T20 Policy Brief

Task Force 1
Macroeconomics, Trade, and Livelihoods: Policy Coherence and International Coordination

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RISK AND RESILIENCE OF GVCs AND THE ROLE OF THE G20

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Saon Ray, Visiting Professor, Indian Council for Research on International Economic Relations (ICRIER), New Delhi.

Smita Miglani, Consultant, Institute of Economic Growth, New Delhi.

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Abstract

The COVID-19 pandemic revealed the fragility of global value chains (GVCs), and there are many imminent risks to the global economy due to geopolitical tensions. Resilience is important in mitigating the effects of disruptions to supply chains, and trade finance and supply chain finance can be important instruments in overcoming the risks to the global economy. The G20 can play a significant role in coordinating support for trade finance and green trade financing. Though nascent, green trade finance can help overcome sustainability challenges. Other measures to improve resilience through international coordination and collaboration by the G20 countries could be necessary to mitigate some of these risks and achieve greater and seamless GVC integration.

The Challenge

1

The COVID-19 pandemic and recent geopolitical tensions have revealed the fragility of global value chains (GVCs). In the aftermath of the pandemic, significant disruptions in the flow of essential goods and services have become common in various sectors.

Following a revival of trade in the first quarter of 2022, the World Trade Organization (WTO) recently forecast a 1-percent growth in global merchandise trade volumes in 2023, a significant drop over the 3.5 percent rise registered last year.

Globally, a significant proportion of trade is being taken over by 'green goods' and is growing rapidly. As per United Nations Conference on Trade and Development's Global Trade Update, world trade reached a record US$32 trillion in 2022, and growth turned negative in the last quarter of the year. However, environmentally-friendly products defied the trend and continued to increase throughout the period (UNCTAD, 2023a). 'Green goods', also known as environmental goods, play an important role in the transition to sustainable, low-carbon economies by improving efficiency, reducing emissions, conserving natural resources, and improving air and water quality.[a]

This policy brief argues that measures to ensure timely and adequate green trade finance could improve resilience in the current global economic scenario. Moreover, the G20 can now play a significant role in coordinating support for trade finance and green trade financing. Other measures to improve resilience through international coordination and collaboration by the G20 countries could be necessary to mitigate some of these risks and achieve greater and seamless GVC integration.

GVCs, SMEs, and the role of trade finance

The pandemic has revealed the nature of the fissures in the system of global production and supply chains. Trade finance and supply chain finance can be important instruments in overcoming these risks. Risks in supply chains

a Examples of such goods include solar panels, wind turbines, electric cars, LED lights, batteries, and water filtration systems, among others.

could be operational in nature and due to unforeseen disruptions. This is especially true for small and medium enterprises (SMEs) that typically have limited working capital and liquidity to remain resilient and functional in the face of crisis.

A direct impact of risks and delays due to supply chain issues is felt in the revenue stream of exporters and importers. This can impact various stages of production, right from delays in procuring raw materials to final delivery of supplies to the importer across the border. At the same time, the importers could choose to hold back payment until the delivery of the goods is finally completed. As the payment delays for international cross-border transactions tend to take more time and the involved information asymmetries are more pronounced, these delays could have a compounding effect in increasing the financial constraints on both sides in a short span of time (OECD, 2021). Amid such a crisis, adequate and timely access to trade finance (i.e. financial instruments and means of payments for international transactions) can provide the cash-constrained exporters with the needed working capital and play a useful role in enabling firms' engagement in international activities through direct exports and participation in GVCs.

SMEs struggle to access bank-intermediated trade finance instruments for a variety of reasons, including high cost of finance and enhanced riskiness in times of crisis. Moreover, the traders might lack the awareness, skills, and expertise in recognising trade finance products. On the supply side, information asymmetries and resource-intensive due diligence processes generate high transaction costs but low transaction volumes during times of economic downturn, disincentivising banks to consider the applications of SMEs. For critical and green supply chains, these issues become even more important. Trade constitutes the backbone of every economy and is a powerful engine for growth and sustainable development. Trade finance supports about 80 percent of global trade through a variety of financial instruments, including letters of credit, trade loans, guarantees, and insurance. In 2020, the value of trade finance transactions supported by major global banks was estimated to be around US$9 trillion (ADB, 2022).

Often, SMEs are underserved and lack access to affordable trade finance

(Castaneda-Navarete, et al. 2021). Up to 80 percent of trade is financed by credit or credit insurance but the availability of finance varies across regions. The 2021 Asian Development Bank Trade Finance Gaps, Growth, and Jobs Survey reported high estimates of global trade finance gap,[b] with more companies unable to find the financing they needed to trade their goods. As per the survey, the global trade finance gap was estimated to have increased from US$1.5 trillion in 2018 to US$1.7 trillion in 2020. Further, it revealed that about 40 percent of such applications rejected by banks were from SMEs (ADB, 2021). The survey found that the SMEs were disproportionately affected by the trade finance gap. SMEs face the greatest hurdles in accessing affordable financing (WTO, 2016). The poorer the country in which they are based, the greater the challenges SMEs face in accessing trade finance. At the same time, the number of international banks involved in trade finance continues to decline.

It is important to note here that an important way in which resilience was built in the aftermath of the 2008 global financial crisis was through the financial institutions that counteracted the consequences of the economic crisis and in restoring the stability of the global economy. Over US$1 trillion of additional resources were allocated to the world economy through international financial institutions and trade finance for the most comprehensive support programme for the financial sector. The G20 leaders hailed the introduction of new initiatives by multilateral institutions in the areas of infrastructure and trade finance and encouraged multilateral development banks to continue their support of the development agenda.

The challenge for the future lies in making trade finance both more inclusive and sustainable. Sustainability, as defined by the Sustainable Development Goals (SDGs), has dimensions of environmental as well as socioeconomic development (ICC, 2022). Sustainable supply chain finance that integrates environmental, social, and governance (ESG) considerations into regular supply chain finance may be useful in this regard.

b The difference between the number of applications to finance companies' participation in international operations and the number of approvals.

Sustainable or 'green trade' finance refers to "financing that supports goods or services produced in a manner that minimise adverse environmental or social impacts or risks, or promote environmental protection" (Monetary Authority of Singapore). Today, with the rise in cross-border trade in sustainable goods, more and "more banks are rolling out green or sustainability-linked equivalents of trade finance instruments" (S&P Global Market Intelligence, 2022).

While many standards and definitions exist for sustainable finance, including those by the International Capital Markets Association (Green Bond Principles) and Loans Market Association (Green Loan Principles[c]), these do not fully meet the needs of trade and supply chain finance as a 'flow' concept (ICC, 2022). As a flow concept, sustainability can be viewed in a holistic way, covering aspects of environmental sustainability (supporting the transition to net-zero carbon emissions, sustainability of local and global environments and ecosystems) and socioeconomic (supporting sustainable economic development, alleviation of poverty, and promoting equity in economic development). These themes find resonance in the SDGs (specifically, SDGs 1, 2, 7, and 13).

About 80 percent of international trade operations today relies on the extension of a financial instrument to manage or secure payments. Financial institutions involved in trade finance (including banks, insurers, and other entities) are therefore critical actors in the promotion of such green or 'sustainable goods' trade.

Green trade finance

Trade is an important driver and engine for economic growth and prosperity globally, and a key means to achieve the SDGs (UNCTAD, 2019). Today, 'green goods' constitute a significant proportion of cross-border trade across all economies.

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c For details on Green Loans Principles, see World Bank (2021): "The GLP comprise voluntary recommended guidelines, to be applied by market participants on a deal-by-deal basis depending on the underlying characteristics of the transaction, that seek to promote integrity in the development of the green loan market by clarifying the instances in which a loan may be categorised as "green". The GLP build on and refer to the Green Bond Principles (GBP) of the International Capital Market Association, with a view to promoting consistency across financial markets."

As per the United Nations Conference on Trade and Development, "Green goods, also called environmental goods, refer to products that are thought to be more environmentally friendly. They are designed to be more energy-efficient, use fewer resources, and emit less pollution than their traditional counterparts… These goods play an important role in the transition to sustainable, low-carbon economies by improving efficiency, reducing emissions, conserving natural resources, and improving air and water quality" (UNCTAD, 2023b).

Green trade finance is where a trade finance facility is made available to exclusively fund environmentally sustainable trade activities. Examples of green trade finance include banks providing financial support to environmentally sustainable trade activities based on Green Bond Principles and Green Loan Principles. The products include solutions such as "loans, receivables finance, imports and exports, commodity and structured trade finance, and portfolio management & distribution, and bank/commercial acceptance drafts discounting," among others (HSBC).

The G20's Role

2

Supply chain disruptions post the pandemic have squeezed exports and imports, and pushed up prices, especially of food and energy. In the aftermath of the pandemic, the G20 has been focusing on structural reform paths to address the uncertainties in food production, the aggravation of geopolitical conflicts combined with increasingly volatile weather conditions in many food-growing countries, and sharp increases in fertiliser prices.

The G20 leaders have consistently underlined the importance of trade and investment as important drivers of growth and prosperity in past summit declarations (Brisbane Summit, 2014; Antalya Summit, 2015; Hamburg Summit, 2017; Buenos Aires Summit, 2018 and Bali Summit, 2022). Maximising trade's potential for realising inclusive growth and securing a fairer share of gains from cross-border exchange for developing countries was also included in the Trade and Investment Working Group Ministerial and G20 leaders' statements (Antalya Summit, 2015; Hamburg Summit, 2017).

Green trade finance is one of the building blocks to achieving this target. The important role of trade finance was endorsed in the immediacy of the 2008 financial crisis (Washington Summit, 2008). The communiqué stated that the G20 is "welcoming introduction of new initiatives by the World Bank in the areas of infrastructure and trade finance and encouraging multilateral development banks to continue their support to the development agenda" (Ray et al., 2023).

Measures to improve resilience through international coordination and collaboration by the G20 countries could be useful to mitigate the risks associated and achieve greater and seamless GVC integration. The G20 must work towards forging a consensus on the need for coordinated trade policies that promote trade.

Bridging the trade finance gap needs participation from a number of multilateral development banks and Export Credit Agencies (ECAs). In this context, international institutions and banks must cooperate to harmonise the definitions of green goods, standards, and data sharing mechanisms.

Green trade finance is a growing phenomenon that will become mainstream soon, as countries across the globe increase trade in 'green goods'. A framework for trade finance facilities will help corporates create and work towards specific sustainable targets, and help banks and financial institutions garner better opportunities, both from a welfare and a commercial perspective.

Recommendations to the G20

3

Green trade finance is a form of financing that exclusively funds environmentally-sustainable trade activities and adheres to the Green Loan Principles. Several banks (such as HSBC and DBS Bank) already provide such financial support.

Some of the common problems faced by the firms trading in green goods (particularly SMEs) in procuring finance from institutions are high interest rates and the requirement for higher collateral (compared to traditional goods). On the other hand, 'green trade' financing is still a new concept and there exist gaps in the perception and assessment of the actual risks of trading such goods. Also, given the finite resources, allocating and prioritising a certain proportion of funds to such goods by the financing institutions remains a problem. Given these problems, we propose a few innovative strategies and sources of finance for the actors.

For the firms, the futuristic scenario will include translating the perceived ESG risks into profit and loss parameters and from there on, seeking solutions such as appropriate bank guarantees and incentivised pricing mechanisms.

At the institutional level, we propose standardising the definition of 'green goods' across the financing institutions, developing indices and nomenclature/formats at various levels. As the market for evolution and trading of green goods are still evolving, the product list might be required to have certain broad definitions (to provide the scope of including new evolving products) and be updated from time to time. Further, there is a need to devise new solutions through digital tools to create testing and monitoring models, and create a repository of green trade finance data.

The International Chamber of Commerce's Wave 1 Framework programme is a step in the right direction. Other initiatives include the green trade frameworks developed by multilateral institutions like the European Bank for Reconstruction and Development. Such standards will help and incentivise traders as they transition to sustainable goods trade with greater urgency in the coming years.

As for the sources of finance, green bonds, insurance, and hedge funds could be created to finance the needs for such trade. Overall, ensuring extensive dissemination of awareness and information on such solutions with all actors and creating exclusive climate finance windows in multilateral development banks could be beneficial in achieving the desired objectives. Well-targeted finance is important to make 'green goods' investable by reducing uncertainty and improving investment risk management by the traders.

Framework to bridge the gap in trade finance in green goods

In Table 1, we propose a framework to bridge the existing gap in trade finance in the cross-border movement of green goods. We highlight the problems faced by different actors in the trade finance ecosystem, and the ways to overcome them, in the process of building resilient models of trade finance that work efficiently in times of prosperity as well as crisis.

Table 1: Framework to bridge the gap in trade finance in movement of green goods

Actors	Problems faced	Ways to overcome
Firms (SMEs)	– High interest rate charged by banks (differentiated nature of green goods)	– Translating ESG risks to profit and loss parameters
	– Higher collateral	– Bank guarantees – Incentivised pricing mechanisms
Institutions (Banks and multilateral export credit agencies)	– Gaps in existing resources – Green trade financing still a new concept	– Standardising the definition of green goods. Developing indices and nomenclature/formats for green goods for capital market financing – Devising new solutions through digitalisation – Developing a taxonomy of trade finance standards – Creating futuristic testing models – Repository on trade finance data; methods of reporting and end use monitoring – Green insurance – Green bonds and hedge funds
Ecosystem	– Gap between perception and actual risks	– Dissemination of information – Climate finance windows in multilateral development banks

Source: Authors' own

Action points for G20

One of the foremost requirements to realise the effective flow of green trade finance across the globe is to formulate and standardise the definition of green goods and standards at the global level. This needs to be followed by the development of indices and nomenclatures for such goods for capital market financing.

Scale up and digitise green trade finance instruments to allow cost-effective disbursals and promote seamless trade in green goods

An effective tool for achieving cost reduction in trade and promoting trade finance is digitalisation. The evolution of fintech solutions and account aggregators in the ecosystem enables transaction risk evaluation based on real-time data on payments and consumer behaviour. This will enable a cost-effective appraisal by trade finance and green trade finance providers. In this context, the G20 countries should endeavour to adopt enabling legislation in the next few years to achieve paperless international trade.

Promote international collaboration to improve acceptance of green trade finance instruments

There is little doubt that a reversal of globalization at a global scale could lead to higher inflation and reduce the potential for growth in the future (WTO, 2023). As had happened during the Global Financial crisis of 2008-09, the G20 countries have once again shown leadership and committed to supporting open trade and investment in the last few years to limit the repercussions of the supply chain disruptions on their economies. The importance of trade finance needs to be adequately highlighted and explored in this regard.

Given the increased cross-border trade in sustainable goods worldwide, the G20 can play a significant role in coordinating support and as a discussion forum for green trade finance. Member countries can use this setting to raise trade concerns and share information with respect to the resources related to green trade finance.

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