

Conclusions

The Mekong-3 – Cambodia, the Lao People's Democratic Republic (PDR) and Viet Nam – are deepening their trade integration, increasing the volume and value of their exports and strengthening their participation in global value chains (GVCs). This expansion of opportunities for new traders in new markets generates expectations of growing demand for trade finance in the coming years.

Free trade agreements recently concluded between Cambodia and China (2021), Viet Nam and the European Union (2020) and the United Kingdom (2021), as well as the Regional Comprehensive Economic Partnership (RCEP), concluded in 2022 between the Association of Southeast Asian Nations (ASEAN) and Australia, China, Japan, the Republic of Korea and New Zealand, will further support these positive trends and create new opportunities to leverage trade for development.

The role of local banks in supporting the internationalization trajectory of the region has been markedly different across the Mekong-3. Although a substantial 20 per cent of local bank assets in Viet Nam is dedicated to trade finance, results of the 2023 IFC survey of trade finance show that banks are more likely to support smaller, local enterprises engaged in intra-regional trade than global trade – with high-value exports in the sectors of electronics and garments relying less on local trade finance. In both Cambodia and Viet Nam, the subsidiaries of multinational enterprises that are driving growth rely less on local bank-intermediated trade finance.

Local trade finance in Viet Nam is therefore more than just a driver of international competitiveness. It also contributes to greater inclusion in the process of internationalization of local production for activities outside the frontier sectors. This is reflected in the simulated estimates of trade finance gaps: raising the coverage of trade by bank-intermediated finance provides the largest contribution to the projected trade increase in Viet Nam; while the share of the electronics sector in total growth is only moderate.

Coordinated action by the corporate sector, financial institutions, national policymakers and international organizations could help to increase the uptake of trade finance in the Mekong-3 and to address the constraints identified in the surveys – specifically, the focus on traditional

trade finance instruments, limited engagement in more dynamic sectors, the lack of relevant market data and greater demand by smaller enterprises. The most effective measures in Viet Nam, and to some extent Cambodia, include:

- diversifying the range of trade finance products;
- strengthening regulatory frameworks;
- broadening the local customer base for trade finance to small and medium-sized enterprises (SMEs);
- improving banks' agility, risk management capacity and international relationships.

In Cambodia and the Lao PDR, actions could focus on the expansion of traditional trade finance instruments such as letters of credit and basic capabilities of banks, without neglecting ways to promote the use of innovative instruments. Supporting evidence-based solutions would be a prerequisite for any initiative involving the improvement in trade finance markets in the Mekong-3.

Diversifying the range of trade finance products

The characteristics of the local banking sector in Viet Nam suggest clear actions that could improve access to trade finance. Geared towards SMEs that are developing their linkages (including connections with foreign direct investors), banks and traders in Viet Nam would benefit from the development of less-traditional trade finance instruments, such as supply chain finance (SCF), which is currently in only limited use.

A number of more innovative digital products at a nascent stage of development in the Mekong region could be supported to reduce overhead costs and to improve access to trade finance. Examples include: promoting common sector-level operating infrastructure (e.g. dedicated electronic platforms) and services for new trade finance instruments; building market awareness; and strengthening the capacity of key stakeholders, including banks and other supply chain participants, to offer and take advantage of related opportunities.

Strengthening regulatory frameworks

Regulatory conditions may inadvertently generate barriers and additional risk for financial institutions, which might then result in firms being excluded from trade finance. The absence of a well-defined legal framework tends to cause banks to be more cautious about taking on risks and less inclined to introduce new products that could even enhance their ability to cater to local markets.

The Mekong-3 governments can review and update the regulations governing both traditional and new trade finance instruments, collateral requirements, digital transactions, central bank conditions and accountability frameworks. A recent successful intervention in this area has been in the Philippines, which adopted a regulatory framework to develop SCF products, including a secured transactions law – the Personal Property Security Act – considered one of the best in the region, and a central online collateral registry.

The expansion of innovative trade finance products will require broader action at the government level. The impact of the COVID-19 pandemic and rising inflation – both of which constrict banks' capacity to meet demand – can be addressed, for example, by expanding guarantees, risk-sharing facilities and syndication arrangements.

Broadening the local customer base for trade finance to SMEs

Banks should be encouraged to expand their customer base of SMEs in dynamic sectors such as chemicals and machinery, as well as of local suppliers to mega firms in electronics, to support the internationalization of the local economy. SMEs would benefit from greater awareness of how to engage with providers of trade finance and the different products available.

Successful interventions include Pakistan, where risk mitigation technical assistance for extending additional financing to new clients has helped banks pilot payable finance programmes to enhance access to finance for SMEs. Knowledge sharing and advisory services were essential complements and resulted in significantly improved access to trade finance for SMEs in the automotive, construction and manufacturing sectors in the country.

Technological solutions could also help banks to develop more sophisticated internal credit risk assessment systems for smaller companies and new entrants in the trade finance markets. Financial institutions can develop specialized tools and rely more on digitalization – a higher level of which could help to reduce the processing costs of trade finance instruments, which remain high among lower-income countries in the region.

Improving banks' agility, risk management capacity and international relationships

Improving banks' agility, risk management capacity and international relationships would allow financial institutions to expand their reach to riskier segments of new traders, active in less well-known product markets or in new destinations. Banks might not be able to compete for lower cost of funds alone; their strength thus lies in their capacity to provide effective services for high-value traders in dynamic routes.

One distinguishing feature of the electronics sector, for example, is its short product life cycle, which demands rapid capital turnover. Local banks should become more effective in this market. A large number of development finance institutions engaged in the region, such as in China and smaller trade-dependent economies, focus on this type of capacity building through dedicated advisory services.

Expanding traditional trade finance instruments and basic capabilities of banks

In Cambodia and the Lao PDR, the capacity of the local banking system to support the internationalization of the economy is more limited than in Viet Nam. Actions in these two countries could focus on the expansion of traditional trade finance instruments such as letters of credit and basic capabilities of banks, without neglecting ways to promote the use of innovative instruments such as SCF to facilitate the integration of local traders into GVCs.

The expansion of traditional trade finance instruments and basic capabilities of banks would involve actions such as liquidity support, updating regulatory frameworks, setting up mechanisms for collecting market intelligence

and assessing risks, as well as expanding correspondent banking relationships. International institutions could support governments and banks with compliance training in areas such as trade-based money laundering. This could help to reassure correspondent banks on counterparty risk and help local lenders to build larger networks.

Supporting evidence-based solutions

Supporting evidence-based solutions is a prerequisite for any initiative involving the improvement in trade finance markets. Despite data collection and analytical studies – including this publication – examining trade finance, evidence on the size of the trade finance gaps and its determinants in emerging markets remains scarce. Additional efforts are needed by all stakeholders, including development finance institutions, to improve understanding of the market, both its failures and its potential.