INTERNATIONAL MONETARY FUND

Trade Finance in Financial Crises: Assessment of Key Issues

Prepared by Policy Development and Review Department
in consultation with International Capital Markets and
Monetary and Financial Systems Departments

Approved by Mark Allen

December 9, 2003

Contents

Executive Summary

Causes of the decline in trade finance. During recent financial crises, trade financing to the crisis countries fell dramatically. Such declines in trade finance could be attributed to the response by banks as leveraged institutions, to the lack of insurance when it was needed, and to herd behavior among banks, official export credit agencies (ECAs), and private insurers. Moreover, the declines were often associated with weak domestic banking systems. Consolidation of the international banking sector in recent years may also have had a bearing on the decline in trade finance during recent crises.

Adverse consequences of collapse in trade credit. The contraction in trade finance in recent crises appears to have been sharper than would be justified by fundamentals and risks involved. As bank-financed trade credits are typically short-term, backed by receivables and self-liquidating, their performance, transfer and convertibility risks are considered lower than other cross-border lending. The loss of financing to the trade sector appears to have disrupted countries' trade and growth performance, possibly exacerbating the crisis.

Lessons from past initiatives. Various schemes to support trade finance have involved the private sector, the government, multilateral financial institutions, and official bilateral credit agencies—they all underscore the importance of good policies and a sound domestic banking system in facilitating the flow of trade finance. Targeted temporary financing and, in some cases, agreements with international banks were helpful in addressing liquidity shortages, risk perceptions and collective action problems.

Improving the resilience of emerging market economies. Structural measures in this regard could include an expanded use of asset-backed securitization funding structures, risk-sharing among creditors and insurers, greater risk differentiation by rating agencies and bank regulators, and possible modification of the incentive structure governing official ECAs to encourage counter-cyclical operations by these agencies.

A broad framework to help mitigate a collapse of trade finance. In cases where solvent enterprises and exporters in a crisis country are unable to access trade finance, and/or the relevant sovereign's ability to provide credible guarantees required by external trade finance providers is limited, targeted support to the country's trade sector could be usefully employed alongside Fund-supported programs. Recent experience suggests that an effective approach could be built around multilateral development bank (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 ECAs. In some cases, this could be reinforced by efforts of the crisis country to encourage private banks to maintain interbank credit lines.

I. INTRODUCTION

1. **During recent financial crises, 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 pre- 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 30–50 percent in Brazil and Argentina last year, about 50 percent in Korea in 1997–98, and from US$6 billion to US$1 billion in Indonesia during the Asian crisis. In the case of 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]

2. **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 in 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: 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 exchange, given an increased probability of delayed receipts of foreign exchange earnings of exports and a decline in exports that depend on imported inputs and materials.[4] The resulting pressure on the

---

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

[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 the cases where data are available, they are often only partial. As a result, many participants of trade finance suggested a systematic effort involving country authorities, multilateral institutions as well as the private sector be launched to collect data to facilitate future empirical research.

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

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.

3. **The crisis-induced collapse in trade finance has become a more serious problem in modern capital markets than it was in the 1980s debt crises**. In the 1980s, 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) banks' willingness to maintain trade credit lines in difficult times has been significantly weakened. In 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.

4. **Fund staff has undertaken a consultative process to deepen understanding of the aforementioned problems and explore possible remedies.** A seminar, held on May 15, 2003, at headquarters, was attended by representatives from private banks and insurers, central banks, official export credit agencies, multilateral organizations and development banks, and research institutions. Staff teams also visited key rating agencies, commercial banks, and banking regulators and continued the dialogue with members of the International

---

[5] Trade finance was conducted against the background of fairly pervasive exchange controls in the 1970-80s. 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 was 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 widespread 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.

Union of Credit and Investment Insurers (the Berne Union) during its Annual Meeting in October 2003 in Mexico.[6]

5. **This paper presents a preliminary assessment of the key issues and outlines possible steps that could be taken to mitigate a generalized loss of trade finance in future crises, based on consultations with public and private sector players involved in trade finance.** The remainder of the paper is organized as follows. The next section examines the underlying causes behind the collapse in trade finance flows during financial crises. Section III briefly reviews recent initiatives to stem this decline. Section IV discusses structural measures that could be taken to improve emerging market economies' resilience in the event of financial crises. The last section outlines an emerging consensus on a coordinated framework for trade finance in crisis resolution.

II. Causes of the Decline in Trade Finance

6. **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-term and medium-term lending, and most countries facing payments difficulties did not suspend payments on trade credits, even when payments on other external obligations were 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.

7. **Based on our consultations, 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 theleveraged 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

[6] The missions comprised staff from PDR, ICM, and MFD.

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 the case of 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 re-insurance 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 (ECAs), 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 following privatization and structural changes in the last decade. The WTO rules on subsidies[7] may make it difficult for ECAs 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 down-sizing 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

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

government securities or investing off-shore, and reducing their exposure to corporate risk.

8. **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 10–15 years has left fewer banks participating in trade finance, leading to a greater tendency towards 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 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.

III. Initiatives Taken During Recent Crises

9. **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, the 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*.

10. **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 US$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 non-performing loans, the central bank deposited US$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 L/C guarantee.

- In Korea, as trade financing shrank following the outbreak of the crisis in 1997, the Bank of Korea provided US$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.

11. **Support from bilateral credit agencies**. Support from bilateral agencies was less common than intervention by crisis country authorities, and 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, 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 in its 1998 crisis (amounting to US$900 million), but this increase was largely offset by a reduction in long-term credit.

12. **Intervention by international financial institutions (IFIs)**. MDB intervention tended to focus on the provision of financing to both government agencies for on-lending to the private sector and to private sector financial intermediaries for on-lending 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 (AsDB) provided a loan to the Export and Import Bank of Thailand for on-lending directly and through local banks to small- and medium-sized export enterprises for pre- and postshipment export financing. Through a partial credit guarantee, AsDB 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 AsDB-supported trade finance facilities decreased as local commercial banks increasingly resorted to their own funds due to eased liquidity conditions. The AsDB 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 exporters.

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

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

13. **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. [8] For example:

- In Brazil in 1999, an agreement was reached by the international banks in March to maintain their short-term credit lines (then approximately US$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 rollover 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.

14. **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 a 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.

---

[8] The agreements called for banks to maintain cross-border exposure, including on inter-bank 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 pre-requisite 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 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 the pre- and postshipment 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 ECAs, are better equipped to provide external financing when needed to address confidence gaps or problems arising from risk perceptions. Some of these institutions, particularly ECAs, are likely to continue to have a relatively limited role. While ECAs 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 ECAs 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.

IV. Structural Measures to Strengthen Trade Finance Facilities

15. **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 aiming at diversifying risks and improving the functioning of market institutions.

A. 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.

B. Expanded Use of Capital Market Structures for Trade Finance

- With greater risk differentiation by rating agencies and development of a country's legal infrastructure, it was suggested that 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, it was suggested that, 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.

C. Risk Sharing Among MDBs, ECAs, and Private Insurers

16. MDBs, including 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 re-insure 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 (PRI) market.

D. Possible Modification of the Incentive Structure Governing Official ECAs

- ECAs may give consideration to allowing a special exception to normal credit-risk practices of bilateral export credit agencies in crisis situations.[9] This may allow ECAs, 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 Consensus Arrangement or the relevant OECD guidelines, could be modified where warranted and supported by international consensus to help remove the disincentives to counter-cyclical operations of ECAs.

- ECAs 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 ECAs 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.

[9] A number of ECAs operate what is commonly referred to as "National Interest Account" for which certain cases can be underwritten, which are outside the ECAs' normal criteria.

E. Regional Approaches to Deal with Intra-Regional Trade

17. Intra-regional 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. It was suggested that regional economic/trade forums could possibly be used to devise appropriate responses in the event of crisis. It was noted that promoting intra-regional 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 intra-regional trade may be worth exploring.

F. Medium-Term Export Financing

18. 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 ECAs 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.

G. Institutional Reforms by Emerging Markets

19. 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 non-performing 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.

V. A Framework for Trade Finance in Crisis Resolution

20. **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 to 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.

21. **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 ECAs. 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.

A. Measures by Country Authorities

22. **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 was also noted that country authorities having the capacity to monitor short-term debt, including trade finance would be beneficial.

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

- **Make 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.

- **Facilitate 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. It was suggested that 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 argued that explicit provision of "de jure" seniority of trade credit would be valuable.

B. Efforts by the Official Sector

24. **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.

25. **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 particularly importance to the success of such initiatives.

- **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 pre-qualified banks that are leading players in a country's foreign trade finance sector. It was noted that these banks, with their networks and information on sub-borrowers, 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 were suggested. The relevant central bank could provide guarantees to enhance the acceptance of L/C 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, it was suggested that non-bank financial entities or structures may need to be established to channel official financing with domestic banks handling trade finance transactions.

26. **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 on-lending to the private sector. MDB trade finance facilities could also provide risk pooling opportunities for private and public trade credit lenders and insurers, for instance through the use of a A/B loan structure, making use of their respective comparative advantages in operation and risk taking.

27. **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, it was noted that ECAs 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 ECAs have provided short-term lines of credit to crisis countries. It was suggested that ECAs could explore ways to play more of a counter-cyclical 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.

C. Efforts by the Private Sector

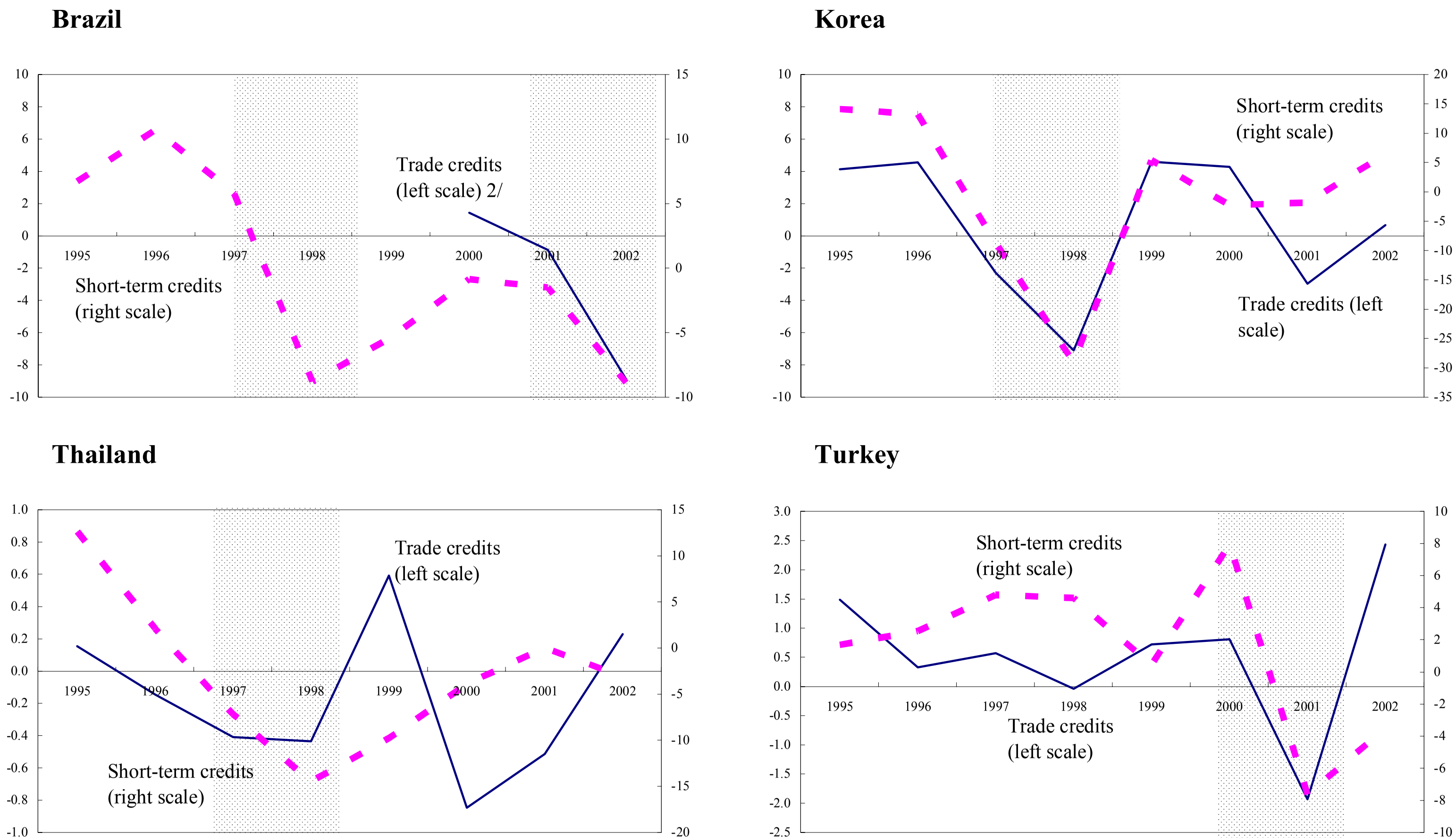
28. **The involvement of private trade credit providers can help facilitate a rapid return to confidence and financing**. Such participation could be in the form of a formal or informal agreement between the country authorities and international commercial banks to maintain these banks' trade credit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

D. Efforts by the Fund

29. **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, Fund 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.

30. **The extent of the Fund's involvement in activating and coordinating the steps outlined in this paper would likely depend on the circumstances of each crisis.** Among the possible modalities, three are worth noting and could be explored further: (i) the Fund staff could support the authorities who would take the lead in the process and cooperate with other creditors. Fund staff would not be actively involved in initiating and coordinating steps to address trade finance declines; (ii) Fund staff could help coordinate with other external creditors and insurers, while the authorities concerned are responsible for activating the crisis resolution framework; (iii) Fund staff could play a proactive role to trigger and coordinate the mitigation steps in cases where such role is required by other external creditors and insurers of trade finance.

Figure 1. Trade Credits and Short-Term Credit Lines for Selected Countries, 1995-2002 1/
(In billions of U.S. dollars)

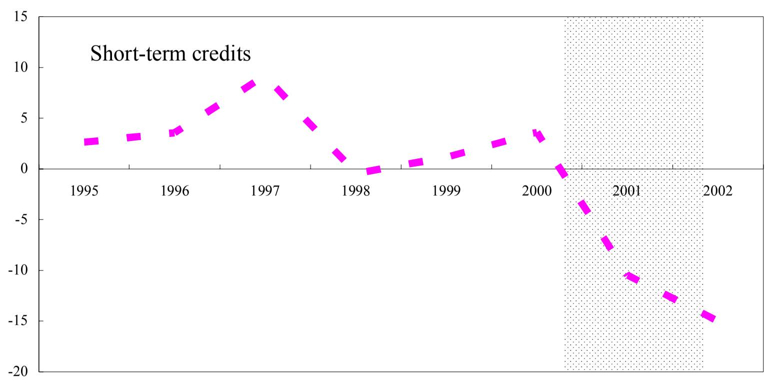


Sources: Trade credits data are derived from balance of payments data provided by country authorities. Short-term credit lines are based on data compiled by the BIS.

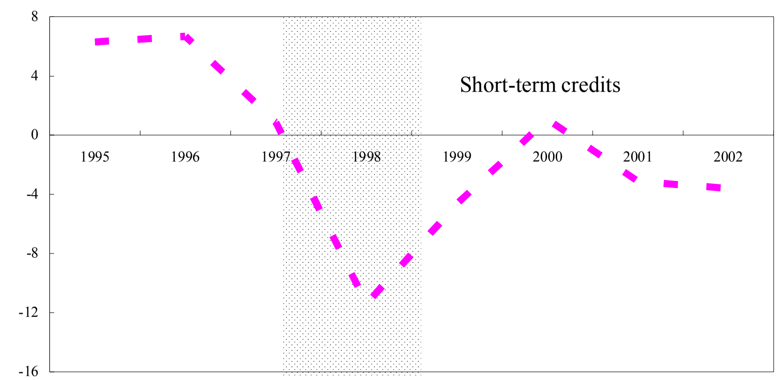
1/ Trade credits, where data available, are net flows. Short-term credits are changes in stocks of credit lines, based on annual data.
2/ The data include both bank-to-bank and bank-to-enterprise lines. In addition to export and import financing, the data also include other financing.

Figure 1 (concluded). Trade Credits and Short-Term Credit Lines for Selected Countries, 1995-2002 1/
(In billions of U.S. dollars)

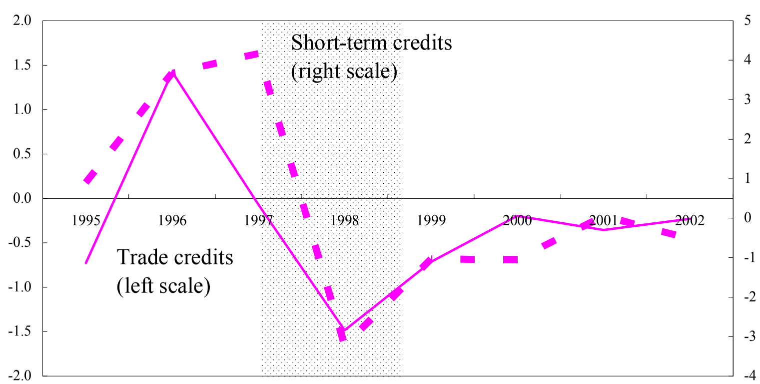
Argentina



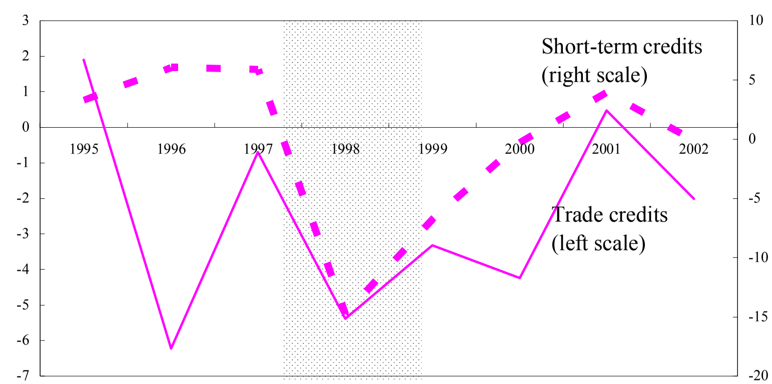
Indonesia



Philippines



Russia



Sources: Trade credits data are derived from balance of payments data provided by country authorities. Short-term credit lines are based on data compiled by the BIS.

1/ Trade credits, where data available, are net flows. Short-term credits are changes in stocks of credit lines, based on annual data.

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—“A” loan—and participates 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 Insurances. Established in 1934, this organization now has 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 among its members. 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 apply usually to medium- and long-term business and only 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 s 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 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 eximbanks 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 one 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 in 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, which may arise in the precredit period (before shipment), or during the credit period (after shipment). Policies may be used 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 I 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, for example 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, for example 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-term 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-term business and medium-term business, or between medium-term 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 ECAs 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.

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, long-standing 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-term 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 which 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 cashflow 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 whole 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 to 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.