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Improving Trade Finance In Low Income Country: A WTO Priority[1]

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Until the financial crises of the 1990s and the 2008-09 financial crisis, trade finance had been taken for granted. But these periods of crisis created distortions in the trade finance market which made policy interventions necessary. Moreover, at the “low end” of the market, in the poorest countries, lack of access to trade finance is largely a structural problem. This problem has been worsened by the 2009 financial crisis, as the international banking system is restructuring —and tends to assume less risk than before. This *Brève* describes efforts by the international community to partly alleviate this problem.

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1. The views in this article are only those of the author and do not necessarily represent those of the WTO. Any possible errors are those of the author.

I. The "big trade collapse" and public support to trade finance in crisis

Finance is the 'oil' of commerce. Most trade transactions are supported by a trade credit. A credit is required to bridge the gap between the time at which exporters wish to be paid (at dispatch, at the latest; with the order, at the earliest), and the time at which importers will pay (at the earliest, on receipt of the merchandise). Hence, a large share (up to 80%) of the USD 18.8 trillion of annual trade flows involves some form of finance, be it a credit, insurance, or a guarantee. While the commercial risks involved in an international trade transaction seem in principle to be larger than in a domestic trade transaction (risk of non-payment, risk of loss or alteration of the merchandises during shipment, exchange rate risk), trade finance is actually considered to be a particularly safe form of finance, as it is underwritten by strong collateral and documented credit operations. According to the International Chamber of Commerce's "trade finance loss register", the average default rate on short-term international trade credit is no larger than 0.2%, of which 60% is recovered.

Despite trade finance being a routine task, at the same time it is systemic for trade. Until the financial crises of the 1990s and that of 2008-09, trade finance had been taken for granted. The crises periods created distortions in the trade finance market which made policy interventions necessary.

In the heat of the 2009 financial crisis, the collapse of global trade was accelerated by the shortage of trade finance linked to the temporary inability of private sector banks to respond to financing needs of their customers. In this respect, the London G-20 Summit's initiative (2009) to mobilize $250 billion in additional short-term trade finance and guarantees to support trade, at the time it was most needed, helped restore confidence in the market.

Large traders have been able to benefit from the rapid export credit support and risk-sharing mechanisms mobilized by international financial institutions: within a year of implementation, the initiative helped mobilize $170 billion in additional capacity, mainly from export credit agencies, of which $130 billion had been used. In the summer of 2009, it was felt that the outlook for global trade finance had improved, in part due to improvements in overall financial markets and partly due to a recovery of trade.

II. Structural difficulties in low income countries

The problems faced by traders in low income countries (LICs) in accessing affordable trade finance are to a large extent structural, but have worsened since the 2009 crisis. It became clear in 2010 that the support package described above had restored confidence in the main "routes" of trade (US-Europe-Asia) but that traders at the "periphery" of main trade routes , particularly low-income countries remain subject to the greatest difficulties in accessing trade finance at affordable cost, particularly import finance. A recent survey conducted by the Dutch Institute CBI (2012) revealed that a majority of SME exporters within Africa considered that trade finance costs to have increased in the last three years, and that access to trade finance, one of the main obstacle to their trade, had become more difficult.[2]

Micro, small and medium-sized enterprises in developing countries have for a long time been faced with a mix of "structural" constraints, ranging from the lack of know-how in local banks to a general mistrust, resulting in traders having to set aside large collateral for a loan (up to 100% of the value of the loan in cash) and pay high fees for such loan. Despite this, the rate of default on trade payments in low income countries is not much higher than in other parts of the world.

The contraction of the global financial industry since 2009 has exacerbated the situation.

2. CBI Policy Intelligence (2012), Access to Trade Finance: Perspectives on Bottlenecks and Impact for SME Exporters in the South, available at www.cbi.eu

Capital for lending in low-income countries has become scarcer and the selectivity of risks greater, so negative expectations regarding the cost of doing business in poorly (or non-) rated countries are translated in either higher costs for traders locally, or simply in less finance available. For example, leading consulting firms active in trade finance have indicated that regular import loans charged on non-sovereign African risks are still well over 10% per annum for at least a third of African countries, and for another 20 countries or so in the rest of the world.

III. The international response

In 2011, the Director-General of the WTO and the President of the World Bank, with the support of the Heads of Multilateral Development Banks have drawn the attention of the international community on this problem affecting specifically low income countries. The G-20 Seoul Summit Document indicated that:

"To support low income countries (LIC) capacity to trade (...), we note our commitment to (…) support measure to increase the availability of trade finance in developing countries, particularly LICs. In this respect, we also agree to monitor and to assess trade finance programs in support of developing countries, in particular their coverage and impact on LICs, and to evaluate the impact of regulatory regimes on trade finance." (Fighting Protectionism and Promoting Trade and Investment, Paragraph 44)

The WTO has reviewed the efforts already deployed by regional development banks and the World Bank Group (through the International Financial Corporation (IFC), its private sector arm) to support trade finance. This effort is not insignificant. Between 2008 and 2011, the total volume of trade supported by existing, so-called trade finance facilitation programmes has increased by 150%, to a total of almost $25 billion. The support of multilateral development banks and that of the IFC is therefore very important for trade in developing and low income countries (see Box 1).

Box1: Trade finance facilitation programs (TFFPs)

The expansion of trade finance facilitation programmes and similar schemes do not cost the taxpayer any money. These schemes are risk-mitigation instruments that are run on a private-sector, demand-basis, with a focus on clients in developing countries, in particular the poorest. All institutions operating such programs are running net operating profits on it, while serving the wider purpose of facilitating trade in places of the word where private markets would not necessarily operate. These programs strengthen financial and trade inclusion in low income countries.

In effect, trade finance facilitation programmes provide risk mitigation capacity (guarantees) to both issuing and confirming banks, to allow for rapid endorsement of letters of credit – a major instrument used to finance trade transactions between developing countries players, and between developed and developing countries. The guarantee provided by the multilateral development bank ensures that the bank (typically the bank of the exporter) accepting to confirm a letter of credit (typically issued by the bank of the importer) will be paid even if the issuer fails to pay. The guarantee would ensure that the exporting bank is paid. Such guarantees are rarely called in but reduce the risk aversion of conducting trade operations in low income countries - as they close part of the "confidence gap" between the existing level of risk and its perception. The demand for these programmes has increased during the 2009 financial crisis and has not fallen ever since. The Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Islamic Development Bank, and the IFC are operating relatively similar programmes. The African Development Bank has just opened a programme in early 2013.

Despite the development orientation of these risk mitigation programs, the institutions involved face, in addition to severe resource constraints, serious trade-offs between supporting trade within systemically important low to middle income countries (be it Bangladesh, Pakistan, Nigeria, Sri Lanka, Kenya), whose small and medium sized enterprises and banks are receiving the bulk of existing support under these programs, and, on the other hand, extend operations in smaller and poorer countries.

The G-20 adopted the recommendations of the WTO Report asking regional development banks and the World Bank group, which have benefited from recent recapitalizations, to expand as a matter of priority their coverage of low-Income Countries, and further expand risk limits to allow for greater support to countries in which local financial institutions cannot support trade and traders cannot afford credit conditions. Two priority regions were clearly set out: Africa and Asia.

Since then, the focus has been on the creation of a permanent trade finance facilitation program at the African Development Bank, the only region where it had been missing. In doing so, the African Development Bank has received the technical and legal support from the Asian Development Bank and the IFC. As noted in Box 2, this resulted in the Executive Board approving a permanent facility for trade finance in February 2013 with a risk capacity of $1 billion. The first transactions have been signed on the margin of the African Development Bank in May 2013.

Other steps have been taken, such as expanding the EBRD's trade finance facilitation program to countries in the middle-east (so-called MENA countries), and to expand further the IFC's own program into other low-income countries. All in all, prime traders and small and medium sized enterprises in low income countries are able to benefit from such programs in almost all regions of the world. Roughly $US 30 billion in trade transactions are supported by these programs every year. Although this may not seem large, the average transaction is of less than $500,000, meaning that up to 60,000 transactions (that would not have taken place otherwise) are supported every year.

Box 2: Creation of a Trade Finance Program at the African Development Bank (AfDB)

The Executive Board of the AfDB has approved on 20 February 2013 the creation of a permanent trade finance program aimed at financing and guaranteeing up to $1 billion of trade loans at any point in time in the poorest countries in Africa. Given that most trade loans under this program have a maturity of 90 to 100 days, the program may finance up to $ 3 or 4 billion in trade transactions per annum. On the margins of the African Development Bank Group (AfDB) 48th Annual Meeting on 29 May, 2013, African trade finance leaders and practitioners met to exchange views on their perspectives of the trade finance industry in Africa. On this occasion, five transactions totaling US$520 million have been signed (out of the ceiling of $1 billion), of which two are risk participation agreements for financing trade signed with Standard Chartered Bank and Commerzbank. These agreements are aimed at bolstering both intra- and extra-African trade, and will ultimately benefit small and medium enterprises.

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