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## Rethinking trade financing for economic growth : the African continent in perspective.

Obademi Olalekan Emmanuel

Department of Finance, University of Lagos, Nigeria

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### Keywords

*Comparative Advantage, Trade liberalization, Trade Finance, Structured Finance*

### Abstract

*This paper discusses the relationship between trade and economic growth with special attention on the African continent against the backdrop of the need to engender a win-win situation in harnessing the benefits of international trade through new trade policies that considers best trade finance policies, the dynamics of trade with respect to supply-side and demand-side variables. Herein the untapped potentials of the continent was highlighted in the light of the recent scramble for Africa within the context of the new wave of globalization and the risk associated with trade in unstable and volatile macroeconomic environment. Consequently, the imperative of regional financing of trade, partnership financing to solve deficit in infrastructure and the need for foreign entrepreneurs to be ready to take calculated risks was recommended while the Nigeria nation and her trade enhancing agencies must scale up their competencies.*

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### 1.0 Introduction

International trade basically is the exchange of goods, services and capital among countries of the world. This component is a significant part of a country's gross domestic product and this has become increasingly important with the trend of economic globalization. How well and how efficient a country engages in international trade as well as her access to qualitative trade financing arrangements is germane to the development quest of nations. The volume of trade and the extent of access to trade finance are key contributors to the growth of the economy of nations even as post World War II global trade has increased resulting in the rise of emerging markets. International trade is imperative due to the obvious interdependence of nations. Trade makes it possible for one country to benefit from the endowments of others and this has been accentuated by the new wave of financial and economic globalisation.

Globalization according to Smith (2002) is the freedom of capital, goods and services and productive capacities to move unfettered across national boundaries. The inherent benefits of globalisation include greater market for export, possibility of increased portfolio investment, possibility of acquiring machines and equipment for productive ventures and the acquisition of new technology/technology transfer due to labour mobility among many others.

It is interesting to note that one of the measures of how well a country's economy is integrated into the global economy is the Participation In International Trade (PIIT) index which is the ratio of the value of imports and exports to its gross domestic product represented thus:  $PIIT = \frac{IM+X}{GDP}$ . Ordinarily, the gains from international trade include:

- a. Possible transfer of technology
- b. Enhancement of global market share
- c. Cost competitiveness in both Countries markets

- d. Stabilization of seasonal market fluctuations
- e. Expansion in domestic business
- f. Improvement in sales and profit

Despite the aforementioned inherent benefits of international trade, many developing countries are not reaping these benefits for different reasons among which is the absence of an adequate trade finance infrastructure being a major barrier to trade and with various negative consequences. Expectedly, trade finance should help in reducing transaction cost and time by streamlining trade procedure and processes but this has been in short supply. Also and unfortunately, most developing countries including Nigeria have largely been exporting primary products and commodities hence making it vulnerable to price volatility and manipulation.

According to Todaro (2000) during the 1990s primary-commodity exports represented over 80% of the total export of Sub-Saharan Africa. This trend has been taken seriously and attempt at reversing it is on-going through the enactment of reforms to restructure the trade policy to engender a win-win situation. Even lately the idea of regional trade is helping to reshape trading patterns among countries. Intra-regional trade like the initiative being pursued in West Africa has resulted in the emergence of regional hubs with South Africa, China and Brazil leading the pack.

Unfavourable terms of trade arising from the high cost of imports when compared with the cost of exports from developing countries is one major issue Nigeria has been grappling with. Most developing countries import raw materials, machines capital goods, intermediate producer goods and consumer products like petroleum products. Hence most developing countries have had to sell more quantity of export to generate enough funds to sustain the needed level of imports due to the unfavourable prices of exports. The social opportunity cost of a unit of import has been so high for most developing economies as their export prices decline relative to import prices. This relationship or ratio between the price of a typical unit of export and the price of a typical unit of import known as the commodity terms of trade has been in favour of developed countries.

The inability of many countries to generate enough revenue from export has led to serious balance of payment problems. The inherent deficit on the current account i.e. an excess of import payments over export receipts for goods and services were usually more than the surplus on the capital account of the balance of payment table i.e. a receipt of foreign private and public lending and investment in excess of repayment of principal and interest on former loans and investments. In many developed nations the agricultural sector is also heavily assisted with subsidies making agricultural products from developing nations less competitive. The fact that production is still largely labour-intensive in many developing countries also has impaired the volume of export. Also, agricultural policy has not been sufficiently aligned or linked with the industrial policy and trade policy. The issue is how best should trade policies be crafted?

There has always been conflicting interest on whether a country should use tariffs as a means of generating revenue or as a means of facilitating trade. Whenever the interest is to facilitate trade, the liberalization of tariffs becomes imperative in order to engender the flow of trade. Now with the on-going second wave of scramble for Africa by China, Europe and America which is not unconnected with the inherent potentials within the continent, African

countries must use trade in fostering international diplomacy to the advantage of her people through intelligent engagements with their trade partners.

## 2.0 The Untapped Potentials of the African Continent

There is no doubt that the African continent holds the key to the next wave of sustainable industrialization and growth to benefit the global economy going by its multiple advantages of high population size of over two billion people, availability of diverse natural resources in major hydrocarbon resources in Nigeria, Cameroon, Ghana, Angola and solid minerals in Southern Africa and East African regions and vast land with relatively clement weather good enough for agriculture. It is this potential that the Chinese have seen that has led to the acquisition of land in Zambia, Nigeria etc and agreements at promoting Chinese language and other partnerships in the African continent. The emergence of a learning economy, the growth of capital market activities and the embrace of information communication technology and the subsequent high degree of info-tech penetration in highly populated countries like Nigeria, Ghana, South Africa and Egypt has prepared a good platform for symbiotic trade collaboration among entrepreneurs in emerging economies and those in developed nations.

Also with the increasing rate of urbanization in Africa with a growing population that needs to be served with goods and services that will improve the quality of life of the people, it is expected that smart entrepreneurs and governments of developed countries will find in Africa the room to expand their productive capacity while countries can expand the scope for the provision of employment for her people.

## 3.0 Literature review on trade, trade finance and economic growth

The theories of trade have been articulated from many perspectives in literature including the perspectives of comparative advantage as it concern resource endowments and cost efficiency/specialization. The concept of relative cost and price difference underscores the rationale for international trade. Hecksher and Ohlin's consideration of differences in factor supplies known as the Hecksher-Ohlin neoclassical factor endowment trade theory has taken trade theory beyond the scope of just labour cost considerations. Their analyses have incorporated the idea of cost and price advantage in other essential factor resources like capital and land and as such developed countries that were considered to be capital abundant countries are supposed to concentrate on the manufacture of capital goods while developing countries considered to be labour abundant countries should concentrate on labour and land intensive primary product export. This proposition however is faulty in my opinion. One question to which answers must be given also is this; Is free trade really free? This is against the backdrop of the possibility of monopoly and the subsidy of production in developed countries.

The argument of the proponents of trade with neoclassical underpinnings with regard to its benefits overstated its advantages. They posited that in free trade all countries gain and global output is increased and that given identical technologies of production throughout the world, the equalization of domestic product price ratio with the international price, trade price ratio will tend to equalize factor prices among trading countries. Also it was believed that international real wage rate and capital costs will ultimately tend towards equalization and as such trade is assumed to enhance more equality in domestic income distribution. In addition, it is believed that by enabling countries to move their production possibility frontier and obtain capital as well as consumption goods from other parts of the world, trade will engender economic growth. While theoretically this may be true, in reality it does not follow.

Many studies have come out with results of the positive impact of trade to economic growth, for example Akpokodje (2009) emphasised that export growth have had a positive impact in catalysing economic growth in many African countries going by the fact that export growth are associated with the periods of gross domestic product growth even if the effect have not been very significant. He posited that Nigeria, Malawi, Zambia, Sierra Leone, Lesotho, South Africa and Ghana recorded increased GDP growth. Nigeria's GDP growth rate improved from an annual average of 0.93% in the 1980s to 3.06% in the 1990s, Malawi's GDP growth increased rose from 1.72 in the 1980s to 4.17% in the 1990s. Exports in Nigeria rose from 7.23% in the 1980s to 9.86 in 2000-2006 while imports growth dropped from 3.48% in the 1980s to -5.51% in 2000-2006. Zambia's exports and imports improved from an annual average growth rate of -2.22% and -2.97% respectively in 1980s to 3.55% and 8.66% in 2000-2006.

Many years back, a lot African countries adopted a strategy of Import Substitution Industrialization (ISI) aimed at producing goods hitherto imported from developed countries with unenviable outcomes when compared with countries in East and South East Asia. According to Babatunde, Onafowora and Owoeye (2009) the better economic performance of the East and South-East Asian countries prompted the International Monetary Fund (IMF) and the World Bank to suggest an outward oriented development strategy to many Sub-Sahara African (SSA) countries which they supposed will enable less developed countries (LDCs) of Africa achieve economic growth propelled by a dynamic and more robust external sector.

Consequently, the structural adjustment programme adopted in the mid-1980s included a huge dose of trade policy reforms with the liberalization of trade through reduction in tariffs and removal of other barriers, since trade was expected to catalyse significant economic growth but this has been a mirage even as export performance has been comparatively low. Nigeria had in the past been part of the agenda of adopting the Economic Community of West African States (ECOWAS) tariff in consonance with the idea of trade liberalization. Within the West African sub-region, promoting integration has been on the front burner. The Common External Tariff (CET) is on-going while negotiations and agreements have also been made in what is known as the African Caribbean Pacific European Union.

Strategic economic initiatives are also being pursued with friendly countries in the West for mutual benefits. One initiative that was funded by the United States Agency for International Development is the Nigeria Expanded Export Programme with the aim of increasing value-added non-oil export of enterprises in selected sectors. The components of the programme included giving technical assistance for access to finance, export competitiveness technical assistance and linkage to broader international markets and partners.

Scholars have put up many anticipated effects of trade liberalization, it's been said that trade liberalization will reduce government revenue, product prices and income of households. According to Kuji (2002) when tariffs are lowered, government import tax revenue is reduced. He also calculated the price elasticities of import and confirmed that they are negative. This is because imported goods became cheaper when compared to domestic goods. The price effect of trade liberalization produces increase in consumption pattern, however, households who are engaged or employed on the production lines of domestic goods that have been displaced by imports experience reduction in income. The reduction in income may after a while lead to a reduction in demand in the long run.

Interestingly, it has also been stated in literature that the static effects of trade liberalization may differ from the dynamic effects as posited by Lofgren (1999). The believe is that with time capital stock and labour supply growth exerts upward pressures on gross domestic product hence it is expected that these will enhance the static gains or reverse the static losses from trade liberalization. In the study by Nwafor, Kanayo and Adenikiju (2009) on the impacts of trade liberalization scheme on poverty in Nigeria, they found that ECOWAS tariff rates brought about mixed results especially as it causes increases in tariffs in some sectors and decrease in others.

Trade flow from many SSA countries are characterised by a shrinking share of SSAs in world trade. The share of SSAs in world export and developed countries export fell from 3.74% and 5.72% to 1.40% and 2.31% respectively between 1980 and 2003. The greed by producers who fix prices and subsidy undermine the capacity of developing countries to compete. There has evidently been unequal trade relation between less developed countries and developed countries. If the trend subsists, the global community will lose out considering the trend of factor mobility within the context of globalization hence a new approach to finance trade is imperative.

Many studies on the determinant of export performance believe that exports are determined by supply-side variables like domestic prices, growth of the gross domestic product, index of variable cost and capacity utilization. Other studies focused on the demand-side determinants of export such as the income and prices in the competitor countries. Since most of the studies took the position of supply side determinants of export performance in which case for an individual developing country, the demand for its' export is infinitely elastic as it were, it then mean for LDC countries to get the most or optimum benefit from their exports, they have to pool their resources and capacity together and form alliances among one another.

With reference to trade finance which are typically short-term and self-liquidating transactions, theoretical and empirical studies have been carried out to explain the causality between trade finance, trade volume and economic growth. In their joint study Kletzer and Bardhan (1987) posited that even in a world in which countries have identical technology or endowments, comparative advantage may differ in the presence of credit market imperfections modelled as both moral hazard in international credit market under sovereign risk and also cross-country differences in credit contract enforcement under incomplete information. Also, Matsuyama (2005) affirmed the aforementioned view but in a different framework using different types of frictions though focusing on a cross-country perspective with representative firms.

#### **4.0 Trade finance and the scramble for Africa: Achieving a win-win situation.**

In the light of the understanding that international trade entails taking risks, the financing aspect is often done with a great sense of caution. The financing need which could be pre-financing shipment or post-shipment financing may be done as a secured loan and lines of credit or where possible in an unsecured manner. How effective trade finance is, is measured by the extent to which risks are minimised. Considering the scramble for Africa and the significance of the need for foreign entrepreneurs to be willing to partner with Africans to achieve a win-win situation an evaluation of the popular approach of trade financing i.e. structured commodity finance is imperative.

According to Bella, Banwo and Ighodalo (2011) structured commodity finance has to do with financing of trade flows and of capital goods while taking security over the goods that constitute the trade flow. Through structured finance, assets that are related to the relevant trade transaction with predictable cash flow can be isolated from the originator (importer or exporter) and used to secure the credit advanced, thus mitigating risks of the originator's default or non-payment. This approach of trade financing can take the form of either import financing collateralized with warehouse receipts or export receivables-backed financing.

In respect of import finance collateralized with warehouse receipts, it is common for banks to secure the financing of international trade by taking pledges over the goods purchased by the importer with credit advanced. With respect to export receivables-backed financing, a loan is granted to an exporter, security is provided by the assignment of export sales contracts and receivables and repayment comes from export proceeds paid by the identified off-takers into a bank account controlled by the bank.

The challenge with the aforementioned approach is that the scope and size of fund that can be accessed is small when compared with what is needed to drive massive internationally trade on a sustainable basis. Hence to achieve a win-win situation the adoption of regional financing of investment will be a better approach in which case for example countries in the West African sub-region can identify companies and countries of common trade interest and pool funds to undertake such trading businesses. The advantage of this approach is that syndicated loans for long term use can be obtained at reduce cost to countries involved in the transaction apart from the fact that better terms of trade can be negotiated with their trading partners.

There is no gainsaying that if foreign trade will be done seamlessly, African businessmen and their governments must begin to do so many things differently. Against the backdrop of how trade is financed and the ability to attract foreign direct investment, Collier and Pattilo (1997) posited that potential investors are exposed to a higher risks in an unstable or volatile macroeconomic environment as it concerns erratic changes in inflation rate, prices and foreign exchange rate. Hence African countries must address the problems of high volatility in exchange rate which impacts negatively on returns to both tradable and non-tradable production (Akpokodje 2009). There has been a significant decline in export growth rate of African countries in the last five years occasioned by increasing exchange rate volatility.

In addition, political stability and other indices for a favourable doing business index such as appropriate contract laws and legislation, procurement procedures, duration of business registration, reasonable tax laws that will enhance long term planning must be pursued especially in the West and Northern parts of the African continent. It is noteworthy to state that despite the potential risk associated with international trade, with the present scramble for the opportunities in the African continent, only businessmen who are willing and ready to take calculated risks will benefit from the huge market and possibilities the continent offers. In clear terms, it is time for astute foreign entrepreneurs to get involved in addressing the challenge of deficit in infrastructure financing.

## 5.0 Recommendations

Many countries have used trade to advance their fortune both economically and politically, and one country that has used her trade policy to advance her political interest very well is the United States of America with reference to policies such as the North American Free

Trade Agreement. Learning from this Nigeria must henceforth scale up her capacity in entering into trade agreements at all levels especially at the multilateral level under the scope of the World Trade Organization. Agencies such as the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN), Bank of Industry, Nigeria Import-Export Bank must synergies their operations to deliver maximum value to Nigeria through her trade engagements. The state of Nigeria's infrastructure should be improved upon if the level of production must also improve and the infrastructure subsector is a huge avenue for foreign investment.

Zero tariffs on industrial and agricultural machineries may be necessary. In tandem with the demand-following postulation of the relationship between financial sector development and economic growth which states that it is the growth of the financial sector and the subsequent supply of finance for trade and investment that propels economic growth, African countries must take advantage of every financing opportunity available. The idea of the free export processing zone that has been embraced by a country like Nigeria should be made more functional through the international collaboration in the area of provision of infrastructure without short-changing domestic business though.

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