

Executive summary

Cambodia, the Lao People's Democratic Republic (PDR) and Viet Nam – referred to here as the Mekong-3 – have established themselves as one of the most dynamic and trade-led regions of the world. In 2022, the value of trade flows surpassed GDP in all three economies. The trade-to-GDP ratio was particularly high in Cambodia and Viet Nam at over 210 and 185 per cent, respectively – several times higher than the global average of 62 per cent. The value of total trade flows has tripled in Cambodia and Viet Nam and more than doubled in the Lao PDR in the past decade.

The rapid trade growth reflects a complex web of domestic and international factors. The integration into global supply chains has been a key driver of trade growth and development, underpinned by better export performance and a favourable environment for foreign direct investment. Cambodia and Viet Nam have also benefited from the relocation of production away from economies with higher manufacturing costs, trade diversion linked to trade conflicts between large countries and the fostering of foreign investment.

However, trade growth in Cambodia and Viet Nam has not been even. It has followed a two-speed trajectory, with exports from subsidiaries of foreign-owned firms outpacing exports from locally owned supply chains. Foreign investments, most notably in the electronics and garment sectors, have in the past decade shifted the structure and direction of imports and exports in favour of these products, towards large suppliers (China) and buyers (United States) who now jointly account for over 40 per cent of the region's total trade.

As a result, exports in a narrow set of activities controlled by foreign subsidiaries outpace exports from locally owned supply chains, for example in (agri-)food and fisheries, industrial parts and manufactures, where growth has also been strong and a source of economic diversification for these countries. Viet Nam's import and export product basket is the largest and most diversified, expanding recently into chemicals, machinery and electric batteries. Starting from a lower base, the respective import and export baskets of Cambodia and the commodity-oriented Lao PDR have been diversifying faster than Viet Nam's.

A question is the extent to which the local financial sector has contributed to the integration and internationalization prospects of the region. In 2023, the IFC conducted a survey of banks in the Mekong-3 and a second survey of hundreds of traders in Viet Nam to gather information on trade finance needed by exporters and importers. The surveys revealed that local trade finance is not only relatively scarcely used in the Mekong-3 but also segmented and traditional. In terms of size, coverage of trade, sector diversity and range of trade finance instruments, Viet Nam's trade finance market can be regarded as more advanced.

In 2022, Vietnamese banks supported 21 per cent of the country's exports and imports, with funds representing 22 per cent of the country's total banking assets. The local banking sector in Cambodia supported a much smaller share of the country's import-export operations, some 3 per cent of total trade, accounting for only 2.5 per cent of banks' total assets. These numbers are low – not only compared to developed country levels of 60-80 per cent but also relative to the coverage of trade recorded in other developing regions, such as West Africa.

Viet Nam's local trade finance market is estimated at US\$ 150 billion in value, about 100 times that of Cambodia, at US\$ 1.6 billion, even though the difference in trade flows is only 12 to 1. Data collected for the Lao PDR suggest that local trade finance supports an even smaller share of trade than Cambodia. Moreover, while the distribution of trade finance between imports and exports is relatively balanced in Viet Nam, with assets concentrating on intermediate goods and inputs, in Cambodia and the Lao PDR trade finance is mainly supplied for imports, notably goods for wholesale distribution and construction.

The segmentation of local trade finance markets in Viet Nam follows the dynamics of trade in reverse: high-growth and high-value exports of electronics and garments production tend to rely less on local trade finance. Local banks are more likely to support intra-regional trade than global trade operations. Lacking more evidence, the existence of alternative, foreign supply chain finance (SCF) arrangements provided by large multinational companies to their subsidiaries and

tier 1 suppliers may explain the limited share of trade finance provided by local banks. However, it is unlikely that local, lower-tier suppliers within foreign-controlled supply chains benefit from such SCF. This would be even more unlikely in the case of Cambodia and the Lao PDR.

Removing constraints to trade finance would significantly boost trade flows further and increase trade inclusiveness. Data collected from banks and traders surveyed in the Mekong-3 were analysed with the WTO Global Trade Model. According to the simulations for Cambodia and Viet Nam, increasing the coverage of trade by local trade finance by an additional 20 percentage points while reducing the cost of loans and letters of credit to international benchmarks would raise imports by more than 5 and 6 per cent, respectively, and raise exports by more than 8 and 9 per cent annually. This corresponds to annual increases in merchandise trade of more than US\$ 3.5 billion in Cambodia and US\$ 55 billion in Viet Nam.

Improving the coverage of trade by bank-intermediated finance holds the greatest potential to expand trade. The sectors delivering the largest contribution are textiles, wearing apparel and leather. The electronics sector plays a moderate role in this expansion owing to large shares of related-party trade (i.e. trade with subsidiaries of multinational enterprises and large conglomerates), which are less likely to use domestic trade finance. The trade partners that stand out as the largest beneficiaries of this scenario are China and East and Southeast Asia on the import side and Europe (for Cambodia) and North America, China and East Asia (for Viet Nam) on the export side.

Increasing the share of trade supported by local trade finance would require local supply and demand constraints be addressed. The surveys point to macroeconomic constraints weighing on both the demand and supply of trade finance, such as persisting disruptions to mobility and operations due to the impact of the COVID-19 pandemic, inflation and limited availability of low-cost funding. Structural constraints include the lack of information about new trade finance instruments, and for which technical and financial assistance is sought. High collateral requirements and onerous application processes are moreover highlighted by hundreds of traders as reasons for not approaching banks in Viet Nam.

Women find it more difficult than men to access trade finance. Only four in ten banks in the survey report that they provide trade finance to women-owned or led small and medium-sized enterprises (SMEs). The gender disparity

in access to trade finance appears more accentuated in Cambodia and the Lao PDR, where only 37 per cent and 33 per cent of banks, respectively, report allocating trade finance to women-owned or led SMEs, compared to 47 per cent in Viet Nam. However, over half the banks in the Mekong-3 do not track whether or not they provide trade finance to female entrepreneurs, which makes it difficult to capture fully the gender gap in accessing trade finance.

Only a small fraction of the banks surveyed fund climate-related trade activities. The share of banks in the Mekong-3 which report that they provide trade finance to climate-related trade activities is low. Only 11 and 29 per cent of the banks in Cambodia and Viet Nam, respectively, report that they provide trade finance to climate-related trade activities. Of the banks surveyed in the Lao PDR, none reports providing trade finance for this category of trade activity.

Harnessing trade opportunities through global value chains (GVCs) and expanding into new products will also require deeper and more diverse trade finance markets. The bank survey confirms the prevalence of traditional trade finance instruments (letters of credit and other guarantees, pre-export loans), routinely provided by nearly all banks involved in trade finance.

Short-term working capital lines are often used by importers and exporters as a substitute to more structured and documented trade finance instruments – particularly in Cambodia, where 40 per cent of total trade finance is provided in this form. Working capital loans are preferred for their flexibility but are also typically more expensive and accessible only to clients with sufficient land or building collateral.

Innovative trade finance instruments are still nascent: although a quarter of banks surveyed envisage expanding its provision within the next two years, SCF currently supplied by local banks in Cambodia and Viet Nam accounts only for 2 per cent of available trade finance. The potential for growth stems from the fact that, while SCF is provided by foreign banks to large subsidiaries of foreign firms for the export of finished products, the number of local producers of parts and components not involved in such arrangements but involved in international trade is growing.

In general, unlocking meagre cash resources trapped in those supply chains is a necessity for local firms – particularly SMEs – to survive, invest and move-up technologically within the value chain. However, many of them still do not have access to

trade finance, as exemplified by the low share of trade covered by trade finance. At best, some firms will have access only to expensive working capital.

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. The most effective measures vary by country. In Viet Nam and to some extent Cambodia, they include: diversifying the range of trade finance instruments; strengthening the regulatory framework; broadening the local customer base for trade finance to SMEs; and improving banks' agility, risk management capacity and international relationships.

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 the case of 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 smaller, local producers into GVCs. Examples of successful engagements of development finance institutions in other countries in Asia suggest that progress towards these objectives is possible. Making data available to support decision-making, offering a modern and predictable legal framework on recourse for SCF creditors and providing for effective enforcement of rules for collateral could all significantly broaden access to trade finance in the Mekong-3.

SCF expansion is a priority given the region's growing integration into GVCs. This will require technological solutions and training for staff in managing credit risk, which according to the survey is in demand. Technological solutions could also facilitate the adoption of supply chain mapping and digital financing, while simultaneously helping banks to develop more sophisticated internal credit risk assessment systems for SMEs and new entrants in the trade finance markets.

A higher level of digitalization could help to reduce the processing costs for trade finance, which remain high in less developed countries of the Mekong region. Banks and other institutions can also provide training and outreach to firms currently excluded, to better inform them of which trade finance solutions are available and help them access markets.

Further evidence-based studies of trade finance and additional efforts by the research community would be welcome in identifying markets where shortages occur and the potential for trade finance expansion exists. This present study on the Mekong-3 and the earlier IFC–WTO study on West Africa outline how trade finance can lead to increased trade inclusion and economic integration for countries with different trade structures and comparative advantages. They serve as guides to explain how the level of development of domestic financial sectors and their orientation towards cross-border transactions impact the ability of economies to participate more fully in the global trading system.