IGC Policy Brief

***Title*: Trade and financial crisis: a focus on developing countries**

***Authors*:**

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I. ***Policy Motivation for Research:***

Our research suggests that both during the financial crisis of 2008-2009 and more generally in the past 50 years, African exporters and also more remote countries were hit harder when the countries they export to experienced a financial crisis. This has potentially relevant policy implications in the context of the present resurgence of financial turmoil in Europe. This vulnerability is not only the result of the composition of African exports and its concentration on primary goods. We have some evidence that the higher dependence of African exports on trade finance may explain African exporters' particular fragility to financial crises in importer countries. Exporters in countries with stronger financial systems and therefore less need for external trade finance may be able to better resist such credit tightening.

II. ***Policy Impact:***

The results of our research suggest two broad implications in the present context of the financial crisis in Europe. From a short-term macroeconomic policy perspective, it points to the importance of the trade impact for both African countries and remote countries (which may at least partly be the same). From a more long term and micro perspective, it suggests that the development and strengthening of trade credit, trade finance markets and more generally of stable domestic financial markets is especially important in the current context of financial turmoil.

III. ***Audience:***

- Regional development banks such as the African Development Bank have an important role in promoting trade finance and trade credit.
- Central banks in developing countries
- Ministries of Trade
- Economists of international and regional organizations interested in trade and financial policy issues

IV. ***Policy Implications:***

- *A particular vulnerability of African and remote countries to financial turmoil in industrialized countries:* The financial crisis of 2008-2009 led to an unprecedented collapse on international trade. Countries were not hit similarly in this respect. African countries and also more remote countries experienced a larger fall in their exports (in percentage terms) to destinations experiencing a banking crisis after the Lehman

Brothers' bankruptcy. We find that this vulnerability to financial crises in African and remote countries (countries far away from the country experiencing the financial crisis) is not specific to the latest crisis and appears to be a stylized fact of the past 50 years.

- *This has potentially relevant policy implications in the context of the present resurgence of financial turmoil in Europe.* This crisis may also have a major negative impact on African exports. This vulnerability is not only the result of the composition of African exports and its concentration on primary goods.
- *We have evidence that the higher dependence of African exports on trade finance may explain African exporters' particular fragility to financial crises in importer countries.* One interpretation is that during a financial crisis, when uncertainty and risk are high and trust and liquidity are low, banks and firms *in the importer country* first cut exposure and credit to those countries they see as more risky. It is also likely that during financial crises, financial institutions "renationalize" their operations and reduce their exposure to foreign banks and firms. Fear of default, (i.e. counterparty risk), is causing banks to tighten lending criteria. This is all the more true for trade relations that involve long shipping times. During a financial crisis, the probability that an importer defaults on his payment obligation increases. When time-to-ship is higher, this effect is amplified and this is one interpretation of our finding that exports of more distant countries are more badly hit when a financial crisis hits the importer country. Exporters in countries with stronger local financial systems may be able to better resist such credit tightening.

V. ***Implementation****:*

Our results point to the importance of both short term and long term policy answers to the financial turmoil in industrialized countries.

- In the short term, in response to a possible aggravation of the financial crisis in Europe, policy makers should pay particular attention to the functioning of trade finance
- Some lessons should be drawn from the policy initiatives of international organizations (World Bank and the African Development Bank for example) on trade credit during the 2008-2009 financial crisis. Were these initiatives effective and could they be improved?
- From a more long term and micro perspective, our research suggests that the development and strengthening of trade credit, trade finance markets and more generally of domestic financial markets is especially important for African and remote countries. This may help lower the dependence of exporters of financial conditions in destination countries.

VI. ***Dissemination:*** *See above*

VII. ***Further Readings****:* "Trade Finance During the Great Trade Collapse; Mariem Malouche & Jean-Pierre Chauffour ; editors, World Bank. 2011,