Learning lessons from trade with emerging economies

Alexander Malaket examines the increasingly important link between emerging markets trade and the use of trade and supply chain finance. Demand on the rise, profile increasing, and solution options evolving: is there a clear sense of momentum in emerging markets trade and trade finance?

The importance of trade and trade finance to global economic recovery is gaining profile, and at the same time, the hard commercial reality – that emerging markets and SMEs are typically the hardest hit in times of crisis – is also better understood as a result of present difficult conditions across the globe. While the WTO and other specialists can report improvement in the access to, and pricing of, trade finance for larger corporates dealing with top-tier financial institutions, and for strong mid-corps dealing with second-tier banks, the reality for SMEs in emerging markets continues to reflect crisis conditions.

Risk and emerging markets trade

There is continued risk-aversion among financiers and businesses engaged in trade, which is reflected in higher priced trade finance in emerging and developing economies. Competition for scarce capital and limited credit facilities continues to underpin a focus on lower-risk, higher-quality transactions among various actors in the trade and trade finance environment. From an emerging markets perspective, this tendency affects both the availability of financing options, and the cost of whatever options are available at a given moment. This comes at a time when some US, European and other financial institutions have retrenched domestically, or reduced their international activities.

Bonnie Galat at IFC in Washington DC

Risk is a core aspect of international trade, and more central to the realities of business in emerging and developing markets. Equally notable however, is the reality that risk is part objective reality and part perception: a reality that does nothing to assist in maximizing the positive impact of trade in markets where perceptions can be skewed, in part through opacity of information.

In practical, transaction-level terms, the challenges faced by emerging markets can be illustrated by the increasingly stringent KYC (know your customer) and KYCC (know your client's client) requirements faced by financial institutions in the provision of trade and international banking services. Ironically however, there is no opportunity to pool data or insights gained through KYC or KYCC efforts – an option which would provide greater objective clarity around risk assessments, and by most accounts, mitigate some of the perceptual aspects of the risk picture related to emerging and developing markets trade.

Risk-related dynamics linked to the global crisis have illustrated, beyond dispute, the valuable contributions of public sector export credit agencies mandated to support capacity in trade finance, just as the invaluable contributions of international institutions have, likewise, been brought into focus over the past several years in particular.

Perhaps more importantly over the long-term, there is recognition that certain actions need to be taken, to address more fundamental issues related to the 'infrastructure' related to international commerce. The WTO has extended its activities into the trade finance space, and is actively promoting the notion of a regular mechanism in trade finance, meant to provide continued support and facilitation around international commerce.

Marc Auboin, economic counsellor at the WTO➤

➤in Geneva, notes: "Trade finance is integral to the successful conduct of international commerce; while trade finance has been relatively inexpensive and risk free for years, it can no longer be taken for granted, and the role of trade finance will remain central as global supply chains evolve and extend to new markets, requiring both international institutions and local financial services firms to be prepared to support international trade. At the WTO, our role is currently to assist in directing public resources to help mitigate risk, and to enable trade – including emerging markets trade – in a sustainable manner, through a combination of effective rules, and available trade financing."

The central importance of risk in the context of trade – particularly developing and emerging markets trade – is illustrated in various ways, not least, the increase in demand, globally, for effective risk mitigation solutions. The central importance of risk in the context of trade – particularly developing and emerging markets trade – is illustrated in various ways, not least, the increase in demand, globally, for effective risk mitigation solutions.

The International Finance Corporation (IFC), a member of the World Bank Group, has seen issuance activity in guarantees supporting trade finance under the IFC's Global Trade Finance Programme (GTFP) increase from $3.4 billion to $4.6 billion year over year, and reports a perceptible increase in the demand for risk mitigation support.

Bank support for the MENA region has reportedly held up because there has been something of an equilibrium between softened demand (given the stress affecting several of the region's economies) and the reduced exposures that global banks have kept available. At the same time however, IFC is looking ahead, and working to devise a portfolio facility for the region, where there is an anticipation of growth in demand which banks may not be able or prepared to accommodate, given current strategies and market conditions.

Baihas Baghdadi at Barclays in Madrid

Bonnie Galat, global head, short-term finance business development, at IFC in Washington DC, says: "At IFC, we have a corporate commitment to continue our flagship GTFP and extend our value proposition to supplier finance, warehouse finance, distributor finance and portfolio-type solutions, which we are developing and engaging in, on a partnership basis with industry and other development agencies."

She adds: "We are, naturally, very focused on our development mandate, and trade has been formally aligned with this mandate, having defined 'development indicators', to measure the development impact of our short-term finance programmes. As pressures arise across the globe, we receive inquiries to support trade finance, even in developed markets in Europe and elsewhere, and while this is certainly a positive sign of our growing profile and effectiveness, we do remain fundamentally focused on emerging markets and development-related activity."

The flow of trade

In addition to the risk dimension and its impact on emerging markets trade, specialists note that the ongoing dialogue around Basel II and III, capital reserve requirements and the eventual impact of this 'soft law' as it is interpreted and enacted by national regulators, may have significant impact on emerging markets trade.

Leaders at the G-20 have recognised this reality and asked the Basel Committee specifically to look into the implications. Meanwhile, industry dialogue with the Basel Committee is showing signs of a more positive tone, with some progress on a more equitable treatment of trade finance in certain respects, with further dialogue needed in relation to leverage ratios and the issue of liquidity.

A senior banker notes, with some irony, that a 90-day, $100,000 loan to an SME is effectively equivalent to a $50 million term loan to a large corporate, in terms of the capital requirements imposed by the Basel Committee under the latest iteration of regulations. At the same time, consumer products such as mortgages, consumer loans and credit cards are treated very differently, as they well should be.

Ashutosh Kumar, global head of corporate cash and trade at Standard Chartered in Singapore, observes: "This is still a fragile recovery in many respects. There are significant challenges on the horizon — in Europe, Japan and the United States. While trade finance liquidity and pricing have shown signs of normalising, it is unclear (at the moment) which way the pricing will trend over the next twelve to eighteen months. If Basel regulations remain as they are in its latest iteration, we estimate that the pricing for trade finance will increase by twenty to forty percent on average. The impact will be most unwelcome at this critical moment when trade corridors and intra-regional trade flows develop and gain momentum."

The continued development and evolution of trade corridors and intra-regional trade, an actualisation of the long-discussed growth in South-South trade, suggests for some, the need to continue to develop trade-related capabilities, capacity and infrastructure. Efforts

Steven Beck at Asian Development Bank in Manila

by development and other international institutions, aimed at enabling the engagement of local financial institutions in international commerce will become increasingly important as these trade flows evolve.

Ali Raza Dharamsey, head of sales – trade and working capital at Barclays UAE in Dubai observes this evolution and increasing focus on intra-regional trade, noting: "We certainly see an increase in trade flows between emerging market economies, including, for example, enhanced flows between the Middle East and Africa, and increasing flows between emerging markets in the Asia-Pacific region and the Middle East. The breadth of trade is expanding, and we are witnessing interesting tie-ups and support initiatives in the UAE between banks and government agencies in support of emerging markets commerce, including trade which extends to the 200,000 estimated small businesses based here."

With a change in the playing field owing to the subprime, SMEs have adapted themselves to build a sustainable business model through consolidation of exposures, revenue diversification and enhanced reliance on retained earnings and equity.

The role of SMEs and their importance in emerging markets trade is well-supported; in the post-crisis environment, intra-regional trade is giving rise to a shift in the nature and dynamic around supply chain management and supply chain finance.

Aneish Kumar, managing director, treasury services, Indian sub-continent at BNY Mellon, observes: "Millions of SMEs, including those from the agricultural sector are, along with the medium and large-sized firms, adding to the huge domestic, intra-Asian and intra-regional trade flows. This is a development that is also changing some of the supply chain structures. The market now refers to regional supply chains – which are shorter and leaner, and which involve shorter transit times and quicker delivery, and by extension, reduced inventory, lower defect rates and generally enhanced efficiency."

Aneish Kumar adds: "With the SMEs, however, there are complexities involved – the current processes, technology and skills are failing to provide adequate risk control measures. Practitioners have started to develop advanced methods to detect, analyse and sense risks to mitigate them, however, KYC and other regulatory requirements will remain a challenge and may impede access to traditional trade finance in these markets."

Transformation in emerging markets trade?

It has been observed that trade is being conducted, increasingly, on open account terms, even in markets traditionally engaging on the basis of traditional trade finance instruments. China has been cited as an example of this trend, which is now observed in other Asian markets such as Vietnam and Indonesia.

The post-crisis environment includes a generally raised level of consciousness about risk elements in trade, and this includes in the context of open account transactions. In fact, there are now observations noting that a well-planned, accelerated shift to open account terms ought to be encouraged and facilitated, in emerging markets trade.

Ashutosh Kumar at Standard Chartered observes: "Trade is vibrant in emerging markets, and while trade finance certainly supports international and intra-regional commerce, a lot more needs to be done. This includes the development and deregulation of the credit insurance markets in Asia and other emerging markets. Open account trade is more efficient and rapid than trade conducted on the basis of traditional instruments. Properly structured and risk-mitigated, the conduct of trade on open account terms ought to be enabled by the market and by political and regulatory authorities. The markets are ready: we have observed high double digit to triple digit growth in supply chain finance (cross-border and domestic) after the close of the crisis environment in 2010."

New economic and business realities will affect all stakeholders, requiring a realignment of business approach by financial institutions, risk insurers, regulators, large multi-nationals and others. This imperative to adapt will not be avoided by SMEs, even as many influential actors acknowledge that this client segment (and political constituency) requires much more in the way of substantive support than has been provided in most jurisdictions to date.

Baihas Baghdadi, head of trade and working capital, EMEA at Barclays, based in Madrid, states: "Small and medium-sized enterprises in emerging markets will have to reinvent themselves, as they have begun to do. Business is no longer just about balance sheet strength and P&L. Rather, liquidity is now the main driver underpinning commercial decisions among SMEs. This reality is impacting the way SMEs conduct business and pursue opportunities, and it is related also to the 'back to basics' approach being taken by banks, which demands greater attention to cashflow and liquidity in risk assessment and credit adjudication decisions. The process of evolution and maturation among emerging market SMEs will necessitate a more conservative approach to risk analysis and mitigation among ➤

➤ entrepreneurs and SME managers."

The need to assess and address risk, and the market and politically-driven demand to reinvent, might suggest that the SME sector in emerging markets will continue to require intervention/support from public sector and from various international institutions, and this argument can certainly be made based on the view that SMEs are underserved, and that a "market gap" persists in trade finance.

Interestingly however, there is an argument, advanced by Steven Beck, head of trade finance at the Asian Development Bank (ADB), based on a different perspective. Notes Beck: "In the course of gathering and sharing data with the Basel Committee, the first group of banks participating in this process was able to demonstrate a history of default of 0.02% over five years, across more than five million transactions. This data point is valuable to regulators and other industry stakeholders, but may also illuminate an issue related to the continued role of international institutions in trade finance."

"One could legitimately conclude," continues Beck, "that such a low-risk business may not be the best environment to deploy the finite resources of development and multilateral institutions: such institutions should focus their interventions where they are most needed – likely where the risk is high, and where private sector activities are limited or non-existent – in order to ensure that maximum benefit is extracted and maximum value created for developing and emerging economies."

Will the 'transformation imperative' which some stakeholders perceive in the context of emerging markets and SME trade finance, extend to the role of international institutions and multilaterals, whose contributions have been widely recognized as invaluable, in the support and provision of trade finance?

Business and trade financing in developing economies, particularly among LDCs, has its unique combination of challenges. Specialists note that in such markets, perhaps 3%-5% of cross-border flows are financed through traditional instruments, with 'cash only' mindsets and the use of gold as a primary currency remain a reality, along with a strong reliance on personal and family relationships across borders. In such markets, the bankability of small business ventures remains an issue, as does the technical competence of local financial institutions, particularly in credit adjudication and risk assessment and mitigation.

Ali Raza Dharamsey at Barclays UAE in Dubai

The UN-affiliated International Trade Centre in Geneva has been acknowledged as a 'best practice institution' in addressing the unique needs of small businesses in LDC economies in particular. Roger Mégélas, trade finance advisor at the ITC notes: "SME finance is a high-profile topic at the moment. At ITC, we have been devising a holistic approach to this issue, assisting small businesses and local banks in developing necessary technical competencies, while providing ongoing coaching before, during and after a loan transaction. Importantly, we are actively engaged with trade promotion organisations and trade support institutions to ensure our efforts lead to concrete commercial outcomes. Going forward, we hope to extend this holistic model to apply to strategically important economic sectors in the markets we serve."

One element of the transformation in developing and emerging markets trade, relates to the reality that there are resources available – including financial resources ready to be deployed through various institutions – and yet, competency gaps present a significant obstacle to the successful deployment and leveraging of these resources. In LDCs in particular, the presence of resources, without the willingness or ability to target deployment to the SME sector, immediately dilutes the potential value of such resources. Notably, the reality for development institutions is that despite their shared non-commercial mandates, these organisations are in competition for donor support, resources, market positioning and other considerations, while facing pressure to control costs.

Angela Strachan, chief, business environment at the ITC in Geneva observes: "Our approach puts the question of SME access to finance – including trade finance – in the broader context of the business environment within which our target clients operate. We contribute in terms of legislative context, trade facilitation and market intelligence based on the work of our sector and country teams, and at the transaction level, with customised tools which can be leveraged by in-market financial institutions and small business managers to create economic value. We seek to be a partner of choice based on our uniquely focused mandate and the range of support, and tools, we offer, across the export transaction chain."

SME and emerging markets/developing markets trade and trade finance have, by all accounts, suffered from the global crisis as many would have predicted. Equally truly however, these businesses, and the markets within which they operate, have shown an admirable tenacity and resilience from which so-called 'developed' economies can draw more than one or two lessons. ■