The Role of Islamic Trade Finance in the Development of SMEs in IDB Member Countries

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Introduction

- Trade is an exchanging of goods and services between people, firms and governments.
- Permissible business in Islam
- Trade finance refers to the financing of imports and exports
- Represents one of the major challenges facing SMEs to penetrate and compete in the international markets.
- SMEs have lower capital and hence higher risks and less competitiveness compared to the bigger firms
SMEs have been given more attention

These characteristics enable the SMEs to play major and essential role for economic prosperities

<table>
<thead>
<tr>
<th>Company category</th>
<th>Employees</th>
<th>Turnover or Balance sheet total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium-sized</td>
<td>&lt; 250</td>
<td>≤ € 50 m ≤ € 43 m</td>
</tr>
<tr>
<td>Small</td>
<td>&lt; 50</td>
<td>≤ € 10 m ≤ € 10 m</td>
</tr>
<tr>
<td>Micro</td>
<td>&lt; 10</td>
<td>≤ € 2 m ≤ € 2 m</td>
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</tbody>
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The role played by the SMEs

- SMEs are playing vital roles:
- diversification of economy
- promoting economic growth and social development
- creating employment
- contributing in innovation and new product
- help in export market expansion due to their aggressiveness
Why SMEs Essential for IDB MCs

- MCs SMEs help IDB in promoting their economic growth
- providing more jobs in their boarders to curb down the high unemployment
- This help eradicating the poverty
- SMEs contributed more than 40% in employment and more than 30% in the economic growth
- SMEs are more labor intensive; the direct support from the member countries and the IDBG
The role of Islamic trade finance in the development of SMEs in IDBMCs

- Islamic trade finance might refer to financing import and export through Islamic financing methods and instruments.
- Trade finance becomes more complicated due to shortage of liquidity and scarce financial resources.
- SMEs have lower capital, high risk and less competitiveness and hence low bargaining power.
- Islamic trade finance becomes the legitimate alternative to provide SMEs (given recent Crisis).
Trade Infrastructure Development IDB MCs

- The quality and the development of the basic utilities such as energy, water, transportations (land and rivers), warehouses, rural infrastructure, and low cost technologies are very essential for the Islamic trade finance.
- The well-developed infrastructure enables SMEs to access trade financing and to promote business at low cost.
- Efforts needed to improve trade infrastructure of the majorities of its member particular the poor countries in Southern and Central Asia and Sub-Saharan Africa.
The OIC report showed that located in Central Asia and Sub-Saharan had:
- thirteen of its countries no energy project
- eighteen no transport infrastructure
- thirty-eight had no water and sewage

for the recent past twenty years (1990 - 2010).

Most of these OIC countries are having poor resources, civil wars, high political risks or high cost of unskilled labor to develop alone their trade infrastructure
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Government revenue depends on tariff and tax

These create trade barriers to the development of the SMEs

The inexistence of encouraging climate to attract direct foreign investment or private sector to participate in the development of their low quality trade infrastructure
So the undeveloped infrastructure represent one of the major obstacles which hinder Islamic trade finance to play appositive role in the development of the SMEs.

It raises the cost of transportations, cost of insurances, costs of financing and reduced the competitiveness of the SMEs to access the large markets.
Easy and smooth accessing Islamic trade finance required from IDBMCs to develop an adequate Islamic trade finance infrastructure.

The impact of trade finance infrastructure is not less than the trade barrier.

Islamic trade infrastructure includes Islamic financial instruments, institutions, Islamic laws and regulations.
Many Islamic trade financing instruments have developed to facilitate pre-shipping and post-shipping financing.

Islamic trade financing instruments help the SMEs to improve their competitiveness and mitigate their risk.

SMEs need Islamic instruments: working capital, manage their trading risk or settling their payment.
Pre-shipping Financing Instruments

- Pre-shipment includes procuring and processing of the goods, transportation, payment of insurances, salary and wages, insurance and freight charges
- Istisna'a: used by the SMEs either to increase working capital or to make pre-shipping financing
- Murabahah: SMEs can use it for acquiring assets or working capital
- Bay' Bithaman Ajil (BBA) used for refinancing of assets or working capital
Post-shipping Financing Instruments

- post-shipment Islamic financing: financing granted to the exporter by buying their shipping documents
- Help SMEs in the payment of the suppliers, salaries and wages, utility.
Islamic Financing Instruments to Mitigate Risks

- SMEs like any other business have to manage their expected trading risks if they can survive.
- SMEs face financing accessing risk, economic risks, exchange rate risk, transportation risk, and political risks.
- In IDB MCs the SMEs might suffer political risks such as the war, restrictions, embargo, and capital control.
Islamic instruments for risk management

- Islamic Cross Currency Swap (ICCS) in Islamic finance is resembled the hedging

- Islamic insurance, bank guarantee, Islamic documentary of collections such as Inward Bills for Collection–i (IBC-i), Outward Bills for Collection–i (OBC-i), LC-I, Trust Receipt (TR-i) and bank guarantee
Other Islamic Financing Infrastructure

- Islamic financial Institutions:
  - development of Islamic Financial Institutions to support or provide finance to SMEs

- Islamic laws and regulations:
  - development of a favorable macroeconomic and legal environment for Islamic trade finance
Despite the existence of Islamic financing instruments but not widely used to finance the SMEs.

Inadequacy in Financial Infrastructure: in most IDB member countries

There are two main problems in financial Infrastructure

1. absence of specific accounting standards for SMEs, to help in accessing financing

2. the absence of a centralized registry system for collaterals within the banking system
Other factors related to the infrastructures and constrained the growth of the SMEs:

- Inadequate skills of workers, and entrepreneurs.
- Limited R&D and innovation,
- Transparency issues
- Unavailability of long term finance
Challenges facing SMEs in IDBMCS

- SMEs nowadays are facing more internal and external challenges.
- The recent financial crisis has constrained the SMEs due to the shortage of funding.
- Prevent SMEs from investing in assets for growth, innovation and research and development, which slowed its growth.
- The challenge of the infrastructure development.
- The regulations and the effective implantation of trade rules (mixed laws).
arbitrary customs valuation,
subjective interpretations,
and arbitrary decisions of clearance goods through customs,
technical barriers,
laws and regulations regarding the various rules of trade
represent the most obstacles for the development of SMEs in IDBMCs
SMEs have much little resources to bear the cost of trade barriers
lack of strong government support increases the business and financial risk for these SMEs
Summary and Conclusion

- Eliminating trade barriers, bureaucratic and regulations that involve hindrances to trade and eventually constrain the development of SMEs
- MCs must improve the trade infrastructure to reduce the cost of Islamic trade financing for the SMEs
- Efficient supporting services and payment mechanism
- Improve Islamic trade infrastructure
- Initiate strong government support for the SMEs
- Need IDB intervention (Directly the ICD, ICEIC, IFSD) or indirectly through reverse linkages
Thanks