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**Research Report**

## Financing global development: The potential of trade finance

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## Financing Global Development: The Potential of Trade Finance

### Summary

*The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.*

Although international trade is an integral component of the conference in Addis Ababa, trade finance itself has not been taken into consideration. This omission represents a serious shortcoming because trade finance is essential to international trade, especially for developing countries with less developed national financial markets and limited access to international financial markets. Every trade transaction must be financed. The non-availability of trade finance may therefore become an obstacle to international trade that impedes sustainable development.

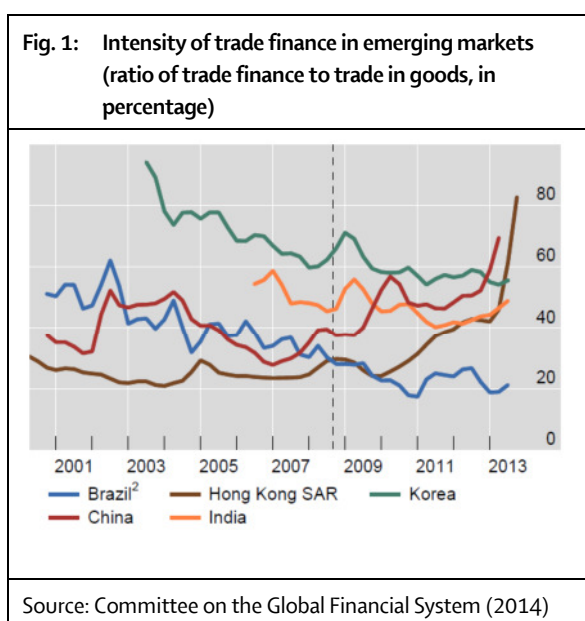
As international trade is one of the most important driving forces for economic development in developing countries and emerging markets, the availability of trade financing is extremely important for sustainable development. In particular, the integration of small and medium-sized enterprises (SMEs) into international trade is essential for emerging markets and developing countries and promotes economic development in an especially effective and sustainable manner. Trading in intermediate products has now become more important than end product trading, since goods are primarily produced within global value chains; two thirds of international trade is based on trade with intermediary products.

Participation in global value chains is therefore an important objective for developing countries. Empirical literature shows that countries which are strongly integrated into global value chains experience, on average, higher economic growth; however, frictions in finance represent one of the greatest obstacles to participation in global value chains. According to estimates from the Asian Development Bank (ADB) for 2013, the annual global gap in trade finance amounts to USD 1.6 billion. Increasing the availability of trade finance by 5% could raise production and the number of jobs by 2%. According to surveys of market participants, the financial crisis led to a huge decline in the supply of trade finance. And yet even after the crisis was resolved, the availability of trade finance remains a significant problem in emerging markets and developing countries. Surveys show that this is especially the case in Africa and Asia. The lack of development within the financial sector can pose a significant hurdle to international trade and prevent emerging markets and developing countries from integrating into the global trade system more effectively and taking advantage of trade benefits.

For this reason trade financing should be an important building block of the future framework for development finance. For developing countries, it is particularly important to put the focus on strengthening both local and regional banking sectors as well as their international interlinkages and on improving the connection between trade finance and value chains in order to promote the integration of SMEs into the global economy, for example by strengthening the respective support programmes for Supply Chain Finance.

## The market for trade finance

Trade finance is the backbone of international trade. In comparison to national trade, international trade implies higher risks: firstly, higher transport and liquidity risks due to longer distances and in addition exchange rate and country risks. Instruments such as loans, insurance, and guarantees from commercial banks, export credit agencies, development banks or central banks are used to overcome these risks, close finance gaps and provide sufficient working capital to businesses. Alongside these bank-based instruments of trade finance, international trade is also financed through inter-company loans, including cash-in-advance or open account payment. In addition, risk of default – when the importer fails to pay or the exporter fails to deliver – can also be offset by companies or financial intermediaries with export credit insurance. Estimates from the Committee on the Global Financial System of the Bank for International Settlements (BIS) indicate that one-third of international trade is backed by one or more trade finance instruments and is kept secure through USD 1.7 billion in export credit insurance. The intensity of trade finance use differs greatly from one region to the next (see Fig. 1).



For instance, only 2% of Mexican trade is backed by such instruments, whereas the rate is over 40% in China, India and Korea. In the Asia-Pacific region in particular, the use of these instruments is so widespread that they account for 50% of all trade finance volume. According to BIS, a further 30% comes from Europe and 5% each for Africa and Latin America (BIS 2014). Generally speaking, the intensity of use depends predominantly on the distance to the trade partners, the type of goods traded and local market practices. Trade relations with countries that demonstrate weaker enforcement of contract terms, lower financial market development and higher political risks are more strongly backed via trade finance.

A relatively small group of major, globally active international banks supply around 30% of trade finance volume, while regional and local banks provide the rest. The availability of trade finance is therefore directly dependent on the economic strength of the major international banks. If this group of international banks is hit by a financial crisis or if new global rules concerning the regulatory capital of these international banks are introduced, this has a direct impact on the supply of trade finance instruments. Furthermore, the availability of trade finance depends on the extent to which the regional or local banking sector is developed and internationally networked. Given that international trade transactions are primarily priced and settled in US dollars, most of the trade finance instruments are also offered in this currency. As a result, the ability of many banks to provide a sufficient supply of trade finance depends on how good their refinancing options are in US dollars. It is precisely this condition that represents a major hurdle for many regional and local banks in providing trade finance. In order to be able to handle letters of credit, the issuing bank of the exporter requires a network of confirming banks outside its own country. If national risk rises, for example, due to political instability, this will directly affect the connection to the confirming banks due to the corresponding rise in banking risks, which in turn affects the provision of trade finance.

## The availability of trade finance and its impact on international trade

Empirical analyses at macro level show that the lack of available trade finance has a negative impact on international trade (e.g. Schmitz & Brandi, 2015). Exports from Sub-Saharan African countries in particular suffer from banking crises in their export destinations, making them more dependent on bank-based trade finance than exporters in other regions. Analyses of financial relationships between banks and companies show, for instance, that the financial strength and situation of the respective domestic banks influence the trade finance conditions for the affected companies and therefore their export growth. As the market for trade finance is dominated by private suppliers and a great deal of the instruments are not reflected on the balance sheet, information on trade finance is not centrally recorded at this time, meaning that there are significant gaps regarding the volume and range of the instruments used. The quantitative analysis of the role of trade finance is complicated by the lack of consistent records; data collection and, in particular, access to records for research and the public therefore need to be improved.

## Gaps in trade finance in developing countries

The availability of trade finance is a major problem in poor countries, most notably in Africa and Asia. With respect to developing countries in Asia, a survey from the Asia Development Bank (ADB) revealed that unmet demand in

Vietnam, Cambodia, Bangladesh, Pakistan and India amounts to USD 425 billion; most affected are small and medium-sized enterprises (SMEs) whose requests for trade finance are rejected in around half of all cases. Many companies also indicated that they would benefit from improved financial education in order to be in a position to better assess alternative financing options. As regards Africa, a recent survey from the African Development Bank (AfDB) conducted with more than 250 banks in 45 African countries found that the market for trade finance amounts to more than USD 330 billion; however, it would be substantially larger if a significant proportion of financing applications from exporters was not rejected. An estimate made on the basis of these rejections reveals that unmet demand for trade finance in Africa is around USD 110 billion, i.e., around one third of the existing market; others put the trade finance gap in Sub-Saharan Africa at more than twice that. These numbers underline the need for action.

African banks in particular face numerous challenges in the provision of trade finance. According to the AfDB survey, among the most important factors are the lack of US dollar liquidity and the inadequate limits of the confirming banks. The need for confirmation in the context of letters of credit remains a considerable challenge for African banks when their counterpart is outside Africa. Off-balance sheet financing (USD 270 million in 2012; mainly letters of credit) is used in African more frequently than on-balance sheet financing (USD 127 million in 2012, e.g. short-term credit). On the one hand, this may be due to the use of 'classic' letters of credit that offer the greatest risk protection with their standard requirements. On the other hand, banking supervision requirements refer, in most cases, to on-balance sheet assets only, which is why off-balance sheet financing might be chosen. In Sub-Saharan Africa in particular, the potential for transnational trade within Africa is greatly underexploited: the intra-continental share of African trade amounted to only around 11% in 2011, compared to intra-continental trade in Europe and Asia, which is more highly valued and stood at 65% and 40%, respectively. An increase in intra-continental trade in Africa would benefit the manufacturing industry as well as those African countries without direct access to an international port. Although African banks finance this intra-continent trade with around 20% of bank-based trade, currently only around half of these flows of goods are even backed by trade finance instruments. It is therefore clear that there is a great deal of potential here.

### New challenges: trade finance and value chains

Over 50% of respondents to a WTO and OECD survey stated access to trade finance as one of the greatest obstacles to participation in value chains. Supply Chain Finance (SCF) simplifies the manner in which receivables and liabilities are handled, processed and subject to interim financing between suppliers, producers and buyers along a

global value chain. Since SCF is based on the binding commitment by the buyer to purchase the primary and intermediary products, the financing conditions are related to the credit rating of the buyer, usually a larger company, so that they turn out to be more beneficial for the supplier than if the supplier requests financing outside this fixed value chain. In developing countries, local financial markets are often not in the position to offer such SCF arrangements, making access to factoring and other arrangements particularly challenging for SMEs. Multilateral Development Banks (MDBs) are putting new programmes in place that can close these gaps. For example, the International Finance Corporation (IFC) has launched a Global Trade Supplier Finance Program to facilitate the integration of smaller manufacturing companies into international value chains. The programme brings together suppliers, buyers and banks, making it possible for banks to offer pre-payment on claims from suppliers from emerging markets and developing countries through relevant refinancing or acceptance of guarantees. These, in turn, have to pre-finance less working capital and provide fewer liquid assets, making it easier for them to plan accordingly. It would appear that the private sector has also discovered this business model as a promising growth market. According to a survey from the International Chamber of Commerce (ICC), two-thirds of the banks surveyed stated that the importance of SCF is growing and that growth rates in recent years are in the double-digit zone.

### Previous approaches to strengthening trade finance

Which approaches have been taken in the past to meet the trade finance-related challenges faced by emerging markets and developing countries?

*Financial cooperation:* Financial cooperation (FC) has helped break down international trade barriers and open up new markets via instruments such as special credit lines for trade finance or guarantee facilities for securing international commercial transactions. As a result, regional integration has been promoted by regional approaches.

*MDB support programmes for trade finance:* All in all, MDB support programmes for trade finance promoted trade to the value of around USD 30 billion in 2013, primarily in the poorest regions of the world. Promotion of trade finance by MDBs and other actors should be welcomed, but it should be optimised through enhanced synergies between the various actors involved in this type of financing.

*Focus on integration into global value chains:* Greater focus should be placed, in particular, on low-income countries (e.g. through a new IFC programme for trade finance) and SMEs (e.g. through the private sector and new instruments for SCF).

*Review the impact of international financial market regulation on the supply of trade finance:* The debate has

since started to revolve around the impact of Basel III, which has the potential to further impede the availability of trade finance in emerging markets and developing countries (Brandi, Hambloch & Schmitz, 2014). The first revisions to the regulations and its implementation are now under discussion and being taken into account.

### Recommendations to strengthen trade finance

What should be done in the future to address the difficulties associated with trade finance in developing countries more effectively?

*Improved synergies in the cooperation between the actors involved in trade finance:* The availability of trade financing should be further improved, particularly through improved cooperation between the relevant institutions (see also Brandi, Hambloch & Schmitz, 2014) and actors. MDBs and their programmes play an especially important role in this. At the same time, the cooperation of MDBs with export

credit agencies, the WTO and the private sector should be improved, e.g. with a view to disseminating knowledge concerning trade finance. A good example is the Trade Finance Institute currently being created by the ICC, which is drawing on existing WTO and MDB e-learning materials.

*More intensive data collection, analysis and knowledge transfer:* Data collection should be further improved, not least to finally be able to generate reliable data on trade finance, assess the market situation more effectively and react more quickly. Bank employees in emerging markets and developing countries should undergo intensive training to strengthen the ability of local banks to provide trade finance instruments.

*Greater focus on trade finance for the integration of SMEs into value chains:* IFC and MDB programmes should be further strengthened. Another starting point is to promote factoring facilities in emerging markets and developing countries, such as was recently done in Mexico and India.

### Literature

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