

# WHY BOOSTING THE AVAILABILITY OF TRADE FINANCE BECAME A PRIORITY DURING THE 2008–09 CRISIS

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Economists disagree on the role trade finance played in the recent collapse in world trade. In contrast, policy makers seem to have reached a consensus. In a nutshell, their reasoning is that trade finance is the lifeline of international trade. The decline in trade is larger than what would be expected given the drop in global output. So part of the fall in trade reflects a shortage of trade finance, which could amplify and extend the plunge in trade and make the financial and economic crisis worse. Hence, boosting the availability of trade finance has to be part of the international response to the crisis. This chapter examines the claims underpinning this storyline and highlights the uncertainties on the role trade finance played in the current crisis.

## **How Big Is the Trade Finance Shortfall?**

International trade presents many risks that trade finance can mitigate. The risk of nonpayment may be limited with the use of instruments such as letters of credit. The credit risk can be reduced with the use of export credit insurance. Trade finance also provides liquidity because some exporters may need loans if they lack

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sufficient liquidity to process and acquire goods and services to fulfill export orders. However, a large part of trade finance does not involve financial institutions because trade partners often extend trade credit to each other.<sup>1</sup>

How much does international trade depend on trade finance? There is no solid statistical answer to this basic question. It is often reported that 90 percent of world trade relies on trade finance (WTO 2007). This estimate is of questionable quality and appears too high given the sharp increase over the past two decades in intrafirm trade, which is unlikely to use external financing. If the widely circulated numbers of trade finance reaching \$10 trillion and world trade flows reaching \$14 trillion are accurate, the share is closer to 70 percent.<sup>2</sup> The precise share of trade relying on trade finance does not matter much because, indisputably, trade finance is essential to trade. However, these uncertainties illustrate the poor quality of data on trade finance.

If it is so hard to measure total trade finance, estimating a shortfall cannot be more than a best guess. According to the World Trade Organization (WTO), a shortfall, albeit limited, existed before the 2008–09 crisis. In March 2007—on the eve of the financial crisis and more than a year before the bankruptcy of a major participant in trade finance (Lehman Brothers) and the collapse in trade—the WTO reported a transaction gap of less than \$200,000 (WTO 2007). By the time of the WTO’s Expert Group Meeting on Trade Finance in November 2008, market participants’ broad estimate of the shortfall in trade finance had increased to \$25 billion.<sup>3</sup> Four months later, in March 2009, at another WTO Expert Group Meeting, the estimate was revised to \$100 billion–\$300 billion, but it seemed that there was no consensus: “On the current market situation, *most* participants agreed that although trade flows were decreasing sharply, constraints to trade finance still existed” (WTO 2009, emphasis added).<sup>4</sup> In May 2010, participants in another Expert Group Meeting indicated that liquidity had returned to the trade market, although some regions (notably Sub-Saharan Africa) continued to face constraints (WTO 2010).

### **Jumping the Gun or Jumping on the Bandwagon?**

Despite the lack of reliable data and the fact that the then-estimated shortfall accounted for only 0.25 percent of trade finance and less than 0.2 percent of world trade, the WTO put trade finance in the spotlight and marshaled strong support to trade finance by as early as the end of 2008.

Initiatives mushroomed. International and government-backed institutions were mobilized and responded quickly. The capacity of export credit agencies as well as regional and multilateral development banks was increased, new products were launched, and cofinancing with the private sector was encouraged,

among other efforts (Chauffour and Farole 2009). Moreover, several countries used their official reserves to supply banks and importers with foreign currencies. The international effort to support trade finance culminated in April 2009 when the G-20 pledged to “ensure availability of \$250 billion over the next two years to support trade finance” (G-20 2009) and the World Bank announced the Global Trade Liquidity Program, which could support up to \$50 billion of trade.

The response was unusual not only in strength, but also in speed. It started as early as October 2008 (arguably even before then), when the magnitude of the collapse in trade was not even known! Initially there were concerns that the financial crisis (more precisely the credit crunch) that started in 2007 could spread to trade finance. However, at least until the first half of 2008, trade finance “was stable with volumes and rates at normal levels.”<sup>5</sup> Signs of possible tension appeared only when the financial crisis morphed into a full-blown economic crisis.

At that time, the political economy was ripe to boost the availability of trade finance. Long before the crisis, many countries had been lobbying at the WTO to find ways to increase the availability of trade finance for developing countries. The Aid for Trade initiative, whose scope explicitly includes trade finance (WTO 2006), was seen as providing leverage (Auboin 2007). The 50 percent increase in the ceiling of the International Finance Corporation’s (World Bank Group) trade finance guarantee in October 2008 was welcomed by the head of the WTO as “Aid for Trade in action.”<sup>6</sup>

The economic crisis provided extra leverage. Boosting the availability of trade finance was seen not only as an answer to the concerns of developing countries but also as a means to address the global crisis. Lessons were evoked from the Great Depression and the role played by trade finance in recent financial crises (such as in Asia and in Argentina and Brazil).<sup>7</sup> Supporting trade finance was also branded as part of the international fiscal stimulus. With a high political profile and no strong interest to oppose it, the policy response could only be strong and swift.<sup>8</sup>

### **An Overestimated Problem?**

Precautionary action against anticipated problems has some merit. Nonetheless, the problem with trade finance may have been overestimated. It has been claimed that the shortage in trade finance could account for 10–15 percent of the decline in trade (*Financial Times* 2009). However, available econometric estimates suggest that the shortfall would need to be much larger than the one reported to contribute that much to the drop in trade flows (Ronci 2004; Thomas 2009; Korinek, Le Cocguic, and Sourdin 2010).

Some econometric studies on the mechanism of the trade collapse fail to find any support for the idea that trade credit played a role (Levchenko, Lewis, and

Tesar 2010). Moreover, from October 2008 to January 2009, when the drop in trade took place, trade volume declined much more than trade finance (possibly four times more, according to Chauffour and Farole [2009]), suggesting that the drop in demand explains the contraction in trade finance.

The perception that the supply of trade finance played a significant role in the crisis stems from the fact that the collapse in trade has been so sharp and so much larger than the contraction in global output (Levchenko, Lewis, and Tesar 2010) that it left the impression that something other than the drop in demand must have hampered trade. Because financial problems triggered the crisis, disruption in trade finance was seen as a possible culprit. However, there is no need to invoke a trade finance shortfall to explain the recent plunge in trade.

First, the rise in the fragmentation of production increased the elasticity of trade to income from under 2 percent in the 1960s and 1970s to about 3.5 percent in recent years (Irwin 2002; Freund 2009). As a result, trade flows reacted more in 2008–09 than in past crises to changes in global output. Supporting this view are these facts: (a) East Asia, the region most involved in the international supply chains (and thus the region exhibiting the largest elasticity of trade to income), is the region that suffered from the largest fall in trade, and (b) the 2008–09 collapse in U.S. trade was exceptional by historical standards but was driven by the drop in trade in intermediate goods (Levchenko, Lewis, and Tesar 2010).<sup>9</sup>

Second, the collapse in trade in goods, which attracts attention, is larger than the drop in total trade because trade in services has been much more resilient than trade in goods. This supports the idea that the initial drop in trade in goods was amplified by a destocking effect (which cannot affect trade in services because services cannot be stored). Firms, anticipating a slowdown in growth, drew down inventories, thus magnifying the drop in trade. A close analysis of the timing as well as the sectoral and regional patterns of trade flows supports this interpretation (*Economist* 2009).

Third, the plunge in trade is often calculated in nominal terms on a year-on-year basis. This calculation overestimates the decline in *real* trade because commodity prices had fallen dramatically since their historically high level of mid-2008. For example, Levchenko, Lewis, and Tesar (2010) calculate that price explains 40 percent of the collapse in U.S. imports and about 27 percent of the collapse in U.S. exports.

All these points do not negate the potential role of a trade finance shortage in the plunge in world trade. Rather, they highlight that the decline in trade is not necessarily much larger than the slowdown in global output would suggest. Thus, the importance of the collapse in trade does not suggest that “something else”—like a disruption in trade finance—has *necessarily* played a *significant* role.

In sum, the lack of reliable data is so dire that there is no certainty that the decline in trade finance contributed significantly to the decline in trade. This lack prevents observers from solving the familiar causality problem: did the drop in trade cause trade finance to contract (a demand shock), or did a shortfall in trade finance contribute to the drop in trade (a supply shock)?

### **Surveys to Fill the Information Gap**

To remedy the lack of data, several organizations came to the rescue with surveys in early 2009:

- *The International Chamber of Commerce* (ICC) surveyed 122 banks in 59 countries (ICC 2009).
- *The International Monetary Fund* (IMF) and the *Bankers' Association for Finance and Trade* (BAFT)—now merged with International Financial Services Association (BAFT-IFSA)—surveyed 44 banks from 23 countries (IMF-BAFT 2009).
- *The Institute of Development Studies* (IDS) surveyed 31 medium- and large-scale, export-oriented Sub-Saharan African firms (Humphrey 2009).
- *The Organisation for Economic Co-operation and Development* (OECD) surveyed its members about measures taken at the national level regarding officially support export credit (OECD 2009).
- *The World Bank* surveyed 425 firms and 78 banks in 14 developing countries (Malouche 2009).

According to these surveys, the problem with trade finance was not its availability but its cost.

Trade finance was somewhat more difficult to get in some regions of the world (mostly in emerging markets), in some sectors (those perceived as more risky than others), and for some firms. Nonetheless, the surveys did not depict an overly dark picture. Few of the African firms surveyed by IDS faced any problems with availability of trade finance (Humphrey 2009). Firms surveyed by the World Bank indicated that “the drop in global demand was their top concern and that trade finance was not a major binding constraint” (Malouche 2009). The Australian government reported to OECD that it holds regular consultations with market practitioners and that “anecdotal evidence to-date suggest to us that the slowdown or contraction in international trade is leading the slowdown in trade finance and export credit insurance uptake rather than a financial crisis-induced tightening of trade credit and credit insurance preventing willing buyers and willing sellers from doing international trade deals” (OECD 2009).

Among the banks responding to the ICC survey, 47 percent reported a drop in the volume of letters of credit, while 32 percent reported an increase and 21 percent reported no change (ICC 2009). In the IMF and BAFT-IFSA survey, “banks in advanced countries reported roughly the same number of trade finance transactions in the final months of 2008 as occurred at the end of 2007. But emerging market banks reported an average 6 percent decline in trade finance transactions” (Dorsey 2009).<sup>10</sup>

This limited decline in transactions may reflect several factors and not necessarily a shortage. Tighter guidelines by banks in light of risk reassessment played a role, but the drop in transactions may have also reflected an increase in the cost of trade financing and a drop in the aggregate demand for trade financing because of the contraction of trade.<sup>11</sup> Although 57 percent of banks in the IMF and BAFT-IFSA survey explained the drop in the value of trade finance transactions between October 2008 and January 2009 as due to less credit availability, 73 percent mentioned a fall in the demand as a reason, and 43 percent cited the fall in transaction prices, which likely reflected the drop in commodity prices. In the World Bank survey, banks “confirmed the increase in pricing and a drop in volume of trade credit. Yet, the drop in volume seems to reflect lack of demand due to the global recession rather than a consequence of the increase in pricing” (Malouche 2009).

For some exporters, trade finance may have been available but unaffordable. Surveys clearly showed that the price of trade financing shot up. The main reasons for this price increase appear to have been a perceived increase in default risks, a rise in the banks’ cost of funds, higher capital requirements, and a decline in the value of collateral (for example, linked to the drop in commodity prices).

In this context, a policy that targets only the quantity of trade finance would most likely fail. If banks are reluctant to lend because of perceived risks, boosting the availability of trade finance is unlikely to result in more lending. As Malcolm Stephens, a former secretary-general of the Berne Union, pointed out in his analysis of trade finance during the Asian crisis, “The traditional role of export credit agencies is to support trade and to facilitate trade. They are less effective in, somehow, trying to create or initiate trade, especially, in circumstances where neither importers nor exporters are really willing (or able) to trade with each other” (Stephens 1998).

A policy that targets the risks would have more impact. According to World Bank President Robert Zoellick, under its Global Trade Liquidity Program, the Bank “would underwrite the riskiest part of the lending, while private banks would provide the bulk of the less risky elements” (*Financial Times* 2009). Although likely to be more successful, this kind of initiative raises the potential issue of moral hazard.

### Need for Regulatory Change?

Policy makers may also tackle the reasons for the increased risk aversion and cost of funds. According to some bankers, regulatory changes could help. They argue that Basel II has a pro-cyclical effect on the supply of credit and particularly affects trade finance, most notably trade finance with emerging markets.

This complaint is not new, but recently it has been voiced more forcefully, notably at the WTO expert meetings (Hopes 2008; WTO 2008a, 2008b, 2009, 2010). Moreover, it has been relayed by Robert Zoellick (who publicly complained about a regulation that tripled the amount of capital needed to back trade finance [*Financial Times* 2009]) and Pascal Lamy (who wrote to the general manager of the Bank for International Settlements and to the chairman of the Financial Stability Forum). However, only one-third of the 15 banks that responded to the IMF/BAFT-IFSA question about the impact of Basel II on their capacity to provide trade finance indicated that it had a negative impact; 27 percent reported it had a positive impact, and the remaining banks reported it had no impact.

Since the 2008–09 crisis, calls for changing the rules have been frequent. They go beyond the call by the Group of 20 (G-20) for “regulators to make use of available flexibility in capital requirements for trade finance” (G-20 2009). For example, in December 2008, the European Commission introduced temporary changes in the Commission State Aid Guidelines on short-term export credits. It increased the flexibility of an existing escape clause so that official export credit agencies can cover short-term transactions in the OECD if the private market fails to do so (OECD 2009). In January 2009, the participants in the OECD’s Arrangement on Officially Supported Export Credits decided to adjust some of the disciplines of the Arrangement to facilitate the financing of projects. These modifications allow signatories to provide officially supported export credit at more favorable terms and to increase the limit of the share of officially supported export credit in intra-OECD project finance. Then, in June 2009, OECD countries agreed to boost official backing for exports of renewable energy and nuclear power equipment by offering more generous terms.<sup>12</sup>

These changes are rather limited, but a lesson from past crises is that pressures to use officially backed export credit to protect or stimulate national exports are considerable during a worldwide recession. This was the case during the Great Depression—an experience that led to the creation of the Berne Union and “apparently convinced the GATT [General Agreement on Tariffs and Trade] founders that export subsidies exacerbate international political tensions and should be eliminated” (Baldwin 1980).<sup>13</sup>

During the 1970s crisis, world leaders pledged to refrain from resorting to protectionism. Today’s leaders do the same. However, they do not follow their

predecessors who also pledged to avoid competition in official trade credit. The concern about competition in official trade credit was so great in the 1970s that, to prevent it, OECD countries negotiated an Arrangement on Officially Supported Export Credit (Ray 1986). When international trade faced another contraction in the early 1980s, export subsidies came back in the form of tied aid and mixed credit (Byatt 1984; Messerlin 1986; Ray 1986).<sup>14</sup>

The rules currently in place were designed to prevent the mistakes of previous crises, namely competitions in export subsidies (through favorable terms) that not only distorted international trade and domestic protection but also proved to be fiscally expensive. They act as a safeguard, and no race for export subsidies has taken place in the current crisis. However, agricultural export subsidies and the lingering Airbus-Boeing dispute are reminders that the temptation to help domestic firms' exports is not a thing of the past. Moreover, pressures on policy makers to help domestic firms may increase if the recovery is not vibrant enough to rapidly reverse the rise in unemployment. The system may need more flexibility, but the lessons from history should not be forgotten.

## Conclusions

Panic stemming from a sharp and sudden decline in trade flows, memories of the Great Depression, and the role of trade finance in recent financial crises, as well as a favorable political economy, explain why policy makers strongly and rapidly supported trade finance in response to the 2008–09 global financial crisis.

However, the trade finance shortfall and its contribution to the fall in trade flows are likely to be overestimated. Lack of reliable data is so dire that it is difficult to know whether a drop in the *supply* of trade finance contributed to the decline in trade or whether the decline was only due to the drop in *demand* for trade finance. In 2008–09, trade finance was somewhat harder to get in some parts of the world or for some firms but, in aggregate, available evidence suggests that a shortfall is unlikely to have contributed significantly to the plunge in international trade.

The cost of trade financing was more of a problem than its availability. If the rising cost was due to increased risk aversion, boosting the supply in trade finance is likely to be ineffective. Rather than trying to increase the supply of trade finance in particular, policy makers should help credit flows in general to return to normal. There are two main reasons to support this strategy. First, the access to intermediated trade finance appears to be less a constraint for exporters than preexport financing, which is similar to a working capital loan (Chauffour and Farole 2009; Humphrey 2009). Second, firms constrained in their access to institutional credit are likely to face difficulties in extending trade credit. Fixing

the financial system will ease the credit constraint and help boost the interfirm trade credit that accounts for a large share of trade finance.<sup>15</sup>

Moreover, boosting the supply of trade finance is risky. Relaxing the rules limiting the competition of government-backed exports credit (on the grounds that more flexibility is needed to provide more trade financing) could make it more difficult to resist pressures to help domestic exporters. In addition, in many countries, the recession and large fiscal stimulus packages have led to ballooning fiscal deficits and public debts. In this context, boosting the availability of trade finance is probably not the best use of scarce public resources, and encouraging export credit agencies to take more risks could result in fiscal contingent liabilities.

## Notes

1. Chauffour and Farole (2009) describe the various instruments. Petersen and Rajan (1997) discuss interfirm credit.

2. In 2008, trade finance reached \$10 trillion–\$12 trillion and trade flows reached \$15 trillion (Auboin 2009). These numbers imply a share ranging from 67 percent to 80 percent.

3. It is interesting to note the precise nature of this estimate: “Market participants gave a broad estimate of the gap in the trade finance market of \$25 billion, which was the amount of trade finance that banks kept on their books but could not off-load on the secondary market” (WTO 2009).

4. A caveat to this estimate: “this being roll-over finance, the gap would nevertheless need to be divided in terms of net flows by the average maturity of letters of credit, which could vary widely across areas of operation” (WTO 2009).

5. WTO Director-General Pascal Lamy’s report to the WTO Trade Negotiations Committee in October 2008 (WTO 2008c).

6. WTO Director-General Pascal Lamy’s report to the WTO General Council in November 2008 (WTO 2008c). The new ceiling would be doubled one month later to reach \$3 billion.

7. Problems with trade finance were sometimes cited among the main risks for trade looking forward. For example, in his address at the WTO’s Second Global Review of Aid for Trade in July 2009, Waleed Al-Wohaib of the Islamic Development Bank claimed that international trade was facing “the twin risks of rising protectionism and dwindling trade finance” (Wohaib 2009).

8. On the political economy of boosting trade finance, see also Baldwin (2009).

9. Levchenko, Lewis, and Tesar (2010) also note that although the drop in trade was exceptional by historical standards, it was comparable to the drop experienced during the 2001 recession when elasticity of trade to income was already very high.

10. There are signs that the situation deteriorated somewhat between October 2008 and January 2009.

11. It is difficult to untangle the reasons for the decline in demand for trade financing. The drop in demand due to lower trade flows can be offset by the increase in demand for the protection offered by trade finance in light of increased risks. In the ICC survey, banks reported such an increase in demand for protection.

12. See “Modifications to the Arrangement on Officially Supported Export Credits” ([http://www.oecd.org/document/40/0,3343,en\\_2649\\_34169\\_42168680\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/40/0,3343,en_2649_34169_42168680_1_1_1_1,00.html)) and “OECD Countries Boost Official Support for Renewable and Nuclear Energy Exports” ([http://www.oecd.org/document/10/0,3343,en\\_2649\\_34169\\_43152266\\_1\\_1\\_1\\_37431,00.html](http://www.oecd.org/document/10/0,3343,en_2649_34169_43152266_1_1_1_37431,00.html)).

13. Auboin (2007) discusses the WTO’s agreement on subsidies and countervailing measures and their link with OECD rules.

14. Ray (1986) provides the history of the negotiations leading to the OECD Arrangement. The intense debates on export-credit subsidies that took place in the first half of the 1980s in both the United Kingdom and France are summarized in Byatt (1984) and Messerlin (1986).

15. For analyses of this mechanism, see Petersen and Rajan (1997) and Love, Preve, and Sarria-Allende (2007).

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