Access to Trade Finance in Times of Crisis

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INTERNATIONAL MONETARY FUND
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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

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\(^1\)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.
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. 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

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Footnote:

4Exports 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.
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 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

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6As 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-expend 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. 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.

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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. 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.

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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 an 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.
Part I

Contraction of Trade Finance During Crises
Trade Finance and Financial Crises

William R. Cline

Is There a Problem?

Are declines in externally provided trade credits a serious problem for a country’s crisis resolution efforts? My answer, in short, is yes. Trade credit lines are short term in nature and routinely rolled over under normal circumstances. However, when a country enters a crisis, foreign lenders tend not to renew such credit lines for fear of being caught up in some form of suspension, or simply because of concern about greater default risk by firms now facing more difficult circumstances. Similarly, official bilateral export credit agencies also tend to curb lending during crises following general prudential guidelines.

It is useful to ask about why supply and demand doesn’t resolve the problem through a modest rise in the risk spread of the credit. Thinking further about this, however, leads toward a powerful conclusion: it is extremely difficult to compensate significant expected capital losses through higher interest on short-term paper. In the Scandinavian banking crisis in the early 1990s, overnight bank rates rising to 500 percent reflected a significant capital loss risk that was being compensated by a meteoric interest rate for a very short period.

Consider, for example, a country that goes from no risk to a 10 percent loss probability. On its 10-year paper, the spread has to rise 150 basis points (Table 1.1). Over the life of the new bond, enough extra interest can be collected (an extra 15 percent cumulative) to compensate the rise in expected loss. But if the country has an expected loss of 10 percent during the next four months, and the interest on a four-month credit has to compensate, then this short-term loan will have to bear a spread of 3,000 basis points, that is, 30 percent. Thirty percent annually on a four-month obligation yields the 10 percent insurance against capital loss. In practice, the lender will simply not issue the loan rather than issue it at an annual interest rate of 30 percent. The basic point is that we can expect short-term credit volumes to be cut back rapidly in a crisis, rather than a smooth adjustment by a minor increase in interest rate.

9William R. Cline is a Senior Fellow at the Institute for International Economics (IIE).
Table 1.1. Required Spread to Compensate for an Expected Capital Loss of 10 Percent

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10-year bond:</td>
<td>150 basis points</td>
</tr>
<tr>
<td>4-month credit line:</td>
<td>3,000 basis points</td>
</tr>
</tbody>
</table>

What is the experience of short-term trade flows during crisis? Figure 1.1 shows the level of total short-term external debt in the year before the crisis and the crisis year for six country cases. The largest drop was in Korea (where short-term debt was even higher the year before what is shown in the figure), but the short-term debt there went far beyond trade credit. The other crisis episodes all show substantial drops in short-term debt, however, and typically a runoff in trade credit was involved. In Argentina, from June 2001 to June 2002 total short-term debt fell by more than 50 percent.

The above data do not discriminate among types of trade credit. It appears, however, that the most sensitive trade credit is for export prefinance. This is essentially a loan to the export firm not secured against goods already in the process of being shipped. Where there is a letter of credit against actual goods, there is physical collateral so the trade credit holds up better in a crisis.

Do such cutbacks represent a serious problem? Available evidence suggests so. One of the most serious effects of a collapse in trade credits is the adverse impact on exports, which—even after the benefits of the depreciation that accompany most crises—tend to be held back by the absence of sufficient trade credits. The increase in exports is critical not just to provide greater foreign exchange earnings, but also to generate a source of demand that offsets the reduction in domestic demand associated with fiscal tightening and the reaction of households to lower real incomes. On both these counts, therefore, the collapse of trade credits is a major problem and the removal of obstacles that stand in the way of an export recovery should be a top priority.

What Kind of Remedies Might Work?

To the extent that there is widespread agreement that a problem exists, a second key question for consideration relates to the type of remedies that might be put in place. In this regard, remedies typically used in much earlier crises are unlikely to be useful. In particular, the debt crises of the 1980s consisted of obligations owed to commercial banks that were often rescheduled through the London Club framework during times of distress. As there was recognition that countries needed to achieve export growth in order to service the debt, there tended to be side agreements providing that short-term credit lines, especially trade credits, would be maintained at existing levels.

The past tendency to exempt short-term trade credits from reschedulings played a role in encouraging banks to lend in this category more than in longer-term debt. One review of
190 cases of London Club reschedulings from 1979 through 1999 found that in more than two-thirds of the cases, there was no suspension in payments on trade credit. Where there were suspensions, three-fourths of the cases involved trade credit maintenance agreements with no loss of principal or interest. Where there was default with loss—in only 17 of 190 cases—the loss was modest, only 11 percent. This experience has meant that in banks’ internal economic capital allocations there tends to be a lesser risk weight attached to short-term trade credit than to longer term credits.

In today’s capital markets, however, long-term syndicated loans from commercial banks no longer comprise much of the debt. Instead, long-term debt tends to be in the form of bonds, and the opportunities to utilize side agreements protecting trade and short-term credits tend not to arise.

Under these circumstances, special coordinated efforts among international banks to deal with short-term debt can help. Two episodes are prime examples:

- In Korea in 1998, after much of the short-term debt (which reached some $100 billion and included debt far beyond that related to trade) had already run off, it became necessary to supplement the initial IMF support package with an agreement converting $22 billion in short-term credits of international banks to Korean banks into three-year paper at somewhat higher spreads than before and with the guarantee of the Korean government. This stretching out of maturities...
offered by this deal proved crucial to halting the downward spiral of confidence and setting the stage for stabilization and adjustment.

- In Brazil, a less formal arrangement was reached by the international banks in March 1999 to maintain their short-term credit lines (then approximately $25 billion) through August. Some key banks interpreted the agreement to be contingent on the Brazilian government implementing promised policy adjustments. The arrangement was relatively informal in part because the Brazilian authorities were extremely reluctant to engage in anything that appeared to be a forced rescheduling of debt, in order not to jeopardize the credit standing Brazil had rebuilt after the debt crisis of the 1980s. The closest thing to a formal component of the arrangement was a form of joint Brazil-IMF monitoring of credit levels. The arrangement was successful, and the voluntary nature of the approach helped avoid a slide toward default and capital controls—which might have been a greater risk if instead there had been some mandatory form of “stay” imposed on credits.

What Are Appropriate International Policy Responses?

One response by the international community in recent years has been to search for systemic disincentives to short-term capital, with a view to limiting their excessive volatility. Short-term lending developed a negative reputation in the East Asian crisis, and countries such as Chile, which imposed tax disincentives to short-term debt, have enjoyed some insulation from the capital market crises of the late 1990s. In addition, it is notable that the Basel Committee reforms for the capital risk-weightings of banks are considering boosting capital requirements against short-term loans.

The challenge of any such initiatives is to arrive at a balance that provides scope for disincentives to excessive short-term debt while retaining creditor confidence that legitimate trade credit will tend to have less default risk than longer-term credit. This challenge is difficult, as short-term financial flows unrelated to trade can be reported as trade credit for regulatory purposes, as occurred in Brazil in the mid-1990s when more favorable treatment resulted in a ballooning of reported short-term credit beyond traditional levels relative to trade. At the same time, some recent initiatives, such as the first version of the IMF’s proposed Sovereign Debt Restructuring Mechanism, had included elements that could have heightened the perceived risk of legitimate short-term credit, most notably some form of an IMF-sanctioned “standstill” enforced by a “stay of litigation.”

Other responses by the international community can be centered on bilateral credit agencies, which could help by adhering to a code of conduct whereby short-term credit lines—including expiring maturities of originally longer-term credits—would be rolled over or expanded so long as the country is in an IMF-supported adjustment program. Although the U.S. EXIM Bank did have a modest expansion of short-term lines to Korea during that country’s 1998 crisis (amounting to some $900 million), this increase was largely offset by a reduction in long-term credit, and medium- and longer-term
credits fell in the crisis cases of Russia and Indonesia. The Japan Bank for International Cooperation played a considerably more active role in providing financing in the principal financial crisis cases. What is broadly needed is a special exception to normal credit-risk practices of bilateral agencies, which understandably curb lending when countries’ credit ratings fall, to provide for emergency support as part of internationally-coordinated adjustment programs.
This chapter assesses the effect of constrained trade finance on trade flows in countries undergoing financial and balance of payments crises. Most of the countries that had a major external crisis had a significant trade contraction, while trade-related finance declined sharply (Figure 2.1).

Despite anecdotal evidence that the contraction of trade financing may have affected trade, there has been to date only a few empirical studies assessing the effect of constrained trade finance on trade flows. In addition, trade may have also been affected by other variables such as world demand, domestic demand, banking crises, changes in export and import prices, and real exchange rate depreciation.

A closer look at the data does not provide a clear-cut relationship between trade and trade finance. Table 2.1 summarizes trade indicators, external short-term credit (as a proxy for trade financing—see the section in this chapter on data), and real exchange rates for 10 crisis countries. Although overall export and import values in U.S. dollars fell, only import volumes contracted sharply, by 20 percent on average, while export volumes increased by 10 percent on average (albeit slightly below the three-year trend growth of 11.7 percent preceding the countries’ crises).

Some observers argue that the sharp decline in import volumes and the slowdown in export volume growth are closely related to the collapse of trade financing, as external outstanding short-term credit to crisis countries fell by 20 percent in real terms compared to precrisis levels. However, the decline in trade financing seems to have had little effect on export volumes, while the fall in import volumes could have been caused by the sharp real devaluation and fall in domestic demand that followed each crisis (Table 2.1 and Figure 2.2).

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10Marcio Ronci is an economist at the International Monetary Fund. The author wishes to thank Charalambos Tsangarides, Shang-Jin Wei, Yo Kikuchi, Lisandro Abrego, Jian-Ye Wang, Jan Gottschalk and Luís Catarino for comments, and Gloria Moreno and Kadima Kalonji for assistance with the data.

11This view was shared by various market participants and authorities in a seminar on trade financing organized by the IMF on March 27, 2003 (see IMF, 2003).

12There is evidence that foreign bank lending to emerging countries is procyclical (see Jeanneau and Micu, 2002).
Table 2.1. Trade, External Short-Term Credit, and Real Exchange Rate in 10 Crises (Annual percentage change)

<table>
<thead>
<tr>
<th></th>
<th>Values in U.S. Dollars</th>
<th>Volume Indexes</th>
<th>Outstanding External Short-Term Credit (in U.S. dollars)</th>
<th>Real Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports</td>
<td>Imports</td>
<td>Exports</td>
<td>Imports</td>
</tr>
<tr>
<td>Weighed average 2</td>
<td>-4.3</td>
<td>-29.1</td>
<td>10.6</td>
<td>-21.3</td>
</tr>
<tr>
<td>1997-98</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>-7.3</td>
<td>-26.6</td>
<td>4.5</td>
<td>-17.8</td>
</tr>
<tr>
<td>Philippines</td>
<td>16.9</td>
<td>-18.6</td>
<td>19.4</td>
<td>-19.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>-6.8</td>
<td>-33.8</td>
<td>8.5</td>
<td>-27.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>-8.5</td>
<td>-27.4</td>
<td>3.1</td>
<td>-11.2</td>
</tr>
<tr>
<td>Korea</td>
<td>-4.7</td>
<td>-36.2</td>
<td>19.6</td>
<td>-23.1</td>
</tr>
<tr>
<td>Russia</td>
<td>-14.3</td>
<td>-19.4</td>
<td>3.9</td>
<td>-18.0</td>
</tr>
<tr>
<td>1998-99</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>-6.1</td>
<td>-14.7</td>
<td>7.7</td>
<td>-4.9</td>
</tr>
<tr>
<td>2000-01</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>0.8</td>
<td>-19.8</td>
<td>4.6</td>
<td>-17.3</td>
</tr>
<tr>
<td>Turkey</td>
<td>11.9</td>
<td>-26.8</td>
<td>15.6</td>
<td>-23.0</td>
</tr>
<tr>
<td>1994-95</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>14.0</td>
<td>-21.4</td>
<td>8.3</td>
<td>-25.5</td>
</tr>
</tbody>
</table>

1Deflated by U.S. whole industrial price.
2Volume changes were weighed using exports (imports) share in the total exports (imports).
3The increase in short-term credit during the crisis was largely due to a gas pipeline project under the Black Sea.
In addition to trade finance, other factors may have affected trade volumes, including exchange rates, relative prices, and domestic and external demand. To control for the various factors that may have affected trade flows during crises, we estimate export and import volume equations including trade financing as an explanatory variable.

This chapter describes the data used and their limitations, discusses model specification and econometric estimation, and presents the estimation of the export and import volume equations and the trade volume-to-trade finance elasticities.

Data

Table 2.2 presents the definitions of variables used in this chapter. We used as a proxy for trade financing flows the change in outstanding short-term credit in U.S. dollars as reported in Global Development Finance (GDF), which includes short-term credit for trade as reported by the Organization for Economic Cooperation and Development (OECD).

![Figure 2.2. Real Effective Exchange Rates](image)


1Average of the 10 countries.

Note that the trade financing flow $F_{jt}$ is defined as the first difference of the logarithm of the outstanding short-term credit $D_{jt}$: $F_{jt} = \log D_{jt} - \log D_{jt-1}$, which is approximately equal to the change of $D_{jt}$ in percent as $
log D_{jt} - \log D_{jt-1} \approx \log(D_{jt}/D_{jt-1}+1) \approx \Delta D_{jt}/D_{jt-1}$ according to the well known result $\log(1+x) \approx x$ if $x < 1$.  

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and the international banks’ short-term claims as reported by the Bank for International Settlements (BIS). However, using GDF short-term credit as a proxy for trade financing has limitations: it excludes trade financing associated with intrafirm trade by multinational corporations (including most processing trade), and trade related to foreign direct investment.\textsuperscript{14} Also, trade financed by domestic banking sources may not be responsive to external trade financing reported in the BIS statistics. We used a dummy variable for domestic banking crisis as trade financing supply is also related to the ability of domestic banks to intermediate foreign trade financing.

The panel data consists of 10 countries over 10 years, which yields a sample of 100 observations. We were constrained to use annual data, as most of the variables have annual frequency. Also, we did not include more annual observations, as we are interested in the trade finance effects on trade around the crisis year, and we would expect that observations far away from the crisis year would add little information on trade finance on trade flows during crisis.

We tested all variables for each country (Table 2.3) for unit roots and found a fair amount of disagreement among the different tests, which may be partly due to the

\textsuperscript{14}Some market participants estimate that about half of all trade is financed outside the banking system.
Table 2.3. Unit Root Tests

<table>
<thead>
<tr>
<th>Variables</th>
<th>Levels</th>
<th>First difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Im, Pesaran and Shin Prob.</td>
<td>PP – Fisher Chi-square Prob.</td>
</tr>
<tr>
<td>logXj,t</td>
<td>-0.6272 0.2653</td>
<td>22.8877 0.2943</td>
</tr>
<tr>
<td>logMj,t</td>
<td>0.5313 0.7024</td>
<td>11.3702 0.9361</td>
</tr>
<tr>
<td>logXWj,t</td>
<td>0.1605 0.5637</td>
<td>28.6842 0.0942</td>
</tr>
<tr>
<td>logYWj,t</td>
<td>0.0023 0.5009</td>
<td>81.3817 0.0000</td>
</tr>
<tr>
<td>logYj,t</td>
<td>0.7378 0.7697</td>
<td>14.9383 0.7799</td>
</tr>
<tr>
<td>logRELPXj,t</td>
<td>0.1355 0.5539</td>
<td>23.6117 0.2598</td>
</tr>
<tr>
<td>logRELPMj,t</td>
<td>0.0549 0.5219</td>
<td>24.2112 0.2333</td>
</tr>
<tr>
<td>FINj,t</td>
<td>-0.9160 0.1798</td>
<td>91.9535 0.0000</td>
</tr>
</tbody>
</table>

**Null hypothesis:** Unit root assuming individual unit root process (see Kim and Maddala, 2001, pp. 134-37).

There is some evidence that most variables are nonstationary in levels but for FIN.

An overview of the data shows that in most countries, external short-term credit fell significantly in real terms following the crisis year (Figure 2.3), while export volumes continued to grow (Figure 2.4) and import volumes fell (Figure 2.5).

However, the sharp depreciation of national currency increased export and import relative prices (Figures 2.6 and 2.7), which may have boosted exports and weakened imports.

Also, at the time of the crisis, the countries did not face a fall in world demand, as world gross product continued increase (Figure 2.8). This certainly contributed to support exports, while most of the sample countries faced a sharp contraction of their GDP, leading possibly to lower demand for imports (Figure 2.9).

---


16In addition to testing presented in Table 2.3, we also tested for common unit root process among countries (Levin, Lin and Chu, and Breitung t-statistics) and the results were also mixed.

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Model Specification and Econometric Estimation Methodology

The data presented in the previous section suggest that other factors may have affected export and import volumes during crises in addition to trade finance. To control for the various factors that may have affected trade flows during crises, we estimate export and import volume equations, including trade financing as an explanatory variable, using panel data with observations for each variable centered on the crisis year.

Our basic equations have the following simple specifications:

\[
\log X_{ij} = a_0 + a_1 \log X_{ij} + a_2 \log RELPX_{ij} + a_3 \text{FIN}_{ij} + a_4 \text{DUMMY}_{ij} + v_{ij} \quad (1)
\]

\[
\log M_{ij} = b_0 + b_1 \log Y_{ij} + b_2 \log RELPM_{ij} + b_3 \text{FIN}_{ij} + b_4 \text{DUMMY}_{ij} + u_{ij} \quad (2)
\]

where \( t \) time annual observations centered around the crisis year (\( t = -4, -3, -2, -1, 0, +1, +2 \)) and \( t = 0 \) year in which crisis began, where \( j \) – country (Argentina, Brazil, Indonesia, Malaysia, Philippines, Russia, South Korea, Thailand, Turkey, and Mexico), where \( M \) and \( X \) are import and export volumes, \( RELPX \) and \( RELPM \) are the export and import relative price indexes, \( FIN \) is trade-related finance, \( Y \) domestic demand, \( XW \) world trade.
volume index, and $DUMMY$ is a dummy for domestic banking crisis (equal 1 for banking crisis and 0 if is not the case).\footnote{Our selection of explanatory variables was guided by two survey studies: Goldestein and Khan (1985) and Fullerton (1999). For an example of import equation specification, including an external financing variable, see Resende (1997 and 2001).}

The error terms $u$ and $v$ are assumed to have zero mean and constant variance and not autocorrelated. The expected coefficient signs for the export equation are: $a_1 > 0$, $a_2 > 0$, $a_3 > 0$ and $a_4 < 0$. The expected coefficient signs for the import equation are:

$b_1 > 0$, $b_2 < 0$, $b_3 > 0$ and $b_4 < 0$.

As the unit root tests suggest that most of variables are nonstationary in levels (Table 2.3), we estimated the first difference of equations (1) and (2), including two lags for each first differenced variable.

We estimated equations (1) and (2) using generalized least squares (GLS), instrumental variables (IV), both with fixed effects and generalized method of moments (GMM). The GLS recognizes the nonsphericalness of the error terms $u$ and $v$ and is more efficient.
Figure 2.5. Import Volume Indexes
(Observations centered around the crisis year = 100)

Source: IMF, World Economic Outlook.
Average of the 10 countries.

Figure 2.6. Export Relative Price Indexes
(Observations centered around the crisis year = 100)

Source: IMF, World Economic Outlook.
Average of the 10 countries.
than LS, particularly in the case of heteroskedasticity. The IV and GMM estimation addresses simultaneity and errors in variable measurement. In particular, measurement error in the trade finance variable may be serious, as there is no reliable data source. Finally, we tested all restrictions on the coefficients of equations (1) and (2) by means of Wald tests to determine a more parsimonious model specification, including the fixed effects assumption.

### Estimation Results

Estimation of equations (1) and (2) suggests that trade finance affects both export and import volumes in addition to relative prices and income. Trade financing explains a relatively small part of the fall of trade flows in recent crisis, as trade volume elasticities to trade financing are small, while a fall in trade financing in connection with domestic banking crisis can lead to a substantial loss of trade.

Tables 2.4 and 2.5 summarize the estimation results. Overall, all variables have the expected signs and most of the coefficients are significant at 1 and 5 percent levels. IV

---

18 Equations (1) and (2) were also estimated using the real effective exchange rate index as an alternative to relative prices, and the results were broadly the same.
Figure 2.8. World Real GDP Index for Each Country at the Time of its Crisis
(Observations centered around the crisis year)

Source: IMF, World Economic Outlook.

1Average of the 10 countries.

Figure 2.9. Countries' Real GDP Index
(Observations centered around the crisis year = 100)

Source: IMF, World Economic Outlook.

1Average of the 10 countries.
and GMM estimates do not differ significantly from GLS estimates, indicating that the results are relatively robust. The statistic Durbin-Watson suggests there is no autocorrelation, and the common intercept hypothesis is rejected at 5 percent.

Trade financing affects both export and import volumes positively, as expected, but its coefficients are relatively small. The elasticity of export volume with respect to trade financing is estimated between 0.02 and 0.04, and is statistically significantly different from zero, while the elasticity of import volume with respect to trade financing is about 0.10, and statistically significantly different from zero in two of the four regressions. The coefficient of the dummy variables for domestic banking crises is relatively large and significant in both equations. The dummy variable explains about 7 percent and 10 percent of the fall in export and import volumes, respectively, compared with precrisis volumes in those countries affected by domestic banking crisis.

Table 2.4. Export Volume Equations

\[
\begin{array}{cccc}
\text{Explanatory Variables} & \text{GLS} & \text{IV}^1 & \text{GMM}^1 & \text{GMM}^1 \\
\hline
\Delta \log XW_{j,t} & 0.2731 *** & \ldots & \ldots & \ldots \\
\Delta \log XW_{j,t-1} & \ldots & 0.2892 * & 0.4133 *** & 0.2953 *** \\
\Delta \log RELPX_{j,t} & 0.0377 *** & 0.0420 ** & 0.0180 *** & 0.0638 *** \\
\Delta FIN_{j,t} & 0.0177 *** & 0.0135 *** & \ldots & \ldots \\
\Delta FIN_{j,t-1} & \ldots & \ldots & 0.0387 ** & \ldots \\
\text{Dummy} & -0.0666 *** & -0.0752 *** & -0.0170 & -0.0550 *** \\
AR(1) & 0.1167 *** & 0.1170 *** & \ldots & \ldots \\
\hline
\text{Number of observations} & 80 & 80 & 80 & 80 \\
\text{R-squared} & 0.75 & 0.75 & 0.31 & 0.30 \\
\text{Durbin-Watson stat.} & 2.031 & 2.324 & 2.334 & 2.072 \\
\text{Common intercept F-test} & 4.020 ** & 3.000 ** & \ldots & \ldots \\
\end{array}
\]

Notes: (*) significant at 10 percent level, (**) significant at 5 percent level, and (***) significant at 1 percent level.

We defined \( \Delta \log Z_t = \log Z_t - \log Z_{t-1} \).

1 Instruments: lagged world demand, real domestic credit and real exchange rate, and dummy for banking crisis.

2 The common intercept restriction rejected at (**) 5 percent level.
Table 2.5. Import Volume Equations

(Dependent Variable: ΔlogMj,t)

<table>
<thead>
<tr>
<th>Explanatory Variables</th>
<th>GLS</th>
<th>IV1</th>
<th>GMM</th>
<th>GMM1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fixed Effects</td>
<td>Fixed Effects</td>
<td>Fixed Effects</td>
<td>Dynamic</td>
</tr>
<tr>
<td>ΔlogMj,t-1</td>
<td></td>
<td></td>
<td></td>
<td>-0.0489 *</td>
</tr>
<tr>
<td>ΔlogYj,t</td>
<td>2.4571 ***</td>
<td>1.7757 ***</td>
<td>1.9086 ***</td>
<td>1.8337 ***</td>
</tr>
<tr>
<td>ΔlogRELPMj,t</td>
<td>-0.2024 ***</td>
<td>-0.1782 **</td>
<td>-0.1453 *</td>
<td>-0.1267 ***</td>
</tr>
<tr>
<td>ΔFINj,t</td>
<td>0.1420</td>
<td>0.1213 *</td>
<td>0.1026</td>
<td>0.0798 ***</td>
</tr>
<tr>
<td>Dummy</td>
<td>-0.0891 *</td>
<td>-0.1141 **</td>
<td>-0.1106 **</td>
<td>-0.1138 ***</td>
</tr>
<tr>
<td>Number of observations</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>80</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.77</td>
<td>0.69</td>
<td>0.69</td>
<td>0.5300</td>
</tr>
<tr>
<td>Durbin-Watson stat</td>
<td>1.998</td>
<td>2.244</td>
<td>2.251</td>
<td>2.9690</td>
</tr>
<tr>
<td>Common intercept F-test1</td>
<td>4.500 **</td>
<td>3.0600 **</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>

Notes: (*) significant at 10 percent level, (**) significant at 5 percent level, and (***) significant at 1 percent level.

1We defined ΔlogZi = logZi - logZi,t-1.

1Instruments: lagged world demand, real gross domestic product, real domestic credit, real exchange rate, trade finance, and dummy for banking crisis.

2Linear dynamic panel data estimation (Arellano-Bond, 1991).

3The common intercept restriction rejected at (**) 5 percent level.

Conclusions

Our results suggest that trade finance positively affects both export and import volumes as well as relative prices and income in the short run. A fall in trade financing in connection with a domestic banking crisis can lead to a substantial loss of trade, while trade financing (narrowly defined here as externally provided short-term bank credit) explains a relatively small part of the fall of trade flows in recent crises, as elasticities of trade volumes with respect to trade financing are small.

Table 2.6 summarizes trade financing effects on export and import volumes. A domestic banking crisis has a large effect on exports and imports, possibly because domestic banks are not able to intermediate foreign trade financing. The domestic banking crisis dummy explains a fall in exports of about 6 percent and in imports of about 10 percent compared with precrisis levels. In contrast, the estimated elasticities are small, and a fall of 20 percent in trade finance—as shown in Table 2.1—explains only a decline of about 1 percent in exports and 2 percent in imports. The low elasticities of trade volumes with respect to trade financing reflect the fact that a large part of exports is financed either from domestic sources or outside the banking system. As a result, export volumes are not very sensitive to changes in available data on externally provided short-term bank trade credit.
These results provide some justification to policies aimed at supporting trade financing during a crisis, particularly when domestic banks are in distress and are unable to intermediate foreign trade financing. At the same time, they point out that disruptions in trade financing explain part of the total fall of trade flows in recent crises, and that other policies are needed to address each country’s external vulnerabilities, in particular large macroeconomic imbalances, banking system distress, low external reserves, and unsustainable external debt.

**Appendix 2.1. Variables and Data Sources**

Import and export in U.S. dollars as reported in *International Financial Statistics* (IMF).

Import and export volume indexes ($M_j, t$ and $X_j, t$) as reported in *World Economic Outlook* (IMF).

Real effective exchange rates ($ER$) and nominal exchange rate ($E$), national currency per U.S. dollar as reported in *International Financial Statistics* (IMF).

Export price indexes ($PX$) - Price deflator for exports of goods as reported in *World Economic Outlook* (IMF) for each country $j$.

Import price indexes ($PM$) - Price deflator for exports of goods as reported in *World Economic Outlook* (IMF) for each country $j$.

Wholesale price index ($WPI$) as reported in *International Financial Statistics* (IMF).
External short-term credit (FIN) as reported in *Global Development Finance* (World Bank). This variable was used as proxy for trade finance. The stock of short-term credit in the GDF is calculated adding information on banks’ short-term claims by country from the Bank for International Settlements (BIS) and the short-term credit for exports from the Organization for Economic Cooperation and Development (OECD). As the BIS data are reported in terms of remaining maturity, the GDF adjusts the BIS data to obtain an estimate of banks’ claims of one-year maturity. Both institutions report short-term claims/credit in U.S. dollars.

Domestic demand (Y) – Gross domestic product, constant prices as reported in *World Economic Outlook* (IMF) for each country j.

World demand (YW) – Trade weighed demand as reported in *World Economic Outlook* (IMF) for each country j. This variable was used as an instrument in the IV estimation of the chapter’s equations.

World trade index (XW) – Volume of exports of goods & services as reported in *World Economic Outlook* (IMF) for each country j.

Relative export price index (RELPX) is defined as export price index divided by wholesale price index and multiplied by the exchange rate: \( \text{RELPX} = \frac{\text{PX}}{\text{WPI}} \times E \)

Relative import price (RELPM) is defined as import price index divided by wholesale index and multiplied by the exchange rate: \( \text{RELPM} = \frac{\text{PM}}{\text{WPI}} \times E \)

Real domestic credit (DC) is defined as the nominal domestic credit as reported in *International Financial Statistics* (IMF) deflated by the consumer price index. This variable was used as an instrument in the IV estimation of the chapter’s equations.

References


For emerging markets, international financing and capital flows are a double-edged sword: they carry tremendous potential for increased economic welfare, but at same time harbour many dangers. Crises over the past two decades have brought about sovereign defaults, moratoria and transfer/convertibility problems in many emerging-market countries, which have led to IMF-supported programs followed by reschedulings of the external sovereign debt of sovereign creditors (mainly Paris Club creditors). Also, the crises have affected the private sector, bringing about bankruptcies and severe social distress.

The crises of the past two decades, although different in intensity and effects, have been caused by various economic factors. However, one economic factor is common to all these crises: many emerging economies do not generate sufficient hard currency income to finance their investments and import needs, and have recorded a negative trade balance over a long period of time. The international financial community will not be able to prevent future crises as long as many emerging economies continue to record large trade deficits. Therefore, it is of key importance to develop policies to stimulate the generation of hard currency income by emerging economies.

While financial crises are not a new occurrence, there clearly has been a shift from an economic fundamentals-based crisis toward more expectations-based crises. This is partly due to the globalization and liberalization process, which accelerated in the 1990s. The growing participation of the private sector has led to more complex structuring of finance deals as well as the use of a number of new debt instruments. In addition, emerging economies have become more involved in the international financial intermediation and integrated into world trade. Both developments have led to greater

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19 Herman Mulder is Senior Executive Vice President and Co-Head of Group Risk Management of ABN AMRO Bank NV. Khalid Sheikh is Senior Vice president of the Emerging Market Analysis & Multilateral Organisations Department within Group Risk Management of ABN AMRO Bank.

20 A financial crisis is defined as an ad hoc massive shock to the financial system, which translates in a very short time span into a dramatic deterioration of the liquidity or solvency position of economic households. Four types of crisis can be distinguished: currency, banking, fiscal and geopolitical.
vulnerability of emerging economies and highlighted the risks they face. On balance, the increased reliance of emerging economies on international financing appears to have been beneficial, but there is little question that this financing has fallen short of its potential and, in some cases, has made borrowing countries worse off.

Evidence suggests that the cost of financial crises has increased (Table 3.1). The total losses are estimated at $249 billion from the 1980s crises and $419 billion from the 1990s crises. Although the average total loss has increased only marginally from 0.6 percent of GDP a year in the 1980s to 0.7 percent in the 1990s, the costs were high and concentrated in some countries, as exemplified by the financial trauma in Asia, where the losses are estimated at 1.4 percent of GDP per year.

This chapter will examine the potential benefits from concerted action to continue financing trade facilities in times of financial crisis and the lessons learned from the different types of crises in recent years. The chapter is motivated by three facts. First, trade finance is the lifeline for emerging economies (Table 3.2), as more than 90 percent

<table>
<thead>
<tr>
<th>Total</th>
<th>1980s</th>
<th>1990s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>13</td>
<td>260</td>
</tr>
<tr>
<td>Latin America</td>
<td>207</td>
<td>123</td>
</tr>
<tr>
<td>Africa</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>Europe</td>
<td>. . .</td>
<td>11</td>
</tr>
<tr>
<td>Middle East</td>
<td>14</td>
<td>7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average</th>
<th>0.6</th>
<th>0.7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>0.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.2</td>
<td>0.7</td>
</tr>
<tr>
<td>Africa</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Europe</td>
<td>. . .</td>
<td>0.1</td>
</tr>
<tr>
<td>Middle East</td>
<td>0.3</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Table 3.2. Global Integration: Change in the Ratio to GDP from 1981-85 to 1997-2001
(In percent)

<table>
<thead>
<tr>
<th></th>
<th>Trade</th>
<th>External Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial countries</td>
<td>3.9</td>
<td>77.3</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>15.4</td>
<td>19.9</td>
</tr>
</tbody>
</table>

Source: IMF, *World Economic Outlook.*

of world trade is conducted on the basis of short term credit. Second, the potential for future growth in trade is substantial, as intraregional trade could be enhanced and the share of emerging economies in the world trade increased. Third, the international community has to develop generally-accepted rules to maintain trade-related finance during crisis, since trade finance is highly dependent on confidence in and information on the actions expected from other market participants.

Addressing these three key areas could help break the recurring cycle of emerging countries’ crises and the reactive crisis management shown by the international financial community. In today’s globalized world, public and private sector parties in both emerging and developed economies have a clear interest in preventing future crises. They should join forces and build a new public-private partnership to assist emerging markets in their export efforts.

In this connection, the financial evaluation of the tools available to manage the country risks of emerging countries and a readjustment of international financial institutions (IFIs) will play a central role. With a few exceptions, most emerging countries are still rated as “noninvestment grade.” While IFIs’ support provides some assurance in limiting the disruptive impact of a financial crisis, new lines of defenses are needed.

This chapter gives a brief historical review and touches upon the complexities of the international finance. It then looks into trade-finance-related issues such as forms, trade finance structures, and treatment of preferred creditor status. The chapter also focuses on other modalities to resolve or prevent crisis and addresses a number of other challenges.

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21Trade finance is a very broad term. It is usually short term, uncommitted, self-liquidating, secured, or unsecured. It has multiple forms, and multiple parties are involved with distinct roles. As a consequence, each form has different implications for growth and exposure to capital market risk.
Growing Complexity of International Finance

Historical Review

Prior to 1990, infrastructure, services, and trade promotion were generally believed to be public goods for which governments were ultimately responsible. However, in a large number of emerging economies, insufficient investment, growing pressures on government budgets and a general concern about inefficient public service provision resulted in greater participation of the private sector in sectors usually dominated by the public sector.

Over the last decade, the private sector has become a key player in providing financing for infrastructure and trade. Lower global trade and investment barriers, reduced communications and transport costs, privatization, and financial deregulation have contributed to a strong performances by emerging economies. This economic performance has been led by rapid export expansion and supported by substantial capital inflows.

A world where capital flows are overwhelmingly private-to-private has been characterized by the following salient features:

- Closer linkages between domestic and international markets, which has increased interdependency and contagion risk.

- The use of more complex financing structures and a range of new financial instruments, which has increased the range of choices enormously, but introduced new types of risk. The complexity is also illustrated by the growing involvement of the export credit agencies and IFIs in covering various types of risk.

- A growing vulnerability of balance-of-payment due to the volatility of short-term capital flows.

- A change in profile and composition of external debt, which is no longer heavily concentrated among relatively homogenous international banks consisting of debt obligations to a much more diverse group of investors.

22A key example is Hungary. In 1994, the change in privatization policy led to a huge increase of proceeds of about $5 billion, which helped the government avoid a balance of payments crisis and hence default.

23Net capital flows to emerging markets rose strongly up to 1996. It should be noted that private capital flows remain focused on a select number of countries. Foreign direct investment flows to the top 10 recipient emerging economies constituted around 80 percent of the total in 2001.

24The amount of new investments insured by Berne Union members increased five times over from $3 billion in 1982 to $15 billion in 1996. Total (investment insurance) exposure of Berne Union members grew from $15 billion in 1982 to $43 billion in 1996, whereas total business grew by $39 billion over the same horizon to $422 billion (Stephens, 1999).
• Following many recent crises, a substantial rise in the perceived risk of infrastructure projects and trade finance, which has threatened project viability and the credibility of long-term governmental commitments. Investors have shown a clear preference for assets with reduced credit risk and enhanced liquidity.  

• No single solution for restructuring debts. Debt restructurings on a case-by-case basis seems more appropriate, hence the role and mechanics of the restructuring bodies (Paris Club/London Club) should be reappraised.

The implications of these changes have been significant, as crises have unfolded more rapidly and deeply and become more complex. There have been eight financial crises within six years and nearly a quarter of a trillion dollars in debt and risk has been shifted from the balance sheets of private sector investors to official ledgers.

**Growing Complexity**

Given macroeconomic imbalances and fragile financial systems in many emerging countries, a recurrence of financial crises should be expected. Further drying up of capital flows and retrenchment in bank finance to the emerging countries are serious concerns, particularly in the process of implementing the new Basle proposals. Accordingly, emerging-country authorities need to make substantial reform efforts to create an investor-friendly environment—especially critical in times of crisis—and to allow the countries to benefit from new and more efficient investments. It is also important to define new roles for all stakeholders and make further progress on crisis prevention. For example, internationally operating banks under new Basle guidelines may have to step up their capital requirements significantly for high risk borrowers.

Risk and profitability concerns rather than clients’ needs will continue to drive banks’ decision on cross-border credit and hence affect trade finance. Greater efforts from the IFIs and the private sector are also needed to provide the support necessary to stabilize a default situation.

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25 In 2002, net private flows to emerging economies were estimated at 2 percent of GDP, half of what they were a decade before. A further drying up of capital flows would impact the credit fundamentals of both nonrated and low-rated governments.

26 The IMF provided large bailout packages to Mexico ($50 billion) in 1995, Thailand ($17 billion), Indonesia ($34 billion), and Korea ($57 billion) in 1997, Russia ($16 billion) and Brazil ($42 billion) in 1998, Turkey ($10 billion) and Argentina ($20 billion) in 2001, and Brazil ($30 billion) in 2002.

27 According to a recent investigation by the Institute for International Finance, the current version of the new accord would result in a rise of more than 100 percent of the risk weighting on sovereign credits to emerging markets, relative to what is currently held.
Key Issues Related to the Provision of Trade Finance to Countries in Crisis

In today’s economically integrated world, trade matters more than ever. Countries that have intensified their links with the global economy through trade and investment have usually grown more rapidly over a sustained period and consequently have experienced more economic opportunities and reduced poverty. Fair and free trade can also foster security and political stability.

Unfortunately, IFIs mainly pay attention—both in terms of resources and funds—to supporting foreign direct investment. There are only a few IFI schemes available to support trade flows and hardly any for South-South trade, which for many emerging countries includes intraregional trade.

Emerging countries are vulnerable to external shocks, high volatility in commodity prices, adverse business cycles in the industrialized countries, and corresponding movements in international savings. The external vulnerability is also due to inadequate domestic policies, lack of strong institutions, and myopic investors’ behavior. The latter is related to the substantial involvement of commercial banks in world trade and investment flows.

Banks have to find a balance between adverse selection and moral hazard by processing borrowers’ information. Banks’ actions (freezing or withdrawing trade lines) not only impact the activities of other investors (herd behavior or risk aversion), but also influence their own actions. Bank flows are highly volatile and an apparently small movement in absolute terms can have disproportionate effects. In times of financial crisis, banks will demand that borrowers supply all information needed to warrant funds to continue on the road of sustainable development and access to the international capital market.

Forms of Trade Finance Before and During a Financial Crisis

The number of players and products in the trade finance market is large. Each of the players has a distinct role as it faces different types of risk, such as performance risk, financial risk, credit risk and sovereign/cross-border risk. To complement their needs for protection and/or cover, the IFIs, export credit agencies, and private risk insurers all have developed products to mitigate these risks. For example, offshore accounts are used in preexport finance to offset transfer and inconvertibility risk. Of all the players, the commercial banks perform a dual role. On the one hand, they are absorbers of

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28In this context it is also important to note that foreign direct investment flows are mainly going to the medium- to highly-developed emerging markets. Companies do not make foreign direct investments in very high-risk countries. Basically, for many emerging markets trade is the only source for generating hard currency income and achieving sustainable development. Against this backdrop, much more effort should be put into trade liberalization and trade support schemes for exporting companies in emerging markets.
counterparty risk and, on the other, they are transaction processors, which makes them vulnerable to, in the case of trade finance, risk transferability and convertibility.

Simple instruments like documentary credits and letter of credit confirmations constitute the major part of facilitating international trade. Experiences with other instruments and risk mitigating tools have been mixed, but the following financing structures could be considered both in times of relative calm and during crises: (i) pre-export finance structures (although on a case-by-case basis); (iii) fully-fledged guarantees from local governments counterguaranteed by IFIs; (iv) the use of escrow accounts; and (v) joint IFI-private sector initiatives. A few of these instruments are highlighted below.

- **Pre-export finance structures** grant payment/loan prior to export of goods and the proceeds of the sale of the goods are collected offshore. This has proved to be quite robust under a stress scenario (payment moratorium), and in a number of cases the exporters’ performance in crisis countries was not affected. It is key to focus on the financing of strategic commodities/products and the top players in the market, which represent low performance risk (e.g., in case of mining companies, typically the low-cost producers) and priority repayment over locally granted debt (via a pledge over export proceeds offshore). Experience with oil and gas clients in Russia (1998), tobacco merchants in Turkey (several crises), and agricultural exporters in Argentina (2002) has been positive, despite financial crisis situations. A concern sometimes is that governments/central banks set tight foreign currency regulations such as mandatory conversion of export proceeds, which may affect repayments.

- **In cases where financing institutions want more control over the use of proceeds from exports, pre-export structures can be tightened by using escrow accounts.** The funds accrued on this account can only be used for previously agree-upon purposes. This typically works for exporting producers, which need to import raw materials prior to be able to export (semi-) finished products. These types of financing structures sometimes have been used to control the flow of goods under UN embargo situations (e.g., the oil-for-food program for Iraq).

- **Joint IFI-private initiatives can support trade, as in the case of the facility jointly established by ABN AMRO and the International Finance Corporation (IFC) in Pakistan.** This facility represented the IFC’s first venture into trade finance after the Asian crisis. The ability for ABN AMRO to put in place a short-term, revolving risk-participated trade facility for Pakistan with the IFC facilitated a significant expansion of ABN AMRO’s existing cross-border commitments to Pakistan. The facility is structured on a 50/50 risk sharing basis for commercial as well as political risks. This 50/50 also reflects the risk fee distribution and recovery sharing in a default situation. Since the program’s inception, there have been no defaults. In addition, the risk mitigation component of this program has allowed a private sector lender such as ABN AMRO to venture into longer-term transactions than would have been normally possible. The facility helped to support Pakistan during times of particular political volatility and relative economic instability. The IFC and ABN AMRO partnership has made it possible for the IFC to provide Pakistan
financial support, which is simple to administer and relies on ABN AMRO's proven risk analysis abilities. Such a division of labor enhances the speed of the decision-making process and thereby the effectiveness of the financial support.

Treatment of Exposures and New Monies

Crisis-afflicted countries perceive international banks as either immediately freezing or reducing credit lines or raising costs and refusing to confirm letter of credits for their trade-related needs. However, this is not always the case, as banks that have existing exposures will be cautious about self-inflicting damage by fully withdrawing their trade facilities. In these instances, banks are most interested in getting clear signals from the debtor country in the form of guarantees or a credible forward-looking plan.

Examples of banks supporting crisis countries occurred with Turkey (2001) and Indonesia (1997). Turkey’s liquidity problems in June 2001 resulted in the international banks’ cautious stance, which translated into a reduction of credit facilities to Turkish banks. In a swift response, the Central Bank of Turkey, in a joint effort with the IMF, requested that these banks maintain their trade and banking lines open. The central bank clearly established its policies and timeframe to address the country’s liquidity problem and the Fund indicated its support. In this environment, ABN AMRO maintained its exposure under the trade lines but also indicated its willingness to meet the commercial needs of its clients.

The case of Indonesia in 1997 is also illustrative. The central bank requested that international banks maintain their exposure for trade finance as of a certain cutoff date (April 30, 1997). Payment of all new exposure and arrears was guaranteed, while exposures between the cutoff date and one year were not guaranteed. However, if the latter exposures were extended they would be considered as new credit and thus guaranteed.

Given the dramatic economic and social consequences of crisis (Box 3.1), country authorities should identify at an early stage which sectors are most vulnerable and unable to acquire sufficient working capital to carry out external trade. In so doing, the authorities will be able to define a credible plan and develop mechanisms to protect key local banks and allow some external trade to continue, especially for imports. On this, it is important that confidence be strengthened at an earlier stage than applying the mechanisms at a later stage.

29In contrast to many ECA programs that focus on particular sales, trade flows, origin requirements, etc., the IFC facility has comparatively few requirements. More importantly, it allows for bookings to occur on a global basis using the ABN AMRO network. The IFC’s approval parameters have also allowed ABN AMRO to exercise delegated authority in a majority of transaction approvals. While the IFC does review high volume transactions, there are no limits on transaction size, and though there is a general pricing minimum under the program, the IFC permits competitive pricing structures and largely defers to ABN AMRO’s recommendation on market pricing practices.
Box 3.1. Impact and Victims of Financial Crisis

When a financial crisis erupts, the following parties in trade finance can be identified as victims, albeit to a different extent:

- **Sovereign borrowers.** The impact is substantial because the sovereign is the lender in last resort to local importers and banks. The needed support in conjunction with declining budget revenues will heavily impair economic growth.

- **Local domestic banks.** The impact is substantial because they will be faced with a steep rise in nonperforming loans because many of their clients have become less creditworthy and/or banks have to bail out the sovereign.

- **Local-currency-generating companies/hard currency borrowers.** The impact is substantial because more local currency has to be made available to meet hard currency obligations. As a consequence, they will face difficulties in generating sufficient working capital at an acceptable cost to enable them to continue their business.

- **Hard currency generating companies/hard currency borrowers.** Limited impact

- **Local currency generating companies/local currency borrowers.** Limited impact

Source: ABN AMRO Bank.

**Complementary or Competitive?**

The growing involvement of private sector lenders in the restructuring of projects, debt, and other obligations has raised a number of questions. Will the restructuring become less orderly? Are public entities competing with or complementary to private sector entities? Should the Bretton Woods agencies continue to enjoy the preferred creditor status?

In general, there is no positive correlation between the number of creditors and a messy debt restructuring. The debt restructurings of the international debt crisis in the 1980s can be characterized as relatively orderly because they involved a limited number of actors, including sovereign borrowers, commercial banks, and IFIs.

With the progress in financial deregulation, both the number and types of borrowers and lenders increased, and debt became more diversified, including many asset classes under many different terms. As a consequence, restructuring with creditors as diverse as export credit agencies, commercial banks, capital market operators and IFIs has become a challenge. As each of them will have their own objectives, limitations, contractual rights and internal requirements. Thus far, workouts have been fairly orderly, and will continue to be so as long as all commercial creditors share in the burden of restructuring.

Our view is that public and private institutions should be complementary. Public export credit agencies and the IFIs have well-defined mandates and responsibilities to their taxpayers and stakeholders. They should not compete with the private sector by offering
products that the private institutions can provide more efficiently and flexibly. On the other hand, IFIs should step in at times where private sector institutions need assistance, as they have a broader mandate to restore confidence, especially during times of financial crisis.

Despite the fact that emerging-country finance is shifting from IFIs’ credits to private sector credit, the IFIs will continue to serve as a catalyst to private investors. Finally, as both public and private entities share the burden proportionally during a crisis, it raises the question of whether the IFIs should continue to have a preferred creditor status in its present form.

Preferred Creditor Status: How to Proceed

The IFI-supported trade facilitation programs to ease the pain in times of severe financial and economic crises should be welcome offerings. However, these programs will not break the vicious circle of external vulnerability and debt accumulation. Also, as an increasing number of creditors try to seek shelter under the same IFI preferred-creditor umbrella, there may not be enough protection for all the parties.

The international financial order has to be revisited and the fora to address this effectively are the Organization for Economic Cooperation and Development (OECD), the Paris Club and London Club, and IFIs. The patchwork done since the first Paris Club rescheduling in 1956 has created very chaotic situations and unsustainable results for almost all stakeholders (major defaults/losses, capital destruction, decreased affordability human and socioeconomic disasters, etc.). Private institutions including ABN AMRO should take an active role in rethinking how development and financing of emerging countries can be done without these countries having to reschedule their debts sooner or later.

Shifting away from the absolute preferred creditor status would require the assessment of risks and competencies of the different parties. Some institutions might be better positioned to take certain risks than others. In this respect, we should look into the nature of the preferred creditor status (de jure or de facto) and the type of the borrower (sovereign or private).

De Jure versus De Facto Creditor Status

Both types of preferred creditor status do mitigate certain financial risks in emerging markets. From a legal point of view, a de jure preferred creditor status provides obviously more comfort than a de facto status. One could argue whether a de facto preferential creditor status would withstand a legal test if other creditors were to challenge it. For example, the preferred creditor status looks at odds with the Paris Club principle that a debtor country that has rescheduled its external debt with its sovereign

50Preferred creditor status is fundamentally a political expression and a matter of conduct rather than a matter of laws.
creditors should seek equal treatment from its other creditors. Given the increasing debt
problems of many emerging countries, it must be considered that the future may bring
about disagreement between creditors on preferred creditor status.

**Sovereign versus Private Borrowers**

The relevance of the preferred creditor status and the level of comfort it provides to
(co)lenders depends also on the nature of the borrower. If the borrower is the sovereign
(i.e., ministry of finance or central bank), the preferred creditor status mitigates both the
financial country risks and the borrower's risks. On the other hand, if the borrower is a
private sector borrower, the preferred creditor status only mitigates the financial country
risks, but does not mitigate private sector borrowers risks, at least not to the same extent
as it does in the case of a sovereign borrower.

Private sector institutions do need the leverage of IFIs to reduce their risks. Various
restrictions on foreign fund movements (typically imposed by countries after payment
default) expose private institutions to transferability and convertibility risks and can
jeopardize recovery of their loans.

In these circumstances, the private sector institutions can still maintain their credit lines
open if the public sector supplies comfort through comprehensive guarantees or at least
de jure preferred creditor status (varying by type of crisis and project). Comprehensive
guarantees—if structured with the requirements of private sector entities and capital
markets in mind—can induce lenders to consider lending again and/or maintain current
credit lines, but more importantly can lead to new money. In addition, guarantees are
flexible instruments and can be tailor-made to any specific transaction, helping to
enhance local capital markets and thereby increasing local currency funding. Sharing or
granting de jure preferred creditor status would encourage private lenders not only to
continue lending but even to supply the new money that is required.  

**Lessons for Crisis Prevention and Resolution**

In drawing lessons for the future, we point out eight aspects of crisis prevention and
resolution. *First and foremost, investor confidence needs to be sustained.* The authorities of
emerging countries need to address the country’s fundamental macroeconomic
imbalances and structural weaknesses and maintain open channels of communication
with creditors and investors, ideally through effective investor relations programs. Strong
investor relations programs—including regular and active dialogue between country
authorities and their investors and creditors—would enable market participants to make
sound risk management decisions and help authorities identify market concerns at an
early stage. In this connection, debtor countries should work toward providing

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31New money is defined as any money loaned during a financial crisis to keep the debtor afloat. In our
view, new money should enjoy seniority.
comprehensive, timely and accurate data to market participants, which is crucial for sound risk management and contributes to the stability of international financial markets.

Second, the authorities should have clear and articulate policy objectives (Box 3.2). For example, the central bank could clearly state that it will protect key financial institutions in the country to maintain the trade-related payment flows. The binding nature of these statements would augment market discipline and contribute to the country’s ability to attract the necessary funds.

Third, the central bank’s international reserves should be used as a safety valve. It has been discovered from recent crises that reserves were activated in order to stem currency volatility and bail out the domestic banking sector (moral hazard of lending). Part of the international reserves could be used to secure ample liquidity not only for a limited number of domestic banks but also for viable corporations key to the trade-flow process. An alternative would be to build up strategic reserves for the times when credit weakens, but on terms negotiated beforehand. These short maturity bridge funds would offer room for borrowers to restructure outstanding debt and/or seek long-term financing from both the private and public institutions for structural reform.

Fourth, weak domestic financial sectors—which have often been the catalyst for recent crises—should be strengthened, primarily through the combined efforts of policymakers, regulators, and bankers with support from IFIs, including the IMF, World Bank, and the BIS. In establishing priorities for action, it is essential for country authorities as well as the IMF and World Bank to engage in a permanent dialogue with market participants, both domestic and foreign. Market participants can impart a pragmatic perspective that can strengthen new programs.

Fifth, the international community should draw up rules of engagement defining principles that will support all stakeholders in coordinating their behavior and accepting their responsibilities. The rules should be such that they cover a broad range of crisis situations such as prevention and resolution stages. More importantly, the rules should be authoritative, comprehensive, focused, and transparent.

Sixth, with regard to recurring trade transactions and especially in the case of strategic commodities, domestic banks in emerging countries should concentrate their relationships with relatively few international banks during the crisis-resolution period. This could help secure a continuing relationship and a steady flow of transactions and finance. Moreover, it would reduce performance risk and enhance an orderly workout, since all bank debt of a given emerging market involves the same type of general obligations, so there will be little conflict of interest among banks.

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32 The current crisis resolution framework is one where private creditors and obligors in distress have a strong interest in seeing multilateral institutions and local governments provide insurance arrangements. They should ensure that guarantees that are offered are as explicit as possible and are priced appropriately, so as to reflect the risks being insured by them. The use of public guarantees could help to leverage-in albeit small amounts of foreign capital in circumstances where there is a scarcity of funds. The importance of such a vehicle is canvassed in the reality that it will contain the political costs of emergency lending.
Box 3.2. Selected Measures Taken by Countries to Safeguard Trade Finance

**Indonesia (1997):** Central Bank took proactive measures to make sure the normal trade flow continued by taking over the banks and the letters of credit.

**Malaysia (1998):** Actions taken by BNM affected trade because all settlement of exports and imports were to be made in foreign currency. Trade-related transactions in MYR from before September 1, 1998 were exempted.

**Russia (1998):** Harsh measurements enacted, but trade was exempted.

**Pakistan (1999):** The central bank took firm measures to impose graduated margin requirements on trade imports, depending on the type of import (consumer products-35 percent; raw materials-10 percent). Strategic imports were exempted from such margin requirements. Normal trade flows continued while the central bank banned banks from making forward foreign exchange deals.

**Turkey (2000/2001):** New banking laws and depositary insurance fund with an IMF commitment gave comfort to keep bank lines open.

**Brazil (2002):** Clear policies and commitment to adhere to IMF program created sufficient confidence to continue trade finance.

Source: ABNM AMRO NV.

Seventh, it is important to develop long-term investing institutions and bond markets denominated in domestic currency. This would enhance the borrowing capacity of firms producing for the domestic market without introducing the financial fragility that comes with currency mismatches.

Finally, assistance and support from the IMF and World Bank, in the context of a strong adjustment program, is essential. Both institutions represent a continuing source of financial support for countries in crisis and can play a special role in signaling to other financial institutions whether or not to cut off lending to a particular country.

**Emerging Themes and the Way Forward**

Greater predictability could help facilitate investors’ assessment, pricing, and management of risks, and hence contribute to improving the efficiency of the allocation of capital. The new focus on market-oriented frameworks and development schemes is well established, and involve private capital flows and export promotion schemes. In our view, the task of the IFIs must be to facilitate these processes, as they have the potential to further expand the frontiers of private sector involvement and development in emerging economies. In order to do so, the IFIs must continue to adapt and build on their strengths. Private sector partners, especially banks, are powerful and dynamic partners in
these efforts, which should be harnessed by the IFIs. Taking advantage of public and private institutions’ comparative advantages will benefit both the international financial system and the emerging countries.

As indicated earlier, trade and investment are connecting our world tightly together more than ever, but it remains a world of different economic systems, different interests and backgrounds, and very different levels of development. In addition to the need for greater cooperation and consensus, we have to provide leadership when mobilizing collective effort in times of crisis, as we have not yet articulated a clear vision of what the new financial and trade architecture should look like. This will be far from straightforward at a time where we are urging a common denominator, i.e., developing a sustainable financial framework resilient to shocks.

Looking forward, one area that deserves particular attention is the promotion of intraregional trade. The extensive expansion of intraregional trade is an important aspect of the integration of emerging economies into the global trading system. A higher degree of integration of trade and production will also bring about increasing intraregional financial flows, making emerging-market economies less dependent on external finance from industrialized countries (Figure 3.1).

One of the major benefits of intraregional trade is that the emerging economies can benefit from being complementary. The comparative advantages of countries of a region could then translate into a more diversified regional export basket. Despite many
initiatives having been undertaken in recent years, there is a need to develop an institution to promote exports among emerging countries by effectively providing medium-and long-term export credit insurance.

Ideally, such an institution should be a multilateral export credit insurance company to be funded and supported by governments from emerging markets and developed countries and the private sector. It would focus its insurance activities both in the area of nonmarketable and marketable risks. By supporting exports from emerging markets, this institution would allow exporting emerging markets to generate additional hard currency income, which would strengthen their external positions. Alternatively, greater use of emerging-market export credit agencies to support trade between emerging markets, in particular the South-South trade of capital goods, could become an integral part of more proactive crisis management.

33In the latter environment (credit risks with a maximum tenor of two years), the primary focus would be to act as an intermediary/broker with the task of seeking private insurance for the emerging-market exporter. If short-term private insurance is not available, the institution could step in. This could be of relevance for countries that do not have good access to the private insurance market (e.g., certain African countries).
Part II

Addressing Trade Finance Shortfalls
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CHAPTER

4

Indonesia's Experience in Dealing with Trade Finance Shortfalls during Financial Crises

Peter Jacobs

The Asian currency crises that began in mid-1997 brought intense pressure on Indonesia's balance of payments. Although Bank Indonesia intervened in the foreign currency market and tightened liquidity by increasing interest rates, confidence was not quickly restored and capital outflows increased rapidly. As a result, gross foreign assets declined by $4.5 billion from $28.6 billion in July 1997 to $24.1 billion in November 1997.

Depreciation of the currency contributed to high inflation (mostly imported inflation) because of the import content for Indonesian products, either for domestic consumption or exports. At the same time, Indonesian imports declined drastically. The drop was most pronounced for semiprocessed raw materials, spare parts, transportation equipment and parts, and capital goods equipment. Expensive and scarce imported materials caused a number of manufacturers to reduce their imports. The supply of raw materials was also disrupted, as a number of plants closed down their operations. These closures not only disrupted the operations of other domestic plants but also reduced the export of raw materials.

Given Indonesia's high dependence on imports for domestic and export production, the sharp increase in the cost of imports (due to depreciation of the rupiah against the dollar) contributed to a drop in both imports and exports. During the six months after the crisis (September 1997 to March 1998), imports declined by 34.8 percent, while exports also fell by (Figure 4.1). The drop in nonoil/gas imports resulted from a major slowdown in production and investment activities in the country, as well as from foreign

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35In 1997, the share of raw material imports was 64 percent of total imports, capital goods imports contributed 30 percent, and consumption goods, 6 percent. In 2001, the share of imports of raw material increased to 72.1 percent of total imports.
banks turning down import letters of credit due to the banks’ reduced confidence in the ability of Indonesian firms to service their debts.

The exchange rate crises translated into prolonged monetary tightening and banking crises and affected trade financing operations in several ways:

- International parties asked foreign banks to confirm letters of credit issued by domestic banks;
- Opening domestic banks faced obstacles in obtaining letter of credit confirmation from overseas banks;
- International banks did not allow amendments to letters of credit; and
- A number of international banks discontinued their credit lines.

As a consequence, national banks become more selective in issuing letters of credit and limited them to sight letters of credit. With increased risks, international banks became more selective in choosing letter issuing banks for letters of credit. Moreover, confirmation fees were raised, while credit lines extended became more limited (Table 4.1).
In view of the important role of trade financing in restoring economic activity and easing balance of payments pressures, the government initiated policies to address the international trade problems and the external debt overhang. This included efforts to (i) expedite flows of trade and provide trade financing facilities to generate foreign exchange earnings, and (ii) overcome liquidity difficulties in foreign exchange through the restructuring of principal and interest payments for maturing short-term external debts.

In November 1997, the ministry of industry and trade announced that exporters of certain products would be designated as “prominent exporters.” These exporters were given priority in financing and expediting procedures for their products. Unfortunately, some countries regarded this facility as a subsidy.

Bank Indonesia, on behalf of the government, also provided some targeted financing and guarantee schemes for exporters through banks. These included the following:

- **A swap and forward facility for prominent exporters.** Introduced in November 1998, this scheme was intended to provide a hedging facility for exporters. However, while the facility was needed, Bank Indonesia was not allowed to give a subsidy in the premium.

56 The premium charged by Bank Indonesia was in accordance with market rates, and as result the premium was high because of the high country risk.
• **Post and preshipment financing (rediscount facility).** To address liquidity problems, banks could issue bank drafts with underlying export transactions to be financed by Bank Indonesia at discount. Most of the exporters that benefited from the scheme were prime customers of some banks, primarily big exporters. Due to problems of nonperforming loans, capital adequacy ratios, and other prudential considerations, Indonesian commercial banks avoided taking the commercial risk involved in financing small and medium-sized exporters.

• **A Bank Indonesia cash collateral scheme.** In order to help banks get their letters of credit accepted internationally, Bank Indonesia deposited $1 billion in 12 prime foreign banks to guaranty letters of credit issued by Indonesian banks. The letters had to be import letters of credit related to exports, and export proceeds had to cover the payment to Bank Indonesia. With this scheme, banks not only enjoyed letter of credit guarantees, but also obtained financing for up to 180 days. The scheme was reasonably successful. Exporters who benefited under the scheme and oil/gas importers also enjoyed the letter of credit guaranty for their critically needed imports. The facility was established January 12, 1998 and terminated June 22, 1999, and there was no default. Total utilization of the scheme was $932 million, DEM 1 million, NLG 36,000, and CHF 130,000.

**Other Initiatives**

Due to the success of Bank Indonesia’s placement scheme, the government signed a loan agreement in 1998 with the Japan Exim Bank (JEXIM) \(^{37}\) to provide a collateral/financing scheme of $1 billion (JPY 138.75 billion) to guarantee and finance imports related to exports. The scheme was not popular because banks that wanted to benefit from the facility were required to use the guarantee as well as the financing. Banks could not benefit only from the guarantee, as was the case in Bank Indonesia’s cash collateral scheme. Besides, banks also need working capital (preshipment financing) to purchase raw material from the domestic market, which was not possible under the JEXIM scheme. Therefore, until December 1999 there was little use of the fund, at only $132.2 million (or 13 percent of total funds).

Also, the government and Bank Indonesia made efforts to arrange cooperation with international institutions as well as to provide guarantees for trade finance, in particular through letters of credit guaranteed by the government. The cooperation has produced several guarantee schemes, such as the Export Finance and Insurance Corporation (EFIC, Australia), the GSM-102 (Commodity Credit Corporation—U.S. Department of Agriculture), U.S. Exim Bank, Export Credit and Guaranty Department (ECGD, England), Kreditanstalt fur Wiederaufbau (KfW, Germany), Export Development Canada (EDC) and the Canadian Wheat Board (CWB). The schemes were designed to smooth exports to Indonesia.

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\(^{37}\) Now the Japan Bank for International Cooperation (JBIC).
When crises occurred, a large amount of trade financing arrears arose because the banks could not honor their obligations. Foreign banks tightened their credit lines, thus aggravating the liquidity problems of Indonesian banks. In this context, the Indonesian government made an agreement with a group of bank creditors in June 1998 to secure a trade finance credit line (the Trade Maintenance Facility – TMF), restructure interbank debt (the Exchange Offer Program), and establish the Indonesian Debt Restructuring Agency (INDRA). The precondition of the agreement was that Bank Indonesia (on behalf of the government) had to settle all the trade arrears so that the trade credit lines would be opened and the interbank debt structured. The amount of trade arrears paid by Bank Indonesia amounted to $1.4 billion.

The settlement of trade arrears enabled the country to obtain credit lines of $2.76 billion from 104 international banks. Of the total, 63 banks submitted their respective confirmation letters that were endorsed by Bank Indonesia to obtain a government warrant worth $2.28 billion (80 percent), and the national banks realized an amount of $1.37 billion (60 percent).

The TMF was initially scheduled for one year but was then extended by two more years. The government extended the program because international banks could not provide credit without guarantees from the government. The TMF was terminated in June 30, 2001. The large size of the unused resources was primarily attributed to uncertain expectations regarding the rupiah exchange rate and the high risk premium carried by the banks in the face of concentrated commercial risks that had not been adequately diversified. Another cause was an unfortunate mismatch of import products between those that were guaranteed and those needed by domestic exporters.

Since 1996, Bank Indonesia has sought to establish an export credit agency to help maintain export competitiveness, mainly against countries that have benefited from the support of a specific institution specializing in export financing. Realizing the urgent need to promote exports, the government in 1999 established such an export credit agency, which was later called Bank Ekspor Indonesia (BEI). The establishment of the autonomous BEI was in line with the new law of Bank Indonesia, which required that the function of supporting exports be removed from the central banks. The transfer included the JEXIM TSL 7 scheme on December 23, 1999.

Lessons Learned

The Indonesia experience offers several lessons for countries in financial crisis. First, in times of crises, when international confidence collapses, the government can play a major role in helping banks and exporters/importers continue carrying out external trade without disruption. The government should provide temporary financing during the crisis and work toward restoring international confidence through transparency in policy and information.

Second, the timing in coming up with proper policy response is very important. Slow responses can worsen the situation, while quick and decisive actions may make a difference in mitigating the worst aspects of the financial crisis.
Third, while the government’s capacity to provide interventions may be relatively limited, its willingness and seriousness to cope with the disruptions in trade finance provides a conducive atmosphere for investors and creditors to restore their financing.

Fourth, government must prioritize any schemes or facilities that support export. At the same time, a government must be very critical and cautious of foreign creditors’ demand for guarantees. For example, an export credit agency may demand government guarantees to cover consumption exports from the agency’s country, while the government should focus on imports needed as inputs for exports to allow for a buildup of reserves.

Fifth, government intervention, where warranted, should be designed in such a way to minimize loopholes or the potential for abuse. In Indonesia’s case, to rescue banks from short-term liquidity problem, Bank Indonesia provided liquidity support, which was later financed by the government through issuing government bonds (recap bonds) amounting to Rp144.5 trillion. The state auditor later found some errors that led to a government agency and some private sector borrowers being taken to court.

Finally, bilateral swap arrangements, either between central banks or commercial banks, can be used to bridge confidence gaps when they arise. In this regard, Indonesia’s recent bilateral swap arrangements with Japan, China, and Korea are intended to prevent and address any future temporary trade finance and balance of payments shortfalls.
A deteriorating international outlook and uncertainty about the future course of domestic economic policies during an election year led to increasing pressure on Brazil’s financial market variables beginning in the second quarter of 2002, as evidenced in a hike in the risk premium for Brazilian government securities and a sharp depreciation of the real (Figure 5.1). At the same time, rollover rates on medium- and long-term public debt fell sharply. These adverse developments occurred despite the maintenance of sound domestic policies and continued progress on the country’s structural reforms agenda.

The depreciation of the real created conditions for exporters to expand their operations, and one important instrument to allow such expansion was pre- and postshipment export financing. Despite the favorable outlook for the export sector, however, foreign financial institutions started reducing the supply of export credits to Brazilian banks and enterprises. There also was a considerable increase in the cost of credit lines for 30- to 360-day financing by mid-2002. Despite a much depreciated domestic currency, the shortage of trade financing for exports was preventing export revenues from growing, which could have offset part of the impact of net outflow of private capital.

\textbf{Decline of Trade Credits by Foreign Banks}

The balance of interbank credit lines (including export, import and other short-term finance) fell sharply to $14.5 billion at end-2002 from around $20 billion in May 2002 (Figure 5.2). Both export and import credit lines followed similar declining trends in the period. Although export credits were gradually restored in 2003, import credits remained at low levels. A fall in import credits was partly determined by demand, as imports declined because of weaker domestic economic activity and depreciated currency.

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\textsuperscript{38} Helio Mori is Senior Advisor of the Central Bank of Brazil.
Figure 5.1. Brazil: Real Effective Exchange Rate
(Reais per U.S. dollars of April 2003)""
(Figure 5.3). On the other hand, the fall in export credit lines seemed not to be associated with a weakening of export performance, but to the shortage of supply. The sharp depreciation of the real, especially since mid-2002, was an important stimulus to exports. In fact, despite the fall in export credits, exports had maintained an expansionary trend, while the share of export finance to total exports had decreased in the second half of 2002 (Figures 5.4 and 5.5).

With an improved international outlook following the reduction in interest rates by the U.S. Federal Reserve and reduced uncertainties surrounding the macroeconomic policies to be followed by the new government, market expectations improved significantly by early 2003. As a result, constraints on the supply of export credit were eased. After a substantial increase in the second half of 2002, the net outflow of funds through short-term credit lines stabilized by the end of the year, with the rollover rate returning to nearly 100 percent (Figure 5.6). Moreover, after a critical period through August 2002, the cost of those lines converged gradually to the precrisis level (Figure 5.7).
Figure 5.4. Brazil: Export Credit Lines and Total Exports
(In billions of US. dollars)

Source: Central Bank of Brazil.

Figure 5.5. Brazil: Total Exports and Export Financing

Source: Central Bank of Brazil.
Temporary Mechanism to Supply Export Finance

In August 2002, the Central Bank of Brazil (BCB) established a temporary financing mechanism to offset part of the reduction in export credit lines. The mechanism consisted of BCB holding auctions to sell foreign exchange to authorized dealers. The objective was to provide liquidity in foreign currency to the banking system by targeting the market of short-term export credits to mitigate the cutback of credit lines by foreign banks.

To set up the parameters to guide the auctions, a survey was conducted by the BCB to assess the turnover of each authorized foreign exchange dealer to compute its acceptable exposure under the mechanism. A quantitative ceiling for a dealer's bid in the auctions was set at 20 percent of the dealer's reference net worth. If a dealer purchased under such a criterion the amount of foreign exchange exceeding four times its accumulated provisions of pre- and postshipment export financing over the previous four-week period, the dealer, on the same day of the auction, had to either sell the excess amount to other authorized players in the market or deposit it at a zero interest rate at the BCB. Also, a dealer had the flexibility to sell, on the same day of the auction, part of the purchased foreign exchange to a bank authorized to operate in foreign exchange, in which case the ceiling for the bank would be set at four times its export finance...
operations over the previous four-week period. To encourage banks to maintain their export financing operations, export financing generated by BCB auctions in the preceding four weeks was not included in computing the bank’s foreign exchange purchase ceiling, so that the auctioned resources would be additional to credit lines available in the market.

In the first phase under the mechanism—from August–October 2002—the BCB held auctions offering foreign exchange to authorized dealers. Each dealer (a domestic bank) presented its proposal with both the amount (subject to the ceiling resulting from the survey) and interest rate in U.S. dollar terms. The bank then acquired the dollar amount with a commitment to pay in the future in reais, calculated with the exchange rate observed on the payment date and the interest rate resulted from the auction. On day two after the auction, the dollar amount was delivered by the BCB to the bank, and the resources so obtained could be used only for pre- and postshipment export finance. In this transaction, BCB’s international reserves were reduced in the amount auctioned.

The commercial bank had seven calendar days to carry out export finance operations with an exporter. If there was no matching client for the bank’s dollars, such a “free” or unused amount of foreign exchange would have to be deposited at the BCB at a zero interest rate. Typically, an exporter contacted an authorized bank for export financing with a commitment to deliver payment in U.S. dollars within a period related to the

![Figure 5.7. Brazil: Interest Rates on Credit Lines (In percent a year)](image)

Source: Broadcast.
shipment of goods abroad. Such a period was fixed at a minimum of 90 days and a maximum of 360 days before the shipment, and actually averaged about 80 to 110 days.

Figure 5.8. Brazil: Cash Flow of Export Credit Lines (In millions of U.S. dollars)

The Bank sold the foreign exchange in the interbank market to acquire reais (bank reserves) to lend to the exporter.

In the mechanism’s second phase—from February-April 2003—upon delivery of exported goods and receipt of payment by the importer, the exporter deposited the amount in the lending bank. The bank then sold foreign currency in the interbank market to acquire reais, and up to 185 days after the auction it transferred reais (bank reserves) to the BCB to complete the process (Figure 5.8).

Assessment of the BCB’s Export Financing Mechanism

The BCB’s auctions between August and October 2002 were effective in providing exporters with resources to smooth out the financing shortfall in the period (Figure 5.9). Also, the costs for the participants were relatively low, as the weighted average interest rate of the auctions was on the order of 4.25 percent during the period, compared with the average of 7.35 percent offered by foreign banks (Table 5.1). The auction program was discontinued on October 18, 2002, as the amount allocated for the program was fully used. The BCB offered a total of $2.1 billion. The auctioned amount was repaid subsequently in its entirety to the BCB, and the relevant regulations were revoked.

Although the foreign exchange amount used in the program was relatively small, the interventions were effective in mitigating the impact of credit contraction during a critical period. BCB interventions and the appropriate timing of the operation might have headed off the occurrence of unfavorable dynamics, with perhaps more damaging
consequences to the economy than the path that was actually followed. Moreover, the program was part of a comprehensive set of measures taken by the government at that time.

Figure 5.9. Brazil: Bank-to-Bank Credit Lines
(In millions of U.S. dollars)

Source: Central Bank of Brazil.
Table 5.1. Brazil: Credit Line Interest Rates
(In annual percent)

<table>
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<tr>
<th></th>
<th>Average</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central bank’s export auction</td>
<td>4.25</td>
<td>4.00</td>
<td>6.10</td>
</tr>
<tr>
<td>Export Financing (ACC)²</td>
<td>7.35</td>
<td>4.50</td>
<td>18.00</td>
</tr>
</tbody>
</table>

Source: Central Bank of Brazil.

1 Weighed average by the amount.
2 1,910 exchange rate contracts from August 23, 2002 to October 25, 2002.

time to weather financial shocks, including the strengthening of public finances and monetary policy supported by resources from international financial institutions. In the area of trade finance, the country’s development bank (BNDES) provided an additional $2.6 billion in trade financing funded with $1 billion from the Inter-American Development Bank and with funding from other external sources. In 2002, BNDES loans to the export sector expanded to $3.9 billion, an increase of 52 percent in the year, indicating the key role of BNDES in providing additional financing for the export sector, replacing private bank loans. The episode showed that, in order to support macroeconomic policy actions under extreme circumstances, some micro measures may be required to address specific problems, especially in the financial sector, that, if not appropriately dealt with, could produce a much larger adverse impact on the economy.
Before the Asian debt crisis in the late 1990s, short- and medium-term credit support from the U.S. Export-Import Bank for exports of goods and services to Korea, Indonesia, and Thailand was very limited because these countries were generally adequately served by private financial institutions without official export credit agency support. However, when the debt crisis emerged, the private sector concerns with repayment prospects caused an increase in demand for financing support from Ex-Im Bank.

In response to the economic and financial crisis in Asia in early 1998, the U.S. Ex-Im Bank, led by Chairman James A. Harmon, embarked on an initiative to ensure that U.S. exports of necessary raw materials, spare parts, consumables, and small capital equipment could continue to flow into the markets of Korea, Thailand, and Indonesia by providing the necessary short-term credit for importers through selected lenders in these markets.

Typically, the transactions supported under the short-term program included raw materials used in the production of goods (e.g., hides and skins, spare parts, auto parts, selected agricultural commodities) and small manufacturing equipment. The transactions were financed up to 360 days.

Korea

U.S. Ex-Im Bank support for capital equipment exports under the program for Korea was available for short- and medium-term export sales (Box 6.1). Specifically, in January 1998, Ex-Im established a short-term export credit insurance program to support U.S. exports being financed with letters of credit issued by selected Korean banks and confirmed by banks operating in the United States. At that time, Ex-Im’s Board of

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39Piper Starr is Vice President, Planning and International Organizations, at the U.S. Export-Import Bank.
Box 6.1. U.S. Ex-Im Bank’s Korea Short-Term Facility During the Asian Crisis

**Products supported:** A large quantity of agricultural products were supported by the U.S. Ex-Im Bank under letters of credit payable at sight because the U.S. Department of Agriculture (USDA) Commodity Credit Corporation’s export guarantee programs were not available on these terms or for the specific types of products. Hides and skins were the largest single product type, while pulp and paper, spare parts, scrap metal, and capital goods components comprised the majority of products supported under the facility.

**Repayment terms:** Excluding agricultural products (handled at sight), the letter of credit tenor breakdown was 40 percent at sight; 40 percent for 150-180 days; and 20 percent, other.

**Administrative efficiencies:** Initially, each individual transaction was handled by Insurance Division credit staff. However, due to the heavy volume of applications received during the initial months of operations (literally hundreds a day) and the need for a 24-48 hour turnaround on the letters of credit, Ex-Im modified the case processing approach by instituting revolving lines with participating U.S. confirming banks. Specifically, individual U.S. banks insured under the program were authorized (for varying amounts depending on anticipated demand and capability levels, but excluding capital goods) to approve individual transactions up to a set amount, provided these approvals were promptly reported to Ex-Im. Capital goods exports that were to be covered under the facility had to be reviewed by Ex-Im Bank prior to approval, due to economic impact review procedures that Ex-Im was required to evaluate. The revolving line approach allowed U.S. banks to respond quickly to their customers’ needs on routine transactions, and freed up Ex-Im staff to process those requiring additional review. As a result of the Korea facility and the pressures on staff resources stemming from the high level of demand for Ex-Im support, the development of the revolving line processing approach has served as a model to handle other situations calling for administrative efficiencies since then.

**Underwriting issues:** Due to the high risk of private corporations in Korea, particularly the chaebols (because they lack current and reliable financial statements), the uncertainty surrounding the pace of reforms in Korea that would have strengthened the private sector, and Ex-Im’s statutory requirement to find reasonable assurance of repayment, Ex-Im Bank determined after extensive analysis that the Korean banking sector represented the most viable primary source of repayment. Moreover, even though the banks were encountered a relatively high level of nonperforming loans, the Korean government took steps to rectify the banking sector’s problems through consolidation and recapitalization. Hence, Ex-Im Bank found comfort that Korea would see the reforms through to ensure a more stable and financially sound banking sector.

**Levels of activity from January 1998-June 1999:** The initial 6 to 12 months of the program accounted for most of the activity, since the private sector was not in a position to assume the risks independently. By March 1999, demand for Ex-Im support began to decline with the upgrade of Korea’s sovereign rating (reflecting progress and growing stability resulting from the reforms initiated during the prior year). With the upgrade, the private sector, particularly the larger money center banks, became more comfortable with Korea risk, while U.S. regional lenders remained less aggressive and consequently constituted a larger portion of Ex-Im’s Korea facility than previously. In addition, the USDA’s Commodity Credit Corporation resumed its export credit programs for Korea, thereby lessening the need for Ex-Im support for agricultural commodities. The cumulative effect was an overall decline and eventual discontinuation of the program, as the private sector once again resumed its ability to assume Korean risk on its own. Ex-Im had successfully filled a market gap during a time of need and willingly withdrew once the private sector stepped back in.
Directors approved a total limit of $750 million with varying U.S. dollar sublimits approved for 10 Korean banks. The program was used actively, with U.S. exports supported at a value of over $1 billion. Moreover, there were no claims filed or paid under the Korea initiative.

Subsequently, in August 1998, Ex-Im and the Korean government signed a sovereign guarantee agreement for up to $2 billion for medium-term transactions (1 to 5-year repayment terms), which included capital equipment sales. Under this program, the Korean government agreed to guarantee up to $2 billion in medium-term direct loans from Ex-Im Bank to the Korea Development Bank (KDB). In conjunction with this agreement, both parties agreed that once a medium-term transaction was concluded under the program, Ex-Im would increase its total limit on the short-term program up to $1 billion (or an increase of $250 million above the previously approved $750 million) to be managed by the KDB.

There were eight correspondent banks located in the United States that were appointed by the Korean government to participate in the medium-term program. Financing was accessed in one of two ways: the end-user could apply directly to the Ex-Im Bank or contact KDB directly and have KDB formally apply to the Ex-Im Bank for financing.

**Thailand**

On July 31, 1998, Ex-Im Bank and Thailand signed a $1 billion sovereign guarantee agreement to support short-term letter of credit transactions. Thai Ex-Im (guaranteed directly by the minister of finance) would act as the intermediary guarantor on behalf of private Thai banks that would issue irrevocable short-term letters of credit to be confirmed by banks operating in the United States. Ex-Im would insure the U.S. bank’s confirmation of the letters of credit on behalf of the U.S. exporter. However, this program never became fully operational because while the Thai authorities were trying to finalize the documentation, conditions within the economy improved and the need for Ex-Im support decreased.

**Indonesia**

On May 8, 1998, Ex-Im Bank and the government of Indonesia signed a $1 billion sovereign guarantee agreement to support irrevocable short-term letters of credit issued by selected private Indonesian banks, guaranteed by the minister of finance, and confirmed by banks operating in the United States. The Ex-Im would be insuring the U.S. banks’ confirmation letters of credit on behalf of U.S. exporters. However, the Indonesian banks that participated in the program required that the Indonesian importer provide at least 100 percent cash collateral to secure the financing. As a result, no business was transacted under this program.
Summary

While the U.S. Ex-Im Bank actively engaged the governments of Korea, Thailand, and Indonesia in developing programs to support short-term trade finance transactions, only Korea actually benefited from it. Under the Korea program, a little over $1 billion was utilized, while not a single claim was filed. Overall, this program was considered a success, as it filled a financing gap that the private sector was not willing to or could not finance by providing a temporary bridge for needed short-term trade finance support. Once conditions normalized in Korea, the private sector re-engaged in trade financing and the Ex-Im Bank phased out its operations.
The financial crisis that hit Thailand in the summer of 1997 expanded rapidly through the entire Asian region. Indonesia was not spared from the contagion. In fact, although Indonesia had enjoyed 30 years of uninterrupted economic growth and a broadly-balanced macroeconomy, confidence there collapsed suddenly. Capital fled, the currency entered a free fall, and depositors and creditors to Indonesian banks went in full retreat. As the banking sector of Indonesia had potential structural problems prior to the crisis, deterioration of the overall economic situation seriously weakened the system’s financial soundness. The banking sector crisis became the heart of the economic crisis in Indonesia.

Under these circumstances, local commercial banks in Indonesia faced immense difficulties in securing confirmation of their letters of credit from foreign commercial banks. In early 1998, the total value of Indonesian imports transacted through letters of credit plunged to less than one-third of the level in the precrisis period. Indonesian companies had difficulties importing raw materials and components in a timely manner. In addition, Bank Indonesia (the central bank) adopted a tight monetary stance in the face of continued pressure on the currency and also strengthened enforcement of prudential regulations. Therefore, the amount of credit available for lending to the corporate sector shrank and the cost of credit became very high. Indonesian companies, including exporters, were faced with severe shortages of working capital and became incapable of holding sufficient stocks of raw materials and components.

**JBIC Financing Facility**

Under the economic circumstances described above, in January 1998, the government of Indonesia requested support from the government of Japan in connection with letters of

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40Prepared by the staff team of the Policy and Strategy Department for International Operations of the Japan Bank for International Cooperation (JBIC), with contributions from the International Finance Department.
credit for imports of raw materials and other inputs used by the export industry. In response, the Japanese government asked the Japan Bank for International Cooperation (JBIC), which at the time was called the Export-Import Bank of Japan (JEXIM), to use its financing to help the export-led economic recovery of Indonesia.

Following discussion between JBIC and the government of Indonesia, a facility was established aimed at providing Indonesian commercial banks with credit enhancement that would enable them to extend trade credits. In June 1998, JBIC and Ministry of Finance of Indonesia signed a loan agreement in the amount equivalent to $1 billion. The loan took the form of an untied two-step loan and had the following features:

- JBIC extended a loan to Bank Indonesia through Ministry of Finance of Indonesia;
- The proceeds of the loan were credited with a bank account in the name of Bank Indonesia at foreign commercial banks that were designated as possible advising banks for letters of credit issued by Indonesian commercial banks;
- Bank Indonesia and those foreign commercial banks entered into an agreement under which the foreign commercial banks were required to either (i) confirm letters of credit issued by Indonesian commercial banks and pay foreign exporters, or (ii) reimburse other foreign commercial banks that negotiated letters of credit issued by Indonesian commercial banks;
- In return, under the same agreement, the foreign commercial banks were authorized to receive the amount of such payment or reimbursement by debiting the account of Bank Indonesia, upon sending a concerned bill and other shipping documents to the issuing bank of the letter of credit;
- The issuing bank replenished the account of Bank Indonesia at the concerned foreign commercial bank in the amount of the concerned letter of credit within a predetermined period; and
- If the Indonesian commercial bank was unable to replenish the account, the Ministry of Finance and Bank Indonesia replenished the account.

With these mechanisms, it was envisaged that letters of credit issued by Indonesian commercial banks would be honored and that trade financing would resume functioning smoothly.

In May 1999, Indonesia enacted new legislation banning Bank Indonesia from the letters of credit support operations. The government of Indonesia proposed that JBIC replace Bank Indonesia with the newly-established Bank Export of Indonesia (BEI)\(^{41}\) to continue the financing facility. In addition, the government of Indonesia asked the JBIC to expand the facility in order to use a part of proceeds of the two-step loan for financing short-term working capital of domestic export companies (pre- and postshipment export financing), and subsequently for financing domestic importers who

\(^{41}\)The JBIC supported the establishment of the BEI through a series of technical assistance operations.
supply raw materials and components to domestic exporting companies. The JBIC agreed to these amendments of the loan agreement, step by step, during 1999-2000.

As Indonesian companies had been generally suffering from the shortage of working capital credit as described above, use of the two-step loan was accelerated after the amendments. The two-step loan was fully repaid in 2003.

Lessons from JBIC’s Indonesia Experience

The Indonesian economy has been steadily recovering from the crisis, as was demonstrated symbolically by its graduation from the Paris Club debt rescheduling and IMF-supported program at end-2003. External support of trade finance for Indonesia is no longer an urgent issue. However, it would be useful to draw lessons from the implementation of the above-mentioned JBIC financing facility during the crisis.

First, it is important for official bilateral institutions to play a countercyclical role. In particular, during an international economic and financial crisis, they should not follow market-oriented practices but policy-oriented practices. They should provide a country in crisis with new financing to support trade finance, or more generally, the balance of payments, with a clear policy objective of mitigating adverse impact on the international economy during the period when other participants in the markets would extend no credit to the country or offer credit with a prohibitively high premium. Such operations of official bilateral institutions would no doubt benefit all parties in international finance and the international economy, and can be regarded as public goods in the same way as those of multilateral institutions. In this regard, it is critical that the international financial architecture, including but not limited to sovereign debt-related operation practices, be designed to assist such a countercyclical role for official bilateral institutions.

Second, the JBIC has found that untied loans are very effective in supporting a country in crisis. If the financing facility to support the trade finance of Indonesia had taken the form of tied loans, i.e., normal export credit, the facility would not have been utilized sufficiently. The flexibility of untied loans is essential to serve as an emergency support for trade finance or the balance of payments in a crisis country.

Third, regarding the design of the facility to support trade finance, two key points need to be emphasized:

- The facility would preferably target not only direct imports of raw materials and components by exporting companies, but also indirect imports through domestic suppliers. In other words, the beneficiaries of the facility should include not only exporting companies but also other domestic companies that supply imported raw materials and components to exporting companies; and

- The facility would preferably support not only trade finance but also finance working capital. In a financial crisis, most companies face difficulties in securing bank credit for their working capital needs, because commercial banks, with a pessimistic view of the economy, become cautious in extending new credits or rolling over existing credits. Domestic companies would thus be forced to limit
their operations due to the shortage of working capital, which would delay the recovery of the economy. This situation would be exacerbated if enforcement of prudential regulations were to be rashly strengthened during the crisis. Although sound management of monetary policy and prudential regulations are certainly important, it is also important to take into account the adverse impact on domestic industries.

Fourth, the international financial community may benefit by preparing for a crisis even when it is not on the immediate horizon. Having a facility to support trade finance on a contingent basis prior to crisis would be useful, as it may be difficult to negotiate the establishment of such a facility in a timely manner once the crisis occurs.

Conclusions

The JBIC had extensive involvement in the emergency support packages for the Asian financial crises in the late 1990s. The JBIC extended sizable new loans to Thailand, Korea, Malaysia, and Indonesia in the midst of the crisis in coordination with international financial institutions. Some loans had parallel financing from the IMF. Those loans covered balance of payments financing gaps, provided trade finance, and supported domestic industries, including small and medium-sized enterprises in those countries. The JBIC believes that such loans helped to mitigate the adverse impact on the domestic economy of crisis-hit countries as well as on the international economy.

Although the Asian financial crisis is behind us, the JBIC continues to pay attention to the stabilization of the international financial system. The JBIC is willing to consider new facilities to prevent international financial crisis or new operations to eliminate the vulnerabilities of developing-country economies, in consultation with the government of Japan, the governments of developing countries, and international financial institutions.

Appendix 7.1. Japan Bank for International Cooperation (JBIC)42

The JBIC is a government-owned financial institution that was created to implement the Japanese government’s external economic policy and promote economic cooperation through lending and other financial operations. Its main purpose, as stipulated in the JBIC Law (1999), is “to contribute to the sound development of Japan and the international economy and community.” As of the end of fiscal year 2003,43 the JBIC’s outstanding loans, commitments, and equities totaled JPY 21 trillion ($190 billion) (Appendix Figure 7.1). The total amount of annual new commitments over the past several years has averaged approximately JPY 2 trillion ($18 billion) (Appendix Figure 7.2).

42Prepared by Yo Kikuchi, an economist with the International Monetary Fund.
Appendix Figure 7.1. JBIC: Total Outstanding Loans, Commitments, and Equities
(In billions of Japanese yen)

Source: Japan Bank for International Cooperation.

Appendix Figure 7.2. JBIC: New Commitments
(In billions of Japanese yen)

Source: Japan Bank for International Cooperation.
The JBIC Financing Facility for Indonesia

JBIC has two separate operational windows: the International Financial Operations (IFO), which supports overseas activities of Japanese corporations and ensures the stability of international financial systems; and Overseas Economic Cooperation Operations (OECO), which supports developing countries in their efforts to achieve economic and social development. In the past, these two different operations were performed by two different agencies: the Export-Import Bank of Japan (JEXIM), and the Overseas Economic Cooperation Fund. They were merged to establish the JBIC in 1999 to make the implementation of these operations more effective.

The IFO's window accounts for about two-thirds of JBIC's new commitments. Of the JPY1.3 trillion ($12 billion) in new commitments in 2003, 38 percent was allocated to Asian countries, 29 percent to countries in the Americas, and 10 percent to European countries (Appendix Figure 7.3). IFO's financing scheme includes export/import loans and foreign investment loans to directly support Japanese private corporations in their overseas activities, and untied loans to create an external environment for supporting the global activities of Japanese corporations. Japan is a participant in the Organization for Economic Cooperation and Development's Arrangement on Officially Supported Export Credits, and the JBIC operates as an official export credit agency whose export loan conditions are subject to the Arrangement.

The JBIC is unique in its mandate to support the international financial system through balance of payments support to developing countries. This mandate—which was

Appendix Figure 7.3. JBIC: New Commitments by Region in 2003
(IFO Financing Window)

Source: Japan Bank for International Cooperation.

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inherited from one of the two JBIC predecessors, the JEXIM—enables the JBIC to extend parallel financing with the IMF program to fill financing gaps of a developing country facing financial difficulties. During the Asian crisis, JEXIM and the IMF cofinanced, in the form of an untied loan, loans totaling $4 billion to Thailand and $1 billion to Indonesia to support their economic adjustment programs.

Under the OECO’s window, the JBIC acts as an agency of Japanese government that provides official development assistance (ODA) loans on concessional terms to developing countries. This operation accounts for about one-third of the JBIC’s new commitments. Of the JPY588 billion ($5.3 billion) in new commitments in 2003, 90 percent was allocated to Asian countries (Appendix Figure 7.4). By sector, power and gas accounted for 48 percent of the total, followed by transportation at 23 percent, and social services (including education and water supply and sewerage) at 20 percent.

The JBIC’s major funding source is borrowing from the Japanese government, followed by JBIC’s bonds that are issued in both domestic and international markets. In FY2003, the Japanese government’s guaranteed bonds issued in the international market accounted for 16 percent, and nongovernment guaranteed bonds issued in the domestic markets accounted for 8 percent of total funding. JBIC bonds were rated by Moody’s at A2 for nonguaranteed bonds and Aaa for guaranteed bonds, and by Standard & Poor’s at AA- for nonguaranteed bonds and AA- for guaranteed bonds, as of the end of April 2004.
Like several other recent emerging-market financial crises, the crisis in Argentina starting in late 2001 as well as in Brazil from late 2002 until early 2003 were accompanied by major cutbacks in pre- and postshipment, export-oriented trade finance extended by international lenders to domestic borrowers.

Heightened global risk aversion, concerns over public sector debt dynamics and private sector international debt amortizations, as well as political uncertainties due to upcoming presidential elections all played a key role in the significant withdrawal of international trade credit to Brazilian borrowers from late 2002 until early 2003. Nonetheless, Brazil’s trade finance cutback was somewhat surprising for four reasons. First, it was greater than trade line curtailments in prior, and arguably more severe, Brazilian financial crises, such as the debt restructuring episodes of the 1980s, the Tequila crisis spillover in 1994–95, the Asian crisis in 1998, and the shock from the devaluation of the real in 1999. Second, a substantial international support package to address the financial crisis was rapidly put in place on the basis of Brazil’s reasonably credible macroeconomic policies. The foreign exchange resources made available by the IMF program were more than sufficient to cover debt service obligations of the sovereign well into the new administration’s first year in office. Third, the country’s domestic financial system was on a sound footing, and was not experiencing any systemic distress. Fourth, trade finance reductions in Brazil occurred in spite of the fact that the pre- and postshipment export finance facilities being withdrawn were usually short term and self-liquidating in nature. In other words, they funded transactions that generated foreign exchange that could be used to repay the relevant trade finance operations, and therefore had considerably less performance as well as credit risk than other types of Brazilian cross-border credit exposure.

There are several possible explanations for this relatively unprecedented cutback in trade finance during the recent Brazilian crisis. Many of the conventional causes of financial crises in emerging markets (public sector deficits, uncoordinated monetary policy, dysfunctional financial sectors, etc.) either did not exist or were being adequately addressed in Brazil in mid-2002, especially after the country’s new $30 billion IMF program was announced in August. Nevertheless, trade finance lines continued to be withdrawn by international banks. Brazil’s experience in mid- to late 2002, therefore, illustrates how international trade finance cutbacks can continue, even after implementation of an IMF or similar international financial support package. Moreover, it starkly shows how such trade finance reductions—particularly in an environment of volatile and skittish markets—can play a central role in exacerbating macroeconomic instability already being experienced by a country during a financial crisis.

The Brazilian crisis also highlights the importance of at least one form of targeted intervention by multilateral development banks (MDBs) that could be undertaken more systematically in similar situations going forward to address the vulnerability of emerging markets to sharp cutbacks in international trade finance during financial crises. However, as discussed below, the intervention that proved particularly successful in Brazil during the period from late 2002 to early 2003 would not in all likelihood have been possible without a well-functioning and solvent domestic banking system—in other words, one that could continue to credibly intermediate international trade finance flows—as well as a sovereign that had not defaulted on its international debt obligations.

On the other hand, the Argentine situation offers some lessons on alternative actions as well as transactional structures that could be taken or encouraged by MDBs to help restore trade finance liquidity during a financial crisis when a country’s domestic banking system has stopped playing its role as an intermediary for domestic as well as international credit flows, and if a sovereign has defaulted on its international debt obligations. In this alternative scenario, rather than mobilizing international credit flows through B loan/preferred creditor status transactional structures, MDBs can help channel locally-sourced liquidity to exporters by supporting securitizations of trade finance assets as well as placement of the resultant debt instruments with domestic institutional investors.45

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45What are called B loan/preferred creditor status transactions are funding operations arranged by an MDB under which the MDB takes direct credit exposure to an emerging market borrower and participates out a significant portion of that credit exposure to international private sector lenders. Therefore, private sector lenders provide funding to the relevant emerging markets borrower under the “umbrella” of the MDB (i.e., the MDB remains the lender of record). Because the MDB is deemed to have preferred access to foreign exchange resources in the event of a transfer and convertibility event, it is assumed in these operations that international private sector lenders will be able to focus solely on the commercial risk of the transaction’s borrower, rather than sovereign as well as transfer and convertibility risks that they would normally assume in a direct lending operation. For these same reasons, moreover, pricing on such transactions should reflect the lower sovereign as well as transfer and convertibility risks associated with the relevant lending operations, and compensate lenders solely for the commercial risk profile of the underlying borrowers.
The Brazilian Situation in Late 2002 and Early 2003

Unlike past financial crises, when international trade finance lines were maintained in spite of cuts in other categories of cross-border debt extended to Brazil, there was a significant decline in this type of credit exposure to the country starting in mid-2002 (Figure 8.1). Banco Central do Brasil has estimated that trade finance lines declined by approximately 30 to 40 percent in 2002 from their levels in 2001, with foreign banks’ credit lines to Brazilian banks (a major part of which are comprised of trade finance exposure) declining from a high point of $22 billion in late 2001 to $16 billion in October 2002. The impact on exporters of this decline in trade finance was magnified by a shortening of tenors on trade facilities left outstanding by international banks, with offered maturities falling from 360 days to as short as 30 days. Spreads charged on lines left in place, if at all, for high-quality borrowers also increased from their conventional levels to more than 6 percent per annum over LIBOR during July-October 2002. The cutback in trade finance was accompanied by a withdrawal of incremental credit insurance and monoline wrap capacity for holders of Brazilian financial assets, including trade finance. This occurred because the international insurance and reinsurance industry had already “maxed out” on Brazil, and could not exceed country limits on Brazilian exposure as a result of its perceived financial crisis. Therefore, insurers would not make new cover capacity available to potential credit risk hedgers.46

46Trade finance has traditionally been viewed as one of the less risky forms of credit exposure. But it is always the easiest asset class for banks to cut back in times of heightened risk aversion (since it is a short-term asset that tends to be self-liquidating, allowing it to be quickly redeemed at par while other types of credit exposure such as bonds and long-term loans would have to be liquidated or hedged by banks at a loss in markets when there is poor sentiment toward the relevant country, and where most likely spreads on financial instruments issued by the country and its borrowers have risen and their financial asset prices have fallen). Given these two fundamental features of trade finance credit exposure, there are two possible reasons for the unprecedented sequence of events in Brazil from late 2002 to early 2003. First, compared with 10 or 15 years ago, there are fewer international banks participating in the trade finance product area, largely a result of consolidation in the international banking sector. Previously, when cutbacks occurred, they were spread over a larger number of banks, and therefore probably happened over a longer period of time. Thus, the “elasticity” of international trade finance flows, i.e., the ratio of absolute amount of increase or decrease in bilateral trade lines to the time over which such increases or decreases occur, has probably increased due to sectoral consolidation. Second, beginning in the 1990s, supposedly “automatic” preferential policies toward trade finance by emerging market-governments gave way to fragmented and inconsistent treatment. And increasingly, where preferential treatment has been given to trade finance debt (i.e., it is excluded from any moratorium/rescheduling as well as transfer and convertibility restrictions that might be imposed on other categories of cross-border debt), such treatment has been in most instances narrowly drawn, for example, with respect to vendor financing only, or with respect to the mode of access to foreign exchange only. Special treatment of banks and other financial companies has also become more sporadic, even where these entities had only refinanced vendor financing. In summary, these two factors probably go a long way in explaining the more rapid contraction in trade finance flows during the recent Brazilian crisis, compared with prior financial crisis episodes experienced by this country.
The shortage of trade finance not only inflicted a liquidity squeeze on the country’s export sector, but also impacted the pace of devaluation of the real and therefore conditions in Brazilian local financial markets. For instance, during the July-October 2002 period, the shortage fueled greater-than-normal corporate demand for U.S. dollars and put downward pressure on the real, as exporters were forced to repay lines that were not being rolled over. It also contributed to a decline in U.S. dollar spot trading activity to 10 percent of its normal volumes, which made the country’s foreign exchange markets less liquid—and therefore more volatile. Accelerating devaluation tendencies of the real, in turn, negatively affected investor perceptions of public sector debt dynamics, since a significant portion of domestic federal government securities in Brazil is indexed to the U.S. dollar.

In response to this situation and as a complement to its recently announced IMF program, the government initiated several measures in the third quarter of 2002 to provide temporary, short-tenor liquidity to trade finance markets. One example was a special provision of $560 million of 180-day funds for 330 export operations from the Fundo de Amparo do Trabalhador of country’s development bank (BNDES). As a result of increased reserve usage flexibility under its $30 billion IMF program, the Banco Central do Brasil also made available to domestic banks, through periodic commercial auctions, approximately $900 million of the $2 billion of available foreign exchange resources for 180-day trade finance onlending.
The above-mentioned government efforts to inject temporary, short-tenor liquidity into the country’s trade finance markets were complemented by an International Finance Corporation (IFC) initiative undertaken between September 2002 and March 2003 to rapidly provide international funding to leading Brazilian banks that are major players in the country’s trade finance sector. Before this intervention was concluded in March 2003 as a result of improved market sentiment and trade finance liquidity in Brazil, IFC trade finance facilities (TFFs) were arranged for four domestic private sector banks that are leading intermediaries in Brazil’s trade finance markets (Unibanco, Itau, BBA, and Bradesco). The four separate TFF A/B Loan (i.e., preferred creditor status) transactions undertaken for these banks raised an aggregate amount of $740 million of international funding for the country. This amount included $110 million of IFC 2-year A loans, a $50 million IDB 2-year A loan, and $580 million of 1-year B loan funding mobilized from 35 international commercial banks (domiciled in Asia, Europe, and the United States).

The B loan/preferred creditor status feature of the TFFs was fundamentally successful in addressing international banks’ political as well as transfer and convertibility risk concerns involving a relatively low-credit-risk asset class such as trade finance. In that regard, it helped to (i) convince international banks with existing credit-line authorizations to the relevant banks to re-extend trade funding that had been withdrawn; (ii) allow Brazilian banks to lock in 12-month funding from commercial sources that otherwise would not have been available, due to the above-mentioned shortening of tenors on trade finance lines left outstanding by international lenders; and (iii) mobilize several “new money” commitments from international banks that did not have existing credit line authorizations to the relevant Brazilian banks.

Since they were all immediately committed and disbursed, the TFFs made trade finance resources quickly available to a broad cross-section of Brazil’s exporter community, in terms of (i) the number of exporters that benefited from onlendings undertaken under the program by the four Brazilian banks; (ii) the amount of onlendings to such exporters; and the (iii) tenors provided to borrowers—which were considerably longer than maturities offered at the time by either government programs or commercial lenders under conventional bilateral lines. The relatively large size of the TFFs, alongside that of the government’s own trade finance interventions, had a noteworthy circuit-breaker effect on the negative exchange rate dynamics referenced above, especially given the extremely illiquid conditions and demand/supply imbalances in spot foreign exchange markets in Brazil at the time.

As risk aversion toward Brazil decreased by mid- to late 2003, normalcy returned to Brazilian financial markets, and conventional trade finance liquidity was restored to banks as well as exporters. All of the above-mentioned TFFs were prepaid by the four borrowing banks that had undertaken transactions under the program.

The Argentine Crisis

One immediate consequence of the Argentine crisis that started in late 2001 was the withdrawal of credit facilities by most international banks for any new financial
operations involving the country, as well as the curtailment of existing credit exposure to Argentine borrowers. In this environment, even trade finance activities were not immune to the cutbacks by international lenders of credit being offered, both to local bank operations as well as domestic exporters, given the perception of heightened political as well as transfer and convertibility risk in Argentina as a result of its sovereign default.

An analysis of the effects of Argentina’s crisis on the country’s banking system is beyond the scope of this chapter. Suffice it to say, however, that the crisis led to a virtual collapse of financial and credit intermediation via the country’s banking system. Even by mid-2004, in spite of some positive developments in the banking sector resulting from stabilization of many economic variables and sustained deposit growth since mid-2002, Argentina’s banks had still not been able to resume normal operations. Banking sector normalization continues to be hindered by the government’s failure to define its stance on certain aspects of bank compensation for losses incurred as a result of various gaps and mismatches occasioned by governmental actions during the early phases of the crisis. And the current scenario is likely to push the banking system’s recovery and, therefore, its ability to play an active role in providing the credit necessary for sustainable growth in the real economy, out further into the future.

Moreover, many leading Argentina banks from early 2002 until mid-2004 were technically insolvent as a result of the crisis (in spite of the fact that most of them soon returned to a position of relative liquidity, or continued to be characterized by reasonably sound operating capacity). They also were in the process of restructuring their international liabilities. As a result of these two conditions, the de facto ability of the banks to act as conduits for trade finance lines would already have been diminished, even if international credit lines offered to them had not been cut as a result of the crisis.

Nevertheless, since mid-2002, as retail deposits returned, banks have started to accumulate significant amounts of domestically sourced Argentine peso and foreign currency (mostly U.S. dollar) liquidity. In spite of this trend, however, they have been slow to resume credit operations (i.e., onlend funds from their growing deposit base). New credit lines that have been made available recently by banks (for instance, peso-denominated, medium-term mortgages at fixed rates and some U.S. dollar-denominated trade finance facilities) remain small or limited, and do not yet indicate a clear trend of improving credit conditions. Instead, banks have remained focused on securing government compensation for losses arising from the crisis, and addressing continuing net worth concerns. The latter point is important, since about half of Argentine bank assets are public sector securities and compensation instruments yet to be issued, whose ultimate value is not certain (on the other hand, private sector nonperforming loans on their balance sheets are now below 3 percent of GDP). Moreover, bank balance sheets are structurally mismatched, mostly as a result of various government actions/regulations (e.g., asymmetric “pesification”). For all these reasons, in the absence of fundamental reform, the country’s banking sector as a whole can be deemed to have negative net worth, and its solvency will continue to be very much linked to the government’s own credit profile.

As mentioned above, most Argentine banks have recently started to provide some level of trade finance that is funded by U.S. dollar deposit inflows they have captured in the
last 12 to 18 months. This has occasioned since 2003 a gradual reduction of U.S. dollar interest rates for trade finance that is offered to exporters. However, with lenders offering few international credit lines to Argentine banks, spreads on trade finance currently made available by local financial institutions to domestic customers remain extremely high by historical standards, basically because of the uncertain stability and short (rarely beyond 30-day) tenor of banks’ U.S. dollar, retail deposit funding base. Therefore, banks have been reluctant to offer funds to borrowers with longer tenors, and if they do so, such funding must necessarily be priced at extremely expensive rates (over 10 percent) to compensate for the banks’ potential asset/liability tenor mismatches, if borrowers actually take money at these rates at all. It is also important to note that large banks, which are primarily foreign-owned, are only lending to top-tier exporters in limited sectors, and that smaller banks have not traditionally been major trade finance players. Moreover, since the U.S. dollar deposit base of the latter is unlikely to grow beyond current levels, their role in providing incremental export finance going forward is likely to be limited.\footnote{One underpinning of any sustainable Argentine recovery from its crisis will be satisfactory export sector performance. For the moment at least, since devaluation of the peso in late 2001 and early 2002, this precondition has been met. Argentina ended 2003 with a foreign trade surplus of $15.5 billion, versus $16.7 billion in 2002, representing the country’s third year of such double digit surpluses. The 2003 surplus was based on exports of $29.3 billion, a 14 percent increase over 2002—with 9 percent of that increase attributable to more favorable prices for Argentine exports, and 5 percent due to the increased physical quantity of export volumes. However, the jump in exports was narrowly based, with 90 percent of it having been due to growing international sales of traditional commodities (soy, cereals, meat products, and petroleum products). Moreover, the three principal factors that benefited the country’s export performance last year—high international commodity prices, a record agricultural harvest, and a favorable foreign exchange rate)—are not necessarily permanent phenomena. In this environment, a continued lack of reliable and reasonably priced trade finance represents a potential impediment to the sectoral broadening as well as eventual sustainability of Argentina’s recent favorable export growth performance.}

Argentina’s top 20 (so-called “first-tier”) exporters (of mostly grain and petroleum-based products) account for approximately 50 percent of the country’s export sales. With the exception of the period immediately after the onset of the crisis, these firms have had relatively little difficulty in obtaining pre- and postshipment export funding from the country’s traditional providers of trade finance (local and international commercial banks, as well as global commodity trading firms). However, second-tier exporters have not had such favorable access to trade finance since the onset of the country’s crisis in late 2001. This second tier of exporters has responded to cutbacks in trade funding from commercial banks by not offering deferred payment terms to purchasers of their products (which reduces their international competitiveness, compared with exporters of the same products in other countries that do so), or by self-financing—from their own net worth—export activity. The latter response, after initial adjustments in 2002 involving both their production cycles and working capital utilization profiles, has allowed them to take advantage of more favorable Argentine export prospects as a result of peso devaluation, in spite of the dearth of reliable and reasonably priced trade finance. However, it is not necessarily optimal from a long-term perspective, since the scarce equity resources of Argentine firms—which should normally be used to finance fixed
assets and increases in productive capacity—are instead being used to fund a portion of
day-to-day working capital needs.

The scarcity of reliable and reasonably priced trade finance for second-tier exporters has
been largely due to the above-mentioned breakdown in conventional trade finance
markets, and has occurred as a result of (i) the inability of Argentine banks (both locally-
and foreign-owned) to obtain ample bilateral credit lines from international banks to
fund the export activities of their clients; and (ii) the relatively unstable and short-tenor
retail deposit funding base of banks, which forces them to price at expensive rates any
loans that might be made with maturities longer than those of their deposit liabilities.
Moreover, the uncertain availability of conventional trade finance credit facilities from
banks has made companies that formerly used such funding facilities—but had them
pulled after the advent of the crisis—reluctant to reaccess them even when these credit
lines may now be made available, as they have little assurance of their medium- to long-
term availability.

In the absence of sufficient, reasonably priced trade finance from conventional banking
system conduits, exporters have at least one alternative funding source (aside from self-
financing). This entails securitization of their pre- and postshipment trade finance
receivables, and placement of the resultant securities with domestic institutional
investors.

For several reasons, there are good prospects in the short to medium term for such trade
finance securitization activity. As far as supply of such securities is concerned, second-
tier exporters may have to turn with increasing frequency to nontraditional sources of
funding, given ongoing difficulties in the country’s banking sector. Although this trend
may be less pronounced now than it was in the immediate aftermath of the country’s
crisis, second-tier companies are still not able to access on a reliable basis reasonably
priced trade finance through conventional bank channels.

In terms of demand for securitized trade finance assets, for several reasons there is likely
to be considerable appetite from domestic investors for this type of credit exposure.
First, domestic institutional investors must hold the bulk of their investments/ assets in
the form of local securities/credit exposure. Second, domestic institutional investors,
such as pension funds that hold increasing amounts of liquidity, are actively looking for
new investment alternatives (to complement their large holdings of government
securities), given the dearth of securities issued by the private sector in Argentina since
mid-2001. Third, unlike Argentine banks during the country’s recent crisis, institutional
investors such as pension funds have relatively long-tenor liabilities (i.e., the retirement
savings of their contributors); thus, they are more willing to fund relatively long-tenor
assets. Therefore, pension funds as well as other “buy-and-hold” institutional investors
are likely to be more willing than bank depositors are with their short-term deposits to
roll over securitized trade finance asset exposure, as they are actively searching for longer
duration assets to match their long duration liabilities.

Such domestic institutional investor appetite for trade finance securitizations has already
been demonstrated in oversubscriptions of trade finance securitization offerings brought
to market so far in Argentina (for example, excess investor demand of approximately
$30 million for a $20 million Export Securitization Program transaction undertaken in late 2003—the largest domestic Argentine securitization undertaken last year.48

In a country such as Argentina, where a sovereign default has occurred and the domestic banking system has essentially jack-knifed, it is probably going to be relatively difficult for MDBs—even with the use of B loan/preferred creditor status structures—to rapidly mobilize international funding from commercial banks to help address the country’s trade finance shortfalls. Thus, the approach used by the IFC during Brazil’s recent financial crisis would not likely be effective in a scenario like that of Argentina, where the state of the domestic banking system, since it is so closely associated with the credit of a defaulted sovereign, is perceived by international lenders to be unsound and not fundamentally creditworthy.

The ability of MDBs to commit additional credit to a country in crisis, however, could be effectively used to help mobilize domestic savings or liquidity from institutional investors to help fill trade finance shortfalls. In the context of securitization programs targeted toward domestic institutional investors of the kind described above, such credit commitments could take three forms. First, MDB credit lines could be provided to domestic financial entities to allow them to originate trade finance assets and warehouse them for eventual securitization and placement with domestic institutional investors. Second, MDB backstop facilities could be made available to domestic financial entities to provide assurance to local institutional investors that a particular securitization placement will not be undersubscribed. MDB firm-purchase commitments for a portion of the relevant securitization offerings could play an important role in keeping such undersubscription scenarios from occurring.49 Third, MDBs could offer partial credit guarantees for domestic securitizations of trade finance receivables.50

48For various reasons, from an operational perspective, Argentine banks are the most likely entities to be able to arrange trade finance receivable securitizations. However, a bank arranging such a securitization transaction does not necessarily have to play the traditional role of a credit intermediary in onlending funds it has borrowed itself or that it holds as deposits. That is because Argentine banks are permitted to invest up to a certain percentage of their peso-denominated equity in foreign currency assets. As a result of this regulatory flexibility—and if the relevant transaction is structured correctly—Argentine banks can undertake all of the following simultaneously, and incur minimal credit risk: (i) purchase foreign currency in the domestic foreign exchange market with pesos; (ii) use the purchased foreign currency to fund and therefore source foreign currency-denominated trade finance assets from exporter clients; (iii) appropriately securitize those assets, and then sell the resultant debt securities to domestic investors for the peso-equivalent of the original foreign currency financing amounts; and (iv) use these peso sale proceeds to replenish their equity.

49Like their brethren elsewhere, pension funds in Argentina tend to invest in unison, principally because they are not permitted by the regulatory authorities to purchase more than a certain maximum percentage of any securities offering. Therefore, the sudden withdrawal of one pension fund from a particular transaction—for reasons that might have nothing to do with the credit quality of the relevant investment opportunity—can result in an entire securities offering having to be withdrawn from the market.

50These partial credit guarantees would offer second-loss protection for investors from credit events in any particular transaction’s portfolio of trade finance assets. First-loss protection would most likely have to be provided by the financial entity sponsoring the relevant securitization transaction in order to adequately align that entity’s interests with those of investors and second-loss protection providers.
Conclusions

The comparative description in this chapter of the effects of Argentina’s and Brazil’s recent financial crises on trade finance availability highlights the importance of well-functioning domestic banking systems in maintaining trade finance flows to local exporters. Moreover, during an emerging-market financial crisis, when a country’s banking system is relatively sound/solvent and the sovereign has not defaulted on its international debt obligations, it is possible for targeted interventions by MDBs to play a role in mobilizing international trade finance liquidity from commercial lenders (and perhaps insurers) through B loan/preferred creditor status structures that address transfer and convertibility concerns of the latter.

However, when a sovereign has defaulted on its international debt obligations and a country’s domestic banking system is dysfunctional or insolvent, B loan/preferred creditor status interventions are not likely to be successful in mobilizing incremental trade finance liquidity from international markets for the emerging market in question.

In these alternative scenarios, nevertheless, there may still be scope for MDBs to play a role in supporting securitizations and domestic placements of trade finance receivables. While more time-consuming and costly to structure than plain B loan/preferred creditor status transactions, domestically-oriented trade finance securitizations as well as accompanying MDB interventions meant to support them could still play an important role in mobilizing alternative domestic sources of trade finance liquidity in emerging markets such as Argentina that are experiencing protracted financial crises.

51In other words, unsecured credit exposure by MDBs to the relevant emerging-market borrower.
Part III

Restoring Access to Trade Finance
Multilateral development banks (MDBs)—including the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB), and the African Development Bank (AfDB), as well as the International Development Association (IDA) and International Finance Corporation (IFC) of the World Bank Group—offer a variety of guarantee, loan, and investment products or “tools” that can help keep domestic and international trade finance available to importers and exporters in crisis-affected countries.

During previous periods of financial crisis, some have argued that these tools focused on “bailing out” the government of the crisis-affected country through more conventional hard-currency loans. This helped restore foreign exchange reserves and international confidence, and enabled continued servicing of existing foreign exchange debt owed to public sector financial institutions and private sector banks—including some that were overexposed to the crisis-affected country or were undercapitalized.

More recently, some MDBs have experimented with (i) lines of credit directly to local banks to ensure access to foreign exchange and thus increase liquidity; (ii) guarantees supporting local bank obligations to pay under documentary credits; and (iii) risk-sharing arrangements that allow local banks to provide more domestic trade credit and other financing to a wider variety of borrowers than their capital base would otherwise allow.

Looking ahead, MDBs can play a more effective role in supporting access to trade finance during periods of crisis. By improving and mainstreaming their available tools, MDBs can more quickly and economically use them in a number of markets well before a crisis starts. MDBs can also focus on filling market gaps that might come up so that private-to-private and cross-border country and bank limits can stay open and domestic intermediation can continue.

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The end result will allow MDBs, both in the run-up to and during a crisis, to use the least amount of intervention possible, prioritizing tools that help maintain private-to-private flows, and leaving the public-to-public foreign exchange loan alternative as a last resort.

This chapter summarizes how these tools are or can be used by MDBs, and argues for the need to prioritize their use by highlighting the strengths and weaknesses of each tool in keeping trade finance available to importers and exporters in crisis-affected countries. The chapter also looks at some related policy issues that need to be addressed for these MDB tools to be fully effective.

**MDB Tools**

To support access to trade finance during periods of crisis, MDBs potentially can intervene through domestic private support to maintain and encourage local credit intermediation; international or cross-border private support to keep country and correspondent bank limits open; and cross-border public support to maintain international confidence in the host government.

**Domestic Trade Finance Support through the Private Sector**

An MDB can encourage local credit intermediation by sharing loan portfolio risk with local banks, making local currency loans to local banks for onlending, making local currency loans directly (or channeled through others) to local borrowers, and injecting equity into local banks.

*First, by sharing loan portfolio risk with local banks through partial credit guarantee facilities, MDBs can share the risk associated with an agreed portfolio of loans provided to targeted borrowers. These loans can be in local or hard currency, and include trade finance in the form of (i) letter of credit opening, advice, confirmation, and discount; (ii) pre- and postshipment finance; and (iii) bid, performance, and advance payment bonds.*

MDBs can share risk on, for example, a 50/50 pari passu basis, allowing the MDB to leverage off local banks’ due diligence and local knowledge. Meanwhile, the local bank can extend twice as much credit to the targeted borrower class with nearly the same amount of risk-taking capital. This arrangement allows MDBs and local banks to work in partnership. However, local banks must have some risk-taking capital and the ability to understand, measure, and price the agreed-upon portfolio risk. Liquidity must exist within the country and government borrowing should not crowd out private sector borrowing. On the other hand, the MDB would need to act in a more commercial manner, delegating a part of its approval process and loan management to others.

*Second, MDBs can make or guarantee local currency loans to local banks for onlending. This would allow local banks to offer longer-term, fixed-rate, or floating-rate loans matching both the longer-term and interest rate base of the MDB loan/deposit and, perhaps more importantly, the needs of local borrowers and their cash flows. An MDB may also*
consider accepting a below-market return from local banks to encourage or force lower onlending interest rates.

However, the below-market return accepted by the MDB may distort the market for deposits taken by local banks. The MDB becomes responsible for picking “winners and losers” in the local bank market. Also, making or guaranteeing local currency loans to local banks for onlending assumes that selected local banks have risk-taking capital available to accept additional deposits and extend additional loans, albeit guaranteed.

Third, by making local currency loans directly or channeling them through others to local borrowers, MDBs may force liquidity into the local banking system and bypass local banks, which are unable or uninterested in making “risky” loans. However, this means that the MDB must have access to equal or better credit knowledge than local banks and have the ability and desire to act commercially.

Finally, MDBs can inject equity into local banks, making available the new risk-taking capital needed to jumpstart local intermediation. Such investments can be seen as a vote of confidence in one or more local banks, giving other investors the comfort of the MDB’s “halo.” Again, this makes the MDB responsible for picking winners and losers in the local bank market. Moreover, the involvement of the MDB must genuinely add value to the local bank, while ensuring that the MDB does not get embroiled in internal management matters. And, in any event, the equity investment may not change the local bank’s risk aversion or ability to attract deposits needed to fund additional loans and trade finance facilities.

**Cross-border Support through the Private Sector**

During periods of crisis, MDBs can keep country and bank limits open and help maintain foreign exchange reserves by providing cross-border support to the private sector through political-risk guarantees for letters of credit issued by local banks, and through comprehensive guarantees for letters of credit issued by local banks (Figure 9.1).

*First, MDBs can provide limited guarantees for letters of credit, documentary credits, and other foreign exchange obligations owed by local banks, to help keep country limits open.* Guarantees limited to foreign exchange conversion and transfer blockage can stabilize the political risk component in confirmation fees and interest margins, while posing little risk to the MDB, given the charter and other protection normally enjoyed by MDBs against foreign exchange conversion and transfer blockage.

Political risk guarantees, however, do not cover commercial and other risks associated with the local bank issuing the letter of credit, which could also be of concern to the confirming bank during periods of crisis.

*Second, through the provision of comprehensive credit guarantees, MDBs can cover not only political risk but also commercial and other risk associated with local banks issuing letters of credit.* This avoids the need to provide direct equity or foreign exchange loans to local banks and helps keep both country and bank limits open during the period of crisis. These guarantees can complement existing letter of credit confirmation insurance schemes provided by public and private sector export credit agencies. They should not distort market pricing if
guarantee fees are a percentage of market-driven confirmation fees determined by confirming banks.

For such guarantee support to be effective, however, local banks must still have risk-taking capital available and be willing to intermediate and provide domestic trade finance. Further, the MDB is again responsible for picking winners and losers in the local bank market. Also, some question what ranking MDB-supported trade finance should have if a host government reschedules as a result of a financial crisis.

**Cross-border Support through the Public Sector**

MDBs can extend foreign exchange direct loans and provide guarantees to crisis-affected governments (Figure 9.2). These are the conventional tools used by MDBs, and they are well understood by ministries of finance and the market. Such public/public support can help maintain or restore international confidence by increasing foreign exchange reserves and requiring structural changes and policy reforms as conditions to disbursement.
However, when compared with the previous forms of private support, foreign exchange loans and guarantees to crisis-affected governments have limited value when it comes to trade finance, in light of the following:

- Short-term emergency support can turn into long-term dependence, if needed structural changes and policy reforms do not take place;
- Governments may not be able to properly price the loans they subsequently make to local banks, and may interfere with the pricing of the trade finance provided by the local bank to borrowers, causing further distortions in the local market;
- Foreign exchange loans made by MDBs to governments do not create risk-taking capital for local banks, unless the government retains all or some of the borrower risk.

A collapse of confidence resulting in the reduction or cancellation of country and bank limits can occur quickly, while the public/public response by MDBs can sometimes take time.

Policy Issues and Conclusions

For the MDB tools discussed above to achieve full effectiveness in ensuring access to domestic and cross-border trade finance during periods of crisis, the policy issues below need to be addressed.
Host governments need to play a major role in improving the creditworthiness of the local bank and nonbank financial sector through better supervision, improved corporate governance, and by cleaning up nonperforming loans. Governments need to work toward improving the legal system and the ability of local banks to enforce security, encourage competition from international and local banks in trade finance, and promote the establishment of local credit rating agencies to rate banks and their customers.

Whenever possible, governments should also encourage the private sector to provide export credit insurance to help exporters safely sell to new buyers in new countries and increase the quality of trade receivables held by exporters.

Local banks need to acknowledge that well structured trade finance is less risky and is good business. Maintaining or improving their credit rating systems will result in lower cost of letter of credit confirmations and interbank debt. These institutions should nurture correspondent banking relationships, since these will become strained during times of crisis. Local banks must also take advantage of export credit insurance offered by leading international credit insurers, official or private.

International and regional banks should consider revisions to country and bank limits only when based on reliable information, and not merely as a knee-jerk reaction to unfolding events. They should also take advantage of cross-border risk mitigation products such as political risk insurance and trade credit cover from both private and public sector political risk insurance providers and export credit agencies. And if necessary, they can also take advantage of the political risk and credit guarantee programs offered by MDBs.

Multilateral development banks need to build confidence among host governments, local banks, and international banks by using carefully-targeted products or tools. But they should do so only when the market is unable to fill a demand gap. MDBs need to keep host governments focused on what they need to do, through policy support and capacity building.

MDBs must continue to recognize that trade finance plays a critical role in helping developing countries increase exports and ultimately earn more foreign exchange, which is needed to service and repay foreign debt and also create employment and reduce poverty.
Chapter 10

Trade Credit for Crisis Countries: The Role of Export Credit Agencies

Glen Hodgson

Developing countries in financial crisis appears to be a recurring feature of the international financial system. For the purposes of this chapter a “crisis country” is defined as one that is unable to service its external debt obligations as scheduled and is experiencing other forms of severe economic stress (for example, a sharp currency devaluation, reserve depletion, fiscal and macroeconomic disequilibrium, etc.). While a framework has emerged for providing financial assistance and relief to crisis countries in an orderly fashion, with the IMF (and to a lesser degree the World Bank) at its center, it is certainly possible to consider enhancements to that framework. Maintaining or restoring access to trade credit is one possible enhancement. This chapter identifies institutional and economic policy constraints faced by export credit institutions when a crisis country needs trade credit. It points to transaction-based action that could be taken by external lenders and insurers to restart the flow of credit to crisis countries, and concludes with some observations on how multilateral policy changes could make the flow of trade-related credit to developing countries more sustainable.

Changing Face of Trade

Global trade in recent decades has grown much more rapidly than global GDP, reflecting the combined forces of increased economic integration and greater disaggregation of production. Economic integration is the result of the greater trade liberalization that has occurred multilaterally and regionally since the 1980s. Since trade barriers are lower, companies are increasingly disaggregating production through global supply chains. They are breaking their products into smaller components, focusing on

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what they do best, and purchasing inputs internationally. Foreign direct investment is used to build global supply chains and is thus an integral part of trade today.

Some developing countries are reaping the economic benefits of trade integration and globalization—China is a stellar example, as are other East Asian economies. In contrast, many other developing countries are still largely engaged in more traditional forms of trade—the international buying and selling of goods. But one need virtually all developing countries have in common is for trade finance. In most cases, that means accessing credit from external sources, since few of these countries have a financial system that is sufficiently mature to meet all their trade finance needs.

**What Is Trade Credit?**

Trade finance covers three broad categories of credit that can be used to facilitate international trade. First, credit can be provided to domestic buyers to purchase imports, especially for those used as inputs when making exports. Second, exporting firms normally require domestic working capital to pay operating costs prior to shipment of and payment for the export. And third, credit can be extended to foreign buyers of exports to facilitate the completion of the export sale. A wide variety of specific financial and insurance instruments have been developed to extend credit for trade, but all these instruments perform one of these three basic functions.

A distinction should also be made between short-term trade credit of a year or less for normal trade in goods and services, and medium- and long-term credit for capital goods and projects. For crisis countries, the loss of short-term trade credit can exacerbate the situation by choking off the capacity to export. Medium- and long-term trade credit is less critical in immediate crisis situations, but can play an important role in crisis prevention and crisis recovery by supporting a sustainable pattern of trade and investment activity.

**Constraints Faced by Export Credit Agencies**

Export credit agencies (ECAs) face a number of constraints to maintaining or restoring trade credit for crisis countries.

**Institutional Limitations**

The first constraint is the nature of export credit agencies themselves. These institutions were never intended to act as international crisis managers; that role belongs to the IMF, World Bank, and the regional development institutions. In addition, ECAs are not homogeneous, even though state-owned ECAs generally have a mandate to foster national trade and advance national interests. There are significant differences between individual ECAs in philosophy and financial underpinnings that lead to major differences in behavior and performance. Finally, ECAs are in a constant state of evolution, and the differences may be increasing, not shrinking. In sum, ECAs are
generally limited from the outset in what they can do to fill credit gaps for developing countries in crisis.

We have already noted the distinction between short-term trade credit for normal trade, and longer-term (i.e., over two years) insurance, guarantees, and financing used for capital goods and projects. Through privatization, the public sector has largely exited the short-term credit insurance business. Japan and Canada are the only Group of Seven countries with a public sector institution offering short-term credit insurance as a core product. Very few other industrial countries have any material public sector, short-term export credit insurance capacity. While there are valid questions as to whether governments should have abandoned the short-term credit insurance field so completely, that bridge has largely been crossed.\(^{54}\)

Private export credit insurers have no public policy mandate and operate for profit. For developing countries in the midst of a financial crisis, private insurers generally have little interest in preserving existing levels of cover or extending new cover—except by cherry-picking the very best commercial credits. Yet because of privatization of their short-term export credit businesses, creditor governments have little or no capacity today to re-open in a crisis country on a shorter-term basis and then gradually extend longer credit terms once a positive payments track record had been established. Therefore, the current state of the credit insurance market is a fundamental constraint to restarting trade credit for crisis countries.

Constraints also exist with respect to medium-term credit. Export credit systems differ widely, reflecting very different operating philosophies and underlying financial conditions. No two creditor-government export credit systems are exactly alike. Compare, for example, the financial conditions for the U.S. Export-Import Bank, which is based on a lender-of-last-resort concept backed by annual budgetary appropriations from Congress, with that of Export Development Canada (EDC), which has government capital originally invested in its balance sheet, is expected to grow through profits and retained earnings, and must take responsibility for all its credit decisions. Countries like France, Germany, and the Netherlands have engaged private insurers that act as agents for the state, but with governments taking the core credit decisions and the risk. These complex institutional arrangements make it very hard to generalize about how export credit institutions providing medium-term credit might play a more prominent role in countries in crisis.

Finally, the practices of individual ECAs along with the international rules governing official export credit—formally known as the “The Arrangement on Officially Supported Export Credits” of the Organization for International Cooperation and Development and commonly called the OECD Consensus Arrangement—create additional constraints to effective cooperation between the public sector and private market and can make it

more difficult to unlock trade credit in times of crisis. The Consensus Arrangement rules defining “official support” were designed for another era, the 1970s. Their principal objective is to minimize trade distortion in the use of medium-term trade credit by establishing a level playing field among OECD governments, even if that level field creates an implicit or even explicit subsidy. Issues such as creating the right incentives to encourage greater use of private, medium-term trade credit by developing countries have not been taken into consideration. Not surprisingly, most OECD official export credit systems are therefore not designed to “crowd in” private credit by working cooperatively with the private sector on a shifting risk-sharing basis. For the Consensus Arrangement, market failure is a binary choice; the official market starts where the private market stops, with little if any transition.

In terms of the current debate on trade finance for crisis countries, there are two consequences flowing from these rules. First, the rules may subtly undermine efforts at crisis prevention in developing countries by encouraging countries to allocate scarce foreign exchange and domestic resources to transactions and projects, supported by official credit, where the financial return is below market-based yields—allowing less efficient transactions with low expected financial returns to proceed. And second, since most official export credit systems are designed to be lenders of last resort, many ECAs have only limited experience with the innovative structuring and risk mitigation practices of the private sector. They also see only a subset of the potential transactions in a given country’s pipeline; hence they cannot even cherry-pick deals that might still make financial sense in a crisis setting.

What is the end result of all the preceding institutional factors? If a developing country experiences a financial crisis that turns off short-term trade credit, foreign private investment and medium-term debt financing, most export credit institutions simply do not have the capacity to step in quickly and fill the gap. To cite work done for the IMF by Malcolm Stephens, ECAs are not a “Sleeping Beauty” that can be awakened with a kiss each time a crisis appears. For many, privatization of their short-term business has removed the technical capacity to provide short-term credit in times of crisis. As for medium-term credit, the existing international rules and practices have left ECAs without the necessary experience and knowledge base to act quickly if private credit dries up.

It should be noted in passing that EDC is one of the few institutions that offers short-term trade credit insurance, has the capacity to operate in both the official and commercial medium- and long-term trade credit markets, and understands the disciplines of both markets. The EDC can potentially help to bridge the private-public gap, which conceptually would be one means of restarting trade credit to countries that have experienced a financial crisis.

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Country Risk Assessment and Management

Heightened country risk is an obvious second constraint to new trade credit for crisis countries. When a country has been through a crisis, it likely will have been downgraded within any credit institution’s risk-rating system. A downgrade invariably reduces the country limit while raising the minimum risk premium to be charged for doing business in that country. If arrears build, or even if existing exposures are rescheduled, a large share of the country limit can be tied up for many years to come. Capitalization of interest as part of a rescheduling simply adds to the problem.

Country risk also comes in many forms, with transfer risk arguably the most prominent issue in times of crisis. Uncertainty about both the foreign exchange regime and the actual exchange rate is a serious constraint on the capacity to extend new credit—to paraphrase Alan Greenspan, risk can ultimately be priced, but uncertainty cannot. If a country’s foreign exchange regime is in a state of flux (like Venezuela today), we have little basis on which to judge whether foreign exchange commitments to creditors will be honored, and at what cost to the local counterparty.

Multilateral Institutions

A final constraint for ECAs emerges from the fundamental nature and practices of multilateral financial institutions and how they relate to export credit institutions. One set of relations is through the management of existing ECA exposures in developing countries. The Paris Club of creditor governments is increasingly being treated as the residual balance of payments gap-filler in IMF-supported programs. In recent years, there has been a shifting boundary line for sovereign debt rescheduling and debt reduction, with a growing list of countries being considered for exceptional treatment—Serbia, Pakistan, and Indonesia to name three specific cases.

Looking ahead, the introduction of the Evian Approach heralds a fundamental shift in Paris Club thinking from a rules-based approach (e.g., Houston terms, debt forgiveness for countries participating in the Heavily Indebted Poor Countries initiative) to a judgment-based approach based on an evaluation of sovereign debt sustainability in each case. The Evian Approach may eventually help to provide clarity on the financial criteria for the recovery and/or forgiveness of sovereign debt, but only when creditor governments have sufficient experience on which to base decisions about the likelihood of future debt service payments from sovereigns. In the interim, uncertainty about the status of sovereign debt restructuring or forgiveness means that trade creditors may be far less inclined to step up and offer new cover for countries that have been through a payments crisis. It bears repeating: you can price risk but you cannot price uncertainty.

Another set of relations exist around new credit and the lending practices and preferred creditor status of the multilateral institutions. Large exposures for the IMF, World Bank, and regional banks may crowd out new ECA activity. Trade credit institutions are well aware that in a few cases, a significant claim that cannot be rescheduled has already been made on future foreign exchange earnings. In other cases, the existing stock of multilateral debt may not be a problem, but the inflexibility of preferred creditor status...
for multilaterals may leave little scope for true risk sharing on new lending among multilateral lenders and trade finance institutions. This refers specifically to the private sector windows of the development banks.

Conceptually, the International Finance Corporation and the other private sector windows of the development banks should be ideal partners for trade credit institutions in re-opening a crisis country’s access to foreign credit—both can fill financing gaps when there is market failure. In practice, however, trade creditors do not receive pari passu treatment with the multilaterals, and thus are structurally delegated to second-tier creditor status—which could further impair their appetite for new credit.

Export Credit Agencies and Crisis Response

Notwithstanding the constraints described above, a number of approaches can still be taken by export credit agencies, consistent with their mandate, to help unlock new trade financing for countries that have experienced a payments crisis.

Start Short Term

The ideal commercial practice would be for trade credit institutions to start by extending credit on a short-term basis, allowing the country to re-establish a repayment track record, and then extending longer terms. This is how EDC often approaches a crisis market in an effort to rebuild a positive credit record. However, as already noted, there is limited scope among ECAs for this commercially oriented practice due to the privatization of most state-owned, short-term export credit businesses a decade ago.

Price to Risk

A second best practice is pricing to risk. Pricing to risk brings rigor and discipline to lenders and borrowers, forcing both to set priorities where capacity is scarce. This is certainly the risk-pricing concept at EDC, where transactions are evaluated using commercial risk assessment methodologies. In contrast, the failure to price to risk eats up scarce institutional capacity, can distort or spoil a developing-country market, and can contribute to future debt service problems if nonpriority transactions are allowed to proceed. Pricing to risk may be a challenging concept in a postcrisis situation, since risk is even harder to estimate in times of greater uncertainty, but the underlying principle is fundamental to good practice.

Use Risk Mitigants

Trade credit institutions should make use of all available risk mitigants when considering new credit in order to help avoid crises and unlock new credit for countries in crisis. These mitigants include:
- Giving preference to transactions that generate net foreign exchange for the country in question;
- Using offshore accounts to capture project or transaction earnings, thus reducing or eliminating transfer risk, and using third-party guarantees from foreign entities;
- Extending credit in local currency to eliminate foreign-currency transfer risk. However, local currency lending requires a source of domestic savings that can be tapped by banks or export credit institutions that are direct lenders, which in turn depends on the depth of local financial markets;
- Focusing on those risks where cover is possible—e.g., there may be appetite to cover the risk of expropriation, but no appetite for transfer or terrorism risk.

**Structure Transactions**

In addition to risk mitigation techniques, export credit institutions could make greater use of highly structured or project financing techniques wherever possible. Projects in resource-extractive industries are prime candidates for structured financing, and one obvious area where export credit institutions can potentially operate in a crisis country and contribute to strengthening the country’s exports and debt service capacity. Institutions that focus on support for foreign investment may also have greater opportunities to restart the flow of capital to developing countries.

However, it must be noted that there is limited ability in most developing countries to use asset-backed financial structures, since the requisite legal foundations are inadequate or do not exist. Work has been done to establish an international convention on asset-backed financing, but a conclusion remains far off.

**Assess All Risks**

Finally, there are “new” risks that have attracted considerable attention in recent years—those related to the environment, human rights, social impact, and corruption. An assessment of these risks must be part of any list of good practices. However, it also raises the question: can crisis countries meet the emerging international standards for these risks? All too often, countries that have been in crisis are least equipped to satisfy the requirements of export credit institutions in these areas of corporate social responsibility or reputation risk, and thus may lose opportunities to re-access foreign credit. The multilateral institutions have a special role to play in building the institutional capacity of countries in crisis and other developing countries to deal with these new risks.
Policy Actions

Earlier, this chapter mentioned some areas where multilateral policy action could be taken to improve crisis countries’ access to trade credit. There is no silver bullet or magic solution, but policy action is possible on a number of fronts.

Agree on Guiding Principles

An obvious place to start is for all external creditors to agree on a common set of guiding principles aimed at making trade credit sustainable for developing countries. While setting the overall framework for crisis prevention and resolution is not the purpose of this chapter, Box 10.1 sets forth four possible guiding principles for sustainable trade credit: first, start with a common definition of trade credit; second, focus on crisis prevention; third, if crisis occurs, take a systematic approach to its management; and fourth, seek a level playing field among providers of exceptional credit. A serious international discussion on guiding principles may well lead to consideration of ways to reduce some of the constraints to ECA action that were identified earlier.

A More Seamless International Financial Market

Conceptually, all emerging markets would benefit from reducing the barriers between multilateral creditors, export credit institutions, and the private market to creating a more seamless international financial market. From an aggregate or “top-down” viewpoint, most immediately see the advantage—it would mean that all sources of funding could be considered when assessing how to close a crisis country’s balance of payments funding gap and speed it on the path to recovery.

In contrast, the international financial market is remarkably segmented at a transactional or “bottom-up” level when it comes to new credit. Relatively hard boundary lines have been created, either inadvertently or by design, between multilateral credit, official support from ECAs, and the commercial market. These hard boundary lines appear as differences in risk pricing, repayment terms and structure, and lender security. They generally frustrate innovation, discourage risk sharing, and lead to inefficiencies. They may well result in funding gaps emerging for specific transactions and can delay or even preclude some bankable deals from being completed. Anyone interested in unlocking new credit for crisis countries should therefore want to make the boundary lines between market segments more flexible and overlapping.

What does this mean in concrete terms? One policy option worth examining is the scope for true, pari passu risk-sharing between the multilateral development banks, especially their private sector windows, and export credit institutions. There will always be circumstances where the multilateral development banks should be the preferred creditor, especially when they are acting as the funding source of last resort for the government of a country in crisis. But there is no compelling reason why preferred status must apply in all circumstances.
Box 10.1. Guiding Principles for Sustainable Trade Credit

1. Include the entire trade credit chain
   - Credit for imports used in exporting
   - Working capital for exporters
   - Credit to foreign buyers of exports

2. Prevention first
   - Macroeconomic policy design and implementation
   - Health of financial sector, including central bank
   - Openness of the economy—capacity to manage shocks
   - Terms and structure of external credit and obligations
   - Trade credit that is not distorting and uses risk mitigants

3. If crisis occurs, take a systematic approach to its management
   - Objective: restore commercial credit as quickly as possible
   - Coordination: reach a shared diagnosis of the problem
   - “No harm” concept for intervention: goal of exceptional trade credit is to sustain and restart commercial credit, not crowd it out
   - Decide who is best placed to do triage of exceptional trade credit:
     - Expect demand to outstrip supply; political constraints on full risk pricing
     - Use domestic financial system as much as possible
     - Next option is local public sector, usually led by the central bank
     - External players as a last resort
   - Use objective criteria for triage of exceptional trade credit:
     - Determine priority export sectors based on:
       - Market shares
       - Pricing power
       - Import dependence of exports (in crisis, lower is better)
       - Cyclicality of exports
     - Determine exporting firms in priority sectors based on:
       - Sustainable business model
       - Financial strength

4. Seek a level playing field among providers of exceptional credit
   - Public sector:
     - Multilateral leadership normally expected
     - Optimal state: pari passu treatment among public sector providers
     - Commercially-based pricing to minimize distortion and crowding out
   - Private sector:
     - Bias in favor of private creditors committed to the market/country
     - Risk-sharing with public sector would encourage self-selection
Consider, for example, a country that has suffered a devaluation shock and has been pitched into a resulting external payments crisis, as was the case during the Asian crisis or, more recently, in Argentina. Existing external creditors are at risk of not being paid on time and are therefore obviously reluctant to provide new credit. Yet the country may have unexploited natural resources that could generate sufficient foreign exchange to cover any new external credits if sufficient funding capacity were to be mobilized to develop the off-take of those resources. Foreign exchange risk is not high, since the devaluation shock has already taken place. Under these circumstances—which are often found in crisis countries—the real need is financing capacity, not just a preferred lender of last resort. A multilateral financial institution that acts as a partner to a group of ECAs by bringing risk-taking capacity on a seamless or pari passu basis could play a valuable public policy role, mobilizing foreign credit to expand the country’s exports without taking undue risk.

Shifting away from absolute preferred creditor status to a more relative or selective use of such status would require a more granular assessment of circumstances, credit risks, and competencies among the various institutions that provide trade credit, since some may be better positioned to take certain risks than others. Here the historical example is of the Multilateral Investment Guarantee Agency (MIGA), the political risk insurance arm of the World Bank. The MIGA traditionally has had a less-than-absolute status as a preferred insurer and consequently has been seen as an integral and integrated player in the political risk insurance market.

The same overlap concept should apply to official export credit agencies and the commercial market. Much of the resistance to market-based practices by ECAs seems to be rooted in a history of win-lose competitive subsidy in trade finance among major industrial countries. Yet ECAs that can also be market players, taking the same terms and conditions as the private sector, have greater capacity to fill gaps when the market boundary line recedes in a crisis country. ECAs that are engaged with the private market on comparable credit terms would have more room for innovation and adaptation, and thus more scope to add to the capacity of the private market.

The challenge of restoring trade credit for countries emerging from crisis makes it abundantly clear that the time has come to take a more objective look at how ECAs can maximize the benefits to all stakeholders, including developing countries. Maintaining or justifying the status quo no longer suffices. Rather than continuing with a Consensus Arrangement guided by the lowest common denominator—a level playing field that constrains trade finance subsidies among OECD governments—a fundamental rethinking of the rules governing official support could help unlock trade credit for countries emerging from crisis, or trying to avoid it. Imagine an arrangement among OECD governments that would create incentives for attaining the highest common denominator—market-based medium- and long-term trade credit for developing countries—in order to encourage improved access to private credit. Change the objective of the exercise and the outcome might look very different.
Crisis-Country Policy Design

The third area for action involves macroeconomic policy design and implementation, which must remain the core of any crisis country’s stabilization and recovery. Export creditors would benefit from improved clarity on the IMF’s advice and expectations with respect to foreign exchange regimes in crisis countries. At a time when the slogan “Washington Consensus” is much used, it is striking just how little consensus there seems to be on a sustainable foreign exchange regime for developing countries—one in which creditors could have long-term confidence.

To encourage the restart of export credit, creditor institutions would also benefit from more explicit IMF support for the best-practice risk mitigants and other innovative approaches outlined earlier. The IMF should be prepared to acknowledge and even encourage risk mitigants like offshore accounts linked to specific projects. While such accounts may channel foreign exchange away from central bank access, the projects they underpin can help to strengthen and diversify the productive capacity of a crisis country, with fiscal and other economic spin-off benefits. Similarly, a priority focus on financial deepening in developing countries would help to underpin local currency lending.

Paris Club

A final area for policy reconsideration is the Paris Club and its underlying practices. It makes sense that the Paris Club has progressively relaxed and expanded its practices to increase the scope of possible sovereign debt relief, since certain classes of debtor sovereigns clearly suffered from a debt overhang that had to be reduced. However, on recent occasions, the baby has been thrown out with the bath water—rescheduling or debt forgiveness terms have been offered that exceeded the actual needs of the sovereign in question.

The move to Evian terms represents a fundamental shift from a rules-based approach to a judgment-based approach stemming from an evaluation of sovereign debt sustainability in each case. What is now needed is multilateral agreement on the methodology for calculating debt sustainability, since that methodology is critical to determining the boundary line for eligibility for debt reduction and exceptional treatment. Without greater clarity on the new operating rules for the sovereign debt management game, new export credit flows will be discouraged. This is of particular importance to middle-income countries that have the potential to re-establish creditworthiness relatively quickly—in months or years, not decades.

Conclusions

Export credit agencies have comparable mandates to promote national trade, but they are not all guided by the same financial objectives—one size does not fit all. There are institutional and practical limitations to what can be done in crisis countries, especially for short-term trade credit. Nevertheless, there also are a variety of innovative underwriting and structuring practices available to ECAs that could help to unlock new
trade credit, earlier, for countries that have come through a financial crisis. Conceptual and policy changes could also be made by the international financial community that would improve the functioning of the international trade credit system, to the benefit of many developing countries. Are official export credit agencies equal to the task?
Improving the access of developing countries to more plentiful and secure sources of trade financing, particularly in periods of financial or exchange rate crisis, has been a matter of concern for some time for developing-country members of the World Trade Organization (WTO). The issue was raised during the emerging markets financial crisis in 1997–98, and more recently was been discussed in the WTO General Council and in the WTO Working Group on Trade Debt.

Two areas of the WTO’s work relevant to the issue of trade financing are multilateral negotiations on services—in particular financial service—and trade rules such as the WTO Agreement on Subsidies and Countervailing Measures, which extends to certain trade financing and guarantee activities of specialized public institutions. More generally, the WTO aims also to exercise vigilance that markets are kept open in periods of financial crisis, and that trade measures that might undermine coordinated efforts by the international community to maintain the flows of trade or trade finance be avoided.

WTO Contribution Through Market Access: Trade in the GATS

This chapter looks at market access with a focus on the current negotiations on trade in financial services in the context of the Doha Development Round. It provides a basic overview of the General Agreement on Trade in Services (GATS), discusses the classification of trade financing activities under that Agreement, describes the current status of commitments in this area, and finally, discusses potential initiatives in the current round of services negotiations.

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56Prepared by the WTO Secretariat. The Secretariat team was headed by Dr. Supachai Panitchpakdi, WTO Director-General, and composed of Marc Auboin, Jesse Kreier, and Moritz Meier-Ewert.
Basic Overview of the GATS

The General Agreement on Trade in Services is the first multilateral framework of rules and principles for the progressive liberalization of trade in services, including financial activities. Without making a comprehensive presentation on the GATS, the discussion here will focus on the most relevant aspects for this chapter, namely, the scope of the GATS, its definition of trade in services, and the schedules of specific commitments.

The GATS sectoral coverage is wide. The agreement covers all services sectors, with the exception of services supplied in the exercise of governmental authority and the bulk of air transport services. In addition, the GATS applies to all measures affecting trade in services.

Going beyond the traditional definition of trade, the GATS defines trade in services in terms of four modes of supply: mode 1, or cross-border supply, whereby the service is supplied from a territory of one country into the territory of the member undertaking the commitment; mode 2, or consumption abroad, whereby the service is supplied in the territory of one member to a consumer of the member undertaking the commitment; mode 3, or commercial presence, whereby the service supplier (e.g., a foreign bank) is legally established in the territory of the member undertaking the commitment and supplies services through that establishment; and mode 4, or movement of natural persons, whereby natural persons supply—a financial service in the territory of the member undertaking the commitment.

In the GATS context, services liberalization is pursued mainly through WTO members’ specific commitments guaranteeing the right to supply services (including financial services) under any of these four modes of supply. Sectoral commitments are included in a schedule, one for each WTO member. Sectors to be liberalized are listed “positively” and applicable limitations (if any) are listed “negatively.” Due to the positive listing of sectors, the GATS is usually characterized as having a “positive list approach” to liberalization. For each service on which a commitment is made, the schedule must indicate, under each of the four modes, any limitations on market access or national treatment that the member intends to keep. Once the sector is included, three scenarios are possible:

(i) No limitations on access to the market, identified by the entry “none”;
(ii) No commitment on access to the market through the mode of supply concerned, identified by the entry “unbound” (i.e., the member remains free to introduce restrictions); and

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For a more comprehensive discussion, see “Opening Markets in Financial Services and the Role of the GATS,” WTO Secretariat Special Study, September 1997.

For a definition, see Article I.3 (b) GATS and the Annex on Financial Services.

See the Annex on Air Transport Services.

Measures by members include those taken by all levels of government—national, regional and local—and by nongovernmental bodies to which governmental powers have been delegated. See Articles I and XXVIII of the GATS.
(iii) Subjecting access to the market to specific limitations listed in the schedule (i.e., so-called partial commitments).

Schedules of specific commitments follow a four-column format. The first column defines the sector or subsector on which commitments are being made; the second column indicates any limitation on market access; and the third column indicates any limitations on national treatment. The fourth column is meant to include any additional commitment made under GATS Article XVIII on regulatory measures not subject to scheduling under GATS Articles XVI and XVII. Contrary to commitments on market access and national treatment, additional commitments are undertakings or positive actions promised by the WTO member making the commitment.

Classification of Trade Financing Activities in the GATS

As shown in Box 11.1, the GATS covers all financial services, including all insurance and insurance-related services, and all banking and other financial services (excluding insurance). The list includes activities such as “lending of all types, including consumer credit, mortgage credit, factoring and financial of commercial transaction,” “financial leasing” or even “guarantees and commitments.”

Trade finance—which is defined as short-term, mainly less than 180 days, externally provided financing to support exports and imports—is covered by the definition of financial services used for GATS purposes, particularly those of lending of all types, and guarantees and commitments. However, the expression “trade financing,” or the alternative financial instruments used in trade financing (e.g., of credit, guarantees, and acceptances) are not spelled out in any detail.

Current Commitments by WTO Members

In most cases, the provision of “trade financing” has not been singled out in WTO members’ commitments. Therefore, this line of business has been kept subject to the same restrictions applicable to other forms of lending, particularly with regard to the supply through a commercial establishment in the host country.

Table 11.1 shows that the number of commitments guaranteeing the free provision of trade financing on a cross-border basis (mode 1) is limited. The table presents the commitments undertaken by WTO members on trade financing before and during the 1997 negotiations, as well as the commitments made by the so-called “acceding members” (i.e., those WTO members that joined the organization through individual accession protocols after the inception of the WTO).


### Box 11.1. Classification of Financial Services  
(GATS Annex on Financial Services)

**Insurance and insurance-related services**

(i) Direct insurance (including co-insurance):
   (a) life
   (b) nonlife

(ii) Reinsurance and retrocession

(iii) Insurance intermediation, such as brokerage and agency

(iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment, and claim settlement services.

**Banking and other financial services (excluding insurance)**

(v) Acceptance of deposits and other repayable funds from the public

(vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions

(vii) Financial leasing

(viii) All payment and money transmission services, including credit, charge and debit cards, travelers cheques, and bankers’ drafts

(ix) Guarantees and commitments

(x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market, or otherwise the following:
   (a) money market instruments (including cheques, bills, certificates of deposits)
   (b) foreign exchange
   (c) derivative products including, but not limited to, futures and options
   (d) exchange rate and interest rate instruments, including products such as swaps and forward rate agreements
   (e) transferable securities
   (f) other negotiable instruments and financial assets, including bullion

(xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues

(xii) Money broking

(xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, and custodial, depository and trust services

(xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments

(xv) Provision and transfer of financial information and financial data processing and related software by suppliers of other financial services

(xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv), including credit reference and analysis, investment and portfolio research and advice, and advice on acquisitions and corporate restructuring and strategy.
Table 11.1. WTO Members with Full Commitment on Cross-Border Supply of Trade Finance¹
(As of December 2003)

<table>
<thead>
<tr>
<th>Pre-1997 negotiations</th>
<th>1997 negotiations</th>
<th>Through accession protocols</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola²</td>
<td>Bahrain³</td>
<td>Armenia</td>
</tr>
<tr>
<td>Benin⁴</td>
<td>Ecuador</td>
<td>Croatia</td>
</tr>
<tr>
<td>Gabon</td>
<td>Ghana⁵</td>
<td>Estonia</td>
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<tr>
<td>Gambia</td>
<td>Indonesia⁶</td>
<td>Georgia</td>
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<tr>
<td>Guyana</td>
<td>Israel⁷</td>
<td>Jordan</td>
</tr>
<tr>
<td>Haiti</td>
<td>Kenya</td>
<td>Kyrgyz Republic</td>
</tr>
<tr>
<td>Malawi</td>
<td>Malaysia⁸</td>
<td>Lithuania</td>
</tr>
<tr>
<td>Morocco⁹</td>
<td>Malta</td>
<td>Moldova¹⁰</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Mauritius¹¹</td>
<td>Panama</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>Philippines¹²</td>
<td>Papua New Guinea</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>Romania</td>
<td>Qatar</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>Slovenia¹³</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td></td>
<td>Switzerland</td>
<td></td>
</tr>
</tbody>
</table>

Source: WTO Secretariat’s elaboration based on schedules of specific commitments.
¹"Full commitment" is understood as a market access commitment with no limitations, except as otherwise indicated in the footnotes. Commitments by Cambodia and Nepal have not been considered since they have not officially become WTO members.
²Residents may borrow abroad after the National Bank of Angola has authorized them.
³Undertaking this activity (including soliciting and advertising) in/from Bahrain requires a licence from the Bahrain Monetary Authority.
⁴Residents may borrow abroad after first obtaining authorization from the Minister of Finance in conformity with the Exchange Control Regulations for loans of over CFAF 50 million.
⁵Commitment on "credit facilities."
⁶Only on "international factoring services."
⁷Such activities can only be carried out through banking institutions licensed by the controller of foreign exchange to act as an authorized dealer.
⁸Financial services associated with lending to residents in any currency in excess of an equivalent of RM25 million must be undertaken jointly with commercial banks or merchant banks in Malaysia.
⁹Commitment on lending to finance commercial transactions with Morocco (CPC 8113*).
¹⁰Commercial presence is required through a branch or subsidiary.
¹¹Excluding factoring.
¹²Commercial presence is required.
¹³Unlimited except accepting credits (borrowing of all types), and accepting guarantees and commitments from foreign credit institutions by domestic legal entities and sole proprietors. Consumer credits will be free upon the adoption of the new Foreign
¹⁴Borrowing by resident companies subject to authorization according to exchange controls regulations.
The current situation can be summarized as follows:

- Of 90 WTO members that have committed to allow the supply of at least some form of lending, only 38 have made full commitments (“none”) ensuring the free provision of finance for commercial transactions by nonestablished financial entities (i.e., on a cross-border basis).

- Almost all of those 38 commitments come from developing countries and economies in transition.63

- Many of the most advanced developing-country members have not made commitments allowing for the cross-border provision of trade finance into their markets. These include Brazil, China, Chinese Taipei, India, Pakistan, South Africa, and Thailand.

Commitments on the cross-border provision of all types of lending have two dimensions of interest for this discussion. On the one hand, they include the direct supply of trade financing by international banks; and, on the other, they also cover interbank lending (i.e., local banks short- and long-term borrowing from the overseas market). Funding abroad is one of the channels used by local banks (whether private or state-owned) to raise capital to finance exports of domestic companies.

Ninety WTO members made commitments on the supply of lending through a commercial establishment in the host country. Establishing a commercial presence (e.g., subsidiary, branch, representative office) is indeed an important aspect of international banks’ strategies on trade finance. However, there are two main reasons why it is more difficult to present a generalized picture of commitments on the provision of trade finance through a commercial presence. First, unlike commitments on cross-border supply, the practice shows that commitments governing the commercial presence of foreign banks are not an all or nothing affair. In other words, while commitments on the cross-border supply of lending are either “full” (no limitations) or nonexistent (“unbound” in the GATS jargon), most commitments on the supply of lending through subsidiaries, branches, or other forms of establishment are “partial” (i.e., subject to limitations such as foreign equity restrictions or limitations on the number of foreign institutions allowed). Therefore, it is difficult to make generalizations. Second, since trade financing activities usually are a part of the range of services provided by banking institutions, the provision of trade financing through establishment is subject to the same limitations applicable to the establishment of any bank (e.g., limitations on foreign ownership).

It is worth noting, however, that the absence of a commitment does not mean that the supply is not permitted. A member may maintain a very liberal regime on the foreign provision of trade finance while not making any commitment under the GATS. But with no commitments there is no guarantee that the country will stay open.

63However, some of them include authorization requirements or even the requirement of a commercial presence (e.g., Moldova and the Philippines). Without additional information, the requirement to have a commercial presence might eventually imply the absence of a pure cross-border commitment.
Potential Initiatives in the Current Round of Services Negotiations

Under the GATS, WTO members may undertake commitments guaranteeing the right to supply financial services, including trade finance, on a cross-border basis (as a service) or through a commercial presence (e.g., subsidiary or branch).

Current negotiations on financial services may contribute to a more secure and predictable environment for trade financing activities. At least five reasons can be adduced for undertaking market access and national treatment commitments on trade financing in the GATS. First, national policies become more predictable and certain, due to the credibility-enhancing effect of a multilateral commitment protected by an efficient dispute settlement mechanism. Second, open markets may help ensure the continued availability of finance for imports and exports under reasonable conditions. Third, further competition in the market is expected to encourage quality improvement, as well as the introduction of new trade finance instruments. Fourth, further competition may lead to an improvement in risk intermediation and increase the market’s liquidity, resulting in lower financing costs and reducing the likelihood of a simultaneous collapse of all financial intermediaries. Finally, a willingness to make commitments in a multilateral negotiation may induce other countries to do likewise, leading to a virtuous cycle of mutual benefits.

The limited number of liberalization commitments, particularly on the cross-border provision of trade finance, leaves ample room for improvement in the current round of negotiations. From a technical point of view, one of the reasons why WTO members may have hesitated to take commitments on short-term lending for trade finance purposes is the highly aggregated nature of the classification of lending activities contained in the GATS, which includes other—more sensitive—types of lending, such as consumer and mortgage credit. However, WTO members are free to make commitments specific to a particular service (trade finance) and mode of supply (e.g., modes 1 and 3). Tailor-made or ad hoc definitions can be used in that regard. The aim would be to circumscribe the sector definition so as to allow the maximum number of commitments possible, and thus provide a truly open environment for such activity. A few WTO members have already used their own definitions to cover foreign trade finance activities. For instance, Chile defined “credit granting” as including “...current loans, loans in letters of credit,...issue and negotiation of letters of credit for imports and exports, issue and confirmation of stand-by letters of credit.” Morocco defined the sectors as “lending to finance commercial transactions with Morocco (CPC 8113).” Commitments on short-term interbank lending for trade finance purposes may also be envisaged.

It is also worth noting that other financial activities related to trade finance, and which are also covered by the GATS, might also have to be liberalized in order to maximize the benefits of specific commitments in this area. A couple of examples may illustrate this...
idea. On the one hand, like any other credit granting activity, trade finance would call for a previous check-up of the financial condition of the loan recipient. Commitments on the cross-border provision of other auxiliary financial services, such as advice, intermediation, and credit reference analysis may be necessary in that regard. On the other hand, the success of a letter of credit, which is the most widely used trade finance instrument, depends inter alia on insuring the merchandise being shipped against damage or loss. In fact, the existence of appropriate documentation (e.g., an insurance certificate or policy) is a sine qua non condition of any letter of credit. Commitments on the cross-border provision of insurance of risks relating to the goods being transported may be of importance in that regard.

Although the main interest is to ensure the continuous availability of trade finance for developing countries, greater value would be added if commitments were made by both developed and developing countries. Even though ensuring the availability of trade financing for developing countries on a continuous basis would require these countries to make commitments in this area, it is fair to acknowledge that trade financing is not a one-way street. The modalities of trade financing (e.g., back-to-back letters of credit), as well as the need to cater to regional trade flows, call for commitments being undertaken also by developed countries. In that regard, banks from developing countries are also major players in trade financing, particularly in the case of regional trade flows.

Apart from ensuring a more open and predictable environment via the expansion of market access commitments, the GATS can also contribute by enhancing transparency. In fact, the GATS already imposes the obligation on WTO members to provide notification, at least once a year, of all the changes introduced to regulations affecting trade in the sectors covered by specific commitments such as lending (Table 11.1).

Specific commitments on trade finance are only one element of a broader initiative toward ensuring the availability of trade finance for developing countries in times of crises. Benefits stemming from those commitments must be put in the right perspective. In normal times, commitments by recipient countries would ensure that trade financing flows are not restricted. However, in times of crises, commitments might not prevent lender countries from pulling back because of a drop in confidence. Other initiatives and policies, both on the part of the international community and the individual countries, would be needed in order to keep those trade finance flows stable.

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65See the classification in Box 11.1.

66Some WTO members have made commitments under the terms of the Understanding on Commitments in Financial Services, which contains a formula approach to undertaking commitments on financial services. Those members have committed, inter alia, to allow for the cross-border provision of “insurance of risks relating to: (i) . . . the goods being transported . . . ; and (ii) goods in international transit.”


WTO Role in the Area of Rules

The second issue, the implications of the Subsidies and Countervailing Measures (SCM) Agreement disciplines for export credits, guarantees, and insurance—particularly to developing countries—is a 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 SCM Agreement:

- The 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.\(^6^9\)

- 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.\(^7^0\) However, given that the OECD Arrangement applies only to medium- and long-term credit (two years or more), and that the main concern on trade finance discussed in this chapter relates to short-term financing, this provision is of limited relevance to the problem under consideration here.

- Least-developed member countries are exempted from the prohibition on export subsidies, as are certain other developing-country members listed in Annex

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\(^{69}\) Under Article 1 of the SCM Agreement, a subsidy is defined as a financial contribution by a government of public body within the territory of a member that confers a benefit. Export credit, guarantee, and insurance schemes involve “financial contributions,” and central banks, export credit agencies, and other government-owned or controlled entities that provide such schemes likely constitute “governments” or “public bodies.” While the existence of a “benefit” will depend on 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 favorable 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 paragraphs, 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.

\(^{70}\) This is the case whether or not the WTO member is a participant in the arrangement, so developing-country members that are not participants may also invoke the safe haven.
VII(b) to the agreement until their GNP per capita reaches $1,000 (in 1990 constant dollars) for three consecutive years.\(^7\)

Although the SCM Agreement is not clear in all respects, certain observations can be made regarding ways to reduce the risk that measures taken to address the problems identified in this chapter could be deemed inconsistent with the agreement. First, the agreement prohibits only two types of subsidies: those contingent upon exportation, and those contingent upon the use of domestic over imported goods. Thus, schemes that deal only with the financing of essential imported inputs, are available irrespective of whether the imported inputs are for use for the production of goods for export or for domestic consumption, and do not discriminate with respect to the origin of the inputs, are not likely to run afoul of the prohibitions found in the SCM Agreement. Second, some members seem to be of the view that multilateral development assistance is not within the scope of Article 1 of the SCM Agreement. Thus, schemes that are funded entirely by multilateral institutions are less likely to give rise to dispute settlement challenges in the WTO. Finally, as noted above, a significant number of less-advanced developing country members are not currently subject to the WTO prohibition on export subsidies. For these members, there is substantially greater flexibility to address the problems identified in this chapter, even through measures that are oriented toward problems of trade financing faced by exporters.

\(^7\)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.
Glossary of Terms

A/B loans. Lending arrangement whereby a multilateral institution makes a loan to a private sector borrower in an emerging-market country, thereby becoming the “lender of record,” that is, the sole contractual lender on the books of the borrower, with this status acknowledged by the government of the borrower’s country. However, instead of maintaining the entire loan on its own books, the multilateral maintains only a portion of the loan—the “A” loan—and participates in the remainder of the loan—the “B” loan—to commercial banks and/or institutional lenders, either directly or through securitization.

Asset-backed financing. Generally refers to all forms of financing where the lender has a claim over specific assets of the borrower, whether with or without a general claim against the borrower. An asset-backed security is characterized as an obligation that is supported by cash flow from a specific pool of assets (typically secured offshore); such securitization can involve the future cash flow of receivables related to exports, services or products. See also structured financing.

Berne Union. The International Union of Credit and Investment Insurers. Established in 1934, this organization now includes almost 50 of the largest export credit agencies and investment insurers from both member and nonmember countries of the Organization for Economic Cooperation and Development. Institutions, not their governments, are members. The Union works for the acceptance of sound principles of export credit and investment insurance and the exchange of information and experience. It also has adopted a series of agreements and understandings by which members undertake to abide by certain maximum credit terms and terms for goods. The secretariat is in London, and members hold two general meetings each year as well as specialist seminars and workshops.

Commercial risk. One of the two main categories of risk insured by export credit agencies (the other being political risk). The term applies primarily to the risk of nonpayment by a private buyer or commercial bank or a public buyer due to default (protracted or otherwise), insolvency or bankruptcy, or failure or unwillingness to take delivery of the goods (i.e., repudiation). Usually excluded are cases where there are disputes between exporter and importer about product quality, delivery dates, performance, and the like. Claims will generally not be considered until these disputes are resolved. Also usually excluded are commercial risks on sales from exporters in one country to their subsidiaries in other countries.

Confirmed letter of credit. See letter of credit.
Country limit. A quantitative limit on exposure set by most export credit agencies and international banks to monitor and control their total commitments on individual countries. Country limits usually apply to medium- and long-term business and rarely include short-term business. They can have various forms, including annual maturities limits and contract limits.

Cover. The insurance provided by an export credit agency. Thus, for example, if some insurance facilities are available from such an agency for country X, that agency is “on cover” for that country. Conversely, where no insurance facilities are available, the agency is said to be “off cover.” An agency’s underwriting policy on a particular buying country is usually referred to as its cover policy for that country. But the term “cover” is also used more loosely to embrace insurance against both political and commercial risks.

Credit insurance. The principal product of an export credit agency. However, the term can include both export credit insurance and domestic credit insurance (i.e., insurance on sales within a country). Credit insurance protects the insured party (normally the seller), in exchange for a premium, against a range of risks that result in nonpayment by the buyer. In domestic cover, only commercial risks are involved. In export credit cover, both commercial and political risks are normally involved.

Credit period. The period from the time of delivery or acceptance of goods (for short-term business) or from the commissioning of the project (in project financing) until repayment is complete. Maximum credit periods are set for repayment periods. The starting point of credit for short-term business is set by the Berne Union agreements, and that for medium- and long-term business by the Berne Union and the OECD Arrangement.

Escrow account. An account, normally in an offshore bank (that is, a bank outside the country of the debtor or importer), into which all or an agreed proportion of the proceeds of export sales from the output of the project are paid. This account is then used first to service the loans that financed the project. Escrow accounts are an increasingly important part of the security package associated with project financing or a limited recourse financing. Normally, lenders and export credit agencies like to see such accounts hold the equivalent of about one year’s debt-service payments. The existence of such accounts is a comfort to foreign creditors.

Exchange risk insurance. In a strict sense, cover issued against the risk of movements in the exchange rate between the currency of the exporter (and thus of the export credit agency) and the currency in which the export contract is denominated. It insures against the risk that, when the overseas buyer pays in the specified currency, the payment will be worth less in the exporter’s currency than was expected when the contract was signed (and less than at the exchange rate for the exchange risk cover agreed upon with the export credit agency). However, the term is more usually—and loosely—used to refer to circumstances governing the exchange rate used by the export credit agency when paying a claim. Should it be the exchange rate on the date the export credit agency came on risk, or on the date the goods were shipped, or on the due payment date, or on the date when the claim is paid? There is no one right answer, but exporters and investors should be sure they understand the position they are taking and, in particular, what date the export...
credit agency will use for the exchange rate, before taking out an export credit or investment insurance facility.

**Eximbank.** A type of export credit agency that normally not only issues insurance but also lends directly. Some export-import banks also act as borrowers for import finance. There is no single or perfect model, and an eximbank’s organization, status, and functions usually differ from country to country.

**Export credit, export credit insurance.** The main type of facility offered by an export credit agency. The term describes a range of facilities and can mean different things in different contexts. Strictly speaking, export credit refers to the credit extended by exporters to importers (supplier credit) or the medium- and long-term loans used to finance projects and capital goods exports (buyer credit). It includes credit extended both during the period before goods are shipped or projects completed (the preshipment period or precredit period) and the period after delivery or acceptance of the goods or completion of the project (the postshipment period or credit period).

**Export credit agency.** An institution providing export credit insurance facilities. All export credit agencies were at one stage government-owned or controlled or, if they were private companies, operated on government account. This is no longer the case, because the position is now rather more complicated, and so there is today probably no single meaning for the term “export credit agency.” It is probably best to define it in terms of the functions of the organization rather than its status. There is, in any case, no single model for an export credit agency. Their organization, function, status, and facilities differ between countries. Ideally, the structure and function of an export credit agency should reflect the conditions in and the needs of the country in which it operates. These can change as time passes, even within the same country. Attempts to transfer a model from one country to another without appropriate adaptation nearly always cause more problems than they solve. Most export credit agencies belong to the Berne Union or the Berne Union’s affiliate organization, the Prague Club for newly created organizations.

**Insurance.** The main business of export credit agencies. These agencies issue insurance policies of various kinds with respect of a range of risks against payment of a premium. For export credit insurance, the risks embrace both political and commercial causes of loss that may arise in the precredit period (before shipment), or during the credit period (after shipment). Policies may be issued to exporters (supplier credit) or to banks engaged in financing trade (buyer credit). For investment insurance, the risks are restricted to political risks. In both export credit and investment insurance, the insurance is against specified risks or classes of risk and is therefore conditional, although individual policies may be loosely referred to as guarantees.

**Letter of credit.** A document issued by a bank guaranteeing payment on behalf of one of its clients when all the conditions stated in the letter have been met. This is a very important mechanism of world trade, including for export credit agencies both in their short-term business and, less frequently, in their medium-term business. Letters of credit can take a variety of forms, but essentially they are a means of payment between an importer and exporter via their banks. The importer is sometimes called the opener, and
the importer’s bank the opening bank (or sometimes the issuing bank). The bank in the exporter’s country is called the advising bank, and the exporter is called the beneficiary. A letter of credit may be revocable, which means that it can be canceled or modified by the importer or the importer’s bank without prior approval from the beneficiary. Thus, a revocable letter of credit offers little security to exporters. The more commonly used irrevocable letter of credit (ILC) cannot be modified without the prior approval of the beneficiary. Unless the letter of credit is conditional, the bank issuing it effectively assumes the risk of default by the importer, provided that the terms and conditions of the letter of credit are fully met. The advising bank, on the other hand, is not required to pay the beneficiary unless and until it receives the funds from the issuing bank. Thus, even ILCs do not provide full protection to exporters. Letters of credit can also be confirmed. This is done either on an open confirmation basis, in which case the issuing bank is aware of the confirmation, or on a silent confirmation basis, in which case the issuing bank and the importer or buyer may not be aware. Confirmed letters of credit reduce certain risks for exporters, such as the risk that the issuing bank may fail or be unable to transfer foreign exchange. But a key point is that when the exporter seeks payment from the advising (or confirming) bank, it must meet all the terms of the letter of credit. Thus, it is vital that exporters carefully read all the conditions and requirements, as these can sometimes be onerous and may contain provisions that significantly reduce their benefit from the transaction. As many as 40 percent of applications from exporters for payments under letters of credit are rejected because of mistakes in documentation and the like. Obviously, this leads to payment delays. But even under a confirmed letter of credit, an exporter may be exposed to risks such as those that arise before the letter of credit is opened. Letters of credit are subject to widely accepted practices and procedures under the International Chamber of Commerce’s Uniform Customs and Practices for Documentary Credits.

**Long-term business.** Traditionally, insurance or financing applied over a period of more than five years. But there is no generally accepted or precise division between long- and medium-term business.

**Medium-term business, medium-term credit.** Conventionally, business with a credit period of between one and five years. However, under the OECD Arrangement, medium-term business is that with a credit period of two to five years. There are no universally-accepted or generally-applied divisions between short- and medium-term business, or between medium- and long-term business.

**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 would help mitigate the decline and facilitate an early resumption of new credits. The latter is important for economic recovery in a crisis country.

**Official creditor.** A public sector lender or insurer. Some official creditors, such as the international financial institutions, are multinational. Others are bilateral, such as
individual creditor governments and their official agencies such as central banks and export credit agencies when writing business on government account.

**Officially supported export credit.** An export credit supported (usually insured) by an export credit agency on government account, rather than on its own account. The credit may be a supplier credit or a buyer credit. For medium- and long-term business, the extent of permissible official support is set by the OECD Arrangement (normally limited to 85 percent of the exported value plus, where appropriate, the maximum permissible share of local costs, normally 15 percent of the exported value).

**Open account, open account business.** Trade finance business whereby goods are shipped and delivered and payment is made on the basis of invoice, usually in cash. There are thus no bills of exchange or promissory notes, and the exporter relies on the importer to pay in accordance with the invoice or terms of the contract. Open account business is thus most commonly used where seller and buyer have a good and longstanding trading relationship. Export credit agencies are prepared to cover open account business if they are content to underwrite the buyer.

**Open confirmation.** Confirmation of a letter of credit in such a manner that the importer and the importer’s bank (the opening bank or issuing bank) and, where relevant, the authorities and the central bank in the importing country, are aware of the confirmation.

**Political risk.** The risk of nonpayment on an export contract or project due to action by an importer’s or buyer’s host government. Such action may include intervention to prevent the transfer of payments, cancellation of a license, or acts of war or civil war. Nonpayment by sovereign buyers themselves is also a political risk. Political risk is one of the two main categories of risks insured by export credit agencies (the other being commercial risk). Some export credit agencies cover political risks in their own countries, especially the cancellation of export licenses. In recent decades the most common political risk claims have been due to inability to convert and transfer foreign exchange, but in these circumstances buyers must first have made local currency deposits.

**Postshipment cover.** Insurance of risks arising during the postshipment period. Sometimes called credit cover.

**Postshipment period.** The period from the date on which goods are shipped or accepted until the last payment has been received. Sometimes called the credit period.

**Preshipment cover.** Insurance of risks arising during the preshipment period.

**Preshipment credit.** Credit extended for the preshipment period.

**Preshipment period.** The time from the date of an insured contract until the date of shipment (or of acceptance by the buyer)—in other words, the period up to the time the credit period begins. Most export credit agencies offer cover for risks arising in this period, but it is sometimes handled through a separate policy or as an addition to the policy, rather than as part of the standard policy or facility.

**Reinsurance.** The practice whereby an insurer passes on to another insurer (called a reinsurer) part of the risk (and a portion of the premium income) of a policy it has
written. Export credit agencies can be involved in reinsurance both as reinsurers and as reinsured parties. Export credit agencies receive reinsurance from their governments or purchase it in the private reinsurance market. These are several varieties of reinsurance (e.g., facultative, quota share, excess loss), but the basic principle is the same. Some export credit agencies (e.g., in the United Kingdom) are beginning to provide reinsurance to some private insurers on political risks in some countries.

**Short-term business, short-term credit.** Transactions involving a maximum credit period of, usually, 180 days, although under some definitions it can extend to 360 days and, in exceptional cases, to two years. For purposes of the OECD Arrangement, the medium term begins (and, by implication, the short term ends) at two years. Short-term business represents the bulk of the business of most export credit agencies and normally includes transactions in raw materials, commodities, and consumer goods. There is no universally-accepted dividing line between short- and medium-term credit.

**Sovereign risk.** A term broadly synonymous with political risk but particularly relevant to defaults by or actions of host governments.

**Structured financing.** Refers to financial instruments that are devised to provide funding on the basis of identifiable assets rather than the credit standing of the borrower concerned. Includes securitization and forms of lending where the cash flow of the borrower is secured to pay off the lender. See also asset-backed financing.

**Supplier credit.** Credit extended by an exporter (supplier) to an overseas buyer as part of the export contract. Cover for this transaction may be extended by the export credit agency to the exporter. Such arrangements are much more common in short-term business. When they arise in the area of medium-term credit, the buyer normally makes a cash down payment (up to 15 percent) and then accepts bills of exchange or issues promissory notes for the balance, at some stage before final delivery or acceptance of the goods.

**Trade finance.** A catch-all term applied essentially to the entire area of short-term business, especially that involving finance provided directly by banks issuing letters of credit.

**Transfer cover.** Insurance written to cover the risk (called transfer risk) that a buyer may make a deposit of local currency to pay for an international transaction but find itself unable to convert the local currency into foreign exchange for transfer to the exporter. A claim issued under such cover is called a transfer claim. Such inconvertibility can happen even where letters of credit exist. The risk normally arises from restrictions imposed by host governments, through laws or through regulations that have the force of law. During the last 20 years, transfer risk has been the most important political risk covered by export credit agencies. This risk is also covered under investment insurance, where investors are unable to convert and transfer profits and dividends. Export credit agencies often stipulate shortfall undertakings in transfer situations to protect against the possibility that, even if transfer is possible, devaluation may have rendered the local currency deposit insufficient to purchase the foreign exchange necessary to effect the full transfer. Transfer risk is more complicated when a currency collapses, so that even though foreign exchange may still be available to purchase, its price will have risen.
sharply in local currency terms since the insured contract was signed (or the insured investment made). These events are probably best looked at case by case.

**Transfer risk.** See transfer cover.

**Working capital.** The financing required by an exporter to start or continue to operate and produce goods and services to be exported. Normally, export credit agencies are not directly involved in providing working capital. But many exporters offer export credit agency cover (including cover of precredit risk) to their banks as security for finance, including working capital. (They often accomplish this through assignment or hypothecation of the insurance policy to the bank.) A few export credit agencies are directly involved in the provision of working capital, offering either facilities or guarantees directly to banks. However, this is a difficult and high-risk area, especially if the exporter fails to perform its contractual duties and as a result is not paid by the importer. The export credit agency is then faced with the (usually politically-sensitive) job of trying to recover from the exporter the money it has paid to the bank under its working capital facilities.