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Trade Credit

Accessing trade finance is not the most serious problem for established horticulture and garment exporters in sub-Saharan Africa – exchange rate fluctuations and falling demand are more important. But trade credit is a major problem for new exporters and small cooperatives as well as for Latin American horticulture exporters.

In October-November 2008, the World Trade Organisation, International Trade Centre and International Chamber of Commerce all raised serious concerns about trade finance (ICC, 2008; WTO 2008). They highlighted declining trade, substantial falls in trade credit, increasing lending costs and credit rationing. Shortly after, the governments of Brazil and India stepped in to guarantee trade finance for exporters. In this situation, will African exporters find that neither their customers nor their banks provide them with trade finance?

How unprecedented is this problem?

Trade credit is far removed from the exotic financial products that have undermined global banking, but previous financial crises that hit developing countries (such as Argentina, Brazil and Indonesia) were all associated with rapid and significant cutbacks in trade credit. Short-term finance dried up as financial institutions reduced their risk exposure. Finance for trade can be cut back in three ways (see box right).

Evidence from the financial crises of the 1990s shows that credit lines for trade fell more rapidly during financial crises than had been the case in the 1980s. Wang and Tadesse (2005) attribute this to banks increasing their leverage and having increased risk exposure. Since then, leverage has increased and, given the current freeze on credit globally, and fears about recession worldwide, trade credit may be greatly reduced. Nevertheless, the likely impacts on capacity to export are far from clear. Ronci (2005) notes that in previous financial crises substantial declines in short-term capital availability in crisis countries was very weakly associated with declines in exports.

How might trade finance be harder to obtain in the current crisis?

- Banks in developing countries cut lending to exporters.
- Letters of Credit (LCs) become harder to obtain.
- Trade credit offered by importers to their developing country suppliers may be restricted if the importers themselves cannot borrow from their banks (see Love *et al.* 2007).

In these circumstances, firms in developing countries that have been encouraged to target export markets find themselves unable to trade.

Are cutbacks in trade credit hurting exporters in sub-Saharan Africa?

IDS arranged for researchers in the UK and Kenya to telephone 25 firms in sub-Saharan Africa and inquire about how they financed their exports and whether the availability of trade finance had changed. They also contacted international trade experts and UK importers. The focus was on horticulture and garments – two sectors that have seen big export increases in the past decade. The overall findings were clear. The capacity of these firms to continue exporting was not being affected by cutbacks in credit, either from their customers, the international banking system (LCs) or domestic banks.
Why not?

- Established businesses remain good risks for domestic banks. The horticulture sector in sub-Saharan Africa was considered a good risk by local banks and lending continued. However, in Latin America, the trade finance crisis is much more severe and horticulture exporters are having serious problems. So far, sub-Saharan Africa has escaped the worst problems.
- Firms are operating in well-established value chains. Even horticulture firms supplying wholesale markets in Europe have well-established relationships with their importers and established lines of trade finance. Very often, these transactions involve no credit from financial institutions.

> The trade finance problem varies greatly between sectors and countries. Governments and multilateral development banks should step in, as in previous financial crises, to sustain trade finance

- Garment-exporting companies in sub-Saharan Africa are predominantly Asian-owned. LCs for exporting to the United States (the main export destination) are usually arranged by the parent company. None of the firms interviewed indicated that this had been affected. These firms did not use domestic credit lines for export finance, and availability of domestic credit for working capital has not changed.
- Trade finance shortages and restrictions on domestic credit are affecting new exporters, small-scale cooperatives and other enterprises that do not have established relationships with their banks and with their customers.

Nevertheless, clear and substantial impacts from the global financial crisis were found. In particular:

- Exchange rate volatility. In particular, firms exporting to the UK are suffering as revenue is priced in British pounds, but airfreight and many inputs are priced in dollars.
- Falling demand. In garments, the exporters from Africa are still completing orders negotiated in mid-2008, but the companies reported that buyers were delaying new orders and pushing for much lower prices. Horticulture producers were concerned about possible falls in demand and downward pressure on prices.

Policy responses

In the short term, the availability of trade credit needs to be monitored. The trade finance problem varies greatly between sectors and countries. Governments and multilateral development banks should step in, as in previous financial crises, to sustain trade finance.

In the longer term, the crisis highlights new sources of risk for exporters. In both garments and horticulture, African exporters have done well from linking up to large customers in dynamic market segments. In the crisis, these customers are transferring the risks and consequences of turbulence and unpredictable markets to their suppliers. Prices and quantities are adjusted rapidly because of the power of retailers in increasingly concentrated retail markets. The problem is not trade finance, but rather the profitability of exporting.

Further reading

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Credits

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For other briefs on the crisis see: www.ids.ac.uk/go/infocus7

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IDS Institute of Development Studies

DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk