

On Credit, Trade, and Food Stability

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Global Interdependence Center Conference on Food and Water: Basic Challenges to International Stability

Paris, France

March 26, 2009



In the United States today there are growing social and political tensions between those who identify with the mainstream public—often called Main Street—and the financial sector, often lumped together as Wall Street. Many of my country's citizens see their interests as disconnected from the banks and financial markets.

In the past few months, I've delivered several speeches with the message that functioning credit markets are absolutely necessary for economic recovery. With a global recession and ongoing and comprehensive interventions aimed at restoring financial stability, I believe it's important for everyone to understand the linkages between credit markets and the broader economy.

Your theme of food and water stability offers me another way to make my point about the interconnection of credit and economic activity. In my remarks, I will offer my views as a central banker on how problems in credit markets have dampened global trade, including trade in that most elemental of traded goods—food.

Trade and finance

I'd like to begin with some background on trade and credit markets. The fall of trade barriers and the rise of market economies, especially those in Asia and Eastern Europe, have driven rapid growth of international trade in recent decades. The value of merchandise trade in 2008 was about \$16 trillion, according to the World Trade Organization. By some estimates, merchandise trade rose from 16 percent in 1983 to 25 percent in 2008 as a percentage of gross global product.

Importantly, about 90 percent of cross-border trade transactions involved some form of credit (as opposed to cash settlement). So functioning credit markets have been and remain crucial to the flow of goods and services around the world.

Trade-related credit is now supplied primarily by banks using the instrument of the documentary letter of credit, whose purpose is to secure payment for the exporter. Letters of credit guarantee that an importer is able to pay and allow exporters to load cargo for shipments with the assurance of getting paid. Pre-export and post-shipment funded credit is tied to the self-liquidating feature of letters of credit.

A significant majority of trade finance is handled by private sector banks and is highly concentrated among a small number of lead institutions. Furthermore, there are anecdotal reports about the disappearance of the secondary market in trade credits and country exposure.

Export credit agencies, which are often state run, tend to step up to play a countercyclical role by supporting export transactions when their domestic banks pull back. Export credit agencies assume risks that private lenders are unwilling or unable to accept and handle a sizeable portion—although a minority—of global trade financing.

This financing infrastructure made possible decades of trade expansion that came to a sudden halt in the fourth quarter of 2008. Since that time, many countries have reported double-digit declines in trade in nominal value terms, with real physical volume also declining.

Economists expect trade to decline during an economic slowdown. But the recent sharp contraction of trade appears to be far more severe than would be expected given the decline in global economic activity.

I believe some of the fall in international trade can be attributed to the disruption of the interbank credit system. The marked reduction of interbank lending appetite has been associated more with the market for short-term liquidity, but it also has affected trade credit. With the interbank liquidity crisis, banks have moved to reduce overall counterparty exposure including trade credit.

Pricing also has been affected and adjusted upward based on perceptions of increased risk. According to the International Monetary Fund, more than 70 percent of banks said that charges for various types of letters of credit have risen in the past year. And the percentage is higher for trade-related secured lending facilities in which goods traded serve as collateral. Trade credit remains available in many cases, but its higher cost means fewer transactions are getting done.

The recent sharp decline of commodity prices also has affected trade financing. Volatile commodity prices have undermined confidence in the value of commodity cargo. There are reports of commodity goods piling up in the physical channels of trade because of trade finance closing down.

Trade finance used to be less affected by macro financial instability. But since the Asian financial crisis of 1997, trade finance has become more sensitive to generalized liquidity squeezes.

The Asian crisis a decade ago was a defining moment in the evolution of trade finance. With the broad-based disinvestment from emerging markets during that period, the threat of contagion among borrowers alarmed international lenders. Capital account instability played a significant role during this period—more than during prior episodes of instability.

In 1998, at the peak of the financial crisis in Indonesia, international trade finance for imports emerged as a problem. In that case, international banks reportedly refused to confirm letters of credit opened by local banks because of an overall loss of confidence in the banking system.

Since this episode, trade credit has tended not to be distinguished from other forms of exposure by creditors and, as a result, is now treated as just another form of short-term credit.

The global food chain and credit

Now, let me add a few remarks about trade in food, which of course is a basic life necessity. According to the United Nations, food trade amounted to nearly \$800 billion in 2007, or close to 6 percent of global trade. As a significant component of overall trade, food trade is also affected by problems with trade credit. Contraction of international trade in food commodities is a serious concern.

Food represents from 10 to 20 percent of consumer spending in industrialized nations, but as much as 60 to 80 percent in developing economies. Many emerging countries depend on imports for a significant share of their food supply. As a result, some of these countries are highly vulnerable to contraction in food trade credit.

My home country has a major interest in this issue. The United States is one of the world's major exporters of food commodities. In the fourth quarter of last year, U.S. food exports fell 23 percent quarter over quarter.

Beyond food exports, U.S. economic growth early last year was supported by overall exports, which held up until the sudden collapse in the fourth quarter. In my economic outlook for the remainder of 2009, I do not expect a sudden return of exports as a driver of recovery in the United States.

An obvious conclusion is the world is interconnected not just by the flow of physical trade but also through the flow of trade credit.

Steps to address financial issues

In the public square of the United States, the tension over government actions to stabilize the banking and financial system has intensified in recent weeks. Much of the reaction to certain developments is understandable but, in my view, draws attention away from what must be the fixed focus of policy—to return the banking and financial system to health.

Furthermore, the framing of the problem has been, perhaps naturally, mostly domestic. As a consequence, consideration of damage to the global trading system has taken a back seat for the most part.

My purpose today has been to bring attention to this dimension of the financial and economic crisis that besets us and to reemphasize the centrality of stabilizing banking systems. Banks are a vital element of the international trading system.

Many actions have been taken to stabilize the U.S. financial system, and further very important measures are in train. For instance, the removal of legacy "toxic" assets from bank balance sheets is an essential step. The Treasury's plan announced Monday should address this issue. I believe the capital adequacy assessment program, which some have called stress tests, will establish a baseline of consistency with regard to balance sheet weakness and capital needs going forward. Finally, I welcome adjustments to fair value treatment of assets trading in illiquid markets that the Financial Accounting Standards Board issued for comment last week.

The subject matter of this conference—food stability—serves to elevate the priority of restoring full functioning of the trade finance system through continuing efforts to fix our various national banking systems. Food stability—or its inverse, food instability—tends to grab our attention and bring needed focus on what must be done.

International trade has lifted millions of people out of poverty. But that progress is at risk. The weakened fundamentals of banks and the resulting diminished availability and higher cost of credit have become weak links in the chain of global trade. By restoring functioning credit markets, I believe these weaknesses can be repaired.

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