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Why trade finance matters – especially now

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Ignore pressures to retrench. Trade finance infrastructure needs to grow now more than ever.

The first known letter of credit dates to Ancient Egypt. It was a clay note that recorded a debt to be paid upon the delivery of wheat, with the noteholder's right of execution in the event of default. While trade finance borrowers no longer risk death for nonpayment, global trade finance has a near-zero loss record, suggesting, in part, its importance to borrowers.
In some cases, trade finance may ultimately support life. How? Letters of credit make imports of life-sustaining goods possible in many poor countries. In many cases, the movement of goods across borders does not occur without trade finance. The unique set of complexities and risks involved in trade are, in part, taken on by cross-border banks. Trade finance, a subset of working capital, has been fundamental to trade, and thus to growth, for emerging markets and developing economies.
Yet despite its importance, developing countries face a large and notoriously persistent trade finance gap, which the current crisis may only exacerbate.
The COVID-19 pandemic has affected both international trade and trade finance, as further detailed by IFC's three recent notes, "When Trade Falls—Effects of COVID-19 and Outlook," "Why Trade Finance Matters— Especially Now" and "Taking Action on Trade: From Concern to Support." In early stages, the COVID-19 shock synchronised across sectors and countries. Both buyers and suppliers found themselves unable to do business. In many cases, demands on financial systems' capital and liquidity rose as short term liquidity, generated by operations, froze across millions of companies. While governments and other institutions across the globe rushed to put temporary financial crisis-response measures in place, the recovery trajectory for this rare and historic event remains ambiguous.

The complexities of COVID-19's economic impact on individual countries, bilateral trade pairs, and global value chains creates differences in trade finance trends and timing. Demand for trade finance faces two opposing forces: increased risk and liquidity to push up demand, while reductions in trade drive it down. While their transmission and effects on economies are different, the situation may quickly change in favour of either of these forces as the crisis evolves. While demand has broadly followed typical crisis patterns, the pandemic has created some new challenges.

As economic effects of the crisis continue to ricochet across countries, the timing of acute liquidity needs and related trade finance demand varies from country to country, in some cases amplified by second and third wave knock-on effects.
Adequate supplies of trade finance can help to "raise the floor" of a crisis-driven cash flow crash. They can expedite recovery when businesses require additional finance to resume both operations and trade. However, when actual, potential, or perceived financial risk increases sharply in countries on either side of a trade border, the supply of trade finance tends to fall. Nearly all—98 percent—of the respondents to IFC's forthcoming Global Trade Finance Program's (GTFP) 2020 Annual Emerging Market Issuing Bank Survey indicated that COVID-19 is affecting their customers in many forms. The pandemic is further exacerbating cross-border bank relationship stress. Over 90 percent of survey respondents indicated that more help is urgently needed.

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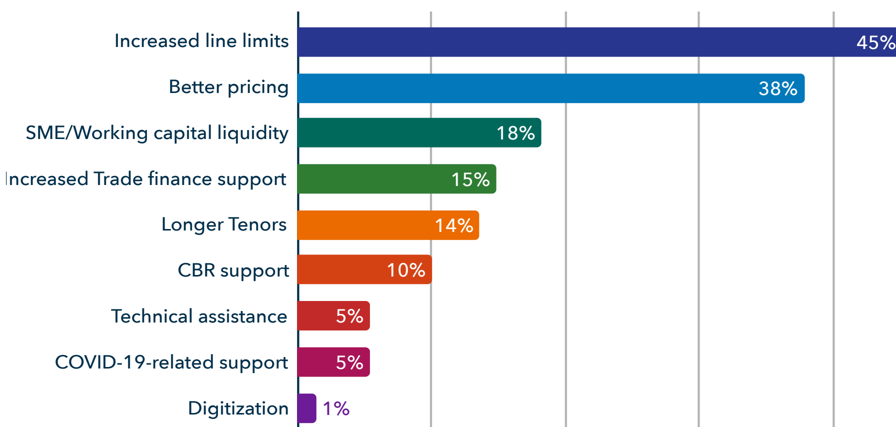
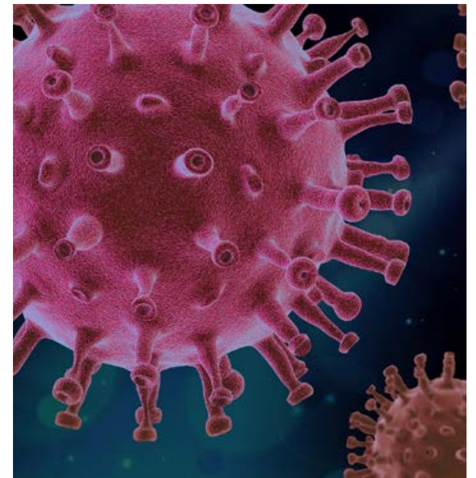


Looking ahead, the impacts of COVID-19 will either be amplified or mitigated by the relative strengths and weaknesses of each bilateral trading partner pair; this, in turn, affects both trade and access to trade finance. The complete recovery of global trade is largely dependent on global vaccine rollouts and their efficacy against emerging strains of the virus. Meanwhile, financial systems facing increased stress will continue to need additional working capital and trade finance infusions to weather the crisis, adapt to the current environment, and help businesses survive.
When remaining shuttered businesses begin to restart and relaunch trade, the immediate demand for trade finance will spike. However, historic patterns suggest that the supply of trade finance will not recover as fast as demand. We expect that demand will increase globally across emerging markets sooner than supply does, as the COVID-19 risk hangover will remain, even as widespread economic recovery is underway. As a consequence, the trade finance gap will only continue to expand.
As the world emerges from the current crisis, trade and trade finance corridors will reflect post-crisis caution in taking risks,



and there will be a movement towards the most deeply trusted counterparties. The social distance-led acceleration of digitalised trade and trade finance will, through reduced cost and risk, pave the way for future trade growth. These dynamics are likely to produce a hybrid of traditional mechanisms (e.g., letters of credit) and more recent innovations (e.g., digitalised open accounts), at least in the medium term.

While trade finance assets are short-term, the infrastructure required is decidedly long-term. Even as trade finance evolves, it will still require the deep and complex network of cross-border finance, unique to this asset class and economic activity. This infrastructure needs to continue to deepen, grow, and evolve in order to reduce the trade finance gap, despite the present pressure to retrench. Just as trade is a critical component of economic recovery, trade finance is a critical component of trade, perhaps even more so going forward.