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TRADE FINANCE FOR SUSTAINABLE DEVELOPMENT IN ASIA AND THE PACIFIC

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1. INTRODUCTION

The flow of bank intermediated trade finance is falling short of meeting the growing demands in the Asia-Pacific region. While the Asia-Pacific region has been in the lead in the world as the largest user of trade finance globally, the persistent trade finance gaps in the recent past have been inhibiting business development, job creation and growth, especially for SMEs. Even with its large presence and making a sizable contribution to the Asia-Pacific economy, the SME sector has been more negatively affected than the large companies (ADB2014). This phenomenon, particularly visible after the Great Recession of 2008/09, has become a continuing feature of the Asia-Pacific financial sector and is persistent. Despite most of the central banks' timely responses and adopting need-based realignments in their banking policy, as well as other remedial measures taken both at national, regional and international levels, the problems are continuing and the gap is widening. This has attracted the attention of some of the policymakers to identify the road blocks and find ways and means to meet the challenges. This paper reviews the status of trade finance in the Asia-Pacific region, highlights the specific issues (obstacles and the needs) faced by SMEs with regard to accessing trade finance, and presents a set of recommendations for national action and regional cooperation.

Recognizing the importance and significant role of trade finance as an engine of growth, this paper proceeds with a review of the trade finance in Asia-Pacific region-its status and constrains, followed by an assessment of trade finance gaps identified by the institutional surveys, the resultant policy implications, emerging issues and the challenges, especially those faced by the SME sector, and finally brings to the forefront a set of recommendations along with a road map for consideration of policymakers. In addition, a few major issues will be presented for thinking ahead. The recommendations are innovative and in the nature of both financial and non-financial inputs, calling for much-needed conceptual, systemic and operational changes to be implemented comprehensively at the national level with built-in regional cooperation mechanism.

2. TRADE FINANCE IN ASIA-PACIFIC: MODALITIES, STATUS & CONSTRAINTS

2.1. Asia-Pacific international trade

Before an analysis is made of the trade finance situation in the Asia-Pacific region, it is perhaps useful to review the current trade situation in the region first.

Contrary to the global lead position retained by the Asia-Pacific region recording the highest use of trade finance in the world, the growth in merchandize goods exports in the region gradually slowed down from 29.9% in 2010 to 19.5% in 2011, 2.2% in 2012 to reach a new low of 2.1% in 2013. A similar slowdown from 4.3% in 2012 to 2.3% in 2013 was also recorded in the imports of merchandise goods. Despite the gradual slowdown, the region accounted for 36% of global merchandise exports and 36.1% of global merchandise imports, *"making it the biggest trading region in the world, in terms of both imports and exports, overtaking Europe in 2012."*[1] However, the current slowdown of economic growth and trade in China is likely to impact the prospects of increasing the volume of intraregional trade (box 1).

Both export and import growth also slowed down, from 7.2% in 2012 to 4.9% in 2013 and from 8.7% in 2012 to 4.2% in 2013, respectively. In 2013, the share of the Asia-Pacific region in global exports of commercial services was 27.7%; of which the majority share (67.5%) was

[1] See ESCAP, "*Statistical Yearbook for Asia and the Pacific 2014*"; p.28.

claimed by six economies, namely China; Hong Kong, China; India, Japan, the Republic of Korea and Singapore. Asia-Pacific was a net importer of commercial services in 2013.

Box 1. Intraregional exports and imports of merchandise goods in the Asia-Pacific region

East and North-East Asia is the largest trading sub-region in Asia-Pacific. In 2013, it accounted for 58.4% (57.8%) of the region's exports (imports) of merchandise goods, followed by South-East Asia which accounted for 18.5% (18.3%). On the other hand, the Pacific subregion accounted for only 4.4% of the region's exports and imports of merchandise.

Merchandise goods export growth slowed down in the Asia-Pacific region (2.1% in 2013) which translated into a reduced trade surplus with the rest of the world, amounting to $72.8 billion in 2013. However, economies exporting labour and resource-intensive goods, such as Afghanistan, Bangladesh, Cambodia, Georgia, Myanmar and Viet Nam, registered double-digit export growth in 2013.

In 2013, the least developed countries in the Asia-Pacific region accounted for only 0.8% and 1.2% of the region's exports and imports of merchandise, respectively. In contrast, China, India and the Russian Federation together accounted for 44.2% and 40.5% of the region's exports and imports of merchandise, respectively.

In 2013, intraregional exports and imports of merchandise in the Asia-Pacific region accounted for around half of total exports and imports of merchandise.

Source: ESCAP, *"Statistical Yearbook for Asia and the Pacific 2014"*, p.28.

The ESCAP Statistical Yearbook 2014 observes that *"in order to enhance the competitiveness of a country in the world of globalized production, focus needs to be placed on raising domestic value-added rather than just increasing gross exports"*.

2.2. Overview of trade finance

During the period 2013-2014, despite witnessing phases of both 'ups and downs', the Asia-Pacific region as a whole remained in the global lead as the largest user of trade finance and trade credit insurance (CGFS 2014, p.9 and Graph 2. p.11.).

Over the years, the Asia-Pacific region has been able to enhance and widen the use of trade finance for business. The progressive increase in the usage of trade finance by volume and demand is indicative of the importance the region attaches to trade finance as a prime mover to growth.

Trade finance is the front-end component of the mother term: "Finance". Finance in its comprehensive sense, is the critical most input for business. It is deeply engrained in the entire life-cycle of business in the form of long-term and short-term finance, such as, start-up capital, venture capital, project finance, working capital, bridge loan, expansion credit, etc. The role of trade finance assumes greater importance at the pre-shipment and post shipment stages of marketing and sale of goods and services, when businesses enter into international trade transactions. Trade finance therefore directly sustains the profitability of business and indirectly contributes to the sustainable development of the economy. A wide range of financial tools such as cash, credit, investments and other forms of assets are used for effecting trade transactions.

Typical trade-related institutional finance products and services that are offered by banks and development financial institutions (DFIs) supporting trade transaction by bearing payment risks are: letters of credit (L/Cs), import bills for collection, import financing, shipping guarantees, L/C confirmation, checking and negotiation of documents, pre-shipment/post shipment financing, invoice financing, and receivables/bills purchased and discounted. Trade finance instruments also include export credit guarantees or insurance.

The other form of trade finance by way of credit is accorded by the buyer to the seller directly (called as buyer's credit) or inversely by the seller to the buyer without bank intermediation. Such "open accounts" involving large amounts of "receivables and payables" under the supply-chains system may, however, necessitate the involvement of banks for the efficient management of transactions. This system of open account inter-firm credit is not much in vogue and is done very selectively to avoid payment risks. This system may be popularized by encouraging the discounting of receivables with factoring or forfaiting companies and mitigating the payment risks by purchasing insurance, which may add to the cost, though. Viewed from a positive angle, this may emerge as an alternative source to reduce the pressure on the flow of bank-intermediated finance.

Trade finance mechanism provides some combination and degree of support in the following four areas (ITC, 2009):

(1) Payment facilitation, enabling secure and timely payment across borders, for example through proven communication methods such as SWIFT (a secure bank-to-bank messaging system used to transmit bank instruments such as letters of credit, as well as payments between financial institutions).

(2) Financing to one or more parties in a trade transaction, whether it is the importer, exporter, or one of the banks.

(3) Risk mitigation, either directly through the features available in a trade financing mechanism, or indirectly through insurance or guarantee products designed to meet the needs of importers and exporters.

(4) Providing information on the movement of goods and/or the status of the related financial flow.

The matrix of trade finance instruments commonly used is given below (table 1).

Table 1. Matrix of trade finance instruments commonly used for raising capital, facilitating payments and mitigating risks

Raising working capital for exports: Debt financing; Asset-based financing; Export factoring; and Leasing
Facilitating payments: Cash-in-advance; Letter of Credit(L/C); Documentary collection; and Open accounts
Mitigating risks: Export credit guarantee; Export credit insurance; Forfeiting; and Hedging.

Source: Compiled by the author.
Note: Warehouse receipts are also in use as specialized financial instrument for Commodity trade.

For due appreciation and subsequent examination of any possibility of making need-based conceptual changes in the scope of trade finance and its existing products, instruments and services, it is desirable to revisit some of their definitions (Annex 1).

2.3. The role of the banking sector and other actors in trade finance

Trade finance assistance is mainly provided by the commercial banks and DFIs. Inter-firm trade transactions within the private sector are gradually gaining acceptance as a second channel supplementary to the bank-intermediated trade finance.

Bank-intermediated trade finance acts as the life-line for trade and commerce, especially in the field of international trade. Banks are the main providers of trade finance in various forms as working capital and/or act as means to reduce payment risks. Inter-firm trade credit is slowly emerging as a non-banking channel of trade finance. Firms' ability to directly extend credit, however, primarily depends on inter-firm business relationships with trust and is generally backed by purchasing trade credit insurance to mitigate payment risks.

A commercial bank acts as a trusted third party to guarantee delivery of goods and services from the exporter and payment by the importer. DFIs and export credit agencies (generally state-owned) are also major actors in international trade and investments. They generally provide long term loans, project finance, guarantees, and insurance to corporations, companies and SMEs. Many Asia-Pacific countries have set up national SME Banks (such as, BRAC Bank-Bangladesh, SIDBI-India, Philippines SME Bank Inc., SME Bank of Thailand) which, inter alia, provide trade finance and offer risk mitigating products.[2]

An overview of the schemes and services offered by the Small Industries Development Bank of India (SIDBI) provides examples of best practices in SME trade financing. SIDBI, in addition to financing in general and resource support to the banking sector and financial institutions, offers a full range of traditional as also innovative trade finance products/ services including business development services to the SME sector at large. In particular, SIDBI has successfully addressed the very critical challenge faced by SMEs in offering collaterals and third party guarantees to help them access finance. In collaboration with the Government of India, SIDBI has successfully implemented an innovative *collateral-free and third party guarantee-free* credit guarantee scheme for the micro, small and medium sizes enterprises in collaboration with the Government of India, which is by now in operation for about 15 years (box 2).

Box 2. Trade finance schemes, products and services of SIDBI for SMEs in India

The Small Industries Development Bank of India (SIDBI), established on 2 April 1990 under an Act of the Indian Parliament, is the "principal financial institution for the promotion, financing and development of the Micro, Small and Medium Enterprise (MSME) sector and for coordination of the functions of the institutions engaged in similar activities".

Facilitating access to finance by SMEs has been one of the prime areas of concern for SIDBI. It has therefore designed a number of relevant financial products and services to meet the demand for finance. The Confederation of Indian Industry (CII) had identified "delay in realization of receivables" as one of the most important challenges faced by SMEs. In order to address the issues in a holistic manner, SIDBI, in addition to various financial schemes and business development services (BDS), effectively implemented trade finance schemes for SMEs. Some of the widely used trade finance schemes operated by SIDBI for SMEs are trade financing and factoring services; lines of credit in foreign currency to

[2] See Abe and others,"Policy Guidebook for SME Development in Asia and the Pacific" (ESCAP, Bangkok, 2012).

commercial banks (LOCFC) for on-lending to exporting SMEs; export houses/trading houses sourcing their export requirements from SMEs; MSME receivable finance scheme and discounting scheme.

As part of its promotional and developmental role, SIDBI also extends a number of business development services, such as market development for entry into global markets, capacity building to gain competitiveness in international trade, assistance for participation in international trade shows, etc.

The collateral-free and third party guarantee-free Credit Guarantee Fund Scheme for Micro and Small Enterprises is an innovative and successful credit risk mitigation initiative of SIDBI. This solves the problem of SMEs' inability to meet the most vexing demand for collateral and guarantees to access bank finance. The scheme helps small entrepreneurs to obtain collateral free loans (including trade finance) up to INR 10 million. As of the end of January 2013, over 1 million guarantee covers (by number of entrepreneurs) for an aggregate loan amount of over INR 480,000 million had been provided under the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE).

Under the Union Budget 2013/14, the establishment of the Credit Guarantee Fund for Factoring was announced with a fund of INR 5,000 million that will further pave the way for orderly growth of factoring services and provide an alternative to bank-intermediated trade credit. The SIDBI is connected both directly and indirectly with a robust network of MSMEs and financial institutions sector serving the MSMEs. The MSME sector presently consists of over 30 million enterprises, employing about 70 million people, manufacturing more than 6,000 products, contributing about 45% to manufacturing output and about 40% to exports. In addition, SIDBI also provides assistance to the services sector, including transport, health care, tourism, etc. The main channel for institutional finance to MSMEs is the commercial banking sector, which serves the sector through its network of about 80,000 branches. SIDBI ranks among the top 30 development banks of the world as rated by The Banker, London.

Source: https://www.sidbi.in.

In the Asia-Pacific region, there are four common methods of payments available to firms engaged in international trade: (a) cash-in-advance, (b) letters of credit (L/Cs), (c) documentary collection, and (d) open account (table 2).

Table 2. Methods of payment in international transactions

Method of payment	Definition	Applicability	Risk distribution	Pros/cons for exporter
Cash in advance	Full payment prior to shipment	Recommended for high risk export markets	Exporter is exposed to virtually no risk; burden is greatest on the importer	Pros: Payment before shipment, eliminates risks of non-payment Cons: May lose customers to competition over payment terms
Letter of Credit	A commitment by a bank on behalf of the buyer that payment will be made to the exporter when the terms and conditions of the L/C are met	Recommended in new and established trade relationships; exporter should be confident of the creditworthiness of buyer's bank	Evenly spread between seller and buyer if conditions are adhered to	Pros: Transaction is secured by a third party. Goods against payment. Cons: Complex and labour intensive process. Relatively expensive.
Documentary collection	Exporter entrusts the collection of payment to a bank with payment instructions	Recommended in established trade relationships and in stable markets	Riskier for the exporter but cheaper than L/Cs	Pros: Payment is made with the assistance of a bank. The process is simple, fast & less costly than a L/C Cons: Bank role is limited, payment is not guaranteed
Open Account	Payment by importer after receiving the goods, usually within a timeframe of 30 to 90 days	Recommended in low-risk trading relationships or in a competitive market to win new customers (should be combined with one or more trade finance techniques)	Significant risk to exporter because buyer could default on payment after goods are shipped	Pros: Boosts competitiveness in the global market; helps establish and maintain a successful trade relationship Cons: Significant risk of nonpayment; additional costs associated with risk mitigation measures

Source: ITC (2009), How to Access Trade Finance: A Guide For Exporting SMEs, International Trade Centre, Geneva, Switzerland, Table 3.1; pp35-36)

Firms in the Asia-Pacific region have been relying mainly on banks' short term maturity products, namely L/Cs and documentary collection for their export transactions. This mode of international payment obligations has so far been considered as a liquid, low-cost payment risk,

time-tested and well-functioning mode for overseas business transactions. However, in the changing global market and with growing demand, heavy reliance only on these traditional modes of payment is no longer sufficient to meet market requirements and unmet credit needs of SMEs. Therefore, the encouragement of the wider use of inter-firm transactions such as “open account system” backed by suitable risk mitigation mechanism and other support mechanisms is necessary.

2.4. Market size of trade finance: global and regional

There is no comprehensive single source to determine and measure the global and regional size of trade finance and the composition of the trade finance market. Different sources use their own modalities and conduct surveys to measure the bank-intermediated trade finance size, structure and developments, including:

- The Society for Worldwide Interbank Financial Telecommunication (SWIFT) provides a window to trends related to documentary credits, such as L/Cs. It helps to track high frequency global and regional transactions.
- The International Chamber of Commerce (ICC Trade Register-2014) collects data from a number of banks considered to be the global leaders in providing trade finance. Currently, the ICC Annual Global Trade Finance Survey is the main broad industry document for exploring drivers and trends.
- The International Monetary Fund (IMF), in conjunction with the Bankers’ Association for Finance and Trade (BAFT) and International Financial Services Association (IFSA), undertook a series of surveys (2009, 2010, 2011) on volumes, pricing and drivers in the trade finance market. Another survey was undertaken by ICC in 2011 in collaboration with the IMF.

  The Institute of International Finance (IIF) undertakes quarterly Emerging Markets Bank Lending Conditions Survey (EMLC) and currently collects responses on trade finance markets from 130 banks.. IIF conducts a quarterly survey among banks based in five emerging markets regions: Emerging Asia, Latin America, Emerging Europe, Middle East and North Africa and Sub-Saharan Africa. The available statistics, however, show significant variation across countries and regions (visit: https://www.iif.com).

1. Global market

The Committee on the Global Finance System[3], based on national statistics, SWIFT and the ICC Trade Register Survey, estimated that trade finance directly supported about one-third of global trade, with letters of credit (L/Cs) covering about one-sixth of total trade. The Survey mentions that the bank-intermediated products are primarily used to finance trade involving emerging markets economies, particularly in Asia. Global banks appear to provide about one-quarter to a third of the global trade finance, and almost half of their exposure is to firms in emerging Asia. The global market size of bank-intermediated trade finance was estimated by CGFS to amount to US$ 6.5-8 trillion in 2011, of which around US$ 2.8 trillion was provided through L/Cs. The IMF, jointly with BAFT and IFSA (2009, 2010, 2011), estimated that about 40% of global trade was supported by bank-intermediated trade finance, while industry studies (ICC, 2009) estimated it to be around 20%.

[3] See Bank for International Settlements; CGFS Papers No.50; January 2014, Table-2, p.10).

2. Regional: Asia-Pacific market

National data show a wide variation in the measurements of trade finance stocks and annual flows, and percentage of merchandise trade covered by trade finance, which range from 2% for Mexico to more than 40% for China (47%), India (41%), Italy (47-63%) and the Republic of Korea (56%) as compared to global estimates at 36-40%. The percentages of measured intensity of trade finance over trade ranged from 29-38% to 56% relating to major Asia-Pacific countries (table 3).

Table 3. Bank-intermediated trade finance markets in 2011

Country	Trade finance US$ billion: Stocks(1)	Trade finance US$ billion: Annual flows(2)	Percentage of merchandise trade(3)
China	218	871	47
Hong Kong, China	44	131-175	29-38
India	82	164	41
Republic of Korea	76	304	56
Global estimates	1625-2100	6500-8000	36-40

Source: ICC, IMF, national data and CGFS Group calculations-CGFS Papers No.50, "Trade finance developments and issues", Table 2, p.10.
Note: (1) Average quarterly stock for 2011. (2) Annual flows for national data are derived by assuming a 90-day maturity of stocks, except in India (and Mexico) where maturities are known to be six for India (and 12 months for Mexico).(3) Trade is measured as the average of exports and imports of goods.

Figure 1.

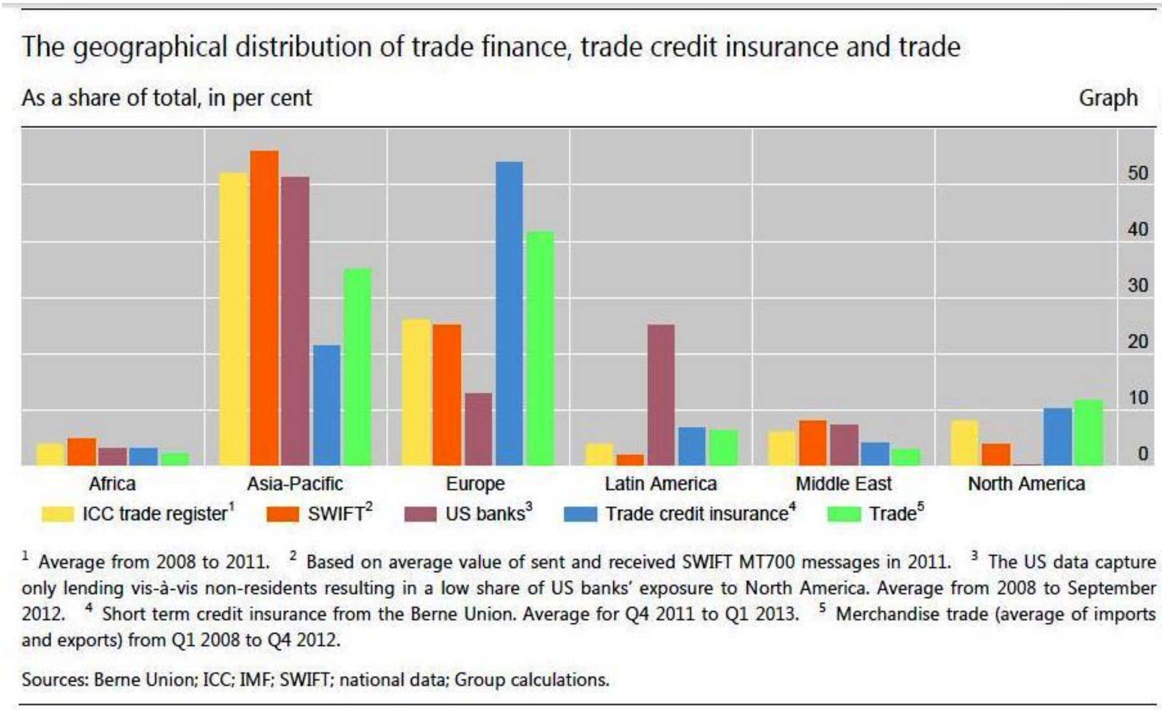


Figure 1 shows that the Asia-Pacific region relied most heavily on trade finance of all regions in the world.

There are various logistic and economic factors contributing to the higher use of trade finance in the Asia-Pacific region, e.g. long distance trade transactions between partners, level of local market efficiency, new trade relationships, expanded trade with countries with weaker legal and contractual systems, political risks, historical preferences, costs of operating through L/Cs, etc. The above mentioned factors may be more at work in countries with foreign exchange regulations or strict banking regulations, such as China (box 3).

Box 3. The use of trade finance in China

Two China-specific factors contributed to the popularity of trade finance, especially in the form of L/Cs, in China.

On the demand side, the interest rate of trade finance was liberalized. In contrast, RMB loans, which form the bulk of bank credit in China, were subject to an interest rate floor set by the Bank of China until late July 2013. As a result, the average interest rate of trade finance was much lower than that for other credits obtained from domestic banks.

On the supply side, banks were willing to provide trade finance to clients for regulatory reasons. In line with Basel II and regulations issued by the China Banking Regulation Committee, trade loans are viewed as low-risk assets on banks' balance sheet. L/Cs are even more popular because of their ability to act as a vehicle for onshore companies to obtain cheap offshore funding and because they are off-balance sheet assets that normally do not consume bank capital. Historically, L/Cs have also been used to arbitrage on- and offshore markets. However, after the China Banking Regulation Committee issued new directives in May 2013, the issuance of L/Cs dropped.

Source: Extracted from CGFS, "Trade finance development and issues, 2014, Box 1, p. 13

2.5. Users of Letters of Credit

The ICC Trade Register estimates that about 90% of the L/C transactions go via SWIFT. As noted before, of the total flow of bank-intermediated global trade finance, which was estimated at US$ 6.5-8 trillion, around US$ 2.8 trillion was through L/Cs in 2011. The Asia-Pacific region accounted for more than half of all L/C related transactions, while Europe accounted for one-quarter and North America, Latin America, Africa, and the Middle East each around 5-10%. The Asia-Pacific region registered the highest volume of L/C used, covering 75% of exports and 68% of imports.

With regard to import traffic, the Asia-Pacific region continued to register greater volume of import messages sent via SWIFT with 68% of the world traffic in 2013. Bangladesh emerged as the highest importing country using letters of credit. The countries that imported the most using L/Cs were from Asia–Pacific region, namely: 1.Bangladesh, 2.China, 3.Korea, 4.Hong Kong and 5.India.

Export traffic: Asia-Pacific continued to register over 75% of the world export messages received through SWIFT in 2013. The countries that exported the most were: 1.China, 2.Hong Kong, 3.Bangladesh, 4.India and 5.Singapore.
In 2013, USD was the currency that represented 82% of the total value of L/C issued via SWIFT. Later in 2013, the Chinese CGY or RMB became the 2nd most used currency in trade finance overtaking the Euro.

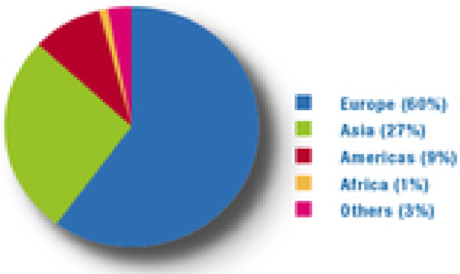
2.6. Factoring in Asia-Pacific

The overall global factoring volume in 2013 was US$ 3,079 billion recording nearly 10 % growth. Europe followed by Asia-Pacific jointly accounted for about 87% of the global factoring volumes (figure 2**).** Over the past 5 years, the factoring industry has grown annually at a rate of 15%-nearly doubling the size globally.

Factoring in Asia-Pacific is gradually gaining popularity as a product designed to provide finance to SMEs. Funding is offered by the factoring companies based upon the accounts receivables created by the client. China and Hong Kong, China are the top Asia-Pacific economies with factoring facilities. China recorded impressive growth over the past five years at a rate of 54% per annum, becoming the largest factoring market in the world with over 20% of the global cross-border factoring volume. The other Asia-Pacific economies with double digit growth included: Hong Kong, China; India, Republic of Korea, Russian Federation and Singapore. Today, the Asia-Pacific region accounts for the largest regional membership of Factors Chain International (FCI). FCI is the world's largest global factoring network with 270 members located in 76 countries. Over 85% of the members of FCI are bank related.

Figure 2.

Global factoring industry 2013 by region *All figures given in Euro Billions*



	2012	2013	Group rate % change
Europe	1,298	1,354	4.3%
Asia	572	599	4.7%
Americas	188	192	2.1%
Africa	23	23	0%
Others	50	62	24%
Total	2,132	2,230	4.6%

Source: Factors Chain Annual Review 2014, Table 1, p.20.

2.7. Forfaiting in Asia-Pacific

Comparative and comprehensive data are not readily available on the volume of trade finance transactions through forfaiting in the Asia-Pacific region.

Under the forfaiting system of trade finance, international trade receivables (such as promissory notes, bills of exchange, receivables and deferred payment under letters of credit guaranteed or issued by banks) with credit periods ranging from 90 days up to 5 years, are discounted, without recourse to the exporter. Over the years, it has emerged as an effective sales tool in the Asia-Pacific region. It improves cash flows and eliminates risks. A number of major companies have started operating in the region to carry on forfaiting in the region and this trend is gaining ground.

A good example is the South Asian Forfaiting Facility (SAFF) which comprises three country-specific forfaiting facilities covering Bangladesh, India and Sri Lanka. SAFF is part of the larger Asian Forfaiting Facility (AFF), which also included China, Indonesia, Malaysia, Republic of Korea, Philippines and Thailand (box 4).

Box 4. The South Asian Forfaiting Facility (SAFF) in Asia-Pacific

IFC joined in as a cosponsor of SAFF. IFC made a significant contribution to the project through its intimate knowledge of each of the markets as well as the top banks in each country. SAFF's total facility amount was envisaged at US$70 million with an IFC exposure of US$28 million in the form of a risk sharing guarantee. SAFF was therefore part of a regional initiative which could provide a new product to a number of markets.

The objective of SAFF was to support trade between the project countries within the South Asian sub-region as well as imports from other countries. SAFF, as part of AFF, built on the success and experience gained to date from the Korea Forfaiting Facility (KFF), the first forfaiting project of IFC. This experience was later extended to a regional initiative to provide trade finance through forfaiting in the major Asian markets. For each country facility, i.e. India, Bangladesh, and Sri Lanka, the sponsors (West LB) were to set up a revolving forfaiting facility with a final two-year term. IFC would provide a partial guarantee of 40% of the exposure of each forfaiting transaction for the first 185 to 365 days depending on the credit quality of the respective local bank. The actual risk of the forfaitor (to be shared by IFC) was that of the importing bank.

Source: http://ifcext.ifc.org/ifcext/spiwebsite1.nsf.
Note: The SAFF's primary sponsor was West LB, a bank in Germany no longer in existence However, with the closure of West LB, the future of SAFF is in doubt and no current information on the facility is available.

Recently, China Trade Solutions launched the Singapore Forfaiting Company to expand its presence across South-East Asia. The company, which has originally focused on the mainland China and Hong Kong, China markets, is aiming to develop its business in Singapore and Indonesia, as well as more generally across South-East Asia.

2.8. Global value chains and Asia- Pacific SMEs

Most Asia-Pacific economies are now well integrated into the global trading system. The Asia-Pacific region is witnessing a gradual emergence and expansion of global and regional supply or value chains systems benefitting SMEs. However, the process is slow in Asia-Pacific.

The term "Global Value Chains" (GVCs) refers to the full range of cross-border, value-added business activities that are required to bring a product or service from the conception, design, sourcing raw material, and intermediate inputs stages, to production, marketing, distribution and supplying the final consumer.[4]

SMEs participate as suppliers, distributors and business service providers by entering into GVCs. In Asia-Pacific, both producer-driven chains and networks (such as Tata Motors and Toyota sourcing automotive components from a large number of small suppliers) and buyer-driven chains or network (such as Levi's in the apparel market) systems are prevalent.

In the supply chains system, the lead firm decides about the details of outsourcing, capacity building of the suppliers for quality control, product standardization, etc. The SMEs as global suppliers offer the products and services to the lead firm. The GVC framework offers room for

[4] ESCAP; "Linking Greater Mekong Sub-region Enterprises to International Markets", Studies in Trade and Investment No. 59, 2007, Bangkok, United Nations).

multiple SMEs to provide services based on their experience and expertise as suppliers, distributors and business service providers (Abe and others, 2012).

The development of GVCs in Asia and the Pacific provides business opportunities for export-oriented and supporting industry SMEs (ESCAP, 2009a). GVCs are expected to provide an efficient network by establishing links with large enterprises or even with other efficient SMEs. They help to boost the value-added activities of affiliated SMEs in international trade by providing an established market. However, Asia-Pacific SMEs currently play a limited role due to low value-addition and lack of proper networking. SMEs are generally at a disadvantage due to their limited operational capacity and lack of knowledge necessary to penetrate regional and global markets (ESCAP, 2007). SMEs in the Asia-Pacific developing countries typically lack the environment to improve their capacity, including a proper policy and regulatory framework, supporting infrastructure, access to finance, a strong entrepreneurship culture, technology incubation and business development services (ESCAP, 2009b).

GVCs are an effective way of exposing SMEs to foreign markets. There are a number of benefits for SMEs joining these chains, but the main advantage is that GVCs increase SMEs competitiveness and widen the scope of international trade. To make the GVC system more acceptable to SMEs as an effective channel to enhance their scale of international operations, suitable policies need to be put in place to make the working environment more vibrant so that SMEs feel easy to operate through GVCs. Additionally, the large companies would be encouraged to include SMEs in their global supply chains framework. However, most local commercial banks in emerging markets of Asia have limited or no tailored financial products for suppliers and exporters to finance sales not backed by letters of credit. Some of the initiatives taken to promote supply chains system related trade finance are given below:

For instance, the Global Trade Supplier Finance (GTFS) programme is a US$ 500 million multicurrency investment and advisory programme which was started by the International Finance Corporation (IFC) in 2010 (box 5). GTFS has started to show positive results benefitting SME suppliers from emerging economies. SMEs are increasingly, though slowly, joining the IFC Global Supply Chain support programme for making cross-border transactions.

Box 5. The IFC-GTSF Programme

The following paragraphs have been extracted from the IFC-GTSF website.

"GTSF extends and complements the capacity of banks to deliver trade financing by providing risk mitigation in new or challenging markets where trade lines may be constrained. IFC issues credit guarantees where others won't and supports trade that would not be possible without an IFC guarantee. Through the Global Trade Finance Program (GTFP) bank network, local financial institutions ("issuing banks") can establish working partnerships with a vast number of major international and regional banks ("confirming banks") in the programme, thus broadening access to finance and reducing cash collateral requirements. GTFP offers confirming banks partial or full guarantees covering payment risk on banks in the emerging markets for individual trade-related transactions evidenced by a variety of underlying instruments such as: letters of credit, trade-related promissory notes, accepted drafts, bills of exchange, guarantees, bid and performance bonds and advance payment guarantees. Guarantees are available for all private sector trade transactions that meet IFC's eligibility criteria. IFC's Trade Advisory Services include over a dozen technical assistance modules to provide basic and intermediate trade finance skills for issuing banks.

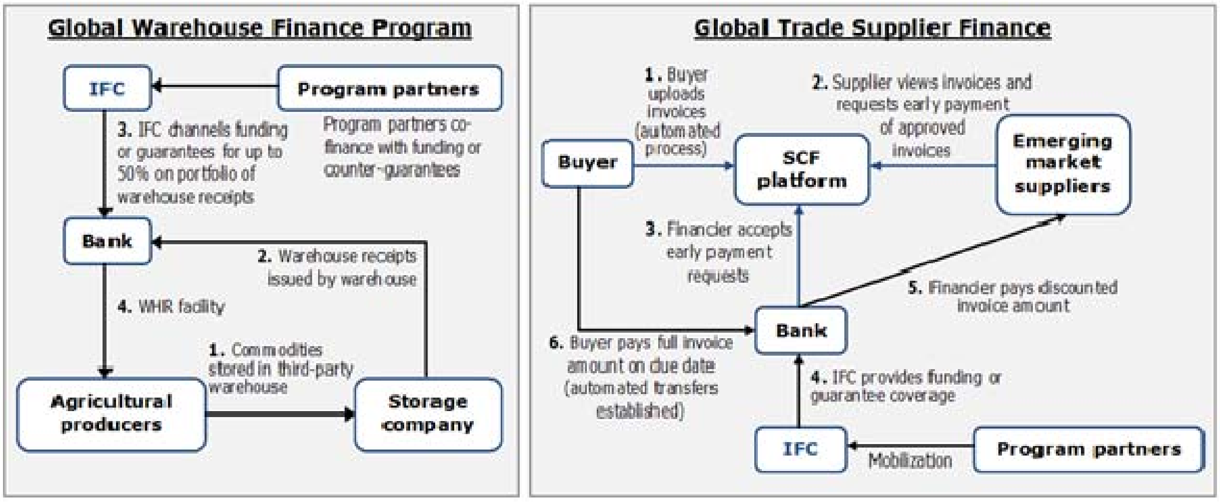
IFC works with buyers across industries that source goods in emerging markets. The GTSF programme provides post-shipment finance to suppliers based upon acceptance of receivables by select buyers approved by IFC. This allows suppliers to improve working capital by converting sales receivables to immediate cash and to access lower-cost financing based on the superior credit risk of the buyer. IFC also provides comprehensive supplier on-boarding and training programmes through advisory services. The GTSF programme maximizes financial inclusion of SMEs and helps SMEs in working capital management and the practical application of supplier finance.

The GTSF programme aims to: increase access to finance for suppliers in emerging markets; maximize inclusion of SMEs and their ability to access finance at competitive terms; support reduction in financing costs; and develop market appetite for supplier finance."

Source: www.ifc.org.

According to a 2010 IFC market survey, the annual export volume from emerging markets to buyers in Western Europe, Japan and the United States is estimated at approximately US$ 400 billion. However, only 10% of exporters in emerging markets have access to supply chains finance. Most of the commercial banks in emerging markets have limited or no tailored financial products for suppliers and exporters to finance sales that are not backed by letters of credit. The global banks that do offer supply chain finance solutions have often little experience in emerging markets. The difficulty in reaching the sheer number of small and medium-sized suppliers in emerging markets has also been a major constraint to the growth of supply chain finance, as observed by IFC. Developing more programmes like GTSF seems a workable solution and an alternate source to ease the pressure on banks' intermediation. Figure 3 shows IFC's two GVC related trade finance programmes, the GTSF discussed above and the Global Warehouse Finance Programme.

Figure 3. IFC's GVC related trade finance programmes



Source: IFC's Guide to Products: Global Trade & Supply Chain Solutions, April 2012.

Gartner, Inc. (NYSE: IT), a leading information technology research and advisory global company, in its 2014 Annual list of the leading supply chains in Asia-Pacific, ranked "Ten of the

Best Supply Chains in Asia Pacific" key strategies, initiatives and best practices **(Annex 2).** Samsung and Lenovo made the top 25 global supply chains list. These multinational companies are benefitting a large number of SMEs through their supply chains system.

The above scenario of supply chain position in Asia-Pacific seems to offer enough potential and scope to enhance SMEs integration into GVCs. The Asia-Pacific Economic Cooperation (APEC), in its survey on "Integrating SMEs into Global Value Chains: Policy Principles and Best Practices" (May 2014)[5] observed that SMEs in developed and newly-industrialized economies, particularly in the agriculture and electronics sectors, offer higher potential to participate in GVCs. However, in developing economies the electronics and handicrafts sectors offer better prospects. To integrate SMEs in GVCs, APEC economies could look at policies to assist companies in developing products and company attributes, and to ensure suitable conditions with easy access to finance.

Access to trade finance, both globally as well as in the Asia-Pacific region, has been the key obstacle for exporting SMEs. Over 60% of the exporting SMEs in the Asia-Pacific region rely on internal financing. Sources other than bank-intermediated finance - particularly supply chain financing - is perceived as advantageous to facilitate the direct export participation of SMEs[6]

2.9. Inter-firm trade credit

The system of inter-firm trade credit between importers (not necessarily manufacturer) and exporters is an alternative to trade finance extended by the banking sector and is different from credit afforded under supply chains system, which are operated by large manufacturing companies. The system of inter-firm trade credit is based on business relationships and trusts and it includes open account transactions, where goods are shipped in advance of payment, or through cash-in-advance transactions in which payment is made before shipment. This type of transaction entails lower fees, more flexibility, but higher payment risks. Hence, reliance on this form of transaction is mostly confined to firms with well-established commercial relationships. In Viet Nam, the system of inter-firm credit has been in existence for a long time. A firm trusts its customers enough to offer credit when the customer finds it hard to locate an alternative supplier. A longer duration trade relationship is associated with large credit. Customers identified through the business network receive more credit.[7]

2.10. Other new non-banking products

Global banks see supply chains finance as an important new area of activity, and a focal point of current competition. Citing new regulatory demands and high marginal costs of equity capital, the trade finance industry is experimenting, though on a limited scale, with new structures and products to distribute trade finance to non-bank companies.

For instance, the Royal Bank of Scotland (RBS) introduced a suite of non-traditional global

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[5] See APEC Issues Paper No. 6, May 2014; http://www.insme.org/insme-newsletter/2014/file-e-allegati/newsletter_documents/Integrating_SMEs.pdf.

[6] See: Yann Duval and Chorthip Utoktham (2014), Enabling Participation of SMEs in International Trade and Production Networks: Trade Facilitation, Trade Finance and Communication Technology, ESCAP Trade and Investment Division, TID Working Paper No. 03/14, 25 June 2014, Bangkok; available at www.unescap.org/publications.

[7] See John MacMillan and Christopher Woodruff. 1999 "Inter-firm Relationships and Informal Credit in Vietnam", *The Quarterly Journal of Economics*, Oxford University Press.

trade finance products which provide visibility in supply chains events, such as the purchase-to-payment and order-to-cash cycles. These products enable access to liquidity by allowing suppliers to sell credit term invoices, unlocking working capital while mitigating risks and leveraging the lower cost of capital of a well-rated purchaser to reduce risk and costs throughout the supply chains. While the trade finance industry has started experimenting, in a limited way, with non-traditional trade finance structure and new channels as alternative or supplementary to bank-intermediated finances, trading companies need to be aware of how the non-bank-intermediated systems/products work to their benefits before they switch to a new funding source. Reach and uptake of the non-financial products had been slow mainly due to information asymmetries and unfamiliarity with the established channels such as export credit insurance. Asset-heavy companies may have to change their mind-set to explore alternative forms of financing to conclude the transactions efficiently taking assistance from the alternative pool of money. Those that do not could be forced to sell assets or face a shut market in the long run (Narain, 2014).

3. AN ASSESSMENT OF TRADE FINANCE GAPS

Trade finance gaps, particularly during and after the 2008-2009 financial crisis, have become a persistent feature of the global trade regime. The Asia-Pacific region is also witnessing the same trend of a widening gap; 'supply falling short of demand'. Market gaps for trade finance in the Asia-Pacific region have persisted even as the global economy has recovered. Gaps inhibit economic growth. Anti-money laundering regulations were a significant contributor to trade finance gaps, while companies lacked awareness of trade finance options and innovations as observed by ADB.[8] However, measuring the trade finance gaps has proved to be a challenge.

The lack of comprehensive data on Asia-Pacific trade finance from a single source makes it difficult to realistically assess the demand-supply constraints and gaps. The 2008-2009 financial crisis served as the trigger point. Responding to the challenges, the IMF, in conjunction with BAFT-IFSA as well as the ICC Banking Commission, conducted a series of bank surveys. The World Bank also conducted a survey in 2009 on firms and banks in 14 developing countries (including a few Asian countries) to gauge the impact of trade finance disruptions. However, these documents were developed mainly with a global outlook.

For the purpose of making an Asia-Pacific trade finance gap assessment, this paper, therefore, heavily leans on two important sources: (1) ICC-Rethinking Trade & Finance 2014 (released in June 2014) and (2) ADB-Trade Finance Gap, Growth, And Jobs Survey 2013 released in December 2014 (first series relates to the year 2012).

3.1. ICC- rethinking trade & finance 2014

The ICC-Rethinking Trade & Finance 2014 Report brought out three major findings from its Survey participation of 298 banks in 127 countries:

(a) In comparison to the previous survey of 2012, there was a more positive global outlook regarding the availability of trade finance in 2013. However, 55% of the surveyed banks believed that there was a shortfall of trade finance globally (ICC 2014-pp94-96). Of the US$ 6 billion worth of proposed trade finance transactions globally, the shares of proposals (as percentage of total global proposals) emanating from the selected few Asia-Pacific countries covered under the 2013 Survey were as follows:

[8] "ADB, Trade Finance Gap, Growth, and Jobs Survey". ADB Briefs, No 25, December 2014.

- Russia Federation- 9.30%
- Other- 9.41%
- Advanced Asia-Pacific (Hong Kong, China; Japan, Republic of Korea, Singapore)- 27.22%
- Developing Asia-Pacific (excluding India and China)- 14.50%
- India and China- 28.30%

India and China clubbed with Advanced Asia-Pacific topped the list by proposing well over 55%, followed by Europe (Western, Central and Eastern) at 30%. However, all the surveyed banks reported a 20.9% rejection rate for 2013.

(b) A gap between supply and demand persisted, even though more than 80% of the respondents reported an increase in the number of credit lines offered in 2013. Trade finance constraints became more pronounced and concentrated in emerging markets for want of necessary skills to propose bankable propositions by entrepreneurs which therefore led to a high rate of rejections..

(c) Financial crimes triggering Anti-Money Laundering/Know Your Client (AML/KYC) requirements proved to be impediments to trade finance and put negative pressure on both bank-intermediated trade finance transactions and client relationships. Among firm types, SMEs were the most negatively impacted.

The key findings of the ICC Global Trade Finance Survey 2014 are summarized below (box 6).

Box 6. Key findings of the ICC Global Trade Finance Survey 2014

- While there are signs that trade finance is more available, the reported increase is marginal.
- The shortage of trade finance for international trade remains a major challenge for economic recovery and development.
- To finance exports and imports traders, especially SMEs in emerging markets, continue to rely on loans/overdrafts in local currency (rather than in foreign currency), restricting their ability to trade at optimum levels during these challenging times caused by volatile exchange fluctuations.
- Encouragingly, 68% of respondents reported that trade finance increased by value, but less than the year before.
- The alarming rise in fees for trade risk after the 2009 trade collapse has abated.
- An enigma surfaced: a large gap remains in the market for trade finance and risk coverage even while 80% reported trade finance pricing is lower or unchanged.
- A total of 69% of respondents noted a decline in reported court injunctions barring payment under trade finance instruments, indicating a return to normal trading conditions.
- Banks remain cautious in examining documents. Worryingly, only 7% reported a decrease in spurious discrepancies when documents are presented under a letter of credit.
- Know Your Customer Principles are seen as hampering the smooth flow of trade finance.
- 65% said implementation of Basel III regulations is to some extent or a large extent affecting the cost of funds and liquidity for trade finance.
- Documented losses are low on trade finance products.

Source: ICC Global Trade Finance Survey 2014 – incorporated in the Rethinking Trade & Finance 2014 Report, p. 31.

Results from the above surveys on trade finance gaps bring to focus a number of common factors responsible for narrowing the supply line across the board. SMEs, as a sector, were the worst hit sub-segment of the Asia-Pacific economy. Despite the increase in bank credit (by volume), the overall trade finance gaps persisted. Lowering the risk of financial crimes also had an impact: AML/KYC regulations restricted over-cautious banks from entertaining credit proposals, more so from the SME sector. The trade finance supply line continued to be sluggish or showing marginal increase mainly due to over-dependency on traditional financial channels despite their high costs, under-utilization of non-traditional financial products and high rates of rejections. In the process, the emerging markets starved of funds remained under-served.

3.2. ADB-trade finance gap, growth, and jobs survey

According to ADB, in 2013, the global trade finance gap was estimated at US$ 1.9 trillion. Of this gap, US$ 1.1 trillion was in developing Asia. Of the US$ 1.1 trillion gap for developing Asia, US$ 699 billion was attributed to India and China. Geographically, Asia recorded the highest share of proposed transactions at 57% of the global trade and also had the highest percentage (79%) of global rejections- with India and China jointly recording 35% of the rejected transactions (table 4)

Table 4. Distribution of proposed and rejected trade finance transactions in 2013 by region as percentage of global total

Region	Proposed transactions	Rejected transactions
Asia	57%	79%
Europe	22%	13%
CIS	8%	3%
Americas	8%	1%
Africa	5%	3%

Source: compiled by the author- data from ADB Trade Finance Gaps 2013
Note: CIS is Commonwealth of Independent States.

About 75% of the banks reported that they had increased the level of credit lines in 2013-firms and financial institutions reported a more positive situation about the availability of finance. As opposed to SMEs, it was generally large corporate companies that reported sufficient availability of trade finance.

Some of the major findings of the ADB Survey are:

(a) SME constraints:

- SMEs constraints were more pronounced. The trade finance gaps affected SMEs more negatively than other company respondents.
- Global rejection rates of trade finance applications were the highest for SMEs. 50% of SME proposals were rejected in 2013 as compared to only 7% for MNCs.
- SMEs familiarity with various types of non-traditional methods to raise trade finance was limited.

(b) **Commercial risk averse bank transactions had a negative impact:**

- The risk factor in banking transactions acted as a systemic credit constraint.
- 61% of responding banks reported that AML/KYC due diligence requirements were significant impediments to the provision of credit.
- Compliance of these rules was costly and laborious.
- AML/KYC led to a reduction of transactions by 68%. More than 33% of banks had terminated correspondent relationships because of AML/KYC.
- Globally, Asia and Africa were the most negatively impacted. More than 50% of banks reported AML/KYC as a significant constraint.
- AML/KYC rules also adversely affected insurance, factoring and forfeiting transactions.

(c) Costs constrained access to finance:

- Over 74% of the respondent banks mentioned factors related to the price of trade finance as a key bottleneck to access.
- The high borrowing costs worked out mainly due to high interest rates/premiums, insufficient collaterals offered by the SMEs and hence stringent credit terms imposed by financial institutions, etc.

Impediments to the provision of trade finance identified by the ADB Survey are presented in table 5.

Table 5. Impediments to the provision of trade finance

Impediments	Very significant (%)	Significant (%)	Total (%)
1. Issuing bank's low credit ratings	30	33	63
2. Low country credit ratings	33	29	62
3. AML/KYC requirements	43	18	61
4. Low company/obligator credit ratings	18	40	58
5. Previous dispute or unsatisfactory performance of Issuing banks	31	21	52
6. Insufficient collateral from company	23	28	51
7. Constraints on your bank's capital	11	32	43
8. Basel regulatory requirements	17	24	41
9. High transaction costs or low fee income	18	21	39
10. Lack of dollar liquidity	7	28	35

(*Source:* compiled by the author using data from the ADB Trade Finance Gap, Growth, and Jobs Survey, Figure 3, ADB Briefs No. 25, Dec. 2014)

According to the Survey, the following are the factors limiting companies' ability to obtain trade finance. High interest rates/premiums followed by insufficient collateral or guarantee, were

identified by the respondents as a very significant factor limiting companies' ability to obtain trade finance (table 6).

Table 6. Factors limiting companies' ability to obtain trade finance

Impediments	Very significant (%)	Significant (%)	Total (%)
1. Interest rates/premiums too high	38	20	58
2. Insufficient collateral or guarantee	34	16	50
3. Long processing time	25	25	50
4. Financial institution's requirements unacceptable	21	23	44
5. Documentation requirements are too burdensome	17	20	37
6. No previous transaction/lack of business relationship	19	16	35
7. My country has 'high risk' ratings	19	13	32
8. No law on receivables or invoice financing	18	10	28
9. Company records are incomplete/unacceptable	14	12	26
10. No law on asset based lending	14	10	24

Source: compiled by the author using data from the ADB Trade Finance Gap, Growth, and Jobs Survey, Figure 5, ADB Briefs No. 25, Dec. 2014.

(d) Nontraditional financial products were underutilized:

- Uptake of innovative products, such as supply chain finance, had been slow. One reason appeared to be information asymmetries.
- In the case of non-traditional products such as factoring, forfaiting, bank payment obligation, and supply chains finance, less than 40% of companies reported familiarity with these instruments. Even within traditional bank products, companies reported limited familiarity (40%) with relatively established products such as credit insurance.
- Case studies of factoring and forfaiting revealed that providers of these products also felt there was a supply shortfall at the same time the demand for these products increased.
- Respondents felt that greater use of new instruments may reduce the trade finance gap.

(e) Trade finance-contributor to production and employment growth:

- Responding firms indicated that additional trade finance would have a positive impact on production and employment levels. A 15% increase in access to trade finance was estimated by them to increase production by 22% .
- Responses also suggest that greater access to trade finance would have a positive impact on employment levels. Respondents noted that a 15% increase in trade finance may enable the firms to hire 17% more staff.

The ADB survey concluded by observing that significant trade finance gaps remained, and that SMEs continued to be credit constrained in every region. Narrowing of trade finance gaps would lead to more economic growth and job creation. Unintended consequences of (overlapping) regulatory requirements, particularly with respect to financial crimes compliance, were contributing to the gap. More outreach to companies about “nontraditional” forms of trade finance can contribute to closing trade finance gaps.

4. EMERGING ISSUES AND CHALLENGES

4.1. Introduction

While the surveys cited above clearly identify the short supply of finance as the most critical major factor causing trade finance gaps, a close look at the factors other than finance prompt us to believe that non-financial factors (such as high rate of credit rejections, high collateral/guarantee requirements, non-availability of timely credit, lack of adequate awareness about international trade and insufficient skills to make cross-border trade transactions, risk-averse banking sector insensitive to SME lending, etc.) also indirectly impact the flow of trade finance and the efficacy of the institutional finance framework. This gives rise to a question as to whether the insufficient supply of institutional funds causing persistent gaps is the only major factor hindering trade development in the region or whether there is something else. While on the one hand paucity of trade finance has been by far the largest complaint of the private sector, on the other hand, the Asia Pacific region, despite the demand-supply gaps, has emerged as the largest user of trade finance in the global market. Europe, Latin America, Middle East, North America and Africa have followed the trail. This trend gives rise to certain policy implications and a clear signal to stakeholders to identify factors other than the paucity of bank-intermediated funds as barriers to growth. An attempt has been made in this section to identify the emerging issues and challenges, which directly or indirectly affect credit flow, business growth and sustainability. Recently, many vexing issues have surfaced giving rise to policy implications as well as posing systemic and operational challenges. To give an example of the realities on the ground, a Bangladesh Case Study entitled “*Bangladesh’s ready-made garments landscape: The challenge of growth*” is presented in Annex 3.

Concerns have also been voiced about the inadequate infrastructure of trade finance that would geographically cover and adequately service far and wide emerging markets in the region; an inadequate financial corpus which leaves behind sizable gaps; a rigid banking system insensitive to the changing global market; unmet demands of ICT related transactions (such as e-marketing, and mobile banking), an absence of legal provisions and appeals in most of the Asia-Pacific countries and above all such electronic transactions not being recognized by the courts of law. The lack of innovative financial products and trade finance instruments is yet another area of major concern.[9]

[9] See for instance: International Trade Centre (ITC), 2009 “How to Access Trade Finance: A guide for exporting

The Asia-Pacific region has been in the lead globally as the largest user of bank-intermediated trade finance, yet it has lagged behind Europe in making effective use of inter-firm non-banking trade transactions through supply chains, factoring, and forfaiting. These innovative non-banking channels offer scope to supplement the dwindling supply of trade credit available from the formal banking sector. Asia and Pacific economies, like many other parts of the world, are saddled with various operational issues and constraints within the region.

4.2. Identifying the major factors and challenges

Some of the major factors and challenges affecting credit flow and, more generally, the systemic and operational efficiency of the trade finance infrastructure in the Asia-Pacific region are discussed below:

1. Trade finance demand and supply gaps

A persistent trade finance gap has been the most critical constraint and an issue of growing policy concern in the Asia Pacific region. This phenomenon, as noted earlier, has become a continuing feature of the Asia-Pacific financial sector and is still persisting. Trade finance gaps, which have widened with the global financial crisis, continue to negatively impact additional employment creation avenues and business sustainability and growth. According to ADB (2014) estimates, the unmet demand of trade finance in Asian developing economies could be as high as US $ 1.1 trillion (global gap estimated at US$1.9 trillion), of which about US$700 billion relates to India and China alone and US$ 400 billion to other developing and the poorest economies, namely Bangladesh, Cambodia, Indonesia, Malaysia, Myanmar, Nepal, Pakistan, Sri Lanka and Viet Nam. Due to the lack of adequate supply and timely trade credit, the SME sector in the region has been more negatively affected.

2. SMEs are the most credit constrained sector

Despite being the largest employer with high potential of exports and significant contributor to the national economies, the SME sector is the most trade credit constrained segment in Asia-Pacific economies. According to ADB Survey-2014, as compared to about 7% for large companies, more than half of the SMEs credit proposals are estimated to have been rejected. 68% of the small companies surveyed did not approach any alternative source for meeting their rejected and unmet credit demands. Some of the identified reasons for the high rate of rejections of SME proposals are: (a) entrepreneurs' lack of adequate knowledge of available banking products/services and inadequate skills to develop viable business plans, (b) inadequate awareness of alternative sources and innovative non-banking channels (such as supply chains, factoring, forfaiting, etc.) operating in the global markets, (c) change-averse mind-set, (d) inability to offer high collateral and guarantee requirements, (d) high cost of borrowings, and, above all (e) banks' own conditions to be in full compliance of statutory and AML/KYC issues. In addition, banks generally consider SMEs as highly vulnerable to market shocks and therefore largely not viable customers for bank credit.

3. Shortages of trade finance affect trade

Whether shortages of trade finance actually affect trade has been an issue of recent debates in academia particularly after the financial crisis (Chor and Manova 2012; Berms R. et.al.2010;

SMEs;" Geneva: ITC, 2009, p. 36, Box 3.4; "Pitfalls in trade transactions-A case study".

Amiti and Weinstein 2011; Bricongne et al. 2012; Auboin and Meier-Ewert 2003 and Aubion and Engemann 2013). While most scholars agree that a fall in the demand for trade finance has been largely responsible for the slowdown and drop in trade flows, the debate has focused on the extent to which other potential culprits, such as trade restrictions, a lack of trade finance, vertical specialization, and the composition of trade, may have played a role. Market surveys conducted by ICC (2009) and IMF-BAFT (2009) point to the sharp fall of trade finance during the financial crisis as the main reason for the drop in trade flows. Given the rapid decline in trade and emerging challenges, a number of protectionist trade policy measures were taken during 2008/09 by the policymakers and central banks around the globe. The major policy responses can be viewed in CGFS 2014, (Papers No.50, Box 3, p.22, January). Although the exact amount of "missing" trade finance may remain unknown, the literature cited in this context has highlighted the wider link that exists between financial conditions, trade credit and trade (WTO, 2015).Taken together, it transpires that credit shocks, including working capital and trade finance, possibly account for 15-20% of the decline in trade during the crisis.

The recent financial crisis revealed that trade finance markets are vulnerable to abrupt dislocations (WTO, 2015, para, 2.2). The emerging markets and LDCs are more prone to such shocks, making policy interventions and support essential to sustain the availability and flow of trade finance. Even with its large presence and pivotal role in making sizable contribution to Asia-Pacific economies, the SME sector remains highly vulnerable to market dislocations and exposed to volatility, especially in LDCs.

4. Inadequate trade finance infrastructure and network

The inadequate infrastructure and weak networks of financial institutions and poor geographical coverage of banking facilities in many parts of Asia and the Pacific inhibit the timely availability of trade finance to the private sector, including SMEs. Unable to provide timely assistance, which is of essence to sustain exporting customers and their trade commitments, the smaller banks are not in a position to serve their clients efficiently without loss of time. Very often these result into cancellations of trade orders received at short notice.

5. Absence of risk-mitigation mechanism

Branch-line managers lend to SMEs only when such loans are backed by high collateral and third party guarantees in addition to legal charges levied on assets created by borrowers. The stipulation imposed by the banks asking for high collateral and third party guarantees has been one of the major barriers for companies in accessing trade finance. While in various Asian countries credit guarantee schemes for banks are in operation, in reality they do not solve the problem of SMEs because bank loans under those schemes still require collateral/third party guarantees.

Some innovative risk-mitigation schemes have been recently introduced. Multilateral institutions have helped to facilitate the flow of trade credit even in the most challenging countries globally. IFC is quite active in this area. ADB's risk-mitigation support mainly caters to the needs of the poorest countries in Asia, inter alia, Bangladesh, Nepal, Pakistan, Sri Lanka, Uzbekistan and Viet Nam. As noted before, SIDBI, in collaboration with the Government of India, has implemented an innovative MSME Credit Guarantee Scheme to guarantee all such bank loans which are collateral free and third party guarantee free. This collateral-free/ guarantee-free bank loan guarantee scheme for SMEs has been successfully working for the past 15 years to the great relief of small borrowers. It also provides sufficient guarantee to the lending banks insulating them from the possible risk of loan defaults.

6. Problems of LDCs to access affordable trade finance

LDCs in particular face the problem of accessing affordable trade finance. This has gradually resulted in a ‘trade finance divide’ between the LDCs and other developing economies of the Asia-Pacific region. The banking sector is generally wary of entertaining credit proposals in such countries and it tries to insulate itself against risks of loan defaults by charging higher interest rates backed by high collateral requirements and guarantee conditions. Small borrowers find it rather difficult to afford and service the institutional credits with such unaffordable stipulations. Such high fees were also found to be out of line with risk statistics revealed by the ICC’s Trade Finance Loss Register. Given the importance of affordable trade finance in LDCs, the WTO supports easy access to affordable trade finance in such economies under its trade finance facilitation measures with priority accorded to such areas in Asia (and Africa), where similar measures are lacking (WTO, 2015, para 1.7 and 1.8).

7. De-risking bank transactions are a constraint

De-risking requirements in bank transactions and inter-bank relationships have become a major systemic credit constraint. Regulatory requirements to mitigate the risk of financial crimes are compelling reasons for banks to sever bank-to-bank relationships, particularly in emerging markets. In particular, the AML/KYC due diligence requirements have become significant time-consuming impediments to effective trade finance access and led to high compliance costs. These reporting requirements have led to a reduction in trade transactions by 68%. In Asia-Pacific, more than 50% of banks reported this requirement as a significant constraint. Providers of insurance, factoring and forfaiting indicated that AML/KYC requirements hinder their provision of trade finance. Market contacts suggest that an uneven playing field in terms of regulatory implementation across jurisdictions may lead to the withdrawal of trade finance providers from some countries or markets (CGFS 2014).

Basel III remains an important subject for banks and the key issue now appears to be how the requirements will be met in a consistent manner by regulators and banks across the globe (ICC 2014).

8. Advantages of low-risk L/Cs have yet to make inroads in emerging markets

Given the fact that L/Cs are a low-risk, safe and a more reliable mode of trade finance transactions, many LDCs especially those in the Pacific, have yet to be fully aware of the potential and the advantages of L/Cs. Unfamiliarity with this instrument and high transactional cost are perceived as the main obstacles. In contrast, Bangladesh emerged as the top importing/exporting country that imported/exported the most using the L/Cs.

9. Awareness and uptake of both existing and new financing structures and products has been limited

Global banks see supply chains finance as an important new area of activity, and a focal point of current competition. Citing new regulatory demands and high marginal costs of equity capital, the trade finance industry is experimenting with new structures and products to distribute the exposure of trade finance to non-bank investors. To date, the scale of this activity has been limited, with take-off apparently not imminent (CGFS-2014).

The reach and uptake of non-financial products (such as supply chain related finance, factoring etc.) has been slow. Information asymmetries appear as a main reason, since less than 40% of responding companies reported familiarity with these non-traditional products in the earlier cited

ADB survey. Even familiarity with established products such as credit insurance was limited. (ADB 2013)

10. Banking sector does not catch Early Warning Signals

The 2008-2009 crisis and consequent strains in 2011-2012 did adversely impact the trade finance sector. Bank finance exposure in almost all countries fell sharply soon after the Lehman Brothers bankruptcy. Trade finance disruptions had a secondary but economically significant role in the sharp reduction in global trade volumes. Given their short-term nature, banks have been able to quickly reduce their exposure in times of stress. However, because of this latter feature, trade finance has acted as a conduit of stress from the financial system to the real economy (CGFS 2014).

11. Emerging markets in Asia-Pacific tend to be less globally integrated

Asia-Pacific countries are very well integrated into the global trading system, but financial integration has lagged behind. Emerging markets in Asia–Pacific tend to be less globally integrated than the markets of other countries. As always, there are exceptions. Malaysia, with a large and active institutional investor base, is as globally integrated as any emerging market. In contrast, India and Indonesia are at the other extreme and have smaller international investment positions than emerging markets in other regions.[10]

5. POLICY IMPLICATIONS AND RECOMMENDATIONS

5.1. Implications

The issues and challenges identified above give rise to various policy implications. The matrix below presents an overview of these implications in a tabular form (table 7).

Adopted policies must be obviously securely aligned with expanding demand for trade finance. They should be market-oriented and designed to adapt to future change. In particular, they should aim at (a) strengthening inbuilt stability of the trade finance sector, (b) increasing its competitive resilience, (c) adequately insulating the sector from possible market shocks, (d) limiting the negative spill-over effects likely to impact the national economy, and in particular, (e) addressing the following issues:

(a) How to make trade finance innovative, resilient, stable and relevant to changes occurring in the trading environment;

(b) How to insulate trade finance (such as pre- shipment and post-shipment) from market shocks and related credit risks;

(c) How to structure central banking credit policies to ensure adequate resource support to the banking sector and set up risk mitigation mechanisms which would encourage banks to lend without inhibition; and,

[10] IMF 2014: "*The Future of Asian Finance*"; Finance & Development, June 2014, Vol. 51, No 2.

(d) How to effectively monitor market developments and disseminate market intelligence to policymakers to help them make informed policy decisions; and

(e) How to set up early warning signals to alert the financial sector of risks and shocks well on time.

Table 7. Matrix of trade finance conceptual, systemic & structural issues and policy implications

Conceptual, systemic & structural issues	Policy implications
Conceptual changes needed to address the supply side: Some of the traditional trade finance concepts have become outdated and are no longer relevant to the changed context of global trade transactions. As a result, the supply side of trade finance falls short of demand and trade finance gaps are increasing	New concepts and instruments such as innovative non-finance and non-bank-intermediated instruments (often supply chains related) have to be promoted and regulated to satisfy unmet demand for trade finance and close the trade finance gap
SME demand side of trade finance is not well served	In particular, additional attention should be given to the trade financing needs of SMEs through the implementation of viable government-sponsored financing and credit guarantee programmes aimed at risk and cost reduction of credit.
Systemic and structural changes are highly required	The administrative, legal and banking systems need to be given a holistic reassessment which leads to an identification of structural factors and constraints that need to be addressed to allow steady credit availability for business and to mitigate risk.
Lack of skills and capacity: Borrowers of trade finance are not aware of the products available; they lack skills, while lenders with low credit ratings are insensitive to the demands especially coming from SME sector	Policies need to be adopted to improve the low credit rating of many banks. DFIs and banks could play a role while regulations in some area may need strengthening.

5.2. The need for change of future trade finance

From the previous sections, an important conclusion emerges: for trade finance systems in Asia-Pacific to be relevant in the future, they need to be globally competitive, innovative, cost-effective and sustainable to effectively address needs-based ‘changes’. The banking system should collaborate with non-banking channels to supplement the supply side of trade finance. This may partially reduce the pressure on banks. The systemic and operational changes will need to be made on on-going basis adopting a holistic approach to both financial and non-financial factors of change

The Society for World Interbank Fund Transfer *(SWIFT)* and the Fung Global Institute have jointly looked at trade flows in Asia and observed; "By 2020, the Asian region is expected to account for almost 35% of world GDP, compared to 27% today. Finance is still stuck in the Letters of Credit and Multilateral support world, but […] times will change quite rapidly." This raises a very basic question: whether trade finance and trade finance products in their present form will be able to keep pace with the expanding demand and changes in the future? The Asia-Pacific trade finance sector is large, diverse and differs in many ways from similar sectors in other parts of the world, especially in LDCs, but is not yet as sophisticated as those in Europe or America. Most Asia-Pacific banks also tend to be more focused on providing traditional bank-intermediated trade finance and are averse to taking commercial risks.

"*As Asia leads the world in growth, will its financial systems lead too*", observed James P. Walsh, Deputy Division Chief of IMF's Monetary and Capital Markets Department. He further stated; "Across Asia, the rapid growth of financial sectors is an important part of the growth miracle that has made Asia the world's most dynamic region. Analysts look closely at the financial risks that Asia faces today, but sometimes it's interesting to look farther forward. So with this dynamism expected to continue, what will Asian financial sectors look like in the future?"[11]

The role of international institutions is important to make trade finance responsive to change and resilient. In this regard, a joint Group of ESCAP, ADB and WTO may be established for this purpose. The Group may initially concentrate on the following:

(a) Play a diagnostic and advisory role to alert, aid and advise the Asia-Pacific public and private sector trade finance community on trends, development, pending changes and shocks;

(b) Provide international support to Asia-Pacific economies to help them augment trade finance resources;

(c) Strengthen the capacity of both banking and non-banking actors to provide trade finance by improving their stress management capacity, resilience, openness and adaptability to change;

(d) Work out synergies for providing technical assistance to developing countries in this area; and

(e) Monitor trade finance markets to disseminate timely market intelligence and early warning signals.

5.3. Policy recommendations

A review of trade finance policies and programmes to identify conflicting issues, emerging challenges and resultant policy implications, is essential. For that purpose, this paper presents a set of policy recommendations adopting a holistic approach. The challenges confronting trade finance have been addressed both from the lenders' and borrowers' angle, and after taking due cognizance of the realities on the ground. The matrix of suggested policy recommendations is presented in table 9.

[11] James Walsh, "The Future of Asia's Finance", Finance & Development, June 2014, Vol. 51, No. 2.

Table 9. Suggested Policy Recommendations

Conceptual	❖ Redefine the traditional concept of working capital by splitting it into two: (a) conventional working capital (for day-to-day operations up to pre –shipment stage), and (b) trade finance and market development working capital such as short-term credit, export credit, insurance, risk mitigation charges, exchange fluctuations, etc. and all post-shipment trade related transactions. For the latter, trade related market development services need to be developed, such as trade fairs, fashion shows, market forecasts, product and design development, capacity building for development of bankable business plans, which will ultimately reduce the rates of rejections, and increase the supply of bank intermediated funds; product development in the global market and identification of potential markets to attract potential business etc. ❖ Setup and enlarge the scope and coverage of a National Exchange Fluctuation Fund to cover all exim transactions. This may be set up as national fund to cover the negative impact of exchange fluctuations. ADB could join hands with central banks to design and operate the fund. Risk coverage should be available up to 100% for SMEs and 90% for other companies. SMEs would pay premiums at subsidized rates. This will halt the default rate. Modalities can be worked out once this is accepted as a concept. ❖ Supply chains and factoring transactions of the private sector should be defined as negotiable financial instruments. This will promote markets for securitization of such instruments and augment supply of the trade finance.
Government & public sector	❖ Design trade–friendly exim policies aimed at the development of both domestic value-added trade activities and exports/imports. ❖ National governments and central banks should promote effective policies to make the trade finance sector stable, forward looking and vibrant and to cushion the after-effects of any financial crisis. Country ratings for this purpose could be developed. ❖ Develop suitable legal frameworks and appeal system for the redressal of grievances arising out of international transactions. ❖ Strengthen collaboration with international agencies (like ITC, CBI-Netherlands for on-going market tie ups, market intelligence generation and technical assistance. ❖ Implement sufficient trade facilitation measures to contain trade transaction and transportation costs. ❖ Strengthen trade facilitation and trade finance mechanisms in multilateral, regional and bilateral trade agreements.

	❖ Trade missions attached to the embassies should support the private sector as nodal points for trade related matters, such as help in establishing supply chains contacts, making forecasts, etc. ❖ Introduce risk-free e-marketing and on-line procurement mechanisms backed by suitable legal and regulatory framework .
Central banks & financial sector	While most of the Asia-Pacific central banks have been proactive and quite vigilant to make need-based changes in trade finance policies governing banks, some of them have to enhance the stability and resilience of their banking sector. ❖ In view of the persisting trade finance gaps, besides releasing liquidity supply to the banks, trade finance supply through non-traditional/non-financial channels with adequate safety net and risk minimization mechanisms needs to be expanded. ❖ Encourage companies to enter open market borrowings. SME sector will need special dispensation. ❖ Encourage and institutionalize inter-firm credit systems, mainstreaming them in cooperation with banks and with adequate risk mitigation support.[12] ❖ To instill confidence and encourage banks to lend without any inhibition, introduce suitable risk mitigation, export credit insurance and workable guarantee mechanisms. Set up a collateral free cum third party guarantee free fund to guarantee collateral free bank loans. ❖ Central banks should simplify the de-risking element in bank transactions and AML/KYC due diligence requirements as these requirements have been identified as a major source of systemic credit constraint.
International and multilateral Institutions	❖ Asia-Pacific countries are very well integrated into the global trading system, but financial integration has lagged. Emerging markets in Asia-Pacific tend to be less globally integrated. ADB and the World Bank should lend support to national governments and central banks to accelerate the financial integration of the emerging economies. ❖ ADB should take the lead in collaborating with other international institutions, such as the IFC, to set up an Asia-Pacific Trade

[12] The CGFS in its Report on Trade finance development and issues 2014 -p55 has cited the findings of various surveys conducted by the World Bank and others, "firms that were more reliant on trade credit to fund their own operations (and hence less reliant on bank funding for working capital) were less affected" during the financial crisis. 14 developing countries show that trade credit was relatively more resilient than bank credit during the 2008-2009 crisis.

	Development Fund for funding innovative and non-financial products, inter-firm trade credits and trade development services, hitherto not funded by the banking sector. Assistance can be given to companies through their local banks backed by a suitable collateral–free guarantee mechanism. The participating banks/companies shall have to participate in the share capital to become members eligible to get suitable line of credit from the Fund. Detailed operational modalities can be developed at a later stage. ❖ A joint Group of ESCAP, ADB and WTO may be set up to monitor trade and trade finance trends and developments, and alert, aid and advise Asia Pacific trading communities and governments to enhance the resilience of the banking and financial sector in the Asia and the Pacific region.
Private sector	❖ ICC should be made the nodal agency for compiling global and regional trade finance data/information for use by various stakeholders. This will enhance the capacity of ICC to add value to its leading publication, the ICC Trade Register. To enlarge the reach and supplement the coverage of its on-going annual series of surveys and publications of the Trade Register, all concerned should agree to supply relevant information to ICC for this purpose. ❖ ICC, in collaboration with ESCAP, ITC and national chapters/apex chambers and export agencies could organize capacity building programmes in international trade/exports/trade facilitation/WTO regime, etc.

ANNEX 1. DEFINITIONS OF THE TRADE FINANCE INSTRUMENTS IN VOGUE IN ASIA-PACIFIC

Following are the concepts, definitions and role of major trade finance instruments, commonly used:

a. *Debt financing*-as a method of trade finance is typically used to obtain Working Capital for transacting export business. It is known as Pre-export Finance as well.

b. *Asset-based financing*-is a term loan that is often secured through the Inventories of goods to be exported.

c. *Export factoring*-is a complete financial package that combines working capital financing, credit protection, foreign accounts receivables, bookkeeping and collection services.

d. *Leasing*- is medium to long term financing of payments that need to be made for the use of assets (such as equipment, property, machinery, etc.) for export operations.

e. *Cash*-in advance- is the full payment of products is made up-front, which eliminates the risk for the exporters.

f. *Letter of credit (L/C)*-is an important financial instrument for securing the interests of both parties that is used by the importer's bank for the exporter's bank. The importer's bank commits to pay as soon as the agreed terms and conditions have been met by the exporter. This method of payment involves third parties, generally commercial banks, as mediators and this reduces the risks for both the exporter and the importer.

g. *Documentary collections*- although similar to L/Cs, documentary collections are, however, specifically shipping and collection documents that are sent from the exporter's bank to the importer's bank in exchange of payments. These documents could be exchanged for payments at sight, against payment, or payment at a specified date.

h. *Open accounts*- these are the methods of payment for importers, as they usually grant importers a payment period of 30 days to 90 days, after the shipment of goods.

i. *Export credit guarantee*-is a protection mechanism for banks that are financing exports, which is generally provided by public agencies

j. *Export credit insurance*-private insurance companies and /or governmental export credit agencies offer this coverage to business entities to insure their export accounts receivable from loss due to the non-payment of valid debt by their debtors.

k. *Forfaiting*- is a method of trade financing that enables exporters who sell capital goods, commodities or large projects to obtain cash, at a discount, against their longer-term foreign account receivables on a non-recourse basis.

l. *Hedging*- is a technique to reduce the risk of fluctuations in exchange rates and to protect expected profitability in the domestic currency.

Supply chains financing- a relatively new method of trade financing, has come into play. A global supply chain refers to the full range of cross-border, value added business activities that are required to bring a product or services from the conception, design, sourcing of raw materials and intermediate inputs stage to production, marketing, distribution and supplying the final consumer. The global supply chain may be: (i) producer-driven chains or networks, where the lead firm (such as automobile) plays a central role, and (ii) Buyer-driven chains or networks, where large retailers, marketers and brand manufacturers (such as Levi's) source from the decentralized network of suppliers. It is expanding business for banks that entails combination of technology and services to facilitate processing and financing of payables and receivables within a global supply chain. The financial services offered by banks as global supply chain finance involve traditional financial instruments, such as pre-shipment, post-shipment finance, and receivables purchase/discounted.

Inter-firm trade credit-can be either on an open account basis or on a cash-in-advance basis. In open account transactions, the exporter extends credit to the importer by shipping and delivering goods before payments are due (which is usually within 30-90 days). In this method, the risk is higher for the exporter. In a cash-in-advance transaction, the importer pays the exporter upfront, and the associated cash flow and settlement risks are reversed. This option is less frequently used, mostly by global multinational companies, where trade between two affiliated companies takes place.

Factoring-is asset-based financing method for increasing working capital and refers to the sale of accounts receivables by a company to a third party (called a factor) for immediate money and finance. Factoring increases short term cash flows, and is different from bank loans in three ways: (i) in factoring, emphasis is on the value of the receivables instead of the firm's creditworthiness (ii) factoring means purchase of financial assets rather than a loan; and (iii) factoring involves three parties (i.e. a firm, a buyer/customer and a factor) while a bank loan involves only two (i.e. a firm and the bank).

Source: Compiled by the author from various sources, including Appendix 2, Background on trade finance and trade credit, CGFS 2014).

ANNEX 2. TEN OF THE BEST SUPPLY CHAINS IN ASIA-PACIFIC

1. Samsung Electronics	South Korean manufacturer Samsung saw a strong financial return through its Galaxy line of mobile devices to become the world's largest provider of smart phones. The company continues to execute initiatives in planning, delivery, product life cycle management (PLM), corporate social responsibility (CSR) and talent.
2. Lenovo Group	Lenovo's growth strategy of looking beyond laptops and desktop systems continues to pay dividends. On the supply chain side, Lenovo has scaled up a corporate analytics centre of excellence (COE), supporting its supply chain, sales and marketing, and business units.
3. Toyota	Toyota is working to improve inter-function communication, introducing new and better systems to collect and analyse supply chain data, and building flexibility in its production methods. They are also putting greater emphasis on customer care, fathering information on vehicle reliability and performance from customers, suppliers and dealers to deliver sustainable solutions.
5. Huawei	Their supply chain strategy revolves around strong customer collaboration, alignment with corporate objectives and the decentralization of customer-facing operations. A supply chain COE drives critical process design and adoption, resulting in fewer supply chain personnel supporting aggressive revenue growth. Huawei has invested significantly in supply chain management technology.
6. Woolworths	Woolworths has embarked on its supply chain transformation journey. Efficiencies gained from historical initiatives like 'Mercury One' – that touched almost every aspect of the supply chain including procurement, distribution, order consolidation, inventory management, merchandising, and in-store stock availability – have helped integrate and mature Woolworth's supply chain capabilities. With an eye towards the future of online retailing, 'Mercury Two' looks to couple an already capable network with advanced analytics and deeper direct selling expertise to drive the future of retail.
7. Honda	Its cloud-based in-vehicle connectivity platform (Honda Link) connects drivers to news, information and media feeds from around the world using intuitive, audio-system-based interface. On the supply chain side, Honda is building a more diverse tier 2 and tier 3 supply base to minimize the risk of disruption.
8. Flextronics	Flextronics focused aggressively on customer-centricity, talent development and disciplined execution, balancing supply chain velocity and risks. The company minimizes risk while maximizing opportunity through product, customer and geographic diversification.
9. LG Electronics	Korea-based electronics giant LG's focus on the end-to-end value chain has seen a drive toward closer integration as they continue to collaborate with suppliers. Their investments in advanced planning and forecasting capability drives tangible benefits across the value network. With a

	strong customer focus, LG continuously tracks trends on future lifestyles and user experience to design and introduce innovative products.
10. Sony	Sony is working aggressively to introduce a new, cloud-based television service. Sony's rise this year shows a focus on network optimization and end-to-end visibility, not to mention an exit plan from PC into mobile, game and imaging. Challenged with a need for faster product innovation, supply chain risk continues to influence Sony's strategy

Source: Compiled by the author from The Report '*2014 Gartner Supply Chain Top 25: Asia/Pacific'*, available on Gartner's web site at: http://www.gartner.com/document/2822721**.**

ANNEX 3. BANGLADESH CASE STUDY

Bangladesh's ready-made garments landscape: The challenge of growth

The following contents have been extracted from the 2011 McKinsey Report. The issues and challenges identified by the Report have direct bearing on trade finance policies, systems and operational modalities requiring on-going need-based readjustments and suitable change.

The sourcing of ready-made garments (RMG) is experiencing a new phase of transition, which is creating the need for companies to react accordingly in order to secure their cost position in the apparel market. Goldman Sachs included Bangladesh in the "Next 11" emerging countries to watch following BRIC (Brazil, Russia, India and China) and JP Morgan lists Bangladesh among its "Frontier Five" emerging economies in which it is worth investing.

Bangladesh offers two main "hard" advantages- price and capacity. Competitive price level is clearly the prime advantage. Within the next three years, a labour cost increase of about 30 percent is, however, expected. Capacity as the second-biggest advantage of Bangladesh. With current 5,000 RMG factories employing about 3.6 million workers from a total workforce of 74 million, Bangladesh is clearly ahead of Southeast Asia RMG suppliers (such as Indonesia, Vietnam and Cambodia. High risk or structural workforce factors prevent India and Pakistan to utilize their capacity).

While Bangladesh represents some very promising advantages in certain dimensions, a number of challenges could create hurdles for companies seeking to source there. Only if these challenges can be overcome, will Bangladesh's RMG industry continue to prosper. Chief Purchasing Officers' (CPOs) have following 5 major issues on their minds when it comes to sourcing from Bangladesh: (i) Infrastructure; (ii) Compliance; (iii) Supplier performance and workforce supply; (iv) Raw material; and (v) Economy and Political stability.

For all business stakeholders, infrastructure (transport and utilities) is the single largest issue hampering Bangladesh's RMG industry. Discussions with Government representatives validated a number of projects addressing the different transport routes (for example expansion of Dhaka-Chittagong highway to four lanes). As a developing country, Bangladesh is under close scrutiny by NGOs and CSR stakeholders regarding compliance. Solving these issues and achieving ethical labour standards and sourcing policies are key prerequisites in Bangladesh apparel industry from a McKinsey

perspective. McKinsey sees careful supplier selection, value chain transparency, a tireless effort, and close relationships with suppliers remaining crucial when sourcing in Bangladesh. To realise the growth potential, garment manufacturers will need to make performance improvements and ensure the supply of skilled workers. Bangladesh's dependency on imports creates sourcing risks and longer lead times. In the opinion of European and US CPOs, economy and political stability are the fifth area of risk when sourcing in Bangladesh. Approximately 5% of suppliers mentioned high interest rates as a hurdle. New industry and services are starting to gain importance for the economy. Bangladesh RMG growth can be realised if the challenges in the five areas are tackled. It will be paramount that stakeholders work jointly to achieve this goal.

Source: Extracted by author from 2011_McKinsey_Bangladesh.pdf: McKinsey & Company.

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