THE ROLE OF TRADE FINANCE IN THE SUCCESSFUL IMPLEMENTATION OF AfCFTA. A RESEARCH BY GITFIC –MAY 2021 REPORT

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ABSTRACT

One of the most recent issues among member states is the ongoing discussion of mutually beneficial intra-African trade under the African Continental Free Trade Area (AfCFTA) as a significant economic phenomenon.

The paper would highlight the importance of Trade Finance as a tool to achieving AfCFTA goals. According to the World Trade Organization (WTO), global trade volume dropped by 12% in 2009. The decline in trade was especially strong in North America and Europe accounting for a 15 percent fall in trade for both regions as opposed to South America and Asia at a fall of 8 percent and 11 percent respectively (WTO, 2010).

The main reason for the enormity of trade fall down, strongly highlighted by the World Trade Organization in 2009, relates to the minimal role trade finance played. Furthermore, determining whether trade finance is important for international and intra-African trade; has significant implications, particularly in terms of financial reforms and trade policies. It is estimated that the trade financing gap in Africa during 2011 and 2014 stood at $90 billion to $120 billion due to significant rejection of trade finance applications mainly due to weak client creditworthiness and inadequate collateral.

Despite the introduction of different development reforms solutions to resolve the problem in Africa, many businesses still have limited access to trade finance, owing to concerns about potential risks and losses. However, the implementation of AfCFTA which poses to increase intra African trade would be effectively implemented given a push in trade finance as well highlighting its importance. Research works proves a rise in the number of privately insured exporters in a given country significantly increases the intensive margin in trade for that country. Trade finance, notably trade insurance is a driver intended to promote intra African trade, notably under trade reforms like the AfCFTA.

It is highly recommended that Implementation of trade finance support programs or enhanced current programs would provide credit and liquidity for intra African trade. The provision of regional integration initiatives such as infrastructure projects will act as a catalyzer for other private sector agents.

Keywords: Africa Continental Free Trade Agreement (AfCFTA), Trade Finance, Insurance, Risk, Intra African Trade, Export, Import

1.0 INTRODUCTION

The continuous discussion of a mutually beneficial intra trade among African countries under the African Continental Free Trade Area (AfCFTA) as an important economic phenomenon is one of the recent topics among member states. The African Continental Free Trade Area (AFCFTA) proves to be beneficial for member nations that have signed unto the agreement.

According to Heckscher (1991) and Ohlin (1933) in their factor proportions model, they demonstrated among other things, that when nations move to free trade, they experience an increase in aggregate efficiency. According to the World Trade Organization (WTO), in 2009 the global volume of trade fell by 12 per cent. The decline in trade was particularly severe in North America (fall of 15%) and Europe (fall of 15%) as compared to South America and Asia at a fall of 8% and 11% respectively (WTO, 2010).

The main justification for the enormity in trade fall down, heavily highlighted by the World Trade Organization in 2009, relates to the key role trade finance played. Moreover, investigating whether trade finance matters for international and intra Africa trade has significant normative implications, particularly with respect to the financial reforms and trade policies such as African Continental Free Trade Area (AfCFTA), General Agreement on Tariffs and Trade (GATT) and Regional Agreements such as North American Free Trade Agreement (NAFTA) and Asia Pacific Economic Cooperation (APEC) among others implemented in developed and in developing and emerging countries. However, it is particularly interesting to investigate the financial reforms underpinning the successful implementation of these trade agreements.

Lack of access to trade finance has been one of the impeding factors to trade, specifically for small and medium enterprises (SMEs) across the continent.

While several innovative development finance solutions have been introduced to address the challenge, many businesses still face limited access to trade finance mainly linked to perceived potential risks and losses. In terms of opportunities, the elimination of inhibitive regulations under the AfCFTA is expected to ease cross border trade, enable capital and information flow, attract greater foreign and intra-continental investments, potentially increase capital funds, and provide a much larger customer base for financial institutions to serve.

This potential new market base includes traditionally excluded micro, small and medium enterprises (MSMEs) that constitute a large share of the African economy. MSMEs are expected to be a major catalyst for increasing intra African trade and shared economic growth. However, the constraint to MSME financing is a major threat to the success of the AfCFTA as effective economic integration and development depends on easily accessible and affordable capital.

This research by GITFIC therefore advocates for urgent implementation of harmonized trade finance policy reforms across the continent to help in the effective implementation of AfCFTA, and allow for a more supportive business environment. An upsurge in trade finance is expected to ease cross border trade, enable capital and information flow, attract greater foreign and intra-continental investments, potentially increase capital funds, and provide a much larger customer base for financial institutions to serve.

2.0 REVIEWS IN LITERATURE

2.1.1 INTRA AFRICAN TRADE UNDER AFRICAN CONTINENTAL FREE TRADE AREA (AfCFTA)

One of the main objectives underpinning the formation of the African Continental Free Trade Area (AfCFTA) is to increase intra-African trade and enhance mutual socio-economic benefits in trade for the continent. According to the United Nations Conference on Trade and Development (UNCTAD), the implementation of African Continental Free Trade Area (AfCFTA) accompanied with its policy reforms is expected to increase the GDP of most member countries by 1 to 3 per cent (UNCTAD, 2018).

Intra-African trade policies under the AfCFTA negotiations are expected to increase by US$34.6 billion by 2022 equivalent to a 52.3% increase above the2022 baseline. The complete abolition of intra trade barrier (tariffs) and implementation of trade facilitation procedures under the AfCFTA is geared towards promoting regional markets as attractive export destinations, thereby enhancing the competitiveness of regional products (Karingi & Mevel, 2016). The existence tariff barriers and low-quality infrastructure among most African countries would hinder the implementation of policy reforms in Africa there by making them less competitive.

These are issues that would persistently discourage the flow of intra trade among member countries (OCED, 2017). According to the IMF, the upgrading of infrastructure basically has a greater impact on trade than tariff barriers; a decline in tariffs has a minimal result on intra trade flows (IMF, 2020). An improvement in the quality of Africa’s infrastructure to global average standards would result in a 7 per cent increase in intra-regional trade flows (IMF, 2020).

The projected increase in intra-African trade will be dependent on the quality of integrative infrastructure that will facilitate the movement of goods and services across member countries as well as an increase in production and productivity.

Research has revealed that encouraging a dynamic comparative advantage as in the case of Association of South-East Asian Nations (ASEAN) member states proves to enhance intra trade flow (Widodo, 1999; Das, 1998; Khalifah, 1995). It is debatable that the dynamic gains as stated by the AfCFTA may be difficult to achieve in the current situation, where most member states have similar factor endowment in the forms of cheap labour and the production of primary goods.

The contribution of intra-African trade as a percentage of all trade conducted by African Countries has since 1990 upsurge from 5 per cent to around 15.2 per cent in 2017, which is lower as compared to Asian developing countries trading within the Association of South-East Asian Nations (ASEAN) (UNCTAD, 2019).Though trade liberalization reforms enhanced under the Regional Economic Communities (RECs) has some point in time worked well in reducing tariffs and increasing intra-regional trade.

Figure 2.1: Exports of goods and services (% of GDP)

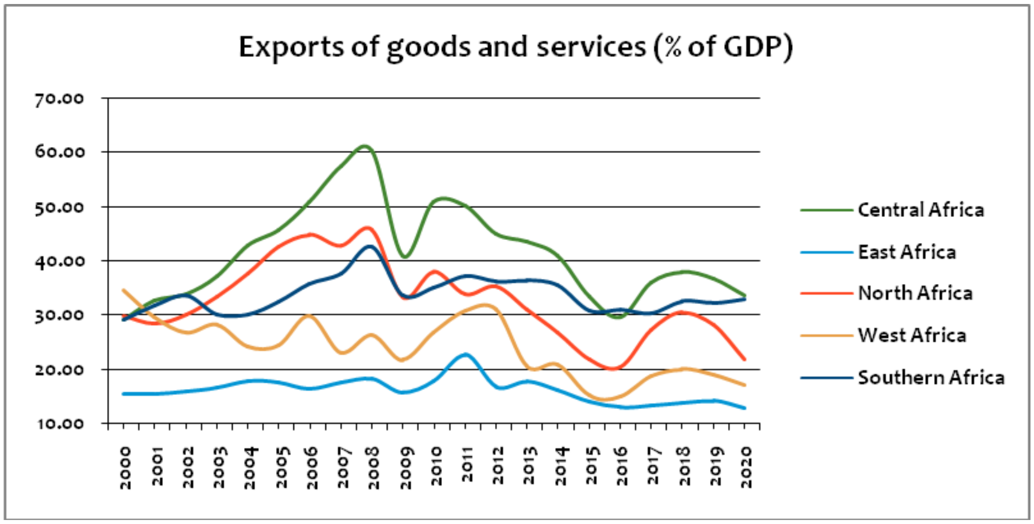
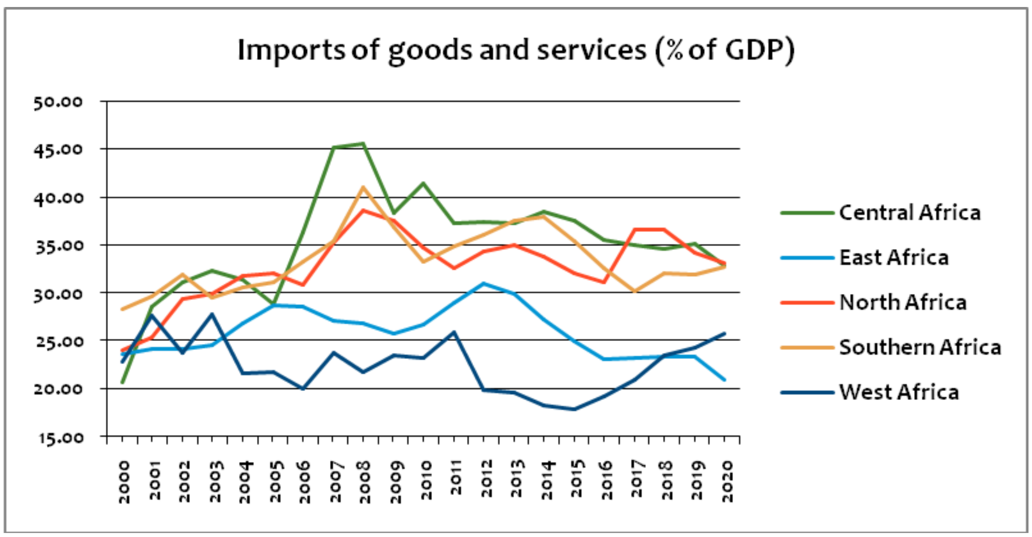


Figure 2.2: Imports of goods and services (% of GDP)



Source: African Development Bank

Figure 1 and 2 shows a trend flow of Intra African Trade from African Development Bank on import and export of goods and service (% of GDP) for the period 2000-2020. Intra African trade has upsurge rapidly over the past two decade, driven by the growing importance of Africa as a supplier of raw materials to developing countries.

African exports performed less poorly during the financial crisis while imports declined faster during the same period. The period 1999 to 2008 saw rapid growth of African trade among the regions in Africa. According to the WTO, African trade grew from 2.2% of the continent's GDP in 1995 to 3.3% in 2008. Similarly, as world trade shrunk by 12% from 2008 to 2009, Africa's export performance remained relatively robust, shrinking 8%. African imports performed less well, shrinking by 18% from 2008 to 2009. Further, there has been a fundamental change in the composition of African trade flows. Africa's total merchandise trade with non-African developing countries increased from $34 billion in 1995 to $283 billion in 2008 while trade with developed countries increased from $138 billion to $588 billion over the same period. The share of non-African developing countries in Africa's trade increased from 16% in 1995 to almost 30% in 2008.

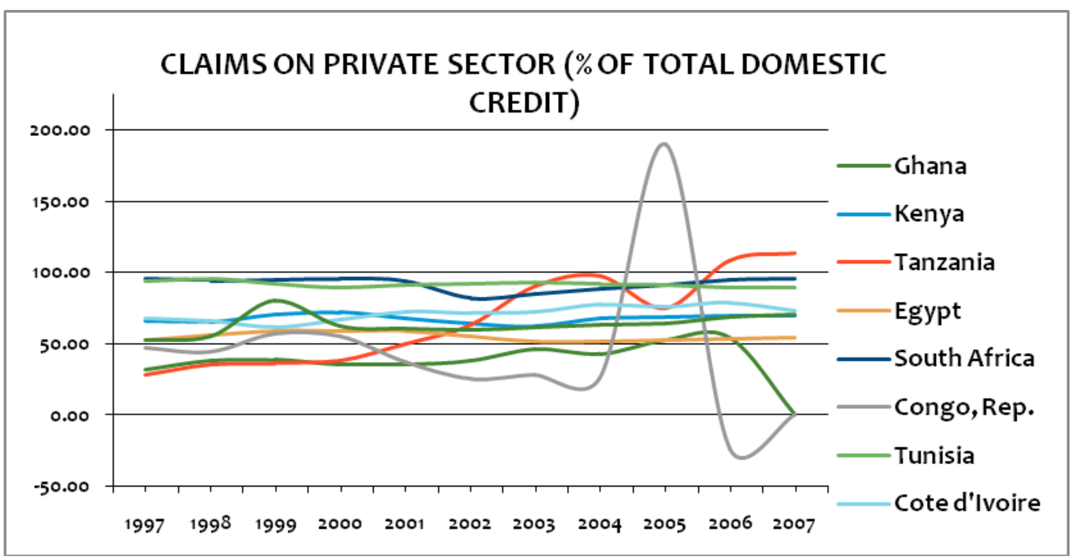
2.1.2 TRADE FINANCE

Trade finance means financing for trade and it is concerns both with intra-African trade and international trade transactions. Financial institutions play a critical role in facilitating intra trade through trade financing. Trade Finance products are specialized financial products designed to reduce the risks and uncertainties associated with commercial transactions, thus, facilitating trade. For financial institutions to compete successfully in the growing intra-African trade area, which requires the financial ability to reduce the consumer's cost, maximize the producer's revenue and manage the commercial, political and currency risks associated with intra-African trade, trade financing is important.

However, surveys conducted on financial institution's activeness in African trade finance by the African Development Bank in early 2009 and updated in the first quarter 2010 and again in the third quarter 2010 show that commercial banks believe that access to trade finance remains constrained, hampering economic growth and that the African Development Bank can play an important role stabilizing and catalyzing private financial markets.

The African Continental Free Trade Area (AfCFTA) provides opportunities for financial institutions to develop across the continent, but it also poses a real test for the country's financial structure. An effective and functional financial sector is fundamental for facilitating intra-African trade and growth; however, the capability of Africa's financial sector to execute this important task at the required scale to sustain the capacity of small and medium firms to contribute to and achieve the benefits of the African Continental Free Trade Area (AfCFTA) remains unstable. The financial structures in African member state have struggled to effectively mobilize funds and allocate capital. Small and Medium sized firms have been the most affected as they are most financially excluded.

In recent times, financial reforms by governments have contributed to a gradual progress in financial inclusion and declining trade finance gap in most African countries. The trade financing gap in Africa was estimated of $90 billion to $120 billion between 2011 and 2014. In 2019, the trade finance gap in Africa was estimated at USD 82 billion by AfDB and Afreximbank. However, the constraint to MSME financing is still real, requiring a more supportive business environment and a well developed policy reforms across the continent to eliminate these constraints. Such interventions are essential, as effective economic integration and development depends on easily accessible and affordable capital, being an important factor of production.



Source: African Development Bank

Include gross credit from the financial system to individuals, enterprises, nonfinancial public entities not included under net domestic credit, and financial institutions not included elsewhere

3.0 FINDINGS

3.1.1 EFFECT OF TRADE FINANCE ON SUCCESSFUL IMPLEMENTATION OF INTRA TRADE IN AFRICA (AfCFTA)

The concept of trade finance theory is that trade financing increases international trade among countries. The main complexity in empirical literature is to ensure that the trade finance used in econometric estimates solely relates to exporting activities and not to domestic ones. Research by Levchenko et al. (2009) found that neither the amount of credit extended to firms by suppliers nor the amount of credit extended by firms to customers can explain the observed decline in international trade.

However, their trade credit indicators are obviously biased because they do not only refer to international but also to domestic trade. The Intra-African trade values above are considered an underestimation of trade flows among African countries since a significant amount of informal cross-border trade takes place on the continent. Yet, even if the value of informal trade were to be included, it is doubtful that the degree of intra-African trade would match that of intra-regional trade in other parts of the world. For instance, intra-regional trade in Europe and Asia, as a share of their total trade, exceeds 65% and 40% respectively as compared to Africa which was 15% in 2016. The average share of trade finance provided by our responding banks to support intra-African trade stood at 16.9% and 21.2% in 2011 and 2012 respectively with significant variations.

Auboin and Engemann (2014) employed data from Berne Union, which comprises private and public export credit insurers representing approximately 10 % of the world trade, for approximately 100 countries during the period 2005-2011. The authors demonstrate that insured trade credit extended for exports to a given country promotes imports in this country.

Focusing on private export insurance, Van der Veer (2014) estimates a gravity model on a sample of 25 countries over the period 1992-2006. The author finds that a rise in the number of privately insured exporters in a given country significantly increases the intensive margin for those countries. He also reports a favorable effect of private insurance on the intensive margin, but only for a subsample of very risky countries.

Finally, Felbermayr and Yalcin (2013) examine the role played by public export insurance provided by the German government (through the Hermes guarantees) between 2000 and 2009. Analyzing sector-level data, the authors demonstrate that public guarantee fosters exports. Based on a sample of Garman firms over the 1991-2003 period, Moser et al. (2008) show that the export-promoting role of Hermes guarantees is robust to introducing a measure of political risk (reflecting the level of corruption, government stability, internal conflicts, etc.) in the estimate. Egger and Url (2006) report similar results for public export insurance in Austria during the period 1996-2002.

Trade finance remains as essential in today's' intra African trade. In many cases, goods cannot cross borders without trade finance. Two counterparts engage in cross-border trade: an exporter that requires payment for goods or services and an importer that requires the correct and timely arrival of those goods or services. Given the many complexities involved with cross-border payments and receipt of goods, cross-border trade has a unique set of risks.

Trade finance instruments, intermediated by commercial banks, are designed to address the risks associated with cross-border payments and timing, which are amplified by jurisdictional and operational differences among trade counterparties. Trade finance instruments are premised on an existing credit relationship between counterparty banks. Trade finance

belongs to an asset class that has short tenors and a cross-border component. It is often vulnerable to the retrenchment of lenders. The global trade finance network, however, requires a long-term commitment by banks on both sides of a border. In fact, the current network embodies decades of the construction of individual banks in building familiarity and expertise in this asset class. It also embodies actual, legal, and documentary pathways of trade transactions, as well as mastery of their cross-border counterparts and geographies.
Extensive economic analysis demonstrates the importance of trade finance to trade policies.

In fact, estimates indicated that credit shocks related both to working capital and trade finance accounted for between 15 and 20 percent of the decline in trade during the 2008–2009 crisis. At the firm level, Behrens et al. (2013), Bricongne et al. (2012), and Coulibaly et al. (2011) all find that financial constraints explain part of the decline in exports during the 2008-2009 trade collapse. Using sector-level data, Chor and Manova (2012) find that tight financial conditions (i.e., higher interbank interest rates) led exports to fall more during the 2008–2009 crisis in sectors with high external finance dependence or low asset tangibility.

4.0 CONCLUSION

Overall, these results support the view that trade finance, notably trade insurance, is a driver to the successful implementation of trade policies. They provide a rationale for voluntary policies intended to promote intra African trade, notably those implemented by the AU (Auboin, 2011), regional development banks (Beck et al., 2011) and Berne Union (Morel, 2011). Thus, a high availability of trade finance can cushion the successful implementation of African Continental Free Trade Area (AfCFTA) by "raising the floor" for global trade, despite downward pressure. Supporting the financial sector's capacity to extend trade finance can also protect working capital when it is most needed.

It can expedite post-pandemic recovery by providing the exact financing needed to restart business activities and renew trade. Both anecdotally and econometrically, trade finance is an important component of Intra African Trade and private sector working capital, especially in periods of crisis. Trade finance is, in effect, a specific form of working capital finance, which injects liquidity into operating cycles. Trade financing is estimated to increase Africa's exports by $560 billion, mostly in manufacturing. Intra-continental exports would also increase by 81%, while the increase to non-African countries would be 19% per the African Development Bank estimates.

5.0 GITFIC RECOMMENDATION

This paper has important policy recommendation for the formulation of policies on Trade Finance aimed at achieving a smooth implementation of the AfCFTA. **Ghana International Trade and Finance Conference** highly recommends the following:

1. Implementation of trade finance support programs or enhanced current programs to provide credit and liquidity for intra African trade. Such programs provide valuable support to Intra African trade community. According the African Development Bank's Report on Assessment of the Trade Finance Market in Africa Post-Crisis 2010, policies like The Asian Development Bank Trade Finance Program which provides guarantees and loans to 180 partner banks in order to increase financial support to companies engaged in import and export activities in Asia's most challenging markets, The Inter-American Development Bank (IDB) which considers trade activities to be crucial to the growth of Latin American economies. IDB considers that the regional Trade Finance Facilitation Program (TFFP) complements their broader strategy to support financial sector growth and the International Finance Corporation Global Trade Liquidity Program the newest program to be instituted in response to the global trade finance crisis. Designed to support up to $50 billion in international trade in the next three years provide trade finance through a network of more than 500 banks in over 70 developing countries across all regions are frameworks implemented in other parts of the globe to boost trade finance.

2. Support regional integration by providing finance for intra-regional trade: AfDB support for trade finance provision via regional integration initiatives could be in the

form of targeted lines or risk participation through financiers of infrastructure projects. AfDB support to trade finance alongside infrastructure investments will act as a catalyzer for other private sector agents.

3. Partial portfolio-based guarantees issued to well-managed commercial banks will stimulate private sector financial support to companies engaged in import and export activities.

4. Encourage reforms and policies that reduce information asymmetry and facilitate credit information sharing through creation of credit information Bureaus and setting up of national collateral registry.

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