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Viewpoint

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Key Role for Trade Finance in Transition and Developing Economies

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Trade finance should get high priority in countries adopting market-oriented reforms. It is less risky than other kinds of finance because it is fundamentally different: it is trade-transaction-based, self-liquidating, and short-term working capital finance. Because of these unique features, it can play a critical and catalytic role in the early stages of trade, enterprise, banking sector, and macroeconomic reforms. This Note explains why trade finance, particularly trade finance based on short-term export letters of credit, can play such a key developmental role. The Note also recommends an appropriate sequence for the provision and strengthening of trade-finance-related institutions and credit instruments.

Trade reform

Trade finance should come early in the trade policy reform agenda. Without it, a supply response to trade policy reform is harder to achieve. And if trade finance helps to boost exports, improve the balance of payments, and increase the international competitiveness of local industries, this will underpin confidence in sustained import and other policy liberalization.

While domestic trade (including import substitution activities) also needs trade finance, export-related trade should be addressed first, for several very practical reasons. In the earlier stages of development, it is easier to assess the profitability and economic efficiency of letters-of-credit-based export-related activities than those of domestic-sales-

What is export-letters-of-credit-based trade finance?

Trade finance based on export letters of credit (payment guarantees) provides:

- import finance, to fund imports of foreign raw materials and intermediate inputs;
- domestic purchase finance, to fund domestic raw materials and intermediate inputs;
- production finance, to fund domestic value-added components (wages, interest, and rents);
- inventory finance, to fund inventories of finished commodities for export.

These constitute preshipment export finance. In addition, a fifth type of finance—short-term postshipment finance for export—may be needed to finance export sales on credit (normally up to 180 days). This finance is based on bankers' acceptances—unconditional promises by the banks to pay the bearers at some future date.

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related activities. In addition, modern documentary payment guarantees such as letters of credit and bankers' acceptances are more common in international trade than in domestic trade. Therefore, it is easier to start export-related trade finance before domestic-sales-related trade finance. In addition, short-term trade finance is more urgent than the medium- and long-term postshipment export finance typically used for the sale of heavy-industry products.

Enterprise reforms

The common approach to enterprise restructuring in several formerly nonmarket economies, particularly the Eastern Bloc countries, has given priority to new investment in facilities and equipment. The record has not been very encouraging. Too little attention has been given to reorienting existing operations and using excess capacity to meet short-term demand. This reorientation could occur more easily if firms had access to trade finance. Therefore, at an early stage of enterprise restructuring, short-term trade finance should receive higher priority than investment finance.

In turn, the survival of newly privatized enterprises in these economies depends in part on their success with letters-of-credit-based enterprise-to-enterprise trade (international as well as domestic) freely occurring at market prices. These firms should have good access to foreign currency import finance to fund export orders backed by confirmed export letters of credit—because the confirmed letters of credit mean that they will already have passed the economic viability test in terms of comparative advantage and self-liquidation of finance. Foreign currency import finance also assures firms of access to foreign exchange at international interest rates and the stability of bank loan values in a high-inflation environment. Recognizing these advantages, two recent Bank projects in Bulgaria and Romania have components designed to support foreign currency import finance for exporting firms.

Banking reforms

Trade finance based on confirmed export letters of credit is the best way to start market-based bank lending. This kind of trade finance is like fully collateralized bank lending. And treating confirmed letters of credit (supplemented by preshipment finance guarantees and export credit insurance or guarantees[1]) as collateral is far superior to using physical collateral (such as buildings, land, equipment), a common approach in many low-income countries. The former assures minimum profitability or economic efficiency, while in the latter there is seldom a careful evaluation of the profitability or economic efficiency underlying the loan project—not to mention the usual difficulties of transforming collateral into liquid assets.

This approach could be used in Russia. A recent Bank report on the Russian economy recommended that International Standard Banks (ISBs) be developed to promote market-based banking. ISBs would decide who is likely to use the loan efficiently and which loan projects are likely to yield the highest return—or most likely to yield returns sufficient to enable the borrower to repay the loan. ISBs would monitor the use of the loan to ensure that the loan is repaid. ISBs can minimize adverse selection and moral hazard issues if they start out with trade finance and select loan projects and borrowers primarily on the basis of confirmed export letters of credit. Trade finance based on confirmed export letters of credit is self-liquidating as long as borrowers' nonperformance risks and foreign buyers' nonpayment risks stemming from political risks do not exist or are properly handled through a preshipment export finance guarantee scheme and an export credit insurance or guarantee scheme.

Macroeconomic reforms

There appears to be no dispute about the need to give the highest priority to macroeconomic stability in sequencing the policies of developing countries or formerly nonmarket economies. Giving priority to trade finance need not put macroeconomic stability at risk. Because the liquidity expansion stemming from increased trade finance demands would be compensated for by the increase in the supply of real goods and services, an increase in trade finance should not lead to higher inflation—as long as the

Developing trade finance: sequencing of instruments and institutional reforms

In most low-income developing countries and formerly nonmarket economies, the following sequence for developing the various instruments, institutions, and mechanisms should be applied:

1. Confirmed export letters of credit; associated (self-liquidating) loans for imports, domestic purchases, and value-added transactions; and liquidation mechanisms.
2. Lender-of-last-resort refinancing or rediscount facilities of central banks or trade banks.
3. Institutions and schemes that protect banks against exporters' nonperformance risk (preshipment export finance guarantees).
4. Inclusion of indirect exporters based on back-to-back domestic letters of credit in (1)–(3).
5. Bankers' acceptance discounting and rediscounting at world market discount rates.
6. Institutions and schemes that protect exporters or banks against overseas buyers' nonpayment risk (export credit insurance or guarantees).

Steps (1) and (2) may require a legal framework, such as the bill of exchange act and trade contract enforcement mechanisms. For example, in Russia the current decrees of the central bank on the payment methods, including the rules on letters of credit, should be modified to make them consistent with the Uniform Customs and Practice for Documentary Credits and Documentary Collections drawn up by the International Chamber of Commerce.

Steps (2), (3), (4), (5), and (6) should not violate the Uruguay Round Agreement on Subsidies and Countervailing Measures on these instruments and institutions. So they should be subject to a full cost-recovery principle.

Step (5) is the best candidate for moving very quickly from bank-loan-based trade finance to bank-credit-based trade finance.

Step (6) would be the last. Once an effective export credit insurance or guarantee scheme is available, the export order not based on export letters of credit but backed by the export credit insurance or guarantee should get the same treatment as the export order based on confirmed export letters of credit, in (1) and (2).

trade matches the country's comparative advantage. But more emphasis appears to be needed on the importance of following the "real bills" doctrine[2] at an early stage, especially in such inflation-ridden formerly nonmarket economies as Russia. Trade finance that correctly follows the "real bills" doctrine is not equivalent to sectorally targeted loans. In fact, trade finance should replace sectorally targeted loans. In transition economies like Russia, the central bank's rediscounting of trade-related bills at a market-based discount rate should replace politically driven targeted or subsidized loans granted to inefficient industries.

In the process of setting up the basic framework for trade finance (including the legal framework for a bill of exchange act and the rediscounting facility of a lender of last resort), domestic trade should be treated, in principle, on the same basis as foreign trade. However, in the early stages of implementing such a framework, it is easier to start with the trade finance based on export letters of credit. The important self-liquidating characteristic of trade finance may not exist in domestic trade because of a highly distorted economy. In addition, letters of credit are not frequently used for domestic trade. As soon as the use of credit instruments (such as letters of credit, domestic letters of credit, and bankers' acceptances) becomes widespread and "self-liquidating" mechanisms are extended to domestic trade activities, domestic trade finance should be treated the same as international trade finance in lender-of-last-resort rediscounting.

Institution-building

Trade finance requires the right mode, institutions, instruments, and mechanisms, in the right sequence (see box on this page for sequencing):

- *Which mode?* There are four main potential modes of short-term trade finance in any economy: (1) company credit, (2) bank credit, (3) bank loans, and (4) self-financing.[3] If trade finance needs cannot be met by bank credit, bank loans,

or company credit, they must be met by self-financing from retained earnings. But the scope for self-financing is usually small. Furthermore, in most low-income developing countries and formerly nonmarket economies, due to the absence of modern domestic banks and trading companies that can internalize risk-taking, trade finance needs cannot be met by bank credit or company credit. So trade finance needs must initially be met by bank loans, and, therefore, the institution-building task for bank-loan-based trade finance is very important.

- *Why institution-building?* Offering preshipment trade finance based on export letters of credit would make commercial sense in mature banking sectors. However, in most low-income countries or formerly nonmarket economies, many commercial banks may be unable to provide access to preshipment finance based purely on confirmed letters of credit because of their lack of capacity to internalize risk-taking or because there are other, higher-profit opportunities in non-trade-related lending. Therefore, assuring access to trade finance based on letters of credit by focusing on the institution-building measures (and financial sector reforms) that would induce commercial banks to provide such access for the sake of their own profits is a development policy task that would enhance the country's export potential. Such measures are tantamount to encouraging private enterprises and commercial banks in these economies to adopt market principles in their trade or banking activities.

Conclusion

In many low-income countries and formerly nonmarket economies, innovative and imaginative approaches may be needed in building effective institutions and schemes. These institutions and instruments need to institutionalize trade finance based on export letters of credit. This lays the foundation for market-based and bank-credit-based trade finance, which can emerge when the capacity of commercial banks to internalize risk-taking is sufficiently developed. Without early institutionalization, trade finance cannot play its key developmental role.

[1] A preshipment export finance guarantee scheme protects export-financing banks against exporters' nonperformance risk; an export credit insurance scheme protects exporters against foreign buyers' nonpayment risk; an export credit guarantee scheme protects export-financing banks against foreign buyers' nonpayment risk.

[2] The "real bills" doctrine, which guided the monetary policies of the United Kingdom and the United States in the nineteenth century, was based on a belief in the neutral impact of trade finance on inflation. The rediscounting of the Bank of England and the Federal Reserve at that time was limited to genuine trade-transaction-based, self-liquidating trade bills so as not to create excess liquidity. This has been termed the "real bills" doctrine, and it has influenced the later policies of the central banks of many countries (for example, central banks may rediscount or take as security only short-term self-liquidating papers).

[3] It is important here to distinguish clearly between bank loans and bank credit and between bank credit and company credit. When a bank provides a *loan*, it lends actual cash. When it creates a bankers' acceptance, it lends *credit*. The bank creates a bankers' acceptance based strictly on the expected revenue from a particular trade transaction. Traders meet their trade finance needs through the bankers' acceptance discount market, which is part of the money market. Company credits involve selling and buying between affiliated companies or between trading companies and suppliers "on credit."

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