Trade Finance: Contractual Terms and the Primacy of Institutions

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The primacy of institutions

- Institutions *versus* geography
- Institutions are the key factor that determines economic development outcomes
- Indicators include things such as protection against expropriation risk or legal origins
- Trade, and trade finance, do not escape from this general principle

Lessons from the economics of contracts

- In economic analysis, a contractual relationship involves two issues:
  - Risk-sharing
  - Informational asymmetries
- Informational asymmetries come in two forms
  - Moral hazard
  - Adverse selection
- All are present in trade finance contracts
  - Tradeoffs determine the contractual form that is chosen

Contractual forms in trade finance and contract theory

- Contractual forms

1. Cash in advance
2. Open account
3. Letter of credit
4. Documentary collection

- How do they vary in terms of risk-sharing and asymmetric information issues?

Available evidence

1. Financial intermediation by banks is relatively infrequent
2. Long-term relationships between importers and exporters reduce cash in advance transactions
3. The institutional environment of the importing country is key

Low hanging fruit for the Swiss financial sector?

- Institutional quality and contractual enforcement
- Targeting letters of credit and documentary collection: banking fees are the key factor
- Financial development: effect of presence of foreign banks is significantly larger in countries with low levels of financial development
- Correspondent banks in developing countries