Trade Finance Stumbles

The rising cost and declining availability of finance for imports and exports is taking a toll, especially in emerging markets

Thomas Dorsey

Empty trucks in Busan, Korea.

GLOBAL trade has plunged in recent months during what is proving to be the worst worldwide economic slump since World War II. Part of that decline in trade reflects the sharp drop in global demand. But the fall in trade that began in the final quarter of 2008 [see "Deep Impact," page 13, in this issue] appears to be far greater than would be expected given the decline in global economic activity. That suggests that part of the fall reflects a disruption of financial intermediation, in which institutions, banks, and corporations facilitate global trade.

Anecdotal evidence indicates that the cost of trade finance has risen rapidly, while in some cases its availability has fallen. But there have been few hard data on trade finance. To fill in this gap, the IMF, in conjunction with the Bankers' Association for Finance and Trade, surveyed major banks in advanced and emerging economies to find out about current conditions in and expectations for trade finance (see Box 1).

The survey results tended to support the anecdotal conclusions. Trade finance is costlier and somewhat harder to get in emerging markets—where much of the intraregional trade is in low-profit-margin items that are part of the manufacturing supply chain for exports to advanced economies. The banks anticipate these trends to continue in 2009. But it is difficult to disentangle cause and effect. Some of the decline in trade finance is the result of the plunge in trade spawned by the recession, while some of the rise in costs is due to the higher probability of defaults from falling trade.

Box 1

Surveying banks

In response to the dearth of information about trade finance, the IMF worked with the Bankers' Association for Finance and Trade (BAFT) to survey advanced, emerging market, and developing country banks about current trade financing conditions compared with a year ago and expectations about 2009. The survey focused on bank-intermediated forms of international trade finance such as letters of credit and trade lending. BAFT and the Latin American Federation of Banks, trade associations of globally active financial institutions, sent a questionnaire to a long list of banks, of which 40 responded—roughly evenly split between advanced countries and emerging markets.

Costs of trade finance

Not all foreign trade is financed through intermediaries such as banks (see Box 2). But banks play an important role in facilitating the movement of merchandise around the globe.

The bank survey showed the following:

- ***The price of trade finance has increased sharply.*** More than 70 percent of the respondents said that prices of various types of letters of credit (LCs), a common technique that uses banks to guarantee importers that they will be paid, have risen in the past year (see Chart 1). About 90 percent of the banks reported increased prices of both short- and medium-term lending facilities in which the goods being traded serve as collateral.
- ***International financial strains are a major factor in the rising cost of trade finance in both advanced economies and emerging markets.*** Roughly 80 percent of the banks said that a higher cost of funds played a role in increasing the price of trade finance (see Chart 2). The pressure of increased cost of funds to banks has outweighed the dampening price effect of sharply less restrictive monetary policies in many nations, especially the United States and other advanced economies. Higher capital requirements imposed by regulators and by banks on their own lending have also boosted the spreads between the banks' costs of funds and the price of trade finance to their customers.
- ***Fear of default, called counterparty risk, is causing banks to tighten lending guidelines.*** More than 90 percent of the banks in advanced economies and 70 percent in emerging markets said they had changed their lending criteria with respect to the specific counterparty bank to the trade transaction. Banks also reported tighter guidelines for a number of specific countries, including Argentina, the Baltic countries, Bolivia, Ecuador, Hungary, Iceland, Korea, Pakistan, Russia, Turkey, Ukraine, the United Arab Emirates, Venezuela, and Vietnam.
- ***Current pricing trends are expected to continue in 2009.*** The survey suggests that emerging markets and commodi-

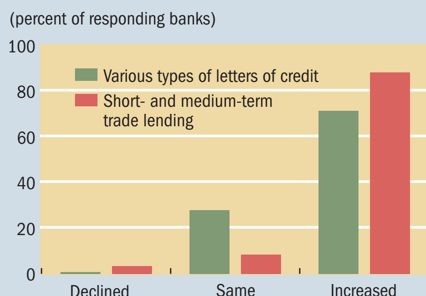
ties trade are likely to be the hardest hit. But a few banks said that spreads could narrow once global demand recovers and that the volume of trade credit could increase as a result of the consolidation of the banking sector that is occurring, especially in the advanced economies. The smaller number of global and super-regional institutions that emerge may end up providing more trade finance than is currently being provided.

Chart 1

Trade finance is costlier

Since late 2007, 70 percent of banks report that prices for letters of credit have risen and 90 percent say the price of trade lending has risen.

(percent of responding banks)



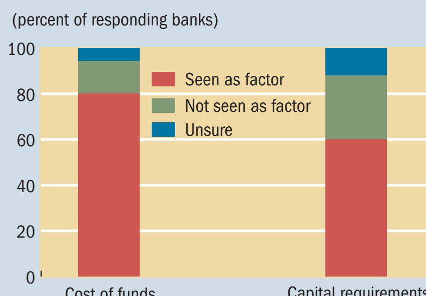
Source: IMF/Trade Finance Survey, 2008.

Chart 2

What makes trade finance pricier?

Most banks cite the rising cost of funds, while a majority also say higher capital requirements are driving up the price of trade finance.

(percent of responding banks)



Source: IMF/Trade Finance Survey, 2008.

Emerging markets are hit hard

Although higher costs of trade finance are global, the decline in availability has occurred more in the emerging markets, especially in Asia. Banks in advanced countries reported roughly the same number of trade finance transactions in the final months of 2008 as occurred at the end of 2007. But emerging market banks report on average a 6 percent decline in trade finance transactions. Responding banks, whether from advanced or emerging economies, anticipated that the trend will continue into 2009: advanced country banks expect no significant change in transactions but emerging market banks expect on average a 10 percent decrease.

Banks reported that intraregional trade among advanced economies seems unaffected so far by the current crisis. More than half the respondents said that financing exports to the Middle East and North Africa has actually increased. But a similar proportion of banks said that financing of imports from South Asia, Korea, and China has sharply decreased. One possible explanation for the collapse of trade in East Asia is that rising costs and increased risk perceptions are having a severe impact on low-margin products in the long global value-added supply chains. For manufactured goods with low profit margins, which are most important in East Asian trade, the higher price of financing could reduce volume because importers may not be able to afford more expensive letters of credit. That effect may lessen with the high-margin products that dominate trade in advanced economies.

Whither prices

With increased costs of funds to banks, higher capital requirements, and rising default risks, the increase in cost of trade finance is easy to explain. Predicting the future is trickier.

The cost of funds is likely to come down as the sharp reductions in official target rates offset somewhat higher spreads. But the effects of increased capital requirements are likely to be more durable. Many banks said that excessively low capital requirements for all bank products had allowed spreads to shrink to unsustainably low levels. That implies a semi-permanent increase in spreads because banks' own internal capital allocation and risk managers, as well as national regulators, are requiring more capital to back risk.

But growth prospects also matter, and the dismal near-term outlook for the world economy will place upward pressure on the cost of trade finance as banks set rates that account for the higher probabilities of defaults by importers and exporters. ■

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Box 2

What is trade finance?

Trade finance can take many forms, depending on the level of trust between counterparties and the degree of financing needed from banks.

If the transaction is purely between the importer and exporter, it can be done on a *cash-in-advance* basis (payment is received before goods are shipped) or an *open account* basis (shipment occurs before payment is due). Otherwise, banks play a role.

Banks offer products to mitigate the risk of nonpayment.

With *documentary collection*, the exporter instructs the exporter's bank to deliver documents and collect payments from the importer. This speeds the collection process, but the bank does not guarantee payment.

With exporter *letters of credit* (LCs, also called documentary credits), the importer gets its bank to certify that it will be able to pay for a shipment. If the exporter does not trust the importer's bank, the exporter's bank can provide *confirmation* of an LC.

Banks also offer products to reduce credit risk. *Export credit insurance* allows exporters to offer open account terms in competitive markets.

Finally, banks offer *trade lending* (also called export working capital lending) against the security of the actual goods. This allows the exporter who lacks sufficient liquidity to cover the entire cash cycle.