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COVID-19 PANDEMIC
Potential Risks for Trade and Trade Finance in Africa

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KEY MESSAGES

1. The Covid-19 pandemic poses risks to African trade. It has contributed to sharp falls in the prices of Africa's top export products and reduced trade with the region's top trading partners. Measures to contain it could impact the region's trade finance market as well.
2. Falling export revenues and deteriorating balance sheets due to the pandemic could limit access to foreign exchange liquidity. This has the potential to increase trade finance rejection rates, particularly for SMEs, and increase the trade finance gap.
3. Because trade finance transactions are largely paper-based, limited in-person interactions could also hinder banks' ability to better conduct due diligence. This could slow down trade finance approval rates and decrease the supply of bank-intermediated trade finance.
4. The crisis calls for emergency facilities such as trade finance lines of credit and risk-mitigation instruments ear-marked for trade related transactions, particularly for SMEs.
5. Regulators could also work with banks to put in place temporary measures to allow digital processing and transmission of trade finance transactions.

1 | INTRODUCTION

The rapid spread of Covid-19 poses significant public health and economic threat to the global economy. In response, many African economies, like the rest of the world, have put in place measures that have invariably reduced physical interactions, closed borders, and shut businesses. These measures are meant to save lives and limit the impact of the pandemic on already weak public health infrastructure, but they are also expected to dampen the region's GDP growth. Current estimates show that Africa could experience its first recession in 25 years due to the potential impact of Covid-19, with economic growth falling -3.4% to -1.7% in 2020 alone (AfDB 2020). This projection is in line with those of other institutions such as the World Bank (2020), and UNECA (2020). While a large part of that decline will stem from the disruptions to domestic economic activities due to the containment measures, some will result from the potential risks the pandemic poses to African trade and the trade finance that underpins it.

2 | IMPACT ON AFRICAN TRADE

The risks to trade may stem from two fronts. First, close to half of Africa's merchandize trade is with economies and regions that are highly impacted by the pandemic, including China, EU and USA (see Figure 1). As these

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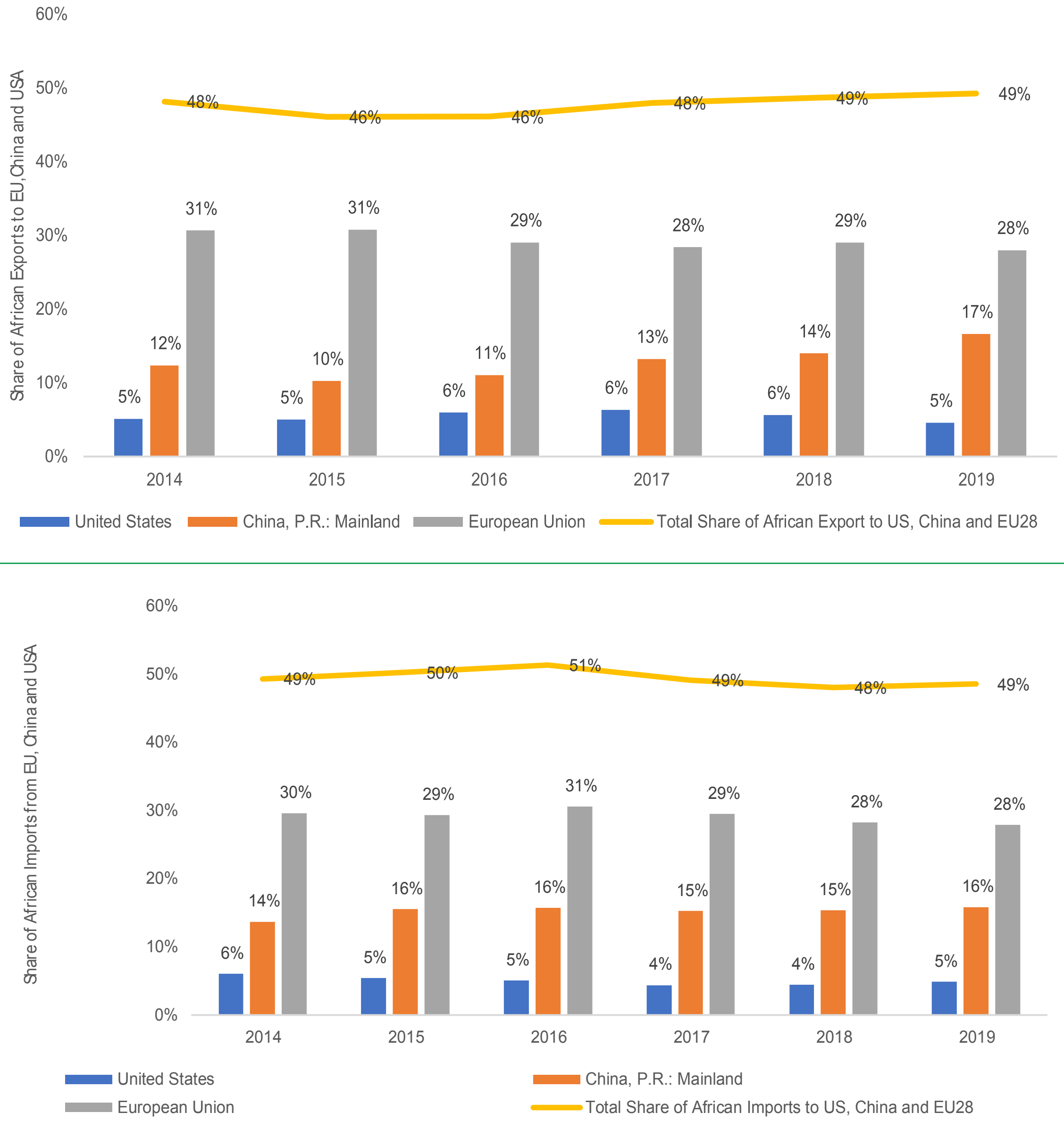
economies experience declining aggregate demand as a result of the pandemic, the need for inputs that support manufacturing processes will continue to fall, thereby limiting African exports of raw materials to these large markets. Take for example, trade with China, the region's biggest trading partner. Between January and February 2020, China's manufacturing Purchasing Managers Index (PMI), a measure of its industrial performance, decreased by 29, although it has since recovered to 50.7 in May 2020. Since many African economies export commodities that feed into manufacturing processes in China, and also rely on Chinese firms for intermediate inputs, a significant decrease in China's PMI is not entirely without economic risk for African trade.[3]

Not surprisingly, China-Africa trade decreased by 14% in the first quarter of 2020 compared to the same period in 2019.

Although some firms in China have restarted production and economies in the EU and the US are easing restrictions, anecdotal evidence suggests that most businesses are operating below capacity, with some firms terminating trade contracts with African economies made before the pandemic started. For instance, in February 2020, copper miners in Nigeria and Somalia reported cancellations of trade contracts by foreign counterparts citing "force majeure" in anticipation of negative demand shocks over the coming months (Financial Times, 2020).

FIGURE 1 SHARE OF AFRICAN TRADE (EXPORTS AND IMPORTS) TO CHINA, EUROPEAN UNION AND UNITED STATES



SOURCE IMF Direction of Trade Statistics.

3 Data from the World Integrated Trade Solution shows that in 2018 55% of sub-Saharan Africa imports from China consisted of capital and intermediate goods while 85% of Africa's export to China consisted of raw materials (World Bank, 2020).

Second, commodity trade may be particularly affected, leaving some of the region's leading economies vulnerable. Decreasing global demand and falling industrial production have led to sharp falls in commodity prices. Except for gold, prices for Africa's top 5 export products (crude oil, natural gas, coal and diamond) that account for close to 30% of the region's total exports by value, are far lower as at end-April than they were in January 2020 (see Figure 2). Brent crude oil price, a global benchmark for oil, fell below $20 in mid-April 2020, from a peak of $64 a barrel in January 2020, due to worsening global economic outlook as a result of the pandemic and the breakdown in negotiations on oil production quotas among members of the oil producing and exporting countries (OPEC) cartel and Russia, a non-OPEC major oil producer (otherwise collectively known as OPEC+). If such downward pressure on commodity prices persist, some of the largest economies in Africa that disproportionally rely on commodity trade for foreign exchange and government revenue could experience significant external and fiscal imbalances that are exacerbated by rising debt levels. For instance, Angola's GDP growth for end-2020 is expected to decrease by 1.4%, largely due the impact of falling oil prices on its economy (International Monetary Fund, 2020).

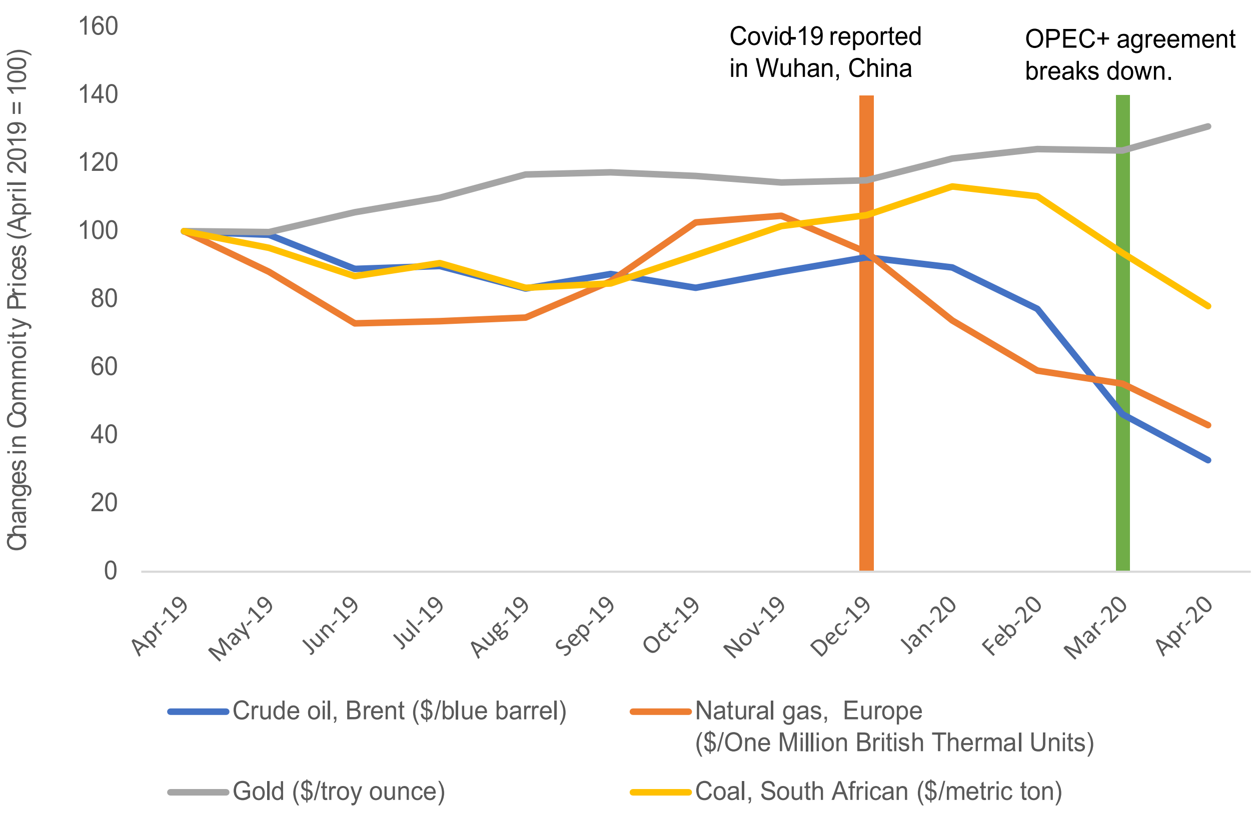
3 | IMPACT ON TRADE FINANCE

To mitigate the potential impact of Covid-19 on African trade and keep market access channels open, uninterrupted supply of trade finance by banks is vital. But there are reasons to believe that the measures adopted by governments to combat the pandemic may also impact firms' ability to obtain trade finance at a time when they need it the most.

In the short-term, the low digitization rate of trade finance transactions could slow down approval rates and therefore decrease supply of trade finance during the pandemic. The pandemic may expose one of the biggest weaknesses in trade finance supply in Africa – the over reliance on paper-based transaction processes. Compared to the rest of the world, Figure 3 shows that the region has been slow to adopt digital and electronic business processes, including for trade finance (World Bank Group, 2016).

Adopting digital solutions to trade finance transactions could reduce the time and monetary costs associated with document processing by banks and increase supply of trade finance. Figure 4 shows a positive correlation between the average level of trade finance (funded and unfunded)

FIGURE 2 MONTHLY CHANGES IN THE PRICES OF AFRICA'S TOP EXPORT COMMODITIES

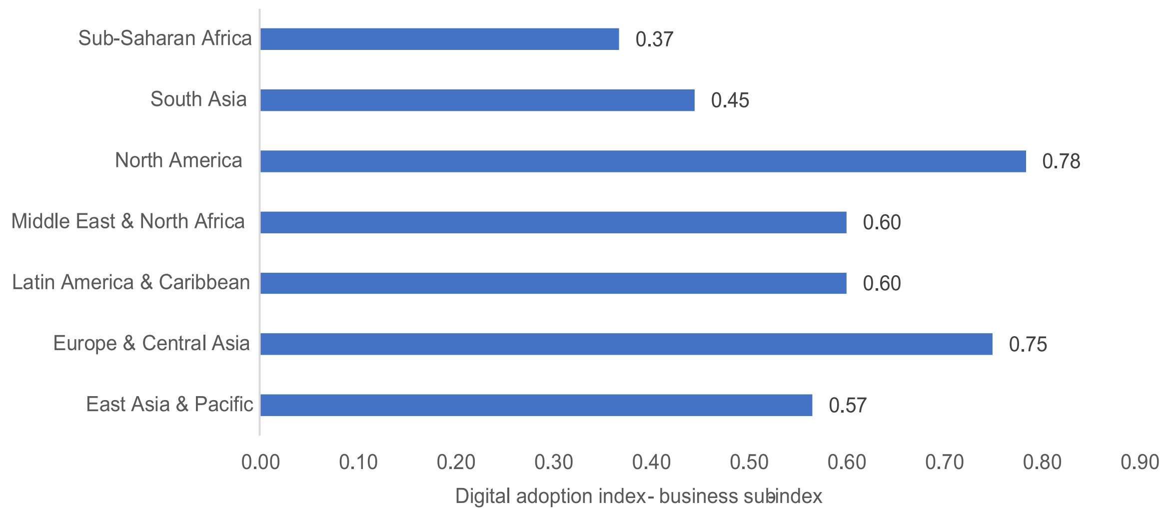


SOURCE World Bank Commodity Price Data.

provided by banks and the level of business digitization across 49 African economies. Yet for many banks across the continent, trade finance origination and authorization are paper driven due to regulatory requirements. For instance, only a handful of countries (Nigeria, Cameroon, Egypt and South Africa) in Africa allow e-signature and electronic authentication of official documents. Most banks therefore require "wet-ink" authentications before transactions could be approved. But the fear of the pandemic could make such simple processes suddenly burdensome and costly, slowing trade finance approval in the process.

The pandemic could also increase the trade finance gap by limiting access to forex liquidity required to finance African trade. In 2019, the trade finance gap in Africa was estimated at USD 82 billion (AfDB-Afrieximbank, 2020). If the

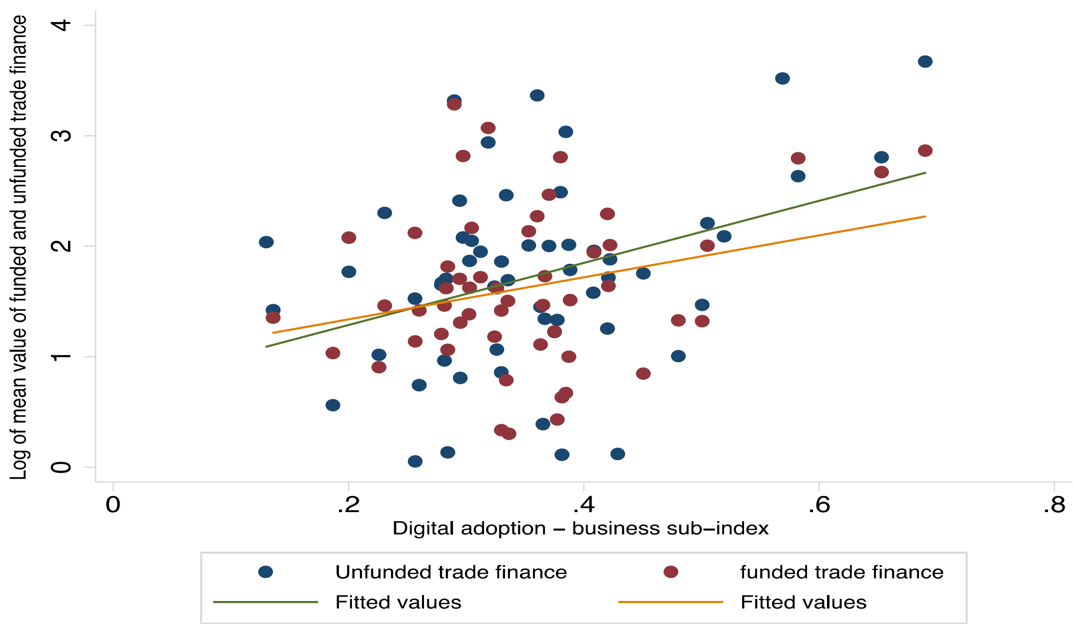
FIGURE 3 DIGITAL ADOPTION - BUSINESS SUB-INDEX (DIA) BY REGION



SOURCE World Bank, 2014 and 2016.

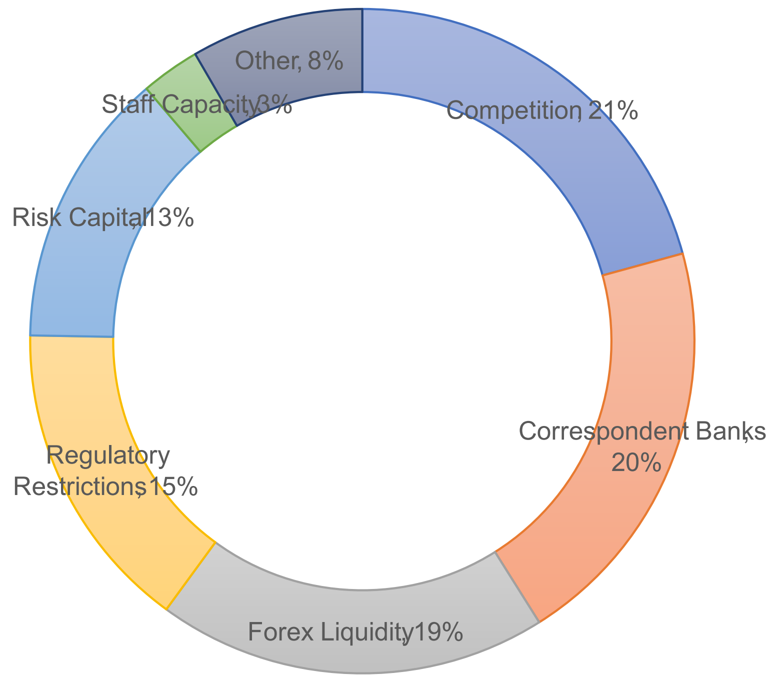
NOTE The index is on a scale of 0–1, where 1 is the best. The business sub-index comprises technologies necessary for businesses to increase productivity and accelerate broad-based growth.

FIGURE 4 RELATIONSHIP BETWEEN BUSINESS DIGITAL ADOPTION INDEX AND AVERAGE VALUES OF FUNDED AND UNFUNDED TRADE FINANCE ASSETS IN AFRICA (2014 AND 2016)



SOURCE AfDB and Afrieximbank Trade Finance Database and World Bank Digital Adoption Index.

FIGURE 5 CONSTRAINTS TO TRADE FINANCE SUPPLY IN AFRICA



SOURCE AfDB-Afriexímbank trade finance survey (2020).

pandemic persists, it could worsen the short fall in liquidity experienced by banks engaged in trade finance in Africa. In normal times, close to 20% of African based banks cite inadequate foreign exchange liquidity as a key constraint to increasing trade finance supply (see Figure 5). Yet, more than half of world trade – in terms of value – is denominated in US dollars (Lim, Masquelier, Raymaekers, & Thorsen, 2015) and 80% of letters of credits are priced in US dollars (International Chamber of Commerce, 2012). Foreign exchange liquidity shortages in the region could encourage global banks to reduce correspondent banking lines for domestic's banks in Africa. This could limit the supply of dollar liquidity demanded by firms for trade, increase trade finance rejection rates, and increase the size of the trade finance gap in Africa above the USD 82 billion recorded in 2019.

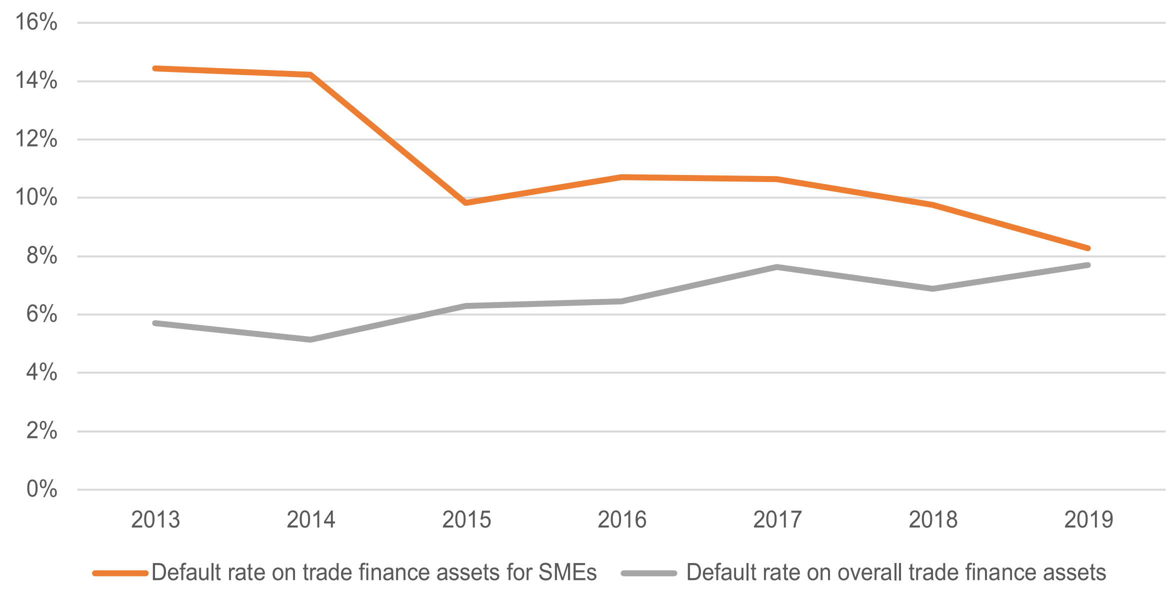
Small and medium-sized enterprises could be particularly exposed to higher rejection rates. When liquidity is low, banks tend to favor larger clients to the detriment of Small and medium-sized enterprises (SMEs). Default rates on SME trade finance transactions have decreased over the past six years, from 14% to 8.5% in 2019 and have edged closer to the overall default rate on all trade finance assets (Figure 6). However, rejection rate for trade finance applications by SMEs is over two times higher than that on overall trade finance applications. Currently, less than a third of bank-intermediated trade finance in Africa is dedicated to SMEs, although such enterprises play a significant role in the private sector - contributing around 80 percent of all jobs created in the continent. In normal times, some banks cite the inability by SMEs to provide appropriate documentation to meet regulatory standards (Know your customer (KYC) compliance and anti-money laundering (AML) requirements as one of the reasons for higher rejection rates of trade finance applications. As in-person interactions are reduced and business are forced to shut-down, the crisis could further worsen SMEs' ability to timely furnish appropriate documentation.

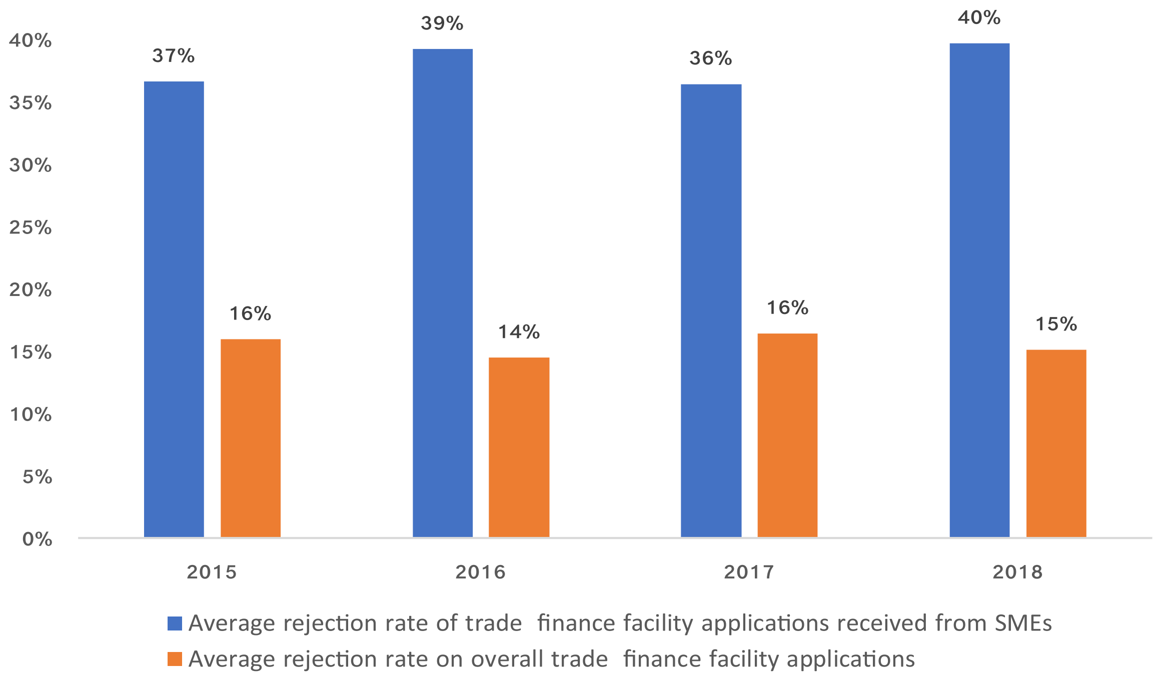
4 | POLICY RECOMMENDATIONS

To overcome the challenges noted above, swift response and regulatory measures could be implemented. For a start, regulators - both domestic and international - could work with banks to put in place temporary measures to allow digital approval and transmission of required documents for trade finance. While some banks have already streamlined internal processes to promote electronic processing of trade finance transactions, they also note that these measures will have limited impact without appropriate national and global regulatory support (International Chamber of Commerce, 2020). The International Chamber of Commerce has recently issued guidelines on how national regulators could build on the positive efforts made by banks. That could serve as a good starting point.

As development finance institutions and governments set up financial facilities to support businesses and critical sectors, part of the solution should entail setting up rapid emergency facilities such as trade finance lines and risk-mitigation instruments ear-marked to support banks, SMEs and other local corporates. The good news is that DFIs have so far responded swiftly to support African trade. Of

FIGURE 6 DEFAULT RATES ON SME TRADE FINANCE ACTIVITIES AND OVERALL TRADE FINANCE ASSETS





SOURCE AfDB-Afrieximbank trade finance survey (2020).

the USD 1.35 billion set aside by the AfDB for Covid-19 rapid response to the private sector, USD 270 million is ear-marked for trade finance support. This is in addition to existing guarantee capacity of more than USD 700 million. Similarly, the International Finance Corporation's Global Trade Finance Program has at least USD 2 billion additional capacity to cover payment risks associated with trade finance globally. These are steps in the right direction, but it is equally important to ensure that firms in more vulnerable economies and sub-regions benefit for this support.

The most recent trade finance survey by AfDB and Afrieximbank shows that DFIs are playing a more active role in the trade finance landscape in Africa but the distribution is far from even, with banks in West and Southern Africa being the largest beneficiaries of such support. While this reflects the importance of those sub-regions in the continent's overall trade, the scale of the pandemic shows that rapid support may be needed for banks and enterprises in vulnerable and fragile states in Central Africa, as well as those that may be severely affected by commodity price shocks.

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