

G20 Trade Finance Experts Group August Report – US-UK Chair’s Recommendations for Finance Ministers

Introduction

Trade finance serves as the life-blood of the day-to-day international trade in goods and services by providing financing for transactions between buyers and sellers around the globe. In response to concerns around the effects of scarcity and high pricing of short-term trade finance as a result of the financial crisis, the G20 agreed in London to ensure the availability of support for \$250 billion of trade finance in 2009 and 2010. The commitment to support the provision of short-term trade finance is an important measure in addition to the wider fiscal, monetary and financial action undertaken in order to ensure the effective functioning of international trade markets.

Trade volumes in 2009 were forecast at the time of the London Summit to decrease by 10%. This was considered to be predominantly due to demand contractions. However, in parallel, trade finance providers experienced sharp increases in liquidity premiums, and tighter internal credit and risk limits. These developments resulted in a rapid increase in the price of short-term trade finance by between 25 to 300 basis points. Moreover, in response to higher perceptions of risk, there was also an increase in the demand for bank-intermediated trade finance transactions as a result of a decline in open account financing in favour of letters of credit and other forms of bank-supported trade finance. While the reasons cited most frequently for the decline in the value of trade finance were the underlying decline in the value of merchandise trade (86% of banks) and a decline in the price of goods (due to falling commodity prices), these tighter credit conditions were increasing the cost of trade finance and thus negatively impacting trade transactions in many markets.

The G20 Trade Finance initiative has been undertaken in a manner that provides a broad and flexible framework to tackle those key bottlenecks affecting North-South trade, South-South trade and even, where necessary, between developed countries. One of the key lessons of the Asian financial crisis is that a bottleneck in any link in the trade finance chain will negate the impact of other trade finance support measures. The G20’s co-ordinated approach agreed in London is targeted at avoiding any blockages that would cause detriment to regional or global trade flows.

Delivery against London Commitment

The G20 Expert Group has met since the London Summit agreement and co-ordinated closely on implementing the initiative. Ahead of the London Summit, 10 G20 countries or multilateral institutions had formally committed to make available increased capacity on trade finance across the key regions, supporting in excess of \$250bn in trade over two years.

The recent coordination exercise by the group has been productive in further scrutinising individual programs, and broadening the consensus for action. This ongoing engagement has seen both the number of G20 members participating, and the overall levels of potential support that could be made available, increase up to 16 members and at least \$400bn respectively. This has been through either new or augmented risk mitigation or liquidity enhancing programs. The former category includes entirely new guarantee, insurance or liquidity programs being put in place such as the UK’s letter of credit guarantee scheme and U.S. Eximbank’s instituting credit facilities for foreign banks/buyers. Many governments

took steps to use unused existing capacity/headroom to support short-term trade finance wherever necessary e.g. increased use of existing German and Italian capacity and Mexico increasing its export credit line capacity. Japan, for its part, enhanced its program to provide financial resources to importers in developing countries through local banks.

On the liquidity side, examples are Korea's new programs to inject liquidity into its banks to support exporters through rediscount and collateralization programs, and U.S. Eximbank dramatically expanding its working capital program for exporters. Similarly, Brazil and India implemented trade-related currency swap programs. The commitments and vehicles vary according to G20 contributor based on the specific problems faced by exporters.

The expert group can confirm that this wide range of support measures is now available to exporters and importers wherever there is corresponding demand for this additional and temporary financing support, and Finance Ministers or Leaders can report on full and ongoing implementation of the \$250bn trade financing support framework, as outlined in London. This represents an important collective signal to the banks, and to exporters and importers, that the G20 is ready to stand behind the international trading system and ensure the effectiveness of transactions in international goods and services during the economic downturn. This does not rule out the possibility of further measures being introduced by G20 members should there be a need.

Options for making available further support

Successful co-ordination since the London Summit has seen both the number of G20 members participating, and the overall levels of potential support that could be made available, increase up to 16 members and at least \$400bn respectively, providing additional capacity of up to \$150bn over and above the \$250bn agreed in London. However, the expert group agreed at its June 5 meeting that the decision on whether to publicly commit to additional support fully depends on utilization of individual programs made available to date by the G20, and a broader assessment from the WTO, IMF and World Bank on the latest global outlook in trade finance availability in late August. This report provides an update on these issues and makes a series of recommendations.

Macro trade finance outlook and G20 utilisation levels

Consistent with other recent macroeconomic indicators, global trade flows appear to be in the process of stabilizing, and evidence is growing that trade is expanding once again, particularly in Asia. Moreover, May data indicates that advanced economy exports increased for the second consecutive month in nominal terms, and rose for the first time in real terms since February of 2008. For example, U.S. export volume rose modestly in June for the second month in a row. Nominal imports also rose slightly in these countries for the first time since July 2008, although increased oil import prices accounted for part of the increase.

Overall, IMF data as of the end of June indicates that export growth, although quite recent, and modest so far, has resumed in both industrial and emerging market countries. Early data also suggests that the dramatic decline in developing country exports that began last summer may be bottoming out. These are all positive signs but a robust recovery in trade is not yet assured.

In line with the developments in macro indicators and trade, the outlook for trade finance, on balance, also appears to be improving. The recent IMF/BAFT Trade Finance Survey of 88 banks indicates that 89% of small banks and 91% of large banks surveyed believe that the trade finance situation is either stabilizing or improving. This is in sharp contrast to responses in March, when 42% of banks expected deterioration. Furthermore, more than 75% of banks reported that they are now in the position to meet increased demand for trade finance.

The respondents also see some improvement in the probability of default compared with views in 2008Q4. More than 75% now expect either no change, or a decrease in the probability of defaults. Respondents expecting an increase in the default rate declined from 45% to 25%. Finally, there is some reduction in the reported use of secondary markets to limit risks, possibly implying that at least for some risk categories, systemic risk is perceived to be declining.

On the less positive side, there continues to be some shift from open account financing to bank-intermediated trade finance. This implies risk perceptions remain high among non-financial corporations engaged in international trade, notwithstanding the higher margins above bank cost of funds. Along these same lines, there continues to be a small movement toward the use of cash in advance as a payment mechanism. Survey data indicate that the margins charged for private trade finance continues to rise, but at a significantly decelerated rate from the 40-60 basis point increases at the end of last year. However, while exact pricing data is not available, it is clear that pricing remains well below the peak prices last September. The data also shows that 47% of respondents identified default risk as a significant force in higher margins, while 53% listed the increased cost of funds as the leading reason.

While there is growing evidence of improvement in trade finance markets, several key factors underlying the development of the G-20 trade finance initiative continue to be major negative factors in the market. Although data seems to demonstrate that demand, not trade finance has been the primary driver of the declines in trade, high trade finance margins, driven by still high cost of funds and concerns over systemic risk remain significant drags on the market. The need for continued risk mitigation and liquidity remain.

Short-term finance recommendations for Pittsburgh

The experience to date on utilization rates suggests that banks and buyers have utilised on aggregate approximately 63% of the G20's commitment capacity in the first six months. In these cases, programs have been put in place in direct response to demonstrated financing needs, and therefore utilization rates have been relatively high. In contrast, some have concluded that their particular markets have been adequately served by the market and have not needed to commitment to institute new programs or expand existing ones. Moreover, ample capacity remains within the original Leaders' commitment.

Historically, it has been shown that rapid declines in economic activity and exports can lead to equally rapid recoveries. In such a case, it may well prove to be the case that a strong recovery in demand and trade outstrips the recovery of the trade finance market, and therefore that additional G-20 financing could be necessary. At the other extreme, we need to remain prepared to address any further unexpected economic shocks. *Therefore, it is recommended that whilst the focus of the G20 should remain on providing the \$250bn*

support package from London, it should also be noted that a total commitment level of \$400bn could be made available if required against both upside and downside economic risks.

It is also recommended that the Trade Finance Experts continue to meet over the next year to monitor developments in trade and trade finance markets and to inventory the utilization of commitments, including assessing the need for additional actions. They should report to Ministers semi-annually on trade finance developments, including the opportunity for scaling back activities as the market recovers.

Medium and long-term finance support

Official medium and long-term export credit support and finance also has an enhanced role in counterbalancing instability in periods of economic uncertainty by helping to fill the gap where market capacities are temporarily limited. OECD Member and Non-Member governments have made clear their determination to substantially increase their export credit support and ensure that sufficient capacity is available as necessary to backstop private markets. These actions should be seen in conjunction with the G20 initiative on short-term trade finance, with the coordinated aim of providing comprehensive support for international trade flows across all tenors through the recovery process.

Demand for medium/long-term export credit support has increased significantly. While comprehensive G-20 data is lacking, preliminary OECD data indicates that medium- and long-term trade finance provided by its members rose to \$171bn from \$106bn, or by 61%, in 2008 compared to 2007. Given the decline in trade last year and the sharp decline experienced early this year, this means that official export credit agencies have begun to play a significantly larger role in global trade finance in these tenors. First quarter data for 2009 show a modest decline from the same period last year but still remain on pace to be over \$160bn for the year, or over 50% higher this year than in 2007.

Experience indicates that during recoveries, private markets return to provide lower risk short-term trade financing more quickly than they return to provide perceived higher risk, longer tenor financing. This suggests that it is important to monitor developments in these tenors to ensure that emerging and developing economies can access financing for development projects and capital goods. Therefore, the expert group concluded that the availability of medium/long-term export credit support is also crucial to the recovery and health of the global economy, and commits to continue to meet increased demand for such support.

Medium-Long-term Recommendations

To ensure that trade finance across all tenors is available to supplement market financing in both upside and downside recovery risk scenarios, *the short-term trade finance initiative should be expanded to include medium and long-term tenors.* Trade finance activity in these tenors should be monitored against the availability of market financing to emerging markets and developing countries. Furthermore, the G20 should commit to continue to support increases in demand for medium and long-term financing until markets recover in these tenors.

Conclusion

In order to provide appropriate levels of support across all forms of trade financing, and to provide solid foundations for the effective functioning of the trading system, the G20 should:

- **Continue to focus on ensuring the availability of short-term trade finance support as per commitments in the London Summit.**
- **Consider using the available additional \$150bn only if market developments require further support over and above the original \$250bn commitment.**
- **Continue to actively monitor trade finance developments via the G20 Expert Group over the next year.**
- **Separately include medium- and long-term tenors in the monitoring process, in conjunction with ongoing work of the OECD.**

Exit Strategies

The expert group reiterates that these efforts represent extraordinary, crisis-related trade finance support, which is being provided on a temporary basis that respects the need to avoid protectionism and that minimises displacement of private market activity. This should be a priority of the Trade Finance Experts Group work going forward.