Auboin, Marc; Meier-Ewert, Moritz

**Working Paper**

**Improving the availability of trade finance during financial crises**

WTO Discussion Paper, No. 2

**Provided in Cooperation with:**
World Trade Organization (WTO), Economic Research and Statistics Division, Geneva


This Version is available at:
http://hdl.handle.net/10419/107037

**Terms of use:**
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
Improving the Availability of Trade Finance during Financial Crises

Marc Auboin
Counsellor, Trade and Finance Division,
WORLD TRADE ORGANIZATION

and

Moritz Meier-Ewert
PRINCETON UNIVERSITY

* We are grateful to representatives of the ADB and EBRD, in particular Martin Endelman. Gratitude is also expressed to Richard Eglin and Patrick Low, Directors at the WTO, and Jesse Kreier, Counsellor, for their very useful comments.
ABSTRACT

An analysis of the implications of recent financial crises affecting emerging economies in the 1990's points to the failure by private markets and other relevant institutions to meet the demand for cross-border and domestic short-term trade-finance in such periods, thereby affecting, in some countries and for certain periods, imports and exports to a point of stoppage. These experiences seem to suggest that there is scope for carefully targeted public intervention, as currently proposed by regional development banks and other actors, which have put in place ad-hoc schemes to maintain a minimum flow of trade finance during periods of scarcity, through systems of direct credit or credit guarantees. This paper explores the reasons behind the drying up of trade finance, both short and long-term, in particular as banks tend to concentrate on the more profitable and less risky segments of credit markets. It also describes ad-hoc schemes put in place by regional and multilateral institutions to keep minimal amounts of trade finance available at any time. It then goes on to examine a number of questions regarding the regulatory framework surrounding trade finance products, and looks at WTO rules in this regard. It also examines other areas where the WTO can play a role in facilitating and contributing to a global solution. In this context, a discussion of various proposals on the table is suggested.
TABLE OF CONTENTS

I. INTRODUCTION ................................................................................................................... ................. 1

II. THE TRADE-FINANCE MARKET AND DIFFICULTIES ENCOUNTERED DURING PERIODS OF FINANCIAL CRISIS ............................................................................................................ .............. 1
A. RISK, LIQUIDITY AND SOLVENCY PROBLEMS AND TRADE .............................................................................. 1
B. FINANCIAL CRISSES AND TRADE FINANCE IN PERIODS OF INSTABILITY ............................................................. 4
C. MARKET FAILURE OR COST OF RULES? ............................................................................................. 6
  1. Supply-side failure............................................................................................................ ............. 6
     (a) Short-term causes .............................................................................................................. .... 6
     (b) Long-term causes............................................................................................................... .... 7
  2. Demand-side constraints?....................................................................................................... ...... 7
  3. Are there any alternatives to bank financing?............................................................................ 8
  5. Initiatives developed by public authorities during the crisis ................................................... 10

III. THE WTO AND TRADE FINANCING ................................................................................................ 11
A. AREAS OF POTENTIAL ACTION OF THE WTO ................................................................................... 11
B. SPECIFIC PROBLEMS POSED BY PUBLIC INTERVENTIONS (FINANCIAL AND LEGAL SIDE) .................. 13
  1. Moral Hazard ................................................................................................................... ........... 13
  2. Possible long-term solutions on the financial side not involving moral hazard ...................... 14
     (a) Improving financial stability in individual markets................................................................. 14
     (b) Developing modern market techniques and institutions in developing countries markets (hedging, securitization of lending, creation of export credit agencies), subject to proper supervision .................................................................................................................... ....... 14
     (c) Eliminating market imperfections (transparency, symmetry of information)....................... 14
     (d) Regulatory aspects............................................................................................................. .. 14

IV. ISSUES FOR DISCUSSION .......................................................................................................... ........ 15

V. REFERENCES ..................................................................................................................... .................. 17

ANNEX TABLE I: DATA ON STOCKS OF TOTAL TRADE FINANCE IN SELECTED EAST ASIAN AND LATIN AMERICAN COUNTRIES (IN US$ MILLION) ........................................................................... 18
LIST OF BOXES, CHARTS AND TABLES

BOX 1: TRADE FINANCE INSTRUMENTS – A TYPOLOGY .......................................................... 2

BOX 2: EXPORT AND CREDIT INSURANCE ........................................................................... 3

BOX 3: SELECTED AD-HOC PROGRAMS BY PUBLIC INSTITUTIONS TO MAKE TRADE FINANCING AND GUARANTEES AVAILABLE TO EMERGING ECONOMIES ................................................................. 10

CHART 1: STOCKS OF TOTAL TRADE FINANCE IN SELECTED EAST ASIAN AND LATIN AMERICAN COUNTRIES .... 5

ANNEX TABLE I: DATA ON STOCKS OF TOTAL TRADE FINANCE IN SELECTED EAST ASIAN AND LATIN AMERICAN COUNTRIES (IN US$ MILLION) .................................................................................................................. 18
I. INTRODUCTION

During periods of extreme financial crisis, such as those experienced by emerging economies in the 1990s, situations of credit crunch may reduce access to trade finance (in particular in the short-term segment of the market), and hence trade, which usually should be the primary vector of recovery of balance-of-payments (WTO (1999)). The credit crunch can affect both exports and imports to the point of stoppage, as was seen in Indonesia for several weeks. The availability of short-term trade finance in such periods has therefore become a major concern of the international financial and trading communities.

This has translated into several initiatives taken by national or international public organizations concerned, including the International Monetary Fund (IMF), the World Bank, regional development banks, some export credit agencies (ECAs), and certain private sector banks, each playing a different role in the process of finding a solution. For its part, the WTO has received a mandate from Ministers at the Fifth Ministerial Meeting in Cancun, in the context of the Working Group on Trade, Debt and Finance, to further work towards a solution in this domain. The report provided by the General Council of the WTO to Ministers states that:

"Based mainly on experience gained in Asia and elsewhere, there is a need to improve the stability and security of sources of trade-finance, especially to help deal with periods of financial crisis. Further efforts are needed by countries, intergovernmental organizations and all interested partners in the private sector, to explore ways and means to secure appropriate and predictable sources of trade-finance, in particular in exceptional circumstances of financial crises." (WTO Document WT/WGTDF/2)

This paper describes the nature of the problem faced by the international trading community, and examines the scope for public intervention at the global level, which encompasses, as indicated above, both the financial aspect, which is within the remit of international financial institutions (IFIs), and the rule-making aspect (e.g. rules that promote market-based solutions), which is within the remit of the WTO, the OECD and regulatory financial authorities. The structure of the paper is therefore as follows: Section II describes the disruptions to trade resulting from the drying up of trade finance during periods of crisis, based on recent country experiences, and provides a description of the ad hoc formulas put in place by public institutions (central banks, regional development banks, export credit agencies) as an alternative to lacking private trade finance. Section III attempts to specifically identify areas where WTO rules and frameworks influence the resolution of the problem, while Section IV raises issues for future discussion.

II. THE TRADE-FINANCE MARKET AND DIFFICULTIES ENCOUNTERED DURING PERIODS OF FINANCIAL CRISIS

A. RISK, LIQUIDITY AND SOLVENCY PROBLEMS AND TRADE

The expansion of trade depends on reliable, adequate, and cost-effective sources of financing, both long-term (for capital investment needed to produce tradeable goods and services) and short-term, in particular trade finance. The latter is the basis on which the large majority of world trade operates, as there is generally a time-lag between when goods are produced, then shipped and finally when payment is received. Trade-finance can provide credit, generally up to 180-days, to enterprises to fill this gap. Cash transactions also take place, but to a smaller extent in many developing and least-developed countries.

Short-term credit/trade finance has been associated with the expansion of international trade in the past century, and has in general been considered as a routine operation, providing fluidity and security to the movement of goods and services. Short-term finance is the true life-line of international trade. Financing instruments are relatively well defined, e.g. letters of credit, open accounts, overdraft and cash with order in that short-term segment of the trade finance market, and bills of exchange and promissory notes in the case of longer maturities or one-off operations. Trade-related credit is granted primarily by banks, but credit can also be granted directly by enterprises (suppliers credit, exchange of commercial notes and paper), without a banking intermediary. (Box 1)

1 The trade finance market has several segments according to maturity, from short-term (usually 0 to 180 days, but possibly to 360 days) to medium and long-term. The medium to long-term end is generally considered to be over two years, and is subject to the OECD Arrangement on Guidelines for Officially Supported Exported Credits (the Arrangement) when insured or guaranteed by a Participant to the Arrangement.

Box 1: Trade Finance Instruments – A typology

The availability of trade finance, particularly in developing and least-developed countries, plays a crucial role in facilitating international trade. Exporters with limited access to working capital often require financing to process or manufacture products before receiving payments. Conversely, importers often need credit to buy raw materials, goods and equipment from overseas. The need for trade finance is underlined by the fact that competition for export contracts is often based on the attractiveness of the payment terms offered, with stronger importers preferring to buy on an open account basis with extended terms as compared to stronger exporters who prefer to sell on a cash basis, or secured basis if extended terms are needed. A number of common trade financing instruments have been developed to cater to this need:

A) Trade Finance provided by banks

a) A bank may extend credit to an importing company, and thereby commit to pay the exporter. Under a letter of credit issued by the bank, payment will usually be made upon the presentation of stipulated documents, such as shipping and insurance documents as well as commercial invoices (Documentary Credit), or at a later specified date.

b) A bank may extend short-term loans, discount letters of credit or provide advance payment bonds for the exporter, to ensure that the company has sufficient working capital for the period before shipment of the goods, and that the company can bridge the period between shipping the goods and receiving payment from the importer (Pre and Post-shipping Financing).

c) To assist an exporter, a bank in the exporting country may extend a loan to a foreign buyer to finance the purchase of exports. This arrangement allows the buyer extended time to pay the seller under the contract (Buyer’s Credit).

Trade Finance facilities provided by banks to importers and exporters can include the provision of:

- Working capital loans or overdraft,
- Issuing performance, bid and advance payment bonds,
- Opening letters of credit (L/Cs),
- Accepting and confirming L/Cs,
- Discounting L/Cs.

Such facilities are usually denominated in hard currencies, with the possible exception of the working capital loan or overdraft.

B) Other forms of financing

Without the intermediary role of banks, companies may also use other instruments to finance their transactions, including:

- Bills of Exchange, by which a seller can get an undertaking from the buyer to pay at a specified future date, as well as
- Promissory Notes, in which a buyer promises to pay at a future date, but which offer less legal protection than Bills of Exchange.

a) The exporting company may extend credit directly to the buyer in the importing country, again to allow the buyer time to pay the seller under the contract (Supplier’s Credit).

b) The exporter sells receivables without recourse at a discounted rate to a specialized house, the receivables becoming a tradable security (Forfeiting).

c) Exchange of valued goods at an agreed value without cash or credit terms, involving a barter-exchange, counter-purchase, or buy-back (Counter-trade).

Asian Development Bank.
Box 2: Export and Trade Credit Insurance

In addition to securing adequate finance, exporters face a number of additional risks including non payment by the buyer or importer for insolvency or political reasons, as well as foreign exchange fluctuation (FX) risk. In developed countries and some developing countries, insurance provided by export credit agencies (ECAs) on behalf of the state (official export credit) or by private sector insurance companies can cover non payment risks, while banks can help with other risks.

i) Non Payment risk
- ECAs and insurance companies offer short-term export or trade credit insurance at market rates covering both pre- and post-shipments periods. These insurance contracts cover the risk of insolvency of the buyer.
- Many of these insurers can also offer insurance or guarantees for medium- and long-term buyer and supplier credit transactions, which in OECD member countries should comply with the OECD Agreement. While this cover may be of less importance in guaranteeing the maintenance of crucial trade flows during short periods of financial crises, such medium and long term export credit is important for developing and least-developed countries needing new and updated technology and capital goods.
- The cost of insurance is determined both by the terms of the contract (proportion of the exposure covered and length of the transaction), as well as the risk associated with the insured party. For medium and long export credit covered by a participant to the OECD Arrangement, minimum premiums apply.
- A letter of credit (L/C) issued by an importer’s bank is probably the best way for an exporter to mitigate non payment risk. However, this does not protect the exporter from failure by the issuing bank to meet its obligations to pay under the L/C. In this case the exporter’s bank could be asked to confirm the L/C and hence take the risk of the issuing bank.

ii) Political risk
- Export or trade credit insurance can also cover a variety of political risks, including currency non-convertibility and transfer restrictions, confiscation or expropriation, import license cancellation, breach of contract by a government buyer, and political violence which cause the non payment by a buyer.
- For long-term buyer credit and project finance transactions, political risk insurance (PRI) can play a critical role in mobilizing foreign direct investment for developing and least-developed countries. However, in the wake of the Asian financial crisis in the 1990’s, 9/11, the collapse of Enron and the economic problems currently facing Argentina, it has become more difficult for the insurance market to offer PRI for the longer tenures and larger amounts needed to support foreign direct investment into developing and least-developed countries. Because of this, collaboration between official ECAs, multilateral development banks and private sector insurance companies has substantially increased during the past few years and needs to be encouraged.

iii) Foreign Exchange risk
- Exchange rate fluctuation risk between major traded currencies can be minimised through a hedging operation by taking a reverse position in the forward market or using options (to buy or to sell) foreign exchange in the futures market.
- These operations are available at a relatively low fee (about 0.3 per cent depending on amount and currency) plus the price of the option. But for importers and exporters in developing and least-developed countries that do not have freely traded currencies or efficient FX markets, these operations can be too costly or simply not available.

iv) Other risk
- Commercial insurance is available to cover freight-related losses for a fraction of one per cent of the freight value and transportation costs depending on the risk and destination.


However, as routine as it may be, for trade finance as for other forms of credit, there is an element of risk to be borne. Commercial risk stems essentially from the inability of one of the parties involved to fulfil its part of the contract: for example an exporter not being able to secure payment for his merchandise in case of rejection by the importer or in case of bankruptcy or insolvency of the importer. Alternatively, the importer bears the risk of a delayed delivery of goods. Traders further have to deal with exchange rate fluctuation risk, transportation risk and political risk. A rapid unexpected change in the exchange rate between countries of the traders could destroy the profitability of the trade, while the imposition of a currency conversion or transfer retraction could be even more damaging.

---

3 In developed countries and some developing countries exchange rate risk can be hedged through derivatives on foreign currencies, while political risks (including currency conversion and transfer blockage, confiscation and expropriation, political violence and breach of contract by a government buyer) can be insured.
Trade finance instruments can, to some extent, mitigate commercial risk, by providing an exporter assurance that the importer will pay through the use of a letter-of-credit (L/C) issued by the importer's bank and confirmed by the exporter's bank, or by advancing to the exporter the amount owed under the contract, thereby partly bearing the exchange rate risk. But these instruments do not offer total security for the parties involved in the transaction. To protect exporters against the risk of non payment by the importer when the transaction is on open account, or the confirming bank when a L/C is used, export or trade credit insurance schemes provided by official export credit agencies (ECAs) or private sector insurance companies fill the gap in developed countries and in some developing countries. Export or trade credit insurance can cover the commercial risk, which is generally provided and priced on a commercial basis, and political risk, which can include currency non-convertibility and transfer restrictions, confiscation or expropriation, import licence cancellation, breach of contract by a government buyer, and political violence which cause the non-payment by an importer. (Box 2)

As explained in the section below on applicable rules, export credit insurance schemes are subject to a number of rules and disciplines, binding under the WTO Subsidies and Countervailing Agreement, and voluntary under the OECD Arrangement and Berne Union disciplines; the restructuring of sovereign bilateral debt, such as publicly guaranteed commercial credits under Official Development Assistance terms falls under the methodology and aegis of the Paris Club.

B. FINANCIAL CRISIS AND TRADE FINANCE IN PERIODS OF INSTABILITY

There were several episodes of international financial crisis in the 1990s, affecting mainly emerging market economies. While each crisis has its own causes and characteristics; to some extent, the crises that occurred in 1997-98 reflected a general movement of disinvestment out of emerging market economies. The threat of contagion among borrowers also created serious problems for international lenders providing various forms of short, medium and long term credit, and together this took on proportions of international systemic crisis in the late-1990s. It is generally acknowledged that capital account instability played a much more significant role during this period than in the more traditional current account/balance-of-payments crises of the 1970s and 1980s, which were linked to uncontrolled spending, high inflation, and excessive public debt.

Financial sector fragility and inadequate banking supervision in the crisis-hit countries, in combination with the role of highly leveraged financial institutions, hedge funds and off-balance sheet operations of some institutional investors, and lack of prudential control over their activities, have been the main contributing factors. "Herd" behaviour on the part of foreign capital is felt by many to explain why the retreat turned into a rout in some of the crisis-hit countries, where inadequate information, particularly about the level of foreign exchange reserves, made an objective evaluation of the situation more difficult. Internal weaknesses outside the financial sector are viewed by many as having reduced the defences of the crisis-hit economies to external shocks. Macroeconomic imbalances do not seem to have been the main factor behind the crisis in South East Asia (IMF (1998), WTO (1999)).

More important are the implications, both macroeconomic and for international trade. There are two implications that have drawn particular attention from the Working Group on Trade, Debt and Finance:

- first, the large swings in exchange rates which have exacerbated the fundamental weaknesses described above (financial fragility, external vulnerability, and poor governance). In particular they created a vicious circle of: depreciation of currencies bringing more financial institutions and their customers into insolvency, and further weakening confidence fuelling more capital flight (see particular details about the impact of exchange rate volatility in WTO document WT/WGTDF/W/4).

- second, the scarcity of short-term trade-financing facilities (in particular the opening of L/Cs and subsequent confirmation). "Cross border" international trade finance for imports became a particular problem at the peak of the crisis in Indonesia, where international banks reportedly refused to confirm or underwrite L/Cs opened by local banks because of a general loss of confidence in the local banking system. Given the high import content of exports (over 40 per cent in the manufacturing sector), Indonesia’s growth of exports was seriously affected by the difficulty of financing imported raw materials, spare parts and capital equipment used in its export sectors (WTO (1998), p. 77). The financing of exports became an issue for enterprises which bear the exchange rate risk or the risk of non-payment from their clients.4

---

4 Spillovers through trade links exist essentially at bilateral or regional level; with high levels of bilateral trade, a financial crisis will negatively affect all other trading partners through loss of competitiveness or fall in demand.
Indonesia was not the only country caught up in this situation, as explained below. In Thailand, Korea, Pakistan, Argentina and other emerging economies in the late 1990's and early 2000's, liquidity and solvency problems encountered by the local banking systems made it difficult for local producers to get pre- and post shipment finance, open L/Cs, obtain advance payment bonds and other forms of "domestic" trade finance. Despite the scarcity of foreign currency and of liquidity in local markets, standard theory would indicate that solvable demand for credit emanating from companies with good credit rating should meet supply at a higher price. In periods of extreme crisis, however, this supply simply did not exist in certain countries, raising suspicions of market failure. In light of a general loss of confidence in a local banking system, international banks forced up confirmation fees or inter bank loan margins, and reduced or cancelled "bank limits" as well as "country limits". In Indonesia, for example, the total value of trade finance bank limits fell from $6 billion, from 400 international banks, to some $1.6 billion, from 50 banks (WT/WGTF/6). After the crisis, some local banks may still suffer from illiquidity/insolvency, or do not feel adequately equipped to assess the creditworthiness of importer and exporter customers. International banks are likely to have consolidated their exposure to risky markets, and are unwilling to take renewed risks by confirming L/Cs or extending other forms of credit to their correspondent bank relations in those markets.

**Graph 1** traces the stocks of total trade finance (both bank and non-bank finance) in a number of East Asian and Latin American countries. *It shows not only the sharp fall in the total stocks of trade finance in June 1998, but also that for some countries the stock of outstanding short-term credit lines recovered after the crisis, while for some others it has not.* However, one should exercise care in interpreting this graph as showing that the availability of trade financed recovered at least in some countries, since it may simply reflect the fact that, in absence of a clear system of sovereign debt restructuring, credit lines had to be rolled over by banks – which implies an increase in the cost of borrowing for the countries concerned. Thus, while in fact no new credit lines were available, the rolling over of outstanding credits also increases total stocks. In other countries, such as Indonesia and Argentina, both local and international banks have been unwilling to immediately roll-over existing lines of trade-finance, without strong guarantees that they will be repaid at a given maturity, i.e. without a wider agreement with debtors that a process of restructuring.
of all debts will start; this may sometimes takes months or years to happen.5

C. MARKET FAILURE OR COST OF RULES?

The issue of what precisely has been the dominant factor behind the shortages of short-term finance in recent crises is open to question. While international public sector institutions tend to favour some kind of market failure hypothesis, private sector operators generally point to the adverse impact of the collapse of the local banking sector due to inadequate prudential supervision, the incorrect signals provided by the central banks, and, in general, the inability of local authorities to provide a clear strategy during crisis times. With respect to the period immediately following the crisis, public institutions have pointed to the herd behaviour of private operators and their confusion between country risk and credit-risk, while private banks blamed the cost of international regulations (in particular that of the new Basle II rules), the lack of orderly work-outs and lack of help from public institutions in granting privileged status to creditors, for the perceived loss of interest of international banks on the trade-finance market since the crisis. Some of these arguments are discussed below.

1. Supply-side failure

A combination of a sharp fall of trade financing in crisis-stricken countries, the shortening of maturities and increase in credit prices contributed to a drying up of the market for most demanders. The failure of private lenders (commercial banks and non-banks) to meet the demand for cross-border and domestic trade finance during the early hours of the crises (in particular in the cases of Indonesia, Thailand and Argentina), was surprising to the extent that trade-credits delivered by banks are normally short-term, self-liquidating in nature, often backed by deliverables,6 and thus of little risk. Part of that failure seems to be explained by the collapse of domestic banks, and also by the blurring of the company-risk assessment that is associated with a massive number of corporate bankruptcies. Still, not all domestic banks and companies went bankrupt, and local subsidiaries of international banks tend to have a greater degree of resilience during liquidity squeezes, as they could access wholesale international markets through their head-offices. Through a "natural selection" process, one could have imagined that they would have concentrated their portfolio on their best (and most solvable) customers, while taking advantage of the higher prices of credit. Instead, the contraction of trade finance seem to have been beyond what the "fundamentals" would have suggested, thereby raising suspicions, as indicated above, about the existence of some market failure.

(a) Short-term causes

A major observation regarding the Asian crisis is what is now referred to as "herd behaviour", reflecting a general withdrawal by international banks from any type of activity in emerging markets at the time, regardless of the type of lending and of risk.7 Many bank and portfolio managers made little difference between trade finance and other forms of short, medium and long term credit when reducing country exposure, and hence lines of credit to the countries hit by crisis. The concern of a majority of international banks has been to limit the overall exposure to the crisis market, rather than to maintain a selective presence on the basis of true risk profiles of their clients. Thus, even the provision of trade finance, which is commonly a relatively safe operation of mild profitability, stopped. The "rush" to repatriate as much cash as possible and to limit losses therefore was the main determinant behind the withdrawal of capital and the cut in credit lines. Domestic lenders were too cash-strapped to provide credit, and international lenders were too uncertain about the continued creditworthiness of local borrowers, despite the fact that several companies did not interrupt payments on trade credit, when it was provided to them with the help of intervention.8

Whether "herd behaviour" is irrational or not has been subject to debate for some time.9 To some extent, one might expect international banks with long presence in the country to also consider the opportunities arising from the situation, and not only potential losses, in particular when market tightening may place them in a favourable competitive situation (as competitors collapse). One could think that profit opportunities may hence arise, as remaining banks could select their clients more stringently and hence adjust rates and charges upwards as they face less competitors. The irrational component of the herd behaviour is therefore linked to such a disproportionate response of lenders, based on risk aversion and fear of losses rather than on the "fundamentals" of the market.

---

5 In the case of Indonesia, a restructuring was agree in the fall of 1998.
6 Off-shore payment mechanisms may also help limit the risk of payment default.
9 Rodrik and Velasco (1999). In light of more volatile capital movements around the world, the fear of "twin" crises where currency crises leads to/or is associated to a banking crisis, results in the spreading of bank-run psychology, where investors rush out of the country to avoid being the last ones in ads international official reserves are being depleted. While limiting losses in such panic situations seems a rational strategy to follow, the bank-run psychology is often based on irrational rumours and self-fulfilling prophecies.
which requires a thorough analysis of the potential costs and benefits in staying in the markets under new conditions.

Inadequate information and extrapolative expectations regarding exchange rates may have contributed to worsen market sentiment. The rapid withdrawal of capital is also likely to have been abetted by the worrying signals from credit rating agencies, which, after having failed to detect the onset of the crisis, had to rapidly downgraded the affected countries severely, thereby contributing to the herd behaviour of international creditors. Recent research confirmed that while the ratings by credit rating agencies did not adequately predict currency crises in emerging markets, conversely, the incidence of a financial crisis is correlated with a future downgrading. The reason for this may be related to the fact that the indicators that credit rating agencies use to derive their verdict are much better suited to predict sovereign default on debt, then a currency crisis. And while these two events have often coincided in the past, they have been increasingly de-coupled ever since 1994 (Sy (2003)).

In addition to the failures of credit rating agencies, several sources also pointed to the unavailability of adequate information regarding companies' balance sheets, in particular as a result of inadequate publication requirements in capital markets for floated companies, distorted information on banks stemming from weak supervision and the multiplication of off-balance sheet operations (WTO, 1998), and disturbing information on the central banks' own accounts (especially on weak international reserves), as revealed in some countries at the height of the crisis (Lane, 1999); in such periods of confusion, rumours tend to spread, and fears about drastic actions by authorities (capital controls, moratorium) lead to the development of panic reactions. Extrapolative expectations regarding a failing exchange rate increase pressure on capital flight, and bank run/panic spirit spreads in the market, as investors shift their focus from evaluating the situation with insufficient or distorted information to evaluating the behaviour of other investors (Summers (2000), p.5). Elements of market failure became evident when false information and herd behaviour were left to be a driving force behind the (credit) policies of experienced players, as a sound evaluation of the real creditworthiness of individual customers should have been their main basis for credit policies at the time.

10 The downgrading of individual country risk took place in a very short period of time and in an abrupt manner. Thailand was downgraded four notches by both Moody's and Standard and Poor's between July 1997 and early 1998, Indonesia five notches by Moody's and six by Standard and Poor's between June 1997 and early 1998, and the Republic of Korea six notches by Moody's and no less than 10 by Standard and Poor's during the same period (Cornford (2000)).

(b) Long-term causes

A more structural reason behind the fall in "supply-capacity" in short-term trade credits seems to be linked to the movement of global consolidation and concentration recorded in recent years in international banking markets. The consolidation of banks tends to customise market behaviours, in particular on decisions of investing or divesting from emerging markets. Consolidation also resulted in the concentration of commercial banks on the most profitable segments of financial markets, abandoning gradually low value-added and profitability products such as short-term finance. It is estimated at present that only 10 to 20 large international banks are active in the global trade-finance market, and perhaps no more than 10 banks have significant portfolios in the short end of that markets. Few of these banks have actually restored lines to emerging markets to their pre-crisis level. One factor preventing this is that, contrary to the past, short-term trade finance no longer seems to enjoy preferential treatment in London Club debt restructurings. Fewer of such workouts between creditors and debtors are now being found. The slow resolution of unpaid credits in certain crisis, such as that in Indonesia and Argentina, as well as the absence of a dispute resolution mechanism for these claims, is playing in favour of the maintenance of credit lines.

The concentration and consolidation of the market should not necessarily be a cause for the reduction of the trade-finance market. On the contrary, as international trade continues to expand about twice as fast as world GDP, the concentration of the trade finance portfolios in fewer hands should encourage the asset-backed securitization of trade financing operations and increased profitability on that market segment. On the contrary, the contraction in trade finance in crisis prone regions has, as outlined above, exceeded expectations, despite the intervention of multilateral, regional development banks and other public institutions, and the absence of major defaults on their proposed programs. It is likely that the perception that domestic local banks were no longer in a position to be reliable counterparts, and the absence of possibilities to "securitize" outstanding loans, convinced international banks that, despite an existing demand, the level of risk had become too high relative to its remuneration.

2. Demand-side constraints?

While the lack of trade-finance was a frequent source of complaints during the recent Asian financial crisis, which saw widespread bank failures and runs on the currencies of the five affected countries, Stephens (1998) points out that during the initial period of the crisis the problem may be one of lack of demand for trade credit as well as lack of supply. When the withdrawal of funds by
foreign investors causes the exchange-rate to fall rapidly, "overshooting" any conceivable long-term equilibrium, very few companies want to make import-purchases in foreign currency, since they cannot know what the exchange-rate will be when the goods arrive or when the buyer or supply credit is repaid. While it is technically possible to insure against such exchange-rate risks through hedging, for companies in developing and least-developed countries that do not have freely traded currencies or efficient foreign exchange markets, these operations can be too costly or simply not available.

Given the general uncertainty about market-conditions, companies may also not be able to anticipate the level of demand for their products, since domestic demand will have contracted, while international demand – despite the boost from a more competitive exchange-rate - may suffer from financial contagion and second-order effects due to lower export-revenues to the crisis country. Nevertheless, both in the initial period and in the medium-term, the supply of trade-credits will also contract. Not only will many local banks not be able to afford to supply working capital or trade credit due to insolvency, but they also face large obstacles in appraising the creditworthiness of companies under conditions of uncertainty. This is particularly the case for companies with high exposures to foreign short-term debt. They will also be unwilling to open L/Cs in foreign currencies, while the exchange-rate is still depreciating rapidly. Even if domestic banks do issue L/Cs, foreign banks may not be willing to confirm them, because of uncertainty about the solvency of local banks or certain political risks that could affect payment. Nor are international banks likely to consider providing domestic trade-credit, since they may not know enough about local market conditions as a result of not having a correspondent bank relationship or actual presence in the country.

Nevertheless, once the exchange-rate has stabilized, demand for trade-credit should pick up, as established companies with certain export-markets try to benefit from the more competitive exchange-rate. Therefore, even if demand for trade credit initially falls together with supply, supply does not pick up when many companies are ready to take advantage of the new market possibilities.

3. Are there any alternatives to bank financing?

The drying up of short-term trade credit provided by banks does not necessarily mean that companies will run short of cash or credit. Trade credit can also be provided by a company to another (its supplier or customer). Relevant instruments are described in Box 1. Such credit may actually prove less expensive as it avoids the cost of intermediation and may provide for discounts to attract buyers.

Recent research (Choi and Kim (2003), using US data, seems to corroborate this, as it indicates that private companies are often in a position to substitute for banks in providing necessary trade finance in times of crisis. Active and short-term cash and treasury management by companies allow them, through financial engineering, to act as lenders in the international trade markets. Some large US companies have even set up large financial subsidiaries, which provide captive finance for projects and trade. Evidence found in this paper nevertheless has to be used with care, as the market in the United States is far more diverse and liquid than anywhere in developing countries. The case of a general collapse of economic activity, where both banks and companies are cash strapped, hasn't happened in the United States since the 1930's.

Among the limitations facing developing countries in this context is the lack of a developed market system, as well as the relatively limited number of companies with sufficient working capital to be able to sustain their operations until payment, particularly in case of large contracts. In addition, foreign exchange regulation may prevent local companies from engaging in short-term credit operations with non-residents, or repatriation obligations may prevent them from having sufficient working capital in their foreign-exchange accounts that they are authorized to hold for international trade purposes. Interestingly, the Choi and Kim paper tends to show that, while US firms increase both accounts receivable and accounts payable in times of tight monetary policy (tight liquidity), smaller firms tend to extend trade credit proportionally more than large firms. This may be very unlikely in the case of most developing countries, since they either lack the necessary working capital or could hardly extend credit in foreign exchange in times of large devaluation, unless they have liquid foreign exchange balances in foreign banks. In addition, the characteristics of the Asian financial crisis have prevented a company-based credit market to substitute for the lack of bank-based trade credit: in countries such as Indonesia, a number of banks had actually been set up by industrial conglomerates in need of credit to finance the expansion of their international business. The collapse of their banks, which were hit by a balance sheet mismatch after the fall of the rupiah against the dollar (thereby creating a strong imbalance between dollar liabilities and assets in rupiah), resulted in the bankruptcy of certain of these conglomerates (WTO, 1998).

The plight of those dependent on bank finance in times of crises is heightened by the fact that major buyers in the biggest export markets of emerging
In modern markets, all forms of credits, regardless of their maturity, including consumer credit, credits to the corporate sector and trade credits are increasingly “securitized”, that is that they are backed by collaterals in the form of securities, which are (generally liquid) assets of the commercial banks, thereby reducing the risk of liquidity squeeze in case of default. If securitization was developed in emerging markets, investors would thus carry less leveraged and more diversified positions.

4. A need for intervention?

In the presence of elements of market failure, the question arises whether there is scope for carefully targeted public intervention, either on a bilateral basis, through export credit agencies, or

---

**Box 3: Selected ad-hoc programs by public institutions to make trade financing and guarantees available to emerging economies**

**a) Indonesia**
- Bank Indonesia deposited a $1 billion collateral fund offshore in mid-1998 to encourage acceptance of letters of credit issued by Indonesian banks. The Government also insured trade-financing extended by Indonesian banks in late 1998 using budget funds, but little advantage was taken of the facility.
- A $1 million short-term credit guarantee program was created in collaboration with foreign export credit agencies.

**b) Thailand**
- In 1998, the Asian Development Bank extended a $1 billion export financing facility to Thailand. This first export financing facility of the ADB consisted of two 5-year loans to the Thai Export-Import Bank: a $50 million loan from the ADB, and a $950 million syndicated loan fully underwritten and arranged by 10 international banks, and partially guaranteed by the ADB. Both loans were lent directly or through selected Thai intermediaries to provide pre- and post-shipment financing to Thai exporters.
- Initially, local banks were not keen to intermediate the risk. Draw down of the fund was modest, since the liquidity of the banking system improved faster than expected (WT/WGTF/W/6).

**c) Pakistan**
- In 2000, the Asian Development Bank made available a $150 million Political Risk Guarantee Facility to international banks confirming Pakistani letters of credit.
- The facility provided open access to any international bank, covering only political risks, while leaving commercial risks to the banks (WT/WGTF/W/6).

**d) S. Korea**
- The Export-Import Bank of the United States in 1998 provided short-term insurance for more than $1 billion of U.S. export sales to South Korea.

**e) Brazil**
- In August 2002, the International Finance Corporation provided separate credit lines and syndicated loans to banks, e.g. $200 million to Banco Itau and $275 million to Unibanco, so as to help Brazil address the shortfall in commercial credit. The money was to be lent to private sector entities to fund Brazilian trade-related activities.
- In March 2003, the Inter-American Development Bank extended a loan of $110 million to Banco Bradesco as part of the joint IDB-IFC initiative to restore access to trade finance. The loan will fund pre- and post-shipment financing for Brazilian companies and their subsidiaries abroad.

**d) E. Europe**
- In 1999, the European Bank for Reconstruction and Development (EBRD) launched its Trade Facilitation Programme, which has so far guaranteed and financed more than 1,300 foreign trade transactions in central and eastern Europe and the Commonwealth of Independent States, totalling more than 900 million Euros.

regionally/globally through IFIs. After a review of successful and less successful country experiences (Korea, Indonesia, Thailand, Brazil – see Box 2), some market participants seem to believe that the intervention of public institutions through schemes granting guarantees on credits and working capital for essential trade operations had been useful in restoring a minimum of confidence in the market, when such confidence in local enterprises and banks of crisis-stricken countries had faltered.\(^{11}\) It is not clear, however, that the lines of credit had an immediate determinant effect on overall trade; it may have actually been useful at the margin, albeit marginal effects matter most in a market economy. Critics believe that intervention by regional development banks, on the contrary, gave a sense of total loss of credit-worthiness in the affected countries, which in fact exacerbated the situation. In any case, leadership by country authorities and international agencies was crucial in designing and delivering the kind of programs that applied in the different countries.\(^{12}\) Further review of the most significant and successful initiatives, in the light of their impact on the market (restoration of lines of credit, incidence on prices, non-discrimination in their use, etc.) would be useful.

5. Initiatives developed by public authorities during the crisis

The ad-hoc solutions developed by regional development banks, as described above (Box 3), are regarded by many analysts and market participants to have been successful, in terms of having suffered no default or losses while keeping minimum cross-border trade finance available. "Urgency" trade finance schemes are now becoming more standardized among regional development banks, a trend that is on-going since the Asian crisis. However, while now being moderately optimistic about their ability to cope with sudden crisis, regional development banks and ECAs are showing relative pessimism regarding the full restoration of stable, pre- and post- liquid private market for short-term cross-border trade finance until certain crucial issues are resolved: First, some banks that provide cross-border trade finance argue that they need "preferential creditor" status in debt restructuring if they are to return to more risky emerging markets; Secondly, little progress has been achieved in the settlement of existing credit lines (which have been rolled-over since the Asian crisis), in particular since the Sovereign Debt Restructuring Mechanism proposed by the IMF has been rejected. No one has yet offered any plan for the securitization of outstanding trade credits (like of the Brady Plan), so little hope exists, for the time being, on that side. In addition, ECAs from G7 countries are clearly subject to budgetary constraints that limit their governments' involvement in covering political risk related to trade. ECAs have in recent years become increasingly commercially oriented, and hence are now subject to the same constraints as private banks. Finally, moral hazard problems may arise if IFIs were to intervene systematically, as guarantees of L/Cs could tend to protect only the best issuing banks, thereby creating a risk of "picking winners".

The risk of "picking winners" is heightened by the fact that the impact of the credit-crunch in the crisis country is likely to differ significantly among different kinds of companies. Some companies, for example, are likely to find alternative ways of financing their trading activities. These can include obtaining credit directly from the importing company or making use of the services of a factoring house. Of course, the former will only be a viable alternative, if the importing company itself is sufficiently creditworthy, and if the revenues from the sale of exports are sufficient to cover the costs of ongoing production. For these companies, the heavy depreciation of the currency is likely to prove to be a competitive advantage. Other companies, however, will not be able to take advantage of this competitive opportunity.

Small local suppliers, who sell specialized products to international importers on a one-off basis, are much less likely to be able to obtain company financing, since they do not have an established relationship with their buyers. In the absence of trade finance from banks, they are unlikely to be able to fulfill their contracts. The highly differential impact of the crisis on various types of companies makes it more difficult to design appropriate, selective programs to keep trade finance alive. A scheme to provide trade

\(^{11}\) IMF (2003).

\(^{12}\) Given the share of US-Korea trade, the trade financing problem in Korea was largely dealt with on a bilateral basis, with enhanced lines of credit provided by the U.S. Eximbank. With inter-regional trade within ASEAN being more complex, the trade finance problem in South East Asia called for a variety of solutions during the Asian financial crisis. The Asian Development Bank supported the Export Import Bank of Thailand to raise SUS 1 billion of 5 year debt to help export related enterprises access much-needed pre- and post shipment finance. This solution was largely inspired by the successful scheme put in place by Bank Indonesia (the Indonesian central bank) which had in the early hours of the crisis deposited SUS 1 billion in cash with the 10 largest international banks stationed in Singapore to guarantee any default on L/Cs issued by local banks. The EBRD commented on its successful Trade Facilitation Programme, which can protect any international bank against loss as a result of confirming a L/C issued by an approved L/C issuing bank in an EBRD developing member country. ADB also explained how its similar program in Pakistan works, but noted that it only covers political risk, and advised that it was planning to launch within the year a more comprehensive regional trade facilitation program modelled on the EBRD program. The IFC/World Bank advised that they just extended to Brazil a SUS 800 million credit line for trade financing, backed up by derivative instruments (Box 3).
financing that is too indiscriminate may end up subsidizing a small group of large international banks as well as those large companies in the crisis country, which would have had access to finance anyway. On the other hand, an intervention whose selective targeting places high administrative burdens on the customers may miss its target. Regional development banks often put a lot of effort into designing appropriate and selective instruments for the most affected actors, applying principles of non-discrimination and market conditions.

In order to secure a greater availability of trade finance in the long term, there seems to be a need to create a better interaction between the regulatory framework and market conditions. One aspect of the problem is the implementation of new "Basel II" rules, which strengthened conditions of operators regarding cross-border operations. Some private banks argue that such new rules are much too stringent, and clearly work against the expansion short-term trade finance to emerging markets. When the Basel Committee submitted its first outline of the proposed new Capital Adequacy Accord, it has been argued that the new regulatory scheme would not only impose such high capital requirements on loans to lower-grade borrowers such as developing countries as to almost cut off many of these countries from bank-financing, but also that it would contribute to the pro-cyclicality of the banking system, and thus exacerbate business cycles (Griffith-Jones & Spratt (2001)). While some adjustments have been made to the original proposals, there continues to be a risk of adverse consequences for bank lending to developing countries (Griffith-Jones, Spratt & Segoviano (2002)). In the context of the latest Quantitative Impact study of the proposed new Accord carried out by the Basel Committee, explicit concerns have also been expressed that the current proposals could have a serious impact on the provision of trade finance, since they impose a significant increase in the risk weighting for this activity, from a level which has already been considered excessive for this relatively low-risk activity (ICC (2002)).

The interaction between the crisis-inspired withdrawal of banks from a country and the longer-term consequence of depressed levels of lending to emerging economies also points to the need for more research on how long the market failure can be thought to last. If one tries to design a remedy for the lack of availability of trade finance due to the rapid and indiscriminate withdrawal of banks from a country during a financial crisis, one needs to identify how long the intervention is needed for. This is made difficult by the fact that the incidence of a crisis is likely to make banks wary of returning to the markets in question for a while. As pointed out above, few of the crisis countries in East Asia have managed to regain the flows of trade finance they enjoyed before the crisis. Therefore more research is needed to see whether a potential intervention should be targeted to assist only during the immediate crisis period, or whether it should have a longer-term horizon.

III. THE WTO AND TRADE FINANCING

A. AREAS OF POTENTIAL ACTION OF THE WTO

At first sight, an examination of the WTO role in the issue of trade finance in periods of crisis may focus on three aspects of the WTO’s work, which are relevant to the problem:

- the supply of financial services involved in trade finance falls under financial services as defined in the GATS. Members' commitments determine the degree of competition allowed for the provision of such services at the country level; developing countries may have an interest in promoting competition in the local market for trade finance, by allowing foreign operators to establish a commercial presence (Mode 3) or provide such services cross-border (Mode 1). The larger the number of operators on the market, the more liquid it will be, resulting in the lower costs, and less likelihood that all financial intermediaries will collapse at once.

- the implications of the Agreement on Subsidies and Countervailing Measures have to be carefully examined. The disciplines of the SCM Agreement apply also to subsidies provided through the financial system, including the provision by a government or public body (e.g. through a central bank or ECA) of export credit, insurance and guarantees.

- the WTO discussions on investment have a bearing on trade credit because an asset-based definition of investment could potentially cover such types of assets, and hence provide it with a degree of legal certainty along with dispute settlement procedures.

The first aspect is not in the hands of the Secretariat, but in the hands of the Members. They decide on whether and when they wish to extend their commitments. They are currently considering improving such commitments in the negotiation on financial services, as part of the Doha Round, relative to the commitments that had already been made under the December 1997 Agreement (the Fifth Protocol of the GATS). Several countries in Asia have more open regimes in financial services than bound under the 1997 Agreement, as they undertook additional autonomous liberalization in the aftermath of the Asian financial crisis, notably under IMF and World Bank-sponsored programs.

The second issue, the implications of the SCM Agreement disciplines for export credits, guarantees and insurance, in particular to developing countries, is
a very complex one. The WTO Secretariat does not have any interpretative power in this domain, as the interpretation and implementation of the Agreement is left to Members, and certain legal issues regarding the scope of the disciplines are unresolved. In addition, the SCM Agreement is being reviewed as part of the Doha Round, and it is too early to say whether the relevant provisions of interest will be affected. This depends only on the Members.

That said, certain points can be made regarding the current Agreement on Subsidies and Countervailing Measures:

- The SCM Agreement prohibits subsidies that are contingent upon export performance, and export credits, guarantees and insurance may under certain circumstances fall within the scope of that prohibition.13
- Under item (k) second paragraph of Annex I, export credit practices that are in conformity with the interest rate provisions of the OECD Arrangement on Officially Supported Export Credits are not prohibited.14 Given that the OECD Arrangement applies only to medium and long-term credit (2 years or more), and that the main concern on trade finance

13 Under Article 1 of the SCM Agreement, a subsidy is defined as (a) a financial contribution (b) by a government of public body within the territory of a Member (c) which confers a benefit. Export credit, guarantee and insurance schemes involve “financial contributions”, and central banks, ECAs and other government-owned or controlled entities that provide such schemes likely constitute “governments” or “public bodies”. While the existence of “benefit” will depend upon the terms and conditions of the financial contribution provided, export credit, guarantee and insurance schemes likely confer a “benefit” in cases where they place the recipient in a more favourable situation than it would be if it needed to rely on the marketplace. As for export contingency, this will almost always be satisfied in the case of export credits, guarantees and insurance. Article 3 of the SCM Agreement, however, refers to Annex I of the SCM Agreement, the Illustrative List of Export Subsidies. Relevant for trade finance are sections (j) and (k), first paragraph, pertaining to export credit guarantee and insurance schemes, and to export credit schemes, respectively. In general terms, item (j) provides that export credit guarantee and insurance schemes are prohibited export subsidies where premiums are inadequate to cover long-term operating costs and losses, while item (k) first paragraph provides that export credits are prohibited export subsidies where, inter alia, they are provided at less than the government’s cost of borrowing. It is not clear whether items (j) and (k) first paragraph can be used to establish that a scheme, which does not satisfy the conditions therein, is not prohibited, even in cases where there is a prohibited export subsidy within the meaning of Articles 1 and 3.

14 This is the case whether or not the WTO Member is a participant to the Arrangement, so developing country Members not participants to the Arrangement may also invoke the safe haven.

The third item is largely prospective for the time being, at least as long as negotiations have not officially started. But it is worth keeping a close eye on it, because of its potential impact with respect to dispute resolution. According to the current state of discussion, the majority of WTO Members have expressed a clear preference for a State-to-State dispute resolution mechanism.

15 Exports benefiting from export subsidies could however be subject to countervailing measures or to dispute settlement claims alleging adverse effects, where certain conditions are met.
B. SPECIFIC PROBLEMS POSED BY PUBLIC INTERVENTIONS (FINANCIAL AND LEGAL SIDE)

1. Moral Hazard

Public intervention in periods of crisis, whether in the form of import L/C guarantee schemes offered by multilateral or regional development banks, or guarantees to financing offered by individual central banks, could focus, for efficiency reasons, on the largest importers (exporters) or importers (exporters) of the most strategic products. These often happen to be inherently the most solvent enterprises in the crisis affected country. Thereby, the intervention could create the risk of “picking winners” if it is not well structured and carefully targeted. Interventions during the period of crisis that inadvertently subsidise or control the price of credit could induce international banks to further reduce their country and correspondent bank limits and domestic banks to reduce the availability of domestic trade credit. Talk by private banks of withdrawing domestic trade credit in times of crisis needs to be examined closely, since it is not always in the interest of banks to actually cut off trade credit limits at that time. Rather it may be in the interest of the banks to keep nursing the companies back to health (Stephens (1998)). This, however, will not be the case if IFI's step in to subsidise. In this case, the banks will still lend money (guarantee), but will do so at lower risk, since part of the risk is borne by the IFI's.

In this context, care should also be exercised in designing an appropriate intervention to ensure that any public provision of funds and/or guarantees is open to as many banks as possible, so as to avoid giving one bank a competitive advantage over another. A scheme that provides one major bank with funds to lend on to trading companies in an emerging economy in distress may well be non-discriminatory between the different trading companies within the country, but it may give the one bank an advantage to gain market-share over its competitors. Thus, to the extent that it is feasible, schemes should be devised that avoid these potential competitive distortions. The intervention should be non-discriminatory both at the level of beneficiaries and at the level of intermediaries.

Private banks sometimes argue that there are "hardly any multilateral development bank schemes available to support trade flows, in particular for South-South" trade.16 First, it would be fair to say that the WTO is very sensitive to the development of South-South trade, which is one of the main focuses of the Doha Round. South-South trade already represents a tenth of world trade, and the protection of a strong rules-based trading system is tantamount to its further expansion. It nevertheless remains to be explained why the intervention of multilateral banks would be indispensable to encourage South-South trade, although their intervention may be a good catalyst of available capital. Also, associations with the private sector may convince market players after a positive experience shared with public institutions, that a real market can be developed. Normally, however, private banks, in particular those of developed countries, have credit ratings that are sufficient to be able to finance trade in these countries at low cost. They even have a comparative advantage to do so, given that local bank do not have similar credit ratings and access to such cheap finance. Why would multilateral banks then need to offer concessional finance to trade? Bilateral donors already offer significant amount of trade financing for projects ("project-finance", either short-term or long-term).

An issue raised by some international banks is their desire to obtain preferred creditors status, to reduce their risk and keep trade financing flows alive during the period of crisis (Mulder and Sheikh (2003)). The argument is that private banks would feel safer to roll-over existing country and corresponding bank lines when comes the time to restructure claims. In this case, the question arises as to how many private operators should obtain such status. If 70% of outstanding credit lines in a country benefit from such status, it would prove to be worthless in the end. Preferred creditor status is deemed to be for a limited number of institutions17 so that if 10% of outstanding debt can be repaid, at least those creditors will benefit. Otherwise, how to determine who should have priority? The problem with preferred creditor status is that if some banks have underestimated risk (or poorly priced it, or did not seek insurance against it), and are protected by this status, they probably have little incentive to roll-over their credit lines or restructure them, so that the country can restart. In a way, preferred creditor status can lead to a status quo, if the debtor is not willing or not in a position to pay at all (Argentina, in the months immediately following the crisis). In developed, deep, liquid markets, preferred creditor status is not asked for by banks, as the likelihood of a liquidity crisis is small. The problem is therefore one of competition. If there is default, it is due to both poor public management (poor prudential practices) and insufficient competition. Greater competition would help sound banks to emerge, reduce the cost of financing and increase market liquidity.


17 These institutions are by their nature "lenders of last resort" and if they did not have preferred creditor status may not be able to fulfill this role.
2. Possible long-term solutions on the financial side not involving moral hazard

(a) Improving financial stability in individual markets

Part of the solution lies, in the long-term, in preventing such occurrences from happening, hence the ground work that the IMF is doing on a daily basis to prevent financial crises, with its early warning indicators, as well as on adherence by countries to codes and standards through the FSAP (Financial Stability Assessment Program). In situations of crisis, no one criticized the limited use of international reserves as a guarantee for trade finance, as done by Bank Indonesia. However, this can only be a temporary solution, the time that the country engages in serious restructuring of its banking system, and hence obtain better credit ratings. It is no long-term substitute for existing debt restructuring mechanisms.

(b) Developing modern market techniques and institutions in developing countries markets (hedging, securitization of lending, creation of export credit agencies), subject to proper supervision

Among other solutions, securitization of lending, and the hedging of exchange rate and other risks appear to be good market-based mechanisms. However, it must be acknowledged that the securitization of lending requires modern markets and instruments that are not necessarily available to low-income countries; similarly, currency hedging is only available in international markets for transactions of fairly large amounts, and at relatively high costs for the traders; it might also be available for cross-rates implying widely traded currencies – but not for low-income countries' currencies).

It should further be borne in mind that, among the US$6,000 billion of world-wide trade transactions per year, it cannot be assumed that the public sector, or international financial institutions can or will be able to take anything more than a small share of it as insurer or financier. While the public sector may have to be more active in the past (with ECAs being more active on public risks), its intervention can be no more than "surgical", or "psychological" in a way that restores confidence in the markets, or maintains the minimum volumes of trade flows that are needed for financial institutions to remain on that segment of the market. So far, the long-term trend has rather been towards the reduction of development aid, particularly through the reduction of the flow of publicly guaranteed-credit. Hence, the share of trade financed by public institutions has anything but increased. Ad hoc solutions in periods of extreme crises can therefore only be temporary and minimum substitutes for market failures, in particular when large swings in exchange rate paralyses all trade and related financing. The other aspect of public intervention is to ensure that international rules are designed in a manner that they do not stand against these short-term solutions, provided that such solutions respect the agreed principles of international trade law (non-discrimination, transparency of access, etc.), and provide comfort to those international and domestic operators that have continued to provide the necessary sources of finance in the most difficult times.

(c) Eliminating market imperfections (transparency, symmetry of information)

In a recent paper, Mulder and Sheikh (2003) suggested preventive approaches that would provide for proper, symmetric, credit-risk information at the country and company level, and suggested that the Government (or Central Bank) would decide in advance who, with good credit rating, should be deemed to be granted a Government or Central Bank guarantee. This would give the private sector a clearer view on who to provide international or domestic trade credit to during times of crisis. Such banks suggested that Governments, along with international agencies, define in advance a list of "strategic enterprises", which should have excellent international credit ratings, on which they would extend guarantees in exchange for international bank support. While this approach would contain an element of predictability and automaticity, also lies a potential problem of moral hazard:

- first, which companies would be selected (transparency of the process, criteria for determining which companies would be granted guarantee given their "strategic" status),

- second, related to the attribution of the guarantee itself (would it be on a historical basis, or would guarantees be offered for competitive "bidding", so that market shares are not "frozen" year-after-year?);

- finally, there is a risk of moral hazard in its most classic form: the companies, once awarded the guarantee, are likely to exercise less care in their business decisions, which in turn may cause them to become less worthy of the guarantee. Similarly, the existence of the guarantee may well lead banks to lend irresponsibly to these companies. Therefore, if such a scheme is to be implemented, it should be designed to in such a way as to overcome the various potential difficulties.

(d) Regulatory aspects

It would be worthwhile for the WTO Working Group on Trade, Debt and Finance, as well as for the ad hoc group of the IMF to have a look at the global state of regulation regarding trade finance. Apart from local prudential rules, trade finance is
governed internationally by a set of rules and understandings that are crafted by different international institutions including BIS for BASEL II rules; WTO for the SCM Agreement; OECD for the Arrangement on Guidelines for Officially Supported Export Credits (the Arrangement) and the Berne Union. Work is currently underway in those fora, for example in the OECD, which is reviewing the parameters regarding the calculation of the formulas applicable to the subsidy element, and in the WTO, under pressure from large developing countries, examining the applicability of rules to developing countries.

(e) Need for a lender of last resort?

Some regional development banks such as the Asian Development Bank and the European Bank for Reconstruction and Development believe that the trade facilitation programs described in this paper provide for a practical and part of a long-term solution to the problems of availability of trade finance in periods of crisis. However, because those programs only take a part of the normal bank risks and are deemed to apply in crisis situations, their contribution to overall trade is bound to remain relatively small. Some of these regional development banks have raised the question of whether a “lender of last resort” may be needed, either the regional banks themselves or a multilateral institution, in so far as this comes as part of an overall macroeconomic program and a restructuring of the financial sector.18

(f) Need for a process

As indicated throughout this paper, the solution to the trade finance problem does not rely on a single program or institution. The complexity of the issues is precisely related to the wide circle of participants, public and private, at local, regional and international level. The solution to guarantee the availability of sufficient streams of short-term trade finance in periods of liquidity squeeze is therefore to have these participants work together and create a process, by which, step by step, each institution responsible would intervene, and bring the element of confidence and support that the private sector needs to continue providing for the necessary finance. From that point of view, each public institution would clearly evaluate the impact of its programs and rules on the establishment of such a climate of confidence.

Regional development banks, as well as export credit agencies should intervene to the extent that a market failure exists, and not in conditions which will discourage international operators to provide lending on competitive terms. At the same time, it might be worthwhile for multilateral financial institutions providing for macroeconomic support to take into account the trade finance issue, as it is a basis for the recovery of trade in a crisis country, and hence the restoration of the balance of payments. International regulatory institutions should provide the necessary comfort to public “operators” (those providing for finance or guarantees) that their programs will not be illegal under prevailing multilateral rules. From this point of view, an examination of these rules with a view to determine whether they are not “excessively” restrictive is warranted, and if so, how could they be applied more flexibly. Likewise, a good balance should be struck between the need for tighter prudential regulations in emerging markets and the need not to discourage the expansion of the short-term trade finance market.

IV. ISSUES FOR DISCUSSION

The salient points of the paper raise further questions, some of which are regarding the structural conditions of markets in times of imperfect competition, which could also be of interest to the academic community.

- Is the concern regarding the availability of short-term trade finance in periods of financial and exchange crises in emerging economies one to be extended to normal times, since the number of market participants in this segment of the market seems to be declining over time? In normal times, concentration does not necessarily mean greater scarcity of credit but may involve greater security in portfolio, longer and deeper lender-borrower relationship, etc... which might actually be positive for the availability of such credit.

- A certain population of enterprises and banks are cash-strapped because they are reliant on trade credit. It is difficult to be able to define in advance which companies will be in difficulty and which bank will face insolvency. Therefore it is difficult to know in advance whether and which alternative forms of finance would be available. What are the main criteria that should prevail in providing finance through public schemes ? What are the risks (moral hazard, etc.) ?

- Ad hoc solutions of a temporary and limited nature have been found by IFIs and other public institutions and seem to be increasingly harmonized. Are they sufficient in kind and amount to prevent or solve any future trade credit "trap" in a period of financial crisis ?

- While the existing ad hoc solutions do not address the roots of the financial crises, they are created to have both a psychological and a

---

18 Question raised by experts from the EBRD in particular.
minimal financial impact on the market. If so, are they truly "confidence-building programs" that bring more participants to the market?

The following questions therefore arise for the WTO:

- To what extent are existing WTO rules consistent with such new ad hoc programs for crisis situations? Should there be a special carve-out for such programs or are they covered by existing provisions? Should the WTO rules be examined along with the Berne Union statutes and the OECD Arrangement for short-term trade financing instruments?

Are WTO rules preventing the effective use of the ad hoc interventions used by the regional development banks during the periods of crisis?

How do WTO rules on trade finance interact with BASEL II rules, in particular with a view to the provision of trade finance to developing countries, in particular for South-South trade?

How can WTO Members be encouraged to make market access commitments under the financial services negotiation to allow short-term finance to flow better, and to create deeper and more liquid markets in developing countries?

These questions require the attention of all different parties concerned (the IMF, the World Bank, the WTO, regional development banks, private credit institutions, export credit agencies and academia), so as to be able to create the "process" referred to above, in order to ensure that each institution provides its contribution to the solution of the trade finance issue, in particular that proper and adequate financial instrumentation is used by public sector participants (that is, only when needed), and that such instrumentation is framed by a sensible, coherent, market and user-friendly regulatory framework. A coordinated effort to achieving this aim is necessary, before another financial crisis in a developing country results in the same effects as previous ones, and further undermines the confidence of market-makers supplying this form of credit.
V. REFERENCES

Bank Indonesia (2001), *Credit Crunch in Indonesia in the Aftermath of the Crisis*, Jakarta


Griffith-Jones, Stephany and Spratt, Stephen (2001), Will the proposed new Basel Capital Accord have a net negative effect on developing countries?, mimeo, Institute for Development Studies, Sussex (available on: http://www.bis.org/bcbs/qis/resp3icc.pdf)


ICC (2002), Letter by the Secretary-General to the Chairman of the Basel Committee on Banking Supervision, 18 December 2002, Paris (available on http://www.bis.org/bcbs/qis/resp3icc.pdf)


Lane, Timothy (1999), The Asian Financial Crisis – What have we Learned, *Finance and Development*, Volume 36, Number 3, International Monetary Fund.


Annex Table I: Data on stocks of total trade finance in selected East Asian and Latin American countries (in US$ million)

<table>
<thead>
<tr>
<th></th>
<th>Argentina</th>
<th>Brazil</th>
<th>Chile</th>
<th>Peru</th>
<th>Venezuela</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
<th>Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-Q2</td>
<td>8161.65</td>
<td>13968.78</td>
<td>1710.31</td>
<td>3624.82</td>
<td>6000.14</td>
<td>11590.8</td>
<td>2845.68</td>
<td>5169.89</td>
<td>4965.29</td>
<td>2995.14</td>
</tr>
<tr>
<td>1993-Q4</td>
<td>8545.62</td>
<td>12740.39</td>
<td>1697.08</td>
<td>3322.63</td>
<td>5708.26</td>
<td>11543.24</td>
<td>2760.69</td>
<td>5796.22</td>
<td>5007.02</td>
<td>3307.59</td>
</tr>
<tr>
<td>1994-Q2</td>
<td>9489.26</td>
<td>12775.75</td>
<td>1867.44</td>
<td>3236.49</td>
<td>6376.99</td>
<td>13215.91</td>
<td>3165.56</td>
<td>6308.59</td>
<td>6505.3</td>
<td>4158.77</td>
</tr>
<tr>
<td>1994-Q4</td>
<td>9085.02</td>
<td>14026.18</td>
<td>2007.91</td>
<td>3301.96</td>
<td>6848.97</td>
<td>13813.87</td>
<td>3320.59</td>
<td>6486.42</td>
<td>7419.41</td>
<td>4668.29</td>
</tr>
<tr>
<td>1995-Q2</td>
<td>9716.22</td>
<td>13596.56</td>
<td>2200.86</td>
<td>3275.83</td>
<td>6987.54</td>
<td>17140.12</td>
<td>4018.28</td>
<td>7316.61</td>
<td>9159.07</td>
<td>5626.73</td>
</tr>
<tr>
<td>1995-Q4</td>
<td>8972.44</td>
<td>12150.13</td>
<td>2053.16</td>
<td>3546.05</td>
<td>6512.85</td>
<td>16103.22</td>
<td>4465.41</td>
<td>7163.01</td>
<td>10369.73</td>
<td>3607.64</td>
</tr>
<tr>
<td>1996-Q2</td>
<td>10088.31</td>
<td>12272.55</td>
<td>2115.2</td>
<td>4761.39</td>
<td>5100.59</td>
<td>17342.52</td>
<td>3613.91</td>
<td>7293.94</td>
<td>9440.73</td>
<td>3361.43</td>
</tr>
<tr>
<td>1996-Q4</td>
<td>9746.88</td>
<td>12403.42</td>
<td>1982.28</td>
<td>4592.35</td>
<td>4712.22</td>
<td>17843.22</td>
<td>3452.36</td>
<td>7141.82</td>
<td>9414.69</td>
<td>3038.63</td>
</tr>
<tr>
<td>1997-Q2</td>
<td>9359.29</td>
<td>12400.93</td>
<td>1602.52</td>
<td>4371.81</td>
<td>3882.9</td>
<td>19802.16</td>
<td>3270.96</td>
<td>8219.63</td>
<td>10912.85</td>
<td>4378.48</td>
</tr>
<tr>
<td>1997-Q4</td>
<td>9271.92</td>
<td>11401.28</td>
<td>1815.28</td>
<td>4261.09</td>
<td>3728.66</td>
<td>19712.4</td>
<td>2724.06</td>
<td>8510.87</td>
<td>10721.56</td>
<td>4623.22</td>
</tr>
<tr>
<td>1998-Q2</td>
<td>937.17</td>
<td>619.34</td>
<td>58.43</td>
<td>24.79</td>
<td>33.4</td>
<td>1320.18</td>
<td>113.76</td>
<td>121.4</td>
<td>9.72</td>
<td></td>
</tr>
<tr>
<td>1998-Q4</td>
<td>10164.87</td>
<td>18221.63</td>
<td>2259.64</td>
<td>4848.04</td>
<td>4203.4</td>
<td>21734.11</td>
<td>2471.6</td>
<td>8724.15</td>
<td>10082.15</td>
<td>8049.02</td>
</tr>
<tr>
<td>1999-Q2</td>
<td>9771.3</td>
<td>17960.43</td>
<td>1998.29</td>
<td>4807.24</td>
<td>4060.34</td>
<td>19584.22</td>
<td>2618.61</td>
<td>8443.98</td>
<td>8969.96</td>
<td>7738.64</td>
</tr>
<tr>
<td>1999-Q4</td>
<td>9696.79</td>
<td>17437.45</td>
<td>2142.89</td>
<td>4500.06</td>
<td>4944.22</td>
<td>21408.23</td>
<td>2701.54</td>
<td>8848.43</td>
<td>8978.32</td>
<td>6533.45</td>
</tr>
<tr>
<td>2000-Q2</td>
<td>7814.1</td>
<td>14820.48</td>
<td>2035.12</td>
<td>3861.07</td>
<td>3845.86</td>
<td>21324.42</td>
<td>3251.96</td>
<td>7822.95</td>
<td>7882.19</td>
<td>6673.38</td>
</tr>
<tr>
<td>2000-Q4</td>
<td>6875.09</td>
<td>14486.35</td>
<td>2140.77</td>
<td>3656.59</td>
<td>3917.31</td>
<td>20366.47</td>
<td>3216.83</td>
<td>8157.17</td>
<td>7111.2</td>
<td>6485.59</td>
</tr>
<tr>
<td>2001-Q2</td>
<td>6197.76</td>
<td>13567.22</td>
<td>1955.6</td>
<td>3549.96</td>
<td>3797.98</td>
<td>19515.53</td>
<td>3653.97</td>
<td>8210.54</td>
<td>6087.66</td>
<td>6666.38</td>
</tr>
<tr>
<td>2001-Q4</td>
<td>5720.91</td>
<td>13650.89</td>
<td>2121.78</td>
<td>3443.27</td>
<td>3647.76</td>
<td>19839.94</td>
<td>2258.94</td>
<td>8230.64</td>
<td>5637.09</td>
<td>6837.68</td>
</tr>
<tr>
<td>2002-Q2</td>
<td>5766.52</td>
<td>14897.58</td>
<td>2148.41</td>
<td>4177.76</td>
<td>3710.88</td>
<td>21230.2</td>
<td>3927.89</td>
<td>8863.15</td>
<td>5836.76</td>
<td>7978.31</td>
</tr>
<tr>
<td>2002-Q4</td>
<td>5675.19</td>
<td>14544.43</td>
<td>2173.97</td>
<td>4182.27</td>
<td>3496.66</td>
<td>21519.03</td>
<td>2779.43</td>
<td>8472.19</td>
<td>6186.47</td>
<td>8009.07</td>
</tr>
</tbody>
</table>

Source: Joint BIS-IMF-OECD-World Bank Statistics on External Debt
RECENT WTO PUBLICATIONS

DICTIONARY OF TRADE POLICY TERMS

This is a guide by the WTO and Cambridge University Press to the vocabulary used in trade negotiations. Its nearly 2000 entries cover in simple language traditional GATT and WTO concepts and terms used in trade-related activities.

Co-published with Cambridge University Press
ISBN: 0 521 53825 4
Price: CHF48

WTO ANALYTICAL INDEX - GUIDE TO WTO LAW AND PRACTICE

First Edition

The WTO Analytical Index is the authoritative guide to the interpretation and application of findings and decisions of WTO panels, the WTO Appellate Body and other WTO bodies. The material is presented in separate chapters for each WTO agreement.

Hardback

Co-published with Bernan Press
ISBN: 0 890 59603 4
Price: CHF203

TO ORDER PLEASE CONTACT:
WTO Publications, 154 Rue de Lausanne, 1211 Geneva 21, Switzerland
Tel: (41 22) 739 5308 Fax: (41 22) 739 5792 Email: publications@wto.org
Order through our On-line bookshop at www.wto.org