



The Role of Trade Finance in Promoting Trade: The Implications of COVID 19 on Trade Finance in Africa

Special Report

By Ibrahim A. Zeidy

Director

COMESA Monetary Institute

The objective of this paper is to examine the role of trade finance for promoting trade in Africa. It covers trade financing gap, obstacles which limit growth, opportunities for expansion, the impact of COVID 19, interventions by Multilateral and Development Finance Institutions to mitigate the impact of the crisis and recommendations on structural measures to strengthen trade finance facilities in Africa.

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Introduction

Trade is a key driver of economic growth and poverty reduction and drives the exchange of goods and services, capital movement, and fosters cultural links between people and between countries. It is an important catalyst for regional economic integration, economic growth and poverty reduction. According to UNCTAD, for the period (2015-2019) total Africa trade average value was USD 760 billion per year which represents 29% of Africa's GDP¹. Despite trade's importance as an engine of growth, Africa's share of global trade is only estimated at 3%, with an even lower share of intra-regional trade compared to other regions (Africa:15%, European Union: 63%, North America: 50%, and Asia:52%). Increased intra-African trade can contribute towards the development of cross-border infrastructure, catalysing intra-regional investment, and reducing the constraints of unfavourable boundaries for landlocked countries².

However, Africa is yet to address the constraints to trade and fully capture its growth-enhancing benefits. One of the constraining factors for expanding trade within Africa and with the rest of the world is a trade finance gap estimated at USD 82 billion by AfDB-Afrieximbank in 2019³. Filling this gap means addressing the obstacles African banks face in expanding access to trade finance. It is worthwhile to note that lack of trade finance is a significant non-tariff barrier to trade and can limit the full trade potential of African Continental Free Trade Area (AfCFTA) and Tripartite Free Trade Area (TFTA).

Banks and other financial institutions help companies engage in world trade, mitigating risks so that goods and services can flow across the globe in a smooth and secure manner. Trade finance is especially crucial for small- and medium-sized enterprises (SMEs), which may lack the resources to import or export valuable goods on their own.

Historically, trade finance has tended to be highly vulnerable in times of crisis such as the current pandemic. Indeed, trade finance differs from other forms of credit, such as investment or working capital, in ways that make it higher risk—during periods of crisis—because of the difficulty of securing and enforcing credible commitments across borders in times of turmoil. In addition, the costs of trade finance could be substantially higher than they were pre-crisis, raising the problem of affordability for exporters⁴.

¹ AU, Impact of the Coronavirus(COVID 19) on the African Economy.p15

² Making Finance Work for Africa, "Trade Finance", mfw4a.org/our-work/Trade-Finance

³ AfDB "African Economic Brief-Covid 19 Pandemic- Potential Risks for Trade and Trade Finance in Africa". Volume 11/issue 6, 23 June 2020, p.4

⁴ J, Chauffour, T, Farole, The World Bank " Trade Finance in Crisis: Market Adjustment or Market Failure" Policy Research Working Paper 5003,p 9, July 2009

The objective of this paper is to examine the role of trade finance for promoting trade in Africa. The first section presents a brief description of trade finance. The second section presents trade financing gap in Africa. The third section discusses obstacles which limit growth of trade finance. The fourth section presents opportunities for expansion of trade finance in Africa. The fifth section discusses impact of COVID 19 on trade finance in Africa. The sixth section highlights Interventions by Multilateral and Development Finance Institutions to mitigate the impact of the crisis. Finally recommendations will be provided on structural measures to strengthen trade finance facilities in Africa.

I. **Trade Finance in Brief**

By providing critical fluidity and security to enable the movement of goods and services, trade finance lies at the heart of the global trading system. Trade finance mechanisms exist to support two fundamental aspects of the trading process: risk mitigation and liquidity⁵:

- (i) **Risk mitigation:** Any economic exchange involves an element of risk, principally that the seller will fail to deliver the goods or services as agreed or that the buyer will fail to pay or to accept the goods or services. In an international trading environment these risks are heightened by such factors as macroeconomic volatility, political risk, information asymmetry, and moral hazard. As a result, traders require facilities which mitigate and/or compensate for these risks.
- (ii) **Liquidity:** Suppliers normally face a gap in time between when they incur production costs and when they receive payment from the buyer. This creates a liquidity gap, which is often made greater by payment terms that grant buyers a period of days or weeks in which to make payment. In an international trading environment, this time period tends to be extended still further due to the relatively longer time required for products to reach their markets. Firms typically require access to credit to offset this liquidity gap.

The vast majority of trade finance involves credit extended bilaterally between firms in a supply chain or between different units of individual firms. Banks also play a central role in facilitating trade, both through the provision of finance and bonding facilities and through the establishment and management of payment mechanisms such as telegraphic transfers and documentary letters of credit (L/Cs). Complementing the activities of the banks are the following entities:

- (i) **Export Credit Agencies (ECAs):** ECAs are quasi-governmental agencies that generally provide cover – including partial or comprehensive insurance and guarantees – to offset counterparty risk. In most cases,

⁵ Ibid, pp5-6

ECAs do not provide direct funding to traders but rather complement the role of banks by guaranteeing the trade financing they provide to exporters.

- (ii) **Private insurers:** Private insurers have recently played an increasingly important role in the market as providers of trade credit insurance, political risk insurance, and bonding facilities. Their involvement in providing short-term credit insurance is substantially greater than that of ECAs in all OECD countries, with the exception of Japan and Canada. Exporters typically use insurance policies as collateral to unlock working capital or accounts receivables; banks also often hold insurance policies on their L/C business lines.
- (iii) **Multilateral Development Banks (MDBs):** The World Bank/IFC and a number of regional development banks (i.e., the ADB, EBRD, AfDB, and IDB) operate formal trade facilitation programs designed to support their member countries. These programs extend and complement the capacity of banks, including developing country banks, to deliver trade financing by providing risk mitigation (by issuing guarantees) in new or challenging markets where trade lines may be constrained. The programs work exclusively with banks; however all are specifically targeted at small- and medium size enterprises (SMEs) customers with no minimum transaction size.

While the commercial risks involved in an international trade seem in principle to be larger than in a domestic trade transactions, trade finance is considered to be a particularly safe form of finance since it is underwritten by a strong collateral and documented credit operations.

Research suggests that, an absence of, or weak access to trade finance by SMEs limit their level of involvement in international trade. Market failures, notably in financial markets (be it crisis or information asymmetry) fall disproportionately on SMEs, resulting in more credit rationing, higher cost of screening and higher interest rates from banks than larger enterprises.

II. The Trade Financing Gap in Africa

Trade finance in Africa is a relatively unexplored topic. The patterns of the market in Africa using primary survey data from commercial banks spanning 2011 to 2014 indicate that banks intermediate almost a third of trade activities across the continent, but still reject a significant value of trade finance applications mainly due to weak client creditworthiness and inadequate collateral. The trade financing gap in Africa was estimated of \$90 billion to \$120 billion between 2011 and 2014. A disproportionate share of the available financing is provided to large corporates (top ten clients) at the expense of SMEs

that make up more than 80% of all businesses in Africa⁶. In 2019, the trade finance gap in Africa was estimated at USD 82 billion by AfDB and Afreximbank⁷.

Filling this gap means addressing the obstacles African banks face in expanding access to trade finance. In the African context, many of these obstacles have a disproportionate impact on SMEs, which are already struggling to access other forms of finance.

III. Obstacles which limit Growth of Trade Finance

The following are some of the key obstacles which limit the growth of trade finance⁸:

- (i) Limited foreign exchange liquidity. Lack of foreign exchange liquidity is a weighing constraint. This is obvious, as the bulk of international trade transactions are priced in US dollars. In addition, when it comes to trade finance transactions, 80 percent of letters of credit are denominated in US dollars (ICC, 2012).
- (ii) Regulatory restrictions: Regulatory restrictions and risk capital requirements present considerable challenges to banks and are among the main constraints to expanding their trade finance portfolios. This is of particular concern since international standards, especially anti-money laundering (AML) and Know Your Customer (KYC) rules have become more stringent since the global financial crisis and may be even more so, when banks will have to comply with Basel III requirements.
- (iii) Response of banks as leveraged institutions to heightened risks. In a crisis, banks generally do not differentiate between the risks associated with trade credit and other credit exposure with longer tenors that may entail greater transfer and convertibility risk. In the height of a crisis, banks typically reduce overall exposure.
- (iv) Absence of sufficient insurance when it is needed: Trade credit insurers, private and public, tend to tighten their cover policy in response, particularly when there is crisis.
- (v) Decision making by international providers of trade finance particularly when there is crises is often dominated by perceptions rather than fundamentals, and a withdrawal by one player tends to trigger similar actions by others. Herd behavior in the form of creditors' "rush for the exit" and inadequate information about the financial condition of corporate clients or of economy-wide prospects can aggravate risk perceptions and make a prophecy self-fulfilling.

⁶ E. Nyantakyi, M. Dhaaou, L. Drammoh, M.Sy, "Africa's Trade Finance Market: Facts and Challenges" [Voxeu.org/Article/africa-s-trade-finance-market-facts-and-challenges](https://voxeu.org/article/africa-s-trade-finance-market-facts-and-challenges)

⁷ AfDB "African Economic Brief-Covid 19 Pandemic- Potential Risks for Trade and Trade Finance in Africa". Volume 11/issue 6, 23 June 2020, p.4

⁸ The constraints are extracted from the following sources:

(i) AfDB "Trade Finance in Africa: Overcoming Challenges", September 2017, p50

(ii) IMF, Jian-Ye Wang, Marcio Ronci "Access to Trade Finance in Times of Crisis" 2005, p.4

- (vi) Weak domestic banking system: A decision by international banks to reduce trade credit lines to a domestic bank will clearly limit the latter's ability to provide trade credit to its domestic corporate clients. However, external factors are not the sole reason for sharp cutbacks in trade credits by domestic banks. It is noteworthy that banking systems that were weak prior to the onset of a crisis contributed significantly to the collapse of trade credits. In such cases, banks under stress will seek to reduce their exposure to risk and raise their capital ratio by downsizing their balance sheets. As a result, they will reduce their intermediation of trade financing provided by foreign banks.
- (vii) Low country ratings is another reason that is likely to have a negative impact on trade finance.
- (viii) Another driver of cost is the labour intensive, physical handling and checking of documents. This is more so the case with LCs, Guarantees/standby Letter of Credit that are paper heavy, very fragmented, and labour intensive.

IV. Opportunities⁹

Governments and development partners have made significant efforts to reduce barriers within Africa's trade finance industry in the last decade. Multi-lateral Development Banks have created facilities to de-risk transactions for banks, by using their strong financial backing and credit ratings, through facilities like the AfDB's Trade Finance Program and the IFC's Global Trade Finance program.

Afreximbank's Mansa, a due diligence platform launched in July 2018, aims to facilitate African trade by providing a single trusted source of primary data for due diligence checks on African counterparties. Technological innovation is also being explored to stimulate trade finance. Indeed, according to a recent survey conducted by the International Trade Centre, African MSMEs have cited failure to access internationally recognized payment systems as a major obstacle to cross-border e-commerce. Although domestic e-commerce offers a wide range of payment possibilities – including cash on delivery – cross-border transactions with customers in high-value markets such as the European Union and the United States, require sellers to have access to internationally recognized payment systems. In a number of African countries, MSMEs can only receive payments from foreign credit card holders through costly intermediaries, as the domestic system lacks the necessary international links. Global platforms such as PayPal or Google Wallet offer integrated payment solutions that could overcome some of these transaction barriers. However, these services come at a cost, and are not available in all countries.

⁹ Making Finance Work for Africa, "Trade Finance", mfw4a.org/our-work/Trade-Finance

Finally, the African Continental Free Trade Agreement (AfCFTA) signed by 52 countries in May 2019 is a major step forward. Through the creation of a single continental market for goods and services, with free movement of businesspersons and investments, it will expand intra-African trade through better harmonization and coordination of trade liberalization and facilitation instruments across the Regional Economic Communities (RECs) and across Africa in general. This represents a unique opportunity to strengthen and develop the trade finance sector.

V. Impact of COVID 19 on Trade Finance

To mitigate the potential impact of Covid-19 on African trade and keep market access channels open, uninterrupted supply of trade finance by banks is vital. But there are reasons to believe that the measures adopted by governments to combat the pandemic may also impact firms' ability to obtain trade finance at a time when they need it the most. The following are some of the impacts of the pandemic on trade finance¹⁰:

- (i) In the short-term, the low digitization rate of trade finance transactions could slow down approval rates and therefore decrease supply of trade finance during the pandemic. The pandemic may expose one of the biggest weaknesses in trade finance supply in Africa – the over reliance on paper-based transaction processes, compared to the rest of the world. Adopting digital solutions to trade finance transactions could reduce the time and monetary costs associated with document processing by banks and increase supply of trade finance. Yet for many banks across the continent, trade finance origination and authorization are paper driven due to regulatory requirements. For instance, only a handful of countries (Nigeria, Cameroon, Egypt and South Africa) in Africa allow e-signature and electronic authentication of official documents. Most banks therefore require “wet-ink” authentications before transactions could be approved. But the fear of the pandemic could make such simple processes suddenly burdensome and costly, slowing trade finance approval in the process.
- (ii) The pandemic could also increase the trade finance gap by limiting access to forex liquidity required to finance African trade. It could worsen the shortfall in liquidity experienced by banks engaged in trade finance in Africa. Foreign exchange liquidity shortages in the region could encourage global banks to reduce correspondent banking lines for domestic's banks in Africa. This could limit the supply of dollar liquidity demanded by firms for trade, increase trade finance rejection rates, and increase the size of the trade finance gap in Africa above the USD 82 billion recorded in 2019. Small and medium-sized enterprises could be particularly exposed to higher rejection rates. When liquidity is low, banks tend to favor larger clients to the detriment of Small and medium-sized enterprises (SMEs).

¹⁰ AfDB "African Economic Brief-Covid 19 Pandemic- Potential Risks for Trade and Trade Finance in Africa". Volume 11/issue 6, 23 June 2020, pp. 3-5

- (iii) In normal times, some banks cite the inability by SMEs to provide appropriate documentation to meet regulatory standards KYC compliance and Anti-Money Laundering (AML) requirements as one of the reasons for higher rejection rates of trade finance applications. As in-person interactions are reduced and business are forced to shut-down, the crisis could further worsen SMEs' ability to timely furnish appropriate documentation.

VI. Interventions by Multilateral and Development Finance Institutions (DFIs) to Mitigate the Impact

- (i) Development Finance Institutions (DFIs) have so far responded swiftly to support African trade. Of the USD 1.35 billion set aside by the AfDB for Covid-19 rapid response to the private sector, USD 270 million is ear-marked for trade finance support. This is in addition to existing guarantee capacity of more than USD 700 million. Similarly, the International Finance Corporation's Global Trade Finance Program has at least USD 2 billion additional capacity to cover payment risks associated with trade finance globally¹¹.
- (ii) The African Development Bank Group has joined the World Trade Organization and other multilateral development banks to reduce trade finance gaps that emerge as a result of the COVID-19 pandemic. In a joint press release, issued on 1 July 2020, the institutions said they would prioritize their support to areas in the world where such support is needed most, particularly the poorest countries¹².
- (iii) IFC allocated \$2 billion from the existing Global Trade Finance Program, which will cover the payment risks of financial institutions so they can provide trade financing to companies that import and export goods. IFC expects this will support small and medium-sized enterprises involved in global supply chains¹³.
- (iv) The African Export-Import Bank (Afreximbank) has announced a \$3-billion facility, named Pandemic Trade Impact Mitigation Facility (PATIMFA), to help African countries deal with the economic and health impacts of the COVID-19 pandemic. PATIMFA, approved by the Bank's Board of Directors during its sitting on 20 March, will provide financing to assist Afreximbank member countries to adjust in an orderly manner to the financial, economic and health services shocks caused by the COVID-19 pandemic. It will support member country central banks, and other financial institutions to meet trade debt payments that fall due and to avert trade payment defaults. It will also be available to support and stabilize the foreign exchange resources of central banks of member countries, enabling them to support critical imports

¹¹ Ibid p6.

¹² [Afdb.org/en/news-keywords/Covid-19](https://www.afdb.org/en/news-keywords/Covid-19), 2 July 2020

¹³ Press Release "World Bank Group Increases COVID 19 Response to USD14 billion to Help Sustain Economies Protect Jobs" March 17, 2020

under emergency conditions. In addition, PATIMFA will assist member countries whose fiscal revenues are tied to specific export revenues, such as mineral royalties, to manage any sudden fiscal revenue declines as a result of reduced export earnings. It will also provide emergency trade finance facilities for import of urgent needs to combat the pandemic, including medicine, medical equipment, hospital refitting, etc. The facility will be available through direct funding, lines of credit, guarantees, cross-currency swaps and other similar instruments, according to Afreximbank¹⁴.

- (v) The following are Trade and Development Bank's (TDB) response to the Coronavirus Crisis¹⁵:
- Support to eligible Member States to procure essential medical supplies
 - Support to suitable financial institutions in the region facing liquidity challenges
 - Support to corporate clients with access to supply chain and necessary inputs;
 - Support to sovereign clients with short and long-term liquidity challenges;
 - Scale-up support to the region by working with global funding partners via risk sharing agreements and co-financing.

VII. Policy Recommendations

The following are some of the key recommendation which could help overcome the challenges noted above¹⁶:

- (i) Enable a rapid transition to paperless trading by: (a) immediately avoiding all existing legal requirements for trade documents to be in hard-copy paper format; and (b) facilitating fast-track adoption of the UNCITRAL Model Law on Electronic Transferable Records to provide a sound legal basis for the use of e-documents in the processing of trade finance transactions.
- (ii) Implementation of regulatory reforms, aimed at promoting trade facilitation to ensure that Regional FTA's are well functioning and facilitate access to trade finance for the benefit of intra-Africa trade.
- (iii) Know your customer (KYC) and regulatory compliance requirements by international banks with respect to their African correspondent banks need to be addressed to avert any withdrawal of these institutions from Africa or any meltdown of correspondent banking relationships.

¹⁴ Afreximbank press release, Cairo 24 March 2020 "Afreximbank Announces USD 3 billion Facility to Cushion Impact of COVID 19" Afreximbank.com

¹⁵ TDB "A Strengthened Response to the COVID 19 Pandemic". Posted on April 2, 2020. tdbgroup.org

¹⁶ The recommendation are obtained mostly from the following sources:

(i) AfDB "African Economic Brief-Covid 19 Pandemic- Potential Risks for Trade and Trade Finance in Africa". Volume 11/issue 6, 23 June 2020

(ii) International Chamber of Commerce "Trade Financing @COVID 19: Priming the Market to Drive a Rapid Economic Recovery". iccwbo.org. May 2020

- (iv) Encourage reforms and policies that reduce information asymmetry and facilitate credit information sharing through creation of credit information Bureaus and setting up of national collateral registry.
- (v) Enhance the capacity of the local banking sector to support trade finance.
- (vi) Avoiding the unintended consequences of Basel III in trade finance particularly for developing countries. Traditional trade finance-mainly letter of credit and other self-liquidating instruments of payment for trade received preferential treatment from national and international regulators on grounds that it is one of the safest, most collateralized and self-liquidating form of finance.
- (vii) As development finance institutions and governments set up financial facilities to support businesses and critical sectors, part of the solution should entail setting up rapid emergency facilities such as trade finance lines and risk-mitigation instruments earmarked to support banks, SMEs and other local corporates.
- (viii) The scale of the pandemic shows that rapid support may be needed for banks and enterprises in vulnerable and fragile states in Africa, as well as those that may be severely affected by commodity price shocks.
- (ix) Ensure all export credit agencies are equipped to provide adequate support for short-term trade transactions with appropriate coverage limits and geographical scope.
- (x) Timely interventions will be especially vital to ensure that MSMEs have continued access to reliable, adequate and cost-effective sources of trade financing, not only to weather the crisis, but hopefully to emerge from it stronger than ever.

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- (xi) TDB "A Strengthened Response to the COVID 19 Pandemic". Posted on April 2, 2020. [tdbgroup.org](https://www.tdbgroup.org)



COMESA SECRETARIAT
COMESA Center
Ben Bella Road
P.O. Box 30051. Lusaka, Zambia



+260 211 229 725



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