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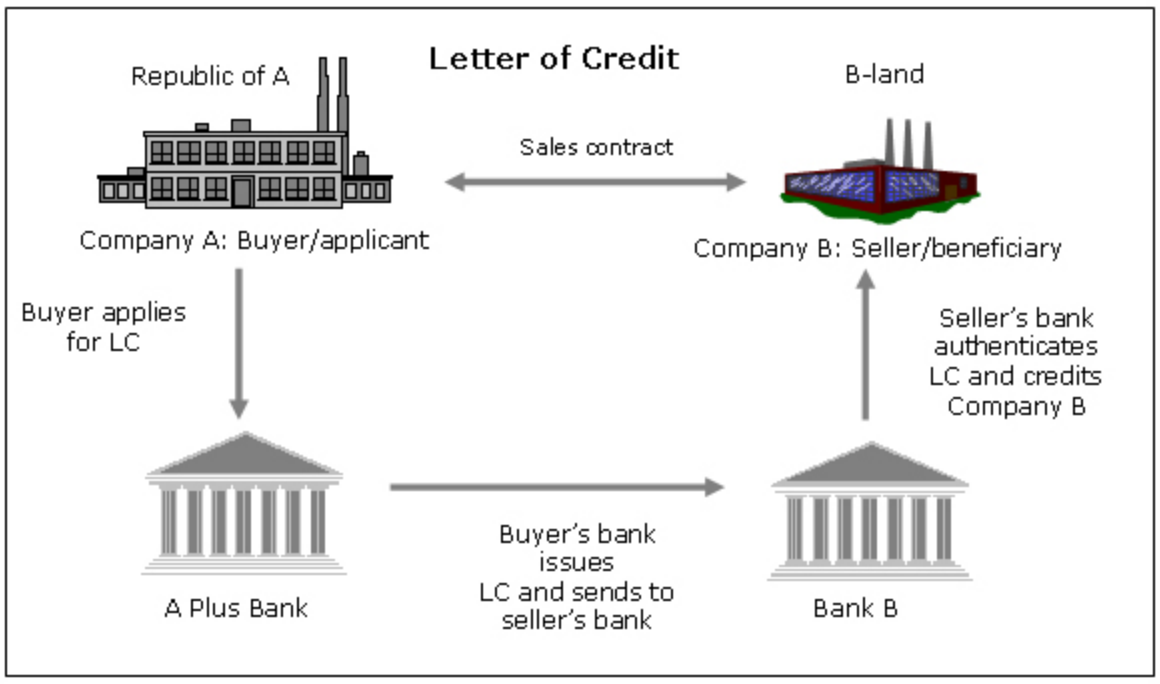
Credit storm hitting the high seas?

Now that the mystery has been solved concerning whether we are in recession or not, our attention can turn to monitoring the conditions that might signal the contraction's end. A nice assist in this endeavor comes from the "Credit Crisis Watch" at The Big Picture, which includes an extensive list of graphs summarizing ongoing conditions in credit markets.

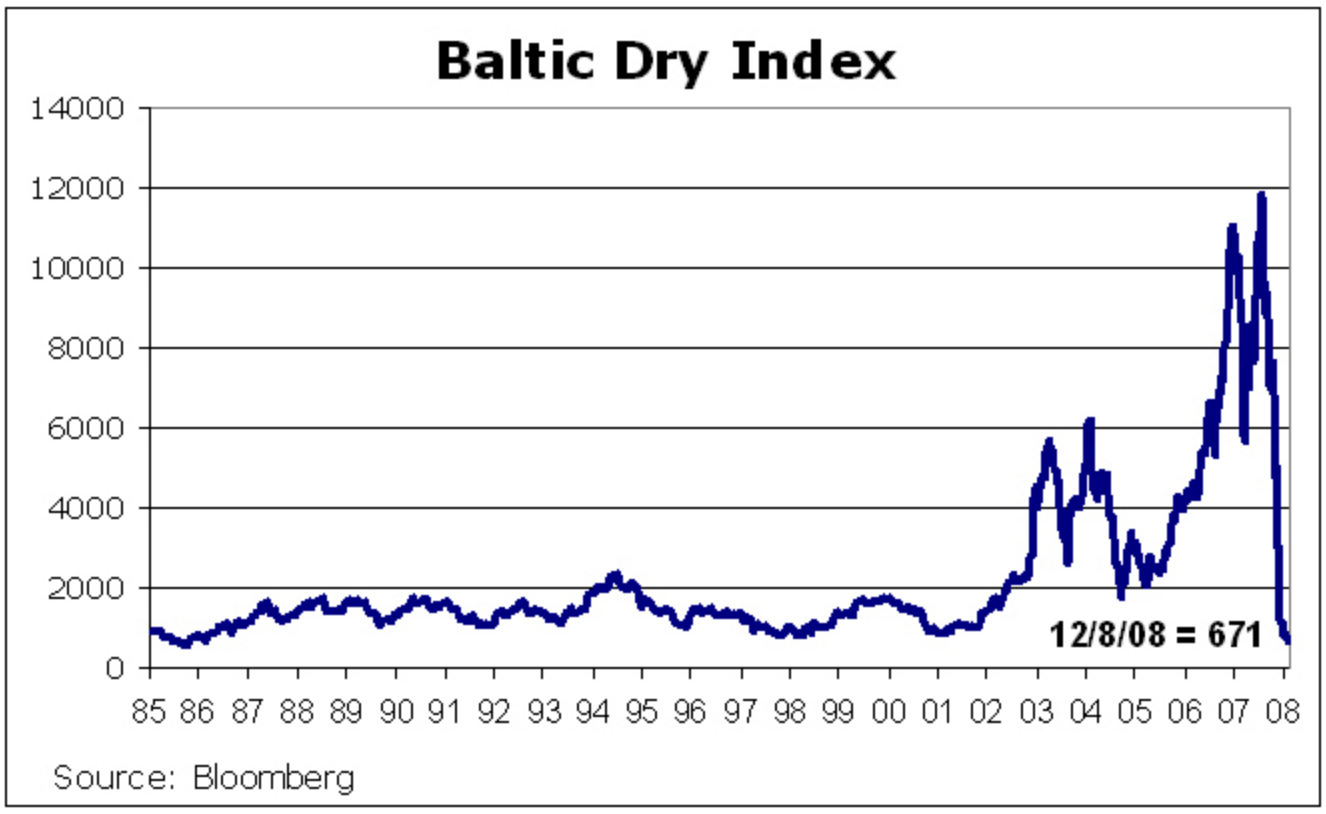
In case that list is not extensive enough for you, allow us to add one more item to the list: the condition of trade finance. International trade amounts to about $14 trillion and, according to the World Trade Organization (WTO), 90 percent of these transactions involve trade financing. Trade-related credit is issued primarily by banks via "letters of credit," the purpose of which is to secure payment for the exporter. Letters of credit prove that a business is able to pay and allow exporters to load cargo for shipments with the assurance of being paid. Though routine in normal times, the letter of credit of process is yet another example of how transactions between multiple financial intermediaries introduce counterparty risk and the potential for trouble when confidence flags.

This is how it works: Company A located in the Republic of A wants to buy goods from Company B located in B-land. Company A and B draw up a sales contract for the agreed sales price of $100,000. Company A would then go to its bank, A Plus Bank, and apply for a letter of credit for $100,000 with Company B as the beneficiary. (The letter of credit is done either through a standard loan underwriting process or funded with a deposit and an associated fee). A Plus Bank sends a copy of the letter of credit to B Bank, which notifies Company B that its payment is available when the terms and conditions of the letter of credit have been met (normally upon receipt of shipping documents). Once the documents have been confirmed, A Plus Bank transfers the $100,000 to Bank B to be credited to Company B.



In general, exporters and importers in emerging economies may be particularly vulnerable since they rely more heavily on trade finance, and in recent weeks, the price of credit has risen significantly, especially for emerging economies. According to Bloomberg, the cost of a letter of credit has tripled for importers in China, Brazil, and Turkey and doubled for Pakistan, Argentina, and Bangladesh. Banks are now charging 1.5 percent of the value of the transaction for credit guarantees for some Chinese transactions. There have been reports of banks refusing to honor letters of credit from other banks and cargo ships being stranded at ports, according to *Dismal Scientist*.

These financial market woes are clearly spilling over to "global Main Street." The Baltic Dry Index, an indirect gauge of international trade flows, has dropped by more than 90 percent since its peak in June as a result not only of decreased global demand but also availability of financing that demand, according to *Dismal Scientist*.



In the words of the WTO's Director-General Pascal Lamy, "The world economy is slowing and we are seeing trade decrease. If trade finance is not tackled, we run the risk of further exacerbating this downward spiral." Since about 40 percent of U.S. exports are shipped to developing countries, the inability of the importers in those countries to finance their purchases of U.S.-made goods can't help the U.S. exports sector, which is already suffering from falling foreign demand as the global economy slows.

At VoxEU, Helmut Reisen sums up the situation thus:

> "As a mid-term consequence of the global credit crisis, private debt will be financed only reluctantly and capital costs are bound to rise to incorporate higher risk. Instead, solvent governments and public institutions will become the lenders of last resort."

That process has begun. In the last 12 months, according to the WTO, export credit agencies have increased their business by more than 30 percent, with an acceleration since the summer. The increase in this activity, the WTO reports, is being backed by governments of some of the world's largest exporters, such as Germany and Japan.

Most recently, to support exports of products from the United States and China to emerging economies, both countries decided on December 5 to provide a total of $20 billion through their export-import banks. The program will be implemented in the form of direct loans, guarantees, or insurance to creditworthy banks. Together, the United States and China expect that these efforts will generate total trade financing for up to $38 billion in exports over the next year.

The sense one gets from The Big Picture charts is that at least some hopeful signs have emerged in developed-economy credit markets. Going forward, progress in markets directly related to trade flows between developed and emerging economies may well be an equally key indicator of how quickly we turn the bend toward recovery.

By Galina Alexeenko and Sandra Kollen, senior economic research analysts at the Federal Reserve Bank of Atlanta

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