



# Contemporary Issues in African Trade and Trade Finance

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**Gloria Li**

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# How Currency Risk Management Can Boost Access to Trade Finance in Africa



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**Abstract:** Access to trade finance is one of the most significant binding constraints to the growth of African trade. Across Africa, this constraint has been exacerbated by a shortage of US dollar liquidity, since the dollar remains the preeminent currency used to settle trade transactions. This paper argues that if development finance institutions increase the supply of synthetic local currency trade finance instruments, this could shield companies from risks associated with currency depreciation and boost both access to trade finance and economic growth in Africa.

**Keywords:** Currency risk management, local currency markets, synthetic local currency loans

## 1. Introduction

Access to trade finance has been one of the most significant constraints to trade in Africa. According to the World Economic Forum's 2015 Executive Opinion Survey, a representative sample survey of business leaders, lack of trade finance is the leading concern for top manufacturing-value-added countries such as Nigeria, Morocco, Algeria and Côte d'Ivoire.<sup>1</sup> The difficulties of financing trade in Africa have been exacerbated

by African entities' excessive reliance on foreign currency, especially the US dollar, which is used in more than 45% of trade transactions. In addition to liquidity constraints, which often are accentuated by recurrent balance of payment crises, the excess reliance on dollars exposes countries to foreign exchange risks.

This paper seeks to understand the role of foreign exchange risk in

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**1.** With the exception of Uganda, South Africa and Egypt, lack of trade financing is a top issue for exporters of commodities, natural resources, and manufactured goods. Among the 10 leading intra-African exporter countries that responded to the Executive Opinion Survey, access to trade finance is the top concern for Senegal, Lesotho, and Malawi and the no. 2 concern for Kenya, Namibia and Zimbabwe. The World Economic Forum's Enabling Global Trade reports in 2014 and 2016 rank access to trade financing as the most problematic factor for exporting for most African countries, followed by identifying potential markets, meeting quality/quantity requirements of buyers, access to imported inputs at competitive prices and high costs of domestic or international transportation.

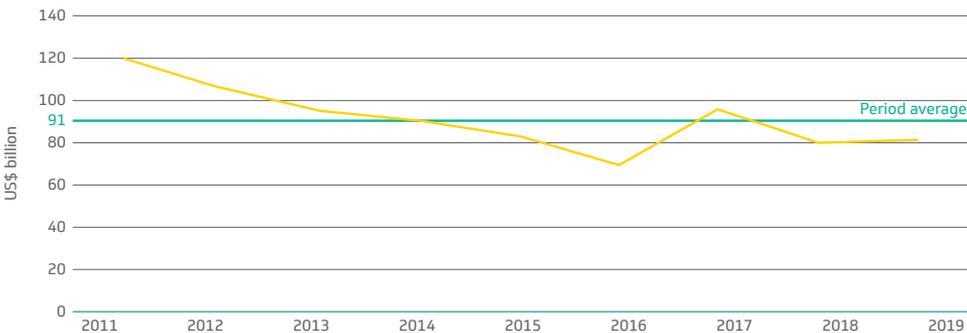
the availability of trade finance. It advocates that if development finance institutions (DFIs) increase the supply of synthetic local currency trade finance instruments, this could shield companies from risks associated with currency depreciation, and thus boost access to credit. The paper first discusses challenges to financing trade in Africa, such as liquidity constraints, currency risk, credit risks, and an overall perception of inflated risk. It next articulates a framework for addressing currency risks to boost trade finance in Africa and describes the benefits of synthetic local currency trade finance instruments. Lastly, it discusses the potential implications of these instruments, and their benefits for financing of trade across the region, for large and small companies alike.

## 2. Challenges to financing trade in Africa

As much as 80% of global trade is supported by some type of financing or credit insurance (World Trade Organization 2016). Banks and other financial institutions act as intermediaries between the buyer and seller, to manage various risks that arise from the gap between the payment for and the delivery of goods. Efficient and fair access to trade finance allows the seller to reduce payment risks and the buyer to reduce delivery risks during the shipment of goods.

Africa has a large trade finance gap that affects its companies' access to affordable trade finance and ability to integrate into global supply chains. In 2019, only one-third of the continent's total estimated US\$82

Figure 1: Trade finance gap by year



Source: Afrexim-AfDB, Trade Finance Survey 2020

billion in demand for trade finance was met (*Figure 1*). That year, across all regions of Africa, 71% of commercial banks participated in the trade finance market. African trade finance tends to be short-term, low-risk and high-collateral, with an average default rate that is much lower than banks' non-performing loans ratio. So, how can we explain the supply bottleneck for trade finance? Three explanatory factors must be explored – a shortage of foreign exchange liquidity, currency risk, credit risk – and an overall perception of inflated risk on the continent.

In terms of liquidity constraints, the share of US dollar trade invoicing across African countries far exceeds these countries' share of trade with the US for all emerging and developing countries. SWIFT data shows that exports are often invoiced in dollars, even when the destination is in Asia or other African countries. Therefore, any factor that disrupts hard currency liquidity can continue to “harm the prospects for the supply of trade finance in the very locations where the trade potential is greatest” (World Trade Organization 2016).

While hard currency liquidity is essential, domestic private companies in Africa lack access to foreign exchange liquidity and long-term deposits in their own currencies. Foreign exchange reserves should form an integral part of a country's self-insurance against currency depreciation, especially in low-income countries. However, according to the

Bank of International Settlements, the private sector in Africa holds few foreign assets or none that can be easily repatriated in hard times. The median share of foreign portfolio assets in gross domestic product is only 3% in Africa, compared with 11% for emerging markets outside Africa (Bank for International Settlements 2014). Even in non-pandemic times, 19% of African banks cite inadequate foreign exchange liquidity and 20% cite a lack of foreign correspondent banks as top constraints to increasing their supply of trade finance.

Macroeconomic instability, including political and sovereign risk, also tends to put downward pressure on local currencies against the value of hard currencies. With the current decline of foreign counterparties for almost every region in Africa, access to US dollars and dollar clearing is even more difficult.

In response to foreign exchange deficits, African government officials sometimes implement foreign exchange controls and rationing, deploying hard currency reserves for the trade of goods deemed essential to their economy, which pushes up the cost of other non-essential goods. When liquidity is low, both banks and governments favour larger clients or companies over small and medium enterprises and rationing further skews the provision of trade finance away from smaller companies.

The US dollar denomination of Africa's trade finance loans, in addition to

trade in foreign currencies, has also contributed to the continent's reliance on dollar credit conditions and its vulnerability to external shocks. Dollar credit conditions take on a central role in trade finance provision in Africa, because trade finance instruments such as letters of credit are typically invoiced in dollars. While companies operating in countries with developed financial markets can use those domestic banking systems to finance trade, African letters of credit issued by African commercial banks frequently require confirmation lines by global banks or institutions in destination countries. From 2011 through 2019, Commerzbank, Citibank, Standard Chartered Bank, Deutsche Bank, UBAF, Natixis, and Société Générale acted as confirming banks of one-third of all trade transactions originated by African issue banks (African Development Bank [AfDB] and African Export-Import Bank [Afreximbank] 2020). Most companies in Africa rely on these seven global banks for financing of trade.

Without adequate currency risk management, tight global credit

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Dollar credit conditions take on a central role in trade finance provision in Africa, because trade finance instruments such as letters of credit are typically invoiced in dollars.

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conditions combined with exchange rate fluctuations have significant adverse effects for the recipients of trade finance provided by global banks and their subsidiaries.

First, these conditions make existing loans more expensive due to local currency depreciation against the US dollar and rising floating interest rates. Convertibility and transfer risk kick in when the local currency can't be converted to another currency, due to changes in nominal value or capital and exchange rate controls. In addition to the primary credit risk caused by exposure to currency volatility, trading partners also face indirect credit risk from currency conversion when they agree on a future dollar transaction. While African exporters that obtain dollar loans and receive dollar revenue have a natural hedge on their balance sheets, importers that obtain dollar trade finance and local currency revenue retain a mismatch on their balance sheet. During global financial instability or exchange rate fluctuations, an importer could find it difficult to meet dollar-denominated payment obligations, due to a significant devaluation of the local currency against the dollar on liquidity constraints when access to dollars is rationed.

Second, adverse credit conditions combined with exchange rate fluctuations reduce the availability of new trade finance loans and increase financing costs. It has been shown that trade finance flow correlates negatively with the US dollar index

(Boissay et al. 2020). In times of stress associated with strong performance of the dollar, the ‘flight to safety’ effect leads banks and companies in importing countries to cut exposure and credit to particular countries that they perceive as riskier. Bruno and Shin (2015) found that a stronger dollar can reduce cross-border bank lending, such as trade finance, through its impact on the balance sheets of global banks. A stronger dollar also can tighten credit conditions; when currency mismatch is present on a borrower’s balance sheet, a stronger dollar inflates the value of dollar liabilities relative to other assets. From the bank creditor’s perspective, this increases credit risk on the borrower. Hence, exchange rate fluctuations against the dollar affect the lender’s risk-taking capability and the borrower’s access to credit.

Another important characteristic that feeds into the persistent trade financing gaps in Africa is inflated perception of risk as opposed to actual credit risk. Between 2013 and 2019, the average rejection rate of trade finance transactions globally was between zero and 10%, but in Africa was 15%. The most frequently reported reasons for rejections of African applications by public, foreign and local/private banks were client creditworthiness (36%), insufficient collateral (30%) and lack of foreign exchange liquidity (30%), if loan applications were made in US dollars (AfDB and Afreximbank 2020).

Selectivity in risk-taking and ‘flight to quality’ customers are also likely explanations for global banks’ decision to redirect offers of trade finance only to their largest customers in developed countries (Auboin and DiCaprio 2017). From 2015 to 2019, top correspondent banks servicing issuing banks in Africa (such as Commerzbank, Deutsche Bank and Standard Chartered Bank) reported lower shares of correspondent relationships than from 2011 to 2014. Central Africa and North Africa experienced the worst deterioration of confirming relationships with foreign banks. Global banks that provide liquidity and risk mitigation reduced correspondent banking networks for several reasons. First, prudential regulations for trade finance under the Basel III framework increased after the 2007–2008 global financial crisis, as trade finance flows were disrupted by contagion during the crisis. Second, non-prudential regulations (such as know-your-customer, anti-money laundering and sanction regulations) increased the cost of due diligence for small transactions. As a result, despite initiatives to avoid unintended consequences of prudential regulations, access to trade finance for developing countries became less affordable.

Even when liquidity is available, increased regulatory burdens and fixed costs per customer pushed banks to focus on bigger customers. On average, the 10 biggest trade

finance customers account for 58% of a bank’s total trade finance assets, while small and medium enterprises account for less than 30% (AfDB 2017). Even though these smaller businesses have seen improvements in the risk profile of their trade finance assets from 2011 to 2019, they still face higher rejection rates from banks (AfDB and Afreximbank 2020). Banks cite the inability by small and medium enterprises to provide appropriate documentation to meet regulatory standards (such as know-your-customer compliance and anti-money laundering requirements) as one reason for high rejection rates. Typically, small and medium enterprises are less profitable clients for banks and particularly

difficult to evaluate due to the lack of clear financial and know-your-customer records.

In addition, most companies with a rejected trade finance application do not seek alternative financing such as trade credit (AfDB 2017), due to lack of awareness. Even when companies do seek alternative trade financing, high spreads on trade credit – a reflection of the disconnect between perceived and actual commercial risk – acts as a deterrent. Accurate and comprehensive information about credit on African loans and bonds is difficult to access due to incomplete issuance knowledge. One report calculated that in 2014, local currency

**Table 1: Africa trade credit pricing (annual interest rate)**

Country	Price range, May 2011		Price range, April 2014	
	Low	High	Low	High
Angola	60%	65%	65%	70%
Cameroon	14%	20%	18%	24%
Congo	22%	26%	22%	27%
Democratic Republic of the Congo	16%	20%	22%	26%
Ghana	78%	82%	74%	78%
Kenya	39%	49%	39%	49%
Mozambique	20%	26%	20%	26%
Senegal	12%	16%	12%	16%
Sudan	15%	19%	9%	14%
Tanzania	10%	13%	25%	35%
Uganda	14%	16%	16%	18%
Zambia	13%	20%	13%	20%

Source: Omni Bridgeway. 2011, 2014. “Debt prices.” Omni Bridgeway News, May 2011, April 2014.

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## Developing national secondary currency markets will help de-risk foreign exchange transactions.

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interest rates on trade loans varied from 74% to 78% in Ghana and from 39% to 49% in Kenya (*Table 1*). In addition, common risk mitigation instruments, such as trade credit insurance or factoring, have only just started to be used widely.

### 3. Framework for addressing currency risks in trade finance

Addressing currency risk is crucial to both reducing the perception of risk and boosting access to trade finance for companies across Africa. There are several approaches to enhance the management of currency risk and the liquidity of trade finance.

First, deepening trade integration and financial integration will likely promote the use of local currencies and reduce the cost of borrowing. Second, developing national secondary currency markets will help de-risk foreign exchange transactions. Third, experimenting with innovative financial instruments – such as synthetic local currency trade finance instruments – can begin as trade integration deepens and local secondary markets develop.

Regional systems eliminate the use of an intermediary foreign correspondent bank so that payments are processed faster and with lower costs across borders. While the volume of transactions denominated in US dollars is still high, there is evidence that regional integration has led to a steady increase in local currency transactions and a decrease in hard currency transactions. SWIFT

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**Table 2: African foreign exchange market development, by country, 2017**

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State of market development	Low-income countries	Middle-income countries
No or negligible foreign exchange market	Angola, Benin, Burkina Faso, the Democratic Republic of the Congo, Ethiopia, Guinea, Madagascar, Malawi, Mali, Mauritania, Mozambique, Namibia, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Zambia	Algeria, Cameroon, Côte D'Ivoire, Gabon, Swaziland, Tunisia
Growing foreign exchange market	Uganda	Botswana, Egypt, Ghana, Kenya, Morocco, Nigeria
More developed foreign exchange market		South Africa

Source: Currency Exchange Fund (TCX).

Note: A lack of foreign exchange liquidity, a perception of high risk, a lack of appetite in African derivative markets and regulatory hurdles all contributed to the slow development of secondary markets. For example, the South African rand (ZAR) is the most liquid of all African currencies, but the US dollar/ZAR market turnover is only the equivalent of US\$5 billion to US\$7 billion daily. In comparison, the euro/dollar market turnover is more than US\$ 1 trillion daily.

data shows that African regions with strong integration saw increased use of local currencies and decreased use of hard currencies. The use of the West African franc by the eight countries in the West African Economic and Monetary Union has overtaken the South African rand and the British West African pound, accounting for 7.3% of payments in 2017, up from 4.4% in 2013. The 16-member Southern African Development Community (SADC) also saw increasing use of the rand and decreasing use of the dollar since the debut of the SADC Integrated Regional Electronic Settlement System. As of 2018, 60% of cross-border transactions in SADC were denominated in the dollar, while 35% were denominated in the rand.

This implies that boosting the use of local currencies will shield the African trade market from adverse global conditions associated with the performance of US dollars. However, further regional coordination is needed to build a continental payment system that encourages the use of local correspondent banks and local currencies in the financing of cross-border trade.

In addition to trade and financial integrations, African importers and exporters would benefit from currency risk management tools that reduce their exposure and convertibility risk. In large markets with established and liquid currencies, forward contracts are widely used to reduce uncertainty. They allow

investors to lock in fixed exchange rates at low costs, which then can be used to settle contracts with suppliers, make payments and remit profits. Cross-currency swaps are contracts in which two parties agree to exchange multiple fixed amounts (normally loan principal and interest payments) in two different currencies. Together, derivatives like these can help de-risk foreign exchange transactions.

Although these markets are nascent in Africa, there have been positive developments in the last few years. For example, Nigeria developed domestic hedging tools after the crash of its Naira currency. The Central Bank of Nigeria supported a naira-settled over-the-counter futures market with a flexible investors and exporters window rate and helped to mitigate exchange rate risk. Investors, banks and importers all have access to the over-the-counter market for hedging foreign currency loans, capital imports, dividend repatriations, remittances, letters of credit and provisioning for foreign currency loans. The size of this hedging market grew to \$4.4 billion in 2018.

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Boosting the use of local currencies will shield the African trade market from adverse global conditions associated with the performance of US dollars.

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However, in general, the development of onshore contracts in domestic derivative markets is difficult in Africa because of a combination of low liquidity levels, government regulation and aversion to risk. Limited currency risk markets are not generally accessible, and companies often lack the financial training and experience to make proper use of hedging instruments and other risk mitigation techniques. Only South Africa has a developed currency risk market (*Table 2*).

In the absence of an onshore hedging tool to mitigate foreign exchange risks, those that seek coverage can establish hedging with an offshore institution. This approach has been used in other parts of the world that are plagued by exchange rate volatility. For example, companies in many frontier market economies in the Association of Southeast Asian Nations use offshore derivative markets in Singapore – which has

extensive financial infrastructure and available liquidity – to establish hedging contracts when their domestic secondary markets are limited.

#### **4. Synthetic local currency instruments as a method of addressing currency risk**

The concept of using an offshore entity to mitigate currency risk and indirect credit risk also can be applied to the African trade finance market. In recent years, DFIs have stepped in to increase US dollar financing lines in Africa through trade finance programmes, with the goal of supporting the unmet demand caused by the flight of global banks. Programmes by several DFIs, including the International Finance Corporation, African Development Bank (AfDB) and African Export-Import Bank (Afreximbank), have expanded the scale of their financing, as well as their risk participation. By

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#### **Box: Cross-currency swaps**

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Cross-currency swaps are contracts under which two parties agree to exchange multiple fixed amounts (normally, loan principal and interest payments) in two different currencies.

For example, if a party has taken a foreign currency-denominated loan, it will have a set schedule for making interest and principal repayments in hard currency. It can use forward contracts or cross-currency swaps (basically, a series of foreign exchange forward contracts bundled together to mirror the cash flows needed to repay the loan interest and principal) to fix a foreign-exchange rate on these payments.

This gives the borrower certainty about the value of its payments in its local currency, reducing its risk and making investment more attractive.

TCX normally offers non-deliverable products in which all cash flows, despite being denominated in local currency, are settled in US dollars. It thus creates a synthetic local currency loan.

Source: Currency Exchange Fund (TCX)

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supporting the financing capabilities of participating commercial banks, the DFIs allow these banks to provide financing for clients who otherwise would have been rejected.

DFIs can take the further step of increasing the supply of synthetic local currency facilities to reduce credit risk and boost access to finance for African companies. This can be done by hedging US dollar funding exposure through a third or offshore institution. Shifting the currency risk to the third institution creates a synthetic local currency loan that can make macroeconomic risk more transparent and also improve the borrower's debt sustainability. It is often the only strategy to mitigate currency risk when local secondary markets are still nascent (Griffiths et al. 2020). (The term "synthetic" refers to the fact despite obligations being fixed in the local currency, all cash flows between the lender and borrower, including disbursements, interest payments and principal repayments, are settled in foreign currencies.)<sup>2</sup>

Synthetic local currency loans increasingly have been offered to private sector borrowers by DFIs, multilateral development banks, and microfinance funds. Another attractive feature of synthetic local currency is flexibility of financing terms. While the US dollar is dominant in trade finance (and in finance generally), financing terms do not

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Shifting the currency risk to the third institution creates a synthetic local currency loan that can make macroeconomic risk more transparent and also improve the borrower's debt sustainability.

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necessarily have to be denominated in dollars. A loan paid out and settled in dollars can still be synthetically denominated in local currency. A non-deliverable cross-currency swap can be used to preserve the original structure of dollar-denominated loans, because it can practically fix an exchange rate on interest and principal payments (see box opposite).

A good example of the development of this new approach is a risk partnership between the Afreximbank and the Currency Exchange Fund (TCX). TCX is a special purpose fund with a long experience of providing hedging instruments for currencies devoid of them in commercial markets (Hirschhofer 2019). It provides over-the-counter derivatives to hedge the currency and interest rate mismatch that is created in cross-border investments between international investors and local borrowers. TCX accepts foreign exchange exposure on transactions originated by regional development banks in hard currencies. It offers swaps and

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2. It is to be distinguished from a true local currency loan, which is paid and repaid in local currency units and the debt repayment conditions are fixed in local currency terms.

Figure 2



- A USD 10m equivalent bullet loan hedged by TCX
- The lender requires a return in USD terms of 5%
- The TCX swap rate is LCY 15% fixed versus USD 5% fixed
- At disbursement the LCY: USD rate is 10:1
- The LCY loan is therefore fixed at LCY 100m @ 15%
- At the repayment date the LCY: USD rate is 12.5:1

- The borrower must repay LCY 100m, but in USD, so USD 8m
- The lender incurs a FX loss on the loan of USD 2m
- TCX 'repays' LCY 100m on the LCY leg, so USD 8m
- The lender 'repays' USD 10m on the USD leg
- Only the difference of USD 2m is paid, by TCX to the lender
- TCX receives LCY interest and pays USD interest

Source: Currency Exchange Fund (TCX)

converts the exposure into domestic currencies for the beneficiaries at the same maturities. TCX's partnership with the Afreximbank, which makes use of local currency lending and guarantees, allows the bank to retain the credit risk of its trade finance operations, while the currency risk is transferred to TCX.

The function of the synthetic local currency trade instrument hedged with a non-deliverable swap through TCX is best presented in a flow diagram (Figure 2). While foreign exchange exposure is shifted to TCX, convertibility and transfer risks often remain with the borrower, which is required to convert the contractually specified local currency (LCY) amount into US dollars (or other hard currency) and settle the obligation via a transfer to an offshore account. The process is as follows: at disbursement or when the hedge is executed, the repayment obligation of the borrower is fixed in local currency at the prevailing local

currency/foreign currency rate. The lender disburses in foreign currency. On the repayment date, the borrower must satisfy the local currency repayment obligation as it was fixed at disbursement, but that obligation must be settled in foreign currency. The amount of foreign currency that the borrower must transfer is calculated by converting the local currency repayment obligation against the local currency/foreign currency exchange rate on the date of repayment.

If the local currency has depreciated, the lender will receive less foreign currency from the borrower than the amount it disbursed. In that case, TCX will cover the shortfall. If the local currency has appreciated, the lender will receive more foreign currency than the amount it disbursed, but it must pay the surplus to TCX. Either way, the lender is perfectly hedged, as a loss or gain on the loan will be precisely offset by an equal but

opposite loss or gain on the swap. The borrower has a fixed liability in local currency terms, which is unaffected by the appreciation or depreciation of local currency against foreign currency. TCX will always gain or lose, bearing the currency risk in full.

This synthetic loan structure has several advantages for trade finance in Africa. First, the synthetic instrument is useful in illiquid currency markets where hedging instruments are not widely available or where foreign exchange markets are shallow and volatile. Second, while the synthetic instrument provides access to much-needed hard currency, the borrower fixes the debt service in terms of its own revenues (which are typically in local currency). Payments in US dollars give the borrower certainty about the value of its payments in local currency, and also make the investment more attractive and less risky from the lender's perspective. Most importantly, in case there is an external shock and a resulting currency depreciation, the borrower pays back a smaller hard-

currency amount. Hence, by shifting the currency risk from the borrower to the financier (*Table 3*), synthetic local currency trade loans can improve the repayment capacity of African importers and lower their risk of defaults.

## 5. Potential implications for financing trade in africa

The intervention of DFIs and multilateral institutions has become particularly relevant as African banks increasingly depend on their support for trade financing. In 2018, the International Chamber of Commerce's Global Survey of trade finance found that 43% of banks headquartered in Africa expected the continent's trade finance gap to widen and that the trade finance programmes provided by multilateral development banks would expand to close this gap. Recently, a global trade finance survey by BNY Mellon and the International Chamber of Commerce showed that most institutions would provide more trade finance to small and medium enterprises or in geographies with high levels of unmet demand for trade finance, if the visibility and efficiency

**Table 3**

Category	All cash flows in	Debt service contractually set in	Assumes currency risk
Plain US\$ loan	US\$	US\$	Importer
Plain LCY loan	LCY	LCY	Financier/exporter
Synthetic LCY loan	US\$	LCY	Financier/exporter

Note: LCY = local currency

of transaction processes were improved through risk reduction.

Currently, during the COVID-19 pandemic, shrinking global demand and drops in commodity prices and export revenues have tightened lending conditions and exacerbated existing constraints in Africa. The exposure to adverse global volatility and commodity price cycles have created recurrent balance of payments crises and liquidity constraints to remain in place without further condition despite the strong liquidity positions of most banks. In the short run, DFIs and multilateral institutions active in Africa can help mitigate this risk through partnerships such as the one between the Afreximbank and TCX. DFIs and multilateral institutions can increase the supply of local currency-denominated lending to local banks, to continue support programmes that target the private sector and smaller enterprises. These programmes will also shield borrowers from risks associated with currency depreciation and US dollar credit fluctuations. Furthermore, the support programmes can lower the risk and the cost of credit for companies that are struggling to obtain affordable financing.

In the long run, reducing foreign exchange risk is key to ensuring the stability of the trade finance market in Africa. DFIs and multilateral institutions will be expected to maintain a proper trade finance environment through innovative means of credit enhancement. These

institutions should expand the offer of local currency trade finance facilities beyond large corporate banks, to small and medium banks. Their effective currency risk management can help local banks safely expand trade credit and ease access to confirmation counterparties. This approach will not only ensure loss minimisation for companies, but it also will contribute significantly to boosting overall trade flows in Africa and to promoting the integration of more companies into intra-African trade.

## **6. Conclusion**

To facilitate trade integration and the development of industrial value chains in Africa, the continent's trade financing gap must be closed. Information asymmetries, an exaggerated perception of risk, and rising compliance costs affect companies across the continent. Denomination of trade finance loans in foreign currencies is not sustainable because it inflates credit risk during currency fluctuations and it is vulnerable to global shocks, such as the current pandemic-induced context of heightened global volatility in both currency and commodity markets. New financial products, including instruments for hedging risks, can address some of these underlying problems and widen access to trade finance for African companies.

Multilaterals and those dedicated to bridging the trade finance gap in Africa should take advantage of the

offshore derivative markets to split currency risk from credit risk, which will provide additional flexibility, risk management and liquidity. Better allocation and management of currency risks can give small and medium enterprises increased

access to local currency-denominated finance and can mitigate the impact of US dollar credit fluctuations. This will have the additional advantage of fully leveraging the benefits of trade integration underway on the continent.

### Box: Overview of trade finance products

Trade finance is a collection of short-term instruments such as loans, letters of credit and guarantees that secure trade flows in a predictable manner, mitigate payment risks for companies and reduce cross-border transaction costs.

Trade finance includes the financing of import and export transactions through loans, letters of credit, factoring, and export credit and insurance. Banks' off-balance sheet commitments in trade finance include export and import letters of credit and bank guarantees. On-balance sheet exposure is loans for export or import.

The bank also can purchase the debt or invoice through factoring and forfeiting. Trade finance is not to be confused with trade credit, which involves no intermediation by financial companies. In trade credit, the exporter of goods provides the importer with a loan, so the buyer does not have to pay immediately at the point of purchase, but within an agreed period of time. The exporter also can take on trade credit insurance to protect against the risk of non-payment by the buyer.

Trade finance products (short-term) US\$	Export finance (medium- and long-term)
(Issued) import letters of credit (off-balance sheet)	Products for which an export credit agency has provided a state-backed guarantee or insurance to the trade finance market
(Confirmed) export letters of credit (off-balance sheet)	
Loans for import/export (on-balance sheet)	
Performance guarantees and standby letters of credit (off-balance sheet)	
Supply chain finance: receivables discounting, forfeiting, factoring, loan or advance against receivables, loan or advance against inventory, pre-shipment finance (between companies, not intermediated by banks)	

Source: International Chamber of Commerce, Trade Register Report 2019



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