



# Economic Premise

SEPTEMBER 2011 • Number 66

## Trade Finance during the 2008–9 Trade Collapse: Key Takeaways

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*Trade finance matters for trade, and when financial markets and world trade collapsed three years ago, a shortage in trade finance was hailed as a possible culprit. Because of the potential for global repercussions, world leaders called on the international community to act swiftly to avoid a depression. Governments and international institutions intervened to mitigate the impacts of the crisis. Then the economy bounced back, and trade picked up. But what did we learn from the crisis? In retrospect, what role did trade finance actually play? Did the freeze in the financial markets cause the unprecedented drop in global trade in 2008–9? This note presents evidence on the role of trade finance during 2008–9 and highlights a few takeaways on the data and knowledge gap of trade finance and government interventions during financial crises.*

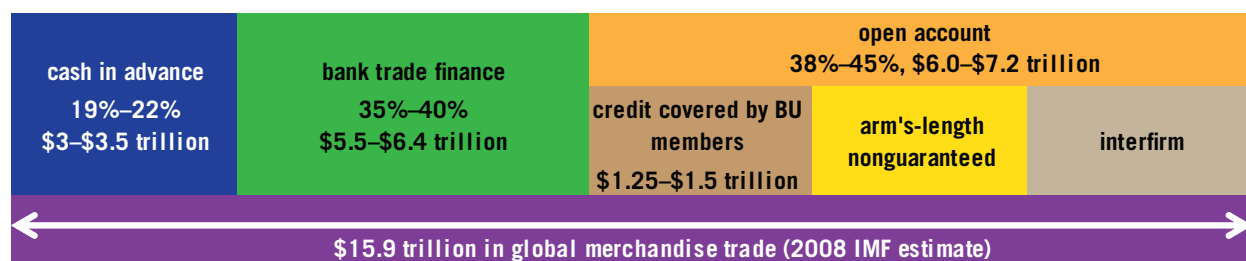
The 1997–98 Asian crisis had already illustrated the critical role that trade finance plays during a financial crisis, especially its effects on trade, but that crisis remained regionally confined, and international institutions and regulators largely blamed the opaque financial sector in the affected economies for the crisis. In contrast, the 2008–9 crisis originated in the United States, which has one of the most transparent and sophisticated financial markets, and quickly spilled over to the European Union and the rest of the world. Policy makers, central bankers, and finance ministers from around the world found themselves in largely uncharted territories. They had to contemplate policy actions to channel liquidity into the real economy to support trade transactions in the absence of data on trade finance. The dearth of data complicated the estimation of a possible trade finance “market gap” and of whether trade finance was indeed a major factor driving the fall in global trade.

Trade finance differs from other forms of credit, for example, investment finance and working capital. Its most distin-

guishing characteristic is that it is offered and obtained not only through third-party financial institutions (trade finance instruments that vary in terms of risk), but also through interfirm transactions, that is, involving contracts between buyers and suppliers. While banks play a central role in facilitating trade, a large share of trade finance occurs through interfirm, open account exchange. As such, it was also not clear whether governments’ interventions in favor of a specific segment of the financial system—the trade finance market—were justified and warranted, and whether they would be effective in filling any market gap.

*Trade Finance during the Great Trade Collapse* (Chauffour and Malouche 2011) is an attempt to answer these questions and provides policy makers and analysts with a comprehensive assessment of the role of trade finance in the 2008–9 “great trade collapse” (Baldwin 2009) and the subsequent role of governments and institutions to help restore trade finance markets.

**Figure 1. Trade Finance Arrangements, by Market Share**



Sources: IMF staff estimates from IMF/BAFT-IFSA surveys of commercial banks (IMF-BAFT 2009; IMF and BAFT-IFA 2010) and Berne Union database. Note: BU = Berne Union. IMF = International Monetary Fund. BAFT-IFSA = Bankers' Association for Finance and Trade-International Financial Services Association.

## Evidence Collected on the Role of Trade Finance

### Evidence from banks in advanced and emerging economies

Assessment of trade finance conditions is complicated by the absence of organized markets for bank-intermediated trade finance and the proprietary nature of bank information about customer relationships. To fill this gap, the International Monetary Fund (IMF) and the Bankers' Association for Finance and Trade (BAFT)—now merged with International Financial Services Association (BAFT-IFSA)—conducted four surveys of banks during the crisis to gather information on the market shares of financing products. The surveys suggested that about 40 percent of trade finance was bank intermediated and that the rest was split between cash in advance (about 20 percent) and open account (about 40 percent), including interfirm financing (figure 1).

While in times of financial crises, interfirm trade credit is often more resilient than bank-intermediated trade finance, at least in the short-term, the bank-intermediated component was relatively resilient during the 2008–9 crisis. To be sure, banks were increasingly cautious with real sector customers and counterparty banks, and pricing margins often increased. They adopted stricter risk management practices in response to higher risks. They differentiated more, depending on the individual client, the business segment (trading, retail, commodities, and so on), and home country. Banks also limited their own risk through expanded insurance, shorter loan maturities and stronger covenants, and by requiring higher cash deposits or other collateral from clients. But these factors were more than offset by an increase in risk aversion on the part of exporters seeking protection from risk. As a result, the share of world trade supported by bank-intermediated trade finance appears to have increased during the crisis. The causes of the increased price and decreased value of trade finance appear to be mostly spillovers from broader financial markets and the recession-induced decline in the value of international trade rather than specific problems in the trade finance markets themselves (table 1).

Large banks proved more cautious than small and medium banks regarding countries seen as posing high financial risks, and they were also more likely to request confirmations or export credit insurance. In contrast, small and medium banks were more likely than large banks to manage risk by requiring greater collateral or stronger covenants. The 2010 International Chamber of Commerce survey examined Society for Worldwide Interbank Financial Telecommunication (SWIFT) message data and found evidence of increased risk aversion by banks and customers, including refusals to honor letters of credit because of discrepancies in documents (ICC 2010).

The survey evidence on pricing is also consistent with a demand-driven theory in which the decline in trade finance plays no more than a modest role in the decline in merchandise trade. The survey results indicate some increased pricing for trade finance, at least relative to banks' cost of funds. Other things being equal, the increased pricing should have reduced the use of bank-intermediated trade finance as a share of trade. The increased share of bank-intermediated trade finance despite increased pricing also suggests domination by demand factors such as exporter risk aversion.

**Table 1. Reasons for the Decline in Value of Trade Finance**

| Reasons   | Percent of respondents |             |              |             |
|---|------------------------|-------------|--------------|-------------|
|   | All banks              | Small banks | Medium banks | Large banks |
| Fall in the demand for trade activities                           | 85                     | 81          | 90           | 80          |
| Fall in the price of transactions (for example, commodity prices) | 38                     | 25          | 24           | 56          |
| Less credit availability at your own institution                  | 30                     | 19          | 24           | 40          |
| Less credit availability at counterparty banks                    | 30                     | 6           | 24           | 48          |
| Shift toward open account transactions                            | 23                     | 19          | 33           | 16          |
| Shift toward cash-in-advance transactions                         | 21                     | 31          | 14           | 20          |
| Decline in support from export credit agencies                    | 8                      | 0           | 5            | 16          |
| Decline in credit from multilateral institutions                  | 0                      | 0           | 0            | 0           |
| Other reasons   | 18                     | 31          | 10           | 16          |

Source: IMF/BAFT-IFSA Trade Finance Survey, March 2010.

Note: This reflects only the views of the 61 respondents that reported a decline in value of trade finance in at least one geographic region presented and that subsequently marked at least one option for the current question.

In sum, bank-intermediated trade finance largely held up during the 2008–9 financial crisis even as it came under several sources of strain. The value of trade finance fell at the peak of the crisis, but it fell by consistently smaller percentages across regions than did the export declines in the same regions. As a result, the share of bank-intermediated trade finance in world trade increased during the crisis. This larger share developed despite considerable headwinds. Banks supplying trade finance shared the general increase in risk aversion observed in broader financial markets, and they restricted their supply of trade finance to certain countries or sectors and otherwise tightened credit conditions. Banks also increased pricing margins, driven by both increased perceptions of default risk and higher capital requirements, the latter partially due to Basel II requirements.

### Impact in developing countries

The World Bank sponsored a unique bank and firm survey in 14 developing countries across five regions in 2009 and 2010. Survey findings confirmed that the global financial crisis constrained trade finance for exporters and importers in developing countries. Yet the drop in demand emerged as firms' top concern (figure 2). The lack of export revenues put pressure on firms' cash flow and, therefore, on their capacity to fund their export and import transactions. The survey revealed some stylized facts at the firm, bank, and country-income levels.

Firms that relied largely on the banking system for trade finance suffered from more risk averse and selective local banks. In contrast, firms that relied mostly on interfirm financing and self-financing were most affected by the slowing global economy, the lack of and cancellation of orders, delays in buyers' payments, and shorter maturity imposed by suppliers. Small and medium enterprises (SMEs) were more affected

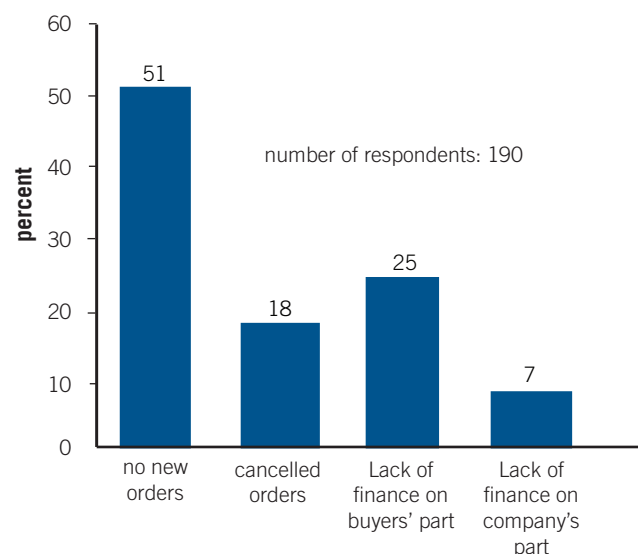
than large firms because of their weaker capital base and bargaining power compared to global buyers as well as banks. Also, SMEs experienced higher increases in the cost of trade finance instruments. Many SMEs operating in global supply chains or in the sectors most affected by the slow global economy, such as in the auto industry, reported being constrained both by the banking system and by the drop in export revenues and buyer liquidity.

Banks in developing countries became more cautious, risk averse, and selective in light of the drastic reduction in global financial liquidity and in the number of intermediary players. Interviews with banks confirmed the increase in pricing and drop in trade credit volume. Yet the drop in volume seemed to more reflect lack of demand due to the global recession than the increase in pricing. Moreover, lack of liquidity in local currency did not appear to be an issue. By April 2010, trade finance value and volume—particularly for interfirm trade credit—also bounced back. Firms' revenues picked up along with the economic recovery, as did interfirm trade finance. However, banks remained relatively risk averse because they needed to deleverage and reassess underwriting risks. As a result, prices of trade finance instruments and spreads, although narrowing, remained higher than precrisis levels. A large number of firms in Egypt, the Philippines and South Africa, where bank intermediation is important, claimed that banks were still imposing stringent eligibility criteria for trade finance transactions. Overall, 45 percent of surveyed firms reported that banks were as risk averse in the last quarter 2009 as in they were in the last quarter of 2008 (figure 3).

The impact of the crisis was also heterogeneous across countries. The three low-income African countries where the survey was conducted (Ghana, Kenya, and Sierra Leone) seemed relatively more insulated from the financial crisis as of March–April 2009. Their primary trade finance constraints originated from more structural problems, such as poorly developed banking systems and trade finance institutions as well as macroeconomic imbalances. Many of the African exporters have traditionally relied on self-financing and cash in advance; therefore, their exports were also hit by the drop in commodity prices and global demand from their main export markets. The drop in their cash reserves further constrained their trade finance. The financial crisis mainly added strains on the countries' domestic financial systems and hindered SMEs and new firms seeking to diversify away from commodity exports.

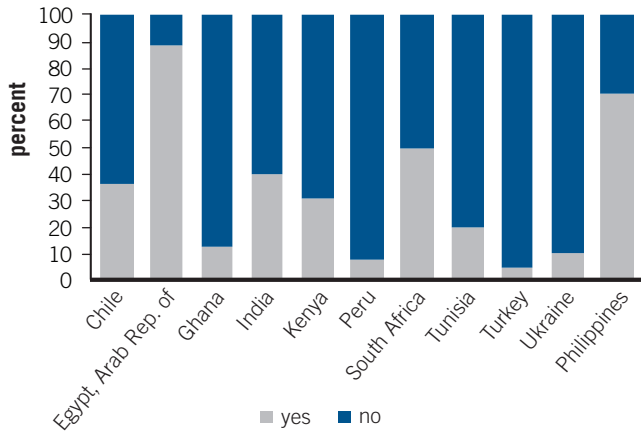
Looking at the impact of the financial crisis on African exporters, most interviewed firms in Africa did not experience direct difficulties with trade finance (Humphrey 2011). Yet, indirectly, the financial crisis—through its effects on global demand and price volatility—led to deterioration of firms' creditworthiness and a decline in their access to trade finance. Moreover, the survey underscores the differentiated impact the crisis may have had by firm type: scarce bank finance reportedly was

**Figure 2. Lack of Orders Main Reason for Export Decline (2009)**



Source: Malouche 2009.

**Figure 3. Are Banks Still Imposing More Stringent Credit Eligibility Criteria for Trade Finance Transactions?**



Source: Malouche 2011.

Note Country breakdown by number of responses, for all respondents = 223.

channeled mainly to firms with established exporting records and regular customer relations, leaving SMEs and new entrants that lacked relationships with banks and customers in a dire situation.

### Government and Institutional Intervention

Notwithstanding uncertainty about the size of the trade finance gap and its potential role in the drop in trade, governments around the world were compelled in the fall of 2008 to intervene to mitigate the impacts of the crisis on their domestic economies. The exceptional nature of the crisis called for immediate action. A critical question was whether the supply of trade finance declined because of market or government failures, and, hence, whether there was a rationale for public intervention to address such failures. Two broad cases that could create a real trade finance gap are: (i) insufficient supply (“missing markets”) and (ii) supply at prices temporarily too high to meet demand (“overshooting markets”)—both of which may have had temporary relevance in fall 2008.

Government actions supporting trade finance were rationalized on the basis of the potential damage shrinking trade finance might have on the real economy. International supply chain arrangements globalized not only production, but also trade finance. Sophisticated supply chain financing operations—including those for SMEs—rely on a high level of trust and confidence in global suppliers that they will deliver their share of the value added and have the necessary financial means to produce and export in a timely manner. Any disruption in the financial sector’s ability to provide working capital or pre-shipment export finance, issue or endorse letters of credit, or deliver export credit insurance could create a gap in complex, outward-processing assembly operations and lead to a contraction in trade and output.

As such, there was a compelling institutional and economic case to support trade finance cooperation. Indeed, one clear lesson from the Asian financial crisis was that—in periods prone to lack of trust and transparency as well as to herd behavior—all actors, including private banks, export credit agencies, and regional development banks, should pool their resources to the extent practicable. Cooperation among players is particularly important because of the lack of a comprehensive and continuous data set on trade finance flows.

### Government and institutional response to the 2008–9 financial crisis

In response to the financial crisis, many governments and international financial institutions (IFIs) put in place programs that either injected liquidity into banks or provided fiscal and monetary stimulus to the economy, sometimes directly in support of affected exporting firms. Central banks with large foreign exchange reserves could supply foreign currency to local banks and importers, generally through repurchase agreements. And government intervention was not reserved to developed countries. The central banks of Argentina, Brazil, India, Indonesia, the Republic of Korea, and South Africa, to name a few, also massively supported their local banks. The measures helped mitigate the global decline in output and trade flows and directly and indirectly supported the provision of trade finance—stimulating more confidence in the outlook of individual countries, reducing risk premiums, and providing more direct financing to financial institutions. However, many developing countries were not in a position to extend credit or expand existing trade finance facilities, and therefore needed support.

The World Bank Group, through the International Finance Corporation (IFC), was quick to act by strengthening its trade facilitation programs between November 2008 and April 2009. The IFC Global Trade Finance Program (GTFP) doubled its revolving ceiling to \$3 billion in late 2008 to support emerging markets’ trade finance. Leveraging the experience gained from the GTFP, the IFC launched the Global Trade Liquidity Program (GTLP) in July 2009 to rapidly mobilize and channel funding to support underserved developing-country markets by providing trade credit lines and refinancing portfolios of trade assets held by selected banks. Additionally, the new program’s premise was to leverage IFC funding by creating a historic collaboration with other IFIs that also contributed their financial resources to the GTLP. Both programs successfully facilitated trade during the crisis period. As the world economy slowly recovers from the crisis, the IFC will bring the GTLP to an end, starting in 2012.

Regional development banks also quickly responded by scaling up their trade finance facilities. The European Bank for Reconstruction and Development increased the overall program limit of its Trade Facilitation Program from €800 million to €1.5 billion. The Asian Development Bank ramped up the ac-



tivities of its Trade Finance Program to support \$2 billion in trade in 2009, an increase of more than 300 percent over 2008. Further enhancements of these programs were agreed on at the G-20 summits, particularly, as already noted, IFC's establishment of a liquidity pool to allow cofinancing of operations with banks in developing countries. From this perspective, the African Development Bank established a \$1 billion Trade Finance Initiative in January 2009 as part of its broader package of crisis response initiatives. For its part, the Inter-American Development Bank (IDB) had already put in place its Trade Finance Reactivation Program (TFRP) when the crisis hit. TFRP supported IDB's fast response in Latin America and the Caribbean, strengthening supply-side capacity and trade-related infrastructure. In addition, the Trade Finance Facilitation Program (TFFP), implemented in 2005, proved an effective fast-delivery vehicle for not only mitigating the effects of the liquidity crisis, but also for expanding trade finance for financial intermediaries and their clients.

## Lessons Learned

The mostly original and unpublished contributions to *Trade Finance during the Great Trade Collapse* suggest the following 10 takeaways.

1. The lack of trade finance data is impeding policy formulation. The absence of data covering all aspects of trade finance (bank-intermediated and interfirm) has proven to be a major constraint to measuring the extent of the trade finance shortfall and its effect on trade flows during the financial crisis. New initiatives such as the International Chamber of Commerce's build-up of the Trade Finance Register are a significant step forward because they will create a living database of the trade finance market and may help demonstrate the resilience of trade finance.
2. Trade finance matters for trade. Results from bank and firm surveys conducted during the crisis as well as postcrisis empirical analyses all indicate tighter trade finance conditions during the crisis and significant adverse effects on trade flows.
3. Not all forms of trade finance are equal. Although the crisis constrained both bank-intermediated trade finance and interfirm trade credit, empirical findings suggest that interfirm trade credit may be more resilient than bank-intermediated trade finance in times of crisis. Trade credit offers features that make it safer, given the better information that buyers and suppliers have on clients' creditworthiness and the liquidating feature of trade credit. Although trade credit (particularly among supply chains) could be a contagion leading to sharp drops in trade during crises, it also contributes to a quicker rebound when economies recover—a pattern observed in Southeast Asia during the crisis.
4. Trade finance was not the main driver behind the 2008 trade collapse. The shortfall in trade finance seems to have been a moderate factor in the sharp drop in trade flows in 2008–9. Trade finance and trade volumes dropped mostly as a result of the spillover of the financial crisis to the real economy, including through lower activity and destocking. The demand effect was further amplified for firms operating in global supply chains or in sectors that were most affected by the slow global economy, such as the auto industry.
5. SMEs have been particularly vulnerable to the tightening of trade finance conditions. The lack of access to affordable trade finance has been especially detrimental to certain firms (for example, SMEs and new exporters), particularly firms in developing countries with underdeveloped financial systems and weak contractual enforcement systems. SMEs have been more affected than large firms because of their weaker capital base and bargaining power in relation to global buyers and banks. Also, SMEs have been subjected to more large increases in the cost of trade finance instruments, with banks being more risk averse and preferring to work with large, sound, multinational firms.
6. Bankers and some international institutions consider Basel II regulations to have further constrained the supply of trade finance during the crisis and in the postcrisis environment, especially banks based in low-income countries (as well as second- and third-tier banks in middle-income countries). They have called on regulators to carefully study the potential unforeseen impacts of proposed Basel III changes on trade finance. In particular, banks argue that the increase in the new liquidity and capital prudential requirements and the nonrecognition of trade assets as highly liquid and safe would lead to a significant increase in the cost of banks providing trade finance, which in turn will lead to a lower supply, higher prices, or both. Conversely, regulators have maintained the view that under Basel II and III, the increase in capital for trade finance exposures is not any greater than for other exposures. The new leverage ratio and the new liquidity rules will not have any systematic impact on trade finance, though they may affect a few large, complex, or wholesale-funded banks, albeit for reasons unrelated to their trade finance activities. Even in these cases, the impact on trade finance is not expected to be greater than on any other class of asset. Given the diverging views, the Basel Committee on Banking Supervision (BCBS) has established a working group to study the impacts of regulation on trade finance, and—at the request of the World Bank and the World Trade Organization—the G-20 will take stock of the situation at its November 2011 meeting.
7. The international community responded swiftly to the trade finance crisis. The G-20 orchestrated the quick and collective actions of governments and the international financial community. This led to a set of cofinancing ar-

rangements among development banks, export credit agencies, foreign commercial banks, private insurance underwriters, and investment funds. While part of the G-20 support was directed mostly at a handful of large banks and international banking groups, the support from the IFC and regional development banks—in terms of both insurance and liquidity—has targeted mainly smaller banks and banks in developing countries.

8. A timely exit for the large-scale trade finance support programs implemented to mitigate the impacts of the crisis is key. As the global economy slowly recovers and demand rises, some governments appropriately cut back their trade finance programs to avoid displacing legitimate private sector activity. Similarly, beginning in 2012, the IFC will wind up the GTLP, which was set up in response to the crisis. Setting clear time limits, planning exit strategies for intervention programs, and sharing, rather than fully underwriting, risks are important considerations to limit moral hazard and the crowding out of commercial banks in times of financial crises.
9. There is a case for implementing and maintaining specific programs to support vulnerable segments of the trade finance market. For example, continued uncertainty in some markets (such as low-income countries with underdeveloped financial systems and weak contractual enforcement) or among some firms (such as SMEs and new exporters) calls for vigilance on the suitability and timing of the retrenchment of governments and international organizations' trade finance programs. At the Seoul G-20 meeting in November 2010, the international community expressed particular concern for low-income countries that may still be facing severe difficulties in accessing trade finance at affordable cost, particularly in import finance.
10. Finally, there is still an important knowledge gap regarding the effect of trade finance on trade and the role of trade finance during crises, as well as on the appropriate banking regulations and supervisory standards for banks' trade finance portfolio exposure. This knowledge gap requires a

continuing analysis of the issues by academics, practitioners, and other interested stakeholders.

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## Note

1. Brazil, Chile, and Peru in Latin American and the Caribbean; Indonesia and the Philippines in East Asia and the Pacific; India in South Asia; Ghana, Kenya, Sierra Leone, and South Africa in Africa; the Arab Republic of Egypt and Tunisia in the Middle East and North Africa; and Turkey and Ukraine in Europe and Central Asia.

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