Asia Pacific Research and Training Network on Trade

ARTNeT

UNITED NATIONS ESCAP

Economic and Social Commission for Asia and the Pacific

Alerts on Emerging Policy Challenges

www.artnetontrade.org, E-mail: artnetontrade@un.org Issue No. 3, April 2009

TRADE FINANCE IN TIMES OF CRISIS AND BEYOND

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Introduction

The current financial crisis has provided a useful reminder of how essential trade finance is to international trade. The capacity to trade is significantly affected by both the availability and cost of financing, as well as the availability of instruments to mitigate the risks associated with international trade transactions.[1]

Preliminary econometric results using the online ARTNeT Interactive Gravity Modeling Database suggest that a 10 per cent decline in the amount of trade finance may lead to a drop of up to 3.6 per cent of total merchandise trade in developing Asia, a staggering US$129 billion.[2] The availability of trade finance has therefore become a major concern of the trading community (Thomas, 2009).

This note briefly reviews some of the information available on the current trade finance situation, with a particular focus on emerging countries in the Asia-Pacific region. It then raises a number of issues and potential solutions that may be considered by policy makers and deserve further investigation by research institutions in the region to ensure that access to trade finance is sustained in times of crisis and beyond.

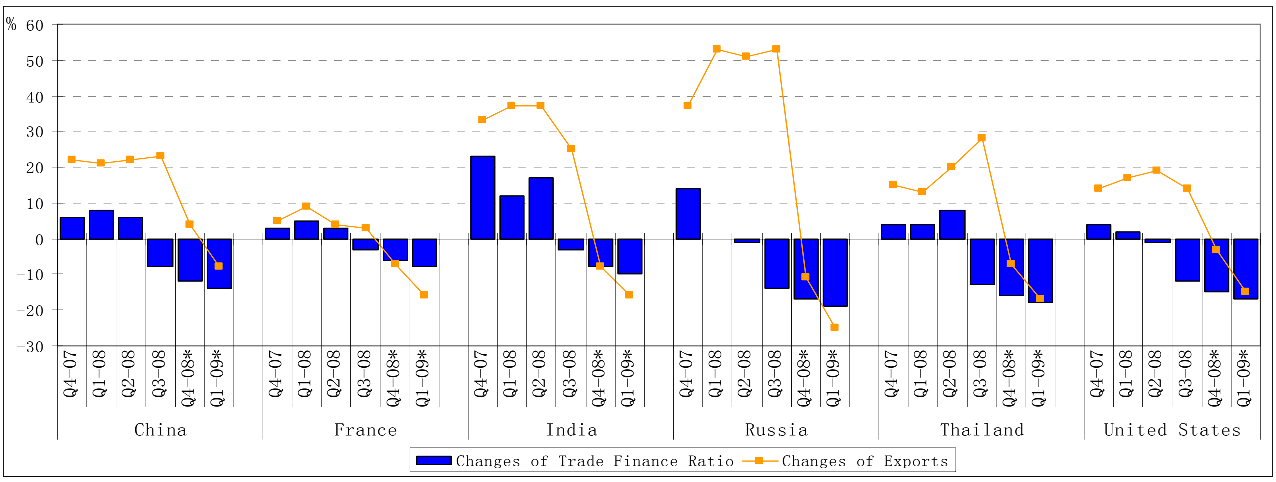
Drop in trade finance

The Asia-Pacific region appeared at first better positioned to weather the turbulence caused by the global financial crisis, thanks to its sound economic fundamentals, substantial reserves, improved regulatory frameworks and generally robust corporate balance sheets and banking sectors.

However, with the rise in risk aversion globally, government agencies and corporations have found it increasingly difficult to obtain trade financing both from international financial markets and their own domestic financial institutions.

Figure 1: A Sharp Drop in Trade Finance

(Change in the ratio of insured export credit to export)**



Source: Joint BIS-IMF-OECD-World Bank Statistics on External Debt and CEIC database. Note: * The ratios of insured export credit for Q4-08 and Q1-09 are estimated based on adjusted trend of last two quarters for which data is available. ** The ratio is calculated as Berne Union members' direct insurance or lending in a country to total export value of that country. The "Change" refers to percentage change from same quarter of previous year.

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Global trade finance (including aircraft and shipping) in 2008-4Q was already down 39 per cent compared to that in 2007-4Q. [3] In the Asia-Pacific region, emerging economies such as China, India and Thailand experienced a double-digit decline in availability of trade finance during the same period (Figure 1). This trend is expected to continue in the first half of 2009 until current uncertainties of the global economy are resolved, and specific measures taken by governments at the national and multilateral levels have taken effect.

Rising risks and costs

The IMF Trade Finance Survey (2008) – covering 40 major banks in advanced and emerging economies – reveals that, overall, trade finance has become costlier and somewhat harder to get in emerging markets. South Asia, the Republic of Korea and China have been the most affected. Overall, a substantial rise in the perceived risk of trade has threatened short-term credit/trade finance. Fear of default, called counterparty risk, is causing banks to tighten lending guidelines. More than 90 per cent of the banks in advanced economies and 70 per cent in emerging markets admitted that they had revised and tightened their lending criteria and guidelines. Many have withdrawn or reduced credit lines, raised costs, and become reluctant to confirm letters of credit (L/Cs) in some markets.

Countries with already high risk ratings have suffered the most from drying up trade finance, as financial institutions looked for quick ways to reduce the overall risk of their trade finance portfolios by reducing coverage of transactions considered as high risk.

Since "country risk" is the basis for setting minimum premium rates for transactions covered by many export credit agencies, a country's sovereign default risk directly affects an individual exporter's ability to get trade financing. Least Developed Countries (LDCs) such as Afghanistan, Lao PDR, Myanmar, and Nepal, are classified in the highest country risk category (see Figure 2).[4] While transactions with LDCs have traditionally been associated with higher risk premiums, the current crisis makes this worse. Some other developing countries may also slip into higher risk categories. Indeed, China, Pakistan, the Russian Federation, and Viet Nam, have recently been added to a watch-list by Coface, a world leader in trade risk management, due to rising risks in various sectors.[5]

A host of emergency measures have been put in place

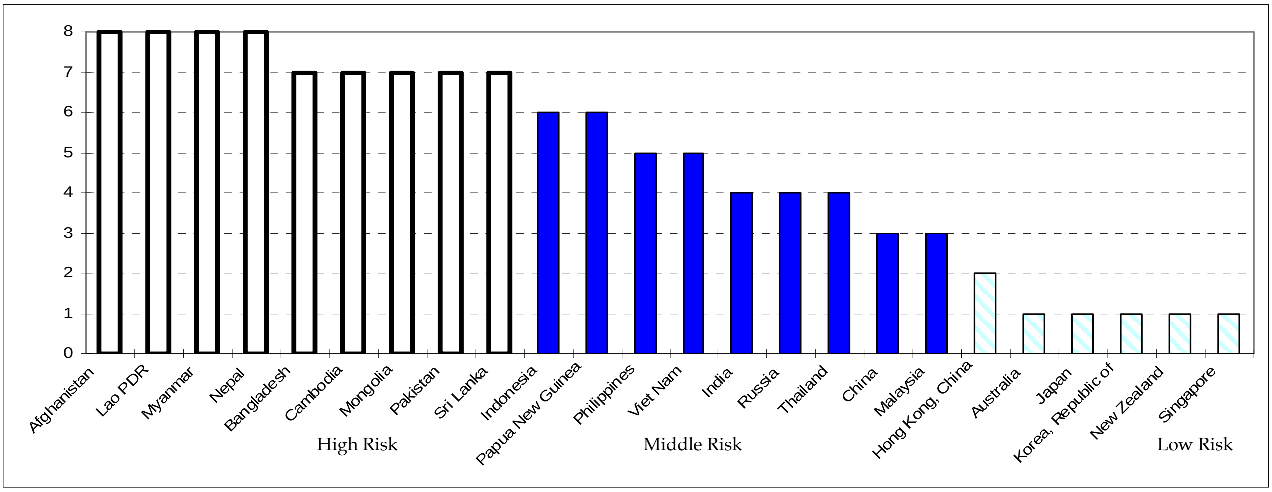
Caught unaware by the speed and scale of the deterioration in international trade and investment flows, individual countries and trade and development related international organizations have implemented a number of measures to sustain trade finance.

At the global level, the countries constituting the G20 committed to ensuring the availability of at least US$250 billion over the next two years to support trade finance through their export credit and investment agencies and trade finance schemes of international financial institutions, including the International Finance Corporation's (IFC) Global Trade Liquidity Pool.[6]

At the regional level, the Asian Development Bank has agreed to a significant expansion of its trade finance facilitation programme, which is expected to provide up to US$15 billion in support until 2013.

At the national level, many countries have taken emergency measures to strengthen existing trade finance institutions by increasing export credit insurance and extending the coverage of default risk.

Figure 2: Country Risk Classification



Source: Country Risk Classification of the Participants to the Arrangement on Officially Supported Export Credits, http://www.oecd.org/dataoecd. Note: the Country Risk Classification Method by OECD measures the country credit risk, i.e. the likelihood that a country will service its external debt. The Country Risk Classifications are produced solely for the purpose of setting minimum premium rates for transactions covered by the Export Credit Arrangement.

The following are a few examples of measures taken or under consideration in the region.[7]

India is considering financial assistance to small and medium exporters by providing a 100 per cent indemnity for insured exports, instead of the current 90 per cent, amounting to an additional support of US$25 million. For large exporters, some US$50 million would be made available to provide for additional indemnity over the present level of 90 per cent, and to provide larger protection from 75 to 85 per cent to cover for bank advances for exporters (both pre-shipment credit and post-shipment cover).

Indonesia's Asuransi Ekspor Indonesia, which provides insurance and guarantees to support non-oil and gas export development, may obtain further capital to enlarge its underwriting capacity. Multilateral institutions operating in Indonesia would set up funds together with local banks (pool of funds) to support trade finance and loans for exporters, while Asuransi Ekspor Indonesia would act as the insurer.

Japan is considering converting its Export and Investment Insurance organization into a new special company with adequate capital, enabling it to respond to increasing client demand.

Republic of Korea is to increase the annual export insurance limit to US$170 billion for 2009 from US$130 billion for 2008, and is considering an additional capital injection of US$260 million for 2009.

Thailand will inject an additional US$140 million baht to the Thai EXIM Bank to increase export insurance. In addition, US$85 million were allocated to the Small Business Credit Guarantee Corporation so it can raise small and medium-sized enterprises' credit guarantee fund and loans. In response to increasing demands from Thai exporters, the Thai EXIM Bank also provided risk assessment services and related trainings.

Strengthening trade finance institutions

The short-term measures mentioned above are essential in times of crisis and it is heartening to see how quickly they have been agreed upon and implemented across the region. However, many developing countries have very limited capacity to address national trade finance shortages on their own. Actions beyond the short-term emergency measures are necessary to strengthen trade finance institutions.

In the medium term, establishing or strengthening government-backed export credit insurance and guarantee institutions and/or export-import (EXIM) banks is essential. As highlighted above, these institutions can play a major role in times of crisis. However, they are inefficient or missing in many developing countries of the region (Auboin and Meiier-Ewert, 2003). Where this is the case, governments should examine different models (e.g., public-private partnerships) for the establishment of self-sustaining trade finance institutions.

In addition, establishing or strengthening domestic credit rating agencies and information-sharing and recording mechanisms – and their supervision – is critical. This would contribute to reducing the cost of trade credit and insurance, which heavily depend on how accurately the creditworthiness of the buyer or seller can be assessed.[8]

In the long-term, a strong, credible and well-developed banking and insurance sector is the key to ensuring access to a full array of trade finance instruments. Good and stable macroeconomic fundamentals, prudential regulations, and a pragmatic approach to financial sector liberalization are essential to achieve this goal.

Deepening bilateral and regional cooperation

Deepening cross-border cooperation by pooling resources and expertise may be necessary to tackle current bottlenecks in trade financing. Several developing countries with already well-developed national trade finance institutions have been proactive in this regard. They tackle the South-South trade finance bottlenecks by opening branches of national trade finance institutions in other countries of the region. For example, the Thai EXIM Bank recently opened a branch in Moscow to facilitate the financing of Thai exports to the Russian market.

The deepening of regional cooperation on trade finance will likely be beneficial to all parties. Options in this area include
i) strengthening the regional network of Export-Import banks and Development Finance Institutions;
ii) expanding multilateral clearing arrangements and related international payment services - based on those offered by the Asian Clearing Union;[9]
iii) strengthening the ADB trade finance facilitation programme; and
iv) establishing a multilateral export credit insurance company and/or a new regional capital market fund for South-South trade and investment finance.

Conclusion

Trade finance is an essential enabler of international trade and requires the continuous attention of trade policy makers. There is a clear dearth of information and reliable analysis in this area and many questions remain unanswered:

- Which models of export credit insurance and guarantee organizations are most appropriate for developing countries of the region?
- How are SMEs financing their imports and exports and what are their needs and priorities in this area?
- How important is trade finance for South-South trade development?
- What are country and regional needs in trade finance statistics? Is there scope to establish a trade finance monitoring system?

Research institutions in developing countries of Asia and the Pacific, in consultation with trade policy makers, may assist in filling the existing trade finance knowledge gap. Consideration should be given to the establishment of a regional trade finance database to facilitate information exchange and share experiences.

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[1] Trade finance is provided by commercial banks, official export credit agencies, multilateral development banks, insurance firms, suppliers, and purchasers. Trade finance can take many forms and may include for example the provision of working capital loans or letters of credit (L/Cs) - a trade finance instrument whereby the bank of the importer guarantees payment to the exporter or its bank upon satisfactory delivery of a shipment. For more details, see ESCAP (2005).

[2] Data and model are available at: http://www.unescap.org/tid/artnet/index.asp. Aggregated export value in developing Asia was calculated by ESCAP based on the data from IFS.

[3] For details, see Dealogic (January 2009). Note: global trade finance (excluding aircraft and shipping) in 4Q 2008 was down 32 per cent compared to 4Q 2007.

[4] OECD, http://www.oecd.org/dataoecd; accessed on 25 March 2009.

[5] Coface, www.coface-usa.com; accessed on 28 March 2009.

[6] The new IFC World Bank group Global Trade Liquidity Pool should provide up to US$50 billion in trade liquidity support over the next three years.

[7] Berne Union Press Release, November 2008, <http://www.berneunion.org.uk/>accessed on March 27 2009; Bangkok Post <http://www.bangkokpost.com>, access on March 29 2009.

[8] For example, see the indicator of quality and availability of credit information in the Doing Business Report 2009; www.doingbusiness.org.

[9] The Asian Clearing Union (ACU) is the simplest form of payment arrangements whereby the members settle payments for intra-regional transactions among the participating central banks on a multilateral basis. The main objectives of a clearing union are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade among the participating countries. See http://www.asianclearingunion.org/.

Announcement: ESCAP and UNITAR will offer a 6-week online course on *Trade Finance Infrastructure Development* from 8 June to 17 July 2009.
For more information and to register, please visit the course website:
http://www.unitar.org/pft/elearning/tradefinance/home.

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