Banks, Firms and Trade Finance Infrastructure in Albania

PhD Cand. Dorina Çumani
dorinacumani@gmail.com
European University of Tirana, Albania

Abstract

Firms engaged in international trade face to some risks, which are either not present or less present for the domestic trade. All, firms- SMEs or Companies contain elements of risk, but when they trade internationally, the risk profile is different than trading home. These include commercial risk, political risk, exchange and the country risks, such as the possibility of war, political unrest, or unexpected import bans or tariffs, act. Banks play a critical role in facilitating international trade by guaranteeing international payments and reducing the risk of trade transactions in exports or imports. The effect of insured trade credit on trade is very strong and remains stable over the cycle, in crisis and non-crisis periods (WTO, 2012). By shortening the time of production, delivery, approved credit, the risk situation can be improved and in the same way as liquidity and profitability (Anders Grath 2008). If Albanian traders control the risks they can expanding exports into new markets and it can be very profitable. Using trade finance and reducing risks Albanian firms will be able to develop and take advantage of business opportunities. The trade finance infrastructure of Albania is the institutions, laws, regulations and other systems related to the following three activities: provision of capital to firms that are engaging in international trade transactions; provision of support services to manage the risk involved in these transactions; and provision of international payment mechanisms (UNCTAD/WTO 2005). All three activities are performed by financial institutions and intermediaries, such as banks, stock exchanges and insurance companies. The main purpose of this paper is to analyze how Albanian firms, to accessing finance by understanding the credit process creating the right macroeconomic environment. In this paper we will be able to give an answer to the question “why this is a successful relationship to be implemented in Albania”.

Keyword: Trade finance, macroeconomic environment, firms, risk, banks.

Introduction

International trade, the cross-border exchange of goods and services, is an important engine of growth in most developing and transition economies. Countries, traders who need to actively engage in international transactions with others to create a favorable international environment and have to be certain that its domestic environment is favorable to trade development. Whether the domestic environment is favorable can ultimately be measured by the economic cost of importing or exporting specific goods and services into or from the domestic market. Major transaction cost factors, in most economies, include transportation and financing (including insurance). One of the most challenging issues faced by new enterprises and SMEs in developing or transition economies have been identified the financing of trade and investment. Financing is needed not only during the export process itself, but also for the production of the goods and services to be exported. To understand the significance of trade finance, it is important to view it in the context of an overall trade development strategy whose purpose is to develop and expand sustainable trade flows to support the country’s economic development (UNCTAD/WTO 2005).
Figure 1. Suggests that a comprehensive trade development strategy includes four main components, with trade finance issues being addressed as part of trade facilitation and infrastructure development. Source (UNCTAD/WTO 2005).

**International trade relations management** involves developing cordial trade relations with other countries to safeguard a country’s trade interests and to ensure market access for its products and services. It also involves responding to restrictions placed on products by importing countries (UNCTAD/WTO 2005).

**Trade promotion** consists of programs and activities to promote and develop trade with other countries. It includes measures to help establish and improve a country’s or a firm’s participation in trade fairs, trade missions and publicity campaigns, as well as providing information and advice on overseas market prospects, contacts and access (UNCTAD/WTO 2005).

Thru this paper we will give an answer to many questions: How to create the right environment for developing trade finance in Albania? What can do Trade Finance for Albanian traders? How can Albanian traders use trade finance? Why this is a successful relationship to be implemented in Albania?

**Creating the right environment for developing trade finance in Albania**

**Macroeconomic environment**¹

Because trade finance tools and instruments are primarily offered by or through financial institutions, the level of development of the trade finance infrastructure is closely linked with that of the overall financial sector. It can therefore be expected that a stable macroeconomic environment will be an important factor in the development of trade finance, along with an open economic policy.

**Trade situation**

For the long-term development of trade finance is favorable better export performance, increased outward orientation and the size of trade flows.

**Net external resource flows**

Net external resource flows may indicate the availability of funds; external funds are generally viewed as being favorable to the development and availability of trade finance. The sustainability of a financing regime becomes questionable when the level of external indebtedness becomes too large. Net resource flows consist of long-term debt, FDI, portfolio flows and grants. Since FDI represents investments by foreign entities in the private sector of the economy and is expected to lead to technological transfers and to enhance a country’s competitiveness, FDI, is considered more positive than other sources of external finance. Also, grants are interest-free and are usually associated with improving or extending public goods and

¹ UNCTAD/WTO, 2005 (for the Macroeconomic environment and its topics you can read more, http://www.unescap.org/)
services so, grants, are considered to benefit an economy. Portfolio flows can be extremely volatile in nature in liquid capital markets so they are not a stable or reliable source of financing.

**External debt and liquidity**

Indirect effects on trade finance availability and development have debt overhang and external liquidity, refers to the stock of external debt. The higher the level of indebtedness, the higher future debt service payments will be which is a drain on domestic finance (debt service payments are the annual flows expended to cover both interest payments and principal). The level of foreign currency that a country holds refers to the external liquidity of a country. A low level of liquidity limits a country’s ability to import goods and services. Fluctuations in the latter will influence monetary policy because foreign debt is denominated in foreign currency. The value of the domestic currency is driven downwards and a financial crisis can ensue when demand for the foreign currency exceeds reserves.

**Exchange rate policy and foreign currency availability**

Trade finance development will be affected by foreign exchange rate arrangements. The monetary and fiscal policies are influenced by business sentiment towards exchange rate policies and volatility of exchange rates which in the same time the existence of foreign exchange reserves are require in international payments. Governments can influence substantially the ease with which international payments are made. Governments can place an anchor on the exchange rate which will facilitate international transactions regarding exchange rate movements. Flexible arrangements may be more favorable for the long-term development of a trade finance infrastructure. Also, positive indirect effects on trade finance have the accumulation and maintenance of significant foreign exchange reserves.

**Monetary and financial system**

Monetary and financial system indicators are primarily proxies of the level of banking and financial development. They indicate the extent to which banking transactions are more important than cash transactions and the extent to which the banking system is present in the economy. The two indicators that are used to assess financial development are:

Financial deepening (the simplest measure of financial deepening is to view the level of broad money (quasi money and narrow money) in comparison with GDP. It measures the degree of monetization of the economy. Narrow money reflects cash, it will represent the level of transactions that take place in the economy and the quasi money should rise correspondingly since the country makes use of financial intermediaries for transacting.

More interesting is the ratio of broad money to narrow money. For this reason, the ratio of quasi money to narrow money may be expected to rise in line with financial deepening and with the increasing availability and use of trade finance instruments.

And the evolution of realm interest rates. Since the banking system is able to attract savings increase the level of deposits. This represents a sign of financial health.

These have a positive effect on the availability and development of trade finance.

**Credit market and ratings**

To reduce the amount of funds available for trade financing government management of public finance can be detrimental to interest rates. Indeed, a large government deficit (when revenue does not cover expenses) can be financed by printing money (seignorage is the action of eroding the real domestic value of public debt by raising inflation) or by issuing government bonds. Since tight monetary policy is generally considered to be a high priority, government deficits crowd out the private savings that will finance the deficit, leaving little room for trade financing. The perception of a country’s financial standing from the international market’s viewpoint may also have an indirect but very concrete impact on the development and availability of trade finance services. For example, poor sovereign debt ratings issued by Standard and Poor’s and Moody’s, two international credit rating agencies based in the United States, suggests a high risk of government default on its debt obligations, which has strong exchange rate implications. This makes borrowing by exporters more expensive,
since the interest premium will rise, and a subsequent depreciation of the currency would have the effect of raising foreign-denominated debt repayment for private and public enterprises.

**Legal environment**

A complete legal system is necessary for the development of a variety of trade finance services (e.g., leasing). Liberalization without sufficient prudential regulations can be detrimental to the economy so the legal framework governing enterprises and banks are extremely important in order to ensure that systemic risks are minimized. The quality of commercial laws, the adoption of international rules, the effectiveness and enforcement of bankruptcy laws, standards and the ability of the legal system to resolve trade disputes in a timely and transparent manner can influenced the development and availability of trade finance. Also, the development of trade finance would facilitate to reduce the cost and time associated with legal requirements.

**Financial institutions**

In the banking system is essentially channeled the trade credit offer this can significantly influence banks system and therefore the structure and efficiency of the banking system will therefore significantly influence the availability of trade finance. The efficiency of the system is measured by the spread between deposit and lending rates, and/or by the number of days it takes to transfer money from one institution to another, will determine the extent to which the needs of exporters and importers may be proactively met by existing institutions. The completeness of the banking sector will also be important, as trade financing is often channeled through specialized banks and credit schemes (guarantees, insurance).

**Capital and credit restrictions**

The existence of government restrictions on capital and market instruments will directly affect the range of trade finance instruments and services available to mitigate risk or secure credit. The degree to which financial intermediaries and enterprises can either draw up financing contracts or deal in financial instruments with or without prohibitive measures imposed by the Government should be examined to ensure that it will not impede trade finance infrastructure development. Legislation on capital controls (one of many tools for conducting monetary policy), which may raise the cost of international transactions, and legislation on foreign direct investment, which is an important source of equity income for resident enterprises, should also be reviewed.

**Cost of borrowing**

Exporters are often faced with a constraint on financial resources owing to the delay between the time they pay for an order and the time they receive money for that order. The exporters usually need financial intermediaries to satisfy their financial needs. The rates of interest for borrowing vary from one country to another and raise the cost of final production while reducing the competitiveness of enterprises. High borrowing costs have a direct effect on exporters and the availability and development of trade finance. For example, domestic inter-bank borrowing rates that are high in relation to international rates, such as LIBOR, are likely to prevent the financial sector from providing exporters with affordable credit. The cost of borrowing is ultimately dependent on the macroeconomic environment.

**What can do Trade Finance for Albanian traders?**

Many countries have developed Trade Finance without creating the right environment because Trade Finance can:

*Trade finance is the lifeline of trade because more than 90% of trade transactions involve some form of credit, insurance or guarantee. When banks are extremely risk-averse, small- and medium-sized enterprises (SMEs) are likely to be more affected than larger ones. With banks allowing a lower amount for loans, SMEs, normally among the last in a pecking order, would have even more problems competing for fewer funds at higher costs. In ordinary times SMEs face difficulties accessing finance; the current extraordinary financial crisis multiplies this difficulty. By some accounts, SMEs in developing and emerging markets are doubly impacted, as financiers tend to retreat from higher-risk markets at the same time as credit shifts further from SMEs and towards larger corporate clients.* (HOW TO ACCESS TRADE FINANCE).
Trade finance facilitates trade by helping overcome the information asymmetry between buyers and sellers, enabling them to trust a system whereby sellers will be paid conditions and buyers will get the products; contributes to international trade in: risk mitigation, financing, payment facilitation and the provision of information about the status of payments. Trade finance transactions are involves some combination of these four elements, adjusted to suit the circumstances of a particular market or of a trading relationship.

**Payment**
- Secure
- Timely & Prompt
- Global
- Low-cost
- All leading currencies

**Financing**
- Available to importer or exporter
- Several stages in the transaction
- No impact in Operating Line for exporters

**Risk Mitigation**
- Risk Transfer
- Country, Bank and Commercial Risk
- Transport Insurance
- Export Credit Insurance

**Information**
- Financial flows
- Shipment Status
- Quality of Shipment
- L/C systems include web & desktop solutions

**Figure 2. The Four Elements of Trade Financing**

*Source: Malaket (2014), Financing Trade and International Supply Chains*

**The four elements of trade financing**

Despite the increase in focus, analysis, and attention on trade financing, this specialism in finance remains poorly understood by senior bankers, regulatory authorities, and private sector finance and treasury experts.

It can be argued that trade financing, at its core, is about some combination of four elements.

1. The facilitation of secure and timely payment across borders.
2. The provision of financing options and solutions for one or more trading parties.
3. The provision of effective risk mitigation.
4. Information flow related to the physical movement of a shipment and/or the associated financial flows.

The exact combination of these elements and their relative importance in the context of a trade transaction, relationship or supply chain ecosystem will vary. Access to affordable trade financing, including effective and viably-priced risk mitigation is critical to the ability of SMEs based in developing markets to pursue opportunities in international trade.

Trade, facilitation and financing with the active participation and engagement of international institutions and national authorities that important linkages can be drawn and acted on, between trade financing, effective trade facilitation, and the successful pursuit and conduct of commerce across borders, leading to positive and concrete impacts on international development and poverty reduction.

It is imperative for authorities and industry leaders to build a bridge between trade financing and trade facilitation with the express objective of leveraging trade finance to benefit international development through the creation of trade-based economic value. (*Malaket 2014*, 2015).

**How can Albanian traders use trade finance?**

*Global and local banks support international trade through a wide range of products that help their customers manage their international payments and associated risks, and provide needed working capital. The term “trade finance” is generally reserved for bank products that are specifically linked to underlying international trade transactions (exports or imports). As such, a working capital loan not specifically tied to trade is generally not included in this definition. Trade finance products typically carry short-term maturities, though trade in capital goods may be supported by longer-term credits. (Trade finance: developments and issues 2014).*
Cash-in-Advance - With cash-in-advance (Trade Finance Guide 2007, 2008, 2012; Eric Bishop 2004) payment terms, an exporter can mitigate credit risk because payment is received before the goods are transferred. Wire transfers and credit cards are the most commonly used cash in advance options available for Albanian exporters. For small export transactions are cash-in-advance by the internet.

Open Account - An open account (Trade Finance Guide 2007, 2008, 2012; Eric Bishop 2004) transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. This is one of the most advantageous options in terms of cash flow and cost for the importer, but it is consequently one of the highest risk options for the exporter because exporters may lose a sale to their competitors. Albanian exporters can use one or more of the appropriate trade finance techniques to mitigate risk. Boost competitiveness in the global market. Help establish and maintain a successful trade relationship.

Consignment - An international consignment transaction (Trade Finance Guide 2007, 2008, 2012; Eric Bishop 2004) is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter. For the exporter shipping with consignment is very risky because is not guaranteed any payment and its goods are in a foreign country, in the hands of an independent distributor. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider and an appropriate insurance should be in place to cover consigned goods. Consignment helps exporters become more competitive boost the availability of faster delivery of goods. Selling on consignment help Albanian exporters reduce the direct costs of managing inventory and storing.

Letters of Credit - Letters of credit (LCs) (Trade Finance Guide 2007, 2008, 2012; Eric Bishop 2004) are one of the most secure instruments available to international traders. An LC is an instrument that the bank on behalf of the importer provides that payment will be made to the Albanian exporter provided that the terms and conditions stated in the LC have been met, as specified the documents. The buyer establishes credit and pays his or her bank for this service. An LC is useful when credit information about a foreign buyer is difficult to obtain. Also, protects the buyer until the goods have been shipped as promised. Recommended for use in higher-risk situations. New trade relationships or less established relationships.

Documentary Collections - A documentary collection (D/C) (Trade Finance Guide 2007, 2008, 2012; Eric Bishop 2004) is a transaction where the exporter entrusts the collection of the payment for a sale to its bank, which sends the documents that its buyer needs to the importer’s bank. They are the instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved. D/Cs involves using a draft that requires the importer to pay on a specified date (document against acceptance).

An example of a letter of credit

The Four Elements of Trade Financing

Why this is a successful relationship to be implemented in Albania?

The trade finance literature has emphasized the role of risk. One of the main concerns for a firm in international trade is that its counter-party may default on the contract. This can happen because the trading partner cannot or does not want to fulfill his or her obligation to deliver or to pay. Intuitively, we expect default risk to be correlated across firms within a country, which share the same legal system, financial sector and social norms and are exposed to the same aggregate shocks. To the extent that default risk varies across countries, the use of trade finance, which is a means to reduce risk, should differ as well (Friederike Niepmann, Tim Schmidt-Eisenlohr).

Thru this paper we saw how trade finance can help Albanian traders to do secure international transactions.

All the authors and trade international institutions are agreed that the partnership banks (Trade Finance) – firms (traders) is successful and so will be for Albanians trader.

This is confirmed by the data too. The 2015 Trade Register demonstrates the low-risk nature of trade finance: Import letters of credit, provided by the receiving bank, saw a 0.08 percent default rate. Export letters of credit, provided by issuing banks to guarantee payment, saw the lowest transaction default rate at just 0.01 percent; Customer default rates landed at 0.04 percent for export letters of credit, 0.29 percent for import letters of credit and 0.72 percent for import and export loan products. Import and export loans saw a 0.22 percent default rate. Businesses, often SMEs that need these products to manage working capital, saw a lower transaction default rate than financial institutions (0.68 percent versus 1.43 percent). (ICC registers 2015).

Conclusion

All authors and financial institutions are agreed that the partnership banks (Trade Finance) – firms (traders) is successful and so will be for Albanians trader. Trade Finance instruments have a low-risk nature and mitigate international trade risk. There are a few instruments where Albanians traders can choose the right one for their needs. TF is secure and timely payment across borders, financing options and solutions for one or more trading parties, effective risk mitigation, shipment and/or the associated financial flows. Using TF instruments, Albanian traders boost competitiveness in the global market, establish and maintain a successful trade relationship.

References


