billion euros) and Russia (2.38 billion euros) were once again the main recipient countries of the exports covered. In total, 79 percent of the volume insured was destined for emerging markets. With a plus of 580.9 million euros, the scheme once again closed with a surplus for the federal budget.

Studies conducted by the Ifo Institute show the positive effects of Hermes cover for policyholder firms in terms of total turnover and employment. During the financial crisis, the positive effects of the guarantees were particularly high, demonstrating that Hermes cover had an important stabilising effect on the German economy.

The Hermes cover scheme has not always been evaluated so positively. Immediately prior to the financial crisis, the importance of Export Credit Agencies (ECAs)[2] had been declining in comparison to the expansion of world trade and global capital flows (Klasen 2011). Indeed, it had even been questioned whether state-related agencies should continue to offer export credit guarantees to protect exporters from the risk of non-payment in the future at all. It had been argued that private export credit insurers would be able to cover almost all types of risks in almost all markets. Moreover, the increasing market for credit default swaps would offer further possibilities for protection. Therefore, a state-supported scheme and thus state intervention in the private market were deemed virtually unnecessary. It was thought that ECAs were facing sharply decreasing market shares; and assumed that nearly all types of risks and markets would soon be covered by private insurers and commercial banks – leaving the ECAs with only extremely risky markets and/or very long credit periods.

This attitude towards ECAs changed substantially, however, with the recent financial crisis. Suddenly, ECAs experienced a renaissance. They became one of the main vehicles for implementing the decision taken by G20 governments to provide 250 billion US dollars in support of trade finance. ECAs expanded their operations in order to help banking systems provide liquidity and restore lending (Auboin 2009). They stepped in to fill the gap left by private export finance markets in supporting international trade flows (Lamy 2010) and thus played a crucial role in keeping export finance viable (Janus 2013). And even after the crisis, the financial instability of a number of EU countries, as well as the Arab Spring with its related political instability, have shown that ECAs still have a role to play.

In order to assure the viability of the instrument, however, constant adjustments are necessary to account for the changes in the export and finance industry. A particular concern that has increasingly been voiced and discussed is whether the Hermes rules on the inclusion of foreign content are still adequate in times of increasingly globalised production and growing international competition. According to the rules for Hermes cover, supported exports should predominantly consist of German content if they are to be eligible for cover. With the exception of the United States, the state-supported schemes of other exporting nations are far more flexible on foreign content. Nevertheless, the economic effect of relaxing the Hermes rules on foreign content remains unclear. Cooperation between academics and practitioners could

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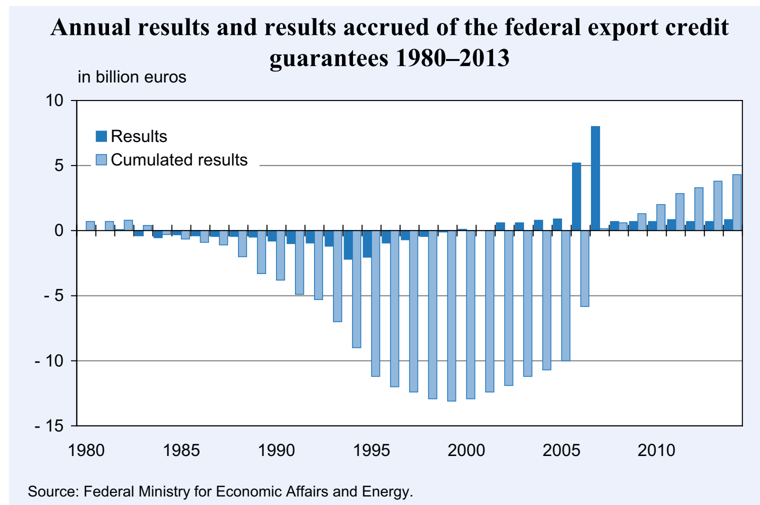
[2] Export credit agency is the common term for all state-supported schemes/institutions established to promote exports.

help to shed more light on the question of whether and how the instrument should best be adjusted in order to remain viable in a world characterised by global value chains.

This article aims to give further insight into the scheme of German export credit guarantees and its development over time – particularly during the financial crisis. Finally, upcoming challenges will be addressed with a specific focus on the question of whether the inclusion of foreign content should be facilitated.

Figure 1

Annual results and results accrued of the federal export credit guarantees 1980–2013



Source: Federal Ministry for Economic Affairs and Energy.

Germany's federal export credit guarantee scheme

The purpose of the federal export credit guarantees scheme is to support the activities of German companies abroad by protecting exporters and banks against the country and buyer risks involved in export transactions. Through this scheme, the federal government assumes the risks of non-payment for political or commercial reasons. The objective is to promote German exports in order to secure employment in Germany. The scheme helps to support companies in accessing difficult markets and maintaining exports in times of unfavourable conditions. Particular emphasis is placed on the support of SMEs, which account for 70 percent of all companies receiving cover. The scheme is available for companies based in Germany exporting predominantly German goods and services, as well as for banks financing such exports. The eligibility for support and the acceptability of the risk related to a specific export transaction are the two main criteria for granting cover. Cover decisions are taken by an Interministerial Committee, a body consisting of the Federal Ministry for Economic Affairs and Energy, the Ministry of Finance, the Federal Foreign Office and the Ministry for Economic Cooperation and Development as deciding parties. Experts of the German export industry and banking sector and representatives of the consortium handling the scheme are advisory members to the Interministerial Committee.

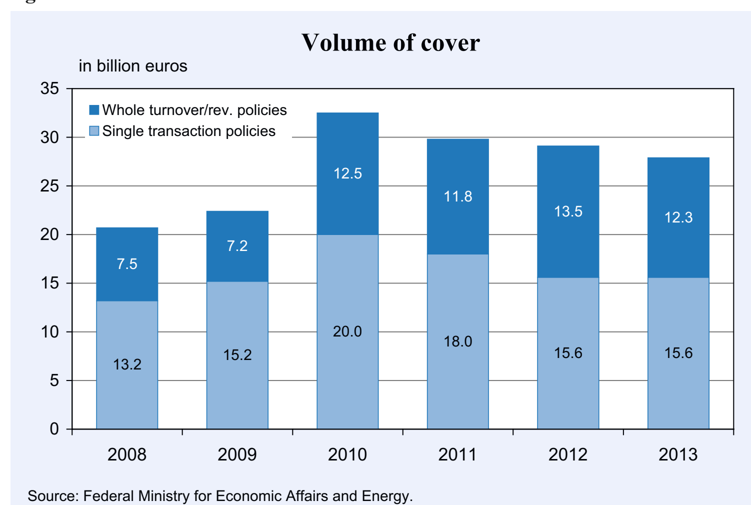
The scheme is conducted as a public private partnership and managed by a consortium of Euler Hermes Aktiengesellschaft and PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft (PwC) on behalf of the federal government. It was established in 1949 based on the Law for the Assumption of Security Instruments and Guarantees. Budgetary responsibility for the scheme lies with the federal government. Currently, cover amounting to a statutory limit of up to 145 billion euros is available. While not every year in the history of the scheme has been profitable, the accumulated results amounting to 3.6 billion euros as of December 2013 show that it has proven self-sustaining in the long run.

Besides the requirement of financial self-sustainability, subsidiarity is another basic principle for the scheme and, indeed, for all ECAs. The objective is to ensure that state-supported export schemes do not interfere with the private market. According to the principle of subsidiarity, ECAs are only allowed to offer cover where the private insurance and financing markets are not available or are dysfunctional. This is particularly true for transactions with risky markets and/or extended credit periods; or for large amounts where ECAs are regarded as insurers of last resort and only step into the breach when private insurers do not offer sufficient cover (Klasen 2011).

In order to ensure fair competition and a level playing field for exporters on an international level, export credit agencies in all OECD countries and selected additional nations[3] cooperate on the basis of the OECD 'Arrangement on Officially Supported Export Credits', commonly known as the 'OECD Consensus', which

[3] The Participants in the Arrangement are currently: Australia, Canada, the European Union, Japan, Korea, New Zealand, Norway, Switzerland and the United States, as well as Brazil for the aircraft sector. Additional countries have chosen to adhere to the principles of the Arrangement without being official participants.

Figure 2



Source: Federal Ministry for Economic Affairs and Energy.

was established in 1978. These ECAs have decided upon a number of agreements regarding various issues such as minimum advance payments and minimum interest rates, maximum credit periods, minimum premium levels and environmental guidelines. The OECD rules ensure that member ECAs do not interfere with functioning markets and maintain WTO-conformity. In the EU, the OECD Arrangement has been transformed into EU regulation and is therefore binding.

Development of business

Demand for export credit guarantees in Germany remains high, albeit at a lower level than when it reached its peak in 2010 (the 2013 figure was 14 percent lower than in 2010).With 27.9 billion euros of newly covered volume, 2013 was nevertheless the fourth strongest year in the history of German export credit guarantees.

As in previous years, the BRIC countries and Turkey were among the top ten countries for which cover was granted, with Turkey and Russia leading the league (India ranked 4th, Brazil 5th, China 6th). Not surprisingly, the BRICs (with the exception of Brazil) also feature among the top ten countries for which mainly short-term cover has been granted. Total outstanding risk currently amounts to 87.7 billion euros.

Hermes cover during the financial crisis

Due to their countercyclical nature, export credit guarantees proved their capability as an effective instrument against market failure (Klasen 2011). With the support of their respective governments and based on their longstanding experience in facilitating international trade, ECAs were able to rapidly expand their operations when needed during and after the financial crisis. There was a significant shift in market composition as a result, with private insurers' share of short-term credit limits declining from 85 percent prior to the crisis to 72 percent in 2010 (Morel 2010). It should, however, be acknowledged that those ECAs fared best that had relevant products (e.g. cover for short-term transactions or direct lending) in place, which only needed to be expanded in volume. Those ECAs, by contrast, that needed to develop new products (mainly those ECAs that used to offer cover for medium- and long-term lending only) faced greater challenges in adjusting to the new market conditions (Bank of International Settlement CGFS Paper 2014).

The German export credit guarantee scheme has traditionally focused on offering pure cover facilities only.[4] In contrast to some other European ECAs, it did, however, continue to offer cover for short-term transactions for all but the EU and OECD core countries. From the outset, the German scheme was thus comparatively well-equipped to expand operations as this became necessary.

At an early stage of the financial crisis, the German government focused on measures to support the financing of export transactions. Based on the so-called *Konjunkturpaket II* (Economic Stimulus Plan), which was adopted in January 2009, a number of concrete, temporary measures were introduced in order to facilitate export financing, including:

- Re-introduction of cover for short-term transactions for all EU and OECD countries based on the respective decision by the European Commission;
- Increase in the percentage of cover for supplier credit guarantees from 85 percent to 95 percent,

[4] ECAs can be classified as those offering insurance only (pure cover) such as the German, Dutch or Spanish ECAs, and those offering both cover and direct lending like the ECAs of Canada or the United States. In some countries like Japan or Korea, two institutions exist: one offering cover and the other one offering lending facilities.

Table 1

Development of business during the financial crisis

	2008	2009	2010	2011	2012
German exports (in billion euros)	984.1	803.3	952.0	1,061.2	1,095.8
Covered volume as % of total exports	2.1	2.8	3.4	2.8	2.6
Number of applications	13,519	28,498	26,212	15,965	16.560
Covered exports for EU countries (in million euros)	795.9	1,991.5	5,583.6	1,873.3	1,448.2

Source: Federal Ministry for Economic Affairs and Energy

while at the same time facilitating the handling of assignment of receivables;

- Securitisation Guarantee for the KfW refinancing programme of 1.5 billion euros annually, enabling banks to take part in the refinancing programme of the KfW banking group to obtain long-term refinancing with congruent maturity for buyer credits covered under a Hermes guarantee from the federal government.

As shown in Figure 2 and Table 1, despite a general decline in German exports during the financial crisis, covered exports increased substantially. The increase in the covered volume as a percentage of total exports from 2.1 percent in 2008 to 3.4 percent in 2010 shows the countercyclical development of Hermes cover particularly clearly. Deeper insight into demand for Hermes cover is gained when looking into the change in the numbers of applications over the years. From 2008 to 2009 the number of applications more than doubled (change of 110.7 percent). While applications for single transactions increased by 11.3 percent, the number of applications for whole turnover[5] cover rose by 129.8 percent. The strong focus on countries where risk was considered to be marketable before the crisis becomes evident when considering the increase in covered exports to EU countries, which more than doubled from 2008 to 2009 and almost tripled in the year thereafter.

To sum up, although the increased provision of Hermes guarantees was not able to prevent the contraction of German exports, such guarantees did fill a substantial gap left by the private market.

New challenges for the scheme – inclusion of foreign content

With the relevance of state export credit guarantees in general – and Hermes cover in particular – firmly re-established, constant adjustments of the instrument to account for changes in the export and finance industry are increasingly important. Of particular concern is the question of how to account for increasingly global value chains. Ongoing internationalisation, the increasing necessity of having a local presence, growing international competition and the pressure on exporters to cut costs, and growing demand by foreign buyers to source locally (which is even required by national law in certain countries) all put pressure on export credit agencies to respond to these changes.

The current regulations on foreign content under Hermes cover were last modified in 2008, when the rules were made more lenient. According to today's system, the inclusion of foreign content for short-term transactions, i.e. transactions with payment terms of up to two years, is relatively ample, as up to 100 percent of foreign content can be included unless capital goods are exported. For the latter, specific reasons have to be given if more than 49 percent of the total contract value is foreign.

For medium and long-term transactions, i.e. transactions with payment terms of two years or more, the German scheme is more restrictive regarding the inclusion of foreign content – in terms of both foreign deliveries from third countries and of local costs incurred in the recipient country. It should, however, be underlined in this context that products with a German Certificate of Origin are considered to be 'purely German' – even if they increasingly tend to contain foreign elements. For all transactions where no overall German Certificate of Origin is available, a three-tier system of permissible foreign content is applicable. Specific rules for the inclusion of local costs apply as determined by the OECD Consensus.

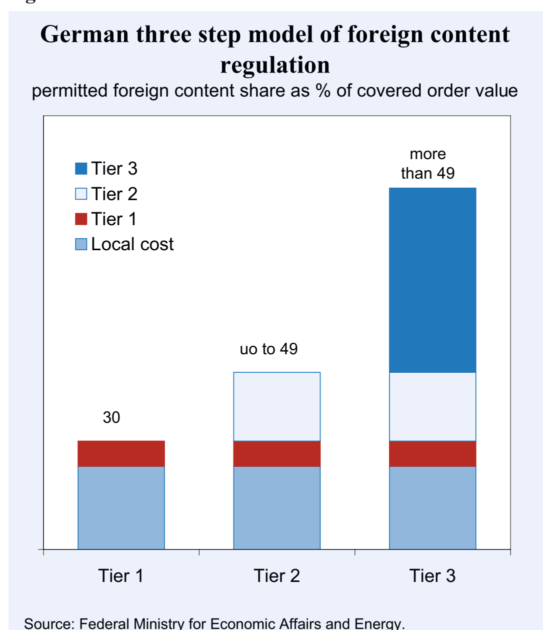
According to the OECD Consensus, a maximum of 30 percent of the export contract value, equivalent to 23 percent of the total contract value of local costs, can be included. According to the German three-tier system, in the first tier up to 30 percent of the total

[5] The whole turnover policy allows insuring short-term receivables from multiple transactions with foreign buyers in various countries.

Figure 3

German three step model of foreign content regulation

permitted foreign content share as % of covered order value



Source: Federal Ministry for Economic Affairs and Energy.

contract value of foreign goods and services (including local costs) can be accepted without any obligation to provide further reasons. The second tier entails rules for transactions for which the total amount of foreign content to be included amounts to up to 49 percent of the total contract value. For example, deliveries from direct subsidiaries of the German exporter classify for this tier. In the third tier, the inclusion of foreign content in excess of 49 percent is possible on a case-by-case basis. In this instance, the exporter must explain in detail why such supplies are crucial.

Compared to other ECAs, the German approach is relatively strict, with only the American US Ex-Im applying stricter rules (a maximum of 15 percent of foreign content for medium/long-term transactions). At the other end of the scale, the Belgian, Swedish and Canadian ECAs, for example, base their decision of granting cover on the respective 'national interest' – without even considering where the goods delivered were manufactured. Several other ECAs have elaborated solutions in between these extremes such as the Swiss SERV (accepting 70 percent of foreign content if the risk of the transaction is acceptable and charging a higher premium), the Finnish Finnvera (accepting a max. of 90 percent of foreign content for transactions with less risky countries) or the French Coface (accepting 50 percent of foreign content in general, but up to 80 percent for SMEs). When comparing these approaches, the very different sizes and diversifications of the respective economies, and thus the number of potential companies to source from, should be kept in mind. Finding the most suitable approach for a specific country is therefore more complex than a 'copy-thy-neighbour' approach.

A closer examination of Hermes-covered transactions shows that between 2007 and 2012 around 25 percent of all covered transactions included foreign content, with the bulk of these transactions containing no more than 30 percent of foreign content. On average, only one percent of transactions p.a. included more than 50 percent of foreign content. One reason for these relatively modest figures is certainly the acceptance of the German Certificate of Origin as proof of national content. The possibility of reinsurance also deserves a mention. In these cases, a higher percentage of foreign content than usual is accepted, provided that the ECA of the country of origin of the foreign goods grants reinsurance. Moreover, the possibility of parallel insurance, i.e. seeking cover from different ECAs for deliveries from various countries, can be applied. In fact, partial rejections of application due to excessive foreign content are extremely seldom. The question nevertheless remains as to what extent self-selection prevents exporters with high foreign content from applying for cover in the first place.

Given that the more flexible inclusion of foreign content has been named as one of the major challenges by experts of the German exporting community, it can be assumed that self-selection is an issue. The reasons for advocating a more flexible approach that have been put forward are diverse and reach far beyond the pure argument of cost advantages. It is certainly true that some companies use internationalisation to cut costs, and that this could endanger less skilled jobs, particularly in Germany. At the same time, this approach may be necessary in order to ensure the respective firms' survival and may lead to the preservation of more skilled jobs in Germany, since these jobs – particularly jobs in areas like research and development, for example, but even in services related to exports – may well not be transferred to low-cost countries. Furthermore, multinational companies in particular have organised their value chains in ways that frequently leave them with no choice but to source particular parts from particular places of production (e.g. Airbus or car manufacturers). Other companies underline that they need to be present in different markets to be close to their customers and to adjust to different markets' needs. In emerging markets in particular, it is no longer sufficient to offer products and services designed for the

industrialised world, while local companies provide better-adjusted offers for local needs at lower prices. Moreover, in some markets local production is actually required by law, leaving companies little choice but to produce – at least partially – in the respective market. In general, there are a number of valid arguments that explain why certain companies are encountering difficulties with the current national content rules. In this context, it should be underlined that most exporters are not asking for a revolution of the German approach on foreign content, but rather for the relaxation of the current three-tier system.

On the other hand, the interests of German subcontractors must not be neglected: relaxed Hermes rules on foreign content may lead to German subcontractors running the risk of losing out to international competitors in the future. This might lead to a negative impact on employment in Germany and could thus harm the political acceptance of any content policy changes.

To sum up, the broader economic consequences of a potential change in the three-tier system remain difficult to evaluate. While a relaxation would certainly be beneficial to globally integrated companies, subcontractors currently benefitting from national content requirements might lose out (although it can also be argued that subcontractors would also lose out if their main contractors become uncompetitive). The net effect of any change of instrument thus remains unclear. Moreover, even assuming that the net effect of a change of policy was positive (which still needs to be demonstrated), the question of how to adjust the instrument in the most appropriate way remains open.

Conclusion

The responsibility for adjusting the German export credit guarantee scheme to account for changes in the export industry clearly lies with policymakers. In order to assume this responsibility, advice and support from both the exporting community and academia are invaluable. Both offer support in identifying relevant trends and changes, making it possible to keep the scheme viable.

As to the particular question of changing the rules for foreign content, the needs of the exporting community, i.e. a relaxation of the rules, are clearly voiced. The net effects of internationalisation in general and a potential adaptation of the scheme in particular nevertheless remain unclear. Academic research – especially studies showing the mechanisms at work – could shed light on these effects and is thus crucial to any decision upon changes.

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