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From the Director's Desk

K.T. Chacko

Trade finance serves as the lifeline of the day-to-day international trade in goods and services. It provides required financing for transactions between buyers and sellers around the globe. Recent global financial crisis has significantly impacted the availability of trade finance, mainly caused by the liquidity crunch. In response to concerns on scarcity and high pricing of short-term trade finance, developed and developing country governments, central banks and regulatory authorities are acting on several fronts. Initiatives such as injecting liquidity, re-capitalizing and restructuring financial institutions, and stopping risky behaviour that could further precipitate markets into depression are currently in vogue, to address the problem.

Trade experts, however, are of the opinion that taking immediate and short-term crisis-combat measure like stimulus package to spur the growth is not sufficient to tackle a crisis of this magnitude. Rather, enhancing market access to developing and least-developed countries and facilitating trade flows will have a more durable impact and that could help in bringing the buoyancy back.

In several WTO meetings in recent years, members have pointed out the need to examine the issue of availability of trade finance as a key variable, particularly, for developing and least-developed countries to effectively participate in Global Trade. Paragraph 36 of the Ministerial Declaration of Doha requested the WTO Members to examine, and if necessary, come up with recommendations, on measures that the WTO could take, within its remit, to minimize the consequences of financial instabilities on their trade opportunities. With the developmental dimension of Doha Round yet to fructify, there is an imperative to examine how trade finance can be augmented.

Trade Credit and the 2007-09 Financial Crisis

Suparna Karmakar*

World economy has witnessed a dramatic decline in its growth since onset of global financial crisis in late 2007. Growth of foreign trade in many developed, developing and transitional economies has been severely hit. Shrinkage in world demand coupled with high commodity prices had led to negative export growth rate in many developing countries. Exporters and importers are facing hardship as they are unable to organize trade finance to remain engaged in trading activity. As ninety per cent of global trade are managed through trade finance and different schemes, in the wake of financial crisis they are not easily available to exporters and suppliers. This paper makes an attempt to examine the issue in details and suggest various measures how they can be addressed.

1. Introduction

THE worst global recession since the Great Depression was triggered by a financial crisis that began in the US, which led to a severe liquidity crunch worldwide, at least in the first year of the crisis. But more importantly, the financial crisis resulted in a crisis of confidence, breeding risk averseness in some stakeholders. One of the more dramatic consequences of the 2007-09 financial crisis was an unprecedented contraction of global trade; in 2009 (calendar year), trade volume contracted by about 12 per cent,[1] the sharpest fall since the World War-II. In trying to explain this implosion of global trade, economists have suggested that limited availability of trade finance may also have played a role, as the contraction in trade was associated with a decline in the value and volume trade financing, especially during the late 2008 and early 2009. Studies revealed that at least in the early stages of the crisis, higher costs and declining of availability of trade finance triggered by the liquidity crunch had a negative impact on trade, especially in the developing and least developed countries (Dorsey, 2009).[2]

Notwithstanding the above, in the third year after the onset of the financial crisis, new data on the availability of financing during the first two crisis years seem to indicate that the projections of impending catastrophe *vis-a-vis* trade financing may have been over-reactions. While the global economic recovery as indicated by GDP growth trends may yet be uncertain and uneven, the recovery in trade flows since late 2009 has been nothing short of phenomenal, which would not have been possible if availability of trade finance was thus severely constrained during this financial crisis. In this paper an attempt has been made to discuss the extraordinary performance of global trade and the trade financing in the 2007-09 crisis, and look for plausible explanations for the same. In particular, the paper seeks answers to the poser: did the constrained availability of trade finance cause the dramatic fall in exports in 2008-09, and what impact did it have for the SME exporters and importers in developing countries like India?

In 2009, the volume of global trade contracted by 12.2 per cent (in current US dollar terms, the value of trade contracted even at a more dramatic 23 per cent, thanks in large part to falling prices of oil and other primary

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commodities), sparking speculations that the rise of protectionist trade measures and the drying up of trade finance may have been the key contributors. However, since last November, global trade flows have continued to rebound ever more strongly from the depressed levels seen during the depths of the global financial crisis. Recent data show that the value of merchandise trade was around 25 per cent higher in the first three months of 2010 than in the same period of 2009, fuelled mainly by demand from Asia and higher commodity prices. The volume of world trade in the first quarter of 2010 was up 17 per cent over the same period in 2009 and 3.5 per cent higher than the previous quarter, the fourth consecutive quarterly increase in all regions.[3]

The trade collapse in the Great Recession has been much deeper than in the past. Trade normally declines more sharply than overall economic activity in a downturn. But the sudden 17 per cent contraction in world trade volume between October 2008 and January 2009 initially seemed out of line with the comparatively small declines in inflation-adjusted gross domestic product (GDP) during the same period, which reached 2 per cent among major advanced economies. But recent data indicates that, unlike in the 1930s, the severity of trade collapse was not a result of any significant resort to protectionism. Despite initial fears, it has now been proved conclusively that the protectionist measures adopted (largely in the form of new trade remedy measures and subsidies/ by local legislations favouring the politically-sensitive affected sectors) by the major trading nations after the onset of the crisis contributed very little to the precipitous collapse of international trade.[4] Instead, the consensus that has emerged infers that it was a globally synchronized decline in overall demand that had a particularly strong effect on international commerce, magnified by the product composition of the fall in demand, by the presence of global supply chains, and by the fact that the decline in trade was synchronized across countries and regions. The weakness in private sector demand was linked to the global recession triggered by the sub-prime mortgage crisis in the US, which soon spread to the real economy, with global repercussions. Recent research on the role of inventories in the decline of production, trade, and expenditures in the US empirically proves that there was a sizeable inventory adjustment in the economic crises of late 2008 and 2009, which can explain in large part the decline in international trade (Alessandria *et al.*, 2010).

But more importantly, for the purpose of this paper, it has now been established that trade finance accounted for only a small part of the contraction in world trade last year, put at 12.2 per cent by the WTO, but the fear remains. The financial crisis brought with it severe risk averseness, making banks unwilling to lend to each other and trade finance was caught up in the panic. As trade finance dried up, the price of what was available spiralled, making financing more expensive (rather than unavailable) for developing country traders, especially the SME traders. Normally, trade finance is considered virtually riskless. But with the dollar liquidity shrinking, dollar denominated export credit was virtually unavailable to SME exporters as banks have limited supply of dollars and prefer to give it to larger corporates. The change in the cost of financing trade deals for developing country SMEs heightened the problem, adding to panic. Also, recent global surveys of trade finance[5] cite that increases in capital requirements due to the introduction of Basel II norms are among specific factors contributing to this tightening. But does all this imply that trade finance should be treated as a non-issue in future financial crises? Was risk averseness the only explanatory variable for the observed strong correlation between the 2007-09 financial crisis and trade finance availability? The complex interplay of policy-induced supply of financing versus external constraints needs to be carefully examined, before conclusions are drawn and remedial policy measures enacted.

The rest of the paper is structured as follows: Section 2 discusses the importance of trade finance in global trade, given that a large part of international trade is mediated through this channel, and highlights the preventive measures adopted in the aftermath of the onset of the crisis by the multilateral organizations and other national bodies to mitigate the worst impact of the liquidity crisis on SME traders. It will be argued that these measures did go a long way in stabilizing the market sentiments, which in turn supported the sharp uptick in trade flows once demand revived. Section 3 will highlight the Indian experience, and identify the key elements of divergence of Indian experience from other developing countries. The final section draws some policy conclusions.

2. The Trade Finance System and Global Trade Flows

Trade financing is an umbrella term covering several different categories of financial transactions including payments or transfers and insurance as well as credit techniques. The broadest definition includes every kind of loan, insurance policy or guarantee directly tied to international transactions—anything from the direct credit extended by exporters to government-backed guarantees issued by official export credit agencies. Other institutions involved in trade finance are commercial banks, multilateral development banks, national credit agencies and private insurers.

Trade finance, fundamental to the working of the global financial system, is primarily about four things: payment facilitation, financing, risk mitigation and the timely flow of information. Relationships between banks, export credit agencies, investment banks and other providers of trade finance are critical to its timely availability. These relationships are built on trust in the integrity and financial viability of trade finance providers; trust that is missing in the current climate. Consequently the trade financing gap, estimated to be in the range of US$100 to 300 billion in 2009, is likely to affect developing country traders around the world, especially the small and medium sectors.

Trade finance, which assures the orderly payment and delivery of goods, is provided in many ways, depending on the needs of the exporter and importer. Trade finance can be structured to cover a wide range of costs necessary to get the goods to the buyer, including providing working capital to cover labour and other expenses required to complete the transaction. A clear distinction between payments or transfers and credit in trade financing is difficult to draw: the lags associated with most methods of payment or transfer necessarily entail the exposure of exporters, their agents and financial institutions to importers in international trade during the period before the receipt of the proceeds due from the latter; and the terms of credit related to many trade transactions are linked to the way in which proceeds will be transferred.

Many of the techniques of trade financing are designed to shift risks between exporters or importers and financial institutions and between financial institutions themselves, or to accelerate the receipt of proceeds. The letter of credit, one of the best known and most widely used techniques of trade financing, is primarily a device for assuring security of payment, while bankers' acceptances which are often issued on the basis of letters of credit are credit mechanisms. However, both techniques expose a bank to credit risks. Other techniques such as lines of credit from banks to exporters and importers, buyer credits, project financing and international leasing are credit mechanisms. Guarantees and insurance linked to trade transactions are also included in trade finance and expose banks to credit risk but are not credit mechanisms as such.

Though trade finance is at the low-risk, high collateral and self-liquidating end of the credit spectrum, it is still not insulated from a liquidity crunch. Some 80 to 90 per cent of world trade relies on trade finance (trade credit and insurance/guarantees), mostly of a short-term nature (Auboin *et al*., 2003). But the risks have been going up in recent times as international supply chain arrangements have globalized trade finance along with production; sophisticated supply-chain financing operations – even for SMEs – have become crucial to industrial activity and trade, which in turn amplifies the impact of liquidity contraction and availability of trade finance as longer supply chains cause firms to seek longer-term financing for their working capital.[6]

What was the absolute effect of liquidity crunch in the latest recession on the finance channel of trade? As mentioned earlier, the WTO estimates that only around 12 per cent of the world trade contraction in 2009 can be accounted for by the decline in trade finance availability. Thus, it can be argued that lack of financing cannot be a significant explanatory variable in explaining the sudden collapse of trade during the crisis. Then, is the continued fear among policy makers *vis-a-vis* the debilitating effect on trade of liquidity shortages resulting from a financial crisis justifiable? While the fear of a European debt crisis and potential sovereign defaults in the near future (which may trigger another global banking/ financial crisis) may explain the constrained supply of financial flows to riskier trading activities, especially those from developing country SMEs, it is unlikely that the absolute risk is significantly higher today as compared to the pre-crisis boom years. Also, with the rapid revival of the financial market activities by early 2009 and the return to health of the international banking sector by late 2009, it can be argued that while the animal spirits may have dampened lately, finance availability remains as strong for legitimate trade and for the established trading community.

2.1 *Recent Developments in Trade Finance - Multilateral Initiatives*

What can then explain the sudden reversal of risk averseness and drying up of trade finance availability within a 12-month period, despite the continued weakness of global economic prospects in the medium-term? As mentioned above, the significance of finance in global trading activities emanate from that fact that about 90 per cent of total international trade is intermediated by a third party. Though a large part of this is short-term financing on secured assets, and irrespective of the rising risks as discussed in the section above, a sudden collapse of finance availability is bound to have an immediate (severely) contractionary impact on trading activities. This perhaps explains the concurrent and sharp deterioration of trade finance in the first year of the crisis. But a more important outcome of the financial crisis has been contagious risk averseness; there was a perceptible shift to trade-finance transactions involving lower risk such as those supported by letters of credit and insurance or guarantees. The constraint felt by SME traders in developing countries was more due to the rising costs of financing, which increased by more than 200 basis points over the LIBOR in many economies.

The ICC Banking Commission survey, conducted in the winter of 2008 when the pressures on financial markets during the aftermath of the disappearance of Lehman Brothers were particularly acute and covering more than 500 banks in 70 countries, found that there had been increases in the proportion of trade-finance transactions involving lower risk such as those supported by confirmed letters of credit and insurance or guarantees and a reduction in the proportion involving the simpler, cheaper but also potentially riskier open-account transactions. Substantial proportions of responding institutions (more than 40%) in the ICC Banking Commission survey reported increases in their fees for guarantees and commercial and stand-by letters of credit (ICC Banking Survey, 2008).

An important effect on trade finance comes from the intermediary roles that Commercial Banks play in trade facilitation. According to figures available from the Berne Union, the volume of export credit more than tripled between 1993 and 2007, from about US$350 billion to over US$1.3 trillion, which coincides by and large with the growth rate of merchandise trade in the period (Herger, 2009). In general, because it is a relatively cheap and standardized funding instrument, trade related companies make intensive use of trade finance to support their operational working capital. Even for intra-firm trade within the production supply chains, very little trade funding is provided directly by the buyers themselves (say from internal accruals). To that effect, in the immediate aftermath of the post-crisis liquidity crunch, funding sources for secure trade dried up suddenly causing panic, as banks have become more selective and stringent in their assessment of counterparty risk.

In addition, the constraints imposed by the Basle II banking norms and regulations on capital adequacy and risk accounting requirements further limited the liquidity available to commercial banks for traditional banking activities (Auboin, 2009).[7] The 2009 ICC Survey found that 40 per cent of respondents had cut trade credit lines for companies and 42 per cent had cut them to financial institutions. However, the impressive rebound of global trade by late 2009 does seem to indicate that the risk-averseness-induced limits on trade financing may have been short lived, though costs of financing continue to remain at levels higher than before. Furthermore, once the dust settled, as was indicated in subsequent surveys, companies evolved/restored supplementary non-commercial bank financial supports and guarantee programmes to ensure that legitimate trade was not hindered because of finance availability. Recent empirical research (Herger, 2009, *op. cit.*) has also shown that contrary to popular perception international trade in large part is financed by cash and payments on account rather than trade credit, and this effect is especially dominant for multinational firms which draw on internal funds when trade occurs between affiliates. With at least 2/5th of world trade[8] thus financed, the net adverse effect of insufficient/costlier trade financing on global trade flows is muted. If one adds to this the higher-than-average trust and interaction levels between participants of established production supply chains, it is not surprising that the financial crisis had a limited impact on trade financing beyond the immediate aftermath of the crisis. Time series data confirms the observation that about 90 per cent of world trade, and in particular transactions that (i) involve commodities and consumer goods, (ii) routine transactions between firms, and (iii) involve multinational firms, are settled directly via open accounts.

But the most noticeable feature in this crisis was the quick confidence building action taken by multilateral forums like the G20, under guidance and advice from the WTO and IMF, to mitigate potential financing problems of emerging market SMEs. Among others, an important multilateral initiative was the buffering of the 3-year Global Trade Liquidity Programme coordinated by the IFC/World Bank by which new credit lines and guarantees were opened for developing country SMEs. The G20 summit in London in April 2009 drew attention to strains in the trade financing sector and led to the group approving a US$250 billion trade finance package. The IFC programme accounts for US$50 billion of that total; the G20 members and international financial institutions committed to provide US$5 billion in funding for the programme, which will be leveraged to make available US$50 billion in assistance. In the trade liquidity programme, commercial banks put up 60 per cent of the funding and the IFC provides 40 per cent. The “risk sharing” on the part of the private banks and the IFC is deemed as one of the major innovations in the program, whose assistance will increase these banks’ liquidity and their ability to support more trade finance transactions.

Thanks to the G20 package, national export credit agencies (ECAs) and Multilateral Development Banks (MDBs) have stepped up their activities, mobilizing some US$190 billion in commitments in one year. However, the average utilization rate for additional capacity committed has declined from some 70 per cent in the first half of 2009 to around 40 per cent in the second half, reflecting the improvement in the global market situation. It has also been suggested that consideration be given to enhancing capacity building to local financial institutions under the Aid-for-Trade umbrella, and to the possible creation of a trade finance facilitation programme at the African Development Bank, to deal with the problems of import financing, in particular the cost and conditions of letters of credit confirmation from the African banks by the rest of the world. The latter proposal has received strong support from the WTO Expert Group on Trade Finance.

In addition to the above, the response of public-backed institutions has been positive,[9] and three types of activities are currently in play:

1. Regional development banks and the IFC have recently enhanced their trade facilitation programmes: the

IFC from US$1.5 to US$3 billion, the Inter-American Development Bank (from US$0.5 to US$1 bn), the EBRD (from US$1 to US$2 bn), and the Asian Development Bank (from US$0.4 to US$1 bn). This has brought the total capacity to US$7 billion on a roll-over basis, financing potentially some US$30 billion or so of trade involving small countries and small amounts (US$250,000 on average by transaction).

2. Export credit agencies stepped in, essentially with the programmes for short-term lending of working capital and credit guarantees aimed at small and medium enterprises. This includes new programmes put in place by the US, Germany, Japan, France, the Nordic Countries, Hong-Kong, China, Chile and others. For certain countries, the commitment is unlimited in amount (Germany). In other cases, cooperation is developing to support regional trade, in particular chain-supply operations. To this effect, the APEC summit announced the establishment of an Asia-Pacific Trade Insurance Network to facilitate intra- and extra-regional flows and investment through reinsurance cooperation among export credit agencies in the region. Japan's NEXI is establishing itself as the leader and main underwriter of this collective re-insurance system. The US and China agreed that their respective import-export banks would make an additional US$20 billion available for bilateral trade, and the US and Korea made a similar commitment for US$3 billion.

3. The central banks in countries with large foreign exchange reserves – and/or which for one reason or another are facing a shortage of liquidity in dollars (due to the fall in remittances, export receipts, and the depreciation of the local currency against the dollar) – have been supplying dollars to local banks and importers through repurchase agreements. Since October, Brazil's central bank has provided US$10 billion to the market. The Korean central bank has pledged US$10 billion of its foreign exchange reserves to do likewise. The central banks of South Africa, India, and Indonesia are also engaged in similar operations. Unfortunately, such facilities are unavailable to developing countries with fewer foreign exchange reserves, unless they swap foreign exchange against local currency with their main trading partners.

Thus, improving economic outlook and demand from China and swift multilateral policy actions undertaken to boost supply of finance availability and helped bolster confidence of the financial market as well as the SMEs, which went a long way to support the recent meteoric rise of trade flows, especially in the Asia-Pacific region.

3. Impact of Financial Crisis on Financing Exports and Imports in India

In India, the RBI acted swiftly to boost credit supply for SME traders. As in other countries, Indian exporters did face credit crunch for trade financing (largely through the increased costs of trade finance) in the aftermath of the financial crisis. However, it will be unfair to attribute this entirely to the crisis. As a part of its stabilizing policies, the RBI had been raising the average Prime Lending Rates (PLR) in the second and third quarters of 2008. This added to the upward cost pressure for SMEs when the financial crisis led to external liquidity constraints. In fact, it can be argued that the trade credit scarcity in India was more due to domestic policy rates than due to global liquidity crisis since (a) Indian banks were largely unaffected in this crisis and liquid were given by the prudential banking norms that have been in place, and (b) the weakness of the foreign banks were not transmitted given that the share of foreign banks in the Indian economy is less than a fifth.[10]

Notwithstanding the above, with the outbreak of the crisis, RBI boosted domestic liquidity by reducing the CRR and Repo rates by about 200 basis points in late 2008 and early 2009, which was supplemented by encouraging nationalized banks to cut interest rates for priority sector borrowers. But with dollar liquidity shrinking, dollar denominated export credit became virtually unavailable to SME exporters as banks have limited supply of dollars and preferred to give it to larger corporates.[11] The interest rate on export finance loans to India, as a result has gone from a fraction above LIBOR to about 5.5 percentage points higher. But as in the rest of the world, finance availability and costs were of lower significance when compared to the inability of firms to obtain the business in the first place.

As in the rest of the world, banks (specially the foreign banks) became more risk averse than the Indian banks. Since many of the credit decisions relating to export/import are taken by their foreign controllers, who attach a great deal of risk premium to the Indian business, the Indian trade finance sector suffered more than it would otherwise have. Some of the tightening measures seen in the export/import financing done by foreign banks in India were as follows:

1. Export financing is done against firm orders or Letters of Credit. In addition, some foreign banks reduced the sanctioned limits if utilization levels of sanctioned facilities have not been up to the mark.
2. Instead of turning away business outright, the foreign banks were quoting interest rates that are a big dampener to clients.

As compared to the above, the nationalized banks operated business as usual, though there were some risk-averse covenants like:

1. Encourage business with established long-term clients only, i.e. new clients are being discouraged.
2. Exercise more caution in financing related to iron and steel.
3. Avoid exports to China in view of the fact that the Chinese banks have been found to reject shipping documents of the Indian exporters on rather flimsy grounds.
4. Due to the bankruptcy of US banks like WAMU (Washington Mutual), export proceeds have remained stuck. As an offsetting measure, the Indian nationalized banks were encouraging exporters to take more export insurance from entities such as ECGC.
5. Hedge exports and imports on the back of massive volatility in currency markets.
6. For petrochemical related imports, although the falling crude price offset the weakening rupee, speculation in currency markets was discouraged.

In sum, the Indian experience in terms of availability of trade credit differed from the other developing countries insofar as the liquidity squeeze were more due to internal conditions than the repurcussions of the crisis in the external financial markets.

4. Conclusion

The financial crisis and economic collapse across nations has invariably affected trade business in India. The steep rise in the cost of borrowing and a depreciating rupee has created a negative impact on business. Banks are more cautious than before towards providing credit to new customers. Many foreign banks in spite of having liquidity seem reluctant to provide credit whereas nationalized banks continue to provide credit only to their existing clients. New policy measures for overcoming the financing problems therefore should reflect the above understanding. Cost of credit is an important determinant for the SMEs, and measures should be taken to reduce such costs. However, policy directives to increase credit to priority sector alone will not be able to make the change. It appears that while economic considerations such as Margins on Bank Guarantee and the market determined spread over LIBOR for rediscounting export bills cannot be controlled, measures such as increasing the post-shipment credit tenure for short-term loans, regulations to incentivize the insurance companies to keep supporting exporters, adoption of flexible single buyer policy and a case by case guarantee approach by Export Credit Guarantee Corporation (ECGC) could go a long way to redress the financial constraints on trade credit availability.

NOTES

[1] One measure, based on work by the economic historians Barry Eichengreen and Kevin O'Rourke, suggests that declines in international trade have exceeded the losses during the 1930s. Indexing to the peaks in global industrial production in both

episodes, the authors calculated that global trade fell *32 per cent* during the first year of the Great Recession, compared with 15 per cent during the first year of the Great Depression. Of course, trade continued to ebb for years in the 1930s, as compared to the dramatic resurgence this time around as indicated by recent data.

[2] The paper postulated that the existence of global supply chains cause firms to seek longer-term financing for their working capital, given that products take more time to reach the end consumer. And because of these longer supply chains, the contraction in bank-intermediated trade financing in 2007-08 had a significant impact on trade flows.

[3] DG Lamy's report to the Trade Policy Review Body, WT/TPR/OV/W/3, 14 June 2010. Data in current US dollars, sourced from CPB Netherlands Bureau for Economic Policy Analysis, Trade Monitor, 31 May 2010.

[4] Furthermore, many protectionist measures adopted were what has now been termed as "legal protectionism", insofar as the tariffs were raised from the applied levels which were much below the permissible bound levels, and the potential downside of those actions was actually not that massive.

[5] The ICC Banking Commission survey, conducted in the winter of 2009, and the Bankers' Association for Finance and Trade (BAFT) and the IMF survey in August 2009. Also see Auboin, 2010.

[6] The trade finance market has several segments according to maturity, from short-term (usually zero to 180 days, but possibly to 360 days) to medium and long-term. The medium to long-term end is generally considered to be over two years. The liquidity crunch in the financial crisis and the lengthening of the supply chains in modern decentralized production-trade systems has however increased the demand for 180 – 270 days post-shipment credit tenures.

[7] Banks argue that the current Basel Committee rules do not reflect the short-term self-liquidating nature of most trade finance, and the proposed tougher regulations (under Basle III) would require banks to set aside 100 per cent of their value as off-balance-sheet assets, compared to about 20 per cent now, further constraining trade finance availability.

[8] While details on the share of intra-firm/affiliate trade in international trade are not available, it has been estimated that in the US, the share of intra-firm trade in total trade has been at a stable range of 35-40 per cent since 1980s.

[9] New data on export insurance and guarantees suggest that publicly backed export credit agencies have played a role to prevent a complete drying up of trade finance markets during the current financial crisis.

[10] Foreign banks share in the deposits and commercial lending in India is around 6.5 per cent. However, their exposure in other financial activities are much higher. Hence this back of the envelope estimation of less than 20 per cent share in Indian financial market.

[11] Mr. Sunil Shirole, MD & CEO, YEN Management Consultants, http://www.yenconsultants.com/Images/MEDC_Nov'08.pdf

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NEWS
(NATIONAL/INTERNATIONAL)

G20 Gains Importance as a Multilateral Body

WITH the world buffetted by simultaneous phases of recovery and recession in an increasingly connected system, where a volcanic eruption in Iceland can upset the business of an Indian exporter, the G20 has become a significant platform for both developed and developing nations.

The G20 was born as an answer to the Asian financial crisis 13 years earlier, to build more effective monetary and regulatory mechanisms that key economies would abide. Over the years, it has assumed a greater role than just being a sort of crisis management body, running parallel to or, sometimes, even challenging the existence of the Bretton Woods brothers – the World Bank and International Monetary Fund (IMF).

"It (G20) is really an agenda of the western world to develop their own institution along with some of the advanced developing countries. It is one platform where everyone is getting a fair chance to voice their opinion, which is seen as a major drift from the traditional approach of the World Bank or IMF, thereby shaping a global viewpoint when nothing else is moving, whether a multilateral trade deal in WTO (World Trade Organization) or commitments on climate change," says Biswajit Dhar, Director General, Research and Information System for Developing Countries (RIS).

Setting the Agenda

Within the Government, it is felt such technical issues need to be handled exclusively by a cell. The Ministry of Finance is, therefore, planning a separate secretariat for the purpose.

"Increasingly, the G20 will both set the agenda and determine the course of action on issues engaging governments the world over," said Dr. Rahul Khullar, Commerce Secretary, while underscoring the forum's importance. He sees it as the new international club to deliberate on matters of global governance.

Experts around the world agree G20 is evolving as the world is undergoing a paradigm shift. However, it lacks an institutional backing and clear framework in addressing issues concerning global imbalances.

The recent crisis in the financial world that shrunk the growth of both developed and emerging nations made G20 a cynosure of the world economy, as it responded proactively by announcing international commitments and measures that restored confidence and boosted growth performance.

"The G20 has assumed a greater role during the recessionary times, and will play a role in the recovery phase, too. One example of this is the G20's framework for strong, sustainable and balanced growth. The framework is a policy process for ensuring that global growth is restored to a strong level, while also addressing the long-term sustainability of growth and its composition," Jonathan Coppel, Economic Counselor, Organization for Economic Cooperation and Development (OECD) said.

According to Bibek Debroy, Professor at the Centre for Policy Research, G20 has assumed greater importance in the past decade due to its host countries.

Coming Meetings Crucial

Experts and analysts also believe the coming annual meetings of G20 in Canada on 26-27 June 2010 and Seoul in 11-12 November 2010 would be crucial, as these would take place while the world would be at a crucial juncture of crisis and recovery.

"If we get out of the crisis successfully, the G20 will be definitely viewed as the core of global regulation, even if the sharing of power and confrontation of interests will not make life easy as in the G7, where the US is the superpower," emphasized Jean-Joseph Boillot, Economic Advisor for emerging countries and Co-chairman, Euro-India Economic and Business Group.

Amit Mitra of the Federation of Indian Chambers of Commerce and Industry agrees the G20 has emerged as a powerful body for giving directions to the global economy. "Without coordinated moves, measures cannot become effective and here lies the importance of the G20", he said.

(*Business Standard*, 5 June 2010)

Crisis in West will Only Get Worse, Warns Stiglitz

WHEN the world's biggest economy gambles with other people's money, blaming smaller nations that pay the price only protects a system that's flawed. Nobel Prize winner and Columbia University Professor Joseph Stiglitz, a bitter critic of that system, says why Greece can't be blamed, why the US is in for another shock, and how Washington is still missing the point.

In one of the bleakest forecasts for the West, Mr. Stiglitz forecasts more pain if economies in Europe and the US go on an austerity drive to improve their deficits. He is certain that there will be more mortgage defaults and unemployment in the US would not fall to normal levels until the middle of the decade. "We expect the number in 2010 to be larger than in 2009. Things are getting worse. That's one of the reasons why I am not optimistic about a quick recovery."

Mr. Stiglitz, a winner of the 2001 Nobel prize and the John Bates Clark medal in 1979 – the latter is awarded to economists under 40, came into public limelight for his attacks on economic orthodoxy in the wake of the Asian crisis of 1997. The IMF had imposed stringent austerity measures, which meant swinging cuts in government spending, as currencies plunged in the wake of a balance of payments crisis.

Ten years later, Europe is following the same flawed policies, says Mr. Stiglitz. "What is clear (is) that the current approach in Europe is wrong and the current approach is to try to impose extreme austerity and that will lead to a weaker economy and lower tax revenues, and so the reduction in deficits will be much smaller than hoped."

But despite the problems in Europe, Mr. Stiglitz feels the euro will survive, albeit with higher volatility as larger European countries like Germany benefit from a common currency. "The benefits that Germany and others get from the euro are sufficiently great, the political commitment is sufficiently great and I think it would survive. But it would be on the basis of muddling through, which will mean a lot of global financial volatility."

Mr. Stiglitz is happy that India did not follow the policies prescribed by the US. "Our regulatory structure was flawed. I am glad that you didn't follow (Henry) Paulson's advice," he says.

(*The Economic Times*, 26 May 2010)

Exporters Shy Away from New EU Orders

APPREHENSIVE of the Euro zone debt crisis, exporters of engineering goods are declining fresh orders from buyers in the European Union. They fear default and lower returns as the curency depreciates. Industry sources said it is the same case in other sectors.

Compounding the situation is Export Credit Guarantee Corporation of India's (ECGC) hesitation to provide insurance cover to domestic exporters against payment risks in Europe on fresh orders, except on a case-to-case basis.

Rakesh Shah, former Chairman, Engineering Export Promotion Council and Managing Director of Nipha Exports (which exports to the EU too), said: "Many exporters, especially from the small and medium sector (comprising half of the total Indian exporters), are not taking fresh orders at current Euro rates. They fear the returns may be lesser. Also, buyers are unwilling to hike prices."

Engineering exports account for about a fifth of India's exports to the EU. Of this, 50-60 per cent of trade is in euro terms. The most hit are the transactions where European buyers are unwilling to do business in any other currency apart from the euro.

Shri Shah said engineering exporters have stopped extending credit to European buyers due to the current high risk perception. Engineering exporters favour long-term contracts as only such transactions make their business viable. Exporters are also watching the health of the banks in the EU. "We cannot bank any more with the smaller and lesser known European banks for letter-of-credit transactions," Shri Shah said, adding that exporters are most comfortable only where there is a long-term relationship with buyers.

The ECGC Chairman and Managing Director, A.V. Muralidharan, says "We are closely monitoring the situation in Europe. Regarding fresh orders, we will look at it on a case by case basis depending on the credentials of the buyer in Europe."

He said ECGC will not deny insurance cover assured to the existing orders, adding, it has so far not advised exporters against taking fresh orders from EU. ECGC provided cover to 12 per cent of India's total exports (of $176.5 billion in 2009-10) and for a fifth of India's shipments to the EU. Adding to the worries is the flash floods in Europe.

(*The Hindu Business Line*, 22 May 2010)

High Stakes: What has the Fund got itself into by participating in Europe's bailout?

THE IMF's star has risen steadily through the global economic crisis. Contributions from its members have tripled its firepower. It has rescued economies from Hungary to Pakistan. Yet despite these achievements, its activities did not extend into the heart of the rich world.

That is now changing. Although initially sidelined by the European Union (EU), the IMF eventually cofunded and devised the terms of Greece's massive bail-out. And on 10 May the EU announced that the IMF is to provide up to •250 billion ($317 bn) to supplement its own •500 billion stabilization fund to prop up the euro area's weaker members.

But the details of the IMF's promised contribution are far from clear. The Fund is keen to emphasize that no money has actually been set aside for the rescue. Its deputy chief, John Lipsky, stresses that the •250 billion figure is "a hypothetical or theoretical number" based on the Fund's role in recent joint EU-IMF rescues, where the IMF has provided about a third of the cash on offer.

The amount is hypothetical for a very good reason. Having to set that amount aside immediately would leave the IMF unable to lend to any other country that got into trouble. As of 6 May its total remaining lending capacity for the year ahead was $272 billion, or •215 billion. It has never lent as much in one go as it would if the euro-area package were to be activated in its entirety.

The Fund could, of course, find more money. Its board recently approved an extension of its standing arrangements to borrow from governments and central banks by more than $500 billion. But about half that amount is already included in its current lending capacity. Activating the rest would require many governments to seek legislative approval.

There are other options. The IMF will get some extra cash at the end of the year from a general increase in quotas, the maximum amounts the countries are having are obliged to supply to the Fund. Last year it also issued $250 billion of Special Drawing Rights (SDRs), its own quasi-currency. These sit in countries' reserves in proportion to their quotas. Dominique Strauss-Kahn, the Fund's Chief, thinks countries could lend some of this money to others. But there is no precedent for SDRs being transferred on such a massive scale.

The Fund could also approach some reserve-rich emerging countries to top up its kitty. Some have already lent to the Fund. China bought $50 billion of notes the Fund issued last year; Brazil, Russia and India each bought $10 billion. But some of these countries are miffed that the Fund did not consult them before rushing to the rescue of the euro area. Emerging Asian economies have bitter memories of the harsh conditions the IMF imposed on them during the Asian crisis; they are concerned about the Fund making a huge commitment of resources without clearly setting out what potential borrowers would have to do to get the money.

Eswar Prasad, a former chief of the Fund's China desk, says that all this is once again leading to questions about "whether the IMF's ultimate fault lies with its main shareholders, the US and the EU". Such concerns repeatedly arise because European countries as a group have the biggest chunk of votes in the IMF, and are over-represented relative to their economic heft.

(*The Financial Express*, 21 May 2010)

Greek Crisis may not have Major Impact on India, says Subbarao

RBI Governor D. Subbarao said the debt crisis in Greece was unlikely to have a major impact on the overall sentiment in India. "We do not see much of an impact in the base case scenario on financial flows and overall sentiment," Shri Subbarao told reporters after RBI's central board meet.

"Using the base case scenario, there will be an impact on the trade side as Europe accounts for 27 per cent of India's trade. More importantly, it might have an impact on services exports," he said.

There could be some "knock-on impact" on India but it would be transient, he said. The Governor said the Central Bank had been studying the developments in Greece for the last one month. "We have been discussing internally about what impact it will have on our economy."

RBI Deputy Governor Dr. Subir Gokarn said the crisis in Greece could result in two absolutely diverse situations. The crisis in the European nation might trigger large outflows from India if foreign investors became risk averse, he said. Also, India could attract large inflows since it was a stable emerging economy with high growth potential, he added. "We are keeping a watch on both the situations. We have the capacity to manage the shocks."

Led by Greece, Europe has been caught in a severe debt crisis that has hit the euro. Euro, the 16-nation common currency, tumbled to a four-year low against the greenback after it slid below the $1.2150 level. It recovered slightly and is trading at $1.2324. However, currency dealers speculate the euro may continue to remain under pressure until there are concrete measures from the European countries.

Earlier this month, the EU and the IMF put together a nearly $1 trillion package to rescue the continent from financial collapse.

On fears of a possible liquidity crunch arising from credit outgo to telecom companies which have bid for 3G spectrum for a mammoth over Rs 67,000 crore, Shri Subbarao said there was no possibility of the general liquidity getting affected and banks could lend credit to telecom companies as part of this process.

(*Business Standard*, 21 May 2010)

"Greece Crisis to Hit India if it Spreads to Euro Zone Economies"

INDIA is likely to witness a short-term impact of Greece's public finance crisis if it spreads to larger Euro Zone economies, said Planning Commission Deputy Chairman Montek Singh Ahluwalia. Expressing his faith in the strength of India's economy the Deputy Chairman added that Asia's third largest economy is in much better position than the Euro zone countries which are on the verge of sovereign default and hoped that the crisis will remain limited to small countries and will not spread worldwide.

Addressing a CUTS International function Shri Montek Singh said, "If it (Greece bailout package) succeeds in stabilizing the global financial situation, that is beneficial for us. The crisis really is the crisis of sovereign debt in the industrialized countries....We are not in that situation..."

Latest official data said a 13.5 per cent industrial output growth in March – its sixth month of double digit growth – has helped the economy to finish the 2009-10 fiscal with a spectacular 10.4 per cent expansion in industrial production. Factory output was a modest 2.8 per cent in the 2008-09 fiscal when the country went through the economic slowdown. The data raised expectations that industrial growth for the just completed 2009-10 fiscal was good enough for the estimated 7.2 per cent GDP growth.

Finance Minister Shri Pranab Mukherjee said that the problem of Greece was mainly on three counts. Their fiscal deficit at 13 per cent of GDP, debt-GDP ratio at 115 per cent and the current account deficit 13.8 per cent. "No economy, however, powerful or strong it may appear to be, can sustain such deficit levels," Shri Mukherjee said, highlighting the need for India to follow its planned course of reducing fiscal deficit.

Monetary and fiscal policy-makers have already expressed their confidence in India's ability to withstand any contagion effect of the Greece crisis. RBI Deputy Governor Subir Gokarn said that the Greek debt crisis could trigger short-term vulnerability in the Indian markets, though its long-term impact might not be severe.

Finance Secretary Ashok Chawla took a more optimistic view about the impact of the crisis and said India is immune to the debt crisis in Greece, and it may actually help the country bag the "safer haven for global capital" tag.

But independent economists expect the Government to go for a more calibrated withdrawal of fiscal stimulus measures in the light of the crisis. A note by financial services firm Citi said central banks all over the world, including RBI, will delay the hike in rates in the light of the risks posed by the Greece crisis. "We no longer expect an intra-policy meeting hike before the July policy review," said Rohini Malkani of Citi group. She added that considering the global growth risks and the room for the Indian rupee to take some brunt of monetary tightening, the expected rate hikes next year would be lower.

(*The Financial Express*, 19 May 2010)

Don't Want Complex Derivatives, But Enforce Existing Rules: SMEs

THE regulator is planning to restrain banks from selling complex derivatives to small and unlisted companies. But, they are hardly impressed as existing rules to regulate the forex derivative markets have not been enforced by the banking regulator.

For instance, the RBI had issued a circular in October 2007, whereby only the regular banker with whom the small & medium enterprise (SME) is having prior credit relationship is allowed to sell derivative contracts to an SME.

This stipulation is a preventive measure whereby only the regular banker of an SME, who is already aware of the risk appetite and underlying exposure of the client, is authorized to sell derivative to it.

This rule, say small exporters, was grossly violated by several banks in the last crisis. Many banks entered into contracts with SMEs who do not have any other relationship with the bank except derivative deals, which grossly violates of the above guideline.

"Putting in place regulation is one thing – following it in letter and spirit is another," said an exporter in Tirupur. For instance, there's another rule which says banks must do strict due diligence of the SMEs books before entering into derivative deals. This too was not followed in the 2007 derivative crisis which triggered a lot of litigation.

"There is no shortage of guidelines and procedures – there is already enough well intended guidelines which, if properly followed, would prevent such a scenario in future. What is required at this point is to put in place proper monitoring mechanism whereby RBI will closely watch whether its stipulations are being followed by the banks in letter and spirit," said another exporter, who didn't wish to be identified.

Exporters allege there's no attempt being made by the RBI to improve the monitoring mechanism that will throw warning signals before such a big damage is done: the last crisis saw banks and companies piling up MTM losses of Rs 31,719 crore.

Shri Raja Shanmugam, another exporter from Tirupur, says a ban on exotic products won't hurt SMEs as what they need is plain vanila options and forward contracts, which are good enough to help them hedge and manage their currency risks.

(*Business Standard*, 18 May 2010)

Small, Unlisted Cos Won't Get to Cut Exotic Derivative Deals

SMALL businesses and unlisted firms will be barred from cutting complex derivative deals. The RBI is planning to bring in entry barriers that will restrain banks from selling derivative products to companies with scant disclosures, inadequate understanding of risks, and balance sheets and net worth below a certain size.

Over-the-counter derivatives help companies to hedge against fluctuations in foreign exchange and interest rates. But often firms buy the more risky derivatives to get a far better exchange rate on their export receivables or convert more expensive rupee loans into swiss franc or yen which carry a much lower interest rate.

In late 2007, such derivative bets backfired when euro, swiss franc and yen rose dramatically against the dollar. While big firms could absorb the losses, many small firms had found that their net worth was wiped out.

By mid-2008, India Inc was sitting on a mark-to-market loss of a few billion dollars on cross-currency derivatives.

Now, numbers compiled by RBI show that small and medium enterprises accounted for just 1-2 per cent of total losses from derivative deals. But these entities were the most vocal when the market turned against them.

"It caused bad press, drew political attention...At the end of the day what is it that a small firm is looking for? It needs a hedge to insulate cash flow to a level. They don't need complex derivative products and nor do they fully understand them," said an official of the central bank. The banking regulator will announce the final derivative guidelines in a month.

The regulator is debating on how and where to draw the line. In the last few weeks, RBI officials have told bankers that SMEs and unlisted firms below a certain networth, where disclosure standards are low, could have limited access to derivatives.

According to a senior banker, RBI is likely to restrict banks from selling to SMEs derivative products like zero-cost deals, a popular derivative which is structured in a way where the company does not have to pay for the hedge. Here, the premium earned by a company from selling an option is simultaneously used to pay for buying another option.

But many SMEs have taken a hit on these contracts due to the high leverage, a situation where the company may be selling three options to buy one option, and will have to pay three times when the market moves against it.

"What I understand is that such derivatives can only be sold to companies which are following AS 30 accounting. SMEs will be out of zero-cost structures...I would support this," said the treasurer of a foreign bank which has been active in the derivatives market.

Under AS 30 norms, a company has to either book MTM losses on a derivative contract in the profit and loss account, or park it in a reserve and show it in the p/l account as and when the contract unwinds. The latter is called hedge accounting and can be undertaken only if a company follows certain stringent rules.

While all listed entities have to follow AS 30 from 2011, as part of a more broader change in accounting principles, unlisted firms with a networth of below Rs 500 crore are not required to migrate to the new accounting standard.

However, closely held firms with networth of above Rs 1,000 crore will have to follow the new accounting standard from next year while those above Rs 500 crore will have to switch over two years down the line. Big corporate and IT companies have told RBI that derivatives help them to compete globally and therefore should be allowed.

"Under the circumstances, the RBI has to do something that's in the best interests of all," said a banker. But its evident that the regulator would like to ensure that there is no more chaos caused by derivative losses.

"Banks have been told to share derivative contract details on a regular basis since February. Banks have also turned careful. Some are insisting on margins and collaterals from clients to protect themselves against possible derivative losses. When a client does not pay, a derivative loss to a bank is just like unpaid credit card dues. There is no difference," said the credit head of a private bank.

(*The Economic Times*, 17 May 2010)

Draw More Foreign Funds for Domestic Infrastraucture

THE Centre's move to raise a Rs 50,000 crore – over $11 billion – fund dedicated for infrastructure makes ample sense, given the sheer shortage of long-term project finance. The only thing that raises an eyebrow is the moderation in the share of the corpus to be raised from foreign investors, a mere $4.4 billion. Investors likely would lap up Indian paper at fine rates, given the lacklustre growth prospects in the mature markets in general, and debt-driven turbulence in the eurozone in particular. Further, the prospect of participating in the real economy here, and not dicey financial assets elsewhere, ought to be doubly attractive, given the huge infrastructure deficit and high economic growth expected even in the long term. But, in tandem, the Centre would need to boost transparency in private sector participation and follow through. In public-private partnerships, having infrastructure projects, it just would not do to tweak the rules, postbidding, in favour of the winning bidder. In most cases, it is favouritism but has become quite commonplace.

The sanctity of contracts must be protected in infrastructure projects, with all project risk reasonably factored in and accounted for. Sugar-coating contracts ex-post, apart from adding to project costs, would also be perverse incentive to lobby and seek more favourable terms, called directly unproductive profit-seeking. In tandem, we need a thriving secondary market for debt securities, so as to better address risks and shore up returns. In any case, the infrastructure fund would need to be actively managed and funds on-lent to projects, based on hard-nosed commercial considerations. Modern project finance also requires that the Planning Commission reorient its policy of estimating project costs sans inflation. Firm estimates would underline real budget constraints, and likely put paid to routine time and cost overruns in implementing lumpy infrastructure projects. Also required is governance reform, including online tracking of projects by stakeholders.

(*The Economic Times*, 17 May 2010)

Plan to Tap Forex Reserves for Funding Infra Projects Pays Off

AFTER the initial controversy, the Indian government's experiment to deploy $5 billion of the RBI's foreign exchange reserves to other avenues disappeared from front pages.

The scheme is not only alive, it's ticking over satisfactorily. India Infrastructure Finance Corporation, UK (IIFC) – the nodal agency based in the UK to route the forex, has sanctioned $1.57 billion in the first 18 months of existence, with a profit after tax (PAT) of $19.5 million. Ms. Ravneet Kaur, Joint Secretary, Ministry of Finance and CMD of IIFC India, said: "As an experiment, the scheme is doing very well, and there is a lot of scope. There is no justification we could look at to scale back the scheme. We could even go back to RBI and look at a further increase," she said. IIFC UK's profits will be ploughed back to expand its operations further, Ms. Kaur said.

Given the timeframe for infrastructure project financing, IIFC UK officials estimate that it will be some years before most of the current funds are disbursed. IIFC UK, a wholly-owned subsidiary of the parent company in India, was set up specifically with a mandate to route $5 billion from RBI's forex, for overseas purchase of capital goods equipment in the infrastructure sector. It started operations around September 2008. IIFC has financed 13 proposals across a range of sectors, mainly power, ports, railways, and metro projects. It has around $1.2 million of proposals in the pipeline at present. The main worry about deploying RBI's forex reserves in infrastructure financing was that the money could find its way back into the Indian market, creating monetary pressures.

The scheme has been ring-fenced such that IIFC UK directly pays the overseas seller, and the Indian importer gets the equipment, in such a way that the forex reserves never enter the country. In addition, IIFC works with a consortium of bankers for various infrastructure proposals, and limits its exposure in any one project. Despite the global recession, Ms. Kaur said, "except for a short period in 2008, Indian corporates are accessing overseas funds, and the flow of funds to the infrastructure sector is on the increase."

(*The Economic Times*, 17 May 2010)

Seeking Less Scrutiny, Hedge Funds Flock to Asia

AS regulators in developed markets step up oversight of hedge funds, these free pools of capital are increasingly set to make their home in Singapore and Hong Kong.

That will accelerate the flow of talent and foreign funds into Asia's top two financial centres, at a time when asset managers are already eyeing the region's rising wealth and strong economic growth.

Assets of Asia (ex-Japan) funds are seen rising 70 per cent over the next two years, outpacing the 50 per cent growth in global assets, according to industry estimates. "Asia, and Singapore in particular, could definitely benefit from the stupid regulatory environment in Europe," said Lionel Martellini, Director of France's EDHEC Risk and Asset Management Research Centre.

Scrutiny of hedge funds has heightened in Europe as politicians in Germany and France blamed the industry for causing the financial crisis – though the crisis was caused more by regulated banks in the United States, Mr. Martellini said.

The G20 nations want greater supervision of hedge funds, with the EU debating more contentious rules that could make it harder to offer non-EU funds to European investors. London has objected to the proposed EU rules.

Tim Rainsford, Managing Director Asia-Pacific at hedge fund manager Man Investments, which manages $39 billion globally, said the increasing focus on emerging markets was also playing a key role in encouraging hedge funds to move to Asia. He said hedge funds are seeking exposure to Asia, encouraged by the developments in China as a global engine of growth as well as the growing importance of Asian currencies to global trade.

Hedge funds with Asia ex-Japan mandates had assets of $105 billion at end-2009, or about 7 per cent of global hedge fund assets of around $1.5 trillion, Singapore-based consultancy Eurekahedge estimates. By end-2012, that will rise to at least $182 billion, as global hedge fund assets grow to $2.25 trillion.

A Deutsche Bank survey of the hedge fund industry in March showed 45 per cent of investors wanted to raise allocations to Asia (ex-Japan) funds, compared with 18 per cent in 2009.

Critical Mass

Singapore, which has not escaped the global pressure to regulate derivatives and hedge funds, recently proposed regulations to licence bigger hedge funds and force smaller funds to maintain a minimum capital base. These rules are set to increase costs, especially for startups, but will not halt the wave of new funds heading to Asia. New York-based Fortress Investment is planning to return to the region through a Singapore office.

"The regulatory arbitrage that Singapore has will be reduced to a certain extent when it moves to the licensing regime which is a bit more stringent," said Lian Chuan Yeoh, an attorney with Allen & Overy in Singapore.

"But the regime is still not heavy touch, it is pretty much similar to what people expect these days. There will be a few more capital requirements, more requirements on compliance, but its nothing too onerous," Mr. Yeoh said.

Tax rates on top earners of 17 per cent in Hong Kong and 20 per cent in Singapore compare favourably with the UK, especially given a controversial plan to raise the highest British rate to 50 per cent from 40 per cent.

Start-up costs are also generally lower than in London's expensive West End — Europe's hedge fund hub — and boutique funds can therefore get going with smaller asset bases than the $50 million or $100 million that many in UK see as critical mass.

But some strategies may struggle in Asia because the region's financial markets do not match the depth seen in the West. Citadel Group, for example, more than a year ago trimmed its special situations team in Hong Kong.

Data from Eurekahedge also shows that about half of hedge fund strategies employed in Hong Kong and Singapore are focused on long or short equities strategies.

"Managers will consider relocating to Asia as long as they know that major institutional investors such as pension funds, endowments, insurance companies and foundations in the region are there to invest in alternative investment schemes," said Aureliano Gentilini, hedge fund research head at Lipper, a unit of Thomson Reuters.

That trend is gathering pace. The Government of Singapore Investment Corp has been increasing its allocation to alternative investments, while China Investment Corp last year allocated $500 million in a hedge fund unit of Blackstone Group.

"I can say from my conversations with institutional investors around the region, not only are they planning to maintain their hedge fund allocation, I think in many instances, they are planning to increase those over time," Man Investments' Mr. Rainsford said.

(*The Economic Times*, 18 May 2010)

Priority Status Sought for Loans to Green Projects

LENDERS have urged RBI to give priority sector status to loans for projects that emit lower carbon. Bankers have argued that in the absence of any policy initiatives from the government and the banking regulator, this move could work as an incentive for banks to finance environmental-friendly projects. All PSUs and private banks have to give 40 per cent of their loans to farmers, the weaker section of the society and as home loans and education loans.

Yashpal Gupta, Chief General Manager at IDBI Bank said: "The key challenge is to convince lenders that financing low carbon emission projects is viable." He was speaking on the sidelines of a seminar on "Financing A Sustainable Low Carbon Indian Economy', organized by the Indian Banks Association (IBA) and The Climate Group.

During the seminar, Shri Gupta suggested three ways to provide financial support to projects that emit lower carbon. He said banks can provide equity support for such project akin to venture funding to make such project more viable. The second option was to charge a higher interest rate – of 25-50 basis points – for financing projects which emit higher carbon.

A fund can be created from the additional money charge and it can be used for financing projects that emit less carbon. This way borrowers of higher carbon emitting projects would cross-subsidies those with lower carbon emitting projects. The third option Shri Gupta suggested was that the government should create a fund and use that fund to guarantee environment-friendly projects which are less viable.

In a survey done by IBA on climate change activities in the Indian banking sector, only eight out of the 16 banks responded to the questions on the topic. Of the eight banks, only four banks rated climate change as very important and in their top priorities critical to success. K. Unnikrishnan, Deputy Chief Executive at IBA is of the view that banks need to productively engage with the government to ensure the right incentives are put in place to unlock financing.

The Indian government has voluntarily set a target to reduce carbon intensity by 20-25 per cent by 2020.

(*The Economic Times*, 14 May 2010)

Fresh Road Map Soon for Capital A/c Convertibility

THE RBI is likely to come out with a third road map for bringing in capital account convertibility after the time table set in the earlier two reports were abandoned following the financial crisis.

RBI Governor D. Subbarao also hinted that flexible exchange rates could be disadvantageous for India if trading partners or competitors (read China) adopted a fixed rate.

"We will continue to move towards liberalizing our capital account, but we will revisit the road map to reflect the lessons of the crisis," said Shri Subbarao in his address at a high-level conference on "The International Monetary System", jointly organized by the Swiss National Bank and IMF in Zurich.

Capital account convertibility is seen as the holy grail of financial sector reforms by proponents of complete liberalization. A decade ago, RBI had appointed a committee headed by former deputy governor S.S. Tarapore to chalk out the road map for achieving capital account convertibility in 1997. However, the Asian currency crisis threw the programme off track. The issue of convertibility was visited again by the second committee, which was also headed by Shri Tarapore in 2006. But the global financial crisis has led to policy-makers having second thoughts on the approach.

Shri Subbarao said the road map for capital account convertibility will be reworked, reflecting the lessons drawn from the global financial crisis, according to the RBI Governor. He also said the central bank feels that the economy should traverse towards capital convertibility along a gradual path – recalibrated on a dynamic basis in response to domestic and global developments.

Shri Subbarao's comments assume significance at a time when the country faces a deluge of dollars on account of which it has to grapple with a strong rupee, which hurts the exporters' interest.

The appreciating rupee *vis-a-vis* the dollar had been a cause of concern even among policy-makers. Shri Subbarao noted that in FY10, the rupee appreciated by 13 per cent in nominal terms but by as much as 19 per cent in real terms because of the inflation differential between India and its trading partners. This has implications for India's external competitiveness at a time when world trade is recovering and concerns about protectionism are resurfacing.

Probably hinting at the adverse impact of China's policy to hold back the value of its yuan to promote its exports he said: "if we have a flexible exchange rate, and if other countries which are our trading partners or competitors for the same export markets have a fixed exchange rate, we get disadvantaged."

He, however, denied that policy-makers back home had any plans to impose any tax to rein in inflows. "However, it needs reiterating that no policy instrument is clearly off the table and our choice of instruments will be determined by the context."

As for the pile-up in reserves on account of surge in inflows, Shri Subbarao said it was important to distinguish between countries whose reserves are a consequence of current account surpluses and countries with current account deficits whose reserves are a result of capital inflows in excess of their economy's absorptive capacity.

India falls in the latter category. "Our reserves comprise essentially borrowed resources, and we are, therefore, more vulnerable to sudden stops and reversals compared to countries with current account surpluses."

(*The Economic Times*, 13 May 2010)

Banking: Emerging Markets

ONE of the most patronizing demonstrations of the alleged superiority of Western finance came in 2005-06, when China's big banks, once part of its communist economic apparatus, floated their shares in Hong Kong. Their prospectuses were in English and stuffed with the Western jargon of shareholder value. Their shares were underwritten by a dazzling array of Western investment banks and bolstered by anchor investments from blue-chip American and European financial firms. The emerging world might have become the factory of the world and its back office. But the globalization of finance, it seemed, would take place on Western terms.

Things look very different today. Whereas some of those underwriters and anchor investors have been disgraced or bailed out (or both), Chinese banks are the world's largest, dwarfing their erstwhile sponsors. Emerging-market banks together account for between a quarter and half of the global industry on most measures. But it is not just the familiar shift in economic weight that has taken place. Emerging economies' financial systems, long regarded as their Achilles heels, have done far better than the Anglo-Saxon model they were once encouraged to emulate.

Doing Things the Old-Fashioned Way

Emerging-market banks are of the old school, with branches, profits, lowish pay and high capital. After decades of crises, they are tightly regulated: Indian bankers joke that their country's red tape is now the envy of regulators worldwide. Thanks to their thrifty customers, banks typically have excellent funding, gathering more in deposits than they lend out, unlike banks in rich debtor countries that rely on fickle international borrowing markets. The state has played an increasingly active role. It owns most of the banking system in China, India and Russia and a growing chunk in Brazil. As part of their efforts to counteract the downturn, governments got state banks to lend more, most notably in China, where new loans in 2009 equated to about a third of GDP. In the big emerging economies the ideal is to have a mixed banking system with a big state presence, some perky private banks, and a few foreigners to keep the locals honest. Only a handful of Western banks, including HSBC, Standard Chartered and Citigroup, have real clout.

So should the world's financial template now be Beijing or Mumbai, rather than Wall Street or the City of London? The developing world's banks had a good crisis, but their big test is yet to come. Emerging economies face a paradox: they need solid banks to help them grow fast, but fast growth will make their banks less safe. As consumers spend more, banks' excess deposits may shrink. Business customers will shift their fundraising towards capital markets, forcing lenders to build volatile investment banks. The great push to serve the hundreds of millions of unbanked people, while noble, is just as experimental as Wall Street's adventures in subprime debt. And most developing-world banks are keen to punch their weight internationally but are painfully aware of the gruesome mistakes made by Western and Japanese firms abroad.

Most importantly, the corollary of fast economic growth is that banks must expand credit at an eye-watering rate. Many executives predict their balance-sheets will double every five years or so. That inevitably creates a risk of bad debts, and having the government involved in allocating credit raises the potential for mistakes and cronyism. China is already grappling with sour loans generated by its lending binge last year. It will be very hard for these banks to satisfy their societies' sky-high expectations for economic growth without scuppering their own newly won reputations for prudence.

(*The Economist*, 13 May 2010)

RBI Eases ECB Policy for Infra Financing Cos

IN a bid to ensure easy financing for the core sector, the RBI has decided to modify the extant external commercial borrowings (ECB) policy in respect to infrastructure finance companies (IFCs) and non-banking financial companies (NBFCs) categorized as IFCs by the central bank. Infrastructure companies have hailed this move.

"As a measure of liberalization of the existing procedures, it has been decided to permit IFCs to avail themselves of ECBs, including the outstanding ones, up to 50 per cent of their owned funds under the automatic route, subject to their compliance with the prudential guidelines already in place. "ECBs by IFCs above 50 per cent of their owned funds would require an approval of the RBI and will, therefore, be considered under the approval route," the RBI said in a notification.

Rajiv Lall, CEO and MD of IDFC, said "there will be a lot of interest from infrastructure companies following the RBI modification in terms of ECBs. We will also be taking the ECB route to raise funds in the next few months. This step will help us lengthen the maturity profile and also diversify our base." The central bank noted that all the other aspects of the ECB policy, such as $500 million limit per company per financial year under the automatic route, eligible borrower, end-use, average maturity period, refinancing of existing ECB and reporting arrangements, will remain unchanged.

(*The Financial Express*, 12 May 2010)

Exporters Upbeat but Cautious as Euro Appreciates

AFTER receiving assurances from European leaders to save the currency from falling apart, Indian traders who export a bulk of their products to that part of the world heaved a sigh of relief. In many export segments like garments, 50-70 per cent of the invoicing is done in euro.

The Director-General, Federation of Indian Export Organizations (FIEO), Ajay Sahai, said though the currency appreciated it would be important to see whether it could be sustained over a period of time. "The efforts made by the exporters to save the currency show the urgency of the situation especially after the Greek crisis. Every effort needs to be put in to save the currency from depreciation," he said.

A garment exporter based in Noida said usually over 70 per cent of the invoicing is done in euro, the depreciation of the currency would leave the exporter with very little margins. "We do not take depreciation into cover hence any dip in the value of the euro eats into the margins," he said. At the back of fears of the raging debt crisis in Greece, the euro sank as low as $1.2523. The EU and IMF have pledged almost $1 trillion in total to protect the euro.

The Vice-Chairman of Apparel Export Promotion Council, Praveen Nayyar, said the exporters should adopt a wait and watch approach rather than jump the gun. "We need to see how the euro peforms in the next few months. The volatility has really hurt us and I don't think the assistance by IMF is going to change much," he said.

Currently, Europe accounts for almost 40 per cent of India's apparel exports.

Executive Director of Gem & Jewellery Export Promotion Council, Sabyasachi Ray, said Europe is a very important market for India and any signs of stability for the currency will benefit the exporters. "Europe is going to become a very important market for India. Signs of the currency appreciating is good," he said.

(*The Financial Express*, 11 May 2010)

Euro Loses Currency for Exporters

THE share of the euro in the Indian foreign exchange markets has shrunk sharply with the crisis in Europe. Traders said till last year the euro's share in domestic foreign exchange markets was as high as 30 per cent. This is now barely 10 per cent. Gross trade volumes in the domestic foreign exchange markets are currently about $2.5 trillion a day, inclusive of cash, spot and forward.

Traders said exporters are now shifting back to invoicing in the US dollar fearing sharp depreciation of the euro. Fears are that the European crisis is likely to snowball to encompass Spain, Portugal, Italy and Ireland. The euro stampede resulted in a sharp dollar appreciation in the global markets since the beginning of January.

The euro has already depreciated by over 11 per cent since January against the dollar (from $1.44 to $1.27). Against the rupee, the euro has depreciated by over 13 per cent (from Rs 66.48 to Rs 57.81).

For the same period, the US dollar has depreciated by less than one per cent. The reversal has prompted a shift back to the dollar, traders said.

Till about a year ago, several exporters including of software services, had looked for euro-based invoicing to take advantage of the dollar's weakness. The shift to the euro was seen more as a strategy for hedging the bottomline against exchange rate volatility. But the traders said that exporters were switching back to invoicing in the dollar even to European destinations.

Coffee Exports

The Managing Director of Balanoor Plantations and Industries, Ashok Kuriyan, said, "Coffee exports have traditionally been invoiced in dollars. Recently, we had made efforts to shift to euro, in view of dollar instability. But in the current situation of currency crisis in Europe, the dollar is the best bet."

Most of Balanoor's coffee exports are to European countries.

Forward Cover

Exporters are also beginning to take forward cover as an additional precaution. As a result, forward premia for three and six months softened to 2.84 and 2.65 per cent respectively from last weekend's level of 3.34 and 3.21 per cent. Part of the premium softening is also on account of a shortage of spot and cash dollars in the foreign exchange markets.

This essentially translated into traders selling forwards and buying spot for meeting current demand. Despite the exporter forward cover, the rupee is unlikely to return to its appreciation trajectory against the dollar.

ING Vysya Bank Economist, Ms. Deepali Bhargava, said, "although the fundamental story appears intact, there is an extreme risk aversion that is happening. A slip below Rs 46 to the dollar at this juncture cannot be ruled out." The cash/spot dollar shortage is also partly on account of non-debt capital outflows.

For the first time since the beginning of this calendar year, capital outflows were negative. Net FII outflows amounted to $185 million.

HDFC Bank Chief Economist, Dr. Abheek Barua, said, "as risk aversion mounts, the outflows could also increase." However, importers, including refineries and corporates with foreign currency liabilities, have preferred to leave their foreign exchange positions open. This, despite banks beginning to caution importers against leaving their positions open. European exporters, traders said, also preferred receiving payments in dollars.

For capital goods importers, the euro has become cheaper and further depreciation would result in reduction in import costs.

(*The Hindu Business Line*, 9 May 2010)

Exim Bank's Net Increases 8%

EXPORT-IMPORT (Exim) Bank of India has recorded a net profit of Rs 477 crore for the year ended March'10, up 8 per cent from the previous year.

The trade-financier attributed the slowdown in profit to higher tax provision, as the profit-before-tax rose 26 per cent to Rs 772 crore as compared to Rs 610 crore in the previous year.

Exim's loans grew by 14 per cent to Rs 39,371 crore. While loan approvals, rose 16 per cent, aggregating Rs 38,843 crore during 2009-10, disbursals rose 15 per cent to aggregating Rs 33,249 crore during the year.

For the current year (FY'11), the Bank plans to raise about Rs 24,000 crore from both the domestic and the foreign market and expects business growth to be maintained at 18 to 20 per cent. It has also applied for a capital support of Rs 300 crore for the current, its newly-appointed Chairman and Managing Director T.C.A. Ranganathan, said at a media briefing.

During the year, the Bank received capital support of Rs 300 crore from the Government of India increasing the paid-up capital to Rs 1,700 crore as on 31 March. The Bank raised resources worth Rs 20,266 crore, comprising rupee resources worth Rs 13,037 crore and foreign currency resources of $1.61 billion equivalent, the Bank's Executive Director, N. Shankar, said.

Among the other business plans, Shri Ranganathan said that the research wing will be further strengthened to improve indepth knowledge of various trading partners' business environment. There will be individual country details on the legal, procedural and other issues that need to be known to conduct business with these countries. This will help the Bank earn some fee-based revenues by selling research to major exporters.

"Keeping in view the need to help country's exports, Exim is planning to assist export clusters comprising various small and medium enterprises achieve scale. "We are in talks with consultancies to find whether Indian clusters are competitive or not. We are also in talks with some multilateral agencies to evolve certain benchmarks and we will help reach these benchmarks. We need price competitive export clusters," he said.

The Bank has also entered into a memorandum of cooperation with leading development banks of Brazil, Russia and China to develop cross border transactions and projects of common interest.

(*The Economic Times*, 8 May 2010)

RBI Rejects Banks' Proposal for Borrower-Specific Base Rates

THE RBI has rejected a proposal by some banks for having borrower-specific base rates. It has also not allowed them to charge a negative premium while calculating the effective interest rate.

Some banks had sought a few relaxations after RBI came out with final base rate guidelines in April. They asked the regulator if they could be allowed to fix different base rates for different customers and if they could charge a negative premium on the base rate.

Charging a negative premium would have meant lending below the base rate. For instance, if a bank uses the marginal cost of one-year deposits as the benchmark for fixing the base rate, a negative premium will be charged for all loans with tenures of less than 12 months.

RBI, however, stuck to its basic principle, that is, it would not allow any lending below the base rate. Some banks, which are indicating that the base rate will be 8-9 per cent, will not be able to give short-term loans to the corporate sector. This is because interest rates for short-term loans are linked to the overnight rate, which is well below 8 per cent. The regulator also ruled out different base rates for different customers.

In its annual policy for 2009-10, RBI announced a review of the present system of benchmark prime lending rate (BPLR) in order to make loan pricing transparent. It formed a committee headed by Executive Director Deepak Mohanty to review the system.

The proposal was mooted in the backdrop of sticky transmission of monetary policy. In addition, the present BPLR system is marked by high sub-PLR loans, which account for as much as 70 per cent of the total lending in case of some banks.

The committee, which deliberated the issue for about a year, decided to replace BPLR with the base rate and said the new system would become effective from 1 July. While RBI gave complete freedom to banks on the methodology to calculate the base rate, it barred them from lending below this rate.

On the parameters that would be used to calculate the base rate, like the tenure of the cost of funds, the central bank gave banks freedom, but said a parameter once chosen would not be allowed to be changed. However, it gave a leeway to banks by allowing them to change the parameters and the methodology for the first six months. This was done to give banks time to refine the system of calculating the rate.

(*Business Standard*, 7 May 2010)

FY10 Exports Slip 4.7%, Europe Crisis Looms

$200 bn Target under Cloud

INDIAN exporters managed to battle the global economic crisis with aplomb to close the 2009-10 fiscal with shipments worth $176.5 billion, a bare 4.7 per cent lower than the previous year, but the shadow of the fresh financial crisis in Europe looms large over the future.

The export target of $200 billion for 2010-11 set by Commerce Minister Anand Sharma, although modest, could be at stake if the Greek contagion spreads to larger parts of Europe.

"That (Europe) is the joker in the pack," said Commerce Secretary Dr. Rahul Khullar. Europe accounts for 26 per cent of India's exports.

The recovery in exports began in November 2009, after a 13-month fall, with March exports growth touching an all-time high of 54 per cent. Imports grew at an even faster 67 per cent in March, indicating the strong recovery in the domestic economy that is buying capital goods in large quantities to expand capacity to meet rapidly rising demand for goods. Imports for 2009-10 are pegged at $278.7 billion, down 8.2 per cent from a year ago, leaving a trade deficit of $102 billion against a deficit of $118 billion in the previous fiscal. Though all exports have grown strongly in recent months, many sectors are still in the red.

But the bigger concern at this stage is Greece. The debt crisis in Greece, which could spread to Portugal, Spain and Italy and has resulted in a further depreciation of the euro, has exporters worried.

Orders booked earlier this year at major fairs in Europe were proving to be unviable as a euro now fetches Rs 57 as opposed to Rs 67 earlier. Exporters to countries such as Italy and Spain are now expecting cancellations and other associated problems like rejection of consignments.

The Government concedes Europe could be a big concern. "Europe is an imponderable not factored into our equations," said Dr. Khullar adding that the policymakers expected 2010-11 to be smooth but it has not turned out to be so. The Government is, however, not thinking of any intervention or support at this stage other than those already under consideration.

The Director General of Foreign Trade (DGFT) is doing a sectoral study and some more incentives for export sectors still in the red could be on the cards. "The foreign trade policy will be tweaked and wherever required we will give more support to sectors that are still needy," he said. The study is expected to be concluded in July.

Indian Institute of Foreign Trade (IIFT) Director K.T. Chacko is less pessimistic. He believes that the recovery in exports was likely to stay on track despite the turmoil in the EU. "If the products that we are exporting to Europe are competitively priced, we should be okay," he said, adding that the export target of $200 billion was feasible.

Dr. Khullar said that "while the Government had given incentives for market diversification, it would take time to make a difference. Maybe exporters would now see that there is merit in what we said", he stated.

Sectors that are still negative, such as engineering, readymade garments, yarn, chemicals, oilmeals, electrical goods and leather, account for 40 per cent of exports while gems & jewellery and petroleum, which account for another 30 per cent, had near-zero growth. Sectors that have done well include tea, tobacco, fruits & vegetables, marine products, iron ore and plastic & linoleum.

(*The Economic Times*, 7 May 2010)

Weak Euro Spells Trouble for Exporters

EXPORTERS are going slow on booking orders from Europe as a weakening euro increases risk and hits profits. "The ongoing economic crisis in Greece and Spain will hit coffee exports. These two markets collectively account for 8-10 per cent of exports in volume terms. Coffee exporters are in a pincer's grip as we have to not just look at currency volatility but have to factor in the record coffee crop coming in from Brazil and Indonesia. Pricing will take a hit," said Ramesh Rajah, President of the Coffee Exporters Association. In the last three weeks, while the rupee has appreciated 3.3 per cent against the euro, it has marginally depreciated against the greenback. An official from Bangalore-based textile firm Gokaldas Exports said the company had stopped accepting orders from Europe. "The volatility is too high and we are taking a cautious approach," said the official.

This fear of losing orders/exports is being echoed by Indian apparel exporters as EU accounts for nearly a third of the $9 billion worth of apparel exports. Estimates indicate cancellations/lost orders in the apparel sector alone could cost India upwards of 15 million euros in foreign exchange earnings. "Our estimate is that only about 50 per cent of our export orders to Europe have been covered through forward contracts with the rest posing a risk," says A. Sakthivel, President of Tirupur Exporters' Association. For Indian apparel exporters, the rising rupee is not the only problem being confronted. "We are already reeling under the impact of increasing cotton prices. Besides this, salaries in the apparel sector have risen by as much as 21 per cent effective 1 April 2010. The hike in cotton prices means our cost structure has already risen by 7-8 per cent," says Rahul Mehta, President of the Clothing Manufacturers Association of India.

But despite the gloom, N. Chandran, CMD of Tirupur-based Eastman Exports, says focussing on value addition could help offset possible losses.

India was EU's 10th largest trading partner in 2008 with a market share of 2 per cent. The total trade between India and EU stood at 61 million euros in 2008, up from the 34 million euros in 2004. Trade has witnessed a 16 per cent compounded growth rate between the two blocs in the period 2004-08. M.C. Dinesh, president of the Karnataka Small Scale Industries Association, says the crisis will hit the micro and small firms hard. "Many of these units with investments of anywhere between Rs 1-2 crore are dependent on mid-sized and large units for sub-contracting or job orders. Conservative estimates indicate that we should have lost around Rs 50 crore in such orders during the last three months," he adds.

(*The Economic Times*, 7 May 2010)

A Pox on Your Swaps

Banks Face up to a Tougher Derivatives Regime than Many had Expected

FOR all the recent posturing on Capitol Hill, financial reform is coming. On three consecutive days Republicans blocked a motion to allow debate of America's financial-regulation bill to begin on the Senate floor, an obstruction that Harry Reid, the chamber's majority leader, denounced as "absurd and stunning". The stand-off finally ended on 28 April, when the opposition party's senators, worried about being branded as bankers' friends, agreed to let discussion proceed.

The bill is now very likely to pass in some form, possibly as early as the end of May. But with the two parties' chief negotiators having reached an impasse in bilateral talks, a number of big issues will have to be thrashed out on the floor. One is the treatment of troubled financial giants (although the two sides have got closer on some points). Another is the proposed consumer-protection bureau, which Republicans fear could be a recipe for regulatory overreach. A third is derivatives.

The last of these has been causing particular consternation on Wall Street. Until recently banks thought they knew what was coming: a palatable batch of changes that included standardized over-the-counter (OTC) bilateral contracts being pushed through central clearing-houses (which guarantee trades if one party defaults); exchange trading for more liquid standardized contracts; and higher capital and margin requirements for derivatives that are too customised for clearing.

Something changed in recent weeks, however. The fraud charges filed against Goldman Sachs, over synthetic derivatives, emboldened those looking to crack down on exotic instruments. On 21 April the Senate's Agriculture Committee – which oversees the Commodity Futures Trading Commission (CFTC) – passed a surprisingly draconian set of derivatives provisions. Elements of this will be offered as an amendment to the main bill.

The most controversial bit is Section 106, which would prohibit entities with access to the Fed's discount window – i.e., banks – from trading swaps or using them to hedge their own exposures. At the very least, it would force banks to spin off their derivatives desks into non-bank subsidiaries, though some interpret the language to mean an outright ban. Some believe that Section 106 has been kept as a bargaining chip, to be removed in return for a Republican concession. But bankers are edgy. The White House, though queasy about a swaps ban, has not publicly opposed it.

A mere five entities account for more than 95 per cent of American financial firms' derivatives holdings. Of these, Morgan Stanley has the least cause for worry, since its swaps already sit in a non-bank subsidiary. For the others, moving the business would be costly, because bank-holding companies generally have a higher cost of funding than bank subsidiaries. Estimates of the extra capital required vary from $20 billion to several times that.

This puts a cash cow at risk. Derivatives-dealing has become one of the most profitable activities for Wall Street's giants. The business is thought to have generated revenue of around $22.6 billion in 2009. J.P. Morgan Chase has said that fully one-third of its investment-banking profits came from OTC derivatives in 2006-2008.

Regulators, too, are nervous. The rules could drive derivatives to offshore markets, over which they have less control. The Fed would not be thrilled at the prospect of having to rely more on non-American banks as dollar intermediaries in the foreign-exchange-swap market. Pushing swaps into new entities may simply create a new class of firms that are too big to fail.

Even if Section 106 is dropped, there are other controversial derivatives-related issues. The bill has been toughened up to require all contracts that can be centrally cleared to be traded on exchanges (partly in response to lobbying from unions, which blame OTC derivatives for falling pension values). To the extent that this exposes in real time the volumes and prices of transactions.

But some bankers worry that it could be the equivalent of ramming square pegs into round holes. Mandatory exchange trading is "a solution looking for a problem," says the head of one bankers' association. "End-users" – firms that use derivatives for hedging, such as airlines – are "not exactly clamouring for it," he says.

Many of those end-users, which collectively hold 10-15 per cent of OTC derivatives outstanding, also want exemptions from clearing. Without one, they argue, increased collateral requirements for cleared trades would make hedging their everyday risks much more expensive. As things stand, some commercial firms would get an exemption, while others – such as sweetmakers hedging against swings in sugar prices – would not. Other sorts of carve-out are being sought, too. Warren Buffett's Berkshire Hathaway has lobbied hard, but so far unsuccessfully, against having to post more collateral for existing trades in its $60 billion derivatives book.

Regulators have further worries, too. In a memo, the Fed complained that the bill's language is too "hard wired", leaving insufficient room to tweak rules as markets evolve. It also thinks the legislation unnecessarily restricts data-sharing among regulators. But it is the banks that are most perturbed. They shiver at the possibility of ceding ground to foreign rivals as forced spin-offs raise their costs – or, worse, having to use the likes of Deutsche Bank to hedge their interest-rate risk. Such worries may prove overdone. But a tougher regime than any of them expected a few months ago appears likely.

(*The Financial Express*, 1 May 2010)

Trade Finance: Rebooting the Engine

FINANCE is a crucial component of the world economy, underpinning some 80 to 90 per cent of world trade. As a result, the tightening of trade finance market conditions, which has been steadily worsening since the beginning of 2008, is particularly concerning.

Public-backed institutions have responded rapidly in the course of 2008, but still their efforts have not been enough to bridge the gap between supply and demand of trade finance worldwide. Recognizing the need for further action, the G20 has pledged another US$250 billion in support of trade finance.

1. Why does trade finance matter?

One of the reasons for the collapse of world trade is insufficient trade credit financing. The global market for trade finance (credit and insurance) was estimated to represent approximately 80 per cent of 2008 trade flows, valued at US$15 trillion. The World Bank estimates that a fall in the supply of trade finance has contributed some 10 to 15 per cent of the decrease in world trade since the second half of 2008.

Despite the overall fall in trade transactions, quantitative and qualitative surveys confirm a general increase in trade credit prices, as banks demand risk premiums often far in excess of loans made to other banks. This has led to a mismatch between supply and demand for credit.

Two arguments are often put forward to explain the presence of trade finance gaps. The *first* relates to market failure arising from the inability of private sector operators to avoid herd behaviour when credit and country risks become highly uncertain (e.g., existence of rumours of sovereign default). *Secondly,* on the regulatory side, commercial bankers have long complained about the implementation of Basel II rules, which are regarded as having a pro-cyclical effect on the supply of credit. Under poor market conditions, trade finance would be unfairly treated as capital requirements are significantly increased, particularly for counterparty risk with developing country customers. In addition, the system of rating agencies does not help, as such counterparty risk tends to be biased against developing countries, according to reports from several developing countries and, in particular, the WTO Working Group on Trade, Debt and Finance.

2. WTO's involvement in trade finance issues

Trade finance is generally considered a very secure, short-term and self-liquidating form of finance. Nevertheless, the reluctance of many lenders to finance short-term credits confirms that trade finance markets have not been immune to the present crisis.

The current credit crunch is having a direct negative effect on trade due to reduced access to trade finance. The same scenario was experienced by emerging economies in the 1990s. According to market specialists, demand for trade credit is far from being satisfied, and prices for opening letters of credit far outweigh the normal reassessment of risk, particularly in developing countries.

Changes in the general perception of the commercial risks related to trade finance derive from increasing doubts about the creditworthiness of banks, a rise in country balance-of-payment risks, and the presence of large exchange rate fluctuations. An expected increase in payment defaults on trade operations in the second part of 2008 meant that some banks were unable to meet the demand from their customers for new trade operations, leaving a "market gap" estimated to be around $25 billion in November 2008. In addition, the price of transactions increased sharply. A re-assessment of customer and country risks and the lack of liquidity – which has spread to the developing country money markets – is making it difficult to back up loans.

The institutional case for the WTO to be concerned with the present scarcity of finance is clear. The experience of the Asian financial crisis led to the establishment of a group of trade finance experts in 2003 by the heads of the WTO, International Monetary Fund (IMF) and World Bank – under the umbrella of the Marrakesh Mandate on Coherence – to examine the causes of the financial crisis and prepare contingencies. The group concluded that rapid action was needed to promote a menu of instruments to facilitate co-financing between private and public sector trade finance providers. This would allow for risk-sharing in an increasingly unstable market environment. In the immediate aftermath of the Asian crisis many outstanding credit lines for trade were rescheduled by creditors and debtors in order to reignite trade flows. The expert group has continued to operate since, and has gained relevance in the wake of the current global economic crisis.

3. What is the situation now?

According to the joint IMF-BAFT (Bankers' Association for Trade and Finance) survey –

undertaken in the context of the WTO Expert Group Meeting on 12 November 2008 and presented at its meeting on 18 March 2009 – flows of trade finance from developing country banks appear to have fallen by some 6 per cent or more between the end of 2007 and the end of 2008. The fact that this number exceeds the reduction in developing country trade flows during the same period, indicates that the lack of available trade finance is indeed an issue.

Results from a survey undertaken by the International Chamber of Commerce (ICC) were also released for the WTO Expert Group of 18 March 2009 and further updated before the G20 London Summit. This survey, relying on a wider panel of banks and countries (122 banks in 59 countries) also confirmed the conclusions drawn by the IMF-BAFT analysis: trade has decreased as a result of the recession and tight credit conditions.

Business associations including BAFT, ICC, Business Europe, as well as individual commercial banks, have been making recommendations to the G20 Summit in London, in the following areas:

Reviewing Basel II Rules. Results from a survey conducted by the ICC United Kingdom in parallel with the ICC Global Survey indicate that the implementation of the Basel II framework has eroded the incentive of banks to lend short-term for trade, because capital weightings are not fully reflective of the low-risk level and short-term character of the activity. In a risk-weighted asset system, increases in minimum capital requirements had particularly adverse consequences on trade lending to small and medium-sized enterprises (SMEs) and counterparties in developing economies.

Creating a ring-fenced liquidity pool for trade finance. The general proposal was to design a small and targeted liquidity fund run by international financial institutions and useful for smaller segments of the market or new countries, in particular those most likely to be hit by the contraction of trade credit supply.

More co-sharing of risk with public sector-backed institutions. The idea would be to encourage co-finance between the various providers of trade finance. Public sector actors, such as Export Credit Agencies (ECAs) and Regional Development Banks, should be mobilized to shoulder some of the private sector risk.

4. Public and private players to boost supply of trade finance

One clear lesson from the Asian financial crisis is that in periods prone to a lack of trust and transparency, and herd behaviour, all actors – including private banks (which account for some 80% of the trade finance lending operations), export credit agencies and regional development banks – should pool their resources, as far as practicable.

Furthermore, the design and implementation of finance facilitation programmes should be undertaken cooperatively. Cooperation would involve both the beneficiaries (exporters, importers, banks) and all export credit agencies in a region, if not globally. The Asian example of export credit agencies supporting both intra- and extra-regional trade by working as a network should be taken as an example by other regions. The WTO has been working to foster cooperation among participants.

Between the fall of 2008 and the G20 London Summit in April, it was intensively advocated in favour of increasing the capacity of International Financial Institutions (IFIs) and ECAs to shoulder the risk with private sector partners. As a result, capacities in three types of activities have been enhanced significantly:

- The regional development banks and the International Finance Corporation (IFC) have, on average, doubled capacity under trade facilitation programmes between November 2008 and the G20 Meeting.
- Export credit agencies have also stepped in with programmes for short-term lending of working capital and credit guarantees aimed at SMEs. For instance, Germany and Japan have made strong commitments on the amounts; and very large lines of credit have been granted to secure supplies with key trading partners in the United States with Korea and China.
- Central banks with large foreign exchange reserves have been able to supply foreign currency to local banks and importers generally through repurchase agreements. This has helped banks and importers in developing countries to acquire

scarce foreign exchange. Since October 2008, Brazil's central bank has provided $10 billion to the local market. The Korean central bank has pledged $10 billion of its foreign exchange reserves to do likewise. The central banks of South Africa, India, Indonesia and Argentina are also engaged in similar operations.

Filling information gaps between public institutions and the private sector is also a high priority. While more financing capacity is provided by public institutions, it seems that the private sector's ability to respond, particularly in developing countries, continues to deteriorate. For instance, BAFT members have complained that the series of measures announced by ECAs and Regional Development Banks were hard to track and that they lack information on who is providing what, and under what criteria.

Another reason why strong links are needed among the various players is the absence of a comprehensive data set on trade finance flows. This makes the collection of informed views and surveys from various institutions the main channel for making a reasonable assessment of the market situation.

5. The G20 Summit in London: A Trade Finance "Package"

The trade finance "package" proposed during the G20 London Summit responds in large measure to the criteria developed by the WTO Expert Group on Trade Finance. It also takes into account the recommendations made by the private sector.

The principal aim of the financial package is to strengthen public-private sector partnerships in the context of existing trade finance facilitation programmes, which will be further enhanced, not only in respect of credit insurance, but also by opening and expanding liquidity windows of regional development banks to allow greater co-lending with banks.

The IFC is reinforcing its global trade finance facility through the introduction of a liquidity pool. A 40 to 60 per cent co-lending agreement with commercial banks has been put in place. The IFC's Global Trade Finance Liquidity Fund started with $5 billion in funds (raised by both the IFC and several individual donors). According to the co-lending formula, these funds should be matched by $7.5 billion in commercial bank funding. The IFC Fund could increase over time by attracting more donors and hence more funding by banks. The objective of doubling the Fund's total capacity in the next two years, from $12.5 to $25 billion, is feasible and will cover financing for up to $50 billion of trade transactions. The Standard Chartered Bank and Standard Bank have already signed off on credit lines, with hundreds of millions of dollars for financing Africa's trade.

Another main point of the package is to strengthen the capacity of OECD export credit agencies, allowing them to offer more finance and a wider spectrum of instruments. These ECAs will be encouraged to provide more direct funding in the short run (such as working capital lending and other forms of short-term direct support), *via* increased capacity on the insurance side.

Finally, several institutions, such as IFIs, ECAs and other government agencies, will try to revive the secondary market by intervening directly in that market.

The logic of acting by way of increasing co-financing and co-risk mitigation has been followed by the Heads of States and Governments. Since the package is expected to be implemented over two years, early commentary by some press and academics about the lack of new funding should be put in a longer-time perspective, bearing in mind that the package has been designed with the objective of raising rather than reallocating existing funds.

The WTO stands ready to continue mobilizing governments, IFIs, export credit agencies and the private sector to implement the G20 commitments. Support for trade during a difficult juncture is a win-win strategy for both developing countries facing all kinds of contractual payment pressures and for developed countries, where output and trade are closely linked to emerging market economies through complex supply chains.

The WTO will continue to assess market developments, mobilize political energy and funding to restore the role of trade finance as the oil needed to keep the wheels of trade turning.

(www.tradeforum.org)

(Contd. on p. 40)

BOOKS/ARTICLES NOTES

BOOKS

The Return of Depression Economics and the Crisis of 2008 by Paul Krugman, published by W.W. Norton & Company, 2009, pp. 191.

THE book "The Return of Depression Economics and the Crisis of 2008" by Paul Krugman is a second edition work. The first edition was written in response to the Asian Crisis; the second edition updates and adds material to the various disruptions of the 1990s but also adds materials attempting to explain how the US evolved into the current crisis it now faces. The first four chapters of the book examine major financial crises in varying detail that include, the Panic of 1907, the Great Depression, the Savings and Loan Problems of the 1980s, the Latin American Crisis of the mid 1990s, the Asian Flu of the mid to late 1990s, Russian Debt Crisis and Japan's Lost Decade. The author offers readers a history of these financial crises to set up his view of the causes, effects, and possible solutions to the current economic woes. Mr. Krugman mentions about the economic crises that had swept across Asia and Latin America, and points out that those crises were a warning for all of us like the economic troubles that caused the Great Depression. He says that as Wall Street boomed and financial wheeler-dealers made vast profits, the international crises of the 1990s faded from memory. But when the great housing bubble of the mid-2000s burst, the US financial system proved as vulnerable as those of developing countries caught up in earlier crises, and a replay of the 1930s seemed all too possible.

The book is written in a style that is easily comprehended; it provides a good synopsis of the financial and economic disruptions around the world over the past twenty years. For example, the babysitting coop analogy is a classic, and still one of the clearest, simplest ways to explain the interaction between monetary policy, aggregate demand, and consumer behaviour. It describes about a babysitting group in Washington DC, where lots of couples agreed to babysit for each other and in order to facilitate the process, they issued coupons. If a couple baby-sat, they'd get a coupon; if they engaged the services of a baby sitter, they'd pay a coupon. As a result couples, fearful of missing important social engagements, were more willing to babysit on a regular night than to go out on one. Because the ability to attend functions was more valuable than a night off, everybody wanted to save their coupons. But Krugman says this scheme ran into problems during the winter. The couples saved their coupons (that is, they refused to hire babysitters) while trying to get more coupons (sell babysitting services) so they would be able to go out more often in the summer. The answer, Krugman says, would have been to tinker with the value of the coupons, like a central bank tinkering with a currency to stimulate an economy.

Krugman also mentions about various crashes, such as the "Tequila crash" in South America in the mid-90s, and the Asian crash that happened three or four years later. He mentions that they all happened because the banking system exposed itself to too much risk. As the people lose confidence, panic starts. Krugman compares panic to a feedback loop of a microphone where the sound of feedback grows until it becomes an unbearable screech. He says that a financial crisis begins with a seemingly small change that chip away at confidence, eventually turning into a pit of panic. He further mentions that in each case, there was a spark that moved confidence to ever greater heights, only to have it all come crashing down. This process leaves a kind of stain on the minds of investors, policymakers, and everyday people alike. As illustrated with Japan's Lost Decade or the Great Depression, confidence, once lost, can be difficult to regain. The author points out that where these surges and eventual collapses in confidence occur, the power of speculators can be found on full display. He mentions that speculators often go by the name of 'hedge funds', but these profiteers rarely do much in the way of hedging. Rather, they are fully engaged in turning a profit wherever opportunities exist and at whatever the social costs may be. In the cases of Latin America and Southeast Asia, hedge funds played an important role in the rapid descent of these financial markets and economies. The basic strategy of hedge funds is to exploit markets by shorting safer assets and then buying long in riskier assets. However, when a market is ripe for a financial crisis, these speculators will engineer trades that will shake the stability of a country's financial markets with currency being a prime target. Mentioning about a singular example, the author points out that Argentina's currency lost 70 per cent of its value due, in part, to the role of hedge funds. This devaluation caused a great deal of pain and hardship for Argentineans, but social costs are irrelevant to profiteers.

Focusing the questions of regulation of financial system Krugman says that the hedge funds are largely unregulated and take great care to stay away from the watchful eyes of regulators. He says that the hedge funds are not alone in taking advantage of regulatory blindness. The author skillfully parallels the so-called shadow banking system with the operations of hedge funds. He points out that in both cases, profits were the motivation, leverage was used at mind boggling levels, each engaged in some form of risk arbitrage, and in the end, both created widespread financial destruction. The only difference between them is that hedge funds profited from the downward spiral while once esteemed companies like Lehman Brothers collapsed. Krugman also presents the right level of details in explaining the shadow banking system so that a reader can understand how the world was blindsided by a banking system. At one point, he estimates that the traditional banking system had $6 trillion in assets while the shadow banking system, which was completely unregulated accounted for another $4 trillion.

Drawing on the themes of past financial crises, the author mentions that the current wave of panic in the US, a previously unthinkable possibility, bore a striking resemblance to all its predecessors. As the largest economy in the world, many believed that the problems of subprime mortgages could be contained. But once the subprime crisis was in full swing, a crisis of confidence developed. The shadow banking system, largely dependent on borrowings between banks began to show signs of great coercion. With rapidly falling confidence in financial institutions, companies attempted to deleverage quickly, selling off assets and abandoning loans to other institutions. This compounded the problem, following the same cycle of confidence degradation that all financial crises share. The net result was the deepest recession in a generation. In the policy realm, Krugman argues that macroeconomic managers and economic policymakers want discretion in monetary policy so that they can fight recessions and curb inflation; stable exchange rates so that businesses are not faced with too much uncertainty; and free international trade. He concludes that, in fact, a country can only achieve two of these…it is impossible to achieve all three at the same time. It is at this point that Krugman offers some advice on what must be done to move out of recession or at minimum, avert a depression. His recommendation for the immediate future is to get credit flowing again and to prop up spending by any means necessary. In addition, he believes that depression economics must be used and that policy should focus on demand side macro-economics. Outside of the immediate needs, Krugman proposes global, coordinated financial reforms for any financial institution or market that meets a very plain definition: anything that needs to be rescued in a financial crisis must be regulated. The crisis had victims in all corners of the globe, but there seems no clear path towards recovery. The flow of credit and fiscal stimulus are good starting points, but much more will be needed. In order to prevent another crisis of this magnitude, regulation will play an important role, but it would be foolish to believe that this will be the last.

The chief goals of this updated edition, as highlighted in the book's introduction, are to answer three important questions: How could this catastrophe have happened? How can the victims recover? How can we prevent this from happening again? In reading through this extensive piece of past financial crises and their commonalities, the author does a thorough job in answering the first question. Additionally, his prescription for preventing future calamities of this sort is sensible and built on sound principles. The book can be easily comprehended by someone who has a basic understanding of economics. Overall, the book offers an important and timely look at the nature of financial crises and is likely a timeless exposition on the subject. However, the book leaves the reader wanting a more detailed proposal for what must be done to repair the damage created by this crisis. The book also lacks details in explaining exactly how victims of this round of financial instability are to recover.

ARTICLES

Asian Face of the Global Recession
by C.P. Chandrasekhar and Jayati Ghosh,
The Hindu Business Line, 10 February 2009.

THE article at the outset describes the worst impact of global economic crisis through the damaging projections presented by different international economic organizations and many other government institutions on the purchasing power parity and fall in non-farm employment in the US in the recent months. It also takes the reference of World Economic Forum meet at Davos and points out that new evidence released during the Forum indicated that the global crisis was not just bad, but worse than originally anticipated. Through different figures and graphical presentation the article locates the declining tendency in the non-farm employment and its impact on the global demand. It also projects that the export growth in the advanced economies will fall from positive to negative level and developing economies will face the same consequences. The article also elaborates about the developing economies in Asia, which as a group grew at 10.6 and 7.8 per cent in 2007 and 2008. It says that these economies are now expected to grow at just 5.5 per cent or 1.6 percentage points lower than the recent projection.

The next section named 'growth engine hit' puts the figures related to the economic growth of Japan and three growth engines in Asia, the Asean-5, China and India which are badly affected by the crisis and projects immediate damaging future for South Korea with projected contraction of its economy by 4 per cent this year. The article also points out the biting effect of recession on employment in Asian countries including China, where 20 million rural migrant workers lost their jobs. A sample sector survey by the Labour Bureau in eight sectors indicates a decline in all industries at an average rate of 1.01 per cent per month. The article states that these trends in Asia are of significance because there was an optimism that Asian economy due to its market-friendly policies will act as the shock absorber and would buffer the global downturn. There is optimism that the phenomenon would be restricted to the developed countries without having a damaging effect on global growth.

While taking the reference of the East Asian financial crisis the article views that 1997 was an aberration that resulted from "cronyism" and not from liberalization and global integration. The economic crisis in the US and other developed countries in the past have dragged Latin American countries down to degrees far greater than the crisis in the developed countries. The article points out that the poor performance of much of Africa and Latin America was due to the emergence of the Asian economies and this emergence happened because of shift to a regime that opened Asian economies to trade, foreign direct investment and intensified financial flows. The article views that more than the last two decades has witnessed a transformed Asia's relationship with the rest of the world due to regional integration through trade and investment flows and creation of an export platform in which multi-country production network created products that were targeted at world markets.

The article elaborates that the impact of the process of liberalization and integration witnessed a sharp increase in foreign investment flows to the region with the liberalization of rules regarding the presence and operation of foreign firms, including financial firms like banks, merchant banks, insurance companies, hedge funds and private equity firms. Finally, the article describes the impact of the global financial and economic crisis on the Asian economies. It states that unwinding of foreign financial investors from Asia has resulted in the form of collapse and steepest fall of stock markets. It also mentions that slow export growth in export-driven economies and outflow of capital has forced central banks to release more liquidity in pressure of their corresponding currencies.

Trade Financing: Is It a Barrier to Africa's Exports? by John Humphrey,
Source: http://www.voxeu.org, 28 April 2009.

THE article attempts to interrogate the impact of the trade finance shortages induced by the crisis on the developing country exporters by taking the 30 export-oriented African firms. The assessment of the surveyed firms points out that very few firms face trade finance problems due to the resilience of the domestic banking system and existing trading relationships. The present article is divided into four parts. The article in the beginning takes the reference of the columns written by Baldwin and Pryce in 2009 which highlights the uncertainty surrounding trade financing. It mentions about the G20 meeting where at least 250 billion dollars over the next two years were promised to support trade finance. It further takes the views of Marc Auboin who emphasizes the importance of increasing trade finance and Richard Baldwin, who raises some doubts on the reasons of decline in world trade due to problems with trade financing. Mentioning about the formation of the WTO task force on trade credit the article points out that the concerns with trade finance and absence of hard evidence about its impact on global trade have both been evident since the second half of 2008.

The second part of the article mentions about the impact of financial crisis on the developing economies by taking the example of the East Asian financial crisis of 1997. It points out that impact of such crises is immediate and effects trade finance severely, as international lenders rapidly reduce their exposure to risky markets. This part of the article also mentions about the opportunities opened up by globalization in developing countries in the area of exports of labour-intensive manufacturing and non-traditional agricultural exports in order to reduce poverty. It questions the fate of exporters from low-income countries in the declining availability of trade finance when the unprecedented financial crisis and its impact through the banking system have affected many sectors around the world.

The third part of the article presents the analysis of the survey of 30 medium and large scale African firms and discusses the impact of trade finance on export of the products from these firms. The article points out that credit in general is available to the firms from domestic banks as long as they showed themselves to be creditworthy. While horticulture firms are considered good risks by local banks, the garment companies are generally considered more risky as export-oriented companies have suffered since the phase-out of the Multifibre Agreement. But as per the findings of the study their access to finance from the domestic banking system had not changed. The article points out the nature of trading relationships of the firms with customers and also mentions the case of horticulture firms where inter-company credit sustained the trade. It further mentions the case of garment companies which has greater reliance on financial instruments such as letters of credit. But it says that most firms relied on the parent companies for trade finance, and with a small number of exceptions, its availability was unchanged.

The final section of the article analyzes the heterogeneous impact of the crisis on trade finance. The findings show that the global financial crisis has uneven impact on exporters in developing countries. The article presents three observations regarding the exports from firms of sub-Saharan Africa. The first observation states that the sub-Saharan Africa appears to have been less affected, so far, by trade finance problems than other regions. The second observation says that restrictions on credit in the domestic market are hitting small traders and cooperatives that do not have the business linkages which are needed to access inter-company credit. Thirdly, the African exporters interviewed were clearly affected by other issues arising from the global financial crisis, particularly declining demand for garments and exchange-rate volatility for horticulture exporters targeting the UK market. The article concludes by saying that impact of the global crisis on developing country exporters is highly differentiated by region, by sector, and by type of firm.

Greek Lessons for World Economy
by Dani Rodrik, *Business Standard*, 18 May 2010.

THE article points out the support package given by EU partners and the International Monetary Fund (IMF) to the Greek government in order to sort out its financial disaster. The author suspects that the given package will be helpful for Spain and Portugal but logically states that the Greek debacle has given the EU a black eye. While mentioning economic globalization, political democracy, and the nation-state as a political trilemma of the world economy, the author says that these are mutually irreconcilable. The author says that only two phenomena from the trilemma can exist at one time and portrays their survival by giving three different combinations.

Taking the example of the history of the world economy the article points out that the first era of globalization, which lasted until 1914, was a success as long as economic and monetary policies remained insulated from domestic political pressures. It further takes the example of the classic case in Britain's short-lived return to gold in the inter-war period, when attempt to reconstitute the pre-World War-I model of globalization collapsed in 1931. It collapsed because once the working class got organized and mass politics became the norm, the domestic economic objectives began to compete with external rules and constraints. The architects of the Bretton Woods regime then redesigned the world's monetary system in 1944 by considering only a "thin" globalization, with capital flows restricted largely to long-term lending and borrowing. Once the Bretton Woods regime collapsed in the 1970s, the third path identified by the trilemma was introduced. This case contemplates economic integration with democracy through political union among states, where loss in national sovereignty is compensated by the "internationalization" of democratic politics. The article mentions that the global financial crisis caught Europe midway through the similar process. The argument for political integration alongside economic integration could not take the proper shape as European leaders always understood that economic union needs to have a political leg to stand on.

While mentioning about the crisis in Greece, the article points out that Greece benefited from a common currency, unified capital markets, and free trade with other EU member states but it does not have automatic access to a European lender of last resort. In the same way Greek banks and firms lose their creditworthiness alongside their government if markets perceive the latter to be insolvent. The article also mentions the vulnerability of both German and French governments over Greece's budget policies and their borrowings (indirectly) from the European Central Bank (ECB). The article points out the messier characteristics of this deep financial crisis by stating that both the countries are neither in a position to enforce their banks' claims on Greek borrowers or seize Greek assets nor they can prevent Greece from leaving the eurozone. It also says that the French and German governments have grudgingly come up with a major loan package and the ECB has lowered the threshold of creditworthiness that Greek government securities must meet in order to allow continued Greek borrowing.

Finally, the article views that the success of this rescue package cannot be assured in the view of the magnitude of the crisis and the hostility that it has created on the part of Greek workers. It further states that this crisis has revealed that in the midst of demanding globalization European institutions still need to evolve in order to underpin a healthy single market. It says that the EU has the same choices as the other parts of the world are facing: either integrate politically, or ease up on economic unification. It concludes by saying that Europe will no longer delay in making the choice that the Greek affair has laid bare.

Can Obama's Team Revitalize Trade Finance?
by Mark Ford, *DC Insight*, (Trade Finance Quarterly of the International Chamber of Commerce), Vol. 15 No.1, January-March 2009.

THE article in beginning points out that the credit crunch in the US sub-prime mortgage market has bitten hard into the letter of credit market, and consequently into international trade and shipping. It says that the global credit shortage can lead to an immediate revival of L/C business and Obama government will play a critical role in the future of international trade. The article mentions about the exporters, importers, shippers and sellers inability of obtaining L/Cs, and states that the financial instrument widely recognized as a facilitator of international trade has become too scarce commodity. It states that while stressed banks, such as Wells Fargo and Wachovia, have forced traders and shippers to look elsewhere for L/Cs, the Chinese banks have tightened standards for L/C issuance.

The next section of the article points out that the impact of the L/C has been felt beyond the banking system. It says that while merchant fleets are stranded, the Baltic Dry Index, which tracks shipping costs for commodities and provides indicator of demand for shipping seems to be disappearing. There are few countries who have attempted to make L/Cs more attractive. While State Bank of Pakistan has removed a 35 per cent cash margin requirement on import L/Cs for certain items, the US Export-Import Bank has widened availability of L/Cs for US firms. Similarly, few non-bank entities such as a UK chamber of commerce that offers its own L/Cs, is experiencing increased demand of L/C. The article mentions about different bail-out plans launched by the governments across the world. Taking the reference of the World Trade Organization's director general the article says that trade finance at high prices has been very difficult for some developing countries and the problem is particularly acute for businesses in emerging markets. The article also highlights the director general's view on the difficulties of fitting a "safety harness" to the global financial system, as it suffers from a lack of regulation, a lack of transparency, a lack of accountability.

The next section of the article points out the importance of trade relations and says that international trade will be one of important catalysts for improving the relations among nations; therefore the US president's policy on trade is critically important. It further says that Mr. Obama sounded more anti-trade during the campaign, when he talked negatively about the Central American Free Trade Agreement and the North American Free Trade Agreement (NAFTA). The choice of Timothy Geithner to run the Treasury Department has also disappointed some people as Geithner and Paulson failed to see the crisis coming and allowed Lehman Brothers to go bankrupt, deepening the global financial crisis. But it says that Geithner has experience in international trade through his involvement in the bail-outs of Mexico, Indonesia, Korea, Brazil and Thailand.

The article also comments on the choices of Obama's secretary of commerce and the US trade representative. It says that Bill Richardson compulsion to withdraw his name as President Obama's secretary of commerce has discouraged the free trade advocates. Mr. Richardson was a staunch pro-free-trade Democrat, and his initial selection indicated that the new administration will not follow a protectionist course as compared to Mr. Obama's protectionist campaign. The article also states that due to his inexperience in trade and labour issues, Ron Kirk's choice as the US trade representative is more problematic because the trade representative portfolio is very important for the nation's international trade policy.

Finally, the article states that in order to revitalize its trade the US needs to develop cordial working relationship with China. As the Chinese have accumulated US$2 trillion in cash reserves and if the US continues to finance its recovery programmes then it will have to negotiate with the Chinese from a weaker position. It also mentions that there will be several issues between the US and China including energy and the environment but the global economic crisis is the most volatile. Therefore, neither Mr. Obama's anti-trade rhetoric, nor measures such as China's increased tax rebates for exporters seems to promise well for restoring confidence in the credit markets and rejuvenating world trade.

Lessons from the Greek Economic Crisis
by A. Rangachari, *The Hindu*, 7 June 2010.

THE introductory section of the article differentiates the Iceland and Greek**'s** economic turbulence by explaining that Iceland episode was the result of instability of its banks and financial institutions while economic turbulence in Greece was triggered by a deep fiscal crisis. It says that the crisis in Greece was driven by a growing fiscal deficit and a declining GDP, which has led to instability in the European Union's common currency. Therefore, the EU leaders have announced a bailout package in collaboration with the International Monetary Fund.

The next section of the article reflects on the limited impact of this crisis in India. While mentioning about the fiscal deficit, government's public debt and the external debt the article says that the Indian government has taken some positive steps in the fiscal area in order to contain fiscal deficit and borrowing. The government has also recognized the importance of medium-term fiscal sustainability while preparing the annual budget. Although there is no such law to put ceiling on public debt but the Fiscal Responsibility and Budget

Management Act (FRBM Act) which curbs budgetary deficits, has stipulated abolition of revenue deficit and reduction of fiscal deficit to 3 per cent of GDP. The article suggests that despite being panic the government should take note of few shortcomings in pursuing the medium-term fiscal approach. The article also states that achieving targets is important and therefore credit is being taken for fiscal consolidation on the basis of conforming to the revenue and fiscal deficits in the FRBM Act 2003. The article further points out about the neglect of reform in major areas of revenue and expenditure that alone can lead to real long-term fiscal health.

The third section of the article mentions about the specific areas for immediate action where reform action should address policy and implementation issues. These areas of action includes major subsidies, vast bureaucracy, proliferation of functions in ministries and departments, overlapping schemes, cost and time overruns in projects, effectiveness of public expenditure, burden of PSUs on the budget, sick and cash-loss PSUs, cross-subsidy of railway fares by freight and revenue foregone through tax exemptions. It further elaborates that the areas such as dismantling of administrative price mechanism in petroleum products, procurement price policy for foodgrains, outsourcing functions, rational allocation of scarce resources among competing priorities, efficiency of public distribution system, making output-outcome budgeting an effective management tool, privatizing PSUs no longer in the current list of areas fit for governmental operation, and winding up sick PSUs also need reform action for addressing policy and implementation issues.

Finally, the article suggests that a realistic medium-term projection of revenue, expenditure and deficits needs to be drawn up, incorporating data based on action plan to implement specific reforms. It also suggests that despite setting commissions, committees and task forces a time-bound action plan is required whose progress should be placed before parliament and the public. The other suggestions include enforcement of reform-oriented medium-term fiscal projections also by State governments where Central Government will use its leverage in that specific area. The article concludes by stating that public debt sustainability will help a combined approach with monetary policy, which will in turn sustain foreign investors' confidence and facilitate inflow of foreign direct investment.

Will the Crisis in Europe Spread?,
by Arvind Subramanian *vs.* Jahangir Aziz, *Business Standard*, 12 May 2010.

THE article presents two different views of two different experts on the issue. Arvind Subramanian a senior research professor, Johns Hopkins University, views that bailout package given to Greece simply shows the political will of European Union leaders. The author says if Greek crisis had spread to Portugal it would have troubled Spanish banks as well, therefore this bailout package will also help to firewall Spain and Portugal. While acknowledging the EUs effort in stanching the very serious prospect of contagion in other parts of the EU, the author says that by deploying the Powell doctrine the crisis can be averted. Discussing the flip side of this intervention the article points out that countries like Greece, Spain and Portugal have to undertake massive adjustment. But in case of Greece, fiscal chaos requires not just adjustment and financing but devaluation and debt restructuring. While suspecting the survival of eurozone in its current form, the author views that Germany will soon realize that it can no longer agree in the situation of being the country that bails out profligate southern partners. The article also presents different arguments in favour of possibilities of separation between the periphery and core countries by mentioning the example of European crisis, which has shown that the attempt to integrate the periphery into the core has failed comprehensively.

The author views that the crisis might be contained, but the risk remains that uncertainty in Europe will spill over to the rest of the world in the sense that there will be a flight to the dollar and to emerging markets. He also views that the recent turmoil is not strong enough to derail US recovery but the process of the US recovery might not be smooth. It says that after uncertainty settles down in the European Union, restructuring of some more debt in countries like Greece and Portugal and need for two sets of currencies in Europe cannot be ruled out. Finally, the author views that uncertainty in Europe also indicates a problem for emerging markets, as they will also see large currency inflows and an appreciation in currencies. Capital coming to emerging markets will hurt exports growth but that will not dampen overall growth due to increase in consumption and investment levels. The author also points out about the danger of the asset bubbles and the distortionary impact created by the outcome of this crisis, and says that it needs to be corrected through possible policy action by the central bank.

The article presents another view by Jahangir Aziz, who says that a political commitment to the EU and financial stability measures by European Central Bank (ECB) will be a likely help for Europe to overcome the crisis. The author compares the current crisis in Southern Europe to the magnitude of 2008 world crisis and says that the entire burden of adjustment has fallen on fiscal policy, which is daunting, given the massive size of the deficit and debt of these countries. The combined funding needs of these countries are so large that a rescue package seems inconceivable. The author also views that consequent economic slowdown in Europe and the further weakening of the euro would adversely affect both the US and the emerging economies, as European banks have increasingly tapped the US markets for funding. While the economics of the EU may have confined the crisis management, the politics of the EU is the key to resolving and containing this crisis. The author also says that in the absence of a central fiscal authority, the euro zone is finding hard to coordinate actions and ECB action in this regard will need to convincingly explain these extraordinary steps in order to preserve financial stability.

The article also points out that unlike the October crisis, when the nature and the extent of the problem and the solutions were largely unknown causing financial markets to freeze; this time the problem and the solutions are both known. It says that financial markets will remain in turmoil, but the crisis will not blow up provided that the market believes that there is political commitment to the EU. Mentioning that one trillion dollar stabilization fund by the EU/IMF an extraordinary action, the author views that following the market reaction some more steps for the bailout package may be needed. The author concludes by saying that good news is that the EU is attempting to neutralize the crisis but at the same time trillions of dollars and probably some more will be added to the already massive global liquidity.

Domino Effect on Commodity Trade

by Nidhi Nath Srinivas, *The Economic Times*, 1 December 2009.

THE article at its outset states that real estate might be the epicentre of Dubai’s debt crisis, but the Indian commodity trade will feel its aftershocks for the coming years. The article mentions the importance of Dubai by stating that it is the hub of most-traded commodities, from pearls, gold and diamonds to tea, cotton, basmati and sugar.

The article also explains that Dubai is equally important place for the Gulf Cooperation Countries, who use Dubai as a convenient and glitzy business centre to meet each other and the outside world. The article mentions that for the Indian companies, Dubai epitomizes their entire west Asian business. Mentioning another importance of Dubai, the article explains that it is attractive place because of light-touch regulation and easy finance. Most people also use the City of Gold as a trans-shipment point and its local banks as moneybags for short-term trade. Since there are no balance sheets available, there is no way for an Indian bank or company to figure the actual exposure of its potential partners to Dubai’s debt crisis. The article presents two different scenarios. For Dubai-based importers, the trade finance will start drying up because the liquidity crisis and higher risk will drive up interest rates on loans and advances. The Indian exporters will reduce open account sales because they are so risky. Therefore, their focus will be on getting back the money they are to be paid. The article also mentions that Indian banks will start demanding more documents and letters of credit as it reduces risk for both exporters and importers. Banks will also charge more for the same trade finance instruments because of exploding counterparty risk.

The article also elaborates about the situation by saying that the volume and value of trade itself may be affected because channels will be clogged and traders will be trying to exit a crumbling credit market. People will hold their cash and get rid of stocks as these areas are vulnerable for trading and there is continued exposure to risk. The article further explains that if UAE chooses to print more notes and devalue its currency, the Indian exporters would suffer further from losses. Mentioning about the volume of debt the article says that every man, woman and child of Dubai owes the world half-a-million dollars. It says that decline in purchasing power would mean that many high-value Indian products would become unaffordable. The article views that Saudi Arabia, Qatar and Abu Dhabi may coordinate to rescue Dubai in a similar way as Iceland was bailed out by the European Union.

Finally, the article compares the last year's global debt and banking crisis with the Dubai crisis and says that positive aspect of this crisis might lead to a deeper scrutiny of crony capitalism that has been the leitmotif of the west Asian business. It also points out that now the balance sheets and risky investments will be put under the lens and the market will favour the prudent and the secure. It concludes by mentioning that at current juncture the Indian companies will quickly discover the really trustworthy partners.

Time to Upgrade Ratings by Hemant Mishra, *The Economic Times*, 4 May 2010.

THE introductory section of the article mentions the role of credit rating agencies and the reaction they evoke among different countries. By taking the example of the crisis in Greece the article states that prior to the rating agencies' opinion the European leaders vacillated from the issue of rescue package. But after the downgrade of Greece, Portugal and Spain, the leaders suddenly felt the urgency to arrest the contagion. It says that the rating agencies are not above the criticism, due to the shortcomings in the methodology that credit rating agencies use to assign sovereign credit ratings. Although the sovereign ratings are considered scientific in nature, the growing criticism from governments points out two key issues about the rating agencies.

The article views that the first issue is about the lack of a clear and well-understood analytical framework used to determine sovereign creditworthiness. The second issue is relevant from the Indian perspective, which is problematic as it has fundamental biases towards the western world and overlooks the developing world. While Greece and other advanced industrial countries have proved far more vulnerable than expected, the performance of lower-rated countries in the past two years has been better than expected.

The article points out that the rating agencies under-appreciated India but the Indian economy and banking system proved resilient to the global financial crisis and the ensuing recession beyond the expectation of the rating agencies. Mentioning about different aspects of the Indian economy the article states that India's sovereign rating should be revisited also because of country's consistent economic fundamentals and potential. Elaborating further upon the Indian economy, the article highlights the advantages of the medium-term fiscal consolidation plan and reform in the area of subsidy and fuel price policies. While Indian economic growth, primarily driven by consumption, is more stable compared to China's investment driven economy, the variety of other economic factors such as dependency to fund its fiscal deficit and its status as the top recipient of remittances in the world, warrant India a higher-than-investment-grade rating. The article also explains that despite the dislocation of international capital markets, confidence in India is supported by high international reserves. Record accumulation of foreign exchange reserves, provides ample resources to support import and all other financing needs. It views that India can bail the EU's most troubled members as its reserves are greater than the combined deficits of Greece, Spain, Portugal, Iceland and Ireland.

The article also points out that despite the rating agencies' slow appreciation, borrowers from South Korea and Malaysia have similar overseas borrowing cost as the Indian borrowers, which shows that market is pricing on India's strong fundamental strengths. Highlighting the importance of an upgraded India's sovereign credit rating the article mentions that it will not only enhance access to international capital markets and lower debt issuance and interest costs but will also foster foreign direct investment and promote more vibrant local capital markets. Finally, the article says that potential benefits to trade finance caused mainly in the form of lowering the letter-of-credit charges, will reduce import cost to the benefit of the entire country. It suggests that Indian government must challenge the status quo of the sovereign rating and engage the rating agencies to ensure that India's massive infrastructure financing needs are well understood.

TRADE FINANCE

The Challenges of Trade Financing

SOME 80 to 90 per cent of world trade relies on trade finance, and there is little doubt that as of mid-2009, the trade finance market is experiencing difficult times – difficulties that will contribute the global economic malaise. Public-backed institutions are responding, but are they doing enough?

Part of the collapse of world trade is due to problems with trade credit financing. Since statistics on this are scare, it is impossible to be precise about the most immediately salient and challenging feature of the financial crisis from a trade perspective – the supply of trade finance.

Trade Credit Financing

Trade finance is at the low-risk, high collateral end of the credit spectrum but this has not insulated it from the crunch (US Dept of Commerce 2008). Some 80 to 90 per cent of world trade relies on trade finance (trade credit and insurance/ guarantees), mostly of a short-term nature. The potential damage to the real economy of shrinking trade finance is enormous (IMF 2003). International supply chain arrangements have globalized trade finance along with production. Sophisticated supply-chain financing operations – including for small- and medium-size companies – have become crucial to trade.

Concerns about the scarcity of trade finance for developing and low-income countries have been identified as an issue in the WTO since the Asian financial crisis, as such countries are prime victims in the general reassessment of risks and liquidity shortages that characterize periods of financial crisis (Auboin and Meier-Ewert 2008). At the request of member governments, the WTO is seeking to encourage the revival of the complex links and networks of actors involved in the trade finance market in order to keep finance flowing for trade, thereby mitigating at least one reason for the shrinkage of trade flows.

As early as 2003, the perceived need to work at an inter-governmental institutional level to find global solutions to trade finance challenges led the Managing Director of the IMF, the President of the World Bank, and the Director-General of the WTO – in the context of the WTO Coherence Mandate – to convene major players to find ways to improve flows of trade finance (for example, letters of credit and other documentary credit) to developing and least-developed countries. Particular emphasis was placed on encouraging regional development banks and the World Bank to expand innovative, WTO-compatible ways of financing trade operations. Since then, the main players, including inter-governmental multilateral organizations (the WTO, World Bank, IMF), regional development banks, the Berne Union of Credit and Investment Insurers, and leading private sector banks, have met regularly at a high but informal level in the format of the WTO "Expert Group on Trade Financing". The group meets as needed and reports to WTO Members through the Director-General and Secretariat. Since 2005, longer-term efforts to boost trade finance for developing countries through better infrastructure for supplying trade finance – such as the development of competitive banks and export credit agencies – have been carried out under the Aid-for-Trade mandate.

How Bad is the Problem Now?

One clear lesson from the Asian financial crisis is that, in periods prone to herd behaviour and a lack of trust and transparency, all actors – including private banks (which account for some 80 per cent of the trade finance market), export credit agencies, and regional development banks – should pool their resources as much as practicable (IMF 2003). Strong links among the various players are also important because of an absence of comprehensive and reliable data on trade finance flows. This means that the main channel for making a reasonable assessment of the market situation is via the collection of informed views and partial statistics from various institutions. This has been a key aspect of the activities of the WTO Expert Group.

While trade finance is generally sound finance (underwritten by long-standing practices and procedures used by banks and traders, strong collateral and documented credit operations), and seemed to have "resisted" rather well throughout 2007 and the beginning of 2008, it became clear over the course of 2008 that the overall liquidity squeeze was hitting trade credit supply. The refinancing of such credit was becoming more difficult, and lending was also affected by the general re-assessment of risk linked to the worsening global economic climate. Spreads on short-term trade credit facilities soared to 300 to 600 basis points above LIBOR, compared to 10 to 20 basis points in normal times. A market gap has emerged among the largest suppliers of trade finance, estimated by the main private Wall Street banks to be around $25 billion in November 2008 – out of a global market for trade finance estimated at some $10 trillion a year. Large banks have reported on several occasions that the lack of financing capacity has rendered them unable to finance trade operations. Recently, for example, a $1 billion bilateral trade contract between the US and China was dropped due to a lack of finance.

The liquidity problem has spread to developing countries, which account for one-third of world trade and are now facing the same problems of opening letters of credit and other trade financing instruments in their local markets. According to a survey conducted jointly by the IMF and the Banker's Association for Trade and Finance that will be released soon, flows of trade finance to developing countries seem to have fallen by some 6 per cent or more year-on-year – significantly more than the reduction in trade flows. If such numbers were to be confirmed (at least local bankers seem to agree on them according to the survey), that would mean that the market gap could be well over the $25 billion estimate mentioned above.

The scarcity of trade finance is very likely to accelerate the slowdown of world trade and output. There is mounting evidence of supply chain operations being disrupted by lack of financing for developing country suppliers, particularly in Asia.

At present, the WTO is doing its utmost to mobilize public-sector actors to shoulder some of the risk from the private sector and to do more by way of encouraging co-financing between the various providers of trade finance. With the support of WTO members, the Director-General has convened the WTO Expert Group for Trade Finance twice in 2008, aiming to (i) find collective short-term solutions, notably by mobilizing government-backed export credit agencies and regional development banks, and (ii) develop technical measures allowing for better interaction between private and public sector players in the short- and medium-term. The latter encompasses projects developed by the International Chamber of Commerce, the IMF, the IFC, and the Berne Union, all of which aim at removing the obstacles to co-risk sharing and co-financing by various institutions.

Ongoing Policy Efforts

The response of public-backed institutions has been positive, and three types of activity are currently in play:

- Regional development banks and the IFC have recently enhanced their trade facilitation programmes: the IFC from $1.5 to $3 billion, the Inter-American Development Bank (from $0.5 to $1 bn), the EBRD (from $1 to $2 bn), and the Asian Development Bank (from $0.4 to $1 bn). This has brought the total capacity to $7 billion on a roll-over basis, financing potentially some $30 billion or so of trade involving small countries and small amounts ($250,000 on average by transaction) Export credit agencies stepped in, essentially with programmes for short-term lending of working capital and credit guarantees aimed at small and medium enterprises. This includes new programmes put in place by the US, Germany, Japan, France, the Nordic Countries, Hong-Kong, China, Chile and others. For certain countries, the commitment is unlimited in amount (Germany). In other cases, cooperation is developing to support regional trade, in particular supply-chain operations. To this effect, the APEC summit announced the establishment of an Asia-Pacific Trade Insurance Network to facilitate intra- and extra-regional flows and investment through reinsurance cooperation among export credit agencies in the region. Japan's NEXI is establishing itself as the leader and main underwriter of this collective re-insurance system. The US and China agreed that their respective import-export banks would make an additional $20 billion available for bilateral trade, and the US and Korea made a similar commitment for $3 billion.

- The central banks in countries with large foreign exchange reserves – and/or which for one reason or another are facing a shortage of liquidity in dollars (due to the fall in remittances, export receipts, and the depreciation of the local currency against the dollar) – have been supplying dollars to local banks and importers through repurchase agreements. Since October 2008, Brazil's central bank has provided $10 billion to the market. The Korean central bank has pledged $10 billion of its foreign exchange reserves to do likewise. The central banks of South Africa, India, and Indonesia are also engaged in similar operations. Unfortunately, such facilities are unavailable to developing countries with fewer foreign exchange reserves, unless they swap foreign exchange against local currency with their main trading partners. This has happened in some cases (both with the Fed and the ECB).

There is little doubt that, as of mid-2009, the trade finance market is experiencing difficult times – difficulties that will contribute to the global economic malaise. But efforts continue, including through the WTO's advocacy and mobilization work, to find durable solutions to what otherwise is yet another source of economic contraction.

(*Source*: www.wto.org)

Supply of Trade Finance

PART of the collapse of world trade, as of mid-2009, is due to problems with trade credit financing. Since statistics on this are scarce, it is impossible to be precise about the most immediately salient and challenging feature of the financial crisis from a trade perspective – the supply of trade finance.

The global liquidity situation has been a major constraint in 2008 on the largest suppliers of trade finance. Trade credit has also been reduced by a general re-assessment of counter-party risk, and an increase in the expected payment defaults on trade operations. In the second half of 2008, the situation spread to developing country markets. The market gap initially appeared in Wall Street and London, as US and UK global banks – particularly those with weak balance sheets – could not off-load/refinance on their excess exposure in trade credits in the secondary market. As a result, some banks were unable to meet the demand from their customers for new trade operations, leaving a "market gap" estimated to be around $25 billion in November 2008 – out of a global market for trade finance estimated at some $10 trillion a year. More disturbing is the fact that large banks have reported on several occasions that the lack of financing capacity has made them unable to finance trade operations. Some very large banks used to roll-over up to $20 billion in the secondary market per month, are doing $200 million right now due to lack of counter-parties. Demand for trade credit is far from being satisfied, and prices for opening letters of credit far outweigh the normal re-assessment of risk according to market specialists. Further, the liquidity problem, although cooling a bit in Asia, has since spread to other developing countries' money markets in South Asia, Africa, and Latin America. This adds to the problems faced by local banks in certain developing countries even in normal circumstances such as lack of deep money markets, lack of capacity to handle large volumes of trade credit, lack of reliable information on the creditworthiness of customers, all of which lead, in periods of crisis, to difficulties in finding partners in developed countries to accept the counterparty risk.

The Efforts by Public Players to Boost the Supply of Trade Finance

One clear lesson from the 1997-98 Asian financial crisis is that in periods that are prone to a lack of trust and transparency, all actors – including private banks (which account for some 80 per cent of the trade finance market), export credit agencies and regional development banks – should as far as practicable pool their resources (IMF 2003). Strong links among the various players are also important because of an absence of comprehensive and reliable data on trade finance flows. This means that the main channel for making a reasonable assessment of the market situation is via the collection of informed views and partial statistics from various institutions. This has been a key aspect of the activities of the WTO Expert Group.

(*Source*: www.wto.org)

(Contd. from p. 27)

WTO: International Regulation and Treatment of Trade Finance: What Are the Issues?

THE paper discusses a number of issues related to the treatment of trade credit internationally, *a priori* (treatment by banking regulators) and *a posteriori* (treatment by debtors and creditors in the case of default), which are currently of interest to the trade finance community, in particular the traditional providers of trade credit and guarantees, such as banks, export credit agencies, regional development banks, and multilateral agencies. The paper does not deal with the specific issue of regulation of official insured-export credit, under the OECD Arrangement, which is a specific matter left out of this analysis. Traditionally, trade finance has received preferred treatment on the part of national and international regulators, as well as by international financial agencies in the treatment of trade finance claims, on grounds that trade finance was one of the safest, most collateralized, and self-liquidating forms of trade finance.

Preferred treatment of trade finance also reflects the systemic importance of trade, as in sovereign or private defaults a priority is to “treat” expeditiously trade lines of credits to allow for such credit to be restored and trade to flow again. It is not only a matter of urgency for essential imports to be financed, but also a pre-condition for economic recovery, as the resumption of trade is necessary for ailing countries to restore balance-of-payments equilibrium.

The relatively favourable treatment received by trade finance was reflected in the moderate rate of capitalization for cross-border trade credit in the form of letters of credit and similar securitized instruments under the Basel I regulatory framework, put in place in the late 1980s and early 1990s. However, as the banking and regulatory communities moved towards internal-rating based and risk-weighted assets systems under the successor Basel II framework, a number of complaints emerged with respect to the treatment of trade credit – particularly in periods of crisis.

Issues of pro-cyclicality, maturity structure and country risk have been discussed at some length in various fora, including in the WTO at the initiative of Members. Part of the issue was that Basel II regulation was designed and implemented in a manner that, in periods of banking retrenchment, seemed to have affected the supply of trade credit more than other potentially more risky forms of lending. With the collapse of trade in late 2008 and early 2009, the regulatory treatment of trade credit under Basel II clearly became an issue and was discussed by professional banking organizations, regulators and international financial institutions. It was suggested in a meeting of G20 leaders in London in April 2009, that calling regulators must exercise some flexibility in the application of Basel II rules, in support of trade finance. As the issue of removing the obstacles to the supply of trade finance spread became part of the public debate, discussions with respect to the regulatory treatment of trade finance in the context of the making of “Basel III” rules are now raising political attention.”

(*Bespecific.com* 13 March 2010)

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NEW BOOK ON INDIA'S TRADING ARRANGEMENT

India's Regional Trade Agreements

Impact on Indian Economy

by Vijaya Katti, Sunitha Raju, and Rajan Sudesh Ratna
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The world trading system is now seeing another change in the form of Regional Trade Agreements (RTAs) which are now becoming the 'rules' rather than 'exceptions' as prescribed under Article XXIV of GATT and Article V of GATS. Today, hardly any country remains outside the involvement of RTAs. And as per the estimates more than half of the world trade is taking place through RTAs.

Currently, more than 200 RTAs are in place and if one takes into account the number of RTAs that are being negotiated and signed but not notified, then the number would touch the figure 400! These RTAs are no longer confined to conventional goods agreements but they go much beyond. There are several commitments which are being undertaken as 'WTO-plus' and they also cover 'Singapore issues' i.e. competition, investment and government procurement – issues which have been dropped from the Doha agenda.

India has always stood for open, equitable, predictable, non-discriminatory and rules-based multilateral trading system. However, recognizing that the RTAs are prominent in operation, India had also started its active engagement with RTAs. The main driving force for pursuing the RTA agenda have been the slow progress of Doha Round, fear of being left out and the fast changing geo-political situation. India is now actively pursuing for Comprehensive Economic Cooperation Agreements (CECA) under which much wider and deeper commitments are being negotiated with the trading partners.

India's RTAs have also got a mix response. Some sectors have been benefitted by RTAs while a few have been marginalized. The cases of circumventions have also been noticed which have hurt the domestic industry adversely. While India's FTA with Sri Lanka is more than a decade old, the one with ASEAN and Korea have just begun.

Against this background, this book examines in detail the significance India's trading arrangement holds in respect to its partner countries. It underscores the need and relevance of such an emerging pattern in global trade and suggests how this trend will witness more vigour and strength till the time Doha Development Agenda settles the gains to the developing and transitional countries promised by the WTO.

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