Letters of Credit and The Disruption of International Trade: Systemic Risk, Contagion and Trade Finance

Back to the Bad Old Days

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Back in the old days (pre-1980s), the term *systemic risk* did not refer to contagion of illiquidity within the financial sector alone. Back then, when the real economy was much more important than low margin, unglamorous banking, it was understood that the really scary systemic risk was the risk of contagion of illiquidity from the financial sector to the real economy of trade in real goods and real services.

If you think of it, every single non-cash commercial transaction requires the intermediation of banks on behalf of – at the very least – the buyer and the seller. If you lengthen the supply chain to producers, exporters and importers and allow for agents along the way, the chain of banks involved becomes quite long and complex.

When central bankers back in the old days argued that banks were "special" – and therefore demanded higher capital, strict limits on leverage, tight constraints on business activity, and superior integrity of management – it was because they appreciated the harm that a bank failure would have in undermining the supply chain for business in the real economy for real people causing real joblessness and real hunger if any bank along the chain should be unable to perform.

As the "specialness" of banks eroded with the decline of the real economy (and the migration globally of many of those real jobs making real goods and providing real added-value services to real people), the nature of systemic risk was adjusted to become self-referencing to the financial elite. Central bankers of the current generation only understand systemic risk as referring to contagion of illiquidity among financial institutions.

They and we all are about to learn the lessons of the past anew.

We are now starting to see the contagion effects of the current liquidity crisis feed through to the real economy. We are about to go back to the bad old days. Whether the zombie banks are kept on life support by the central banks and taxpayers of the world is highly relevant to whether the zombie bank executives pay themselves outsize bonuses and their zombie shareholders outsize dividends with taxpayer money. It appears sadly irrelevant to whether the banks perform their function of intermediating credit and commercial transactions in the real economy along the supply chain. The bailout cash and executive and shareholder priorities do not seem to reach so far.

The recent 93 percent collapse of the obscure Baltic Dry Index – an index of the cost of chartering bulk cargo vessels for goods like ore, cotton, grain or similar dry tonnage – has caused a bit of a stir among the financial cognoscenti. What is less discussed amidst the alarm is the reason for the collapse of the index – the collapse of trade credit based on the venerable letter of credit.

Letters of credit have financed trade for over 400 years. They are considered one of the more stable and secure means of finance as the cargo is secures the credit extended to import it. The letter of credit irrevocably advises an exporter and his bank that payment will be made by the importer's issuing bank if the proper documentation confirming a shipment is presented. This was seen as low risk as the issuing bank could seize and sell the cargo if its client defaulted after payment was made. Like so much else in this topsy turvy financial crisis, however, the verities of the ages have been discarded in favour of new and unpleasant realities.

The combination of the global interbank lending freeze with the collapse of the speculative, leveraged commodity price bubble have undermined both the confidence of banks in the ability of a far-flung peer bank to pay an obligation when due and confidence in the value of the dry cargo as security for the credit if liquidated on default. The result is that those with goods to export and those with goods to import, no matter how worthy and well capitalised, are left standing quayside without bank finance for trade.

Adding to the difficulties, letters of credit are so short term that they become an easy target for scaling back credit as liquidity tightens around bank operations globally. Longer term "assets" – like mortgage-back securities, CDOs and CDSs – can't be easily renegotiated, and banks are loathe to default to one another on them because of cross-default provisions. Short term credit like trade finance can be cut with the flick of an executive wrist.

Further adding to the difficulties, many bulk cargoes are financed in dollars. Non-US banks have been progressively starved of dollar credit because US banks hoarded it as the funding crisis intensified. Recent currency swaps between central banks should be seen in this light, noting the allocation of Federal Reserve dollar liquidity to key trading partners Brazil, Mexico, South Korea and Singapore in particular.

Fixing this problem shouldn't be left to the Fed. They aren't going to make it a priority. Indeed, their determination to accelerate the payment of interest on reserves and then to raise that rate to match the Fed Funds target rate indicates that the Fed are more likely to constrain trade finance liquidity rather than improve it. Furthermore, the Fed may be highly selective in its allocation of dollar liquidity abroad, prejudicing the economic prospects of a large part of the world that is either indifferent or hostile to the continuation of American dollar hegemony.

. If cargo trade stops, a whole lot of supply chain disruption starts. If the ore doesn't go to the refinery, there is no plate steel. If the plate steel doesn't get shipped, there is nothing to fabricate into components. If there are no components, there is nothing to assemble in the factory. If the factory closes the assembly line, there are no finished goods. If there are no finished goods, there is nothing to restock the shelves of the shops. If there is nothing in the shops, the consumers don't buy. If the consumers don't buy, there is no Christmas.

Everyone along the supply chain should worry about their jobs. Many will lose their jobs sooner rather than later.

If cargo trade stops, the wheat doesn't get exported. If the wheat doesn't get exported, the mill has nothing to grind into flour. If there is no flour, the bakeries and food processors can't produce bread and pasta and other foods. If there are no foods shipped from the bakeries and factories, there are no foods in the shops. If there are no foods in the shops, people go hungry. If people go hungry their children go hungry. When children go hungry, people riot and governments fall.

Everyone along the supply chain should worry about their children going hungry.

When that happens, everyone in governments should worry about the riots.

Controlling access to trade finance determines who loses their jobs, whose children go hungry, who riots, which governments fall. Without dedicated focus on the issue of trade finance and liquidity from those in the emerging world most interested in sustaining the growth of recent years, little progress can be expected.Trade finance is rapidly communicating the stress on bank liquidity to the real economy. It presents a systemic risk much more frightening than the collapsing value of bits of paper traded electronically in London and New York. It could collapse the employment, the well being and the political stability of most of the world's population.

The World Trade Organisation hosted a meeting on trade credit in Washington Wednesday to highlight the rapid and accelerating deterioration in trade finance as an urgent priority for public policy.

I look at the precipitous collapse of the Baltic Dry Index and I wish them Godspeed.

Further reading:

WTP warns of trade finance 'deteriorating' amid financial crisis

Cost of some trade finance deals up sixfold – WTO

Shipping holed beneath the water line

Shipowners idle 20 percent of bulk vessels as rates collapse