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GLOBAL TRADE AND FINANCE: SOME ISSUES

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ABSTRACT

International trade shifted in the forty years to 'new trade' theories to scale economies and product differentiation which have placed on the role of firm heterogeneity and renewed interest on the credit constraints to hamper its export activities. Emerging market economies of major producing and consuming countries strengthened by young workforces and rising middle-class population, play a greater role in the global trade of commodities. Barriers to external financing activity play a key role to the undertaking exporting activities of firms especially younger and small of them. As result, every need raised to reinforce of global finance crisis. The political and technological developments in the recent period have put up trading relationships between countries and companies around the globe in the spotlight again.

Trade is a basic economic concept, involving the buying and selling of goods and services with compensation paid by a buyer to a seller or exchange of goods or services between parties. Network allowing trade is a market. Barter, an early form of trade saw direct exchange of goods and services for other goods and services. The purpose of trade is to enable to specialise; the purpose of specialisation is to enable to produce more; the purpose of producing more is to enable to consumer more. Therefore, the benefits of trade deliver more competition, greater variety, lower price, better quality and innovation.

A Nation's prosperity squarely lies in fuelling economic growth, supporting good number of jobs at home, raising living standards and helping citizens provide for their families with affordable goods and services. Global trade gives consumers and countries an opportunity to be exposed to the goods and services not available in their own countries or which would be more expensive domestically. The importance of international trade was recognised early by political economics like Adam Smith and David Ricardo.

International trade is the exchange of capital, goods, and services across international borders or territories[1] because there is a need or want of goods or services[2]. Such trade, in most countries, represents a significant share of gross domestic product. International trade has existed throughout history; its economic, social and political importance has been on the rise in recent centuries. Carrying out trade at an international level is a complex process when compared to domestic trade. Trade influence on the factors like currency, government policies, economy, judicial system, laws and markets between two or more nations. To smoothen and justify the process of trade between the countries of different economic standing, some international economic organisations like the IMF and WTO were formed. Such organisations work towards facilitation and growth of global trade.

Trade Finance symbolises the financial instruments and products which the firms use for facilitating international trade and commerce. It makes possible and easier for importers and exporters to transact business through trade. Also, it allows access of importers and exporters too many financial solutions tailoring to their situation; when multiple products often become tandem to ensure transactions very smooth. Trade finance covers many financial products of firms in utilising to make their trade transactions feasible. This is why; trade finance could call an 'umbrella' of financial needs of the firms. Trade finance includes from (a) Banks, (b) Trade Finance Companies, (c) Importers and Exporters, (d) Insurers and (e) Exports Credit Agencies and Service Providers. The focus of this paper is to examine various issues of on finance prompting international trade.

SPUR FOR INTERNATIONAL TRDE

International trade is vital to ending global poverty. Countries open to international trade tend to grow faster, innovate, improve productivity and provide higher income and more opportunities to their people by offering affordable goods and services and reduces half proportion of people suffering from hunger and those living on less than one dollar a day, and developing a global partnership for development. Thanks to increases in modern technology, international trade is still thriving. However, the extensive amount of rising tariffs, counterfeiting and intellectual property theft, and government seizures of vessels are all creating problems for global trade right.

As a result of international trade, the market is more competitive pricing and brings a cheaper product home to the consumer. A product is sold by a party in one country to a party in another country is an export from the originating country and an import to the country receiving that product. Exports and imports are accounted for in a country's Balance of Payments in 'Current Account'. Almost every kind of product can like food, clothes, oil, jewellery, etc., is found in the international market. A country specialises in a specific commodity due to mobility, productivity and other endowments of economic resources. This stimulates a country to go for international trade. It increases revenues, decreases competition, long-product lifespan, easier cash-flow management, better risk management, benefit of currency exchange, access to export financing and disposal of surplus goods.

PROS AND COS OF INTERNATIONAL READE

A boon for human interaction brings a cross-cultural contact to a whole new level. People first settle down in larger towns [in Mesopotamia and Egypt] to get self-sufficiency as products absolutely everything that one wanted or needed to trade. In 2009, the great trade collapse experienced is one of the most striking phenomena observed in recent years. Moreover, several opinion surveys conducted by the IMF and WTO reveal that credit shortage is considered by bankers and exporters as the second cause of the great trade collapse, after the decline in demand.[3] As a result, slump in world trade appeared much stronger than the contraction in Gross Domestic Product. The magnitude of trade collapse affected the financial systems worldwide. The reasons are (a) large number of banks suffered liquidity and solvency problems and inducing failures or massive state bailouts, and (b) respect to the financial reforms and trade policies implemented in developed and developing, and emerging countries. Resultantly, the financial underpinnings of international trade and external finance a key determinant of international trade at macro-and-micro-level.

FINANCIAL SYSTEM

Mobilization of savings and allocation of funds to investors is a key function of financial system. The production sector may be (a) intermediate goods and (b) final goods, the latter needs working capital from outside financing entails. However, due to information asymmetries between firms and funders, external financing entails honest moral hazard trouble. A developed financial system ensures mitigation of search costs and allocation of larger share of funds to the productive activities. Thus, financial development is only beneficial to the final goods sector on which achieve quite more financial development. The well and weak developed financial systems allow a country to specialize in the risky goods and non-risky goods respectively. Adoption of a classical model of international trade is representative. As such, only a small proportion of firms particularly the most productive sector participate in international trade. The exporter due to financial friction may face explicit costs and on the other, exporting induce upfront costs on account of advertising, gathering information on foreign customers, administrative procedures, translation, organizing foreign distribution networks, etc. Therefore, the export firm may face variable transport costs that depend on shipping time and export volume. For this reason, a firm productivity plays a key role in its decision to export as productivity does affect competitiveness on foreign markets and determines the amount of profit earned covering upfront export costs.

FINANCIAL INSTRUMENTS

Trade finance may be used to protect against the international trade's unique inherent risks of currency fluctuations, political instability, issues of non-payment or the creditworthiness of the parties involved, etc. But for this feature, international trade finance is different from conventional finance which is used to manage solvency or liquidity. A few of the financial instruments used in international trade finance are given below.

- Credit lending line is issued by banks to help both importers and exporters
- Credit Letter reduces risk associated with global trade since the buyer's bank guarantees payment to the seller for the goods shipped. Also, the buyer protects since payment will not be made unless the Credit Letter is met by the seller. Both the parties have to honour the agreement for the transaction
- Firm uses factoring on percentage when it is paid its accounts receivables
- Working capital or export credit supplies to the exporters
- Insurance uses for shipping and delivery of goods and also protects the exporter from non-payment by the buyer
- Wide-spread use of trade finance facilitates the growth of international trade

TRADE AND FINANCIAL CRISIS

Chore and Manova (2012)[4] explore the adverse impact of external financial dependence on the export sector due to global credit tightening. Such dependency between the inter-banks, particularly on financing the needy sectors augmented during the financial crisis. Data set of developing and developed countries covering a total of 23 banking crises between 1980 and 2006, concluded that the banking crisis magnify the adverse effect of external financial dependence on sectors' export growth rate. Berman et al. (2012)[5] corroborate the adverse impact of financial crisis on the firms' export

performance by proposing an innovating measure of financial friction, time-to-ship not only increases the cost of working capital, but also the probability that an importer will default. Reliant

ISSUES ON TRADE FINANCE

Trade finance accounts 90 per cent of international trade which is substantially disclosed by literature. Trade finance is also called trade credit. This corresponds to credit that an entity grants another. Cash-in-advance (CIA) consists of a buyer (importer) paying a seller (exporter) in advance. Symmetrically, open account (OA) consists in an exporter allowing him to delay payment. Both, CIA and OA exist in the case of domestic activities. Nevertheless the users of CIA and OA face two main difficulties amplifying in case of international trade. They are (a) either importer or exporter requires working capital to cover the delay between the payment and the delivery of goods and (b) enforcement problems and default risk substantially in international trade, as a foreign partner is difficult to monitor. But for these reasons, OA is used when the financial cost is low in the exporter country or the enforcement framework is robust in the importer country while CIA is more attractive when the financial cost is low in the importer country or the enforcement framework is robust in the exporter country. For financially constrained exporting firm, OA acts as a positive signal of firm quality, facilitating the efforts it get bank credit.

Exporting firm resorts to intermediated trade finance involving a third party *i.e.*, a bank, an insurance company between the importer and the exporter. According to a survey conducted by the International Monetary Fund-Bankers Association on Finance and Trade/International Financial Services Authority, Letter of credit is the primary tool of intermediated trade finance represents 47 per cent compared to 26 per cent and 27 per cent for OA and CIA transactions respectively.

The terms of sales contract often require (a) importer to ask its “issuing bank” to issue a letter of credit guaranteeing payment for the imports upon certification that the exporter has met the terms of the contract. (b) Use letter of credit as collateral, the exporter will often obtain a working capital loan from its bank to cover the production costs of the goods and (c) Transfer of the goods to the carrier and title of the goods to importers’ issuing bank. Assuming all documents are in order, the issuing bank will issue a bankers’ acceptance to the exporter guaranteeing payment at a future time, often around 90 days after the goods arrive. Letter of credit thus solves the working capital issue. As the transaction is transferred to the exporter and importer banks, letter of credit alleviates the enforcement problem. Consequently, a letter of credit is preferred to CIA and OA when the financial cost of working capital is low and the enforcement frameworks in both the exporting and importing countries are weak.

Export credit guarantee is another type of international trade finance mechanism. Trade credit insurance can be used in the case of OA or letter of credit. In the case OA, the insurer compensates the exporter if the importer fails to pay while, in letter of credit, the insurer protects the importer and the exporter’s banks against any default. International trade increases insurance contract by reducing risk of trading partners. But, it has a multiplier effect by providing information to non-insured firm about a firm or a country and encouraging them to export to this destination.

At the micro-level, investigating the existence of a causal link running from international trade to finance consists of examining whether being involved in export activities mitigates firms financial constraint. Theoretical arguments suggest that “export participation allows firm to lessen the severity of their financial constraint” is observed by Greenway *et al.* 2007[6]. Exports may facilitate firms’ access to international financial markets and provide them with the opportunity to better diversify their risk and sources of financing.

DOES GLOBAL TRADE GOAD FINANCIAL DEVELOPMENT?

Once the financial system develops, free access to increases the international financial markets, raise competition level and enforce transparency and contract resultantly becomes more difficult for financial institutions to get profits from rents and informal connections with entrepreneurs. This is also the case for incumbent firms, as financial liberalization is likely to allow potential entrants which previously had no privileged relationship with incumbent financiers, to be financed by foreign financial institutions. The impact of international trade on finance explains thus: Trade flow is liberalized, a country export financially intensive goods increase in demand for financing because they have a comparative advantage and induces higher financial development.

Financial development alleviates the financial constraints of vulnerable firms by facilitating their access to finance, it promotes their exports. Therefore, financial reforms may be particularly favourable to international trade when trade costs are high. Symmetrically, trade openness policies may be more effective when the economy is poorly financially developed.

CONCLUSIONS

Shown exports performance strongly depends on the sectors' external finance. More of the firms are vulnerable in export less than others in comparison. In addition, insufficient financial development and financial crises have a greater adverse effect on exports when firms or sectors strongly rely on external finance. Notably, because they involve banks, letter of credit provide a powerful transmission channel for the effects of banking crisis which affect international trade to a greater extent than they do on domestic activities. Finance is also driven by trade patterns. Financial development is determined by trade patterns. On the other hand, trade openness reforms appear to be more effective in promoting GDP growth when financial systems are well developed. The relationship between finance and trade calls for further studies on the impact of institutional interactions on employment and interaction of trade reforms with bank and market-oriented financial reforms respectively. Such investigations could provide a fruitful framework to think about policies advocated by the global trade organizations notably in developing countries.

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