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Trade finance for emerging markets

- **Commercial banks have become an increasing source of trade finance**
- **The process of financing trade has become less conventional over years**
- **Trade finance has been resilient and a particularly important source of finance for marginalized countries**

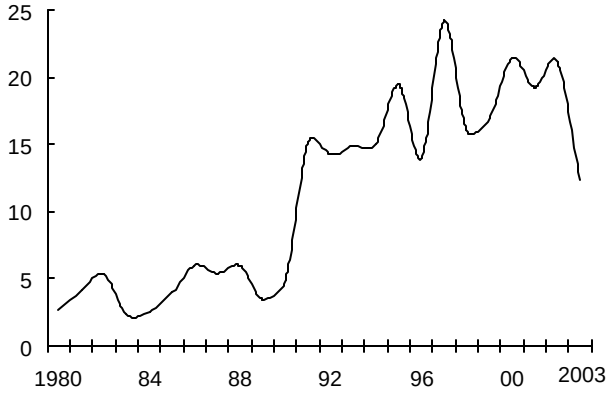
A growing source of finance

Trade financing plays a crucial role in facilitating international trade for emerging market economies, which in turn has a positive impact on their economic performance and external liabilities. Cross-border financing for trade can take place through official sources (such as Export Credit Agencies), commercial banks and via direct funding arrangements between trading partners. This note focuses on funding from commercial banks. For a description of methodology used to compile data see box on the next page. Trade financing from other sources would be discussed in subsequent briefing notes.

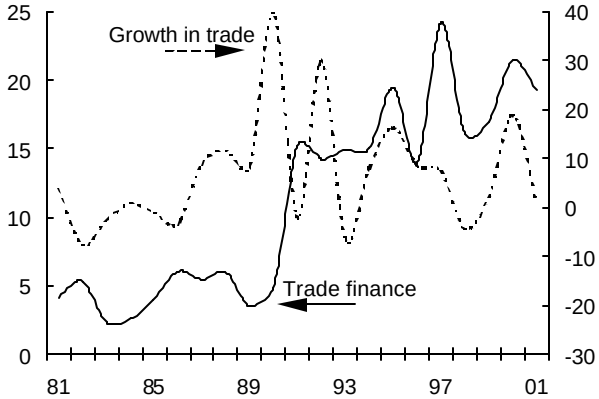
Over the past two decades, abstracting from short-run cyclical patterns, trade finance for emerging markets has been rising (upper chart, right). The level of trade financing has undergone a structural adjustment. Financing quadrupled from an annual average of around $4 billion dollars between 1980 and 1990 to an average of $16 billion between 1991 and 2000, and has held at around $20 billion in 2001 and 2002.

International financing for trade is particularly important for countries that typically have limited access to foreign financing, as well as during times of economic stress when countries usually lack access to foreign capital markets.

Trade finance from market-based sources
$ billion



Trade finance and growth in emerging markets' trade
$ billion *Percent*



Oiling the wheels of trade

Trade finance through commercial banks has helped oil the wheels of trade for emerging markets. For the most part since the early 1980s, trade finance has coincided with the pattern of trade for emerging markets (lower chart, above). During the 1980s, most of the growth in emerging market trade came from the Latin America and Caribbean region. However, having undergone a debt crisis, trade finance to the region declined significantly from the early

1980s to mid-1980s. Thus the growth in trade finance to Latin America accounted for only a small part of the growth in trade finance to emerging markets as a whole during 1980s. Most of the growth in trade finance during this period came from East Asia and Middle East and North Africa. In the mid-1990s, as the growth in trade shifted to Europe and Central Asia, so did the growth in trade finance to emerging markets. Since the late 1990s, as the growth in trade spread out over various regions, so has the growth in trade finance (table, right).

Growth in trade finance and trade

Percent of total growth; annual averages

	1981-90	1991-95	1996-02
Trade finance			
Europe & C. Asia	2	380	8
East Asia & Pacific	91	-17	33
South Asia	1	9	11
Latin America	-9	-112	-26
Mid. East & N. Africa	32	-210	28
Sub-Saharan Africa	-16	50	47
Trade growth			
Europe & C. Asia	8	99	15
East Asia & Pacific	14	-3	46
South Asia	2	5	6
Latin America	42	-2	10
Mid. East & N. Africa	24	-4	22
Sub-Saharan Africa	10	6	2

The changing face of trade finance

Until the 1990s, nearly three fourths of trade financing took place through conventional means that entailed a series of steps and procedures for the various parties involved (see exhibit on the next page). Export credit, a financing facility used by the purchaser of the exported goods, was the most commonly used means, and accounted for almost 80 percent of the conventional mode of financing trade (table, next page). Buyer Credit, which involved a bank in the supplier's country extending a payment facility to a bank in the purchaser's country (or to the purchaser directly), was the second most commonly used means of financing trade. Also,

Methodology for trade finance data

The trade finance data used in this note comprise financing of trade via conventional instruments plus through general bank credit arranged explicitly for the purposes of trade.

The conventional instruments refer to methods that have been traditionally used for financing trade, and emphasize hedging against non-completion and foreign exchange risk typically associated with cross-border trade. Included in this category is lending primarily via Buyers Credit, Export Credit, Supplier Credit, Letter of Credit, Bill Facility, Guarantee and Lease Facility, Promissory Note Facility, and other facilities for purchase and issuance. With the evolution in finance and trade, however, not all financing takes place via conventional means. Thus, added to conventional methods is financing via revolving lines of credit, Term Loans, Co-financing facilities and Bridge Loans that are arranged solely for the purposes of trade.

Over time the definition of trade financing has become murkier. Part of international financing for projects that relate specifically to cross-border purchase or sale of goods may also be considered as financing trade. Such financing is not included in the data used in this note, as it is likely to lead to double counting, as for example in the case of infrastructure project financing.

The data compiled for this note take into account only financing through syndicated credit, and only that part which has been reported in the markets. While a part of these data does refer to financing guaranteed by public sources, such as Export Credit Agencies of countries, not all trade financing via public and official sources is captured, as many financing arrangements take place bilaterally. The market source data, however, do provide an opportunity to analyze various aspects of trade financing for emerging markets, and should provide insights into the comprehensive trends in trade financing. In addition, such data are available on a timely basis and have the advantage of providing information on the covenants of such financing.

up until the early 1990s, the official sector (Export Credit Agencies) played a major role in facilitating trade finance for emerging markets.

Since the early 1990s, however, trade for emerging markets has come to be financed increasingly from the private sector, specifically through general bank lending via Term Loans and Revolving Credit facilities. Term Loans specify a fixed amount of financing that can be used by the borrower for a specified period of time, over which the principal is repaid at regular intervals. Revolving Credit allows borrowers much greater flexibility in drawing down and paying back the principal sum on the loan. These general forms of bank lending have become more popular because of the growth of multinationals, improvement in technology and monitoring capabilities, and partly because they circumvent the lengthy procedures associated with more conventional forms of bank lending.

Resilience through periods of stress

The increase in trade financing has taken place alongside the upward adjustment in the overall level of bank lending to emerging markets (seen in both data on bank lending from market sources, as well as claims of BIS banks on emerging markets). After the resolution of the debt crisis of the early 1980s, banks were encouraged to increase exposure to emerging markets. However, the importance of trade finance for emerging markets is manifested by the resilience that such financing has shown during periods of stress and its increased contribution to supporting bank lending to emerging markets:

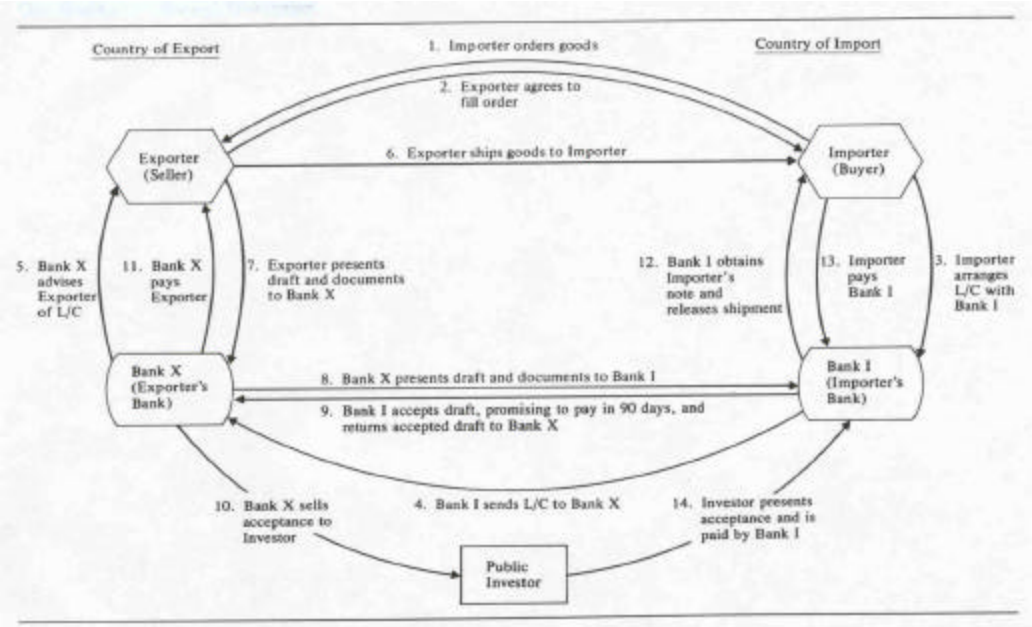
- During the debt crisis of the 1980s, when bank lending to emerging markets dropped from $57 billion in 1981 to $21 billion in 1987, the share of trade financing in total bank lending almost

Breakdown of trade finance from market-sources

% of total	1980-85	1986-90	1991-95	1996-02
Conventional	77	91	62	32
Buyer credit	10	22	28	4
Export credit	67	68	30	19
Letter of credit	0	1	3	8
Other	0	0	1	0
Term loan	12	8	33	62
Revolving credit	9	1	5	5
Other*	2	0	0	1

* Includes Note purchase, issuance and promissory facility.

A typical conventional method of trade finance



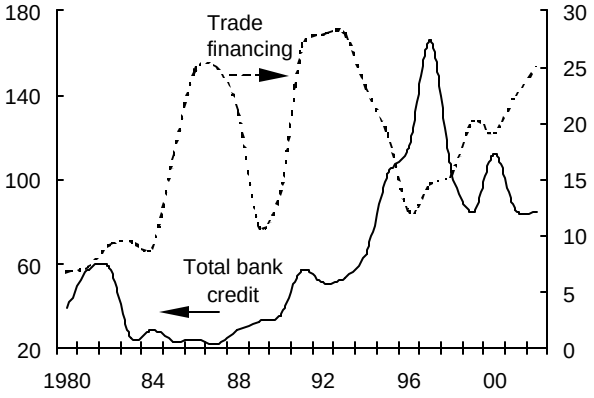
Source: Multinational Business Finance, Eiteman and Stonehill.

doubled from 8 percent to 15 percent during the same period (upper chart, right).

- From 1988 onwards, banks increased their exposure to emerging markets throughout most of the 1990s, to a peak of $165 billion in 1997. In part, this was driven by an increase in financing for trade. The share of bank lending devoted to financing emerging market trade increased from a yearly average of 15 percent during the mid-to-late 1980s to an average of 20 percent between 1988 and 1997.
- Since 1997, despite the retrenchment of banks from emerging markets, leading to a drop in lending to $85 billion in 2002 (from $165 billion in 1997), the share of trade financing has in general been rising and has held stable on average at around 20 percent of the total bank lending to emerging markets.

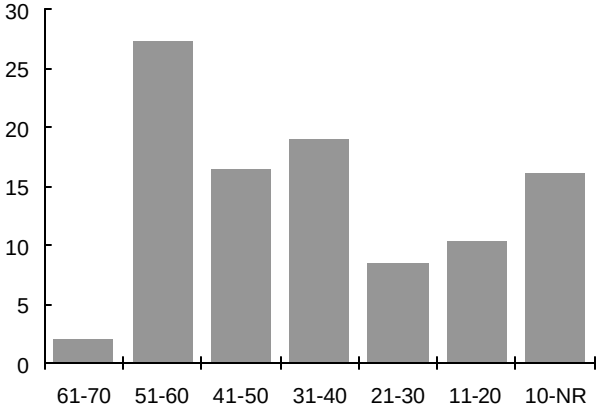
Trade financing compared to total bank lending

$ billion *Share of total bank credit (%)*



Distribution of trade finance by credit risk category

Percent of total emerging market trade finance; 1980 - Apr 03



Institutional Investor credit rating (Scale: Best=100 - Worst=0)

Outreach to marginalized countries

Trade financing via commercial banks has reached emerging market economies that are marginalized both in terms of their credit risk (or its perception) and share of international trade. It is even more widely spread out than general bank lending, which unlike other forms of market-based financing is much more widely accessible by emerging markets. Using the Institutional Investor credit rating spectrum (the largest rating spectrum for emerging markets covering about 100 economies), a little over 25 percent of total trade finance for emerging market economies between 1980 and April 2003 went to countries that were rated at the lower end of the credit spectrum (middle chart, right). In comparison only 9 percent of the *total bank lending* went to these countries during the same period.

Changes in distribution of trade finance

	1986	Average 1987-89	1995	1996	1997	1998
Total *($ bn)*	6.0	4.9	19.5	14.0	24.2	16.1
Percent of total emg. mkt. trade finance						
Rating						
61 - 70	0	1	3	2	2	2
51 - 60	68	19	34	28	15	28
41 - 50	8	16	18	19	23	11
31 - 40	2	8	11	14	30	19
21 - 30	8	9	10	7	8	10
11 - 20	1	8	14	11	7	13
0 - 10	0	10	0	0	0	0
Not rated	12	29	9	21	14	18

Of particular importance has been the availability of trade finance to marginalized countries during periods of stress and credit retrenchment by banks. During the three major episodes of decline in total trade finance to emerging markets, countries with high credit risk (low credit ratings) fared quite well in terms of their share in total trade financing arranged for emerging markets from international capital markets (table, above). Countries with credit ratings of less than 20 (on the Institutional Investor rating scale), or those not rated at all, fared particularly well during years of shrinking overall trade finance.