The Role of Public Intervention in Trade Finance

Zongxin Qian (钱宗鑫)
School of Finance, Renmin University of China
qianzx@ruc.edu.cn

1.The Impact of Trade Finance

TRADE

Trade finance can boost the export which allows firms to lessen the severity of their financial constraint (Greenway et al.[2007]).

- Exports may facilitate firm's access to international financial markets and provide them with the opportunity to better diversify their risk and sources of financing;
- Provided that national financial conditions are not perfectly correlated, export participation could make firms less dependent on the domestic business cycle;
- Being present in a foreign markets can also be interpreted as a favorable signal concerning in the productivity of the firm and its ability to face export-specific costs. This may improve its access to capital providers and its financial conditions.

ECONOMY

Trade finance bridges the time gap between when the exporter wishes to be paid and when the importer will pay for the merchandize. (Claude Lopes et al.[2015]).

Trade finance can boost the development of economy in ways as follows:

- loosen the constraints of companies to enter the international trade in which way can stimulate the economy;
- decrease the risk that financial institutes such as banks faced during the financing process and avoid the possibilities of financial crisis.

2. The State of Trade Finance

THE WORLD

Aggregate

Over 31 million trade finance transactions and over USD$9 trillion in trade finance processed in

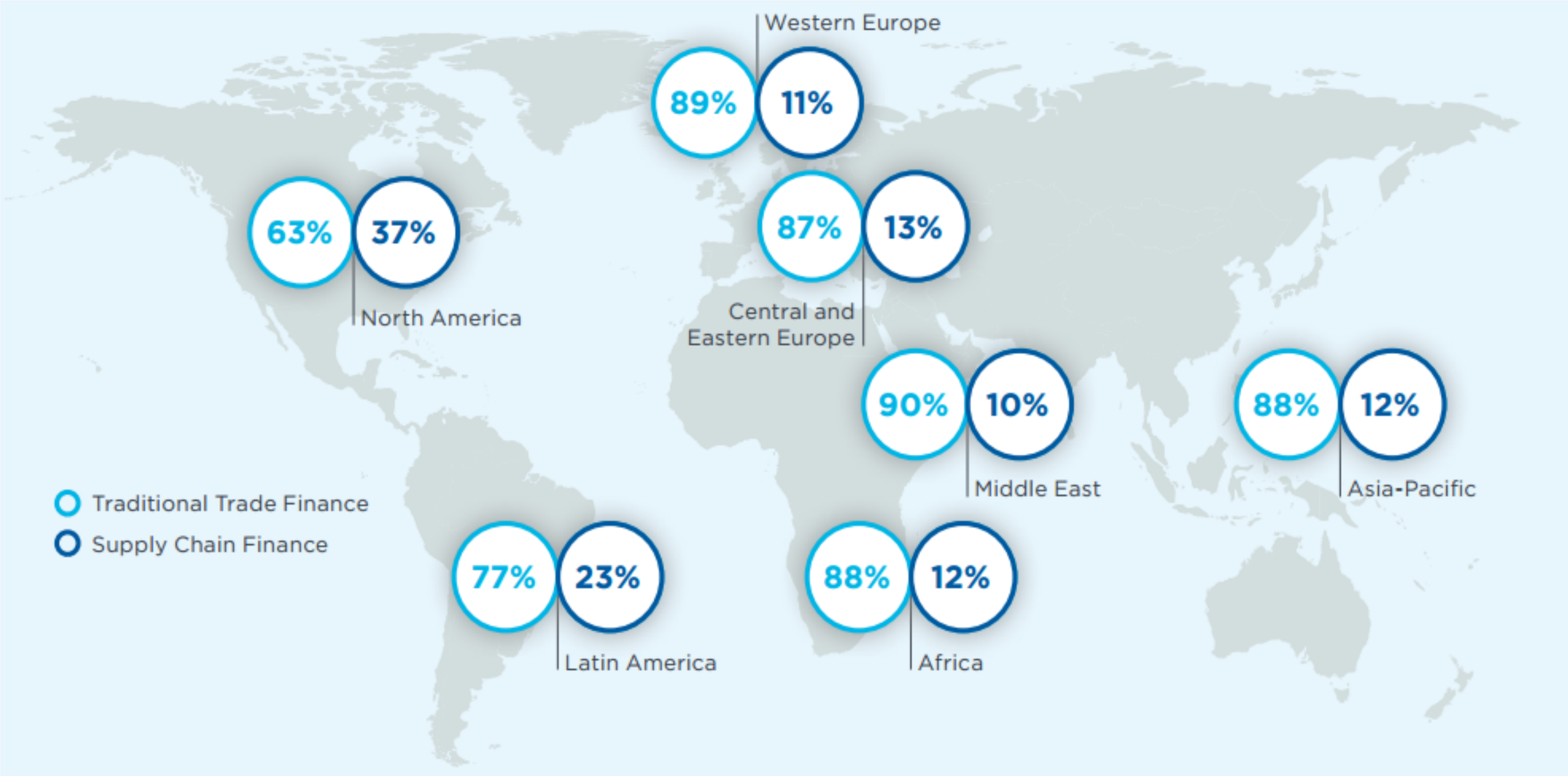
REGION	MEDIAN VOLUME	MEDIAN ESTIMATED VALUE (US$)	TOTAL VALUE (US$)
Asia-Pacific	35,979	3,143,174,686	2,151,338,487,916
Africa	3,571	408,928,760	145,256,084,814
Central and Eastern Europe	519	190,436,519	293,120,517,801
Latin America	1,640	267,100,895	121,529,556,535
Middle East	5,714	1,000,000,000	506,894,228,092
North America	20,000	6,314,903,500	524,211,167,315
Western Europe	23,500	4,224,696,775	822,771,643,418

Source: 2018 Global trade-securing future growth, ICC.

THE WORLD

Structur
e

In 2017, the global portfolio splits between about 85% in TTF and about 15% in SCF.

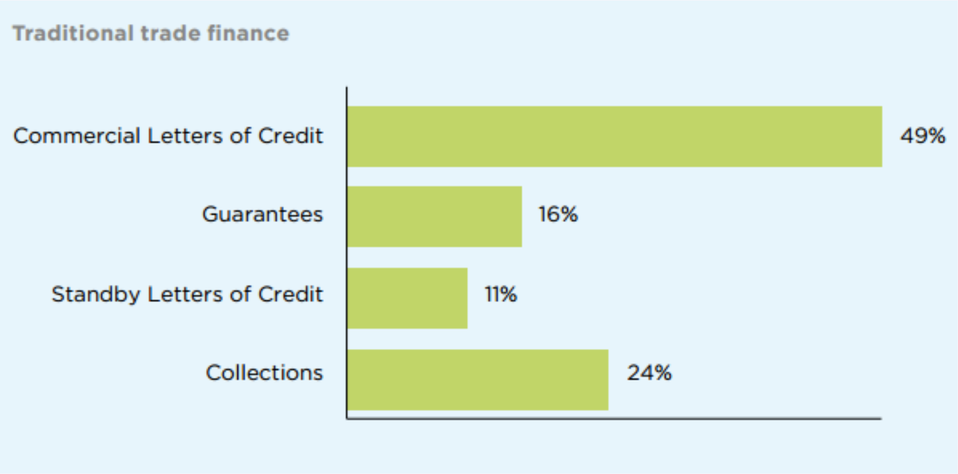


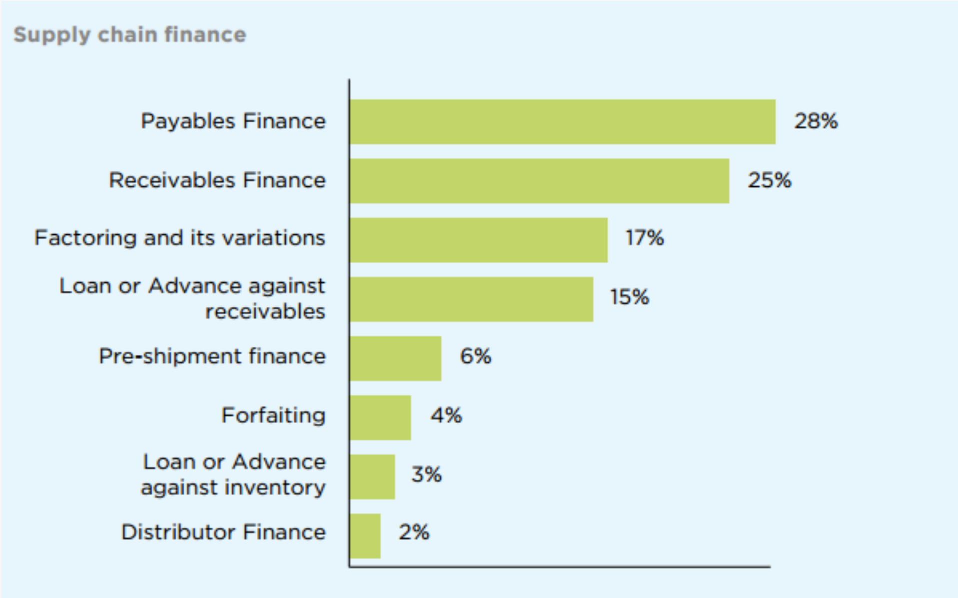
Source: 2018 Global trade-securing future growth, ICC.

THE WORLD

Structur
e

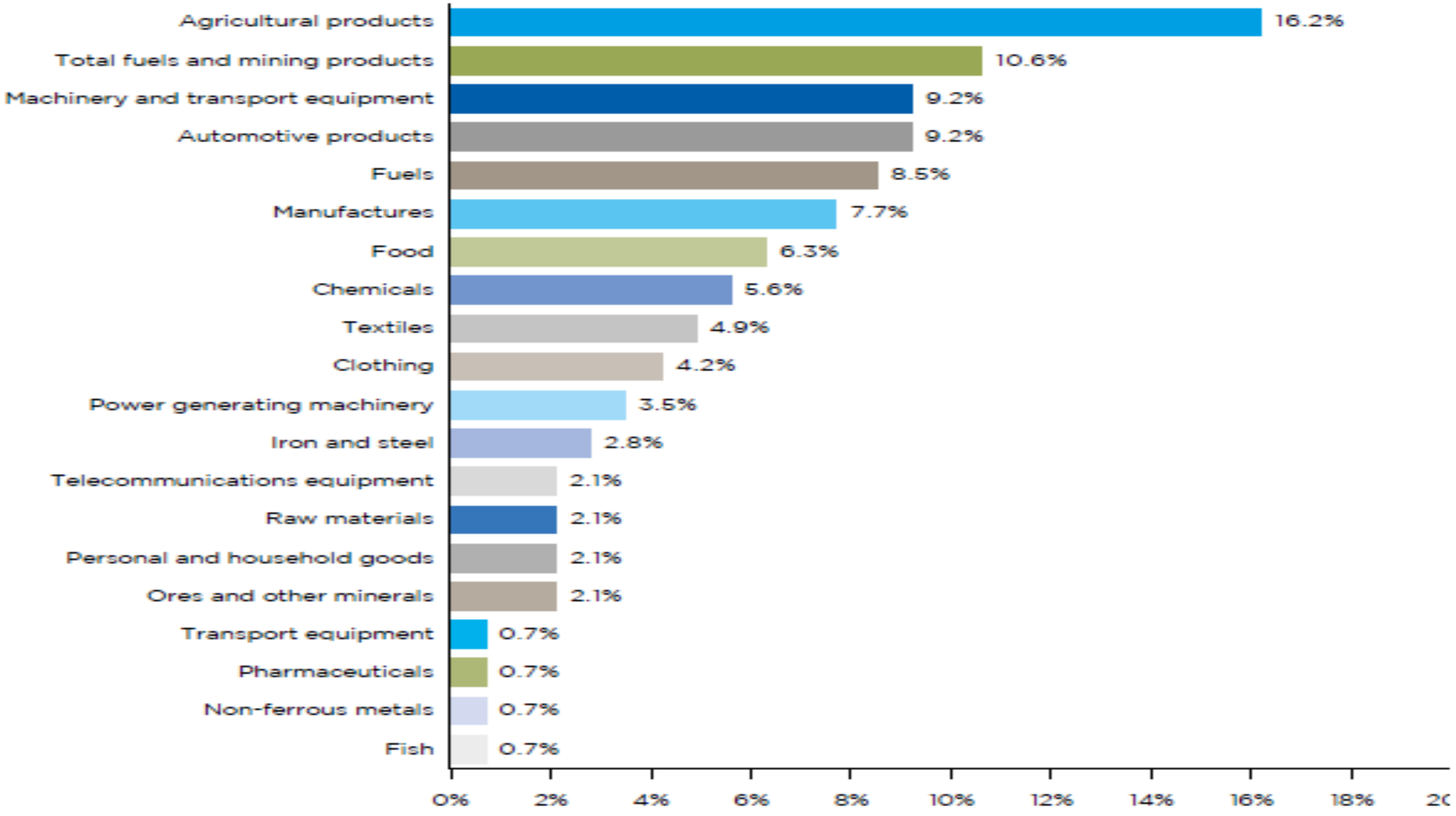
In 2017, the global portfolio splits between about 85% in TTF and about 15% in SCF.





Source: 2018 Global trade-securing future growth, ICC.

Figure 34: Industry sectors receiving most trade finance

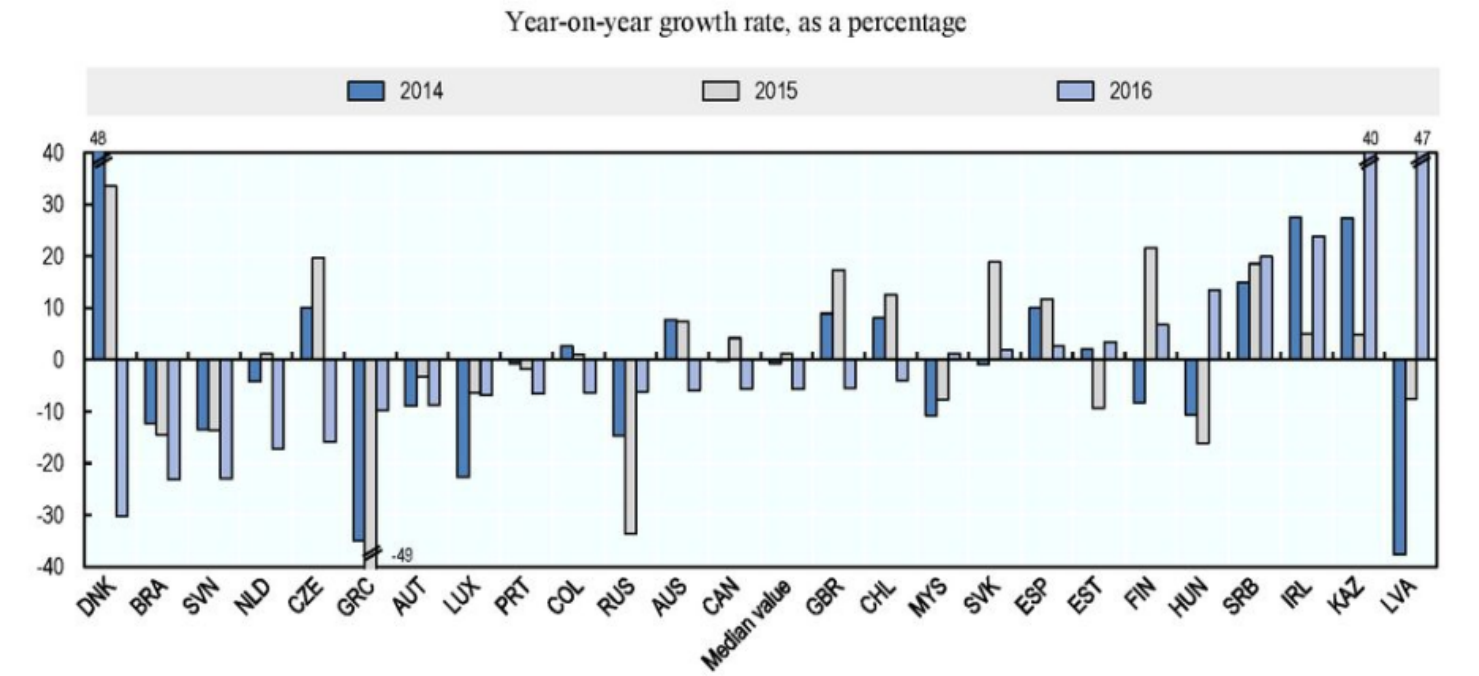


Source: ICC Global Survey on Trade Finance 2017

3. The State of SME’s Financing

THE WORLD

Trends in new SME lending

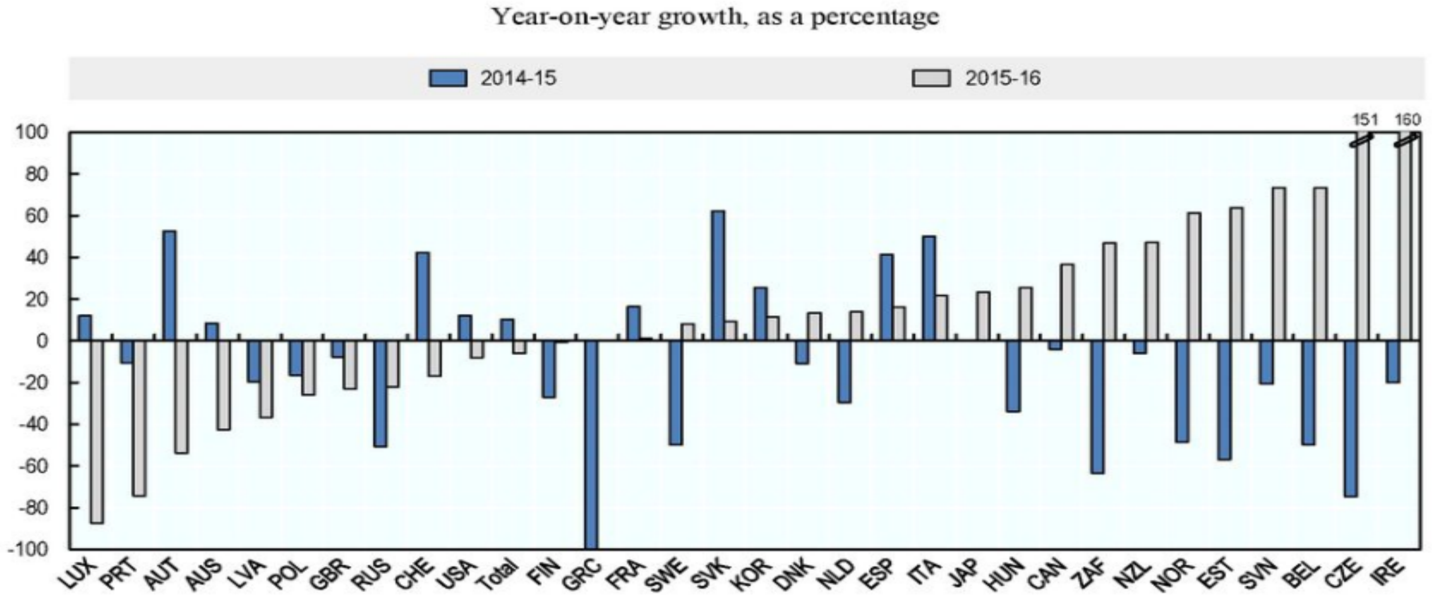


Note: Notes. 1. Definitions differ across countries. Refer to the table of sources and definitions in the full country profiles available online. 2. Countries with stock data only are not included. 3. All represented data are adjusted for inflation using the OECD GDP deflator. Data for non-OECD countries was extracted from the World Development Indicators, World Bank. 4. Countries not providing 2016 data were excluded.

Source: Financing SMEs and Entrepreneurs 2018, OECD.

OTHER SOURCES OF FINANCE

1. Venture Capital



Data on venture capital investments come from the OECD's *Entrepreneurship at a Glance 2017* publication. This annual study provides harmonised data on venture capital investments for 31 countries participating in the Scoreboard. All data in this section are expressed in USD, with the annual exchange rates (National currency per USD, period-average) sourced from the OECD Annual National Accounts database.

Source: OECD (2017b). Latvian data are sourced from Invest Europe at the request of the Latvian Government.

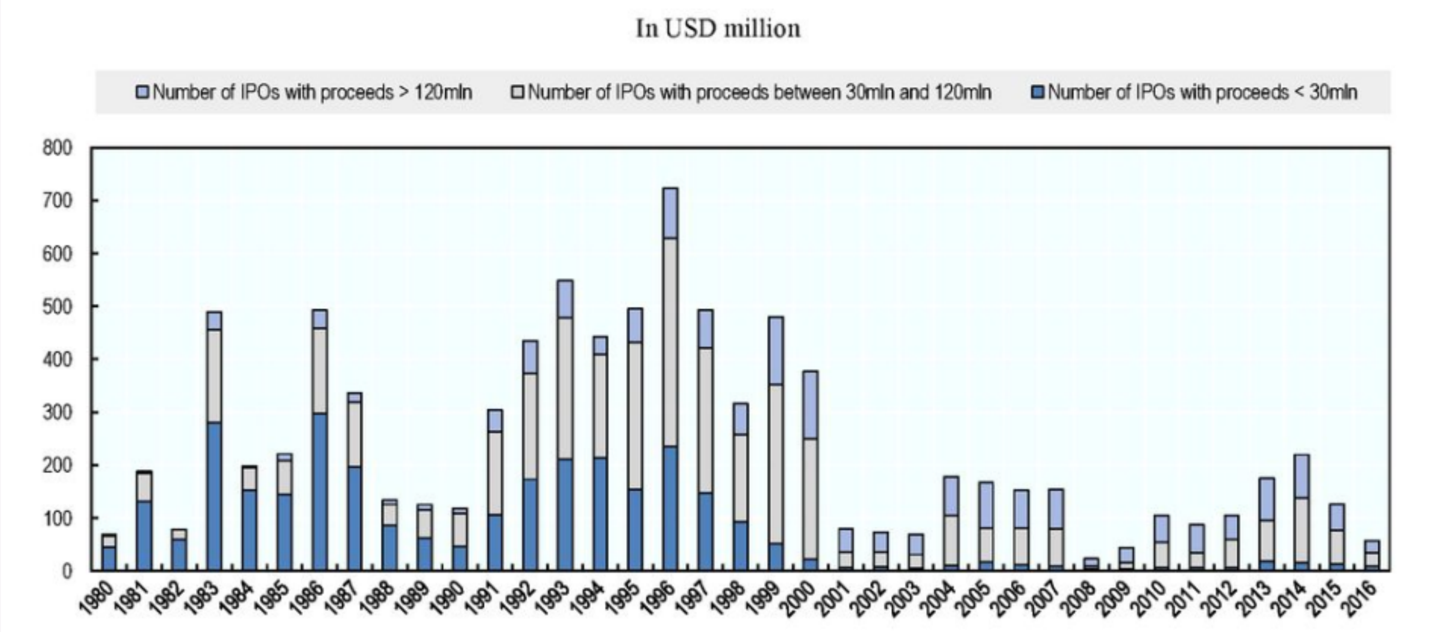
Other sources of financing

2. Private Debt

- Between 2006 and 2016, the global private debt industry nearly quadrupled in size, with assets under management increasing from USD 152 billion to USD 593 billion (McKinsey, based on Preqin).
- Around one-third of this market, USD 206 billion consisted of ‘’dry powder”(unused capital commitments
- Most activities are thought to fund SMEs (OECD).

Other sources of financing

3. Stock Markets



Source: Financing SMEs and Entrepreneurs 2018, OECD.

Other sources of financing

3. Stock Markets

There are several potential reasons for this apparent decline in participation in stock markets by SMEs:

- Entrepreneurs may be more likely to seek exits through mergers and acquisitions, rather than to acquire capital through an IPO;
- A stock market launch may not be particularly viable for entrepreneurs, who may lack the resources, knowledge or finances to structure an IPO;
- Investor sentiment may not have fully recovered from the shock of the global financial crisis, and similar to bank lending, may have turned more risk-averse and favorable to large caps, lending SMEs to look for alternative sources of financing.

Source: Financing SMEs and Entrepreneurs 2018, OECD.

Other sources of financing

4. Collective Investment Vehicles

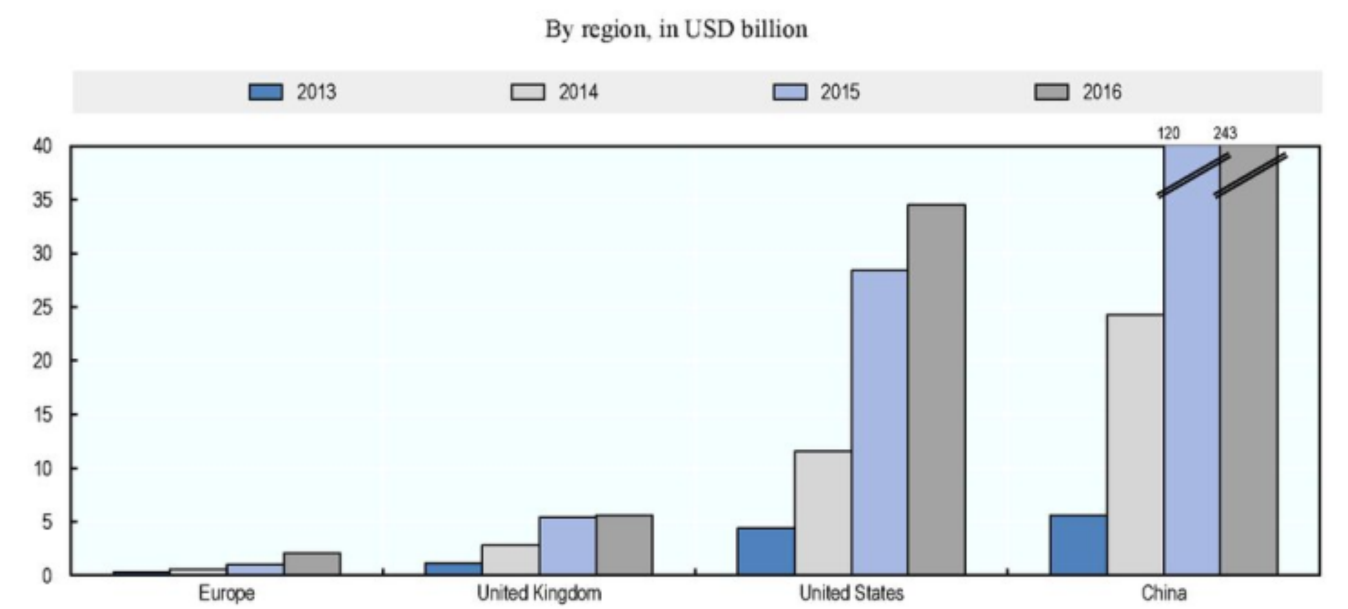
Collective investments vehicles offer retail investors an opportunity to invest in SMEs,

A firm specializing in investment management creates a fund for collective investment with a stipulated investment strategy and markets the fund to the public.

Source: Financing SMEs and Entrepreneurs 2018, OECD.

5. Online Alternative Finance

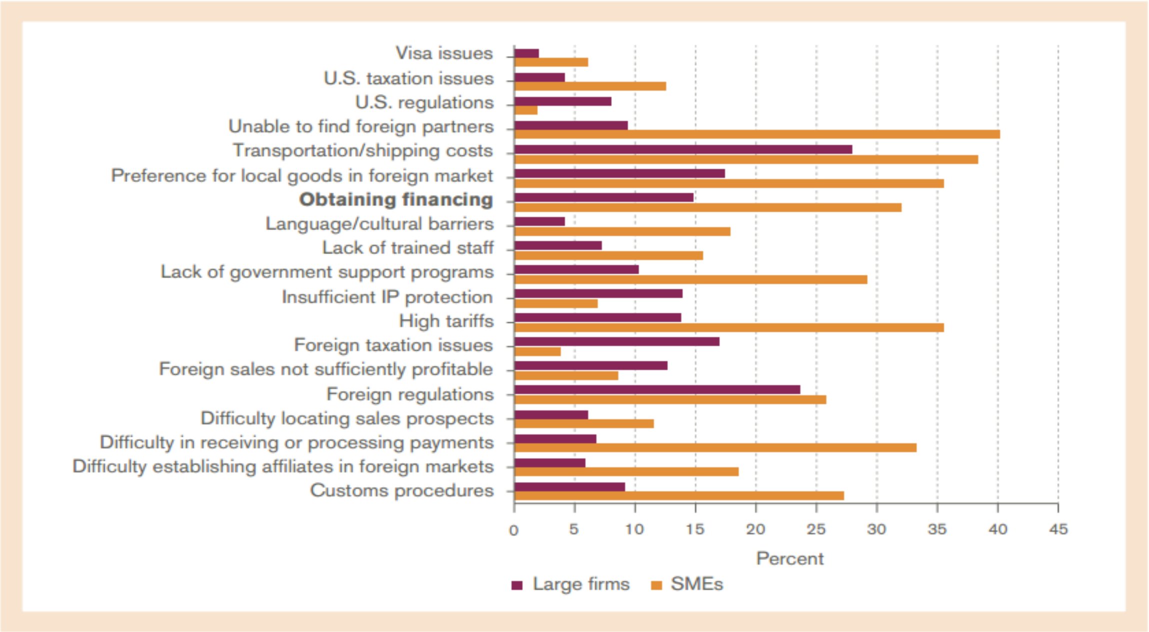
Total online alternative finance market volumes



Source: Financing SMEs and Entrepreneurs 2018, OECD.

Trade Finance of SMEs

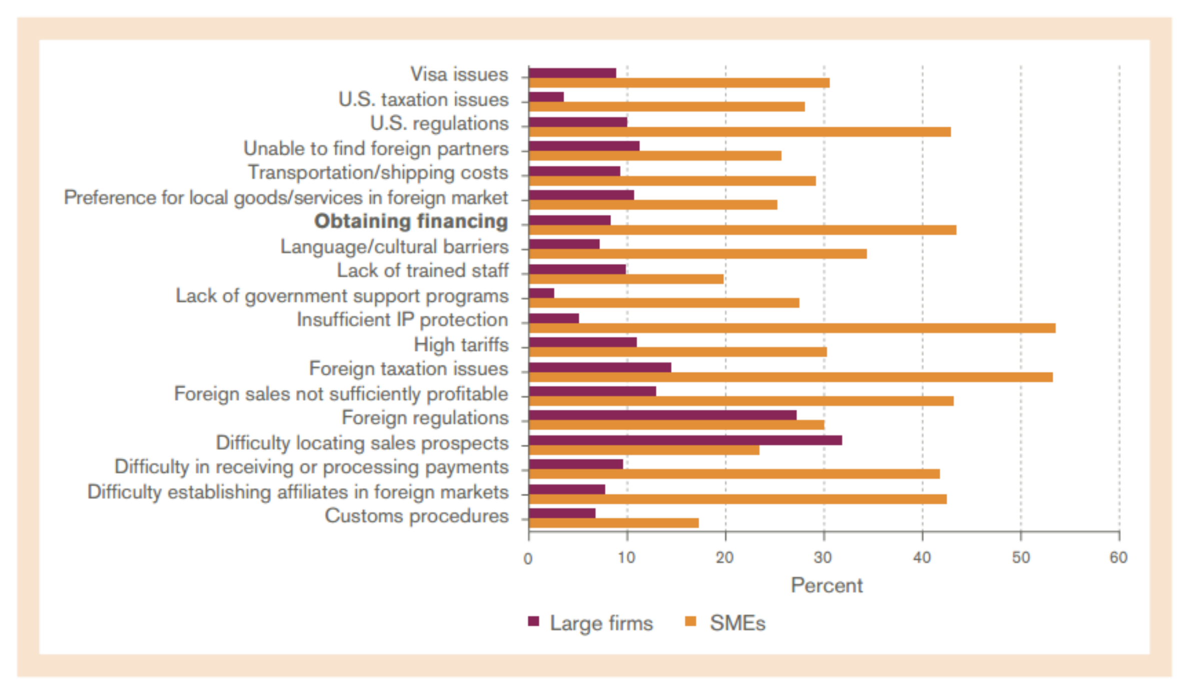
Credit constraints are particularly reflected in access to trade finance. A survey of 2,350 SMEs and 850 large firms by the US International Trade Commission (USITC) showed that 32 per cent of SMEs in the manufacturing sector considered the process of obtaining finance for conducting cross-border trade "burdensome".



Source: Trade finance and SMEs: Bridging the gaps in provision 2016, WTO.

Trade Finance of SMEs

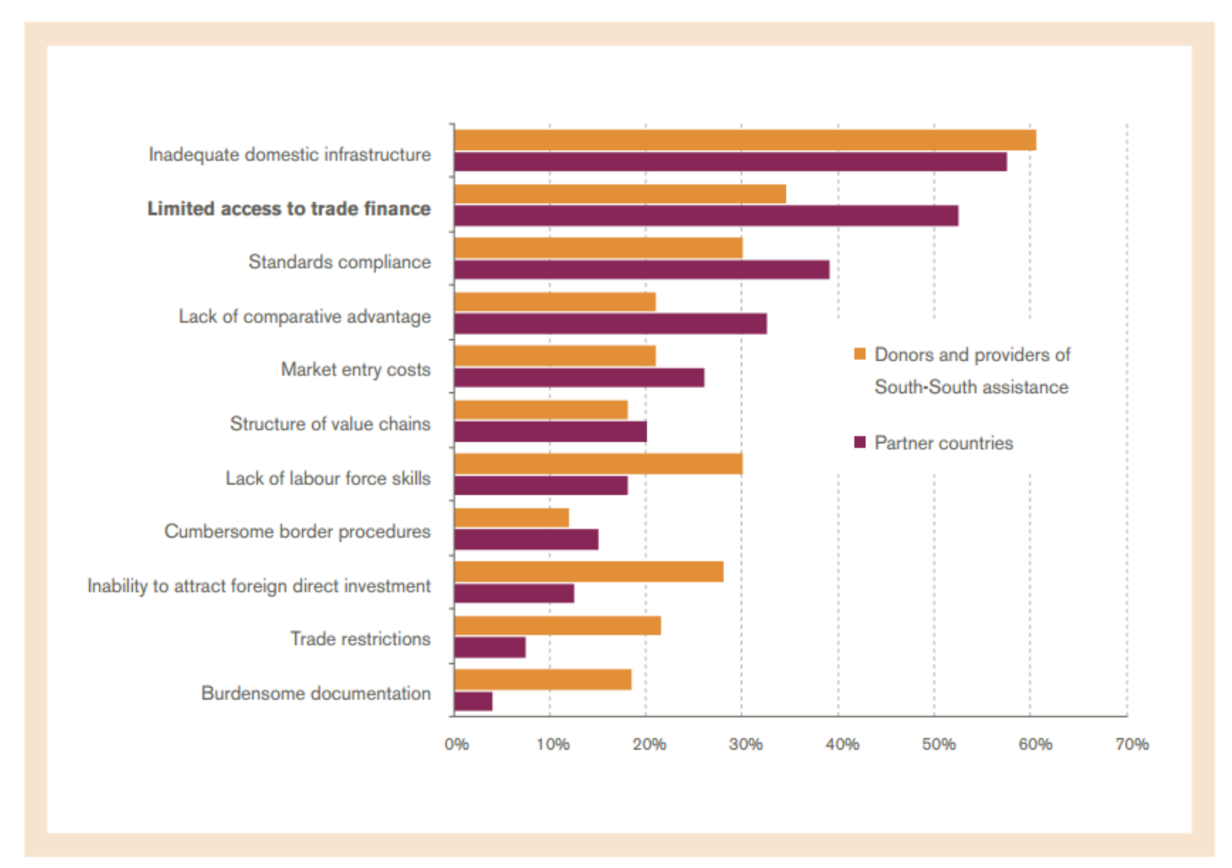
Credit constraints are particularly reflected in access to trade finance. A survey of 2,350 SMEs and 850 large firms by the US International Trade Commission (USITC) showed that 46 per cent of SMEs in the services sector considered the process of obtaining finance for conducting cross-border trade "burdensome".



Source: Trade finance and SMEs: Bridging the gaps in provision 2016, WTO.

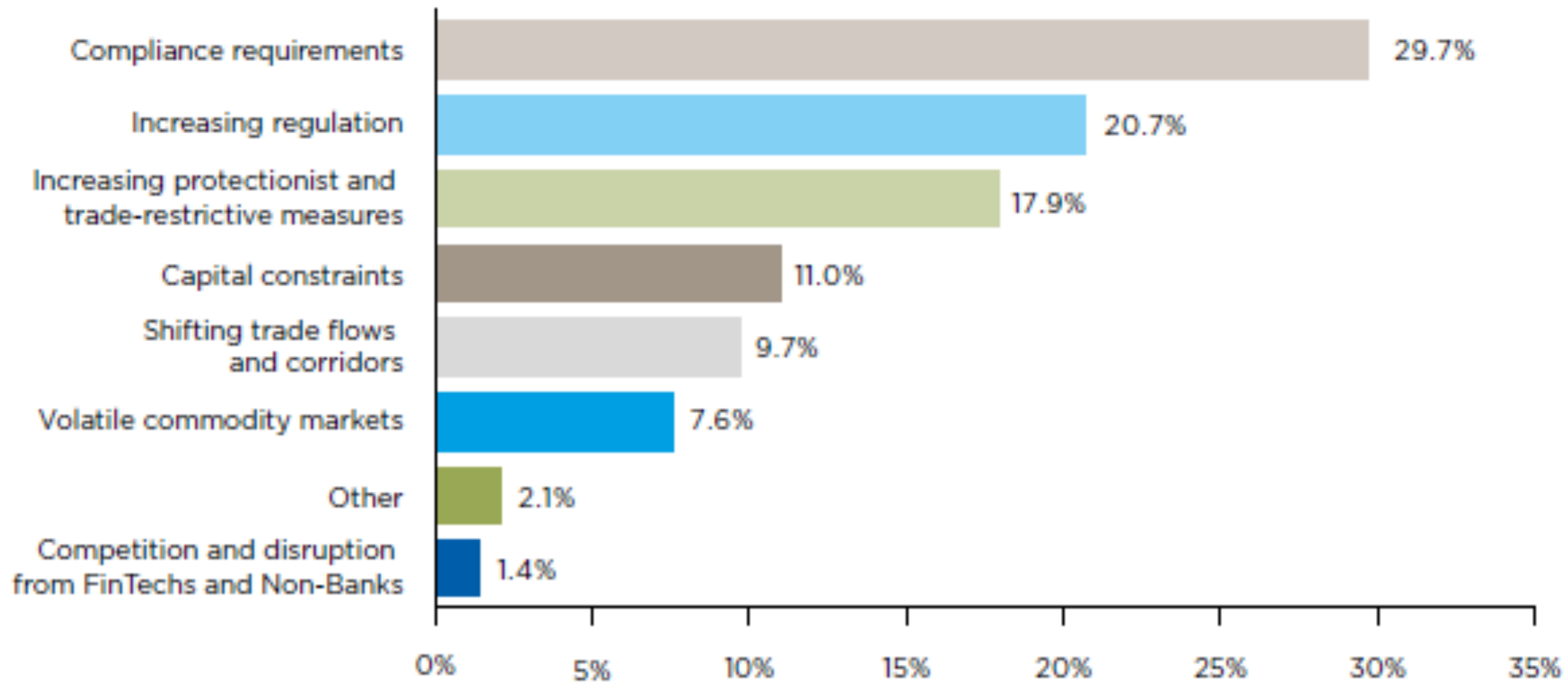
Trade Finance of SMEs

A survey conducted by the WTO and the OECD concluded that lack of access to trade finance was a key obstacle to low-income countries participating in global value chains



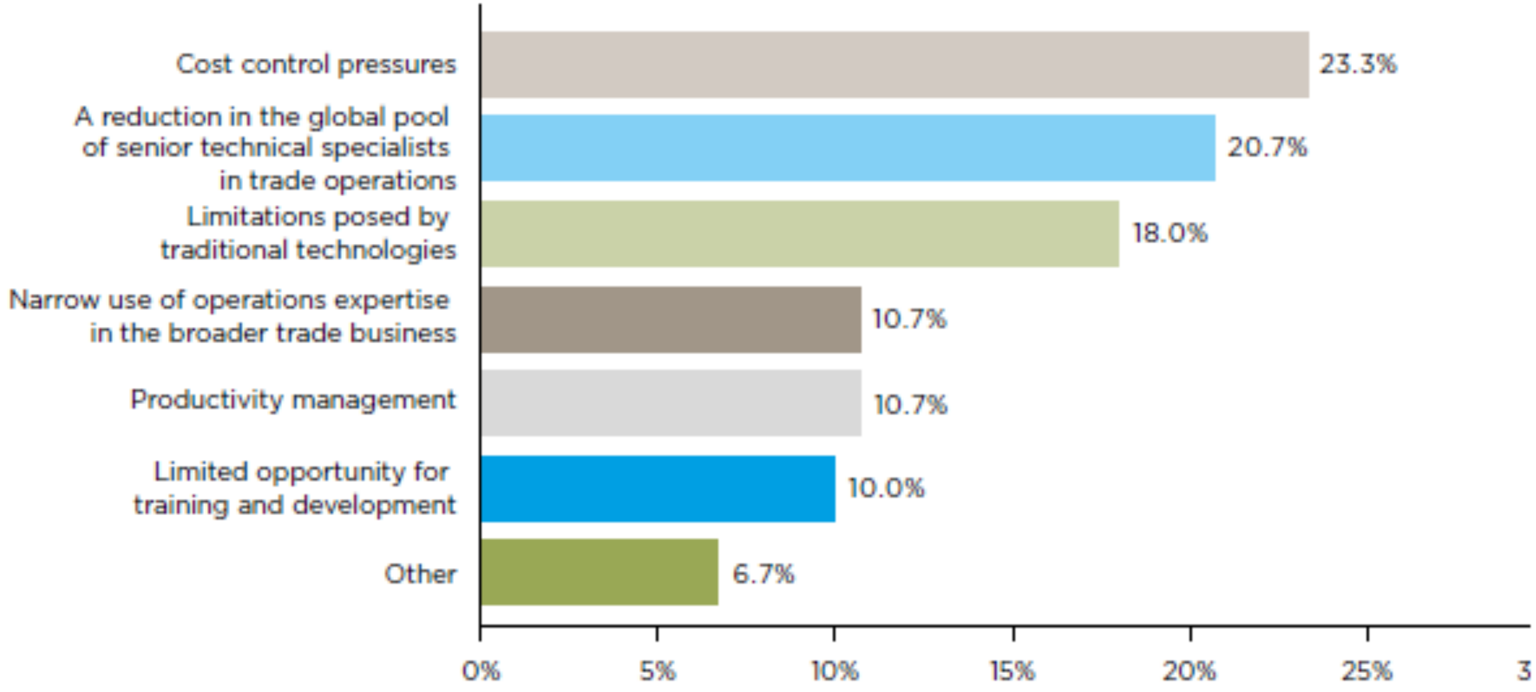
Source: Trade finance and SMEs: Bridging the gaps in provision 2016, WTO.

Supply side difficulties: challenges for banks I



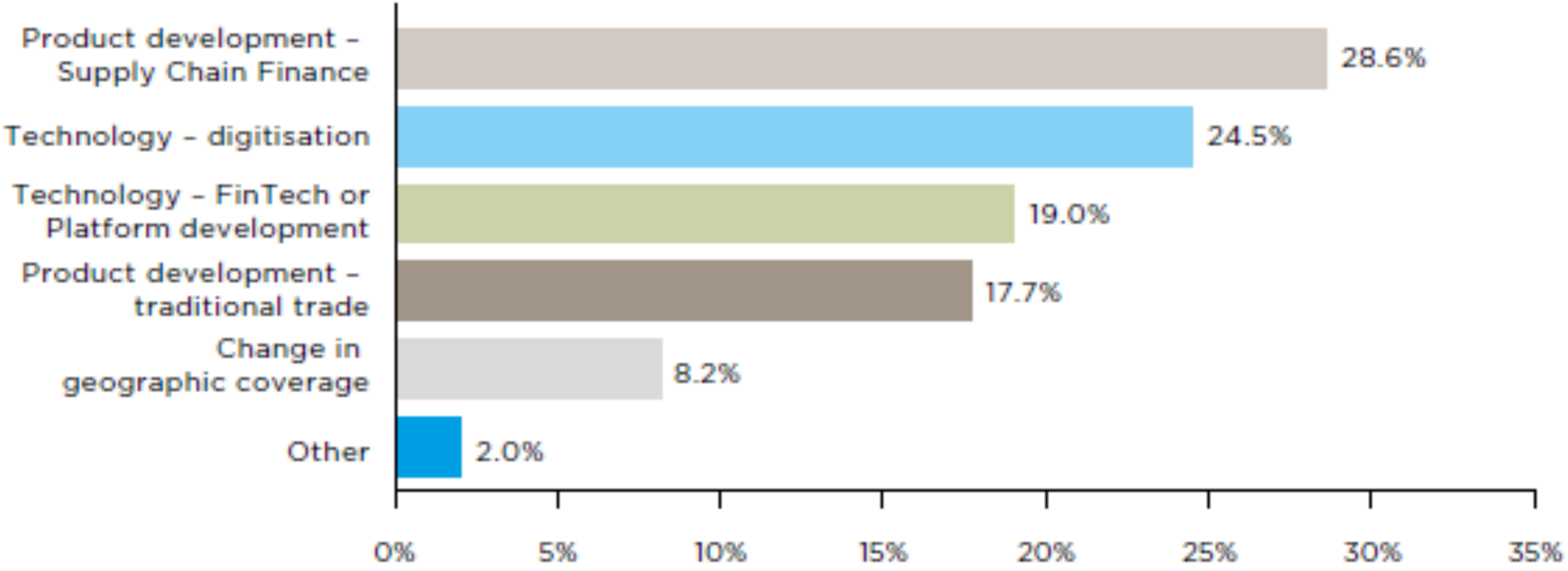
Source: ICC Global Survey on Trade Finance 2017

Supply side difficulties : challenges for banks II

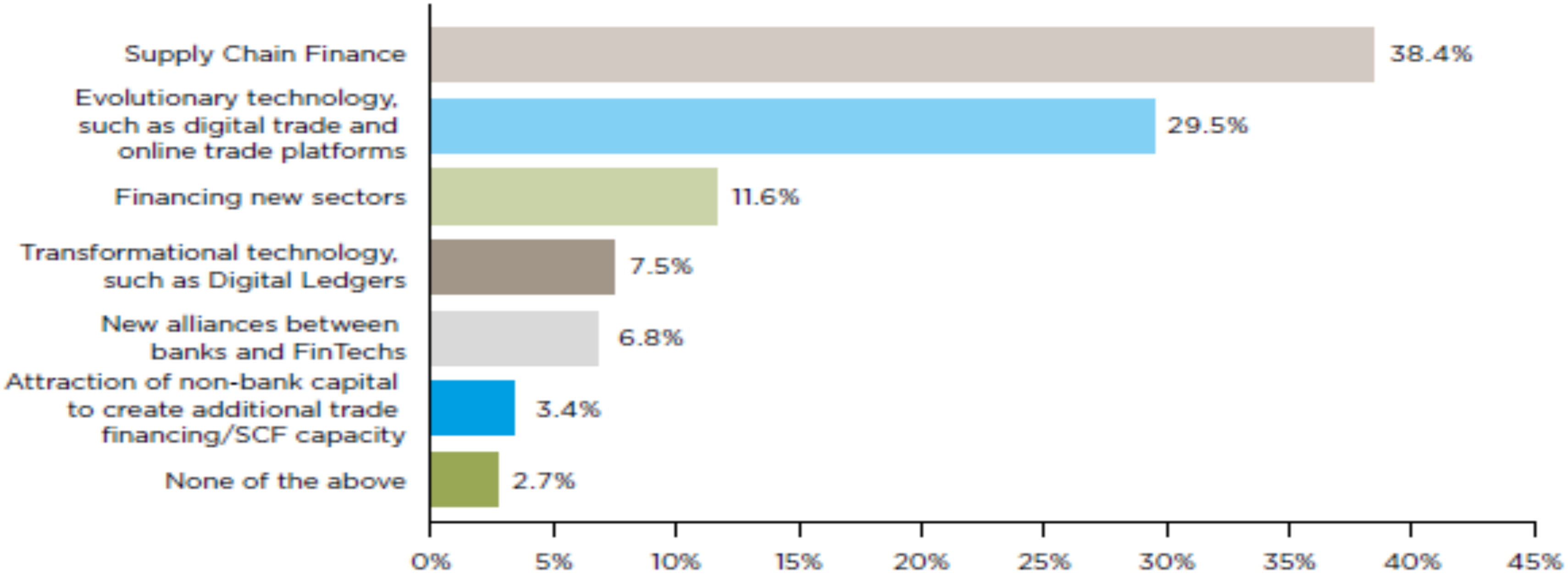


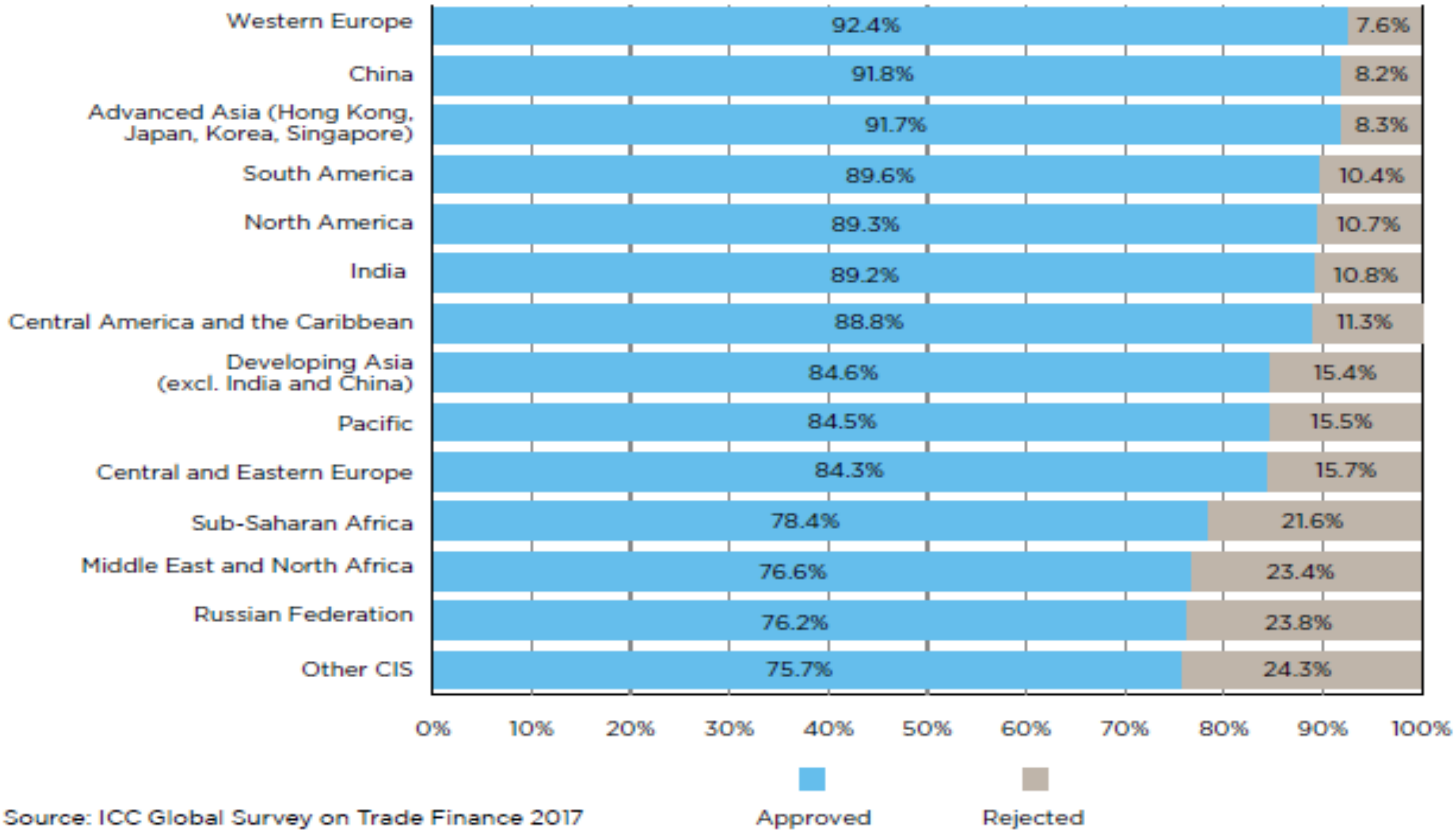
Source: ICC Global Survey on Trade Finance 2017

Supply side developments I



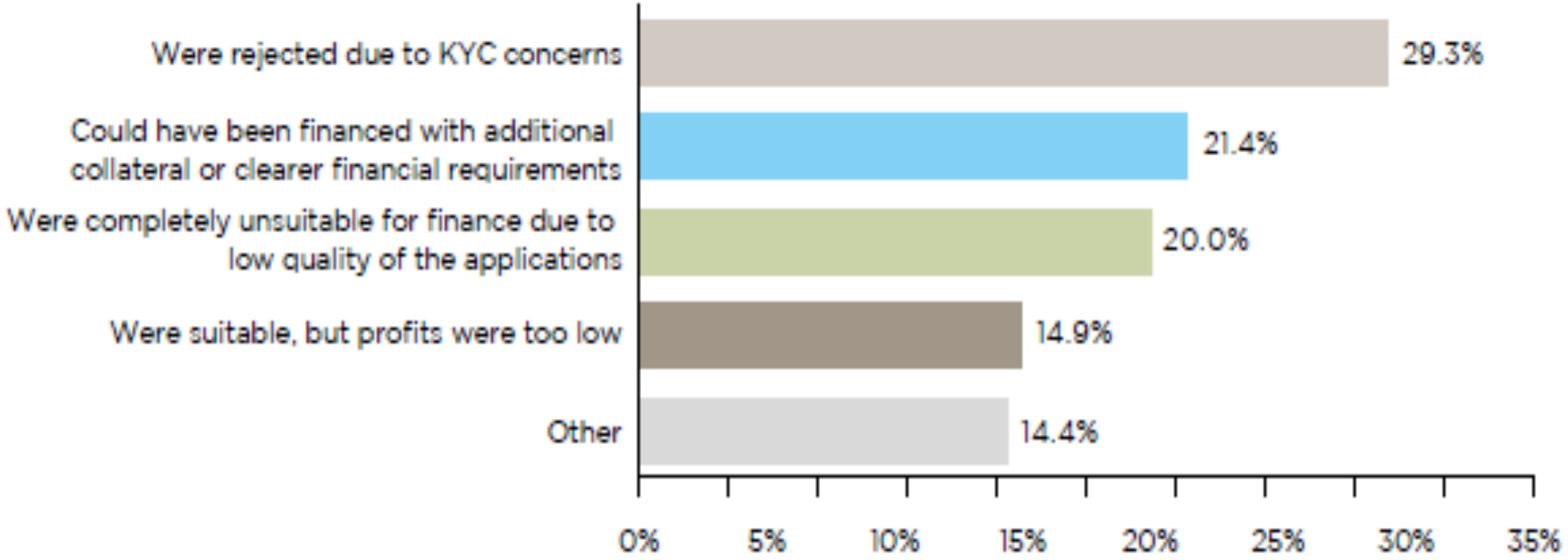
Supply side developments II





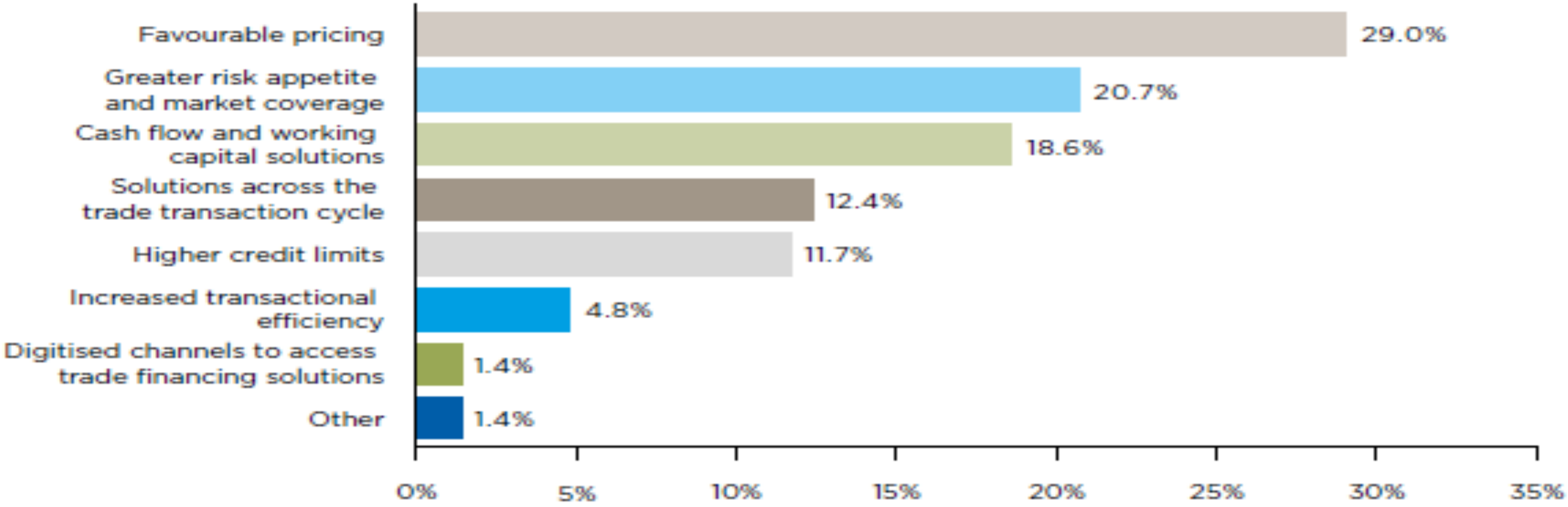
Source: ICC Global Survey on Trade Finance 2017

Reasons for the rejection of trade finance



Source: ICC Global Survey on Trade Finance 2017

Demand side requests



Summary from the data

- Limited access and high price are the major issues faced by SMEs in trade financing
- Claimed major reasons are

◆ regulatory burden

◆ lack of collateral and other credit information

◆ lack of human resources and expertise

◆ low profit margin

4. Role of Public Intervention

What have been done?

- State-owned specialized financial institutions
- Small private banks
- Multi-layer capital markets

Limitations of current policies

- Limited public financing resources: the tradeoff between outreach and sustainability
- Policy arbitrages: policy arbitrageurs versus productive producers
- Policy arbitrages: financing for export versus financing for diversion
- Regulatory difficulties: limited liability and excessive risk-taking versus inaction and insufficient risk taking

State-owned policy financial institutions

- State-owned policy financial institutions can reduce the shortage in the supply of trade financing due to low profit margin and high costs.
- However, this requires public financing which is limited by the current public leverage ratio and expected tax revenue flows.
- Moreover, to incentivize the officials, the compensation package has to be competitive enough compared to commercial financial institutions, which makes the financing burden even heavier.
- More focused on big projects
- State preferential policies induce firms to arbitrage on policies, leading to adverse selection and resource misallocations

Private versus public provision of trade finance

	2013	2014	2015	2016	2017
CEXIM	383.25	456.55	442.43	468.79	446.36
ICBC	1737.00	1486.00	1040.00	702.00	667.30
ABC	-	1263.3	1178.8	1038.7	933.00
MERCHANT	337.13	370.06	219.35	-	-

Small private financial institutions and multi-layer capital market

- Small banks also prefer large firms and those with strong credit enhancements
- Under competitive pressure, they excessively take risk when regulation is loose; they die when regulation is tough
- Similar logic applies to Fin-tech firms
- Capital markets were used by many incompetent firms to sell lemons to investors
- As a result, more productive firms might be undervalued due to pooling when priced by investors
- Inefficient markets and incompetent financial investors lead to mis-pricing of financial assets, which diverts limited financial resources from trade financing to over-priced asset markets.

Suggestion: more efficient rather than weaker regulations should be installed

- A uniform weakening of regulation is dangerous since financial firms over-take risk because of limited liability
- Efficient regulation should dynamically change regulatory strength with economic and financial cycles
- It should also be flexible enough to be adapted to specific environment of different industries

Suggestion: providing public technical supports to smaller financial institutions

- Financing to SMEs is highly technical, especially in customer screening and risk management
- Facing competitive pressure, smaller financial institutions are more likely to lend to SMEs
- However, those smaller financial institutions have less resources than big ones and usually have less techniques
- One way to help alleviate this problem is to provide public supports by providing viable templates and personnel training
- Another way is to encourage strategic investment by bigger financial institutions in smaller ones to promote technology spillover

Suggestion: reforming the capital markets

- Multi-layer capital markets could provide smaller firms more financing options, but this relies on a few conditions:
  - Allowing bad firms to exit
  - Introducing shorting mechanisms to correct mis-pricing and resource misallocation
  - Strengthening the competence of financial investors, especially institutional investors
  - Strengthening the protection of smaller investors and regulation on the retailing behavior of financial firms on collective financial products, such as various wealth management products and mutual funds

Summary of suggestions: some basic principles

- Simply providing public funding is not sustainable and subject to policy arbitraging and resource misallocations
- Efficient rather than loose regulation is a better reaction to financial firms' argument that regulation is the most important obstacle for trade finance
- Private financial institutions and markets can have better functions in providing trade finance to SMEs with the help of the public sector
- The public sector can help in that aspect by providing technical support, better regulations and market institutions

Thank You