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ENHANCING SOUTH-SOUTH TRADE AND INVESTMENT FINANCE

Background note by the UNCTAD secretariat

Executive summary

South-South trade grows much faster than world trade, and so do South-South investments. The latter now account for more than one third of investment flows into developing countries. This is despite the fact that financing support for such South-South flows are weak: the generic gaps that exist in the financing system for commodity trade and investments in developing countries are even more pronounced for such non-traditional transactions.

The availability of finance, in particular for the medium- to long-term, is often poor for developing country exporters, importers and investors. International banks apply strict country credit ceilings, and impose high risk premiums on lending to developing countries. Financing for South-South investments and trade is particularly scarce. While the institutional capacity of developing country banks to provide finance to non-traditional sectors is improving, several factors are hurting the availability of funds – in particular, the consolidation of the international banking sector (which reduces overall country credit lines), and the forthcoming Basel 2 New Capital Accord (which also will reduce country credit lines for the more "risky" countries, and will lead to higher risk premiums for non-investment grade clients).

While gaps in trade and investment finance remain (and continue leading to a non-level playing field for non-OECD companies), these institutional developments have to be taken into account when considering the shape and form of a prospective new arrangement to deal with the financing gap for South-South trade and investments. Two other relevant developments are the Basel 2 New Capital Accord, due for 2007, which will make bank lending for "risky" borrowers much more expensive; and the growing sophistication of the capital market.

Finding ways to strengthen South-South financing can be a win-win game, reducing the costs of trade, enhancing South-South investments, and bringing attractive returns to those providing the finance (particularly compared to the returns they can make on western capital markets). In this regard, there is a range of options.

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The creation of a new, dedicated financing institution is just one of these. One can also consider new institutional arrangements such as strengthened cooperation among developing country Export-Import Banks and Development Finance Institutions, strengthened trade finance support organizations, and the creation of new financial capacity by setting up investment funds earmarked for South-South trade and investments.

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INTRODUCTION

1. The international community has considered ways of improving financing for developing countries' trade and investment for a long time. Ambitious proposals to create a new "South Bank of Developing Countries" were first made in the early 1980s, and several other similar proposals have been made since. But while such proposals have served to highlight the importance of financing issues and the gaps in existing systems, they have so far not been implemented.

2. This brief paper starts with a review of efforts, since the early 1980s, to strengthen trade and development finance specifically for South-South trade and investments. The first chapter discusses the "South Bank" proposal made in 1981, as well as various other proposals; and it considers other efforts that have been made to improve financing systems, in particular through regional clearing unions and more recently, new multilateral funding facilities.

3. Chapter 2 then looks at the current financing system as relates to South-South trade and investment flows. Given institutional developments, are there still good reasons to make additional efforts to strengthen South-South financing systems? What are the developments that affect the availability and costs of South-South finance? Would the provision of additional facilities be necessarily a form of charity by the fund providers, or should it rather be seen as an alternative investment that can bring good returns compared to the risks taken?

4. Chapter 3 argues that there is a range of options to strengthen South-South finance, options that are not mutually exclusive. These include reinforcing the capacity of developing country commercial banks to deal with non-traditional transactions; strengthening trade finance supporting institutions; building a network of Export-Import Banks and Development Finance Institutions; developing multilateral clearing arrangements; setting up a new dedicated institution; and creating new specialized investment funds.

5. This paper focuses on "commercial finance" – the support of concrete trade and investment activities. It does not address the issue of balance of payment support, which was one of the objectives of the "South Bank" proposed in the early 1980s, and is often (but not always) an important objective of regional clearing unions. Also, an implicit assumption of the paper is that any proposed facility or arrangement should be commercially viable – that is to say, the financing should be at rates commensurate with the risks taken by the lender, and the ultimate provider of the funds should get a return at least as high (adjusted for risks) as what he could obtain through other placements of his funds.

Chapter I
Strengthening South-South trade and development finance: a brief history

A. Creating a "South Bank": proposals, and rationale

6. In 1975 an UNCTAD expert group met to discuss export credits as a means of promoting exports from developing countries. It came up with a proposal to establish an international Export Credit Guarantee Facility (ECGF). The idea was to create an institution with capital coming from both developing and developed countries as well as the World Bank that would guarantee export credit paper issued by developing countries' national export credit agencies and development banks, and then discount those papers at competitive terms in international capital markets. The discussion around the ECGF was quite lengthy and continued taking place in the framework of UNCTAD's CIFT (Committee on Invisibles and Financing related to Trade) until 1983 (see TD/B/552, TD/B/C.3/183 and others).

7. The basic hurdle to the creation of such an institution was that the group of developed countries (Group B) as well as the World Bank were basically not ready to contribute to the capital of such an institution. To their mind export diversification should primarily be the responsibility of developing countries themselves. The main lesson derived from negotiations around ECGF in 1970s and 1980s was that a regional or South bank and/or export and import credit bank or guarantee institution should be primarily endowed by capital coming from the South countries themselves. At the same time, such a bank should be sound enough to be accepted by capital markets on the merits of its solidity in terms of shareholders capital, organisational structure, and professional record of its employees; it was also recognized that even then, these would only lay the necessary foundations with time for a positive track record, which after a number of years would permit the institution to make its export credit paper negotiable at competitive terms.

8. This lack of support from developed countries for a new trade finance facility for developing countries inspired the nature of the discussions in the Summit of Non-Aligned Countries in Havana in 1979. Spurred on by these discussions and then the debt crisis of the early 1980s, the Group of 77 had an intensive debate on the possibilities for strengthening monetary and financial cooperation. In 1981, the possibility of the creation of a South Bank of Developing Countries ("South Bank") was mooted. [1]T This Bank was to have the following objectives:

- to mobilise more resources from the international capital market
- to fill gaps in the structure of international finance, and thereby promote greater resources transfer within the developed countries (including for South-South investments) and ensure better resource utilization among them; and
- to provide financial and technical assistance to its members, particularly in order to increase their absorptive capacity.[2]

[1] See UNCTAD, *First progress report on the technical study of the feasibility of a Bank for developing countries", 1982;* Dragoslav Avramovic (ed.), *South-South Financial Cooperation, Approaches to the Current Crisis -The Jamaica Papers*, Frances Pinter Publishers, 1983; *Report on the South Bank – the Bank of Developing Countries*, Office of the Chairman of the Group of 77, New York, and International Center for Public Enterprises of Developing Countries, Ljubljana, Yugoslavia, 1983; and *Report of the Intergovernmental experts meeting for the study of the feasibility of a bank of developing countries*, Ljubljana, 29 August-2 September 1983, G.77/ECDC/F-5a/83/Rpt.1.

[2] Y.V. Sivaramakrishnayya, "South Bank – rationale for its formation", in V.R. Panchamukhi et al. (eds.), *Money and finance in world economic order*, Indus Publishing Company, New Delhi 1987.

9. The South Bank was envisaged as an institution with a broad mandate: to provide finance for joint ventures and investments in mining and processing; export credit and guarantees; balance of payments support; commodity stabilisation finance; and support to regional payments and credit arrangements. The South Commission, which supported the proposal, suggested however a more gradual approach in developing the different services, starting with export financing and support to payments arrangements.[3]

10. The envisaged subscribed capital was US$ 20 billion, of which US$ 1.5 billion paid-up in convertible currency and another US$ 3.3 billion in other currency.[4] Several possible institutional arrangements were discussed in the early 1980s; initially, the South Bank was conceived as a public-sector intergovernmental institution (with a limited role for participation by the private sector), then discussions shifted to a purely private sector version. No agreement was ever reached on the establishment of the bank.

11. For much of the second half of the 1980s there was no further organized discussion on the issue. In 1989, UNCTAD's Committee on Economic Co-operation among Developing Countries adopted a resolution calling on UNCTAD to undertake a study on the problems of trade financing in developing countries, how to support and strengthen existing mechanisms, and the feasibility of establishing a commercially viable interregional mechanism for financing South-South trade in non-traditional exports.

12. After undertaking this work, in July 1991, UNCTAD organized a meeting of an Expert group on trade financing mechanisms in and among developing countries. The meeting concluded that:

a. Many developing country exporters suffer an acute paucity of foreign exchange resources for trade financing. This paucity of credit exists for all classes of exports, especially non-traditional exports for a wide range of developing countries in different stages of development.
b. In most developing countries there are functional and institutional gaps in the financial infrastructure which cannot be met by domestic resources. Consequently, there are real merits to the idea of establishing an International Trade Financing Facility (ITFF) as complementary to national institutions and initiatives.
c. A facility which finances and refinances in foreign exchange developing country exports can be commercially feasible. It should initially concentrate on short-term credit and increase gradually its medium-term credit. A broadly based shareholding would be highly desirable (the original South Bank initiative planned only for G77 shareholders). The initiative for launching the Facility must come from developing countries and their institutions, public and private. The participation of public and private sector institutions from developed countries, and the appropriate multilateral funding institutions, would be crucial for its success and market credibility.[5]

13. While this proposal was much less ambitious than the previous South Bank proposal (and the proposed capital base was much lower, in the US$ 300 to 750 million range), again, no action was taken to implement the proposals.

[3] *The challenge to the South,* Report of the South Commission, 1990, pages 171-72.
[4] UNCTAD, *Strengthening the weakest link: a review of certain aspects of South-South trade and finance*, October 1985.
[5] Report of the Expert group on trade financing mechanisms in and among the developing countries, TD/B/1313, Geneva, 15 January 1992.

14. In the G77, the idea of creating a G77 Trade and Development Bank remained alive. In the mid-1990s, the G77 decided that such a bank should be established as a mixed public/private sector initiative under the G77 Chambers of Commerce and Industry. Kenya offered to host it, and with its funding, a feasibility study was prepared in 1998.[6] The 2000 South Summit in Havana took note of the initiative, and requested the G77 Chambers of Commerce to submit it for consideration by the governments of the G77. This was done in December 2000; but just five out of 134 countries reacted, of which only two supported further work.

15. On the request of the G77 Chambers of Commerce, a road map was developed by Accenture.[7] The Accenture paper (which was still rather short of detail) proposed a bank with the following characteristics:

- G77 and non-G77 shareholders
- A network ("hub and spoke") approach: accredited agencies would deliver credit and evaluate counterparty creditworthiness, linkages through Internet
- Use of its own monetary unit to reduce need for hard currencies
- Strong role in trade payments, through fiduciary services for trade documentation
- Provision of short-, medium- and long-term finance
- Provision of various types of insurance, including performance guarantees

Yet again, no decision was made on moving forward with the project.

16. The issue continued to be kept on the agenda of G77 discussions. The Eleventh Meeting of the Intergovernmental Follow-up and Coordination Committee on Economic Cooperation Among Developing Countries (IFCC-XI) held in Havana, Cuba, from 21 to 23 March 2005, decided to "establish, in line with the Marrakech decision [taken in a 2003 G77 meeting], an open-ended Intergovernmental Study Group to hold a workshop in New York, on the Trade and Development Bank in May 2005, and to report to the Second South Summit in June 2005, in Doha, Qatar. This meeting indeed took place, from 2 to 3 May 2005, but it provided more questions than answers (24 years after the proposal was first made, delegations still asked for "further study"). Nevertheless, the process may be nearing its end: the Study Group recommended three clear steps that will lead to an unequivocal decision to either move towards implementation, or to drop the idea:

> (i) The Second South Summit mandate a meeting of Finance, Central Bank and/or other experts to consider the proposal including the outstanding issues and make recommendations on the feasibility and viability of the proposed Trade and Development Bank;
> (ii) The Second South Summit request the G-77 Chamber of Commerce and Industry to consult with their members to ascertain their level of commitment including their contribution to the capital of the Trade and Development Bank;
> (iii) The Second South Summit request G-77 Ministers of Finance to meet and consider the outcomes of 2 and 3 above with a view to making a definitive determination of the viability of the Trade and Development Bank.[8]

17. As argued before, the problem of South-South finance is real, it is hurting developing countries' competitiveness and growth, and it is becoming larger. The indecisive debate at the Government level, focussing on just one of the possible solutions, has however held back

[6] Committee of Experts on the G77 Trade and Development Bank, *Proposed G77 Trade and Development Bank feasibility study*, January 1998.
[7] Accenture, *Proposed G77 Trade and Development Bank*, August 2001.
[8] *Open-ended Intergovernmental Study Group workshop on the Trade and Development Bank, Final report,* G-77/OEISG/TDB/RPT, New York, 2-3 May 2005.

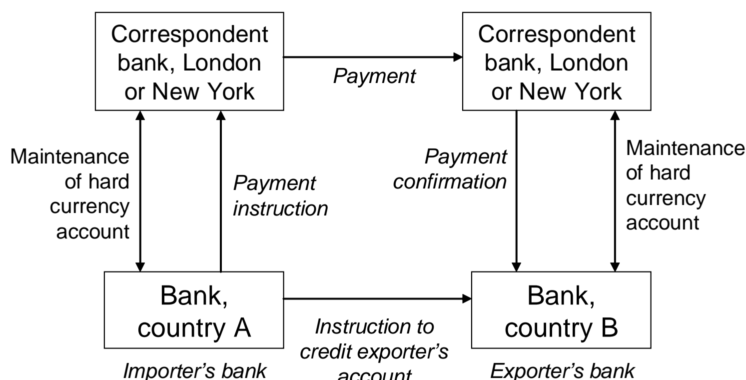
progress on this front. It is perhaps useful for G77 governments to shift some attention to a number of these other, institutionally less cumbersome solutions.

B. Other efforts to strengthen South-South finance

B.1 Regional clearing unions

18. Probably the most widespread forms of South-South cooperation in trade payments at the governmental level are regional clearing unions. They were all based on the successful experiences of the European Payment Union, which was set up in West Europe in 1950 and functioned very successfully for eight years, until economic and export growth made it superfluous. Without such clearing unions, South-South payments and any related financing arrangements traditionally had to pass through western banks. Here both the importer's bank and the exporter's bank would maintain commercial banking relationships with money centre banks (generally in London or New York), and the importer's bank would instruct his correspondent bank to transfer hard currency to the exporter's correspondent bank (see figure 1).

Figure 1
Typical South-South trade payments flow in the absence of a clearing union



19. Such a system forces developing country banks to immobilize hard currency in western banks, which leads to extra costs (fees are up to 1%) and often, delays in payment. A clearing union strongly reduces hard currency requirements: in such unions, payment balances are settled multilaterally with a certain frequency (e.g., once a month), and only net balances have to be transferred in hard currency.

20. Several regional clearing unions have been formed in the past; table 1 gives an overview. As can be noted, not all of them survived. In some cases, governments signed agreements to form clearing unions, but never followed up.

21. In themselves, clearing unions only grant very short-term credits, from one settlement date to the next. However, several clearing unions included explicit financing components: countries were allowed to delay hard currency payments due to other members of the clearing union in the case of balance of payment problems – commercial parties were paid, but there remained a Government-to-Government debt.

Table 1
Regional clearing unions for developing countries

Clearing Union	Creation	Members / website	Status / comments
West African Clearing House (Chambre de Cooperation de l'Afrique de l'Ouest, CCAO)	1975	Members of the Central Bank of West African States as well as other West African countries	Inoperative. Replaced by West African Monetary Union, which so far has not become operational.
Central African Clearing House (CACH)	1982	Principally functioned as a bilateral arrangement between BCEAC and the Bank of Zaire.	After arrears of the Bank of Zaire accumulated, CACH became inactive in 1992.
Great Lakes Economic Community's Monetary Arrangement (CEPGL)		Burundi, DR Congo, Rwanda	Inactive
COMESA clearing house	1984	Members of COMESA (Eastern and Southern Africa) www.comesa.int	Operational
Eastern Caribbean Clearing House (successor to the East Caribbean Currency Authority) The common central bank, "*Eastern Caribbean Central Bank*" works as the clearing house	1983	Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts-Nevis, St Lucia, and St Vincent and the Grenadines www.eccb-centralbank.org	Apart from clearing operations, the organization has mooted the creation of a investment/venture capital fund, which will access domestic and international capital for private sector development
Caribbean Community Multilateral Clearing Facility (CMCF)	1977	CARICOM member countries	Credit lines, by country and with a tenor of up to 6 months, were part of the arrangement. After failure of one member to pay up, CMCF stopped in 1983.
Central American Clearing House (Cámara Centroamericana de Compensación de Monedas)	1963	Guatemala, Honduras, El Salvador, Nicaragua (later joined by Costa Rica)	Was closed in 1996. Used to be backed by a Special Fund to provide liquidity in times of balance of payments problems.
Reciprocal Payments and Credit System	1982	Member countries of Latin American Integration Association (ALADI) www.aladi.org	Backed by multilateral financing facilities to provide liquidity in times of balance of payments problems ("Santo Domingo Agreement").
Asian Clearing Union	1974	Bangladesh, Bhutan, India, Iran, Myanmar, Nepal, Pakistan and Sri Lanka www.asianclearingunion.org	Two-monthly settlement of balances. No credit system.

22. While regional clearing unions make perfect sense on paper, in practice they often faced difficulties. After the onset of the Latin debt crisis, in 1981, one assessment found that "the situation of various payment arrangements, in particular the clearing arrangements, may be termed as very critical."[9] Not only were these arrangements vulnerable to economic crises, they were also plagued by operational problems. For example, the West African Clearing House, now dissolved, had large delays in crediting exporters' accounts owing to cumbersome documentation requirements by central banks; and was not able to obtain agreement of its member states that would have allowed it to provide value-added services, such as a short-term financing facility, or trade promotion instruments like bills of exchange or traveller's cheques. The Central American Clearing House was supposed to promote the use of local currencies in the settlement of intraregional trade deficits; but within a very short period, all such deficits were settled bilaterally in US$ (with European Union support, a system of multilateral clearing was introduced in recent years). A fairly general problem has been that debtor monetary authorities often failed to settle their obligations in time, leading to an accumulation of arrears. And to avoid creditor countries from reducing these arrears by buying commodities and manufactured products in the debtor country for exporting to a third party, debtor countries often reduced the number of goods included in the arrangements in times of crisis.

23. One existing and relatively successful regional clearing union is the Asian Clearing Union (ACU). It was set up in 1974 under the auspices of UN ESCAP, and became operational in 1976. Its objectives were as follows:

- to provide a facility to settle, on a multilateral basis, payments for international transactions among the participating countries
- to promote the use of participants' currencies in transactions between their countries; and
- to promote monetary cooperation among the participants and closer relations among their banking systems

24. As its clearing currency it established the "Asian Monetary Unit" (AMU), equivalent to the SDR. Volume was 22.8 million AMU in its first year of operations, increasing more than tenfold (to 272 million AMUs) in just seven years.

25. In its lifetime, more than US$ 64 billion of exports and imports were routed through ACU. The Governor of the State Bank of Pakistan in the ACU Annual Meeting (May 2005) stated that while there exist some persistent debtors in the ACU system , the ACU has not experienced a default. Their negative net balances have not been large and there has not been a "structural creditor problem".[10] This illustrates that clearing unions can work and provide a useful service, under certain conditions and as long as member governments remain supportive.

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[9] Alfonso Inostroza, UNCTAD, "Payments arrangements of developing countries: summary review of their present situation" report to the High Level Governmental Experts Meeting on the South Bank G.77/ECDC/F-5b/3/84, August 1984.

[10] See BIS, Mr Ishrat Husain, Governor of the State Bank of Pakistan, inaugural ceremony of the 34th Annual Meeting of the Board of Directors of the ACU, Lahore, 16 May 2005. http://www.bis.org/review/r050525g.pdf

B.2 Initiatives by international financial institutions to strengthen trade financing facilities

26. Starting in 1999, multilateral finance organisations have become much more involved in trade finance. The European Bank for Reconstruction and Development (EBRD) was the first, in 1999, to create a trade finance facilitation programme (TFFP), and this example was then followed by several others. Box 1 gives an overview.

27. To some extent, these programmes were a response to trade finance constraints which arose during times of international instability – in the late 1990s, economic crises had led to the reduction or even cancellation of bank or sovereign credit limits, and even profitable import-export operations (e.g., local processing of imported cotton for export of textiles) had become impossible. For example, the Inter-American Development Bank (IADB) introduced a two-year US$ 1 billion "International Trade Finance Reactivation Program" in March 2003. As IADB's President commented, "With this instrument the Bank will be helping countries cut the Gordian Knot of tight or nonexistent credit that is a real obstacle to resuming growth."[11] The International Finance Corporation (IFC) introduced its first dedicated trade finance facility in August 2002, when, as "a response to cutbacks of credit lines from international banks to Brazilian borrowers"[12] it provided a trade finance facility to Brazilian banks. However, in all cases these "emergency" programmes quickly made place for more structural programmes, based on the comparative advantage of the multilateral agency in providing sovereign risk cover rather than as a stop-gap measure to cope with an economic crisis. For example, in the case of the IADB programme, the TFFP expects to support and develop intra- and interregional trade and to help local banks in IADB borrowing member countries establish track records with international banks, thus improving the prospects for their participation in international trade finance.[13]

28. The basic mechanisms of the various TFFP are very similar. The multilateral agency provides guarantees to confirming (international) banks which covers the commercial and political risk of non-payment by banks issuing trade paper – the latter are the banks in "risky" countries, including local subsidiaries of international banks. In other words, the agencies put their own triple-A rating in the place of that of the original issuing bank. Various types of trade paper are covered: letters of credit, promissory notes, performance bonds, etc.

29. The EBRD programme shows the potential relevance of TFFPs for trade in between non-OECD countries. In its TFFP, the number of intra-regional transactions has been growing constantly with more than 130 intra-regional transactions financed in 2003. Examples of trade facilitated by the programme include export of grain from Kazakhstan and Russia to the Kyrgyz Republic and Ukraine, of agricultural machinery from Russia to Kazakhstan, of tractors from Belarus to Moldova, of butter from Lithuania to Uzbekistan, meat from Hungary and tomato paste from Uzbekistan to Moldova.[14] The facility has been successfully used to facilitate wheat exports from Kazakhstan, including to non-traditional destinations. A partial guarantee by EBRD, which supported a US$ 2 MM export consignment of wheat from Kazakhstan to Madeira, helped establish a new export market for Kazakhstan. In 2003 the facility was also used to promote wheat exports from Kazakhstan with a letter of credit issued by Moldova to Kazakhstan for the import of Kazakh grain by a private Moldavian importer. Project financing like the Euro 160 million loan given to a polish hypermarket chain Kaufland Polska to finance its expansion in Central and Eastern Europe is another example of financing towards regional co-operation.

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[11] IADB press release, 5 March 2003.
[12] IFC press release, 3 April 2003.
[13] ADB Annual Report 2004
[14] http://www.ebrd.com/pubs/factsh/themes/trade.pdf

Box 1
Trade finance facilitation programmes of multilateral finance organisations

A) European Bank for Reconstruction and Development (EBRD)
EBRD's TFFP program, which began in 1999 with the objective to promote trade in Central & Eastern Europe and the CIS, has covered about 2,350 trade transactions totaling over €1.4 billion. The TFFP issues guarantees to issuing banks to obtain credit confirmation from foreign correspondent banks, provides uncommitted trade finance lines and short term loans for on-lending to domestic markets.

B) Inter-American Development Bank (IADB)
IADB has had several programmes in place:

- The IADB board approved a US$ one billion "International Trade Finance Reactivation Program" in 2003 to assist economic reactivation and growth in Latin America and the Caribbean through the expansion of international financing.
- 'The Crecera Regional Trade Finance Facility' was set up in August 2004 as a US$ 60 million trade finance fund to provide pre-export and post-export financing to medium-sized exporters in Argentina and Brazil, and subsequently to other countries in Latin America.
- The "ABN AMRO Uruguay Trade Finance Facility" was set up in December 2004 as a partial credit guarantee of US$ 22.5 million to extend pre-export financing to large, medium and small-scale Uruguayan exporters.
- The Banco Bradesco project approved in 2003 was a joint initiative with IFC which provided Bradesco with an IADB 'A' loan of US$ 50 million and an IADB 'B' loan of US$ 60 million. The B-loan structure (in which commercial banks provide loans under a multilateral agency umbrella) was Brazilian government's efforts to persuade international lenders to retain outstanding credit lines to Brazilian financial institutions.
- A US$ 400 million "Regional Trade Finance Facilitation Program" was launched in April 2005 to play a counter cyclical role by providing liquidity to the international trade finance system, particularly during times of economic difficulties.

C) Asian Development Bank (ADB)
In the background of the East-Asian and Latin American financial crisis, the appetite of international banks to take unsecured risk on local banks was severely curtailed. This put pressure on the trade lines with confirming banks limiting trade finance operations. Already in December 2000, ADB approved a "SME Trade Enhancement Finance Project" for Pakistan, which, *inter alia*, guaranteed letters of credit issued by Pakistani banks. ADB's US$ 150 million TFFP was launched in May 2004 to boost the liquidity and stability of the trade finance system in Asia and Pacific. It includes a guarantee facility (for up to 80% of the risk of trade finance instruments issued by participating local banks – this is lower than the percentage guaranteed by the schemes described above), and a revolving credit facility under which ADB provides short-term loans to local banks for on-lending to private sector exporters or importers. For Central Asian Republics, there is a risk sharing agreement with EBRD which guarantees L/C issued by local banks.

D) International Finance Corporation (IFC)
IFC's first significant facility was jointly with IADB, to finance Bradesco in 2003. A year later it introduced an African Oil&Gas Trade Finance Facility, and also a US$ 500 million Global Trade Finance Facility, which targets specifically Small- and Medium Enterprises. This facility brings together a network of local banks issuing trade finance instruments, and then provides IFC confirmation (guarantees) on these instruments. This facility aims to increase developing countries' share of global trade and promote South-South flows of goods and services. The facility provides guarantees and pre-export cash advances to banks in over 70 countries.

30. In another relevant area of trade finance support, the World Bank has led the process of development of the African Trade Insurance Agency (which started functioning in 2003), and the Asian Development Bank has worked on a business plan for a new Asian Political Risk Insurance Company, to fill market gaps for political risk insurance in Asia.

31. ATI, for example, is meant to become an African-wide institution (even though currently it is mostly covering Eastern and Southern Africa), set up specifically to improve the terms of trade finance for imports into and exports from its African member countries. It does so by making political insurance readily and cheaply available, with cover provided, inter alia, for inability to convert or transfer currency; imposition of exchange controls; cancellation of licenses/restrictions on import/export; and, seizure of goods, prevention of sale, or of export.

Chapter II
Are there good reasons for strengthening South-South finance in today's world?

A. Rapid growth of South-South investment and trade flows

32. As a direct result of the relatively fast growth of the economies of developing countries, during the 1990s, South-South trade grew twice as fast as North-South and South-North trade. Since, the rate of growth has accelerated, and the difference has become even more pronounced: the South-South trade from 2000 to 2003 was14.2%, compared to 5.2% for world trade as a whole. And given the spread of Regional Trading Arrangements especially those involving developing countries (see table 2) and of South-South investment treaties[15], pressure on developing countries to reduce import tariffs, as well as the continuing integration of worldwide markets, this fast growth is likely to continue.[16]

33. While driven by rapid growth of demand in China and India, the increase of South-South trade is a generalized phenomenon. Within each developing region and among developing regions, and for virtually each category of commodities and manufactured goods, growth of South-South trade has been faster than growth of world trade for that category.

34. Developing country companies are increasingly important international investors. As a result, South-South FDI has been growing fast (see table 3). Many developing country firms are now actively looking for investment opportunities in other developing countries. With the exception of commodities (principally oil, minerals, timber and pulp), they tend, however, to invest in neighbouring countries.

Table 2
Notified RTAs in goods by the date of entry into force and type of partner

	1958-78	1980-99	2000-02	2003-05	Total
Developed-Developed	7	9	0	2	**18**
Developed-Developing	4	12	11	9	**36**
Developed-Transition	0	4	4	0	**8**
Developing-Developing	5	13	8	4	**30**
Developing-Transition	0	3	2	2	**7**
Transition-Transition	0	21	5	16	**42**

Source: WTO

[15] Bilateral investment treaties (BITs) signed between the governments of two "developing" countries represent the largest portion of BITs signed in recent years. They are similar to the North-South BITs in terms of setting new policy standards and privileges for transnational corporations. They can be used by companies to set up operations in one of the parties and conduct business in the other under favourable terms. UNCTAD is developing perhaps the most comprehensive HdatabaseH of South-South BITs available online. See http://www.unctadxi.org/templates/DocSearch____779.aspx

[16] See *International trade negotiations, regional integration and south-south trade, especially in commodities*, Hhttp://www.unctad.org/en/docs/ditctncdmisc20043_en.pdfH; and *Some key issues in south-south trade and economic cooperation: outcome and papers presented to the workshop on trade, Doha High-Level Forum on Trade and Investment*, Doha, Qatar, 5-6 December 2004.

Table 3
Estimation of South-South FDI flows, 1994-2000

	1994	1995	1996	1997	1998	1999	2000
Billions of US$	4.6	15.3	25.0	57.4	56.6	49.7	53.9
As % of total FDI flows to developing countries	6.0	16.2	22.3	38.7	36.8	31.0	36.4

Source: Dilek Aykut and Dilip Ratha, "South-South FDI flows: how big are they?", *Transnational Corporations*, Vol. 13, No. 1 (April 2004)

35. This rapid growth of South-South transactions is putting strains on financial networks. For trade finance, the exporter, or his bank, has to take financial risks towards an importer in a country that is likely to have a high credit risk, and for which risk insurance facilities may not be readily available. For investments, longer-term risks are taken, again often without the benefit of proper risk mitigation tools.

B. Finance as a bottleneck

36. It is widely recognized that there are "credit gap" and "funding gap" issues for developing countries, and also for countries with economies in transition. "Export financing has long been considered a key element in determining the competitiveness of regional suppliers. However, the dearth of trade-financing facilities is a hallmark of many developing countries and this has been a major weakness which has adversely affected the development of South-South trade."[17] Or according to a recent assessment of the Asian situation: "Since the Asian financial crisis in the late 1990s, banks are more careful taking on medium- to long-term export finance assets notwithstanding ECA cover. The impeding Basel 2 regulations may exacerbate this trend."[18]

37. Weaknesses in financing structures for developing countries are not just felt by governments, but also by bankers (including western bankers, who are often unable to do proposed transactions because their own bank's credit ceilings for the country or sector concerned have been exhausted, and there is no available capacity in the market). For example, in 2003, the Asian Development Bank was approached, independently, by two major international banks proposing cooperation in addressing problems in the short term, medium- to long-term export credit market.[19] The trade finance support facilities created by multilateral agencies, discussed in section B.2 in the previous chapter, were responses to expressed needs of the financial market place.

38. For export flows to OECD countries, international and local banks are generally able to mitigate risks, and are thus more willing to provide pre-export and particularly, post-shipment finance. But for non-traditional goods or goods destined for non-OECD markets, the situation is different. As is noted in a paper prepared for UNCTAD by the Export-Import Bank of Korea, "existing sources of trade finance for traditional products into traditional markets are not as readily available for non-traditional markets. This is particularly significant when considering the

[17] United Nations General Assembly, *Operational activities for development: economic and technical cooperation among developing countries: State of South-South cooperation - report of the Secretary-General,* A/50/340, 11 September 1995.
[18] *Concept paper on the creation of a regional export credit and finance scheme*, submitted by International Financial Consulting to the Asian Development Bank, April 2004.
[19] idem.

potential of South-South trade, for which there is little financing capability in place at either the importing or the exporting end."[20]

39. Another problem is that the availability of trade finance is affected by political and economic developments. Financing facilities can rapidly disappear in times of crisis. "An analysis of the implications of recent financial crises affecting emerging economies in the 1990's points to the failure by private markets and other relevant institutions to meet the demand for cross-border and domestic short-term trade-finance in such periods, thereby affecting, in some countries and for certain periods, imports and exports to a point of stoppage. These experiences seem to suggest that there is scope for carefully targeted public intervention, as currently proposed by regional development banks and other actors, which have put in place ad-hoc schemes to maintain a minimum flow of trade finance during periods of scarcity, through systems of direct credit or credit guarantees."[21]

40. Developing countries have recognized already that finance is a bottleneck, and that cooperation can be to their mutual benefit. This is evident in initiatives taken by organizations such as the Andean Development Corporation, the regional development banks in the Asian, Latin American and Caribbean regions, the ASEAN-Japan Plan of Action, and the Arab Fund for Economic and Social Development, to improve trade financing for regional trade.

C. Basel 2 and other developments affecting the availability and costs of South-South finance

41. Basel 2, the international standard for banking regulation with its thrust on capital regulation[22] is indisputably changing the conduct of banking business. The new standard changes credit risk management, which leads to a re-defining of the very basis of credit delivery.

42. Credit ratings as indicators of risk profiles are becoming a key ingredient in the credit risk assessment process. Here, Basel 2 proposes two approaches: the standardised approach where *external* ratings are used (including ratings by Export Credit Agencies) and the Internal Rating Based (IRB) approach where banks depend on their own internally developed measures for assessment. Given that both approaches demand more capital to be set aside for loans to poorly rated borrowers, banking relations with developing country clients will be put under strain and in many cases, may even be severed.

43. The situation for developing countries is worsened because many of them have virtually no credit infrastructure. As banks sieve for higher grades, such countries will simply be over-looked. E.g., in 2002, only 150 out of 80,000 registered corporates in Argentina had a rating. As proclaimed by the Bank of Guyana "having no rating agencies in Guyana and the Caribbean may subject banks to higher capital charges vis-à-vis those countries that have such agencies." This puts a heavy burden on companies and limits their possible banking counterparts: companies with

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[20] Jaimin Lee, *A prototype model of a trade finance facility in developing countries: an Export-Import Bank*, UNCTAD/ECDC/256, 1 July 1996.

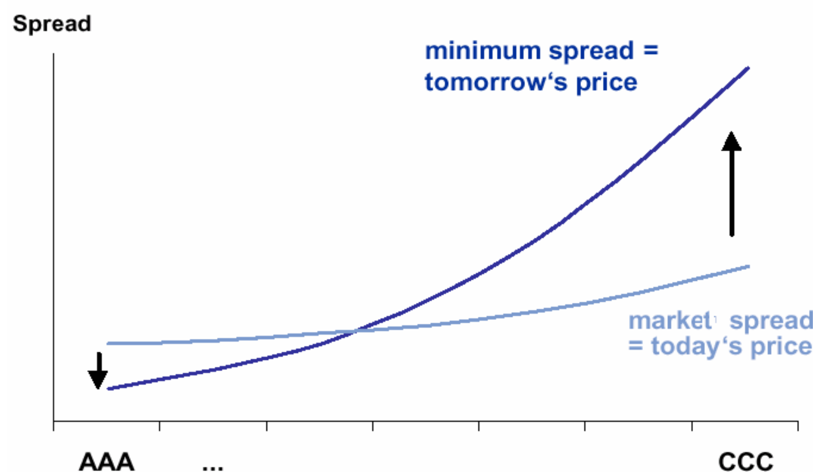
[21] Marc Auboin and Moritz Meier-Ewert, *Improving the Availability of Trade Finance during Financial Crises*, World Trade Organization Discussion Paper, 2003.

[22] Capital regulation, as under Basel 2, urges banks to set aside capital for the market, credit and operational risk they bear. The adequacy of capital is measured by the capital adequacy ratio (CAR), represented as regulatory capital upon risk weighted assets. See for a discussion of its likely impact on lending to developing countries UNCTAD, *Basel 2: the New Basel Capital Accord and its impact on commodity financing in developing countries,* forthcoming.

no rating or non-investment grade rating need to ensure that the banks they are dealing with will give them right treatment for perfectly "secured transactions" or would know how do to structured deals to secure trade transactions; and they also need to ensure that these banks are allowed, by their regulators, to set aside less capital because of the reduced risk.

44. While many factors, including the nature and extent of banking competition, influence interest rates, the capital that banks have to set aside for their loans has a major impact. With the IRB approach, as credit ratings become lower, the increase in capital requirements is exponential. For example in the IRB approach, while a downgrade from a AAA rating to a AA rating leads to an increase in risk weight of 21% a similar downgrade from a BBB rating to a BB rating could lead to an increase in risk weight by as much as 845%.[23] Figure 2 illustrates the likely impact on interest rates.

Figure 2
Impact of Basel 2 on lending costs for variously rated borrowers



45. Developing country governments and their banks have a number of possibilities to mitigate the negative impact of Basel 2 on credit availability and interest rates for their countries's firms. Bank regulators need to adopt a pro-active approach, and for this to be acceptable to the western financial markets, a concerted approach is highly desirable. Policy makers need to improve their legal and regulatory regimes for commodity finance, and in particular, for structured finance. [24] Developing country banks need to invest in the information required to assess risks, and in the skills and systems to develop structured finance schemes.

46. There are several other developments that affect the availability and costs of finance for South-South trade and investment finance, some positively, others negatively.

The principal positive factors:

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[23] See, BCBS (2001), The New Basel Capital Accord: The Internal Ratings Based Approach

[24] A checklist is available in *Nicholas Budd, Legal and regulatory aspects of financing commodity exporters and the provision of bank hedging line credit in developing countries,* UNCTAD/COM/56, 3 February 1995.

- Financing skills in developing country banks are improving. Since the late 1990s, several banks have been developing expertise in factoring, forfaiting, project finance and structured trade finance, which will make it easier for them to structure South-South financings (which are inherently more complex than North-South and South-North financings).
- Some key trade support institutions, and in particular collateral management agencies, are since two or three years improving their capacity to support South-South transactions. A bank in, say, Vietnam, will thus no longer be required to be able to evaluate the creditworthiness of a buyer in, say, Guinea when providing credit for rice exports: the risk can be laid off on a collateral management agency.
- The government export credit and credit insurance agencies in several developing countries are pro-actively developing new financing facilities for South-South trade. These can at times be very large – e.g., China's Eximbank recently gave a US$ 5 billion credit line to Angola. India's Eximbank has agreements with banks not just in other Asian countries, but also in Latin America, Eastern Europe and Africa.
- Western banks with large international networks have built up their capacity to service transactions between their subsidiaries in developing countries (Citibank and Standard Chartered may now well be the largest financiers of South-South trade). As little as five years ago, they were, by and large, unable to use their branch network to support South-South trade (and indeed, some of the smaller banks with offices in several developing countries are still in this situation). Western banks are also making continuous efforts to open up new interbank credit lines for developing country banks.
- The international community has started to provide trade finance facilities, which though not dedicated to South-South trade, can be used for this purpose (see box 1).
- Capital market investors (pension funds, private banks and the like) have started to invest in hedge funds that specialize in financing trade flows into non-OECD countries, including South-South trade.

On the negative side:

- Trade finance for commodities used to be less complicated, as trade (both exports and imports) was in the hands of state-owned enterprises, who often had a monopoly. Liberalization and privatization in the 1980s and 1990s has, however, radically changed this situation. While it is quite straightforward to finance a monopoly cocoa exporter like the Ghana Cocoa Board, it is much more difficult (and risky) to finance a series of privately-held cocoa exporters with little or no track record, each of whom might be unable (because of competition) to actually buy the cocoa that the bank is financing.
- Greater competition, driven by a number of factors including improved information flows, means that profit margins are down. Relatively small shocks and operational problems can thus eliminate profits, and endanger the ability of a borrower to reimburse his lenders. This forces banks to take more control over the actual transaction, and mitigate to the extent possible the implicit risks; and this is much easier to do for traditional trade flows than for South-South trade.
- The fast growth of South-South trade and investments is putting itself a strain on financing availability. Banks allocate their funds in a very systematic manner, with specific credit ceilings for specific countries, industries and clients. These credit ceilings are determined by portfolio considerations rather than by the demand for credit. Banks are thus unlikely to re-allocate capital from, say, OECD country lending to developing country lending even if the demand for the latter increases fastest.
- Banks have gone through a fairly radical process of mergers and acquisitions, and there are many less banks active in developing countries than a decade ago. In a merger, the credit ceilings of the merged banks for a specific country is unlikely to be the total of the

country credit ceilings of its two constituent banks: rather, it is likely to be little or no higher than the credit line that the most "generous" of these two banks previously had in place. In other words, the process of bank mergers and acquisitions has strongly reduced country credit ceilings.[25]

47. On balance, however, the perspective is rather bleak for developing countries, or at least the vast majority of them which do not have investment grades. Unless if new facilities are introduced (and the facilities introduced so far by multilateral finance institutions are not yet sufficient), access to finance for their companies will become scarcer, shorter-term, more pro-cyclical, and more expensive.

D. New facilities: a win-win game or charity?

48. Any proposal to improve financing flows to developing countries should be evaluated in terms of need, usefulness and costs. Does the proposed scheme create a real value-added, as compared to currently available institutions and mechanisms? Is the proposed institutional arrangement the most effective and does it provide the best possible cost-benefit ratio?

49. In particular, the countries that are asked to provide the funds (or think they will be asked) wonder whether the proposal is as good for them as its proponents argue (the "South Bank" proposal and all others argued that these would be commercially viable schemes and capital providers would not be subsidizing the operations), or whether in reality, they stand to loose their money. For example, in 1984 during the discussions on the South Bank, Saudi Arabia produced a 26-page feasibility study which argued that the proposed Bank was not only unworkable, but also irrelevant[26] - existing channels were already more than enough to absorb "available resources of co-operation" (in other words, Saudi Arabia felt it was asked for development grants, rather than being offered a profitable investment opportunity).

50. There are, however, good *prima facie* reasons to believe that it can be profitable for developing countries to invest part of their capital in improving South-South trade and investments. For example, several capital market funds have been set up in recent years to invest in trade and investments in developing countries. Most of these funds are focused - on a certain region and/or sector, trade transactions, emerging country stock markets, equity investments, etc. Their returns have generally been rather good, as compared to the risks taken. For example, the largest fund that focuses on trade transactions has had, since its inception in 1996, an average annual return of 8%, with not a single month with a return less than 0.6%. The funds that focus on less liquid markets (e.g., long-term infrastructural investments) target returns of more than 20% a year, and by and large have realized their target returns. The investors in these funds are largely western institutions (one notable exception are Arab investments, including by the private sector – with US$ 50 million from Sheikh Mohammed Al-Amoudi in the AIG African Infrastructure Fund). Developing country funds are generally invested in low-earning assets in the OECD, which are perceived to be safer.

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[25] For a discussion on how banks determine country credit ceilings, see UNCTAD, *Counterparty and sovereign risks: issues involved, problems and possible solutions*, TD/B/CN.1/GE.1/3, 2 August 1994. For a discussion on how such ceilings impact on trade finance, including for South-South trade, see UNCTAD/FAO, *Mechanisms for financing imports of basic foodstuffs by net food-importing developing countries and possibilities for improvement,* FAO, Rome 2003.

[26] Talif Deen, "Group of 77 sets up economic and legal structure for South Bank", *Special United Nations Service (SUNS),* No. 1169, 24 January 1985.

51. It would be good business for developing country investment managers to invest some of their funds in developing country risk.[27] Not only do these bring higher returns (as also discussed in the previous chapter), but also they would serve to diversify their portfolio and thus, reduce their investment risk (as a rule of thumb, research has found that a portfolio which includes an optimal portion of developing country investments has a risk that is some 20% lower than that of a portfolio which includes only developed country investments).

52. The principal reason for the attractiveness of funding developing country borrowers (the good risk/reward ratio that one can obtain) has to do with imperfections in the psychology of the capital market. Once, IBM had an advertisement slogan saying that "no one ever got fired for buying IBM". A similar safety-in-tradition argument applies to institutional investors and bankers. This provides interesting opportunities for those less affected by tradition, and more open to making objective risk/return assessments.

53. If it is indeed attractive, in principle, for developing countries to place some of their capital in financing facilities for South-South trade and investments, the question becomes how this can best be done. This will be discussed in the next chapter.

[27] Indeed, one could argue that in the current period of high oil prices, oil exporting countries should use their windfall earnings not to put them into western bank accounts at a low rate of return, but should create investment funds in particular to finance infrastructure development. See UNCTAD, *Boosting Africa's growth through re-injecting "surplus" oil revenue - an alternative to the traditional advise to save and stabilize,* forthcoming.

Chapter III
Options for strengthening South-South finance

54. As is argued in the previous chapter, there are considerable weaknesses in the current systems for financing South-South trade and investment flows. Remedying these weaknesses can be a profitable business, and would have positive externalities for all the countries involved. However, as with any market failure, there are reasons why "the market" has not yet jumped into the gap. These reasons have to do firstly, with the organizational difficulty of setting up mechanisms for South-South trade and investment finance, and secondly, with the perception of developing countries as risky places in which to provide finance (a perception shared even within these countries).

55. In general terms, then, one can strengthen South-South finance firstly by capacity- and institution-building; and secondly, by convincing potential financiers to overcome unwarranted perceptions of risks and put a larger part of their portfolio in South-South transactions. Concrete policy options fall in either one, or sometimes both of these categories. These options are not mutually exclusive, but rather, in several cases mutually reinforcing. Among the possibilities for action:

- Strengthening the trade and development finance institutions in the South – e.g., governments can improve the risk-taking capacity of export credit agencies by making extra capital available.

- Enhancing capacity- and institution-building efforts. Such efforts are an important pillar of UNCTAD's work in the commodity and trade finance area. UNCTAD has built up a considerable body of materials on structured financing techniques, materials that are used by many developing country banks.[28] Such techniques are well-suited to the financing of non-traditional trade flows, including South-South.

- Strengthening trade finance support agencies, such as collateral management agencies, rating agencies, and political risk insurance facilities. UNCTAD has been instrumental in setting up a large collateral management agency in India, and has formulated proposals for the creation of a pan-African collateral management agency. Another trade-finance-supporting institution is commodity exchanges; sometimes these can directly link capital market to export sectors (this is the case in Colombia and Venezuela), but more generally, the price discovery services and marketing opportunities that they offer facilitate regional trade. UNCTAD has been actively supporting the development of new commodity exchanges in developing countries and countries with economies in transition, including a pan-African commodity exchange.[29]

- Improving the capacity of developing country commercial banks to work together. There are several efforts in this direction, including a UNDP-supported programme to rate

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[28] See, for example, UNCTAD, *Potential applications of structured commodity financing techniques for banks in developing countries*, UNCTAD/ITCD/COM/31, August 2001; Emmanuelle Moors, *Structured Commodity Finance: A Comprehensive Guide to Structured Techniques and Applications.* Euromoney/UNCTAD, December 2003; and UNCTAD, *Financing commodity-based trade and development: innovative agriculture financing mechanisms*, TD/B/COM.1/EM.24/2, September 2004.
[29] In the agreement establishing the African Economic Community (the predecessor of the African Union), such a regional exchange is mentioned as one of the key "instruments of integration" for Africa (Abuja Treaty, 1991, article 46(d)). This has been reiterated in several later African Union meetings.

countries (if a country is rated, it becomes much easier to rate the institutions within this country), and multilateral facilities that, in effect, "endorse" certain developing country banks (see box 2 for an overview).

- Bilateral initiatives to enhance financing systems for trade with certain countries. For example, Malaysia has signed "Bilateral Payment Arrangements" with several developing countries and countries with economies in transition. Several Eximbanks have taken similar initiatives.

- Improving the capacity of developing country Export-Import Banks and Development Finance Institutions to support South-South trade and investment flows. This option, and the three following ones, is discussed in more detail below.

- Strengthen the capacity of developing country companies to import from other developing countries using their own currency, rather than hard currency. This would be through the strengthening of regional clearing unions and enhancing their cooperation, or through the creation of a new multilateral clearing union.

- Create a new bank dedicated to the financing of South-South trade and investments.

- Set up new capital market funds to invest in South-South trade and investments.

A. Building a network of Export-Import Banks and Development Finance Institutions

56. When discussions on the creation of a new financing facility for South-South trade and investment started, in 1981, there was definitely an institutional weakness in the international system with respect to such trade and investment flows. There were only a few developing countries and regions with export-import bank or export insurance agencies, and those which existed had limited operations in terms of size, and in terms of the trade flows that they covered (often, only "non-traditional" exports to OECD countries).

57. As was noted in a 1991 UNCTAD paper on the need for developing countries to cooperate in order to remedy trade finance problems, "while it is possible to effect such cooperation at the national or regional levels, interregional cooperation promises more benefits, savings, cost advantages and possible additionalities." This assessment remains valid. However, the political will for interregional cooperation has so far been weak, and the problems of trade finance have remained important. It is therefore not surprising that developing countries have opted for national and regional initiatives. As the table below shows, more than one-and-a-half as many export credit agencies were established in non-OECD countries after 1990 as were in existence before (in most OECD countries, such agencies date from before 1980). Also, the role of these institutions has evolved, both in terms of the amount of trade they finance and in terms of the facilities that they provide.

58. The institutional context for South-South finance is therefore now very much different from the early 1990s, let alone the early 1980s. In the early 1980s, one virtually had a *tabla rasa,* and in the early 1990s, the coverage of South-based export credit agencies was far from comprehensive. Proposals that would have filled a vacuum in the 1980s and 1990s now would inexorably lead to duplication and overlap (see table 3 and box 2 below): there are many more agencies, and they provide many more services to South-South trade and investments.

Table 3: principal export credit agencies outside of OECD, and their years of establishment

Region / Country	ECA (current name)	Year of formation
Africa	- African Export-Import Bank (Afreximbank) - African Trade Insurance Agency (ATI)	1993 2001
Algeria	Compagnie algérienne d'assurance et de garantie des exportations (CAGEX)	1996
Andean countries	CAF, Andean Development Corporation	1967
Arab countries	Arab Trade Financing Programme	1989
Argentina	Banco de Inversión y Comercio Exterior	1991
Black Sea region	Black Sea Trade and Development Bank	1992
Brazil	BNDES Bank	1952
Central America	Banco Centroamericano de Integracion Economica (BCIE-CABEI)	1961
China	The Export-Import Bank of China	1994
Colombia	Bancoldex - Banco de Comercio Exterior de Colombia	1992
Eastern and Southern Africa	PTA Bank	1984
Hungary	Hungarian Export Import Bank	1994
India	Export Import bank of India	1982
Indonesia	PT Bank Ekspor Indonesia (Persero)	1999
Islamic countries	Islamic Development Bank	1974
Jamaica	National Export Import Bank of Jamaica	1986
Jordan	Export & Finance Bank	1995
Latin America	Banco Latinoamericano de Exportaciones (BLADEX)	1977
Malaysia	Export-Import Bank of Malaysia Berhad	1995
Mexico	Bancomext	1930s
Nigeria	Nigerian Export-Import Bank (NEXIM)	1991
Oman	Export Credit Guarantee Agency	1991
Pakistan	Pakistan Export Finance Guarantee Agency Ltd.	200
Philippines	Philippine Export-Import Credit Agency (PhilEXIM)	1977
South Africa	Credit Guarantee Insurance Corporation of Africa Limited	1956
Thailand	Export-Import Bank of Thailand	1993
Trinidad & Tobago	Export-Import Bank of Trinidad and Tobago	1998
Turkey	Türk Eximbank	1987
Venezuela	Foreign Trade Bank (Bancoex)	1997
West Africa	Ecobank Transnational Incorporated	1985
During the 1990s, new ECAs were also set up in Bosnia, Bulgaria, Czech Republic, Moldova, Poland, Romania, Russia, Slovakia, Slovenia.		

Box 2

Overview of Exim-bank of India's trade and investment financing facilities (Lines of Credit) with developing and Eastern European countries

1988	1992	1999	2000	2001	2002	2003	2004
							Angola
							Trinidad & Tobago
							Venezuela
							Poland
							Kazakhstan
		Zimbabwe	EADB				Brazil
		ADB	EBRD			Hungary	Suriname
					Iran	Sri Lanka	Sudan
		PTA	Tunisie		Romania	Ghana	WADB
Mexico	CAF	Namibia	Thailand	Colombia	Seychelles	S.Africa	Zambia

Export finance for:

Trade | Investments

CAF(Andean Development Corporation), ADB (African Development Bank) , PTA(Eastern and Southern African Trade and Development Bank) , EADB(East African Development Bank), EBRD(European Bank of Reconstruction and Development), WADB (West African Development Bank)

59. There are undoubtedly still many lacunae in the South-South financing system. But the number of institutions is now sufficiently large, and their scope of operations sufficiently meaningful, for them to act as a base for a much stronger South-South financing system.

60. This was the reason for UNCTAD to take the initiative in facilitating the creation of a Network of Export-Import Banks and Development Finance Institutions (DFIs). This idea was launched at the UNCTAD XI Conference in Sao Paolo, Brazil, in June 2004, and was endorsed at the Doha High Level Forum on Trade and Investment in December 2004, which decided that the Network should be supported and consolidated. There is strong pressure on eximbanks to augment their services, not only in terms of the directions of the trade flows that they support, but also in terms of the products that they offer. Today, many eximbanks and related institutions are not only performing their traditional role of providing export and import credits but also offer a gamut of other products. They act as a trade financing institution, a commercial export insurer, a foreign investment catalyst and a project finance expert and provider of early support to emerging niche markets. In many developing countries, they play a crucial role in creating export capacity.

61. These institutions need to continue adapting to the increasing pressures they face. Greater cooperation among them can provide valuable assistance in this regard. Having a regular forum for meetings and interaction will enable the development of mutually beneficial relationships, the identification and adoption of best practices, and a better response to new trends and needs.

62. There is much bilateral cooperation between Exim Banks, from exchange of information to technical assistance, from co-financing agreements to bilateral letter of credit confirmations. In Asia, official export credit agencies have been organizing annual meetings since 1996, which have resulted in a series of new bilateral agreements between participants as well as a multilateral letter of credit confirmation facility. But while there is an international organization of export credit insurers (the Berne Union), there has so far not been an organization bringing together worldwide official export credit agencies.

63. Several eximbanks and DFIs signed a Memorandum of Understanding in March 2005 calling for the creation of a formal network, and in cooperation with these institutions, UNCTAD will work on this in the course of the year. The network will have the following functions:

(a) Promote cooperation and common understanding of the various issues related to trade and project financing among its members;

(b) Facilitate the flow of information among its members, including through the strengthening of information systems at the national, regional and international levels, and through the organization of regular meetings;

(c) Disseminate relevant specialist knowledge made available by UNCTAD and other international organizations;

(d) Share country and regional experiences and best practices in trade and project finance, including those relative to services and Small and Medium Enterprises (SMEs);

(e) Assist its members in benefiting from technical assistance through the Global Network's sponsored research work on various policy issues, new trends and opportunities, innovative financing mechanisms, and common problems and challenges facing its members; as well as SMEs development and competitiveness;

(f) Help its members benefit from capacity building and training services through the Global Network's sponsored events, study tours, internships, or by way of referrals to relevant international or multilateral agencies;

(g) Assist members in exploring various cooperative arrangements, such as co-financings and joint operations;

(h) Assist, on request, members in the structuring and implementation of export or import financing transactions.

B. Multilateral clearing arrangements

64. One proposal that has been floated from time to time is to intensify links between existing regional clearing arrangements, or even, to create a new multilateral clearing arrangement.[30] The G77 has repeatedly explored the issue. For example, the G77's "Bali Plan of Action on the Regional and Sub-Regional Economic Cooperation of the Developing Countries"[31] calls for a common payment system within and between sub-regions. Negotiations have taken place between some regional clearing unions (e.g., between the ALADI Central Bank and the Central American Monetary Council), but so far without success.

65. The general consensus is that the idea of creating a global South-South payments arrangement is too ambitious, but that possibilities for greater cooperation between existing regional clearing unions should continue to be pursued. If financing arrangements can be linked to such cooperation (so that outstanding balances can be temporarily finance by third party resources), meaningful linkages would become feasible.

C. Creating a new South-South Trade & Development Bank

66. The financing gap for developing country exporters, importers and investors is serious, and the need to do something about it is felt widely. Calls for setting up a new institution to deal with the problem are perhaps a logical result, and it is not just governments and NGOs who have this reflex. For example, in a paper presented in 2000, a senior manager of ABN AMRO bank, one of the world's largest commercial banks, called for a "Multilateral Emerging Market Export Credit Agency" (EMECA).[32] He noted that developing countries are strongly debt constrained, and that their exporters suffer from poor availability of, in particular, medium- to long-term finance. Even if a country has an Export Credit Agency, it tends to focus on short-term supplier credits. The implementation of Basel 2 will only worsen credit constraints. Setting up a high-rated "EMECA" would make it possible to overcome this constraint, and create a more level playing field for developing countries in international trade. By using proper risk mitigation techniques, EMECA could obtain high leverage for its operations. The ABN AMRO manager concludes that "EMECA is key for sustainable development of emerging markets".

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[30] This latter idea was first mooted by John Maynard Keynes, and became popular again among NGOs in the first part of the 2000s.
[31] http://www.g77.org/docs/Bali%20plan%20of%20Action.htm
[32] Paul Mudde, "A multilateral emerging market ECA: a key driver for sustainable development", *Export Credit and Political Risk Conference,* London, February 2000.

67. Similar proposals have been made at the regional level – e.g., for a "Regional Export Credit Agency" in Asia.[33] One valid argument made in respect of this latter proposal is that "An interesting paradox is that the developing countries in Asia invest their forex reserves in AAA rated banks and institutions in OECD countries earning marginal returns, while Exim Banks from these developing countries borrow from these OECD markets at much higher rates of interest."[34] Having a regional ECA in which part of forex reserves can be invested would "cut out the middleman", and thus allow higher returns to Asian investors, while reducing the interest rates paid by Asian borrowers.

68. Nevertheless, one should keep in mind that while creating a new institution may seem like the simplest way to fill the gap, in effect, there are alternatives: new mechanisms and institutional arrangements, rather than new institutions.

69. Creating a new bank is a large undertaking. The bank will need sufficient capital to be taken seriously; it will need to meet the technological and organizational requirements of modern banking, have commensurate level of staffing; and importantly, it will need to develop a meaningful network, both with prospective clients and with other banks. But new banks do get created from time to time, and if a good business case can be made for setting up a bank focusing on the specific South-South niche, then lack of precedent, or even, negative precedents (given the experience with the Bank of Credit and Commerce International, BCCI, which profiled itself as a commercial bank of and for the developing world), should not prevent potential financiers from giving it serious consideration. If such a bank is to be set up, it could be advisable to give it the statute of a multilateral Export Credit Agency, as under the rules of the New Basel Capital Accord (Basel 2), ratings given by such agencies will become highly valuable.

70. However, it should be noted that compared to alternatives that do not lead to the creation of a new Bank, proposals for a new "South Bank" or for new regional banks in developing countries suffer from one inexorable problem, and that is ironically Basel 2. As discussed above, Basel 2 will strongly affect the availability of finance to developing countries and the costs of such finance, and makes it more than ever necessary for developing countries to find new ways to improve their trade and investment finance mechanisms. But if one creates a new Bank, this Bank would be affected by Basel 2 in very much the same way as existing banks (while there would not be a legal obligation to this effect, if the new Bank does not follow Basel 2 rules it will be unable to work with money centre banks). It is doubtful then that such a new Bank would make much of a difference. If developing countries decide to allocate some of their resources for supporting South-South trade and investments, it may be a better option to chose other institutional arrangements, that of capital market investment funds (not regulated under Basel 2). This option will be discussed in the next section.

D. Creating new capital market funds for South-South trade and investment finance

71. In some ways, the difference between setting up a new bank and setting up a new capital market fund is not that large. In both cases, it entails additional capital being allocated for financing South-South trade and investments. But the operational differences are significant. In the first case, one needs to set up a large new organization that will be heavily regulated; in the

[33] Rahul Sen (ed.), *Regional Economic Integration – Case for a Regional Export Credit Agency for Asia*, Insitute of Southeast Asian Studies/Capital Publishing Company, 2005.
[34] Introduction by T.C. Venkat Subramanian, Chairman and CEO of Eximbank of India, in Rahul Sen, *op.cit.*

second, one expects to rely largely on existing risk analysis and finance distribution tools, and the organizational burden is much less (for example, the largest capital market fund specializing in emerging market trade finance has only 20 staff of all categories).

72. The capital market has developed considerably in recent years, and there are now many possible modes of operations for capital market funds – with different risk profiles, different tenors, different entry and exit conditions for investors, etc. One advantage is that one can quite easily structure funds that are compatible with Islamic principles. There now is somewhat of a scarcity of good investment vehicles for Islamic investors – lacking many alternatives, much money for example used to be placed in USA real estate projects. One can even replicate the functioning of an Export Credit Agency through a capital market solution: an interesting model in that regard is that of New Zealand's new "virtual" Export Credit Agency: the government only provides risk capital, but risk analysis and operations are outsourced to the Danish ECA.

73. Probably the most viable model is to have a number of investment vehicles specializing in different aspects of South-South trade and investments (for example, trade finance; Islamic trade finance; infrastructure finance, perhaps with funds for each of the regions; small- and medium-enterprise finance; Islamic project finance); and one "superfund" which can invest in these various investment vehicles, and thus provide a maximum amount of portfolio diversification for the most risk-averse investors.

74. There is, of course, a risk that absorption capacity in emerging markets would fall short of that necessary for the proper investment of all these new funds. In this respect, actions to increase this absorption capacity (e.g., through capacity-and institution-building including focusing on local banks, and by developing the network of Export-Import Banks and Development Finance Institutions) would be useful.

E. Conclusion

75. When speaking about deficiencies in financing for South-South trade and investments, one deals with two different problems: weaknesses in institutional capacity; and insufficiency in financial resources. Any serious effort to address these financing deficiencies has to tackle both sets of problems. Setting up a "South Bank" would seem a convenient albeit somewhat optimistic shortcut, but this is not the only option. It may be equally, if not more effective to have a combination of policies and technical assistance. These would focus, on the one hand, on the improvement of institutional capacity by strengthening local banks, and building networks of commercial banks and export-import banks and related institutions: and on the other, on the enhancement of the availability of finance earmarked for South-South trade and investments through the creation of new financing facilities and capital market funds.

76. However, the range of options available should not be used as an excuse to delay action. Lacunae in the financing system for South-South trade and investments handicap enterprises from these countries, and hinder them from using the full potential of the international market place – and therefore, hamper developing countries' economic growth. With Basel 2, due to come into operation in 2007, financing constraints are likely to worsen. Should it wish so, the international community, including the developing countries as a group, has the capacity to influence this situation in a positive manner.