The structure of global trade finance

Banking and liquidity problems can have far-reaching consequences on global trade. Olivier Accominotti and Stefano Ugolini take a very long-run view and reconstruct the evolution of trade finance

The 2008 crisis has revealed how banking and liquidity problems can have far-reaching consequences on global trade. This column reconstructs the evolution of global trade finance from the Middle Ages until today. Just like in medieval times, today's global trade is predominantly financed through banks so that banking problems automatically transmit to international trade.

In contrast, from the 16th to the 20th century, trade finance was mostly market-based. The decline of market-based trade finance was triggered by major geopolitical shocks.

The Global Crisis of 2007/8 was followed by a sudden and unprecedented contraction of world trade – an episode known as the 'Great Trade Collapse' (Baldwin 2009). One of the explanations commonly advanced for this phenomenon is the reduced supply of trade finance following the global liquidity crunch (Ahn *et al*. 2011, Auboin and Engemann 2012, Del Prete and Federico 2014, Paravisini *et al*. 2015).

Since 2008, economists and analysts have highlighted how a well-functioning trade finance market is essential to the global trading system. Renewed attention has been paid to the instruments used for financing trade as well as to the structure and regulation of the global trade finance market (Asmundsson *et al*. 2011, BIS 2014, Niepman and Schmidt-Eisenlohr 2016a, 2016b, 2017).

Trade finance is the oldest domain of international finance. From the very beginnings of the history of international commerce, merchants and firms have been in need of working capital in order to finance their commercial transactions and have looked for methods to reduce the risks involved in long-distance trade.

However, relatively little is known about how trade finance evolved over the very long run. In a recent study, we review the main developments in international trade finance from the Middle Ages to today and compare its structure and governance across time (Accominotti and Ugolini 2019). Our goal is to understand whether alternative structures existed in the past that might provide regulators with insights on how to design more resilient trade finance.

The emergence of trade finance

Historically, the most widespread instrument for financing merchandise trade was the bill of exchange. A bill of exchange is a private written order addressed by one party (the drawer) to another (the drawee), asking to pay a given sum at a given date to a third person (the beneficiary). Bills of exchange are instruments of both international payment and credit.

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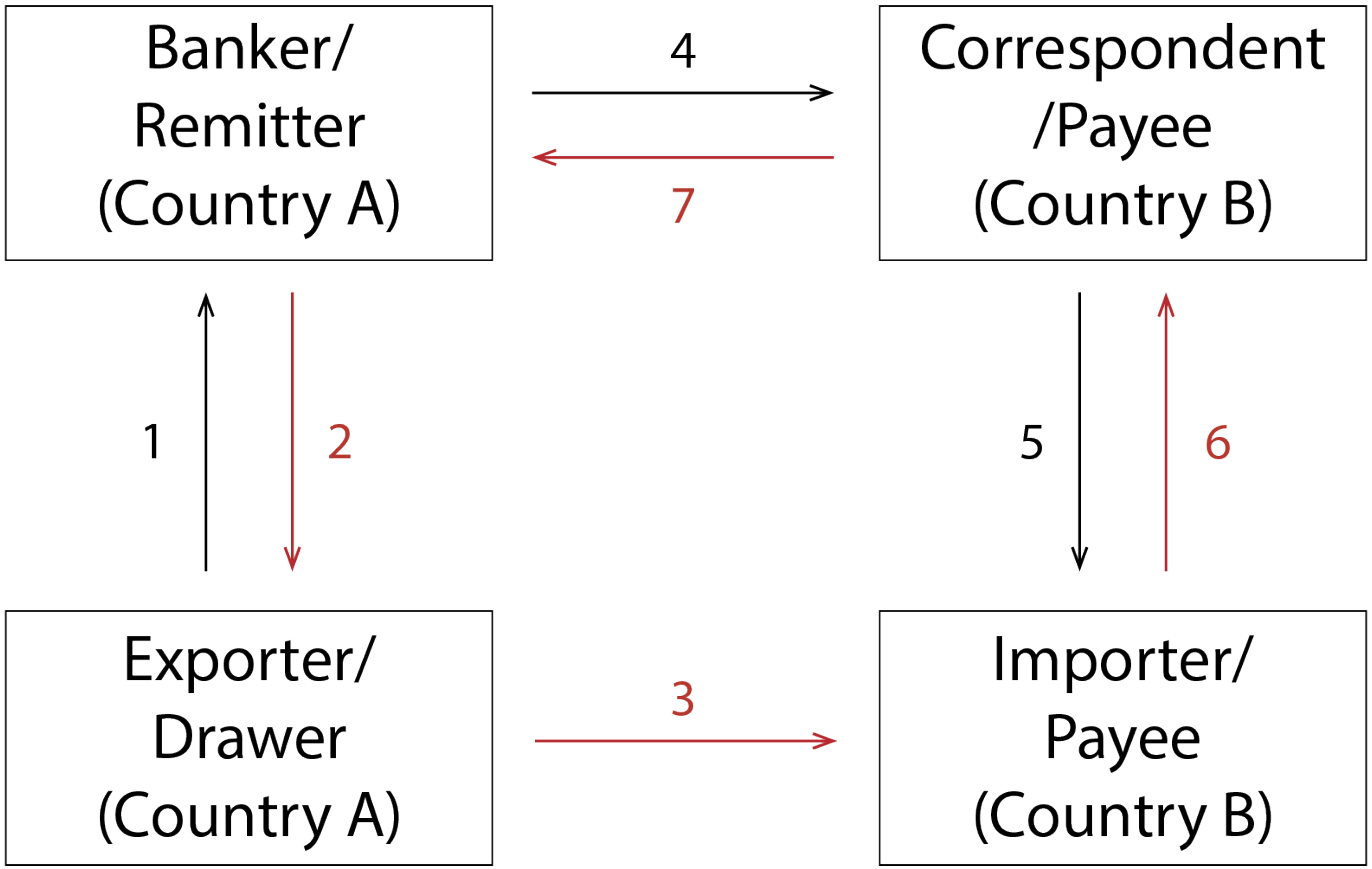
Figure 1. The medieval bill of exchange



Note: This example is based on a transaction described by De Roover (1953, pp. 45-47). A Florentine exporter (the drawer) established in Bruges (country A) issues a bill of exchange and sells it to her Bruges-based banker (the remitter, also originally from Florence). The bill orders the importer (the payer, also a Florentine) in Barcelona (country B) to pay a given sum to a specified correspondent in Barcelona (the payee) of the Bruges-based banker at a certain date in the future. 1. Issues bill of exchange; 2. Purchases bill of exchange/provides cash; 3. Ships goods; 4. Sends the bill; 5. Presents the bill at maturity; 6. Pays the bill at maturity/provides cash; 7. Credits remitter at maturity.

Until the early modern period, in Western Europe trade finance products consisted of idiosyncratic instruments issued by local merchants and bankers. In the 13th century, Italian mercantile companies with correspondents in major European trading centres (Florence, Venice, Genoa, Bruges, etc.) were the main providers of trade finance. It is in this context that the medieval bill of exchange emerged.

The original bill of exchange was not a standardised financial instrument, but rather a certificate of a private credit contract passed between two local agents and to be presented to a foreign correspondent (De Roover 1953). An example of a transaction financed through a medieval bill of exchange is provided in Figure 1.

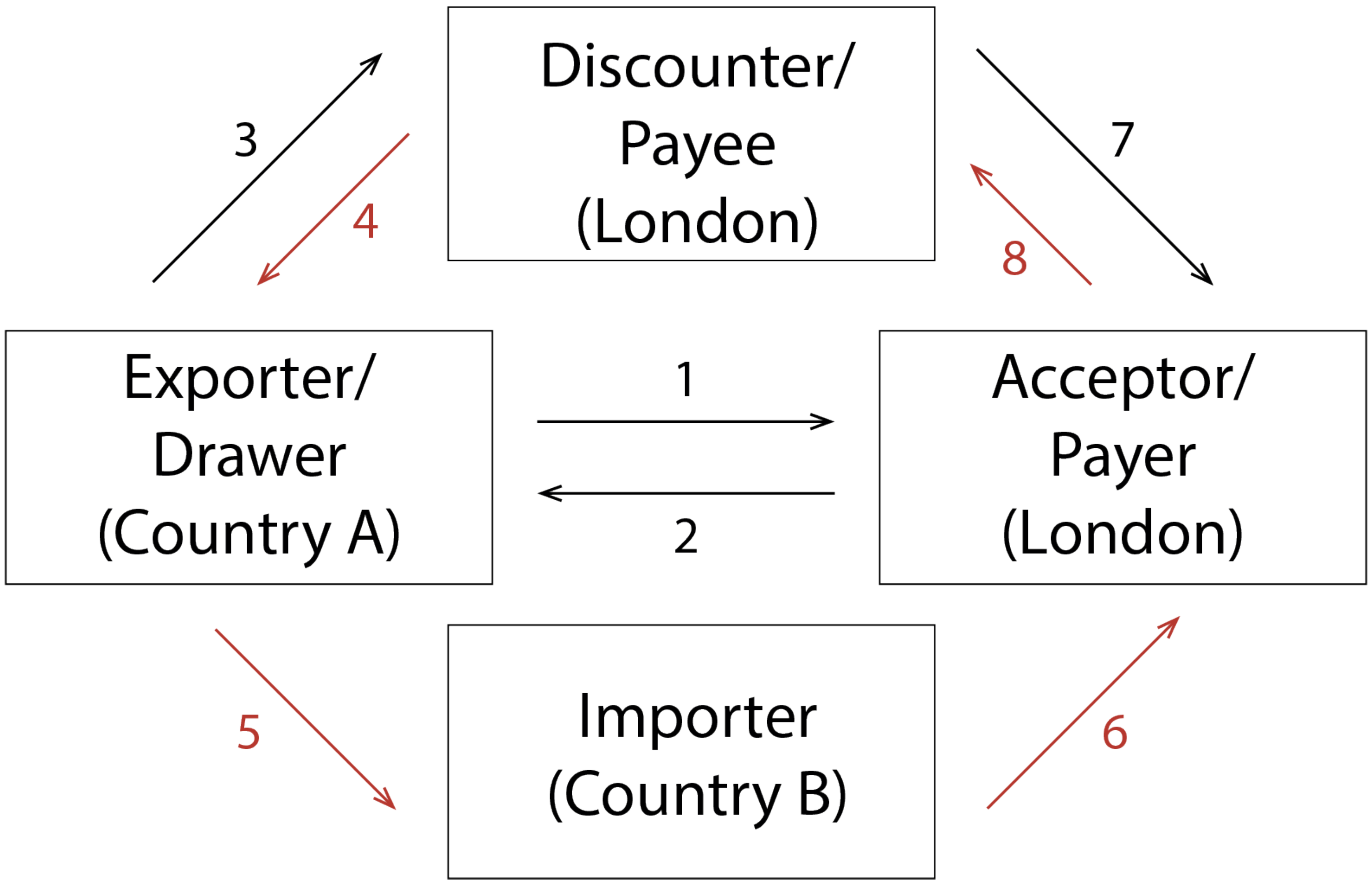
The nature of the bill of exchange then changed considerably in the early modern period when new legal provisions in Antwerp and Amsterdam instituted the right to 'negotiate' bills – the ability to transfer the original creditor's claim on the debtor to a third party. The bill of exchange transformed into an exchange-traded financial instrument. Nevertheless, in that period the circulation of bills of exchange still remained limited within a relatively small group of merchants.

Trade finance during the first globalisation

From the 18th to the 20th century, the global trade finance market became increasingly concentrated around one leading financial centre – London. A large discount market for bills of exchange emerged in London at that time, which progressively evolved into the world's money market.

During the first globalisation, international trade was mostly financed through sterling bills issued through specialised agents in London but purchased by all kinds of domestic and foreign investors. Bills of exchange payable on London were used to finance commercial transactions taking place across the whole world. Figure 2

Figure 2. The bill on a London accepter (or acceptance)



Note: An exporter in country A has sold goods to an importer in country B and needs to finance production/shipment. The importer instructs the exporter to draw a sterling bill on a London acceptor with whom she has a relationship. The acceptor puts its signature on the bill ("accepts" the bill) in exchange for a fee, thereby committing to repay the holder at maturity (guaranteeing payment). The exporter discounts the bill to an investor in London at the market interest rate. At maturity, the bill holder asks for payment (in sterling) to the acceptor, who, in the meantime, has obtained payment from the importer. 1. Draws a bill; 2. Accepts the bill; 3. Sells the accepted bill; 4. Discounts the bill/provides cash; 5. Ships goods; 6. Makes payment ('provision') before maturity; 7. Presents the bill at maturity; 8. Pays the bill at maturity/provides cash.

gives an example of how a bill on London could be used to finance a commercial transaction between two foreign countries.

Access to the global trade finance market was regulated through a set of informal governance rules enforced by a few private and public agents in London. In particular, financial institutions known as 'acceptance houses' specialised in guaranteeing the debts of foreign firms willing to borrow on the London bill market. These intermediaries screened and monitored a large number of borrowers around the world who needed their signature in order to access London credit facilities. They acted as gatekeepers to the London market.

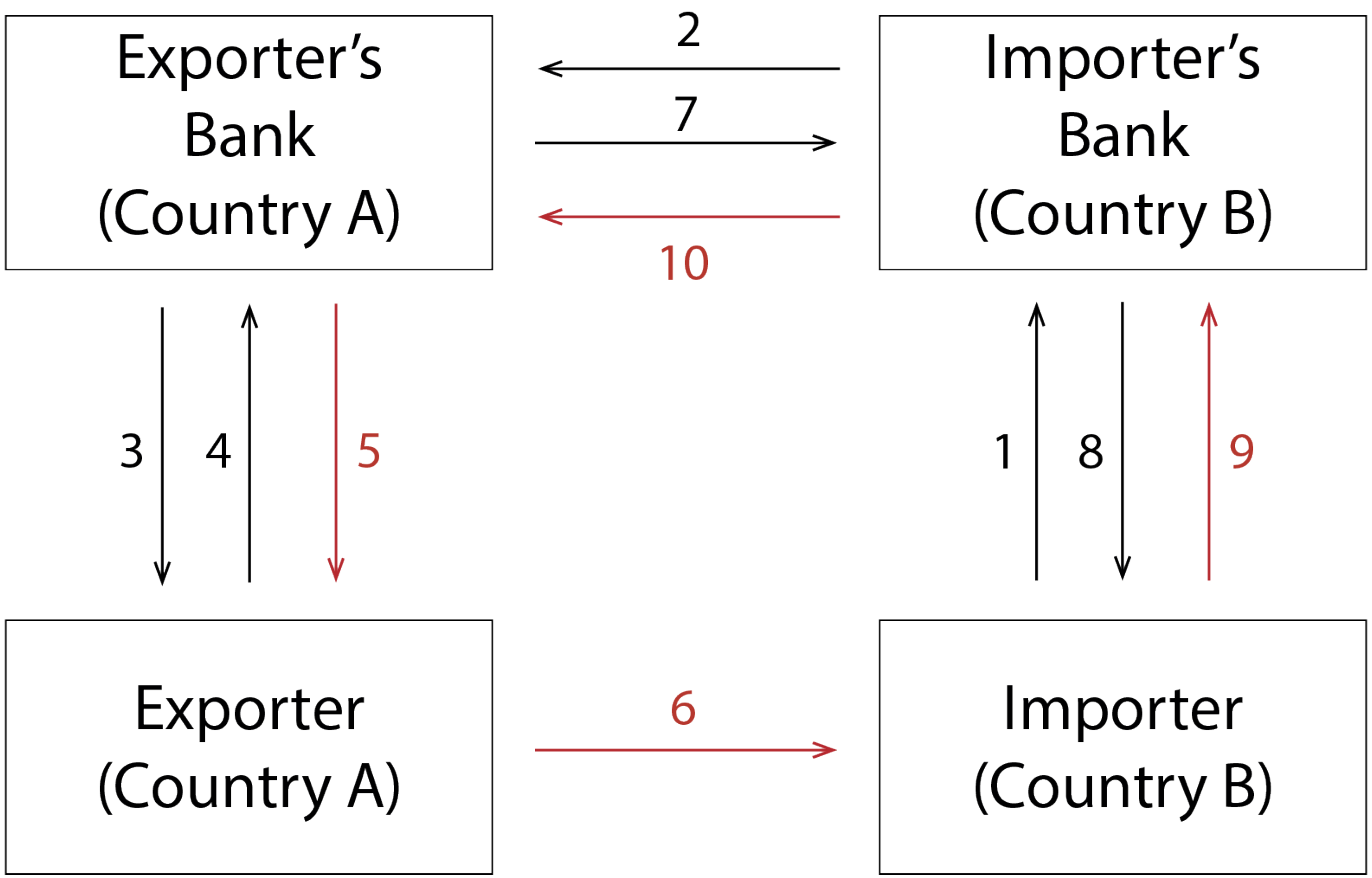
The Bank of England's purchases of bills for its monetary operations and its commitment to rediscount eligible bills under any market condition also contributed to their high liquidity. By setting eligibility rules for bills, the Bank contributed to regulating the production of trade finance products (Flandreau and Ugolini 2014, Jobst and Ugolini 2015).

London's dominant position therefore gave UK public authorities and private agents considerable power to regulate trade finance globally. This centralised market structure was an important component of the broader system of British imperial dominance that prevailed on the eve of the First World War.

The disintegration of trade finance during the de-globalisation

The importance of London in global trade finance then progressively declined during WWI and interwar years. WWI created major disruptions in the functioning of the London bill market and, when international trade recovered in the 1920s, London now had to face the competition of New York as an international trade finance centre (Eichengreen and Flandreau 2012). At the beginning of the 1930s, New York and London were financing equal shares of global trade.

Figure 3. The confirmed letter of credit



Note: An exporter in country A sells goods to an importer in country B. The importer asks her local bank to issue a letter of credit in her favour guaranteeing the exporter that payment will be made upon presentation of documents. Payment is also guaranteed by the exporter's bank (the letter of credit is confirmed). The letter of credit is accepted by the issuing bank and the exporter discounts it to her local bank (obtains a credit). 1. Applies for letter of credit; 2. Sends letter of credit; 3. Confirms letter of credit; 4. Sells letter of credit; 5. Discounts letter of credit/provides cash; 6. Ships goods; 7. Sends documents; 8. Presents documents at maturity; 9. Pays at maturity/provides cash; 10. Credits at maturity. Based on description of the instrument in Amiti and Weinstein (2011), BIS (2014), Niepman and Schmidt-Eisenlohr (2016, 2017).

The Great Depression and the global financial crisis of 1931 precipitated the demise of international trade finance. Between 1929 and 1933, world exports contracted at an unprecedented pace. The 1931 crisis also severely affected London and New York intermediaries involved in the issuance of trade finance products (Accominotti 2012, 2019). In the mid-1930s, many countries imposed quantitative restrictions on trade flows, which reduced the scope for extending cross-border credits.

The reconstruction of trade finance during the second globalisation

Until the collapse of the Bretton Woods system in 1971-1973, international payments remained subject to tight government regulations. The progressive removal of capital controls in the 1970s and 1980s resulted in the revival of international trade and in increased demand for credit from firms.

The most common trade finance instruments used nowadays are the letter of credit (see Figure 3) and documentary collections (Amiti and Weinstein 2011, BIS 2014, Niepman and Schmidt-Eisenlohr 2016a, 2016b, 2017).

The structure of global trade finance today differs from that of the first globalisation along two dimensions. First, in contrast to the 19th century when a large share of global trade flows were financed through London, trade finance nowadays is mostly intermediated on a local basis – ie. by national banks or branches of global banks located in the exporter's and importer's country (BIS 2014).

One implication of this decentralised market structure is that firms located in countries where the banking system is underdeveloped might suffer from a lack of intermediation, a phenomenon known as the 'trade finance gap' (Asmundson *et al*. 2011).

Second, the decreased use of trade finance products for money market transactions has substantially narrowed the range of investors involved in the provision of trade finance. In the 19th century, investors in sterling bills were numerous and extremely diverse as such bills were regarded as highly liquid and safe monetary instruments.

By contrast, trade finance products nowadays mostly remain on the balance sheet of the banks that have issued them. While attempts have been made to securitise trade finance credits, demand for such products has remained limited due to a lack of information about them (BIS 2014: 27-30).

Conclusion

The long-run evolution in the structure of international trade finance has implications for its governance. In the 19th century, the global trade finance market was highly centralised and regulation was exercised by the leading political and economic power of the time – the UK. London's monopoly over the trade finance market was criticised by potential competitors as it granted UK financial institutions a significant rent.

By contrast, the more decentralised structure that prevails nowadays makes international control over the trade finance market less feasible. While this market structure clearly has advantages, it also makes exporting and importing firms more dependent on local credit conditions and pushes back the governance of the trade finance market into a sort of anarchy. ■

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