Access to Trade Finance in Times of Crisis

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INTERNATIONAL MONETARY FUND

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Production: IMF Multimedia Services Division
Cover Design: Lai Oy Louie
Page Design: Alicia Etchebarne-Bourdin

Cataloging-in-Publication Data

Access to trade finance in times of crisis: conference proceedings/editors, Jian-Ye Wang, Marcio Ronci—Washington, D.C.: International Monetary Fund, 2005.

p. cm.
ISBN 1-58906-404-6

1. Exports—Finance. 2. Export credit. 3. Financial crises. 4. Development banks. 5. World Trade Organization. I. Wang, Jian-Ye. II. Ronci, Marcio Valerio.
HG3753.A33 2005

Price: $27.50

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Acknowledgments

This book would not have been possible without the contribution of many people within the Policy Development and Review Department (PDR) and International Capital Markets Department (ICM) of the International Monetary Fund. The seminar from which this book originated was devised by Timothy F. Geithner (former Director of PDR) and Martin Gilman (PDR) and supported by Gerd Häusler (Director of ICM). The seminar was organized by Martin Gilman, Jian-Ye Wang, and Marcio Ronci, with assistance of Ritha Khemani (PDR), Cheng Hoon Lim (ICM), Sulochana Kamaldini (PDR), and Helaway Tadesse (PDR).

The editors are grateful to Helaway Tadesse and Julie Kozack (both PDR) for organizing the various authors' contributions; Siddhartha Choudhury (PDR) for the preparation of tables and charts; Sulochana Kamaldini, Lorna Campbell, and Esther George for secretarial assistance (all PDR); and Gail O. Berre and David Einhorn (External Relations Department) for editing the manuscript and coordinating production.

Foreword

Trade finance has long been an important component of international financial flows, as firms—particularly in emerging-market economies—rely heavily on bank-financed trade credits to support their export and import activities. Indeed, credits that facilitate international trade are so routine and taken for granted that their significant presence tends to be overlooked during times of normal economic activity. However, as recent experience has shown, trade finance can fall dramatically during episodes of financial crisis. Such a sharp contraction can prevent even creditworthy borrowers from securing adequate funds to finance their ordinary export and import activities. As a result, a country's ability to recover from the crisis can be seriously compromised, as credit constraints faced by exporters hold back their ability to contribute to economic recovery and growth.

Despite the central role played by trade finance, there has been surprisingly limited analysis of its role in international capital flows, especially during periods of crisis. This volume of essays on trade finance in financial crisis attempts to address this gap. The collection of essays is largely based on a seminar held at the International Monetary Fund in May 2003 involving participants from both the private and public sector as well as experts in academia and research institutions.

The volume attempts to view the issue of trade finance from three perspectives. In Part I, several authors present perspectives on why and how much trade finance flows decline during periods of financial crisis. The specific experiences of several countries, including Indonesia, Brazil, Argentina, and Korea, are reviewed in Part II. Finally, Part III presents some options for mitigating declines in trade finance during financial crisis, both by reviewing responses taken in the past and by looking forward to potential tools that might be utilized in the future.

While recognizing that a comprehensive macroeconomic and structural reform program will remain essential to any effort to recover from a crisis, we aim to encourage further thinking on specific responses that countries may consider to forestall a decline in trade finance. We hope the dissemination of this collection of papers will serve this purpose.

Mark Allen

Director, IMF Policy Development and Review Department

Overview

Jian-Ye Wang and Helaway Tadesse

During financial crises in the late 1990s and the early years of the new century, trade financing to the crisis countries fell dramatically.[1] Available data suggest that emerging markets rely heavily on bank-financed trade credits to support exports at preshipment and postshipment stages, as well as imports. Such financing, provided by international commercial banks, tends to be channeled to local borrowers through leading domestic banks and is an important source of working capital for many emerging market companies. Bank financed trade credits declined by as much as 30 to 50 percent in Brazil and Argentina last year, by about 50 percent in Korea in 1997–98, and from $6 billion to $1 billion in Indonesia during the Asian crisis. In Brazil, maturities of remaining bank-financed trade facilities fell from 360 days to as short as 30 days and interest rate spreads increased from about 100 basis points to 600 basis points over LIBOR.[2] There is evidence that confirmation fees for letters of credit also soared. Sharp declines in trade finance were also observed in Russia, the Philippines, and Thailand in 1997–98 and in Turkey in 2000–2001 (Figure 1).[3]

Sharp declines in trade credit have a number of adverse consequences, disrupting a country's trade and growth performance and possibly exacerbating the crisis. At a microeconomic level, firms involved in foreign trade may run into difficulties maintaining their production and trade activities because they are unable to borrow previously accessible and relatively low-cost foreign-currency-denominated working capital. The loss of liquidity in the trade sector also has macroeconomic consequences because it forces importers and exporters in crisis countries to obtain spot foreign exchange to make necessary payments and service debt falling due, thereby increasing demand in the foreign exchange market. It may also reduce the supply of spot foreign

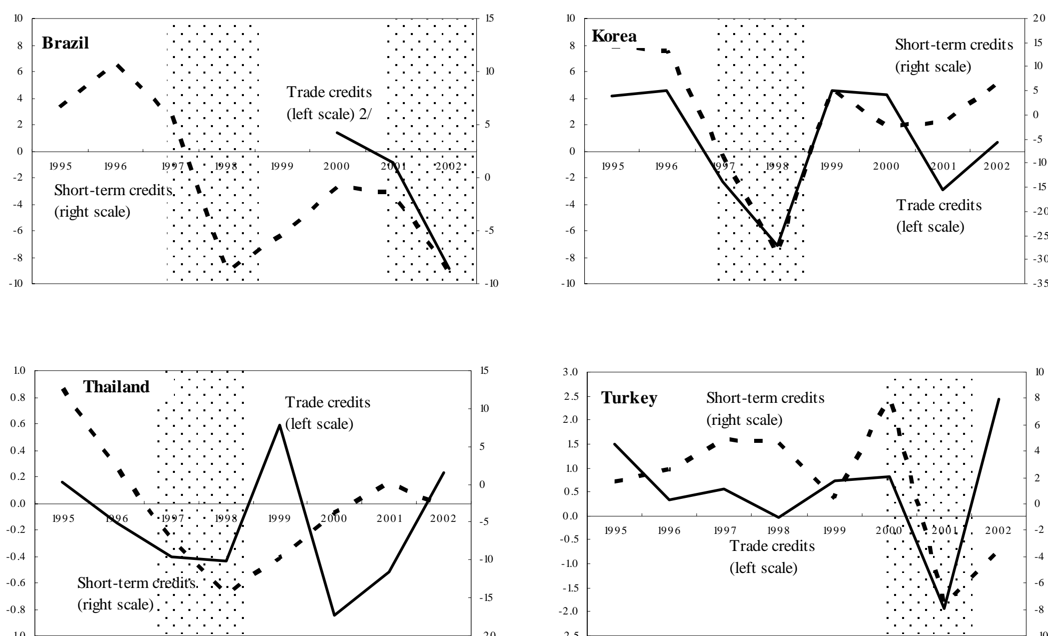
[1]This paper concerns mostly short-term (mainly less than 180 days) and externally provided financing to support exports and imports of a developing country. Medium- and long-term trade financing, while relevant, is not addressed here.

[2]Estimates based on data collected from private market sources.

[3]Data on trade credit are not readily available, complicating efforts to carry out comprehensive empirical analysis. In cases where data are available, they often are only partial. As a result, many trade finance officials have suggested that a systematic effort involving country authorities, multilateral institutions and the private sector be launched to collect data to facilitate future empirical research.

Figure 1. Trade Credits and Short-Term Credit Lines for Selected Countries, 1995-2002[1]

(In billions of U.S. dollars)

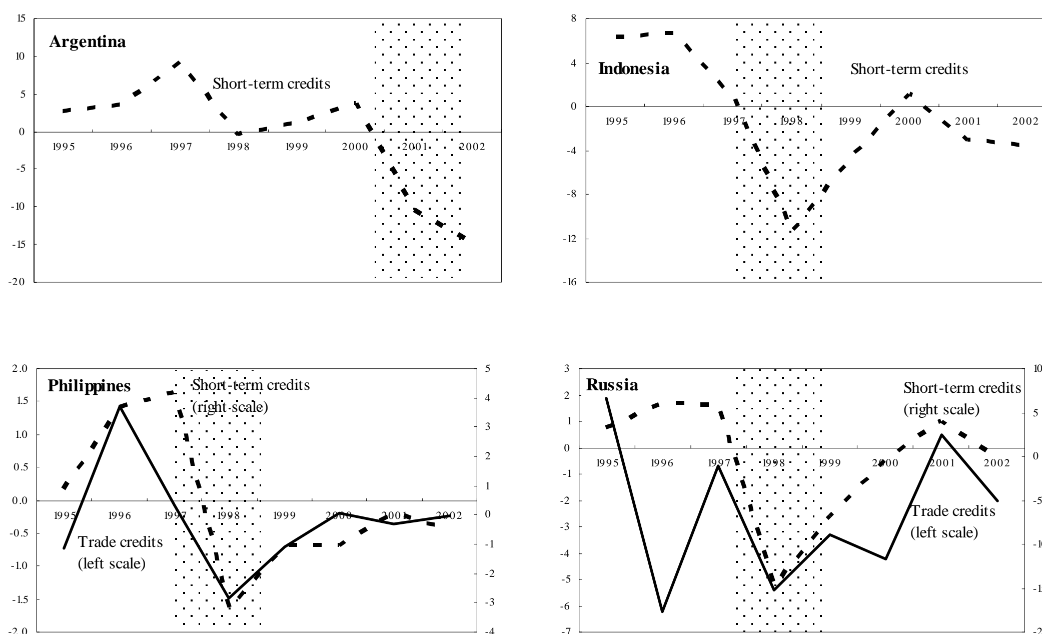


exchange, increasing the probability of delayed receipts of foreign exchange earnings of exports and a decline in exports that depend on imported inputs and materials.[4] The resulting pressure on the exchange rate may compound the country's external debt and payment difficulties and increase country risk, leading to further cutbacks in all funding, including trade finance. Finally, the scarcity of trade credit may frustrate the potential stimulus to a crisis country's exports from the exchange rate depreciation that accompanies the crisis, impeding economic adjustment and recovery. Thus, in cases where such negative externalities associated with sharp contractions in trade finance exist, the damaging effects on the trade sector may extend to the wider economy.

The crisis-induced collapse in trade finance has become a more serious problem in modern capital markets than it was during the debt crises of the 1980s, when banks provided both long-term finance and trade financing. Thus, banks' interests were aligned with those of countries in crisis to the extent that they had incentives to provide trade credit in order to limit the scale of economic dislocation, and thereby protect the value of their long-term claims. In modern capital markets, with long-term finance provided predominantly by bondholders (who do not provide trade finance), the willingness of banks to maintain trade credit lines in difficult times has been significantly weakened. In

[4]Exports from emerging markets may have high import content as a result of these countries' integration into the global supply chains. In these cases, a collapse in import financing may adversely affect exports.

Figure 1 *(concluded)*



Sources: Trade credits data are derived from balance of payments data provided by country authorities. Short-term credit lines are based on data compiled by the BIS.
[1]Trade credits, where data available, are net flows. Short-term credits are changes in stocks of credit lines, based on annual data.
[2]The data include both bank-to-bank and bank-to-enterprise lines. In addition to export and import financing, the data also include other financing.

addition, developments in international finance in recent years have blurred the boundary between trade credit and financial credits, thereby reducing international banks' confidence that payment priority would be granted by a crisis country to trade credit over other types of short-term financing.[5] Moreover, with the removal of exchange controls and liberalization of capital movements in many developing countries, trade finance has become more vulnerable to surges of capital flight—and hence the ebb and flow of confidence among fickle investors, resident and nonresident.

[5]Trade finance was conducted against the background of fairly pervasive exchange controls in the 1970 and 1980s. In order to qualify for exemptions relating to trade financing, this type of credit typically took the form of documentary credits, under which the bona fides of the transaction were monitored through documentation relating to shipping, customs, and financing. This gave a reasonable assurance that any carve-outs from debt restructuring would indeed be limited to trade credits and would not open the door for widespread evasion. With the liberation of capital movements, international banks moved away from providing documentary credits and toward revolving lines of credit extended to banks and even enterprises in emerging markets. These developments have made the distinction between trade credit and other types of short-term financing increasingly difficult.

This overview presents a preliminary assessment of the key issues based on a seminar held in May 2003 at the headquarters of the International Monetary Fund and the subsequent discussions by the authors with public and private sector players involved in trade finance. The overview examines the underlying causes behind the collapse in trade finance flows during financial crises; briefly reviews recent initiatives to stem this decline; discusses structural measures that could be taken to improve emerging market economies' resilience in the event of financial crises; and outlines an emerging consensus on a coordinated framework for trade finance in crisis resolution.

Causes of the Decline in Trade Finance

The contraction in trade finance is widely perceived to be more than would be justified by fundamentals and the risks involved. Bank-financed trade credits are usually short-term and self-liquidating in nature. As such credits are typically backed by receivables and often by offshore payment mechanisms (particularly for export trade credits), their performance is typically good, and transfer and convertibility risk tends to be low. Indeed, such credits have traditionally been considered less risky than other cross-border short- and medium-term lending, and most countries facing payments difficulties have not suspended payments on trade credits, even when payments on other external obligations have been interrupted. The extent to which trade credit lines were withdrawn in recent crises was unprecedented, especially in countries (such as Brazil) with virtually no defaults on such credit lines and where policies were supported by a substantial international financial package.

Available evidence suggests that the collapse of trade finance in recent financial crises has been predominantly attributed to the following factors:

- ***Response of banks as leveraged institutions to heightened risks.*** The interaction between perceived risks and the leveraged positions of banks—the primary sources of trade credit to emerging markets—has been singled out as a key factor causing the collapse in trade finance. Banks play two roles in the provision of trade financing: as creditor and as transaction processor. In a crisis, banks generally do not differentiate between the risks associated with trade credit and other credit exposure with longer tenors that may entail greater transfer and convertibility risk. In the height of a crisis, banks typically reduce overall country exposure following management's decision to cap the institution's country limit. Pressures from shareholders and the benchmarking of performance relative to competitors are also factors that induce banks to reduce their trade finance exposure to the crisis country. Since trade credit lines are usually short term and can be redeemed quickly at par, they are operationally the easiest asset class for a bank to cut at a time of heightened risk aversion (often, for example, by simply not renewing maturing credits). Observers have further noted that the trade finance industry has in recent years become a two-tier industry: smaller and more opportunistic players tend to pull out quickly at signs of distress, while the top players tend to scale back their overall exposure while adjusting the terms of their trade facilities.

- ***Lack of insurance when it is needed.*** Trade credit insurers, private and public, tend to tighten their cover policy in response to crises. In Brazil, the cut in bank-financed trade credit was accompanied by the disappearance of incremental credit insurance to those who were not previously insured. Since the international commercial insurance and reinsurance industry was constrained by country limits on Brazilian exposure during its recent financial crisis, insurers could not make new cover capacity available to potential credit risk hedgers. Again, the lack of sufficient differentiation between short-term, self-liquidating trade credits and other categories of credit exposure by rating agencies may have played an important role in the process. Most export credit agencies, with a mandate to promote national trade, are required to break even in their operations. In addition, many of them are no longer involved in the provision of short-term trade credits as a consequence of privatization and structural changes over the past decade. World Trade Organization (WTO) rules on subsidies[6] may make it difficult for export credit agencies to undertake countercyclical operations amid a crisis environment.
- ***Herd behavior among trade finance providers such as banks and trade insurers.*** Decision making by international providers of trade finance during crises is often dominated by perceptions rather than fundamentals, and a withdrawal by one player tends to trigger similar actions by others. Herd behavior in the form of creditors' "rush for the exit" and inadequate information about the financial condition of corporate clients or of economy-wide prospects can aggravate risk perceptions and make a prophecy self-fulfilling.
- ***Weak domestic banking system.*** A decision by international banks to reduce trade credit lines to a domestic bank will clearly limit the latter's ability to provide trade credit to its domestic corporate clients. However, external factors are not the sole reason for sharp cutbacks in trade credits by domestic banks. It is noteworthy that banking systems that were weak prior to the onset of a crisis contributed significantly to the collapse of trade credits. In such cases, banks under stress will seek to reduce their exposure to risk and raise their capital ratio by downsizing their balance sheets. As a result, they will reduce their intermediation of trade financing provided by foreign banks. Moreover, banks may trade up in terms of asset quality by purchasing government securities or investing offshore, and reducing their exposure to corporate risk.

Changes in the banking sector and external financing to emerging markets in recent years also have a bearing on the decline in trade finance during recent crises. Consolidation of the international banking sector in the last 10 to 15 years has left fewer banks participating in trade finance, leading to a greater tendency toward similar and simultaneous decisions on cutbacks in trade credit lines to a crisis country. Moreover, many international banks provide relatively low return-on-capital trade finance services

[6]As specified in Articles 1 and 3 and Annex 1 of the WTO Agreement on Subsidies and Countervailing Measures.

alongside other higher value-added products (e.g., investment banking business) to their emerging market clients. When markets for the latter dry up, there is less impetus to provide trade finance to emerging markets. Finally, as international bond issues have replaced syndicated bank lending as the main form of private capital flows to emerging markets, London Club debt workouts are no longer common. As a result, the side-agreements on maintaining short-term trade credit lines associated with such workouts do not tend to arise.

Initiatives Taken During Recent Crises

In the context of a stabilization and reform program, several initiatives were launched during recent financial crises to deal with the collapse in trade finance**.** These initiatives have involved the private sector, government, multilateral financial institutions, and official bilateral credit agencies, and can generally be characterized as addressing *liquidity shortages, risk perceptions and confidence gaps*, and *collective action problems*.

Intervention by Crisis Country Governments

Country authorities, with the support of official bilateral creditors in some cases, have provided funding directly or through the domestic banking system to exporters and importers to alleviate the shortage of trade finance. These facilities were aimed mostly at meeting *liquidity shortages* when international banks reduced their trade credit lines.

- In Brazil, where the domestic banking system was considered on a sound footing, the central bank provided $1.8 billion between August 2002 and early 2003 through auctions to banks to meet demand for pre- and postshipment export finance. The credits were short term and carried a market-determined interest rate, and the credit auction stopped when private sector financing seemed to be normalizing.
- In Indonesia, where the domestic banking sector was weakened by mounting nonperforming loans, the central bank deposited $1 billion of its international reserves in 12 foreign banks as a guarantee to letters of credit issued by Indonesian banks for the financing of imports by export-oriented firms. In addition, the government set up a hedging facility (swap and forward facility) for exporters, and a rediscount facility to provide liquidity for pre- and postshipment exports. These measures were deemed to be helpful; no claim was made on the fund deposited by the central bank for the letters of credit guarantee.
- In Korea, as trade financing shrank following the outbreak of the crisis in 1997, the Bank of Korea provided $2.3 billion from its foreign exchange reserves to commercial banks to finance imports of raw materials and purchase export bills of exchange from exporters.

Support from Bilateral Credit Agencies

Support from bilateral agencies was less common than intervention by crisis-country authorities, and was targeted to address *risk perceptions* through the use of guarantees as well as *liquidity shortages* through direct financing. For example:

- To support the Indonesian authorities' stabilization effort, the Japan Export and Import Bank (now JBIC) provided financing via the Bank of Indonesia to guarantee payment of letters of credit issued by local banks. The facility was hardly used at the beginning due to stringent qualification requirements and restrictions on lending for working capital. Utilization of the facility improved as the impediments were addressed.
- The U.S. Eximbank extended short-term credit lines to Korea during its 1998 crisis (amounting to $900 million), but this increase was largely offset by a reduction in long-term credit.

Intervention by International Financial Institutions (IFIs)

Intervention by multilateral development banks (MDBs) tended to focus on the provision of financing to both government agencies for onlending to the private sector and to private sector financial intermediaries for onlending to their corporate clients. In most cases, IFI initiatives addressed *liquidity concerns* through the provision of temporary financing, although in some cases guarantees were provided as a means of reducing *risk perceptions*. For example:

- During the Asian crisis, the Asian Development Bank (ADB) provided a loan to the Export and Import Bank of Thailand for onlending directly and through local banks to small and medium-sized export enterprises for pre- and postshipment export financing. Through a partial credit guarantee, the ADB supported a parallel syndicated loan that was much larger than its direct lending and effectively mitigated transfer and convertibility risks for the participating international creditors. Exporters' demand for ADB-supported trade finance facilities decreased as local commercial banks increasingly resorted to their own funds due to ease liquidity conditions. The ADB also supported trade finance in Pakistan by providing a political risk guarantee facility for international banks confirming letters of credit issued by Pakistani banks on behalf of small and medium-sized exporters.
- The International Finance Corporation (IFC), jointly with ABN-AMRO, set up a trade financing facility in Pakistan in 2000. This facility entailed IFC assuming a portion of the credit risk associated with trade finance business originated and booked by ABN-AMRO. During Brazil's financial crisis in late 2002, the IFC extended loans to Brazilian banks that are major players in the country's trade finance sector for the provision of pre- and postshipment export finance to their clients. The IFC loans were complemented with loans syndicated among several dozen international banks, as well as the Inter-American Development Bank

(IDB). A preliminary assessment by the IFC suggests that the IFC-supported trade finance facilities were successful—because of their de facto mitigation of perceived transfer and convertibility risk—in convincing international banks to re-extend trade funding that had been withdrawn and thus contributed to the government's crisis resolution efforts.

- The European Bank for Reconstruction and Development (EBRD) provided guarantees to foreign banks on their trade credit lines, which helped mitigate risk. While support provided under its Trade Facilitation Program was largely successful, interventions in Russia in the 1990s were less so because of the domestic banking crisis.

Agreements with International Banks

To address *collective action problems* following the withdrawal of trade credit lines by international banks, several crisis-country authorities reached agreements with these banks to maintain their cross-border exposure.[7] For example:

- In Brazil, an agreement was reached by the international banks in March 1999 to maintain their short-term credit lines (then approximately $25 billion) through August. The arrangement—helped by moral suasion from the authorities—was relatively informal and involved joint Brazil-IMF monitoring of credit levels.
- The government of Indonesia sought to induce major international banks to maintain trade credit exposure to the country in 1998 by asking banks to roll over trade exposure until the authorities could launch an offer to exchange short-term claims for medium-term bonds. The resulting agreement included clearance by the government of trade finance arrears owed by private Indonesian banks, which were recovered later, and a Trade Maintenance Facility under which foreign banks would open trade credit lines and maintain their exposure to Indonesian banks.

Several lessons can be gleaned from the experiences with past policy initiatives to address collapses in trade finance, which may help provide some guidance on key issues to be addressed before undertaking measures to preserve trade credit lines to crisis countries (see Box 1). As more data become available, an appraisal of the effectiveness of these initiatives will provide additional insight. This will, for instance, help to assess the extent to which financing mobilized under the umbrella of an MDB A/B loan structure is additional and to address the question of whether wider use of B loans would diminish the willingness of the private sector to sustain ongoing trade financing operations to emerging markets.

[7]The agreements called for banks to maintain cross-border exposure, including on interbank and trade credit lines, which would still permit banks to shift the composition of their overall exposure. Moral suasion from the central banks in creditor countries was important in some of these cases.

Box 1. Lessons from Past Initiatives

Five key lessons generally emerged from a review of the recent experience:

- **Macroeconomic adjustment and reform policies.** The implementation of macroeconomic and structural policies to address the underlying causes of the crises is a prerequisite for the restoration of confidence and the maintenance of trade credit lines. In some cases, this may prove to be sufficient to reverse the decline in trade (and other) credit flows. Without the right policy environment, trade finance initiatives are unlikely to be effective, no matter how appropriately designed.
- **Strength of the domestic banking system.** The lack of success of several initiatives highlights the importance of a sound domestic banking system in facilitating the flow of trade finance. The spillover of financial crises to the domestic banking system has affected the role of banks in the trade finance chain. As a result, trade finance facilities that relied heavily on intermediation by domestic banks were unsuccessful.
- **Targeted initiatives to support short-term pre- and postshipment export financing.** As noted above, many of the initiatives put forth by country authorities, IFIs, and official bilateral agencies focused on financing exports at the pre- and postshipment stages. In many cases, exporters require financing at these stages to undertake critical activities (including importing inputs) for the production of exportable goods. However, some observers noted that postshipment export financing is a problem of buyer's risk, which is different from the risk arising from preshipment export and import financing. Given the importance of exports in generating much needed foreign exchange and reinvigorating economic growth during a financial crisis, interventions rightly targeted this part of the export production process. Other initiatives—particularly those aimed at supporting key imports that are vital for production and export activities in a crisis country (such as energy)—may also merit consideration.
- **Role of key players.** Leadership and ownership by country authorities was seen as a crucial element in the effective design of initiatives and the restoration of private sector confidence. In addition, country authorities, through their knowledge of their economies, are arguably in the best position to provide short-term liquidity to the export sector during crises, when such intervention is warranted. Other institutions, such as MDBs and export credit agencies, are better equipped to provide external financing when needed to address confidence gaps or problems arising from risk perceptions. Some of these institutions, particularly export credit agencies, are likely to continue to have a relatively limited role. While export credit agencies did play key roles in the provision of financing in some cases, their focus on medium- and long-term credit, as well as institutional limitations under various formal and informal rules, suggests that without changes in their existing policies, most of these agencies would not be in a position to play a major role in the maintenance of short-term trade credit during financial crises.
- **Design of the initiatives**. The most successful initiatives satisfied several key criteria: (i) timeliness, in that the initiatives were put in place quickly and could also wind down quickly; (ii) appropriate pricing; and (iii) flexibility in design to ensure that the facility was actually used by the relevant parties. Going forward, it would be important to ensure that these initiatives are based on market principles and facilitate the resumption of private sector financing.

Structural Measures to Strengthen Trade Finance Facilities

The review of recent country cases indicates that efforts to facilitate the financing of trade should focus not only on crisis episodes but also on appropriate structural changes which can, and probably should, be taken to enhance the efficiency of capital markets and to reduce the severity of crises. In this regard, a range of measures could be considered to diversify risks and improve the functioning of market institutions.

Risk Differentiation by Rating Agencies and Bank Regulators

- It has been noted that assessments of credit risk by international rating agencies have focused heavily on transfer and sovereign credit risk and that rating agencies could be encouraged to take a more differentiated view of trade credits. Explicit ratings differentiation between trade finance assets and other categories of emerging market credit exposure may help reduce the sensitivity of trade credit lines to changes in perceived transfer and sovereign credit risk. It could also open the door for wider use of capital market structures for trade finance (see below).
- Some have suggested that more homogenous treatment by banking regulators of implicit or explicit seniority of appropriately documented pre- and postshipment export trade finance transactions could help reduce the pressure for banks to cut trade finance exposure to emerging markets. Bank regulators in several European countries provide explicit provisioning benefits for credit exposure taken by banks within their national jurisdictions when assets being funded or acquired are included in syndication structures. However, other countries leave it up to the banks to decide how they should provision for a certain loan. The implementation of new generation of general prudential guidelines (Basel II) may strengthen the relation between trade credit and internal bank capital allocation. This and other implications of Basel II need to be explored.

Expanded Use of Capital Market Structures for Trade Finance

- With greater risk differentiation by rating agencies and development of a country's legal infrastructure, asset-backed securitization funding structures for trade finance could be more widely used in emerging markets, thereby reducing their reliance on international commercial banks for trade finance. Structured financing diversifies risks to capital and money market investors who are much less leveraged than banks and hence less risk averse. The potential benefits as well as limitations of structured financing would need to be explored further.
- In addition, where possible, increased use of domestic market liquidity (e.g., pension funds) to fund trade finance would also help diversify risk and provide a relatively secured asset class for domestic investors. Nevertheless, there is some question whether pension funds could be a source of significant trade financing.

Risk Sharing Among MDBs, Export Credit Agencies, and Private Insurers

Multilateral development banks, including the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, could explore ways to play a more prominent role in addressing the transfer and convertibility concerns of international insurers.

- An MDB could act as "insurer-of-record" for a particular insurance policy being underwritten on behalf of an emerging markets borrower, but reinsure much of the underwritten policy with other insurers. The MDB's preferred creditor status, arising from the actual assumption of contingent credit exposure to an emerging market borrowing entity, would provide transfer and convertibility risk mitigation to other participant insurers.
- There may be scope for exploring more risk-sharing between the MDBs, especially their private sector windows, and other public and private export credit institutions, including in the political risk insurance market.

Possible Modification of the Incentive Structure Governing Official Export Credit Agencies

- Export credit agencies may give consideration to allowing a special exception to normal credit-risk practices of bilateral export credit agencies in crisis situations.[8] This may allow the agencies, where appropriate, to participate in risk-sharing arrangements with other external creditors or a crisis-country central bank or to provide emergency support as part of internationally-coordinated adjustment programs.
- Formal or informal international rules, such as the WTO rules on subsidies and the Organization for Economic Cooperation and Development Consensus Arrangement or the relevant OECD guidelines, could be modified where warranted and supported by international consensus to help remove the disincentives to countercyclical operations of export credit agencies.
- Export credit agencies could also be encouraged to make full use of available risk mitigants, including instruments already used by the private sector, such as derivatives, third-party guarantees, collateralized lending, and local currency lending where possible.
- Greater clarity could also be provided to export credit agencies about the likelihood of future debt restructuring under the auspices of the Paris Club, which may have contributed to a cautious stance on new lending.

[8]A number of export credit agencies operate what is commonly referred to as a "national interest account" for which certain cases can be underwritten, which are outside the agencies' normal criteria.

Regional Approaches to Deal with Intraregional Trade

Intraregional trade is a significant share of external trade in many emerging markets and such trade may not be financed by industrial country-based commercial banks. While more evidence needs to be collected for an assessment of the problems and possible remedies, participants in this market may be influenced by the collective action problems mentioned earlier. Regional economic/trade forums could possibly be used to devise appropriate responses in the event of crisis. Promoting intraregional trade in ways consistent with WTO norms could reduce emerging markets' reliance on trade financing from industrial countries and help diversify risk. Various ways to support finance for intraregional trade may be worth exploring.

Medium-Term Export Financing

Medium-term export financing is an important dimension of trade credit, both for necessary capital goods and project-related imports into a crisis country and for selected capital goods exports from the country. During recent financial crises, medium-term trade financing to the crisis countries also declined sharply. Wider use of structured financing and improvements on the incentive structure governing export credit agencies as discussed in the previous sections would help mitigate the decline and facilitate an early resumption of new credits. The latter is important for economic recovery in a crisis country.

Institutional Reforms by Emerging Markets

Institutional reforms are important for strengthening the legal framework for international transactions, fostering competition in foreign trade and trade finance sectors, and deepening local capital markets. Steps to strengthen banking supervision, address nonperforming loans, and improve corporate governance could help mitigate the fall in credit during a crisis. An effective macroeconomic and structural policy response to the pressures that arise during financial crises would also help minimize the adverse effects of a collapse in trade financing.

A Possible Framework for Trade Finance in Crisis Resolution

The effectiveness of the various recent initiatives and the lessons drawn offer insights into possible elements of a broad framework to help mitigate a collapse of trade finance in a crisis. While the focus needs to be on implementing the right macroeconomic policies, there may be circumstances where, even in the presence of a sound macroeconomic reform strategy, targeted support to the trade sector could be usefully employed. This could arise where (i) solvent enterprises and exporters in a crisis country, due to heightened risk aversion, are unable to access trade finance as external creditors either cannot or are unwilling to provide such financing; and/or (ii) the relevant sovereign's ability to provide credible guarantees required by external trade finance

providers is limited. In these situations, timely and appropriate external support could help enable country authorities, by implementing an adjustment program, to address the market failures that can contribute to the collapse in trade finance.

Recent experiences suggest that, while the different characteristics of each particular crisis would require careful assessment and actions tailored to the specifics of each case, an effective approach could be built around MDB trade finance facilities in support of actions by the country authorities to facilitate a resumption of private sector financing, complemented by a more coordinated approach by export credit agencies. In some cases, this could be reinforced by efforts to encourage private banks to maintain interbank lines. The following outlines elements of such an approach where further considerations may be useful.

Measures by Country Authorities

Removing policy uncertainty early on would go a long way in reducing perceived risks. At the time of an imminent crisis, export creditors and insurers would benefit from improved clarity on the country's macroeconomic policies and on the views of the international financial institutions, especially with respect to the foreign exchange regime. An early dialogue between the authorities and trade credit providers and insurers would help set the stage for closer consultation and more coordinated action in crisis resolution. It would also be beneficial were country authorities to have the capacity to monitor short-term debt, including trade finance.

In addition, steps could be taken by crisis-country governments to signal their willingness to address the decline in trade finance**.** In this regard, a range of options for helping induce a quick resumption of trade finance by the private sector might include:

- Making foreign exchange available for appropriately documented pre- and postshipment export trade finance transactions. Maintaining short-term trade credit lines can help support foreign exchange-generating activities. Such credits have considerably less performance and credit risk than other types of cross-border debt.
- Facilitating risk sharing among private and public domestic and foreign creditors and insurers. In exceptional cases and as part of a credible adjustment program, country authorities could use part of their foreign exchange reserves to provide guarantees for new credit extended by the private sector. Authorities should make a commitment that trade-related external credit would not be affected by any future foreign exchange transfer and convertibility restrictions or debt moratorium or rescheduling. Some market participants argue that explicit provision of "de jure" seniority of trade credit would be valuable.

Efforts by the Official Sector

By providing temporary short-term trade finance liquidity, timely intervention by official sources of financing may help in avoiding a collapse in trade financing and preventing a

liquidity crisis from becoming a solvency crisis. Such financing could be provided by the country's central bank or fiscal authorities with resources from multilateral creditors or official bilateral creditors.

The effectiveness of such intervention depends on a timely and correct diagnosis of the underlying causes behind the trade finance decline, particularly the relative roles of local and foreign banks and other providers of trade credit. In addition, official financing would need to be provided so as to minimize moral hazard and to facilitate the resumption of private sector funding. Drawing on past experiences, the financial health of the domestic banking sector would be of particular importance to the success of such initiatives because of the following.

- In countries with a relatively sound banking system, local banks could be used to channel short-term credits to the trade sector. Foreign exchange liquidity could be made available via commercial auctions to prequalified banks that are leading players in a country's foreign trade finance sector. These banks, with their networks and information on subborrowers, would be better positioned to deal with adverse selection and moral hazard problems.

- In cases where the domestic banking system has experienced systemic distress and banks are unable and unwilling to provide trade finance, official intervention would need to be channeled through other means. A number of approaches have been suggested. The relevant central bank could provide guarantees to enhance the acceptance of letters of credit issued by domestic banks. It could provide liquidity to the export sector by purchasing export bills of exchange from export enterprises or by setting up discount facilities to support appropriately documented pre- and post–shipment export transactions. In certain situations, nonbank financial entities or structures may need to be established to channel official financing with domestic banks handling trade finance transactions.

Recent experience suggests that MDB trade finance facilities, properly designed and implemented, can be effective in mobilizing additional private sector funding during a period of heightened risk aversion. MDB support, where appropriate, could include direct provision of financing or guarantee of financing to government agencies and intermediaries for onlending to the private sector. MDB trade finance facilities could also provide risk pooling opportunities for private and public trade credit lenders and insurers, for instance through the use of a A/B loan structure, making use of their respective comparative advantages in operation and risk taking.

Most official export credit agencies, as currently structured, are generally not well equipped to fill short-term trade financing gaps in times of crisis**.** However, export credit agencies are not a homogenous group, and, in some cases, some have played key signaling roles in helping to restore the confidence of the private sector and reinstating trade credit lines. In partnership with MDBs or country authorities, some agencies have provided short-term lines of credit to crisis countries. Export credit agencies could explore ways to play more of a countercyclical role, especially in the recovery stage, when a country is undertaking an internationally supported adjustment program. This could include facilitating medium- and long-term financing for investment in emerging

markets, and rolling over or expanding short-term credit lines, including expiring maturities of originally longer-term credits.

The IMF may be able to play a supporting role in facilitating a country's efforts to address a decline in trade finance. In situations where the authorities have sought Fund financing in support of an adjustment program and there are concerns about the loss of access to trade finance, IMF staff could facilitate the country authorities' efforts in exploring ways to encourage the maintenance of trade finance to the country, and Fund programs could build in the flexibility to accommodate the use of external resources and foreign exchange reserves in support of well-designed trade finance schemes.

Efforts by the Private Sector

The involvement of private trade credit providers can help facilitate a rapid return to confidence and financing. Such participation could be in the form of a formal or informal agreement between the country authorities and international commercial banks to maintain these banks' trade credit exposure to the country.