

CHAPTER 13

Financing Foreign Trade

Opening Case 13: US Export–Import Bank Seeks Private Investors

The official US export finance agency is seeking private investors to help it provide billions of dollars in loan guarantees and risk insurance for American exporters. On February 16, 2000, the Export–Import Bank (Ex–Im Bank) asked investment banks, commercial banks, insurance companies, and other financial institutions for proposals on how they might share the risks and rewards from future Ex–Im Bank financial deals. The Ex–Im Bank, which supported almost \$17 billion in US sales overseas in 1999, hopes to raise \$1 billion or more through this new proposal.

In essence, the Ex–Im Bank wants to sell, to one or more partners, stakes in future export-financing deals, in the hopes of making its own resources go further at a time when the US trade deficit is piling on the records. The agency is leaving it up to the private financial institutions – American or foreign – to come up with a creative way to structure the deal. The idea is for a private partner to put a certain amount of money or credit at Ex–Im Bank’s disposal, and then share in Ex–Im Bank’s fees. The financial institution might limit how that investment can be used – perhaps setting a dollar limit for a particular country – but not approve or reject individual Ex–Im Bank decisions.

In an unusual move, the agency put 1,500 pages of its own financial and institutional information on a website to make it easier for potential investors to perform due-diligence research. Hoping for quick action, the Ex–Im Bank held a pre-proposal conference on March 7, 2000. Ex–Im Bank officials first conceived of the idea in 1997. Private institutions showed interest, but pulled back soon after the Asian financial crisis sent US banks and investors fleeing the developing markets. Ex–Im Bank revived the concept after the crisis subsided.

Source: M. M. Philips, “Ex–Im Bank Seeks Investors for Guarantees,” *The Wall Street Journal*, Feb. 16, 2000, p. B10.

This book emphasizes financial problems that arise when managing multinational operations. However, the financial manager of a multinational company (MNC) must be familiar with certain mechanics of financing foreign trade, because most MNCs are frequently engaged in foreign trade activities.

This chapter consists of three major sections. The first section discusses three basic documents involved in foreign trade: the draft, the bill of lading, and the letter of credit. The second section analyzes the various payment terms of foreign trade. The third section describes the major sources of financing foreign trade.

● 13.1 Basic Documents in Foreign Trade

Three important documents involved in foreign trade are:

- 1 A draft, which is an order to pay.
- 2 A bill of lading, which is a document involved in the physical movement of the merchandise by a common carrier.
- 3 A letter of credit, which is a third-party guarantee of the importer's creditworthiness.

13.1.1 *Basic objectives of documentation*

Documentation in foreign trade is supposed to assure that the exporter will receive the payment and the importer will receive the merchandise. More specifically, a number of documents in foreign trade are used to eliminate noncompletion risk, to reduce foreign-exchange risk, and to finance trade transactions.

NONCOMPLETION RISK The risk of noncompletion is greater in foreign trade than in domestic trade. This is why exporters want to keep title to the goods until they are paid and importers are reluctant to pay until they receive the goods. Foreign trade and domestic trade use different instruments and documents. Most domestic sales are on open-account credit. Under this credit, a buyer does not need to sign a formal debt instrument, because credit sales are made on the basis of a seller's credit investigation of the buyer. Buyers and sellers are typically farther apart in foreign trade than in domestic trade. Thus, the sellers are seldom able to ascertain the credit standing of their overseas customers. The buyers may also find it difficult to determine the integrity and reputation of the foreign sellers from whom they wish to buy. Much of this non-completion risk is reduced through the use of three key documents: the draft, the bill of lading, and the letter of credit.

FOREIGN-EXCHANGE RISK Foreign-exchange risk arises when export sales are denominated in a foreign currency and are paid at a delayed date. In international trade, the basic foreign-exchange risk is a transaction risk. Transaction risk is the potential exchange loss from outstanding obligations as a result of exchange rate fluctuations. Forward contracts, futures contracts, currency options, and currency denomination practices can be used to reduce foreign-exchange risk associated with foreign trade.

TRADE FINANCING Because all foreign trade involves a time lag, funds are tied up in the shipment of goods for some period of time. Most trade transactions are free of noncompletion and foreign-exchange risks due to well-drawn trade documents and forward contracts. Banks are thus willing to finance goods in transit or even prior to shipment. Financial institutions at both ends of the cycle offer a variety of financing alternatives that reduce or eliminate either party's (exporter or importer) working capital needs.

13.1.2 Drafts

A **draft** or a **bill of exchange** is an order written by an exporter that requires an importer to pay a specified amount of money at a specified time. Through the use of drafts, the exporter may use its bank as the collection agent on accounts that the exporter finances. The bank forwards the exporter's drafts to the importer directly or indirectly (through a branch or a correspondent bank) and then remits the proceeds of the collection back to the exporter.

A draft involves three parties: the drawer or maker, the drawee, and the payee. The **drawer** is a person or business issuing a draft. This person is ordinarily the exporter who sells and ships the merchandise. The **drawee** is a person or business against whom the draft is drawn. This person is usually an importer who must pay the draft at maturity. The **payee** is a person or business to whom the drawee will eventually pay the funds. A draft designates a person or bank to whom payment is to be made if the draft is not a negotiable instrument. Such a person, known as the payee, may be the drawer himself or a third party such as the drawer's bank. However, this is generally not the case, because most drafts are a bearer instrument. Drafts are negotiable if they meet a number of conditions:

- 1 They must be in writing and signed by the drawer–exporter.
- 2 They must contain an unconditional promise or order to pay an exact amount of money.
- 3 They must be payable on sight or at a specified time.
- 4 They must be made out to order or to the bearer.

If a draft is made to order, the funds involved should be paid to the person specified. If it is made to the bearer, the funds should be paid to the person who presents it for payment.

When a draft is presented to a drawee, the drawee or his bank accepts it. This acceptance acknowledges in writing the drawee's obligation to pay a sum indicated on the face of the draft. When drafts are accepted by banks, they become bankers' acceptances. Because bankers' acceptances are highly marketable, the exporter can sell them in the market or discount them at his bank. Whenever they are sold or discounted, the seller adds his endorsement on the back of the draft. In the event an importer fails to pay at maturity, the holder of the draft will have recourse for the full amount of the draft from the last endorser.

Drafts are used in foreign trade for a number of reasons:

- 1 They provide written evidence of obligations in a comprehensive form.
- 2 They allow both the exporter and the importer to reduce the cost of financing and to divide the remaining cost equitably.
- 3 They are negotiable and unconditional; that is, drafts are not subject to disputes that may occur between the parties involved.

TYPES OF DRAFTS Drafts can be either sight (demand) drafts or time (usance) drafts. A sight draft is payable upon demand to the drawee–importer. Here the drawee must pay the draft immediately or dishonor it. A time draft is payable a specified number of days after presentation to the drawee. When a time draft is presented to the drawee, she may have her bank accept it by writing or stamping a notice of acceptance on its face. When a draft is drawn on and accepted by a bank, it becomes a bankers' acceptance.

Drafts may also be documentary drafts or clean drafts. Documentary drafts require various shipping documents, such as bills of lading, insurance certificates, and commercial invoices. Most drafts are documentary, because all these shipping documents are necessary to obtain the goods shipped. The documents attached to a documentary draft are passed on to an importer either upon payment (for sight drafts) or upon acceptance (for time drafts). If documents are to be delivered to an importer upon payment of the draft, the draft is known as a D/P (documents against payment) draft. If the documents are passed on to an importer upon acceptance, the draft is called a D/A (documents against acceptance) draft.

When a time draft is accepted by an importer, it becomes a trade acceptance or a clean draft. When clean drafts are used in foreign trade, the exporter usually sends all shipping documents directly to the importer and only the draft to the collecting bank. In this case, the goods shipped are surrendered to the importer regardless of payment or acceptance of the draft. The clean draft, therefore, involves a considerable amount of risk. This is why clean drafts are generally used in cases in which there is a considerable amount of faith between the exporter and the importer, or in cases in which multinational firms send goods to their foreign subsidiaries.

13.1.3 *Bills of lading*

A **bill of lading** is a shipping document issued to an exporting firm or its bank by a common carrier that transports the goods. It is simultaneously a receipt, a contract, and a document of title. As a receipt, the bill of lading indicates that the specified goods have been received by the carrier. As a contract, it is evidence that the carrier is obliged to deliver the goods to the importer in exchange for certain charges. As a document of title, it establishes ownership of the goods. Thus, the bill of lading can be used to insure payment before the goods are delivered. For example, the importer cannot take title to the goods until she obtains the bill of lading from the carrier.

TYPES OF BILLS OF LADING Bills of lading are either straight bills of lading or order bills of lading. A straight bill of lading requires that the carrier deliver the goods to the designated party, usually the importer. It is used when the goods have been paid for in advance; thus, it is not a title to the goods. An order bill of lading provides that the carrier deliver the goods to the order of a designated party, usually the exporter. The exporting firm retains title to the goods until it receives payment. Once payment has been made, the exporting firm endorses the order bill of lading in blank or to its bank. The endorsed document can be used as collateral against loans. It accompanies a documentary draft that requires such other documents as the bill of lading, commercial invoices, and insurance certificates. The procedures to handle these two types of bills of lading are well established. Commercial banks and other financial institutions in almost every country handle these documents efficiently.

Bills of lading can also be either on-board bills of lading or received-for-shipment bills of lading. An on-board bill of lading indicates that the goods have actually been placed on board

the vessel. On-board bills of lading are important because some insurance coverage, such as war risk, is effective only if goods are on board. By contrast, a received-for-shipment bill of lading merely acknowledges that the carrier has received the goods for shipment but does not guarantee that the goods have been loaded on the vessel. The cargo could sit on the dock for some time before it is shipped. This bill of lading is thus unsatisfactory when seasonal or perishable goods are involved. A received-for-shipment bill of lading can easily be converted into an on-board bill of lading by an appropriate stamp that shows the name of the vessel, the date, and the signature of an official of the vessel.

Finally, bills of lading may be either clean bills of lading or foul bills of lading. A clean bill of lading suggests that the carrier has received the goods in apparently good condition. The carrier does not have any obligation to check the condition of the cargo beyond external visual appearance. On the other hand, a foul bill of lading bears a notation from the carrier that the goods appeared to have suffered some damage before the carrier received them for shipment. Because a foul bill of lading is generally not acceptable under a letter of credit, it is important that the exporter obtains a clean bill of lading.

13.1.4 *Letters of credit*

A **letter of credit** is a document issued by a bank at the request of an importer. In the document, the bank agrees to honor a draft drawn on the importer if the draft accompanies specified documents such as the bill of lading. In a typical use, the importer asks that his local bank write a letter of credit. In exchange for the bank's agreement to honor the demand for payment that results from the import transaction, the importer promises to pay the bank the amount of the transaction and a specified fee.

ADVANTAGES OF LETTERS OF CREDIT The letter of credit is advantageous to both exporters and importers because it facilitates foreign trade. It gives a number of benefits to exporters. First, they sell their goods abroad against the promise of a bank rather than a commercial firm. Because banks are usually larger and have better credit risks than most business firms, exporters are almost completely assured of payment if they meet specific conditions. Second, they can obtain funds as soon as they have such necessary documents as the letter of credit and the bill of lading. When shipment is made, the exporter prepares a draft on the importer in accordance with the letter of credit and presents it to his local bank. If the bank finds that all papers are in order, it advances the funds – the face value of the draft less fees and interest.

Although its major beneficiaries are exporters, the letter of credit also gives a number of benefits to importers. First, it assures them that the exporter will be paid only if he provides certain documents, all of which will be carefully examined by the bank. If the exporter is unable or unwilling to make proper shipment, recovery of the deposit is easier from the bank than from the exporter. Second, the letter of credit enables the importer to remove commercial risk to the exporter in exchange for other considerations. Thus, the importer can bargain for better terms, such as a lower price. Moreover, it is less expensive to finance the goods under a letter of credit than by borrowing.

TYPES OF LETTERS OF CREDIT Letters of credit can be irrevocable or revocable. Most credits between unrelated parties are irrevocable. An irrevocable letter of credit can be neither cancelled

nor modified by the importer's bank without the consent of all parties. A revocable letter of credit can be revoked or modified by the importer's bank at any time before payment. This letter of credit is used as a method of arranging payment, but it does not carry a guarantee of payment. Most banks do not favor revocable letters of credit; some banks refuse to issue them because they may become involved in resulting litigation.

Letters of credit may also be confirmed or unconfirmed. A confirmed letter of credit is a letter of credit confirmed by a bank other than the issuing bank. An exporter might want a foreign bank's letter of credit confirmed by a domestic bank when the exporter has some doubt about the foreign bank's ability to pay. In this case, both banks are obligated to honor drafts drawn in accordance with the letter of credit. An unconfirmed letter of credit is a guarantee of only the opening bank. Thus, the strongest letter of credit is a confirmed, irrevocable letter of credit. Such a letter of credit cannot be canceled by the opening bank, and it requires both the opening and confirming banks to guarantee payment on drafts issued in connection with an export transaction.

Finally, letters of credit are either revolving or nonrevolving. A revolving letter of credit is a letter of credit whose duration may revolve weekly or monthly. A \$50,000 revolving credit, for example, might authorize an exporter to draw drafts up to \$50,000 each week until the credit expires. The revolving letter of credit is often used when an importer must make frequent and known purchases. However, most letters of credit are nonrevolving. In other words, letters of credit are typically issued and valid for a single transaction – one letter for one transaction.

13.1.5 *Additional documents*

In addition to the three documents described here – the draft, the bill of lading, and the letter of credit – other documents must generally accompany the draft as specified in the letter of credit. Some additional documents commonly required in international trade are commercial invoices, insurance documents, and consular invoices. These and some other documents are required to obtain the goods shipped; they are also essential to clear the merchandise through customs and ports of entry and departure.

THE COMMERCIAL INVOICE Issued by the exporter, a **commercial invoice** contains a precise description of the merchandise, such as unit prices, quality, total value, financial terms of sale, and shipping features. Some shipping features are FOB (free on board), FAS (free alongside), C&F (cost and freight), and CIF (cost, insurance, freight). The commercial invoice may also include some other information, such as the names and addresses of both the exporter and the importer, the number of packages, transportation and insurance charges, the name of the vessel, the ports of departure and destination, and any export or import permit numbers.

INSURANCE DOCUMENTS All shipments in international trade are insured. Most insurance contracts used today automatically cover all shipments made by the exporter. The risks of transportation range from slight damage to total loss of merchandise. In most cases, insurance coverage, provided by the carrier up to the port of destination, is sufficient. But most ocean carriers do not have any responsibility for losses during the actual transportation, except for those directly attributed to their negligence. Therefore, some form of marine insurance should be arranged to protect both the exporter and the importer. Additional coverage ranges from such limited coverage as collision, fire, and sinking to the broad coverage of all risks.

CONSULAR INVOICES Exports to many countries require a **consular invoice** issued by the consulate of the importing country. The consular invoice provides customs officials with information and statistics for the importing nation. More specifically, a consular invoice is necessary to obtain customs clearance; it also provides customs officials with information necessary to assess import duties. The consular invoice does not carry any title to the goods, and it is not negotiable.

OTHER DOCUMENTS Other documents might be required by the importer or might be necessary in clearing the goods through ports of entry or exit. These documents include certificates of origin, weight lists, packing lists, and inspection certificates. A certificate of origin certifies the country in which the goods are grown or manufactured. A weight list itemizes the weight of each item. A packing list identifies the contents of individual packages. An inspection certificate is a document issued by an independent inspection company to verify the contents or quality of the shipment.

13.1.6 *A typical foreign trade transaction*

As shown in figure 13.1, there are many steps and documents in the entire process of completing a foreign trade transaction. Each step or document is a subsystem of the entire transaction process, which itself is closely connected by a variety of other subsystems. Thus, the successful completion of a trade transaction may be viewed as an integral unit of many parts, which are directly or indirectly interrelated. A typical trade transaction might require the following 14 steps:

- 1 Importer places an order for a \$1 million worth of machines, with an inquiry if Exporter is willing to ship under a letter of credit.
- 2 Exporter agrees to ship under a letter of credit and thus Importer arranges to have its bank open a letter of credit in favor of Exporter.
- 3 Importer's bank issues the letter of credit (L/C) in favor of Exporter and sends it to Exporter's bank.
- 4 Once Exporter's bank receives the L/C, it will notify Exporter.
- 5 Exporter ships the machines to Importer through a common carrier that issues an order bill of lading.
- 6 Exporter prepares a 60-day draft on Importer in accordance with the L/C and presents it to Exporter's bank along with such other documents as the bill of lading. At the same time, Exporter endorses the order bill of lading so that a title to the machines goes with the holder of the documents.
- 7 Exporter's bank forwards the draft and other documents to Importer's bank for acceptance. When the draft is accepted by Importer's bank, it becomes a bankers' acceptance (B/A). This means that Importer's bank has promised to pay the draft in 60 days.
- 8 Exporter instructs its bank to have the B/A discounted by Importer's bank. Alternatively, Exporter's bank receives the B/A from Importer's bank and then it may sell the B/A to an investor at a discount. Another alternative is that Exporter's bank may hold the B/A for 60 days and present it to Importer's bank for payment.
- 9 If Exporter's bank has discounted the B/A with Importer's bank, it transfers the proceeds less any fees and discount to Exporter.

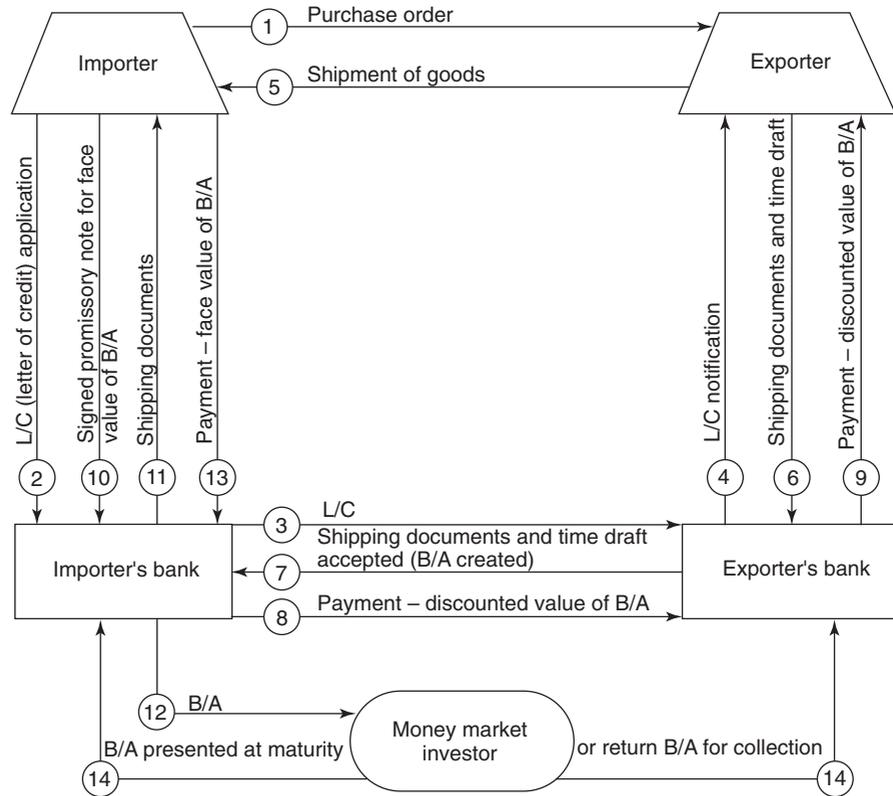


Figure 13.1 The process of a typical trade transaction

- 10 Importer's bank notifies the arrival of the documents to Importer. Importer signs a promissory note to pay its bank for the machines in 60 days.
- 11 Then Importer's bank releases the shipping documents so that Importer can claim the shipment.
- 12 Importer's bank may sell the B/A in the money market to an investor.
- 13 In 60 days, Importer's bank receives the funds from Importer to cover the maturing B/A.
- 14 On the same day, the holder of the B/A presents it to Importer's bank for payment. Or, the holder of the B/A may return it to Exporter's bank for collection through normal banking channels.

● 13.2 The Payment Terms of Export Transactions

Because trade competition has become increasingly severe, MNCs must know how best to finance their foreign trade. The terms and conditions under which foreign trade takes place vary significantly. They range from cash before delivery to sales in a foreign currency with credit terms over

1 year. Supply and demand conditions at the time of sale determine the actual terms and conditions of any particular transaction. But most foreign transactions involve longer credit terms than domestic transactions.

13.2.1 Countertrade

Countertrade refers to world trade arrangements that are variations on the idea of a barter. Modern countertrade covers various international trade arrangements in which the sale of goods and services by an exporter is linked to an import purchase of other goods and services. It became popular in the 1960s and 1970s as a way for communist countries to finance their international trade without money. In recent years, countertrade has gained new stature in international trade.

World trade continues to grow faster than world production because of increased countertrade. Unfortunately, no reliable figures on the volume of countertrade are available, because there is so much secrecy involved. In the 1980s and 1990s, countertrade increased within the nonsocialist world. In 1972, there were just 14 countries engaged in countertrade. By 1979, the list had increased to 27 countries, by 1984, 88, by 1989, 94, and by 1995, over 140 countries (Stevens 1995). The countries engaged in countertrade today range from developing nations, such as China and India, to industrialized nations, such as the United Kingdom and Japan. By the year 2000, the International Monetary Fund, the World Bank, and the US Department of Commerce estimated that countertrade would account for half of all world trade transactions (Anyane & Harvey 1995).

There is no way to determine the actual magnitude of countertrade, but some analysts estimate that it accounts for a third of world trade. In the past, the United States and international organizations frowned on countertrade as an inefficient form of commerce. However, the USA has been forced to recognize the cold fact that countertrade is growing in importance. The Omnibus Trade and Competitiveness Act of 1988 created a Finance and Countertrade Division within the International Trade Administration of the Department of Commerce, to monitor trends for government. The Countertrade Division also disseminates information to US companies concerning countertrade opportunities and assists firms desiring to engage in countertrade commerce.

We discuss several forms of countertrade below: simple barter, the clearing arrangement, the switch trade, counterpurchase, the compensation agreement, and the offset agreement.

SIMPLE BARTER Foreign trade, like domestic trade, is conducted in terms of money. However, foreign trade without money is possible through a barter system. **Simple barter** is a direct exchange of goods between two parties without the use of any currency as a medium of exchange. Most barter arrangements are one-time transactions carried out under a single contract. Barter terms are usually arranged between two countries on a bilateral trading agreement. For example, in one recent year General Electric traded its turbine generator to Romania in exchange for Romanian products.

Of course, individual transactions are made within the framework of intergovernmental trade agreements. Such barter deals are popular among nonmarket countries. Barter deals allow countries with a shortage of foreign exchange to obtain their deficit goods in return for their surplus goods. They also allow companies in countries that are short on foreign currency to obtain goods that they would not be able to obtain otherwise.

THE CLEARING ARRANGEMENT A **clearing arrangement** is a form of barter in which any two countries agree to buy a certain amount of goods and services from one another within a given period of time. Both parties set up clearing accounts with each other that are debited whenever one country imports from the other. At the end of an agreed-upon period of time, any account imbalances are cleared by a hard-currency payment or by the transfer of additional goods.

Payments for exports to nonmarket countries are often made through clearing arrangements whereby sales are balanced with purchases from importing countries. This clearing arrangement has led to many bilateral trading agreements that try to identify the goods each country will trade and to set overall trade limits. For instance, in 1994, China and Saudi Arabia had a clearing agreement of \$1 billion to exchange goods and services. Their agreement contained a provision that any account imbalances would be settled for hard currency.

THE SWITCH TRADE A **switch trade** is a trading arrangement under which a third party purchases any account imbalance between the two countries. In other words, the third party will purchase the imbalance from the surplus country on behalf of the deficit country; the imbalance is then resold. Thus, switch trading is not really a separate form of countertrade but, rather, the inclusion of a middleman who serves to multilateralize the barter arrangement. The basic purpose of switch trading is to eliminate the imbalance in barter trade between two countries. Unfortunately, one of the countries frequently fails to sell sufficient goods to its trading partner. In this case, a shortage in clearing funds will be incurred for the deficit country. Hence, one country becomes a creditor, and the other becomes a debtor. When this occurs, the bilateral trading agreement tends to break down.

A breakdown is harmful to both countries, but there are two practical methods to avoid this breakdown. First, the bilateral trading agreement may specify that the debtor country pay amounts in excess of the allowable variations in the form of gold or convertible currency to the creditor country. This type of solution is known as a clearing arrangement. Second, to reconcile the imbalance in barter transactions between the two countries, they may agree to utilize a switch trade broker.

Example 13.1

Assume that Russia has agreed to trade its machinery for Cuban sugar. Russian machinery and Cuban sugar are then given arbitrary unit prices in clearing dollars. The agreement specifies that \$1 million in commodities will be exchanged during the following year. By the end of the year, Russia finds that it has accumulated \$400,000 in unneeded sugar.

To meet its obligations as well as to dispose of the unwanted goods, Russia may seek the services of a switch trader. Russia calls one of the switch trade brokers and offers her \$400,000 worth of sugar in the clearing account at a discount of 30 percent. Once the actual value of the sugar has been ascertained by the broker, she calls sugar dealers who might pick up the credit. Eventually, she finds a buyer who offers 75 percent of the credit. Russia receives 70 percent of its \$400,000 credit in hard currency for the unneeded sugar, the broker takes 5 percent on the deal, and the buyer purchases the sugar for \$400,000

minus a 25 percent discount. Russia, the switch-trade broker, and the buyer benefit from the deal, but Cuba may find that it has undersold its sugar in the world sugar markets by the unexpected dumping of its own goods.

COUNTERPURCHASE This form of countertrade typically takes place between a Western industrial country and a Third World country. A **counterpurchase**, also known as an “indirect offset,” involves a standard hard-currency export, but the seller agrees to a return purchase of goods and services that are not directly related to the goods that the seller sold. For example, General Motors (GM) may agree to sell 500 passenger cars to Poland for \$10 million and to buy \$2 million worth of Polish coal within a 2-year period.

The seller is frequently forced to buy some goods that are not easily marketable in its country. Thus, in our example, for GM to cover its potential losses, it could demand marketable goods or increase its prices. If GM charges 15 percent more for its cars, it can buy back a comparable percentage of worthless goods. Another alternative available to GM is to assign its obligation to other Western companies or export trading companies that may market these counterpurchases more readily.

THE COMPENSATION (BUYBACK) AGREEMENT A **compensation agreement** is an agreement by an exporter of plant and/or equipment to receive compensation in the form of future output from that plant. Examples of buyback transactions include Japan’s recent agreements with Taiwan, Singapore, and Korea to exchange its computer chip production equipment for computer chips produced by the plant as full or partial payment.

A typical buyback transaction involves very large expenditures and a long-term time frame for fulfillment. Thus, such an arrangement has attributes that make it an alternative form of direct investment. The value of the buyback agreement normally exceeds the value of the original sale.

THE OFFSET AGREEMENT Frequently called “direct offset,” an **offset agreement** is an arrangement similar to the counterpurchase, but the seller is required to use goods and services from the buyer country in the final product. In other words, under an offset agreement, the seller is required to offset the purchase price of the buyer in some way.

For decades, foreign buyers of US arms mostly wanted to help the US seller build the planes, missiles, or other weapons being sold to reduce the purchase price. Since the mid-1980s, buyers have increasingly wanted commercial and military technology to broaden the purchaser’s economy. In fact, such contracts and technology transfers now occur in aerospace, transportation equipment, and electrical equipment. The terms of the offset on individual contracts may vary substantially. The most common categories of offsets are coproduction, licensed production, subcontractor production, overseas investment, and technology transfer.

AN EVALUATION OF COUNTERTRADE Hennart (1989) studied 1,277 countertrade trade contracts between June 1983 and December 31, 1986. These 1,277 transactions consisted of 694 for clearing arrangements, 298 for counterpurchases, 171 for batters, 71 for buyback agreements, and 43 for offset agreements. Hennart found that each country grouping had a tendency to engage in certain types of countertrade transaction. Oil-exporting and -developing countries used

more counterpurchases, centrally planned economies engaged in more buyback agreements, and developed and middle-income countries utilized more offset agreements. Barter was most common between two middle-income countries, between developed and middle-income countries, and between middle-income countries and centrally planned economies. The study by Marin and Schnitzer (1995) is consistent with Hennart's findings.

In theory, countertrade is a movement away from free trade. This form of trade often forces some MNCs to set up operations to deal in products very remote from their expertise. Countertrade is also inflexible and involves a limited range of products.

Nevertheless, several reasons have been suggested for the current growth of countertrade. They include: (1) limited access to hard-currency finances; (2) the opening of new markets; (3) the use of countertrade as an alternative to direct investment; (4) the avoidance of trade restrictions; (5) the fulfillment of state planning goals; and (6) the disposal of surplus and poor quality goods.

13.2.2 *Cash terms*

Cash terms may be either COD or CBD. COD terms mean cash on delivery of the goods, and CBD terms mean cash before delivery of the goods. Under either COD or CBD terms, an exporter does not extend credit. Although credit risk does not exist under either terms, COD terms are accompanied by a risk that an importer may refuse a shipment, while CBD terms avoid all risk. Under CBD terms, an exporter may insist on cash at the time of order or he may specify the time of cash payment prior to shipment. Another possible arrangement is that a part of the payment is made at the time of order, that progress payments are made between the time of order and the time of shipment, and that the final payment is made just before the release of goods to a common carrier.

Cash terms are the exception in these days of severe international competition. An importer does not like cash-type transactions, although such transactions are ideal from the exporter's point of view. One reason for this dislike is that an importer is forced to accept all risks in transit, in exchange fluctuations, and in the quality of the goods received. Consequently, the exporter will insist on cash terms only in instances of the importer's poor credit standing or extreme political risks in the importing country. If the sale involves products specially manufactured for the importer, the exporter may demand some kind of advance-payment arrangement.

13.2.3 *Consignments*

Goods for export may be consigned to a subsidiary, the exporter's own agent, an independent agent, or an import house. Assume that an exporter in New York ships, to an importer in London, 100 cases of quart bottles on a consignment basis. A **consignment** is the delivery of goods into the possession of another for the purpose of sale. Because the exporter pays all the expenses connected with the shipment, the importer incurs no expenses at the time this shipment is delivered to her warehouse. Actually, the 100 cases of bottles are still on the exporter's inventory. Thus, if the importer should fail, the exporter can demand that all the unsold bottles be returned to him.

Let us further assume that this consignment arrangement has a 10 percent commission on all bottles sold. If the importer sold all of the 100 cases at \$50 per case, she would deduct her com-

mission of \$500 ($100 \times \50×0.10) and remit to the exporter a dollar draft for \$4,500 on a New York bank.

A consignment to an independent agent or an import house has most of the same problems as an open-account transaction. Hence, this type of operation is usually confined to companies that are working together very closely or that completely trust each other.

13.2.4 *Credit terms*

Most importers are not required to pay for goods before or on delivery, but they are allowed a short postponement period before payment is made. During this period, the exporter extends one of three types of credit to the importer: (1) open account, (2) notes payable, and (3) trade or bankers' acceptances.

OPEN ACCOUNTS Credit of this sort does not require the importer to sign a formal debt instrument as evidence to the amount that she owes the exporter. The importer simply charges her purchases, much in the same fashion that domestic retail stores extend credit to their customers. Then the importer's account is carried on the books of the exporter like other receivables. This arrangement places the entire financial burden upon the exporter. Because banks usually refuse to advance against accounts receivable, this ties up large amounts of the exporter's capital. In addition, with this arrangement the exporter assumes the risks of foreign-exchange blockage and buyer default. Therefore, open-account terms are extended only to trusted customers in countries that have no foreign-exchange or political problems.

PROMISSORY NOTES In some export transactions, promissory notes are given instead of open-account credit. In this case, the importer is requested to sign a **promissory note** that provides evidence of her debt to the exporter. Thus, this arrangement makes the importer recognize her debt formally. The note calls for the payment of the obligation at some future date.

TRADE ACCEPTANCES A trade acceptance is a form of short-term financing common in almost all foreign trade activities. In fact, it is the largest source of short-term funds for importers. Under this method of financing, the exporter draws a draft on the importer, ordering her to pay the draft at some specified future date. The exporter will not release the goods until the importer accepts the draft. When the importer accepts the draft, it becomes a **trade acceptance**. When a bank accepts the draft, it becomes the bankers' acceptance.

THE COST OF THE CASH DISCOUNT FORGONE Most credit terms include a net period that refers to the period of time allowed for payment. The terms "net 30" mean that the invoice price must be paid within 30 days. The terms "2/10, net 30" indicate that a 2 percent discount is offered if payment is made within 10 days; otherwise, the full amount of the bill must be paid within 30 days. The annual interest cost of the cash discount not taken may be computed as follows:

$$\frac{\text{percent cash discount}}{100 - \text{percent cash discount}} \times \frac{360}{\text{net credit period}}$$

Thus, the annual interest cost of forgoing the terms “2/10, net 30” is:

$$\frac{2}{100-2} \times \frac{360}{20} = 36.73\%$$

Here we have used 360 days rather than 365 as the number of days in the year, for ease of calculation. If 365 days are used, the cost of the cash discount forgone increases to 37.24 percent. It is also important to note that the cost of the cash discount forgone is not an explicit cost associated with trade credit, but an implied cost.

COLLECTING OVERDUE ACCOUNTS Normally, between 1 percent and 3 percent of a company’s exports go uncollected. Small exporters, however, take more risks than do larger ones, for a number of reasons. First, they are eager to develop new market opportunities. Second, they often sell on terms other than a confirmed letter of credit. Third, they are not as well versed with the mechanics of foreign sales. Consequently, their percentage of uncollected export sales may be higher than that of large exporters (see *Global Finance in Action 13.1*).

To establish clear-cut procedures for past-due accounts, the exporter must decide how overdue it should allow an account to become before collection procedures are started. If collection procedures are begun too early, they may be too expensive in terms of both out-of-pocket expenditures and lost goodwill to the additional revenues that may be gained. As an account becomes older, however, it becomes more expensive and more difficult to collect.

Once an account becomes delinquent, exporters have three options. Exporters will attempt to collect overdue accounts themselves by letters, phone calls, telexes, and/or personal visits. If all these attempts to collect overdue accounts fail, exporters can turn over the account to a collection agency or take direct legal action against the account. However, both alternatives are extremely costly in terms of both out-of-pocket costs and the customer relationship.

Global Finance in Action 13.1

Pitfalls for Small Exporters

Rotary Corporation is a medium-sized US company that supplies aftermarket outdoor power equipment parts and accessories. The company now delivers parts to customers in more than 48 foreign countries, as it explores avenues to maintain a worldwide presence in the outdoor power equipment industry. There are lessons from Rotary’s success that may help other small and medium-sized companies develop international sales. Rotary avoided nine common pitfalls to global expansion by stressing the “three Cs” of international commerce: commitment, customers, and cultural sensitivity.

Four pitfalls in the area of commitment are: (1) insufficient commitment by top management to overcome the initial difficulties and financial requirements of exporting; (2) failure to obtain qualified export counseling and obtain a master international marketing plan before starting an export business; (3) failure to use an export management company; and (4) failure to consider licensing or joint venture agreements.

Two pitfalls in the area of customer relations include: (5) insufficient care in selecting overseas distributors; and (6) chasing orders around the world, instead of establishing a basis for profitable operations and orderly growth. Three pitfalls in the area of cultural sensitivity are: (7) failure to assist vendors in complying with the North American Free Trade Agreement; (8) failure to treat international distributors on an equal basis with domestic counterparts; and (9) failure to print service, sales, and warranty messages in local languages, or to modify products to meet cultural preferences in other countries.

Source: L. B. Fletcher, L. S. Hamilton, and L. T. Denton, "Exporting the Right Way," *Strategic Finance*, July 1999, pp. 26–30.

● 13.3 Sources of Financing Foreign Trade

Banks, private nonbank financial institutions, and governments pool their resources to finance foreign trade. Banks finance foreign trade through a variety of methods. Export trading companies, factoring, and forfaiting are also used to finance foreign trade. The Export–Import Bank and the Private Export Funding Corporation are major forces in helping US exporters sell their goods and services to foreign buyers.

13.3.1 Bank financing

Banks are important lenders to those engaged in international trade. They provide several forms of credit that are convenient to exporters and importers, including trust receipts, bankers' acceptances, loans to exporters, and loans to importers.

TRUST RECEIPTS When goods are shipped under a time draft, the importer generally signs a **trust receipt** that collateralizes the draft by the goods, and establishes that borrowers hold certain goods in trust for the lender. The document provides that the importer will be the agent of her bank in the sale of the goods. The bank retains title to the goods until the importer has made full settlement. The importer is allowed to sell the goods but must turn the proceeds of the sale over to the bank in payment of the loan. The bank assumes any losses that occur under a trust receipt.

BANKERS' ACCEPTANCES We can best explain how this method of financing operates with the following illustration. Assume that a Detroit firm desires to import a \$10,000 shipment of perfumes from a French firm. The French firm is willing to grant a 60-day credit. The Detroit firm may arrange to have its Detroit bank open a letter of credit in favor of the French firm. The letter of credit states that the Detroit bank will honor drafts drawn on the Detroit firm if they are drawn in accordance with detailed terms in the letter of credit. When shipment is made, the French firm prepares a 60-day draft on the Detroit firm and presents it to its French bank. The

French bank will advance the euro equivalent of \$10,000, less interest and fees, to the French firm. Then the French bank will forward the draft, along with such shipping documents as the bill of lading, to its Detroit correspondent bank which, in turn, will present it to the Detroit firm's bank for acceptance. If all papers are found to be in order, the Detroit bank accepts the draft and it becomes a bankers' acceptance. Thus, **bankers' acceptances** are drafts accepted by banks.

Because bankers' acceptances are of very high quality, the French bank can easily arrange its sale and thus recover the funds it advanced. If the French firm did not discount the draft at its French bank, it could sell the draft to an investor at a discount. The Detroit firm obtains the credit it wants, and the risks with the exception of the accepting bank are minimal. The credit transaction is completed when, in 60 days, the Detroit bank, which looks for repayment, pays the bankers' acceptance by the Detroit firm.

Example 13.2

An exporter has a \$10,000 bankers' acceptance for 6 months, the acceptance fee is 1 percent per year, and the discount rate on this bankers' acceptance is 12 percent per year. If the exporter chooses to hold the bankers' acceptance until maturity and then collect, it will receive the face amount less the acceptance fee:

Face amount of the bankers' acceptance	\$10,000
Less: 0.5% acceptance fee for 6 months	<u>50</u>
Amount received by exporter in 6 months	\$9,950

Alternatively, the exporter can sell the bankers' acceptance at a 6 percent discount rate (12 percent ÷ 2) and receive \$9,350 immediately:

Face amount of the bankers' acceptance	\$10,000
Less: 0.5% acceptance fee for 6 months	50
6% discount rate for 6 months	<u>600</u>
Amount received by exporter immediately	\$9,350

LOANS TO EXPORTERS AND IMPORTERS Bankers' acceptances are a form of bank loan to exporters. Banks can also make loans to exporters by cashing, purchasing, discounting, and collecting drafts. Banks cash drafts if the drafts are denominated in local currency and are drawn on time. They purchase drafts if the drafts are denominated in foreign currencies. In this case, drafts are generally exchanged for local currency at an appropriate exchange rate. They discount drafts if the drafts are denominated in local currency and if the terms of the sales involve time drafts. When banks collect drafts,

they simply act as agents for exporters. However, they may lend against either the total or a percentage of the drafts outstanding.

13.3.2 *Other private financing*

Some popular forms of other private financing consist of export trading companies, factoring, and forfaiting.

EXPORT TRADING COMPANIES In October 1982, President Reagan signed into law the **Export Trading Company Act**, to help small and medium-size firms sell their goods overseas. Originally, the Export Trading Company Act was conceived as the US answer to highly successful Japanese trading companies, which handle most of that country's exports.

The Export Trading Company Act of 1982 removed two major barriers that had long put US exporters at a disadvantage. First, this Act allows bank holding companies, previously barred by Federal regulations from investing in commercial enterprises, to invest in export trading companies. Second, it permits competing companies to join for export purposes without fear of antitrust ramifications. An export trading company (ETC) must obtain certification from the Secretary of Commerce that it will not restrain domestic or export trade of the USA. When the Secretary of Commerce notifies the Attorney General of certification, the ETC is exempted from both criminal antitrust prosecution and the Bank Holding Company Act, so long as its activities conform to those described in the certification.

Export trading companies engage primarily in two forms of activity: trade intermediation and export outlets for US manufacturing companies. In their role as trade intermediaries, export trading companies can provide small and medium-size firms with comprehensive "one-stop" services, such as market analysis, distribution services, documentation, financing, foreign-exchange transactions, transportation, and legal assistance. They can buy products from other US companies and export these products either through their own outlets or to outside distributors.

FACTORING **Factors** buy a company's accounts receivable largely on a nonrecourse basis and thus accelerate the conversion of the company's claims against its customers. "Nonrecourse" means that the factor has no right to claim reimbursement from the seller of accounts receivable if the seller's customers fail to pay their bills. Factors perform a number of additional functions such as credit checking, bookkeeping, collecting accounts, and risk bearing. The factor reviews the credit of the borrower's customers and establishes credit limits in advance. The maximum amount of advance against uncollected accounts receivable is established as a percentage of the invoice value. The factor receives an interest charge on the daily balance of advances plus a commission for credit analysis, bookkeeping, collecting accounts, and risk taking.

Exporters may turn to a factor when they have difficulty collecting on open-account sales or when their bank is unwilling to collect notes receivable. Factors' rates on foreign accounts are usually higher than those of banks. Thus, factors are frequently used as a last resort by exporters who need funds badly and/or have almost no hope of collecting.

The factor's credit investigation of the exporter's customers is relatively quick and inexpensive. For this reason, even if the exporter does not discount his accounts receivable, he can still use the factor's facilities to estimate his prospective accounts' creditworthiness. If the exporter discounts his accounts receivable on a nonrecourse basis, the factor will assume all commercial

and political risks of nonpayment. For these services, factors charge a commitment fee of 1–2 percent and a rate of interest in excess of the prime lending rate.

In June 1999 the Factors Chain International, the world's largest network of factoring companies, reported that 700 factors from 50 countries had financed \$500 billion worth of exports in 1998. An exporter's use of factors depends on two considerations. The first consideration is whether the exporter can perform credit evaluation functions as well as the factor. Because large international factors evaluate the same customer for many companies, they build credit files and expertise, allowing them to evaluate credit at a lower cost than the exporter. The second consideration is whether the availability of funds and the interest charged by alternative sources are more attractive than those offered by the factor.

Example 13.3

An exporter has recently sold its accounts receivable of \$10,000 to a factor. The factor advances 80 percent of the receivables, charges 1 percent interest per month, and charges a 2 percent factoring commission (a one-time charge). Both the interest and the commission are paid on a discount basis.

The exporter's net proceeds are computed as follows:

Face value	\$10,000
Less: 20% reserve due from factor	2,000
2% factoring fee	<u>200</u>
Funds available for advance	\$7,800
Less: 1% interest on advance	<u>78</u>
Net proceeds from advance	\$7,722

Hence, the exporter receives a cash advance of \$7,722 now and expects to recover the \$2,000 reserve later. The annualized cost of factoring the accounts receivable is 14.71 percent $[(\$200 + \$78 \times 12)/(\$7,722)]$.

FORFAITING Because capital goods such as plants and airplanes are quite expensive, the importer may not be able to make payment on the goods within a short period of time. Thus, long-term financing may be required on some international trade of capital goods. The exporter could finance such a sale, but may not desire to do so because its credit may extend over several years.

A forfaiting transaction involves an importer that issues a promissory note to pay for the imported goods over a period of 3–5 years. The notes are extended to the exporter, who sells them at a discount to a forfaiting bank. The importer will make semiannual payments during the period to the forfaiting bank. In other words, a **forfaiting** transaction refers to the purchase of financial obligations such as promissory notes without recourse to the exporter. The forfait-

Table 13.1 Differences between factoring and forfaiting

<i>Factoring</i>	<i>Forfaiting</i>
Occasionally with recourse	Always without recourse
Maturity of 6 months or less	Maturity of 6 months to 10 years
Ongoing, revolving deals	One-time deals
Works with consumer goods	Works with capital goods
Avoids developing countries	Works well in developing countries
Less expensive	More expensive

Source: G. S. Hill and K. Tanju, "Forfaiting: What Finance and Accounting Managers Should Know," *Financial Practice and Education*, Fall/Winter 1998, pp. 53–8.

ing markets, centered in London and Zurich, are largely free of government support, supervision, or regulation.

A typical forfaiting transaction involves four parties: the importer, the exporter, a bank, and the forfaiter. The importer pays the exporter with promissory notes that will mature at set intervals over a several-year period. A bank in the importer's country then guarantees these promissory notes; those notes guaranteed by a bank are usually irrevocable, unconditional, and transferable. The exporter in turn sells the guaranteed paper to the forfaiter at a discount from the face value; the amount of discount depends on the importer's credit rating, the guaranteeing bank's credibility, and interest costs over the paper's lifetime. As the paper matures, the forfaiter or the holder of the paper presents it to the guaranteeing bank for payment.

The forfaiting arrangement allows the exporter to avoid most risks involved in his export sales. However, this financing method has a number of drawbacks. First, the amount of the discount can be quite large. Second, the guaranteeing bank normally charges a substantial fee and places a freeze of equal value on the importer's account. Third, the exporter still faces some risk if the bank guarantor and/or the importer refuses to pay on the ground that the notes have some hidden legal defect.

The value of world exports financed through forfaiting arrangements reached about \$30 billion in 1998. Conceptually, forfaiting is a form of factoring. Factoring is normally used for short-term, relatively small deals with repeat customers. Forfaiting, on the other hand, is typically used for medium-term, one-time major deals up to \$100 million in size. Table 13.1 shows the major differences between these two forms of export financing.

13.3.3 *Export financing methods in practice*

To determine the usage of major export-financing vehicles, Ricci and Morrison (1996) surveyed treasurers of Fortune 200 companies in 1995. They received a 63 percent response rate from their questionnaire. These two researchers found that Fortune 200 companies exhibit a high degree of internationalization: more than 98 percent sell overseas.

Table 13.2 shows how frequently large US MNCs used the six export-financing methods described in this chapter: the open account, letters of credit, drafts, cash in advance, factoring, and consignment. Open accounts and letters of credit were the most frequently used methods.

Table 13.2 The usage of export-financing methods

<i>Method</i>	<i>Often</i>	<i>Sometimes</i>	<i>Rarely</i>	<i>Never</i>
Open account	52.1%	34.5%	10.1%	3.4%
Letters of credit	43.5%	46.8%	7.3%	2.4%
Drafts	13.2%	52.9%	27.3%	6.6%
Cash in advance	12.5%	41.7%	40.0%	5.8%
Factoring	2.6%	13.0%	34.8%	49.6%
Consignment	1.7%	15.4%	51.3%	31.6%

Source: C. W. Ricci and G. Morrison, "International Working Capital Practices of the Fortune 200," *Financial Practice and Education*, Fall/Winter 1996, pp. 7–20.

Because both methods provide significant benefits to importers, US MNCs appear to increase their export sales by offering attractive terms to foreign customers. About half of the respondents reported that they sometimes used drafts and cash in advance.

13.3.4 Government financing

The USA has several government sources of export financing: the Export–Import Bank (Ex–Im Bank), the Private Export Funding Corporation, and the Foreign Credit Insurance Association.

THE EXPORT–IMPORT BANK (EX–IM BANK) The bank was founded in 1934 as an independent agency of the US government. It is a financially self-sustaining agency, set up to promote US exports through a variety of export financing and loan guarantees. The creation of the Foreign Credit Insurance Association (FCIA) in 1963 completed the triad of official loan, guarantee, and insurance offerings demanded by US exporters. Ex–Im Bank officials have fully managed these three basic export-finance programs since the bank took over the FCIA in 1983. Ex–Im Bank operations must conform to the two general guidelines. First, loans must be used exclusively to finance the export of goods and services of US origin. Second, loans should have reasonable assurance of repayment and related transactions should not adversely affect the US economy.

The Ex–Im Bank was originally created to facilitate trade with the former Soviet Union, but its purpose has been expanded over the years. It now finances US exports to Russia and many other countries through a variety of loan and guarantee programs, such as direct loans, discount loans, cooperative financing facility, and guarantees.

THE PRIVATE EXPORT FUNDING CORPORATION (PEFCO) The corporation was created in 1970 at the initiation of the Bankers' Association for Foreign Trade, with the support of the US Treasury Department and the US Ex–Im Bank. The basic purpose of the PEFCO was to mobilize private capital in order to finance US exports of big ticket items such as aircraft and power plants. PEFCO's stockholders consist of 54 commercial banks, seven large manufacturers, and one investment banker. All of PEFCO's loans are guaranteed by the Ex–Im Bank and are general

obligations to the USA. Thus, the PEFCO itself does not evaluate credit risks of foreign borrowers, economic conditions in foreign countries, and other factors that might affect the collection of its loans. Most PEFCO loans have medium-term maturities of 7 years, but some have maturities over 15 years.

THE FOREIGN CREDIT INSURANCE ASSOCIATION (FCIA) Most exporters sell under letters of credit, as described in the earlier part of this chapter. In this type of sale, banks assume all risks in export transactions except for transactions under revocable letters of credit. However, importers frequently do not want to open letters of credit because of the cost or difficulty of securing them. At other times, under severe competition, exporters must sell on open account or on draft terms without letters of credit. Under these circumstances, an exporter could suffer heavy losses even after carefully examining an importer's creditworthiness. These losses may develop from such situations as expropriation and riots beyond the control of the exporter or the importer.

The governments of most industrial countries have helped their exporters in many ways over the years. Although the US Ex-Im Bank had helped US exporters reduce their risks since 1934, they still lacked the protective umbrella that many of their competitors were enjoying. In the fall of 1961, the Secretary of the Treasury, the Ex-Im Bank, and 50 leading insurance companies organized the **Foreign Credit Insurance Association (FCIA)**.

The FCIA provided credit protection for US exporters. It insured exporters for an agreed percentage of losses from credit risks, whether they were commercial, political, or both. Commercial risks included such risks as the failure of an importer before payment and its protracted payment default. Political risks included currency inconvertibility, cancellation of import licenses, expropriation, and war or revolution. But in October 1983, 41 of the original FCIA members withdrew from the association because of heavy commercial losses, particularly in Mexico. Since October 1983, the Ex-Im Bank itself has insured exporters against both commercial and political risks, leaving the FCIA to operate as its marketing and service agent. The Ex-Im Bank credit protection program for exporters covers short-term cases of up to 180 days and medium-term cases of 181 days to 5 years.

SUMMARY

This chapter has discussed various documents and operations essential to finance foreign trade. The extension of credit on foreign trade is of critical importance to both exporters and importers in a transaction. For exporters, their willingness and ability to extend credit are crucial determinants of sales volume across national boundaries. For importers, their ability to continue operations relies on the lag between payments by their customers and remittances to their foreign suppliers.

The three basic documents used in normal export-import transactions are the draft, the bill of lading, and the letter of credit. A draft is an order written by an exporter that requires the importer to pay a specified amount at a specified time. A bill of lading is a shipping document issued to the exporting firm by a common carrier that transports the goods. In the document, the bank agrees to honor a draft that results from an import transaction by a foreign buyer. The letter of credit assures that there will be payments for goods shipped to the importer.

Some forms of countertrade such as barter and switch trading make international transactions possible without money. However, most transactions across national boundaries are conducted in

terms of money. The payment terms of foreign trade include cash terms, consignments, and credit terms, all of which require money. The actual payment terms of exports depend largely upon competitive conditions prevailing at the time of initiating the transaction.

Finally, this chapter has examined a number of private and government sources to finance foreign trade. Banks are important lenders to those engaged in foreign trade. Bank-financing operations include trust receipts, bankers' acceptances, and several other forms of loans. In addition to bank financing, there are several other sources of private financing. The Export Trading Company Act of 1982 allows bank holding companies and other financial institutions to set up trading companies for export purposes. International factors buy accounts receivable from exporters and then collect them as they become due. Finally, forfaiting can be used to finance capital goods such as power plants and airplanes. Under a typical arrangement, an exporter receives immediate cash by discounting its promissory notes or trade receivables to a forfaiting bank.

The Ex-Im Bank is the only US government agency established solely to facilitate the foreign trade of the USA. It is also a major force for helping US exporters reduce their commercial and political risks. The Private Export Funding Corporation finances US exports of aircrafts and other big ticket items.

Questions

- 1 What are the objectives of documentation in international trade?
- 2 What are bills of lading and how do they facilitate trade financing?
- 3 The basic problem in assessing different forms of export financing is how to distribute risks between the exporter and the importer. Explain the following export financing documents in this respect:
 - (a) the time draft;
 - (b) the sight draft;
 - (c) the confirmed, revocable letter of credit;
 - (d) the confirmed, irrevocable letter of credit;
 - (e) cash before delivery;
 - (f) cash on delivery;
 - (g) consignment;
 - (h) open-account credit.
- 4 In addition to the draft, the bill of lading, and the letter of credit necessary in foreign trade, other documents must generally accompany the draft as specified in the letter of credit. Such other documents include commercial invoices, insurance documents, and consular invoices. Briefly describe each of these three documents.
- 5 What is countertrade?

- 6 What are bankers' acceptances? What are the advantages of bankers' acceptances as an export-financing instrument?
- 7 What are the major elements of the 1982 Export Trading Company Act? What are the major objectives of the Act?
- 8 What is the role of a factor in foreign trade? How can a factor aid an exporter?
- 9 What is forfaiting? List the parties involved in a forfaiting transaction.
- 10 What is the role of the Export-Import Bank?
- 11 Describe the role of the Private Export Funding Corporation (PEFCO).

Problems

- 1 For each of the following import purchases, (a) calculate the annual cost of the cash discount forgone, and (b) determine the date and amount paid if the discount is taken. Assume that the invoice date is March 10 and that there are 30 days in a month.
 - (i) \$500, 2/10, net 30;
 - (ii) \$3,500, 4/20, net 60;
 - (iii) \$1,500, 3/30, net 40;
 - (iv) \$4,400, 2/10, net 70.
- 2 An exporter has a \$20,000 bankers' acceptance for 6 months, the acceptance fee is 2 percent per year, and the discount rate on this bankers' acceptance is 10 percent per year.
 - (a) How much cash will the exporter receive if it holds the bankers' acceptance until maturity?
 - (b) How much cash will the exporter receive if it sells the bankers' acceptance at a 10 percent discount rate?
 - (c) The exporter's opportunity cost of funds is 10.2 percent per year. If the exporter wishes to maximize the present value of her bankers' acceptance, should she discount the bankers' acceptance or hold it until maturity?
- 3 An exporter has recently factored its accounts receivable at a rate of \$10,000 a month. The factor advances 80 percent of the receivables, charges 1 percent interest per month on advances, and charges a 3 percent factoring fee. The interest and fee are paid on a discount basis.
 - (a) Determine the net proceeds to the exporter.
 - (b) Determine the effective annual cost of this financing arrangement.

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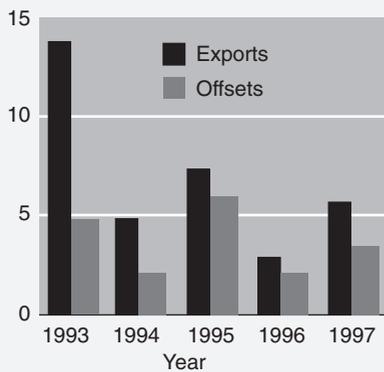
Case Problem 13: Arms Dealers Get Creative with Offsets

In December 2002, Lockheed Martin, with its F-16 Fighting Falcon, beat French and Anglo-Swedish rivals to land a \$3.6 billion deal from Poland, which is Eastern Europe's largest defense order. Do you know how Lockheed won the contract? The answer is simple. Lockheed's offset offer was larger than that of their two rivals. Lockheed put together over 100 projects it valued at \$9.8 billion, compared with \$7.8 billion from its Anglo-Swedish rival and \$3.9 billion from its French rival.

In recent years, The General Accounting Office (GAO) of the USA examined offset agreements between the US arms producers and 10 buyer countries in the Middle East, Asia, and Europe (which included the world's most active buyers of US arms, such as Taiwan, South Korea, Saudi Arabia, Kuwait, and the UK). The USA controls about one-half of the world's arms exports and dominates sales in most regions. The GAO study also found that the United Arab Emirates (UAE) have broken new ground in recent years by demanding that Boeing invest in and help with big projects that are not related to the company's main lines of business. For example, the UAE requires that Boeing and other sellers return 60 percent of the value of its arms purchases through investment in commercially viable ventures. And the seller company is deemed to have satisfied its obligation only on the basis of the profits generated by these ventures. The UAE and other countries increasingly insist that the contracts and technologies be delivered into new businesses, rather than existing ones.

"Offsets" are trade demanded by a foreign buyer, which for decades mostly wanted to help the US seller build the planes, missiles, or other weapons being sold. Since the mid-1980s, buyers have increasingly wanted commercial and military technology to broaden the purchaser's economy. In fact, such contracts and technology transfers now occur in aero-

The USA makes ...
US defense exports and offset obligations
\$ billions



... The world takes

Recipients of new offset agreements,
and their share of total deals by value,
1993–7

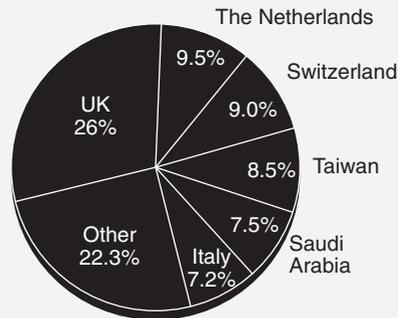


Figure 13.2 US arms exports and offset obligations

Source: *The Wall Street Journal*, Apr. 20, 2000, p. A18 (from the US Department of Commerce); reprinted by kind permission.

space, transportation equipment, and electrical equipment. This form of countertrade is an arrangement similar to counterpurchase, but the seller is required to produce parts, source parts, or assemble the product in the importing country. Many countries demand ever-higher percentages, often 100 percent or more, of the value of the contract to be returned to the purchasing nation through offsets. For example, Boeing sold AWACS to the UK Ministry of Defence and agreed to buy 130 percent of the value of the transaction in British goods. In April 2000, the US Department of Commerce reported that offset transactions had increased from 35 percent of the value of the contracts in 1993 to 42 percent in 1994. Figure 13.2 shows that offset obligations have accounted for approximately 70 percent of the contract value from 1995 to 1997.

One recent GAO report cited an instance in which, in return for its sale of AH-64 Apache helicopters to the UAE, Boeing helped the country to form companies that make products for cleaning up oil spills or for recycling used photocopier and laser printer cartridges. The US government has expressed concern about this and other offset transactions. A spokesman for Boeing, however, said that the big plane-maker has no choice but to offer offsets if the company wants to win foreign sales. "The only other alternative is to let the sale and all of the related jobs go to another manufacturer that is willing to provide offsets," he added. Other US defense companies say that without the offset agreement, they would lose the sales to providers in Europe, Russia, or elsewhere. They also say that the deals lower the cost to US taxpayers of acquiring weapons for the Pentagon, because these deals lessen US companies' dependence on Pentagon contracts.

In recent years, entrepreneurs in the Middle East and Asia have launched more exotic plans, called offset investment funds. They have pooled money from weapons sellers to be

invested for offset credit. Lockheed Martin Corp.'s \$6.4 billion sale of F-16 jets to the UAE in March 2000 corroborates this inference. Lockheed satisfied its offset by investing \$160 million in the petroleum-related "investment portfolio" of the Offsets Group, which administers the program in the UAE. Some US government officials have expressed a concern about the possibility that such offset payments could be used to channel favors to foreign officials. That is barred under US law.

Case Questions

- 1 The terms of the offset on individual contracts may vary substantially. The most common categories of offsets are coproduction, licensed production, subcontractor production, overseas investment, and technology transfer. Briefly describe each of these offsets.
- 2 What are the policy goals of those foreign countries that demand offset concessions to US arms producers?
- 3 What is the adverse economic impact of offset agreements in the USA?
- 4 Name and discuss the US law that makes it illegal for US companies to make payments to foreign officials with hopes of winning their favors in business transactions? (Hint: look at chapter 20: Multinational Accounting.)
- 5 Explain why Lockheed's \$160 million investment in the UAE Offset Group might violate the US law.
- 6 Use the website of the American Countertrade Association (ACA), www.countertrade.org, to list the types of services provided by the ACA.

Sources: J. K. Cole, "Evaluating Offset Agreements: Achieving a Balance of Advantages," *Law and Policy in International Business*, Vol. 19, 1987, pp. 766–809; J. Cole and H. Cooper, "Buyers of US Arms Toughen Demands," *The Wall Street Journal*, Apr. 16, 1997, pp. A1, A16; H. Cooper, "US Defense Firms Hurt by Offset Deals Abroad," *The Wall Street Journal*, May 21, 1997, pp. A2, A4; G. T. Hammond, *Countertrade, Offsets, and Barter in International Political Economy*, New York: St Martin's Press, 1990; "Lockheed Wins \$3.5 B F-16 Deal With Poland," <http://www.foxnews.com>, Dec. 27, 2002; and D. Pearl, "Arms Dealers Get Creative with Offsets," *The Wall Street Journal*, Apr. 20, 2000, p. A18.