Czech Export Credit Agencies and their Market Power

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Abstract

We describe the export credit agencies in the Czech Republic and the export promotion strategy of the Czech government. The policy part of the paper is focused on the interaction of government owned and supported Czech Export Bank with the Czech commercial banks. We argue that the major market share of Czech Export Bank in export credit market may be explained by a number of factors in addition to the competitive advantage provided by lower profit margins of Czech Export Bank. These factors may be grouped into strategic factors related to competition among commercial banks and into factors based on Czech Export Bank being state owned specialized export bank as opposed to private general banks.

Keywords: international trade, state promotion, export credit agencies, Czech Republic

JEL classification: F14, G21, G28

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1 Introduction

This paper introduces the Czech export credit agencies as an representative example of the approach to state export credit guarantees undertaken in new EU member countries of so called Visegrad Group. This Visegrad Group includes Czech Republic, Hungary, Poland, and Slovakia. While more detail on the international trade and state export credit guarantees in the whole Visegrad Group is provided by Janda, Michalikova and Psenakova (2013), this short paper concentrates only on the Czech Republic.

The institutional arrangements of state export credit guarantees usually use one of the following three models: export insurance company only, Eximbank providing both export insurance and direct credit, and two separate institutions, one providing insurance and one providing direct credit. All these three institutional models are frequently used by many countries as shown by the following overview of the models used in different OECD countries (Nakladal, 2013). The model with insurance company only is used in Denmark, Italy, Netherlands, New Zealand, Portugal, Greece, United Kingdom, Spain, and Switzerland. The Eximbank model is used in Australia, Belgium, Canada, Mexico, Romania, Slovakia, Taiwan, Turkey, and US. Finally the model with separate bank and insurance company is used in three Visegrad countries (Czech Republic, Hungary, Poland) and in Bulgaria, France, Germany, Japan, Luxembourg, Norway, South Korea, and Sweden. This country-listing shows that the post-socialist OECD countries in general prefer models in which the export credit insurance is complemented by a provision of direct export credit.

Export credit agencies (ECAs) over the world differ not only according to the institutional model as presented in the previous paragraph, but also according to their type of ownership (public, private, ...), legal form or according to their connection to government budget. According to connection to government budget we may distinguish between ECAs closely connected to the government budget with a low independence in their decisions and risk management and ECAs more loosely connected to government budget, which are obviously more independent in their operations. Czech ECAs – Czech Export Bank (CEB) and export insurance company (EGAP) – are highly independent ECAs.

The independence of Czech ECAs is highlighted by the Czech legislation which explicitly provides for separation of government insurance company EGAP from commercial export insurance and for opportunity for all Czech commercial banks to provide export credit insured by EGAP. That is, the Czech legislation is quite clear in emphasizing that CEB does not have any monopoly on using government supported export credit insurance provided by EGAP.

As shown in the previous discussion of three most usual institutional models of export credit support, all models always include an export insurance company. This shows that institution like EGAP is clearly distinguished from commercial insurance companies. However that fact that many countries do not provide direct export credit through Eximbank or through separate export bank indicates that the CEB may not be such a necessary component of the government export credit policy and that some of the export credit provided directly through CEB could have been provided through Czech commercial banks. Therefore this paper, after presenting the necessary description of the Czech export credit system, focuses on providing and discussing a list of possible explanations of the reasons why the CEB keeps its key position in provision of EGAP insured credit and why the commercial banks were not able to secure bigger part of this potentially important and profitable market.

2 International Trade Development in the Czech Republic

This section is based on material already contained in the bachelor thesis prepared by Lucia Psenakova under the supervision of the author of this paper at the Institute of Economic Studies at Charles University in Prague. Some of the material accumulated for preparation of that thesis is used in other sections of this paper too.

The Czech Republic is the most Western-oriented among the four Visegrad countries, having a favourable geographical position located in the heart of the European Union surrounded exclusively by other European Union members. The proximity of developed economies has also been an important factor of its relatively above averaged economic development. Nowadays it is often characterized as one of the most successful cases of transition economies. Despite a cost related to the break up of Czechoslovakia in 1992-1993, the Czech government was fastly able to implement some perspective market-oriented reforms during the early post-communist period after the Velvet Revolution in November 1989. Extensive economic reforms, such as mass privatization and liberalization of the international trade, were the top priority for the Czech government in early 1990s even at the cost of a short run performance.

Czechoslovakia was one of the less reformed Central and Eastern European (CEE) countries and much less of a market economy in comparison with Poland and Hungary. It had the highest share of public sector (97% of net national product). The economy was concentrated within monopolistic firms and it was the most dependant economy on a trade with other Soviet countries. A complicated system of bilateral trade agreements based on the non-convertible currency was introduced within the COMECON. Contrary to other Central and Eastern European countries which faced hyperinflation already in 1980s, Czechoslovakia had to face a rather moderate inflation during early years of its transition process and Czechoslovak budget deficit and unemployement were also relatively low.

After the end of centrally planned history of the Czechoslovakia and the creation of the Czech Republic, it increased its export to EU in years 1993-1999 from US$8 billion to US$18.4 billion. That implies an annual average growth rate of 16.3%, while Czech exports to the rest of the world continued to grow by a normal rate of 4% annually. Trade liberalisation created enormous opportunities for Czech exporters. This suprisingly fast development of external trade in 1990s is a crutial moment of Czech economic transition. Czech import and export both increased by almost 500% in total during last two decades.

At the beginning of the transition period the Czech international trade was plagued by its imbalances. Balance of payments surplus was reported in 1991, however, there has already been a balance deficit one year later. It was caused by expected instability linked to a political situation and a tax reform introducing VAT taxation. A share of imports increased as a form of pre-supplying. The first year of the Czech Republic was considered to be quite successful with export surplus. A sharply increased demand of Czech consumers could not be satisfied exclusively by Czech manufacturers in the following years and thus it needed to be covered by import. Czech export and import achieved growing year-on-year performance each time with an exception of 2002 and with the highest annual difference in 2004 for export and 1995 for import. However, Czech balance deficit has been reported each year during last 2 decades.

Territorially, Czech export shifted from former COMECON countries into mostly 15 European Union countries. European Union export formed at least 80% of Czech export and minimally 70% of Czech import ever since 1993. Thus developed countries, especially Germany, have created the widest group for both Czech export and import, followed by European transition and developing countries. China has been an important import partner with gradually increasing performance. Overally, the most important trading partners for the Czech Republic after 2004 were Germany, Slovakia, Poland and France. The European Union states accounted for more than 85% and other developed states outside of the European Union for more than 9% of export.

Czech export has been historically composited mostly of goods for processing. Export of machinery and means of transportation increased throughout last two decades and they formed 43% of overall export in 1999. Their quantity increased by 1000% during this period. Other imporant group of export goods are chemicals and consumer goods such as textile and furniture, scientific devices and other industrial goods. In the first decade of the 21st century, machines and other transport equipment formed the biggest group of exporting products (50%), followed by manufacturing products (around 20%). Those two groups formed the biggest share of import goods too.

3 Czech Export Strategy

The export credit support in the Czech Republic is conducted according to the Export Strategy of the Czech Republic 2012-2020 which was adopted by the Czech government in

March 2012. It is a document describing visions and activities of the state for promoting and developing Czech export. It follows the Czech Export Strategy 2006-2010 and its extended update for the year 2011. Its primary vision is to promote the Czech Republic among the 20 most competitive countries by 2020.

The Strategy identifies some of the major obstacles of Czech export. These are a high orientation on European Union markets, an insufficient following of trends on world markets, an insufficient utilization of European Union funds and projects for Czech exporters and a separation of a role of export agencies financed by the state. More detailed description of the development of Czech international trade since the late eighties up to the time of creation of Czech Export Strategy 2012-2020 is provided by Janda, Michalikova and Skuhrovec (2013) and by Janda, Michalikova and Psenakova (2013).

The Czech Export Strategy is divided into three pillars. They are: Export Information (to build a so-called Export Intelligence providing easier access to information resources and databases, internalization), Export Development (export education, consulting and financing), and Development of Business Opportunities (building a network of exporters and their partners, marketing and lobbying activities, business policies). Major targets that the Czech Export Strategy wants to achieve by 2020 are

- to increase a number of Czech exporters by 15%, the overall export by 25% per capita and SME exporters by 50%,
- to diversify export, especially into the countries outside of the European Union,
- to shift Czech exports into economic sectors with higher added value, more innovation in export production and manufacture.

In this Strategy, two groups of countries were explicitly recognized, according to their ability to grow and to absorb foreign export as well as their compatibility with Czech exporters. The most import group are so called priority countries: Brazil, China, India, Iraq, Kazakhstan, Mexico, Russia, Serbia, Turkey, Ukraine, USA and Vietnam. The second in the order of importance are so called countries of interest: Angola, Argentina, Australia, Azerbaijan, Belarus, Egypt, Ethiopia, Chile, Ghana, Croatia, Israel, Japan, the Republic of South Africa, Canada, Colombia, Morocco, Moldova, Nigeria, Norway, Peru, Senegal, Singapore, United Arab Emirates, Switzerland and Thailand. Therefore the activities of Czech export-promoting institutions described in the next section are primarily focused on the priority countries, with somehow lower level of exposure on so called countries of interest.

4 Czech Export-Promoting Institutions

The Czech Export Strategy is supported by specialized export-promoting institutions. There are three main export-promoting organizations in the Czech Republic. The first is Czech Export Bank (CEB), which specialized in export financing especially to less developed and risky countries. The second is Export Guarantee and Insurance Corporation (EGAP), which provides insurance against political and non-marketable commercial risk. The last is the CzechTrade, which provides export information and consulting services. We will take a closer look at those organizations in the following subsections.

4.1 Czech Export Bank

Czech Export Bank (CEB) was established in July 1995 as an important part of a government export-promoting programme. CEB is fully owned by Czech government, either directly or indirectly through EGAP. Czech government directly owns 80% of shares of CEB. The votes corresponding to these 80% of shares are divided among 4 relevant ministries of Czech government, where the Ministry of Finance has the main decisive power with 52 votes out of 100. Ministry of Industry and Trade has 30 votes, Ministry of Foreign Affairs has 12 votes and Ministry of Agriculture has 6 votes. The remaining 20% of CEB shares are indirectly owned by the Czech government through EGAP. Since the CEB is fully owned by the Czech government, it does not belong to any bank group. This distinguishes it from all major Czech banks which are always owned by some international bank group. A registered value of capital of CEB at the time of incorporation was CZK 1.5 billion (EUR 59 million) and it was later increased up to CZK 4 billion (EUR 158 million).

CEB was created to offer complementary products to Czech commercial banking products. Thus CEB should specialize on exporters that are not able to find necessary financing among Czech commercial banks. That means export financing with a state guarantee to countries to which Czech commercial banks do not prefer investing because of their higher riskiness. CEB's goal is to increase competitiveness of Czech exporters abroad so exporters would be operating in the same or similar conditions as their foreign counterparts. (OECD 2011, CEB 2013)

CEB clients mostly use export buyer credit and export supplier credit. They deal especially with long-term credits with a maturity period longer than five years. Both in 2011 and 2012 slightly more than 95% of the loan principal portfolio of CEB was with repayment term over five years. The Czech Republic export is oriented towards countries with some close geographical or political relations with the Czech Republic, primarily the European Union countries. Those countries are evaluated as less risky according to quarterly classification published by the Organization of Economic Cooperation and Development (OECD). However, most of new CEB contracts are located in higher risk countries with a classification of 3 or more, where OECD country risk classification range between 0 (no risk) and 7 (very risky). The risk structure of new commitments of CEB in 2012 according to this OECD country risk classification involves 14% in class 0, nothing in classes 1 and 2, 36% in class 3 and 50% in classes 4 and higher.

4.2 Export Guarantee and Insurance Corporation

Export Guarantee and Insurance Corporation (EGAP) insures in particular bank loans due in over 2 years, intended to finance export of energy, machinery and technological systems, investment projects, transport constructions and investments, usually to countries where political, economic and legal environment increases the risk of default. EGAP services complement the range of commercial credit insurance products and fill the gap on the market. Therefore EGAP and acts as a standard export credit insurance company in the role of a government instrument to promote exports. The EGAP corporation is by its rules obliged to provide insurance services to all exporters of Czech goods, services and investments, irrespective of their size, legal form and volume of insured exports.

The Export Guarantee and Insurance Corporation (EGAP) was established already in June 1992. Like CEB, it is also wholly owned by Czech government and its capital has a value of CZK 1.3 billion (EUR 51 million). Similarly to CEB, Ministry of Finance has the biggest share of votes (520 votes), with the rest of votes distributed among Ministry of Industry and Trade (468 votes) and Ministries of Foreign Affairs and Agriculture (each of them has 156 votes). EGAP owns 20% of CEB shares and 34% of KUPEG. KUPEG is the biggest domestic risk insurance company and it was created out of EGAP by separating commercial insurance away from government supported core insurance business. KUPEG insures various kinds of commercial risks usually for a short-term period.

EGAP is a typical ECA and so according to its rules, EGAP provides state promotion only for products and territories where no commercial market insurance is applicable. That implies that EGAP insures mid-term and long-term credits in riskier territories. The most common EGAP insured credit is the export buyer credit with a maturity period of 2 years or longer, according to OECD Arrangement. EGAP cooperates with almost all Czech commercial banks, however, CEB is its main partner. They also work with foreign banks financing Czech exports. (EGAP, 2013)

One of the fundamental principles stipulated in the OECD Consensus, which EGAP and other insurance companies providing insurance of export credit risks must adhere to, is the principle of self-financing of their activities, meant and measured in the long term. This means that the Czech Republic should not subsidize operation of the EGAP insurance company on a long-term basis, since it would become an illegal support. From the very beginning of its existence, i.e. since 1992, EGAP fully covers all its operating expenses, including payments of claims to clients, from revenues of its own activities. EGAP functions as a self-sufficient, yet targeted and de-facto non-profit tool of state support for exports in the long term. Obviously, similarly to other ECAs all over the world, the Czech government remains with its backing in the case that because of some large scale defaults etc. EGAP would not be able to satisfy the insurance claims out of its own budget and reserves.

4.3 CzechTrade

The Czech Trade Promotion Agency or the CzechTrade was founded by the Czech Ministry of Industry and Trade in May 1997. Its objective is to encourage Czech export by improving its competitiveness on foreign markets. The CzechTrade has a network of eight managers operating in different regions in the Czech Republic other than in Prague. They closely cooperate with the Czech Chamber of Commerce, EGAP and CEB. There are 33 permanent establishments of CzechTrade abroad on four different continents. The CzechTrade supports export especially on markets outside the European Union (CzechTrade, 2013).

The CzechTrade provides various services for potential exporters such as consulting, information, export assistance and export education. They organize lectures and seminars, publish export manuals and other publications, provide contact information of potential clients, market researches, marketing on foreign markets etc.

5 Market Power of Czech Export Bank

As we have already shown in the previous sections, the Czech system of the government support of export credit in based on the model of two separate independent ECAs (Czech Export Bank and the insurance company EGAP). While EGAP was established already in 1992, CEB was established only in 1995. Given the transition situation in the Czech trade and in the Czech banking sector in the middle of nineties, the establishment of CEB was a logical and fully justified decision of the Czech government. At that time the majority of the Czech commercial banks focused on different goals than the development of a dedicated department of export financing. Also the on-going transformation of essentially all major

Czech exporters meant that their credit and performance risk was quite high and they were not sufficiently attractive for many Czech commercial banks.

Together with privatization of Czech banks during late nineties and their gradual acquisition by well-established international banks the quality of these Czech banks improved. Their internal processes, their rating and the portfolio of their services offered to their consumers also improved and widened. The dedicated departments of export financing for a majority of Czech banks were established only during advanced stages of economic transformation. However currently a number of Czech commercial banks already has a significant experience with export financing. Also the rating of these banks is comparable with the rating of the Czech Republic. This means that we should expect a significant increase of the share of Czech commercial banks on the export financing market. This is supported by comparison of high 54% share of CEB on outstanding commitments of EGAP as of 31 December 2012 with lower (31%) share on newly EGAP insured export credit provided during the year 2012 (EGAP, 2013).

The dominance of Czech Export Bank in the export financing insured by EGAP is in a contrast to stated policy goals to support competitive environment in Czech export financing and to provide the EGAP export insurance to all Czech banks, not only to CEB. In the following paragraphs we will provide a number of possible explanations of the dominant position of Czech Export Bank on the Czech export finance market.

The most obvious advantage of CEB is a possibility to provide long term credit with fixed interest rates. CEB is essentially the only Czech bank using fixed Commercial Interest Reference Rate (CIRR). Czech commercial banks provide almost all their long term loans under the variable rates derived from LIBOR or EURIBOR. This is because the costs of fixation of long term interest rates of loans provided in foreign currency are relatively high for the bank and therefore the resulting interest rate would be too high to be competitive. In the case the Czech commercial banks want to use the interest rate support provided by the Czech government they have to ask the administrator of this interest rate support (which is CEB) for refinance credit. To arrange this refinance credit would require significant administrative and time effort on the side of the commercial bank.

Since the CEB is owned by the government, there may be missing strong incentive of private owners/market on achieving high profitability. Therefore this lower pressure on profit may lead to lower profit margins at the CEB credit contracts than it is for private contracts. This means that CEB may be offering lower interest rate/ better conditions for debtor than commercial banks.

While the CEB as a government owned institution may be less profit oriented, its management is quite likely to be interested in maximization of its size as measured by the volume of credit provided. In connection with lower risk aversion of CEB this may lead CEB management to rejection of many possible syndicated credit contracts in favor to credit provided fully by CEB. This leads to much higher share of CEB on export credit markets as compared to the situation when the CEB would invite commercial banks to participate at syndicated credit or other joint credit arrangements.

However there is also a number of other factors supporting the dominant position of CEB. One of them is insufficient legislation. OECD Consensus provides only general statements about complementary role of ECAs on the export finance market, which is similar to treatment of export credit insurance. However as opposed to export credit insurance, the export credit provision is not covered by EU legislation in sufficient detail. The absence of specific rules and laws promoting export finance competition provides for significant advantage of CEB as compared to commercial banks.

Another factor supporting the strong position of CEB in Czech export financing is the lobbing from the big exporters. The profit maximizing commercial bank may easily justify the rejection of export credit if the risk is too high relative to expected return. However it is not so simple for CEB. Since its mission is the support of the Czech export, it is more vulnerable to lobbing of big exporters. These big exporters lobby the major shareholders of CEB (Ministry of Finance and Ministry of Industry and Trade) for the support for more risky credit. As long as the exporter is afraid that the commercial bank could reject his project as too risky, he prefers to go directly to CEB. This notion of risk is relevant not only for risky territories, but also to the project financing (financing through special purpose vehicle) connected with significant commercial risks.

CEB has a lower aversion to risk than commercial banks. The shareholders of CEB do not require long-run profitability of CEB and short-run losses are considered to be natural. CEB is therefore more willing to provide risky loans than the commercial banks.

Another reason of high involvement of CEB in some risky countries is its ability to finance large projects in the order of magnitude in EUR hundreds millions without a need to cooperate with other banks. Majority of commercial banks on the Czech market would not be willing to extend such large loans and they would search for partners to share these loans with them.

CEB is also not restricted by internal limit of territorial credit exposure as it is for commercial banks. As of June 30, 2013, the total value of CEB‘s product portfolio (EUR 2.9 billion) was distributed in a following way: Russian Federation 42%, Turkey 17%, Slovakia 15%, Azerbaijan 8%, Georgia 7%, Ukraine 3%, Bulgaria 3%. The total share of all other 18 countries covered in CEB‘s portfolio is 5% and none of these countries has individual share of 3 or more percent in the total CEB‘s product portfolio (Bakajsa, 2013). As we could see, almost half of CEB‘s portfolio is in Russian Federation and CEB does not apply conservative portfolio risk management. This difference from portfolio management of commercial banks is clearly understandable and appropriate given the goals and mission of the CEB. In addition to territorial limits the commercial banks may be limited by industry exposure limits and by the limits of exposure with respect to Czech government. For example as long as the internal limit of exposure to Czech government of commercial bank is binding, the increase of the volume of credit insured by the Czech government agency EGAP has to be compensated by for example selling off some Czech government bonds.

Sometime CEB may profit from the strategic competitive considerations on the side of commercial banks. Many commercial banks use a number of internal restrictions in their operations which do not apply for CEB. Some commercial banks do not provide credit for some industries (for example nuclear energy or weapons). Some commercial banks do not want to finance some risky debtor even with credit insurance provided by EGAP. Sometime particular commercial banks follow certain blacklist of countries or individual borrowers in more strict way than the Czech Republic and CEB. Because of such internal restrictions, it may happen that the bank staff may have to reject potential borrower and advice him to ask CEB for loan instead of advising him to go to another commercial bank. The reason is that CEB provides only export financing, therefore particular commercial bank which is not able to provide the export financing may loose only this particular export contract while keeping this client for the general banking purposes. In the case this client would be directed towards some other commercial bank, there is a danger that this client could switch some or all his banking operations to that commercial bank.

Similar strategic reasons may lead to increase of CEB portfolio in the case that a banking group exposure limits are binding in a particular case. Since the Czech commercial banks are almost always members of some bigger international bank group, it occasionally happens that a provision of a large credit by a Czech bank would violate group-wide exposure limit with respect to some country or subject. In such a case Czech bank staff may be again likely to direct rejected debt applicant to CEB instead to any other commercial bank.

The simplicity and speed of loan approval is another factor supporting the advantage of CEB. Essentially all Czech banks are foreign owned and each large loan, usually over the credit limit in the order of magnitude EUR tens of millions, has to be approved by appropriate body of the particular bank located outside of the Czech Republic. Together with the previously mentioned pooling of credit risk among several lenders this implies clear advantage of CEB loan from the point of view of borrower. The speed and convenience of dealing with a single financing institution based in the Czech Republic is an important competitive advantage of CEB.

The role of CEB as an experienced incumbent on the Czech export credit market is another important advantage. The arrangements of large credit transactions in many cases take more than a year to finalize and personal contacts and long term experience from a good working cooperation among lender and borrower are very important. The experience of the CEB staff members with the relevant markets in many countries is also an important asset both for exporter and the export insurer (EGAP).

The incumbent advantage of CEB is also relevant in the case of some financial covenants to existing credit contracts. These covenants do not allow the debtor significantly increase its indebtedness without prior approval by the bank providing the previous credit to which these covenants were related. Therefore as long as some party in the contemplated export credit contract is already related to CEB through some of these covenants, it is quite likely that this new contract will be financed through CEB rather than through any other bank.

While the debtors in many developed market economies do not really care whether they are dealing with private or government sponsored bank, many clients from developing countries have a clear preference for dealing with government owned bank. In the case that debtor is some government agency, any part of government or any public institution, they often appreciate that CEB is an official export bank of the Czech Republic. In some cases the debtors explicitly require the involvement of government institution, like the CEB, in the investment process.

Sometime a misperception of the role of CEB provides CEB with a competitive advantage. Some small exporters may think that CEB is much better suited to export credit financing than commercial banks. They expect that CEB for sure provides better and cheaper services than any commercial bank. In some cases customers do not distinguish among the services of CEB, EGAP and subsidy programs of other Czech public institutions.

6 Conclusions

The analysis of this paper was very much focused only on brief institutional description of Czech export credit support and on several selected policy issues addressed in the terms of the Czech Republic institutional setup. However the export credit policy lessons treated in this paper are much more general and relevant to other post-socialist new EU member countries and essentially to any country in which the export credit support has a similar institutional setup as it is in the Czech case. Since the focus of this paper was on the Czech export credit support, we do not deal with general discussion of the economics of credit guarantees and trade finance. An up to date review of these topics is provided by

Felbermayr and Yalcin (2013) and by Auboin and Engemann (2014).

We discussed in detail the possible explanations for strong position of Czech Export Bank (CEB) in direct financing of Czech exports as compared to the much weaker position of Czech commercial banks. We have shown that the advantage of CEB is based not only on low profit margin argument, but also on a number of more complex reasons. Major strategic advantage of the CEB is its specialization on export finance, which allows the commercial bank not to view CEB as a competitor in their general banking business. Another important advantage of CEB is its clearly defined role as Czech government owned export bank with a goal of supporting Czech export as opposed to profit maximization goal of other Czech banks, which are almost always part of some bigger international banking group.

As long as the European legislation will not impose regulation restricting the role of government export bank in a similar way as the role of government export insurance companies is regulated, it is very likely that CEB and export banks in other EU countries will keep significant share of direct export financing despite the potential ability of commercial banks to engage more in this market segment.

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