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Balance of Payments: The Problem Can Export Credits Help Solve It?

For several years, the United States has been faced with large balance of payments deficits. These deficits occurred because we have been buying from foreigners and lending and giving them more than they have bought from us or lent or given us. One consequence of these deficits is that we have had to settle them partially with gold; and this has caused us to lose about $6½ billion of gold in the last five years.

Naturally, Americans are worried about the situation. On taking office, President Kennedy announced that one of his primary goals was the elimination of the balance of payments deficit; and one of the most effective ways he saw of achieving this objective was the stimulation of our civilian exports. There were other steps that could be taken, to be sure. Our allies have been persuaded to buy more of their military equipment from us. Costs of maintaining our troops abroad have been cut. The Secretary of the Treasury has urged European governments to relax their controls over their capital markets, so that foreign businesses can borrow at home rather than in New York. Nevertheless, an increase in exports has high priority in the campaign to eliminate the balance of payments deficit.

Various measures are being employed on this particular front. Current efforts to hold down price and cost increases are part of the attempt to improve our balance of trade. The revision of the guidelines for depreciation of business capital assets, i.e., plants, machinery, etc., is expected to encourage modernization of this equipment, thus lowering costs and enabling our manufacturers to compete more effectively abroad. The Commerce Department has streamlined its organization in order to provide quicker and more effective information to American businessmen about export opportunities.

Many foreign governments have provided special help to their exporters for years. One such aid was the provision of export credit insurance. A business firm selling abroad naturally runs somewhat greater risks than when it sells at home. The credit risk is greater because credit information is frequently not so reliable or readily available and because the exporter is at some disadvantage in pressing his claim in a foreign court if the foreign buyer defaults. In addition, he runs a risk that the foreign government will prevent its citizens from paying their bills through the imposition of exchange controls or through expropriation of their property or will devalue the currency. To relieve their exporters of these burdens, some foreign governments guarantee them (for a fee) against losses from these causes.

Export Credits in the United States

In the United States, the Export-Import Bank (frequently called Eximbank) has for some time offered guarantees on letters of credit issued by banks and on some loans by American banks to foreigners. It has

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also assisted American exporters by making loans to foreigners for the completion of projects that require the purchase of American equipment and supplies. In 1961, Eximbank initiated three new programs designed to put American exporters on a par with their foreign competitors, insofar as credit insurance is concerned. The first of these is a program of political and credit risk guarantees to banks that is administered by Eximbank. The other two provide insurance for exporters, rather than for banks, and are administered by the Foreign Credit Insurance Association, which is a group of seventy-two insurance companies plus the Export-Import Bank.

Eximbank Credit Guarantees This program is designed for medium-term transactions, i.e., those in which credit is extended to the foreign buyer for a period of between six months and five years. For the transaction to be accepted by Eximbank, the foreign buyer must pay 20 percent of the purchase price in cash, although, if the buyer and the country are both considered to be good risks, the down payment may be reduced to ten percent. The exporter will take the promissory notes of the foreign buyer for the rest of the amount and will carry 15 percent of each note for his own account and risk. The exporter's bank must be willing to accept the credit risk on the earlier maturities of the remaining 85 percent of each note (the time period covered by the first half of the instalments or the first eighteen months, whichever is shorter). Eximbank will then guarantee the bank against loss due to political events for the early maturities and against both credit and political risks for the later ones. The bank must finance without recourse, however. This is to say, it must agree that, if the foreign buyer defaults, the bank cannot demand payment from the exporter. This holds true both on the earlier maturities, where the bank has no Eximbank credit guarantee, and on the later ones, where it does.

To illustrate, suppose that an exporter sells some farm machinery to a company in Venezuela, providing for semi-annual instalment payments (the instalments must be semi-annual or more frequent to qualify) over a period of three years. If the contract price (including interest on the financed portion, insurance, freight costs, and so forth) comes to $60,000, the buyer will pay $12,000 in cash and will give the exporter six notes of $8,000 each. The exporter's bank will immediately pay the exporter 85 percent of the $48,000, or $40,800. Upon receipt of each of the buyer's instalments, the bank will pay the exporter $1,200, so that over the six instalments the exporter will get back his $7,200 or, in other words, his 15-percent stake in the transaction. The bank takes the credit risks on the first three instalments, but after that it is fully guaranteed by Eximbank. The 15-percent stipulation is included to assure the continuing interest of the exporter in the transaction until final payment is received.

Foreign Credit Insurance Eximbank was given the power in 1954 to provide insurance directly to exporters on commodities held abroad on consignment awaiting sale. In 1960, Eximbank provided political risk insurance on export sales, and in February 1961 the President directed Eximbank to provide comprehensive export credit insurance covering commercial as well as political risks. During 1961 Eximbank worked out a program with private insurance companies to form the Foreign Credit Insurance Association (FCIA), which began business in February 1962. FCIA now provides two types of insurance for exporters, short term and medium term.

(a) Short-term transactions are those that provide for payment by the foreign buyer within a period usually no longer than 180 days. An exporter may insure his sales to any reputable foreign buyer up to a limit of $15,000 per buyer if he meets certain conditions. In the first place, he must insure all his foreign credit sales and report monthly on them (except in the case of sales to Canada and sales in which the buyer provides security for payment). The reason for this requirement is that FCIA must be able to spread its risks over a large number of transactions. If it were not for this provision, an exporter would be free to insure (and pay premiums on) only his riskier sales. Second, the exporter must maintain at least two credit reports on his customer. Third, the goods sold abroad must be sold for dollars and must be "made in the United States"—meaning specifically that at least 50 percent of the product's value must have been added by U. S. labor or materials.

If the exporter meets these conditions, he is insured against 95 percent of loss due to political risk and 85 percent of loss from credit risk. Eximbank assumes all of the political risk, and it and the insurance companies split the credit risk equally. Policies are written for one year and may be renewed. The amount of premium the exporter must pay depends upon the riskiness of the countries in which his buyers are located and the length of the credit terms he offers. Countries are rated, and the premium rises as the rating declines. Likewise, the longer the terms of credit, the greater the risk of loss and, so, the higher the premium. On "average risk" countries, the premium is currently averaging about one percent.

(b) Medium-term transactions are those in which the exporter extends credit to his foreign buyer for periods between six months and five years. Unlike the short-term plan, the exporter does not have to insure all his medium-term sales, although he may do so if he likes. In other words, the exporter may insure an individual transaction, a series of sales to one buyer, or all of his export sales. The last category (called the "whole turnover") costs the least because the spread of risk is greatest. The conditions are mostly the same as for an Eximbank guarantee to a bank, i. e., the buyer must put up 20 percent of the purchase price, the debt must be paid off in instalments no less frequent than every six months, the notes must be payable in dollars at a U. S. commercial bank, and the exporter retains 15 percent of the credit and political risks, spread over all of the notes. Again, premiums vary with the country concerned and with the term of credit. Like the short-term plan, Eximbank assumes the political risk, and the insurance companies split the credit risk equally with Eximbank.

The proceeds of both short- and medium-term insurance can be assigned. This should make it easier for exporters to get bank financing, for they can assign the proceeds of the insurance to the bank that takes the foreign

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buyer's notes. Unlike the Eximbank guarantees, the bank does not have to finance the exporter without recourse, although, naturally, the exporter would prefer nonrecourse financing.

Export Credits and the Sixth Federal Reserve District

In the November 1962 issue of this *Review,* we examined some of the actual practices of District banks in financing foreign trade. This study led to the conclusions that District banks were rather less inclined to commit their own funds in this business than were their New York counterparts and that export financing was less important than import. The explanation for these observations is relatively simple. The District for many years was primarily agricultural, and its exports were predominantly agricultural staples, such as cotton and tobacco, and the products of forests and mines, such as naval stores, lumber, and phosphate. These commodities were (and still are) frequently exported by national concerns, headquartered perhaps in New York, that buy from local producers and consolidate their purchases into entire shiploads. It was often more convenient for them to finance their operations in New York or London. Consequently, few District banks acquired a tradition of dealing in foreign trade or a great deal of experience in it. In manufacturing, which is growing in importance, the same tendency is at work. Local plants are often divisions or subsidiaries of national concerns. Export shipments are frequently handled by the head office or a special international subsidiary located, usually, in New York. Then, too, the really big shipments may require financing that is beyond the capacity of any but the large New York banks.

In other words, District banks finance a relatively small proportion of District exports, and bank management has traditionally preferred to commit its funds in domestic loans, where the risks are more clearly understood and the costs are lower.

District banks apparently are interested in increasing their share of export financing, however, and believe that the new programs may help in this direction. For example, the banks interviewed in our recent survey indicated that in 1961 about 60 percent of the exports financed by them were staple commodities, such as phosphate, lumber, grain, naval stores, cotton, and tobacco, and that 25 percent were consumer goods, such as citrus products, seafood, poultry, household appliances, and so on. Thus capital goods, such as industrial and business machinery, constituted only 15 percent of the exports they financed. The largest growth in exports, however, is likely to come in the last category, as manufacturing grows in this area. Then, too, the medium-term guarantee and insurance programs are specifically aimed at these types of manufactures, which are relatively expensive and yield their returns only over a considerable period of time. Several banks pointed out, however, that there are still comparatively few manufacturers of these types of goods in this area and cautioned against accepting the new programs as miracle workers.

The Future of Export Credits

The guarantee and insurance programs are still quite new, and bankers and exporters are still feeling their way in their use. Only time and experience will resolve some of the questions that now exist in people's minds about them. For example, the new programs obviously cannot eliminate all risk. Banks, it will be remembered, are required to accept the credit risk on the early maturities under the Eximbank guarantee program, and they must give up their right of recourse against the exporter in case of default by the foreign buyer. Several of the bankers interviewed in our survey were apparently not willing to accept even this degree of risk; and several indicated that they were retaining the right of recourse even when the exporter assigned FCIA insurance to them. Underlying this attitude may be uncertainty about interpretation of some of the fine print in the guarantee and insurance contracts. For instance, the FCIA policy specifies under "Exclusions" that the policy does not apply (among other things) to any loss (a) due to the fault of the insured exporter; (b) where a dispute exists, until the loss shall have been finally determined to be a valid and legally enforceable indebtedness of the buyer; and (c) arising from unwillingness of the buyer to accept the products.

Representatives of FCIA point out that it is possible for a bank to retain its right of recourse in the case of failure of the exporter to conform to terms of the insurance contract, but not otherwise. At least one District bank is prepared to finance insured medium-term exports if the exporter will execute an agreement to (a) meet all the requirements of the insurance contract and (b) reimburse the bank if FCIA, because of the exporter's failure to meet the requirements, does not pay the insurance benefits within seven months. The bank is thus fully protected, having recourse against either FCIA or the exporter. It must depend on FCIA for reimbursement so long as the exporter meets all his obligations and cannot look always to the exporter if any delay in payment occurs, as it could if it had retained full right of recourse against the exporter.

FCIA also argues that to eliminate the requirement that the buyer accept the goods would open the door to fraud by unscrupulous businessmen. In any case, they say, the bank can protect itself by not making a loan to the exporter until it has the promissory note of the foreign buyer. This note would presumably be delivered to the foreign bank that acts as the exporter's agent at the time the documents covering the shipment are delivered to the foreign buyer. Further protection can be provided by insisting that the exporter write into his sales contract a provision that delivery of goods in accordance with the terms of the contract constitutes acceptance of the goods.

As knowledge of the guarantee and insurance programs becomes more widespread, banks and exporters will come to understand more clearly their possibilities and their limitations. Certainly, whatever their limitations, they reduce to some extent the risks of foreign trade. They should not be expected to provide by themselves the solution to our balance of payments problem. They should, however, contribute measurably toward this goal.

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