

# Chapter

# 18

## *Financing International Trade*

**I**nternational trade has been conducted for over 2,000 years. A host of institutional arrangements, some of them quite elaborate, have developed over the years to facilitate such activity. Major international banks, in particular, are key players in bringing together importers and exporters. This chapter introduces and describes these institutional relationships.

The chapter first introduces the fundamental problems of international trades. Then it examines the important documents that control the ownership and insurance of goods that are being shipped internationally. Commercial banks require these documents when they provide financing to importers and exporters. We then look at alternative payment methods and a variety of ways in which exports can be financed. Governments often have special export–import banks that provide subsidized financing and insurance to promote international trade.

For example, in November 2009, the U.S. Export–Import Bank announced that it would lend \$80.66 million to Electrica del Valle de Mexico (EVM), a subsidiary of France’s EDF Energies Nouvelle, which is building a wind farm in Oaxaca, Mexico. EVM was purchasing the wind turbines from Clipper Windpower, a small U.S. manufacturer with a sole production facility in Cedar Rapids, Iowa. The sale of the turbines to EVM represented Clipper’s first international sale. EVM was able to obtain a 14-year term loan priced at 100 basis points over 7-year U.S. Treasury notes. Because Clipper Windpower was too small to offer financing to EVM directly, and because bank and bond financing may have proven too expensive at the time, the deal probably would not have gotten done without the Export-Import Bank’s assistance. It is difficult to assess how much of a subsidy the loan represents.

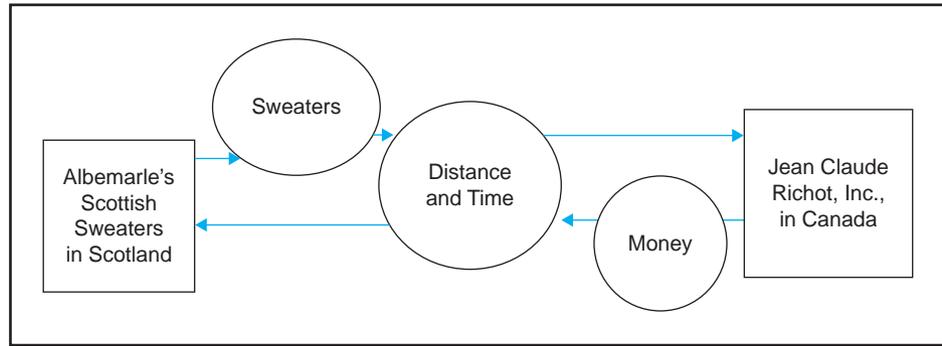
The chapter concludes with a discussion of countertrade and the host of ways goods can be traded more or less directly for other goods.

### **18.1 THE FUNDAMENTAL PROBLEM WITH INTERNATIONAL TRADE**

Shipping goods across a country as large as the United States poses many complex logistical and financial problems. Shipping goods across international borders creates a host of additional complications.

Exhibit 18.1 describes the fundamental situation: An importer in Canada, Jean Claude Richot Men’s Apparel, Inc., would like to buy some sweaters from a Scottish exporter of wool sweaters, Albemarle’s Scottish Sweaters. Because it takes time to ship the sweaters

### Exhibit 18.1 An Example of the Fundamental Problem in International Trade



internationally, the sweaters cannot be delivered from the Scottish exporter to the Canadian importer immediately after an agreement is reached to purchase the goods. Either the Canadian importer or the Scottish exporter must own the sweaters during the time they are being shipped. Consequently, either the exporter or the importer must engage in some method of financing because the goods cannot be sold immediately after production.

When the shipment and sale of goods occur within a single country, there is a common jurisdiction and system of courts that adjudicates contractual disputes between buyers and sellers. When goods are shipped across borders, though, additional legal complexities arise. One such complexity relates to collecting on delinquent accounts. Differences in languages, cultures, accounting standards, and other information issues make it quite difficult, in some cases, to assess who is a good credit risk and who is not. The International Chamber of Commerce, which we discuss in the following box, attempts to overcome some of these problems.

Of course, exporters, like other producers, must obtain financing during the manufacturing process. They can finance their production in a number of ways: from retained earnings, with bank loans, by issuing securities, or by obtaining advanced payments from importers.

Techniques for handling these international financing issues and credit transactions differ across countries and industries and have evolved over time.<sup>1</sup> Firms within the same industry can use a variety of methods, depending on the competitive pressures specific to the individual firm. For example, established exporters who are the international leaders of their industry are in a better position to demand more stringent payment terms from importers than other exporters. A single firm might also use different strategies, depending on its customer. For example, the policy that an exporting firm finds appropriate when dealing with an importer located in a developed country will probably not be appropriate for importers located in a developing country. This chapter explores alternative ways that firms deal with such financing and credit issues to establish overall credit policies. Before discussing these issues, however, we cover the documents that banks and other intermediaries use to control the ownership of the goods, the insurance, and the billing processes.

<sup>1</sup>Greif (1993) describes how some eleventh-century traders known as the Maghribi developed an institutional coalition to overcome the problems inherent in international trade. The Maghribi were Jewish traders who were operating in the Muslim western Mediterranean. Greif notes, "Agents provided merchants with many trade-related services, including loading and unloading ships; paying the customs, bribes and transportation fees; storing the goods; transferring the goods to market; and deciding when, how, and to whom to sell the goods, at what price, and at which credit terms" (p. 528).

## The International Chamber of Commerce

The **International Chamber of Commerce (ICC)**, based in Paris, was founded in 1919 with the goals of promoting international trade and investment, opening international markets for goods and services, and facilitating the free flow of capital between countries. The original members of the ICC were private companies in Belgium, Britain, France, Italy, and the United States. Membership has expanded dramatically, and today, the ICC is a world business organization with thousands of member companies and associations in more than 130 countries.

The activities of the ICC include setting rules and standards for international trade, arbitration and other forms of dispute resolution, and business self-regulation; making the political case for open trade and the market economy system; fighting corruption; and combating commercial crime. Each year, the ICC International Court of Arbitration hears hundreds of cases from around the world. The disputes are quite varied; examples include differences over the supply of steel pipes, the liquidation of a bank, the interpretation of a shareholders' agreement, the insurance for a film, and the construction of a shopping center.

One of the ICC's most important activities is setting standards for commercial contracts. This includes establishing the meaning of acronyms used internationally. The acronyms indicate who pays the costs of shipping, insurance, and import duties. On January 1, 2011, the eighth edition of the ICC publication *INCOTERMS* came into effect. It groups

these terms into four different categories. The *E* terms, as in *EXW* for "ex works," indicate the goods are available to the buyer at the seller's premises. The *F* terms, such as *FAS* for "free alongside ship" and *FOB* for "free on board," indicate that the price quoted by the seller includes delivery of the goods to a carrier appointed by the buyer. The *C* terms, including *CFR* for "cost and freight," and *CIF* for "cost, insurance, and freight," imply that the exporter's quoted price includes the cost of transportation to the named port of destination for *CFR* and that the cost of insurance is also included in the price, in addition to the transportation charges for *CIF*. The *D* terms refer to delivery specifics. *DAT* for "delivered at terminal" implies that the exporter's quoted price includes the cost of transportation and unloading from the transportation vehicle, which could be a plane or a ship, at a particular terminal or port. *DAP* for "delivered at place" is similar except the buyer must pay for the unloading.

The ICC's Uniform Customs and Practice for Documentary Credits (UCP 500) consists of a set of rules banks use to finance billions of dollars of world trade annually. The ICC is also leading the charge to establish standards for e-commerce. For example, a supplement to UCP 500, called the eUCP, was added in 2002 to create standards for electronic international trade documents. In addition, the ICC's codes on advertising and marketing influence both national legislation and the rules adopted by professional associations.

## 18.2 INTERNATIONAL TRADE DOCUMENTS

This section examines several of the important documents of international trade. International banks require many of these documents when financing international trade. The documents include bills of lading, which come in various types; commercial invoices; packing lists; insurance certificates; consular invoices; and certificates of analysis. Exhibit 18.2 provides a summary of the documents and their definitions.

### Bills of Lading

A **bill of lading (B/L)** is a contract issued to an exporter of goods by the shipping company (also called a *common carrier*) that will transport the goods to their destination. The bill of lading serves several purposes, but most importantly, it documents that the exporter's goods have been received by the carrier.

The bill of lading contains the contractual terms between the carrier and the shipper (exporter). It describes the kind and quantity of goods being shipped, who the shipper (also called the *consignor*) is, who the importer (also called the *consignee*) is, the ports of loading and discharge, the carrying vessel, and the cost of the shipping. A **negotiable bill of lading**

## Exhibit 18.2 Documents of International Trade

- Bill of Lading** A contract issued to an exporter or a shipper of goods by the company that will transport the goods from the place of shipment to the destination.
- Commercial Invoice** A detailed description of merchandise being sold, including the unit prices of the items and the number of items that are being shipped as well as the financial terms of the sale, including the amount due from the buyer and any charges to the buyer arising from insurance and shipping.
- Packing List** A description of merchandise to be exported, including the containers in which the goods are packed, the contents of each container, and the total number of containers.
- Insurance** Documents indicating that the owner of goods will be compensated in the event that the goods are damaged, destroyed, or stolen when being transported internationally.
- Consular Invoice** A document that must be filled out by an exporter in consultation with the consulate of the importing country that is located in the exporting country; it provides information to customs officials in the importing country, with the goal of preventing false declarations of the value of the merchandise.
- Certificate of Analysis** A document which assures an importer and possibly government officials that a shipment meets certain standards of purity, weight, sanitation, or other measurable characteristics.

is the most common form. It can be used to transfer title or ownership of goods between different parties.

In our example, Albemarle's Scottish Sweaters receives a bill of lading from its shipping company. If Jean Claude Richot, Inc., had already paid for the sweaters, a negotiable B/L would indicate that Jean Claude Richot, Inc., should receive the sweaters upon their arrival in Canada.

### **Straight Bill of Lading**

In its simplest form, a **straight bill of lading** states that a carrier has received merchandise from a shipper (a consignor) and will deliver the merchandise to a designated party (the consignee). A straight bill of lading is not title to the goods and is consequently not required for the consignee to obtain delivery of the merchandise. Because it is not a title to the merchandise, a straight bill of lading is not negotiable and cannot be used to transfer title of the goods to a third party. Consequently, it cannot serve as collateral with a commercial bank and is used only when no export or import financing is desired. A straight bill of lading is used when goods have been paid for in advance, when the exporter is financing the shipment and retaining title to the goods, or when the shipment is between affiliated parties of the same corporation.

### **Order Bill of Lading**

If the transfer of title to goods is desired, or if some form of third-party financing is desired, an **order bill of lading** is used. Because most export transactions do involve financing, order bills of lading are most common. An order bill of lading consigns the goods to a party named in the contract, which is usually the exporter because the exporter wants to retain title to the goods until payment from the importer has been received. The exporter can endorse the order bill of lading on the reverse side to transfer title of the goods to a specific party designated in the endorsement. At the destination, the carrier of the goods delivers the goods only to the party bearing the endorsed order bill of lading, who surrenders it to the carrier.

Having an order bill of lading is tantamount to having the title to the goods. This means that the goods can be used as collateral for bank loans. Banks are willing to lend to the party bearing an endorsed order bill of lading. In addition, the goods are usually fully insured. An order bill of lading is also required with a documentary credit or for discounting drafts, as we will see later in the chapter. Discounting is simply the taking of the present value of the payment promised in the draft.

### **On-Board Versus Received-for-Shipment Bills of Lading**

Bills of lading have several unique characteristics. An **on-board bill of lading** indicates that goods have been placed on a particular vessel for shipment. This is the type of bill of lading that is usually used in a documentary credit. An alternative form is a **received-for-shipment bill of lading**, which indicates only that the merchandise is at the dock awaiting transport. A received-for-shipment bill of lading is not an acceptable document in a bank financing unless it has been explicitly authorized in a documentary credit. A received-for-shipment bill of lading is issued by the carrier upon receipt of the merchandise. It is easily converted into an on-board bill of lading when it is stamped appropriately with the name of the vessel, dated, and signed or initialed by an authorized representative of the carrier. The reason a received-for-shipment bill of lading is not acceptable in bank financing is that no one knows for sure when the goods will be shipped.

### **Clean Versus Foul Bills of Lading**

A bill of lading contains information on the status of the merchandise when it is received by the carrier. A **clean bill of lading** indicates that the carrier believes the merchandise was received in good condition after an external visual inspection. Carriers are not responsible for formal evaluations of the condition of the merchandise. In contrast, a **foul bill of lading** indicates that the carrier's initial inspection uncovered some damage that occurred before the goods were received by the carrier for shipment. Foul bills of lading are typically not negotiable because no one knows the extent of the damage to the merchandise.

## **Commercial Invoices**

A **commercial invoice**, issued by an exporter and given to an importer, contains a detailed description of the merchandise, including the unit prices of the items and the number of items being shipped. The invoice also specifies the financial terms of the sale, including the amount due from the importer and any charges to the importer arising from insurance and shipping.

In the example that we have been following, the total number of sweaters of all types might be 7,500, and if each sweater costs \$200, the total invoice would be for \$1,500,000. Notice that in this case, the U.S. dollar is used as the currency of invoice even though neither party to the transaction is in the United States. Alternatively, the transaction could be denominated in British pounds, the currency of the exporter, or in Canadian dollars, the currency of the importer.

## **Packing Lists**

Because goods shipped internationally are often prepackaged in a container, the shipper must include a **packing list**. This list contains a description of the merchandise to be exported, including the containers in which the goods are packed, the contents of each container, and the total number of containers. In our example, the packing list would contain a description of the numbers and types of sweaters.

## **Insurance**

Merchandise that is shipped internationally is invariably insured. The insurance documents must be signed by an authorized representative of the insurance company, its agents, or its underwriters. (An insurance broker's signature is unacceptable.) The insurance must either be issued in the name of the consignee or in the name of the exporter, who can then endorse the policy to the consignee. The value of the insurance must be expressed in the same currency as the currency of the invoice. Otherwise, there would be transaction foreign exchange risk.

### Open Insurance Policies

Firms that do a substantial amount of exporting can purchase insurance policies that are described as “open,” or “floating.” Such a policy automatically covers all the exports of a firm, which eliminates the necessity of arranging coverage for each individual export order. In such cases, the evidence of insurance is an insurance certificate that the insurance company supplies. The entry of information on the insurance certificate should conform exactly to the information describing the merchandise on the bill of lading, the commercial invoice, and, if it is required, the consular invoice.

### Consular Invoice

Imports into many countries require a **consular invoice** filled out by the exporter in consultation with the importing country’s consulate located in the exporting country. A consular invoice provides information to customs officials in the importing country, with the goal of preventing false declarations of the value of the merchandise. Failing to fill out such forms correctly can lead to fines and substantial delays in the clearing of goods through customs. A consular invoice is sometimes combined with a **certificate of origin** of the goods, which indicates the source of the goods.

### Certificates of Analysis

A **certificate of analysis** is sometimes required to assure an importer that a shipment meets certain standards of purity, weight, sanitation, or other measurable characteristics. These documents may be required by the health or other officials of the importing country, especially when it comes to food and drug imports. Certificates of analysis may be issued by private organizations or by governments.

## 18.3 METHODS OF PAYMENT

Ideally, an exporter wants to be paid when the importer orders the goods, especially if they are being made to order. Prepayment helps finance the production of the goods and assures the exporter of his profit. Moreover, if the exporter must finance the production of a highly customized good, the exporter will usually demand that the importer bear some of the cost. Importers, on the other hand, prefer to pay as late as possible. If an importer can pay the exporter after being paid by the final buyer of the product, the exporter essentially finances the importer’s inventory until it is sold.

This section examines the different methods available for an importer to pay an exporter, ranging from cash in advance, which is the least risky from the exporter’s perspective, to documentary credits and documentary collections and to open accounts, which are increasingly risky methods of payment from the exporter’s point of view.

### Cash in Advance

**Cash-in-advance** transactions require the importer to pay the exporter before the goods are shipped, implying that the exporter does not have to finance the goods during their shipment. For exporters, cash in advance is obviously the least risky policy. The importer must finance the purchase of the goods, incurs the cost of shipping them, and bears the risk of their being damaged in transit.

Cash in advance is used primarily with high credit-risk trading partners and in countries in which political risks are large. If a credit rating agency, such as Dun & Bradstreet, has

given a foreign importer a low credit rating, or if a credit insurance agency has removed the foreign firm from its list of eligible firms, the exporter may demand cash in advance. Also, if the exporter thinks the importer may have difficulty securing foreign currency because the importer's government might close the foreign exchange market during the time of shipment, the exporter may demand cash in advance. If the importer is unable to get trade finance, negotiations between the exporter and the importer might break down.

Because few importers are willing to pay for goods in advance, international banks developed a method of securing payment that substitutes the bank's credit risk for the importer's credit risk. This method is the documentary credit.

## Documentary Credits

**Documentary credits (D/Cs)** are designed to solve the problems caused by the fact that importers and exporters want to pay and be paid at different times.<sup>2</sup> Documentary credits also provide a way for exporters to finance the production of their goods. With a documentary credit, at least one commercial bank stands between the importer and the exporter. The exporter must assess the credit risk of this international bank, not the credit risk of the importer. Because the involvement of commercial banks in the transaction is extensive, using a documentary credit is the most expensive method of payment.

Exhibit 18.3 presents an example of a documentary credit associated with the transaction between an importer, Jean Claude Richot Men's Apparel, Inc., and an exporter, Albemarle's Scottish Sweaters, written by the importer's bank, Bank of Quebec.

### Drafts

A D/C is created when an importer asks its commercial bank to write a letter to an exporter on behalf of the importer. In the D/C, the importer's bank indicates that it will honor a draft, drawn on it, if the exporter satisfies certain conditions set forth in the D/C. The draft is a written order by the bank to pay the exporter and may be either a **sight draft** or a **time draft**.

Exhibit 18.4 presents an example of a time draft. The time draft indicates that the Bank of Quebec will pay \$1,500,000 to Albemarle Scottish Sweaters 3 months after the date the D/C was written, at which time the draft can be presented to the bank. The account of Jean Claude Richot, Inc. will be charged for the payment. If the draft is a sight draft, the bank is obligated to pay the draft any time it is presented, as long as the documents associated with the D/C are in order.

If a bank accepts a time draft, the draft becomes a **banker's acceptance (B/A)**, where the bank agrees to pay the face value of the draft at maturity, or may pay a discounted value immediately. More details follow later.

Once the documentary credit is established, it becomes a financial document that substitutes the credit of the bank for the credit of the importer. The conditions that the exporter must satisfy in order to be paid include providing formal documentary evidence that the goods have been shipped, that the freight has been paid, and that the goods have been insured.

### Advantages of Documentary Credits to Exporters

Documentary credits offer a number of advantages to exporters:

1. The most important advantage of a D/C is that it substitutes the creditworthiness of the bank for the credit risk of the importing firm. If the exporter satisfies the requirements of the D/C, the exporter will be paid by the bank.
2. Establishing a documentary credit enhances the probability that the exporter will not experience delays in payment due to the imposition of foreign exchange controls or

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<sup>2</sup>In the United States, a documentary credit is often referred to as a letter of credit (L/C).

## Exhibit 18.3 A Documentary Credit

Irrevocable  
Documentary Credit

Est. 1847

### Bank of Quebec

860 Rene-Levesque Blvd W  
Montreal, PQ H3B4A5 CA

International Division

Commercial D/C Department

www.boq.com

**Documentary Credit No.:** 0087349824    **Amount:** USD1,500,000    **Date:** July 3, 2011

This number must be mentioned  
on all drafts and correspondence.

. Albemarle's Scottish Sweaters  
. Edinburgh, Scotland  
.

. Bank of Edinburgh  
. Edinburgh, Scotland  
.

**Dear Madame or Sir:**

**By order of** Jean Claude Richot Men's Apparel, Inc.

**and for the account of** SAME

**we hereby authorize you to draw on** Ourselves

**up to an aggregate amount of** One Million, Five Hundred Thousand, U.S. Dollars

**Available by your drafts at** Ourselves, but not before October 3, 2011

**Accompanied by**

Signed invoice in triplicate

Packing list in triplicate

Full set of clean ocean bills of lading, made out to order of shipper, blank endorsed, marked freight prepaid and notify: Jean Claude Richot Men's Apparel, Inc., Montreal, dated on board not later than July 30, 2011.  
Insurance policy/certificate in triplicate for 110% of invoice value, covering all risks.

Covering: Shipment of sweaters, as per buyer's order no. 86354011, dated June 15, 2011, from Edinburgh, Scotland port C.I.F. to Montreal, Quebec, CANADA.

Partial Shipments not permitted.

Transshipment is not permitted.

Documents must be presented within 7 days after the board date of the bills of lading, but in any event not later than August 7, 2011.

**Drafts must be drawn and negotiated not later than** August 3, 2011

**All drafts drawn under this credit must bear its date and number and the amounts must be endorsed on the reverse side of this Documentary Credit by the negotiating bank. We hereby agree with the drawers, endorsers, and bona fide holders of all drafts drawn under and in compliance with the terms of this credit, that such drafts will be duly honored upon presentation to the drawee. This credit is subject to the uniform customs and practice for documentary credits (International Chamber of Commerce Publication No. 500)**

Francois Montblanc  
Commercial Credit Officer  
Bank of Quebec

other political risks. Countries are well aware of the importance of international trade. As a result, governments generally permit banks to honor existing documentary credits. Failing to do so severely damages a country's reputation and its ability to borrow in international financial markets in the future.

## Exhibit 18.4 An Example of a Time Draft

not before October 3, 2011		July 3, 2011 Montreal, Quebec, Canada
INDICATE ABOVE WHETHER PAYABLE ON DEMAND, ARRIVAL, OR OTHER TIME LIMIT		DATE AND LOCATION
<b>PAY TO THE ORDER OF</b>	ALBEMARLE'S SCOTTISH SWEATERS	USD 1,500,000
ONE MILLION, FIVE HUNDRED THOUSAND UNITED STATES DOLLARS		
JEAN CLAUDE RICHOT'S IMPORTED MEN'S APPAREL, INC.		
VALUE RECEIVED AND CHARGE TO ACCOUNT OF		
<b>TO</b>	Bank of Quebec	
	860 Rene-Levesque Blvd W, Montreal, PQ, H3B4A5 CA	
<b>No.</b>	D/C No. 0087349824	Robert Rochambeau, Treasurer Jean Claude Richot, Inc.

3. A D/C reduces the uncertainty of a transaction by clearly establishing the acts that the exporter must carry out in order to receive payment.
4. Because a D/C is a legally binding document between a bank and an exporter, the exporter is protected if the importer desires to cancel the contract during the production process. This is especially important if the goods are being made to order.
5. A D/C makes it easy for an exporter to receive early payment because a time draft can be accepted by the bank, which creates a banker's acceptance.

### Advantages of Documentary Credits to Importers

Documentary credits also have advantages from the importer's perspective:

1. The foremost advantage for an importer is that a D/C clearly indicates a time frame by which the goods must be shipped. The importer knows that the exporter must ship the goods by a certain date and must provide certain documents to the bank if the exporter wants to be paid. The importer is thus assured of having the goods when they are needed for the importer's production process or for resale in the importer's market.
2. Another advantage of a D/C from the importer's perspective is that the importer's bank assumes responsibility for checking the documents provided by an exporter. Hence, if the exporter does not properly ship the goods, the bank will not pay the exporter, and the importer is protected from having to pay for goods that are not valuable. If the importer takes possession of the goods and it is discovered that there is a problem with the shipment that should have been caught by examining the shipping documents, the bank is responsible for this oversight.
3. The fact that a D/C substitutes the bank's credit standing for the importer's credit standing means that the importer may be able to command better payment terms. A D/C may be required by some exporters if they cannot get cash in advance.
4. If some form of prepayment is required by an exporter, an importer is better off depositing money in an escrow account at its domestic bank than with a foreign company. If the exporter encounters some difficulty that limits its ability to follow through on its contractual commitments, the importer can recover its deposit from a local bank more easily than it could from the foreign exporter.

### Attributes of Documentary Credits

A documentary credit can be either revocable or irrevocable. A **revocable D/C** is a means of arranging payment, but it provides no guarantee of payment. The importer reserves the right to revoke the D/C at any time prior to the presentation of the draft by the exporter to the

bank. A revocable D/C establishes that the importer has a working business relationship with a reputable bank. It also establishes that the transaction is one that is legitimately eligible for scarce foreign exchange if there is a crisis in the importer's country. Hence, it is useful for transactions between related affiliates of a multinational corporation to assure that exchange controls do not disrupt the importing process. It is less expensive than an irrevocable D/C.

Most documentary credits between unrelated parties are irrevocable. An **irrevocable D/C** cannot be revoked unless all parties, including the exporter, agree to the revocation. International transactions between parties not well known to each other are typically conducted with irrevocable documentary credits. Otherwise, much of the benefit of substituting the credit of the bank for the credit of the importer would be lost. Once an irrevocable documentary credit has been received, the exporter is assured that it will be paid by the importer's bank if it performs certain tasks by certain dates in the future.

A documentary credit can also be confirmed or unconfirmed. A **confirmed documentary credit** is one in which a second commercial bank agrees to honor the draft presented by the exporter. Typically, the bank that issues the documentary credit is from the country of the importer. Two issues arise from the perspective of the exporter. First, although the issuing bank may be a reputable international bank, it is still subject to the legal jurisdiction of the importing country and may not be well known to the exporter. Second, the exporter might ultimately want to present the draft to a bank in the exporting country. By having a bank in the exporting country confirm the D/C, the exporter obtains a guarantee that a domestic bank that the exporter trusts will accept the responsibility for paying the draft. Of course, the second bank will demand some additional compensation for the confirmation of the D/C, and this increases transaction costs.

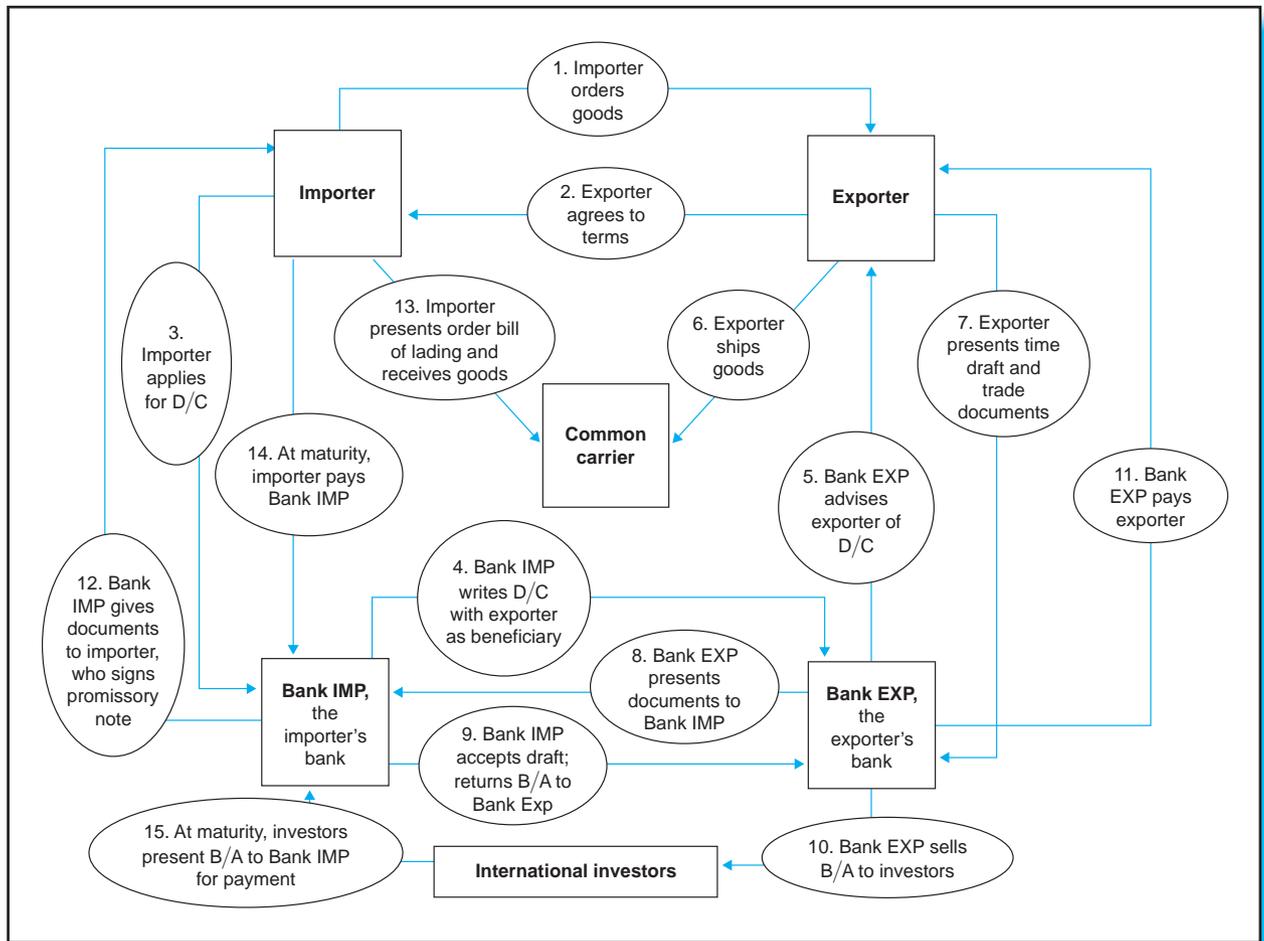
In summary, the three primary types of documentary credits, in decreasing order of security to the exporter, are (1) an irrevocable, confirmed D/C; (2) an irrevocable, unconfirmed D/C; and (3) a revocable D/C. Choosing among these three and who pays for the increased cost of the deal depends on the bargaining strength of the importer and the exporter. Making the deal more secure for the exporter makes the deal more expensive because banks charge additional fees. This added expense must be paid either by the importer, who agrees to a higher cost, or by the exporter, who accepts a lower price. Of course, if the exporter demands the most stringent terms and forces the importer to pay the transaction costs, the exporter risks losing business to lower-cost exporters willing to take greater risks.

### **Summary of the Creation and Use of a D/C and a B/A**

As we have seen, international trade can be handled in a number of different ways. This section provides a summary diagram of some complex transactions—the creation and use of a documentary credit with the discounting of a draft to create a banker's acceptance. Exhibit 18.5 provides a general diagram of the transactions involved:

1. The importer orders goods from the exporter and asks whether the exporter is willing to ship the goods under a documentary credit containing a time draft.
2. The exporter and importer agree to ship the goods under a documentary credit. The two parties negotiate the price of the goods and the other aspects related to how the goods will be shipped.
3. The importer applies for a documentary credit to its commercial bank, designated in Exhibit 18.5 as "Bank IMP."
4. Bank IMP issues the documentary credit, with the exporter named as the beneficiary. The D/C specifies the information associated with the deal and is sent to an advising bank, "Bank EXP," in the exporter's country.
5. Bank EXP advises the exporter that the documentary credit has arrived. If the exporter so desires, Bank EXP confirms the documentary credit for a fee and adds its guarantee to Bank IMP's guarantee.

**Exhibit 18.5** Exporting with a Documentary Credit (D/C) and a Banker's Acceptance (B/A)



6. The exporter ships the goods to the importer using a common carrier.
7. The exporter presents a time draft, with a maturity of, say, 90 days in the future, to Bank EXP. The draft is drawn on Bank IMP, as specified in the D/C from Bank IMP. The exporter also presents the documents required by the D/C, including the order bill of lading. The exporter endorses the order bill of lading “in blank” so that the title of the goods passes to the holder of the endorsed bill of lading, which is Bank EXP at this point.
8. Bank EXP presents the draft and the export documents to Bank IMP, which accepts the draft and takes possession of the documents. A banker’s acceptance, B/A, with a maturity of 90 days is created.
9. Either Bank IMP returns the accepted draft to Bank EXP, or Bank EXP could ask for the discounted cash value of the B/A, in which case Bank IMP would deduct a discounting fee. The interest rate in the B/A market is used to take the present value.
10. Assuming that Bank EXP receives the B/A, it now either gives the B/A to the exporter or pays the exporter. In the latter case, Bank EXP can either hold the B/A in its own portfolio or sell the B/A to an investor in the international financial markets.
11. Normally, the exporter receives the discounted cash value for the B/A less any bank charge for a discounting fee rather than wait for 90 days to receive a cash payment.

12. Bank IMP informs the importer that the documents have arrived. The importer either signs a promissory note or follows through with some mutually agreed-upon plan for paying Bank IMP, at which point Bank IMP releases the documents, including the order bill of lading, to the importer. Often, the maturity of the promissory note is the same as the maturity of the B/A, which is 90 days in this case.
13. When the goods arrive, the importer collects them from the common carrier, using the order bill of lading.
14. At the maturity of the promissory note, the importer pays Bank IMP.
15. At the maturity of the B/A, Bank IMP pays the holder of the matured banker's acceptance. The investor receives the face value of the B/A. The holder may present the B/A directly to Bank IMP, or it may have Bank EXP collect the amount through its normal banking relationships with Bank IMP.

## Documentary Collections

Firms can avoid directly assessing the creditworthiness of their trading partners by using a **documentary collection**. With a documentary collection, the exporter retains control of the goods until the importer has paid or is legally bound to pay for them, and the exporter gets banks involved in the collection process, although the degree of responsibility banks bear for assuring payment to the exporter in a documentary collection is not as high as with a confirmed documentary credit. Documentary collections are also less expensive than documentary credits.

When conducting an export transaction through documentary collection, the exporter uses a remitting bank as its agent to collect the payment from the importer. The exporter ships the merchandise to the importer, but the exporter retains title to the goods. The exporter next presents the shipping documents and a draft or bill of exchange that is drawn on the importer to the remitting bank. The remitting bank (the agent of the exporter) sends the documents, the draft, and the instructions to a bank in the importer's country. This bank is called the collecting, or presenting, bank, and it could be a foreign branch of the remitting bank or a correspondent bank in the foreign country. The collecting, or presenting, bank notifies the importer that the documents are available and that they may be obtained when the importer complies with the terms of the documentary collection.

The exporter instructs its remitting bank that the payment should be collected from the importer in one of two ways, either as a **documents against payment (D/P) collection** or as a **documents against acceptance (D/A) collection**. Under a D/P collection, the importer must pay the amount of the sight draft to the collecting bank before the documents are released. When the funds are received, they are transmitted to the remitting bank for payment to the exporter. The exporter consequently does not give up control of the merchandise until payment is received by the collecting bank.

Under a D/A collection, the exporter extends credit to the importer in the following way. The collecting bank presents a time draft to the importer, who must sign it, date it, and write *accepted* across it. The shipping documents are then released to the importer. By accepting the draft, the importer acknowledges his legal obligation to pay the face amount of the draft at maturity, which is usually 30, 60, or 90 days after the date of the acceptance. An accepted draft is known as a **trade acceptance**. It can be retained by the collecting bank on behalf of the exporter for presentation to the importer at maturity, or it may be returned to the exporter. At maturity, the draft is presented by the collecting bank to the importer, who must pay the face amount. The funds are then transmitted to the remitting bank for payment to the exporter. With a D/A collection, the exporter gives up title to the goods in exchange for the legally binding commitment of the importer to pay the trade acceptance. Hence, it is important for the exporter to understand the creditworthiness of the importer.

### **Advantages of Documentary Collections**

From an exporter's perspective, the documents against acceptance collection create a negotiable trade acceptance, which is an enforceable debt instrument. Not only is the importer legally bound to pay, but the exporter can sell the trade acceptance in the short-term money market to obtain financing. Of course, the sale of a trade acceptance is done at a discount that reflects both the time value of the money in which the acceptance is denominated and the money market's perception of the default risk of the importer.

Exporters often find that they are paid more promptly when using documentary collections rather than just invoicing the importers because importers are more responsive to their local banking communities than to the invoices of the exporter. The documentary collection does add the expenses of the remitting and collecting banks to the process, but these transaction costs are lower than the expenses involved in establishing a documentary credit.

### **Disadvantages of Documentary Collections**

The chief disadvantage of a D/A collection arises because the banks are only acting as the agents of the exporter and are not obligated to pay, as they are with a documentary credit. The exporter consequently bears the importer's default risk.

How might the deal break down? One way is if the importer refuses to take ownership of the shipment after inspecting the shipping documents. The importer consequently refuses to pay the sight or time draft. Or it might happen if, from the viewpoint of the importer, there is a document discrepancy. Documents are rejected by importers for a variety of reasons. The invoice price may not be the price that the importer agreed to in the sales contract. The goods may have been shipped late or incorrectly packaged. Sometimes, importers will use documentary discrepancies that are otherwise superficial as a reason to refuse shipment when they have changed their minds about the deal because their business has slowed down. In such a circumstance, if the exporter is not able to reconcile the issue with the importer, the exporter is forced either to warehouse the goods until another foreign buyer is located or the exporter must pay to have the goods reshipped. Sometimes, even though the exporter has a trade acceptance that is signed by the importer, getting paid by the importer entails a lengthy and costly legal battle in the importing country's courts.

Finally, because the exporter is extending credit to the importer, the exporter must bear the political risk of the importer's country. Situations can arise, having nothing to do with the importer, that prevent the exporter from being able to repatriate funds at the maturity of the trade credit. For example, the government of the importing country might impose delays or prohibit the payment of foreign exchange to foreign corporations. Delays can also arise when foreign exchange is rationed by a country's central bank, and the importer or the collecting bank must wait in the queue to buy convertible currencies.

### **Sales on Open Account**

Demanding cash in advance poses the least risk to the exporter, but it imposes the most financial burden on the importer. At the other extreme, exporters allow **sales on open account**, which poses the most risk to the exporter. Under an open account arrangement, the exporter establishes an account for the importer, who is allowed to order goods, which are either produced to order or shipped from inventory at the instruction of the importer. The payment for the goods is based on an invoiced amount, but there is no particular date in the future when the payment must be made. In other words, the exporter extends trade credit on certain terms to the importer. There is typically a discount offered from the invoiced amount if payment is made within a certain number of days. In contrast, the invoice indicates that overdue payments carry additional interest and financial service charges. The terms of such accounts must be negotiated and are subject to the competitive pressures of the industry.

Open accounts are used primarily between related affiliates of the same multinational corporation, but they also arise when exporting and importing firms have long-standing relationships or when the importer's credit rating is high. Open accounts offer importers more flexibility with regard to their financing, which can enhance an exporter's sales, and transaction costs are lower because banks are not involved in the process.

The open account method of payment is risky to the exporter, though, because an unpaid invoice is the only evidence of an importer's indebtedness to an exporter. If an importer fails to pay, the exporting firm must use the importing country's courts to attempt to enforce payment. It is possible that a court in the importing country might decide that an unpaid open account invoice is not an enforceable debt instrument. In that case, the exporter will have no rights in a bankruptcy proceeding against an insolvent importer.

An exporter is also exposed to political risks of foreign exchange controls that may prevent a solvent importer from fulfilling its promise to pay. Before granting an open account to an importer, exporters should monitor the macroeconomic and political developments in the importer's country. The exporter wants to avoid problems with blocked funds, which arise when a currency is inconvertible into other currencies. We will discuss this further in Chapter 19.

## 18.4 FINANCING EXPORTS

Now that we have seen how payments can be arranged between importers and exporters, let's examine how exporters can obtain financing while they are awaiting payment from importers. Exhibit 18.6 lists the six methods that we will study, starting with the exporter arranging a bank line of credit, the most popular financing method among U.S. exporters according to surveys. We also cover discounting of a banker's acceptance, another popular method, and end with export factoring. The entire array of financial products, including loans and insurance policies or guarantees that facilitate international sales, is often referred to as "**trade finance**."

### Bank Line of Credit

Exporters often finance their accounts receivable from importers with a bank line of credit. The terms of this type of loan agreement allow the borrower to draw up to a prespecified maximum amount during a given time period at a stated interest rate. The line of credit is generally renewable, usually annually. Although the exporter's normal revenue stream is thought to be the primary source of repayment of interest and principal associated with the line of credit, banks may require that the exporter designate assets to serve as collateral. The bank may also require the exporter to purchase insurance designating the bank as beneficiary and covering the value of the exports.

#### Exhibit 18.6 Methods of Export Financing

1. Bank line of credit
2. Discounting of a banker's acceptance
3. Buyer credit
4. Receivables purchase
5. Limited-recourse financing—*forfaiting*
6. Export factoring

## Banker's Acceptances

In Section 18.3, we saw how the use of a time draft in a documentary credit creates the opportunity for the creation of a banker's acceptance. The bank stamps and signs the draft as accepted, indicating that it will pay the face value of the draft at maturity. The accepted draft can then be discounted either by the issuing bank or in the money market. Given the current and historical importance of this method of export financing, let's examine the creation, use, and pricing of a banker's acceptance in more detail.

There are two types of banker's acceptances. As we have seen, a documentary acceptance is created by the use of a time draft in a documentary credit. A **clean acceptance** is created under a separate credit agreement, without an underlying documentary credit between the exporter and the bank. The bank agrees to accept a certain number of time drafts for various amounts that are submitted by the exporter. The bank then immediately discounts the drafts to provide financing for the exporter. At maturity, the exporter repays the face amounts of the drafts to the bank.

Using a banker's acceptance to finance exports involves two associated costs: the acceptance commission charged by the bank and the discount due to the time value of money. Typical acceptance commissions for medium-sized companies range between 0.75% and 2% of the face value of the draft. When setting the negotiable commission rate, the bank assesses the creditworthiness of the company, any country risk factors that affect the exporter's business, and the bank's competitive position. Whether the exporter or the importer bears the cost of the acceptance commission depends on their respective competitive negotiating strengths.

### *Eligible Versus Ineligible Banker's Acceptances*

In the United States, the Federal Reserve regulates the market for banker's acceptances. A distinction is drawn between eligible and ineligible banker's acceptances. If a bank sells an **eligible banker's acceptance**, it does not have to maintain reserves against the proceeds of the sale. On the other hand, if the bank sells an **ineligible banker's acceptance**, the bank must keep the proceeds of the sale on reserve with the Federal Reserve in a non-interest-bearing account. Clearly, if banks want to use the proceeds of the B/A for future lending, they must sell an eligible B/A.

The eligibility requirements for banker's acceptances are as follows:

1. The tenor, or maturity, of the B/A must not be greater than 180 days, although it is possible to seek an exception.
2. The acceptance must be created within 30 days of the date of shipment of the export goods.
3. The transaction must be between two separate legal entities either within the United States, between a U.S. firm and a foreign firm, or between two foreign firms.
4. The eligible B/A cannot be renewed at maturity unless a legitimate delay occurs in the transaction that is being financed.
5. During the transaction, only one B/A is allowed to be outstanding, although the importer and the exporter can finance the transaction, just not for an overlapping interval of time.
6. The B/A cannot be drawn without recourse to the second party in the transaction. In other words, if the bank that accepts the B/A defaults, the holder of the B/A must have recourse to the drawer of the B/A (that is, the party ultimately responsible for paying the bank).
7. The B/A must not be used to finance trade with any country for which trade is prohibited by the U.S. Department of the Treasury.

## Buyer Credit

When expensive capital equipment is being purchased, an exporter sometimes arranges for a financial institution or a syndicate of financial institutions to grant credit to the importer in what is known as a **buyer credit**. By arranging credit for the importer, the exporter is

ultimately paid cash up front, and the financial intermediaries bear most of the importer's default risk.

Setting up a typical buyer credit involves several steps. First, the exporter and the importer must agree to a commercial contract for which the importer can pay a down payment of 10% to 20% of the face value of the invoice. Then, the exporter must agree to provide part of the financing to the importer, which allows the bank to establish an analogous agreement with the importer in a commercial contract. The exporter must insure the goods with an export credit insurer and assign the insurance policy to the bank. After delivery of the goods, the bank either purchases the signed promissory notes of the importer from the exporter or grants a direct loan to the importer. In either case, the exporter receives its cash right then. Notice that the buyer credit is a contract between the bank and the importer, so there can be no recourse against the exporter by the bank if the importer defaults. Consequently, the credit of the exporter is unaffected by the transaction.

Buyer credits are much longer-term contracts than banker's acceptances. The maturity can be from 4 to 12 years, and the interest rate in the contract typically floats with a spread over LIBOR. The spread reflects the riskiness of the importer and the bank's competitive position, including its potential to win other business associated with the deal. Other costs of a buyer credit include an arrangement fee and an annual commitment fee of 0.25% to 0.75% on the unused portion of the loan.

## Selling Accounts Receivable

If an exporter wants to raise cash, it can sell drafts or invoices related to its accounts receivable to a financial intermediary. The sale could be on a recourse or non-recourse basis. In the United States, it is usually done with recourse to the exporter. That is, the exporter remains financially liable for the payments that the importer is scheduled to make should the importer default in the future. Typically, the accounts receivable must also be insured. European customs are somewhat different. In these markets, a method of export finance developed to allow financing without recourse to the exporter.

## Limited-Recourse Financing: Forfaiting

In limited-recourse financing, the financial intermediary purchases the promissory notes of the importer from the exporter at a discount. The term **forfaiting** is often used interchangeably with the term *note purchase* to describe this financing technique.<sup>3</sup> The forfaiter must assess and ultimately bear all the commercial and political risks of the project. Typically, the forfaiter removes the commercial risk by requiring the guarantee of the importer's government or its bank (which may be government owned).

Exporters often use limited-recourse financing, or forfaiting, to finance medium-term projects for importing countries that have substantial commercial and political risk. In such a financing, the exporter receives cash, and the financial intermediary bears the risks without recourse to the exporter unless the exporter fails to fulfill its contractual commitments or commits fraud. If the exporter fulfills its contractual terms, it does not have to worry about getting paid.

Forfaiting describes the practices of European banks and their subsidiaries in various countries such as Germany, Switzerland, Austria, and the United Kingdom. Banks in these countries were requested to finance capital goods exports to eastern European countries and needed to develop expertise in assessing the risks of delayed payments. Although the techniques were

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<sup>3</sup>The expression derives from the French phrase *forfait et sans garanties*, which means that the legal right of recourse (to the exporter) has been forfeited, or surrendered.

developed to deal with eastern European countries when they were state controlled, they can be applied more broadly.

### **The Mechanics of Forfaiting**

Let's examine several stages of a typical forfaiting transaction.

First, the exporter and the importer agree on a commercial transaction that covers a fixed interval of time. The exporter agrees to ship various amounts of goods to the importer at various points in time in return for periodic payments made against the progress of the project.

Second, the exporter and the forfaiter negotiate financing in which the forfaiter discounts the payments promised by the importer at a fixed discount rate. The exporter receives the discounted amount when the promissory notes of the importer are delivered to the forfaiter. The forfaiter charges the exporter an additional standby fee of 0.1% or 0.125% per month between the time that a commitment is made to the exporter and the time that the exporter delivers the notes. The forfaiter must arrange to have the funds available when the exporter presents the notes, which might require the forfaiter to borrow and deposit the funds in the short-term money market.

Third, the importer signs a sequence of promissory notes obligating it to pay the exporter certain sums, usually every 6 or 12 months, contingent upon the exporter performing certain functions related to the project. The notes are usually guaranteed by the importer's government or bank. In Europe, this irrevocable guarantee is referred to as an **aval**. With this guarantee, all subsequent holders of the note view the importer's government or its bank as the primary obligor to the note.

Fourth, the importer delivers the notes to the exporter. The exporter then endorses the notes "without recourse" and sells them to the forfaiter at the agreed-upon discount.

Fifth, the forfaiter endorses the notes and sells them in the money market. Investors know that the notes are the liabilities of both the importer's bank and the forfaiting institution, but it is the latter whose credit risk is of most concern.

The final step involves investors presenting the notes to the importer or its bank at maturity. If both of these default on the scheduled payments, the investor turns to the forfaiter for payment because the forfaiter provides a guarantee with its endorsement.

Essentially, the forfaiting institution provides two services to the exporter: country risk assessment and financial intermediation in the money market. In its role as country risk assessor, the forfaiter must price the default risks of different countries. In its role as a financial intermediary, the forfaiter packages discounted notes in various maturities for sale to the money market. Because the forfaiter guarantees the notes it sells, the success of the forfaiter ultimately depends on its ability to price the default risks of countries.

### **Export Factoring**

A technique for financing exports that is closely related to forfaiting is export factoring. An **export factor** is a company that performs credit risk investigations and collects funds from the accounts receivable of other firms. In international trade, factors provide both of these services to exporters. They may also provide financing of exporters' accounts receivable.

An example is the International Factors Group (IF-Group) of companies. When dealing with the International Factors Group of companies, one IF-Group member acts as the export factor, which deals with the exporter's country; the second member of the IF-Group, the import factor, handles credit risk cover and collection in the importer's country. *Credit risk cover* is the amount that the factor accepts as a risk that an individual buyer may be financially unable to pay.

Factors perform several services for exporters. The primary service is credit investigation. During the negotiations between an exporter and a foreign importer, the exporter provides information to the factor about the potential importer and the nature of the deal

under negotiation. The factor uses its network of local affiliates in various countries, which are usually in partnership with local banks, to perform a credit check on the importer. The factor may also be asked to provide a guarantee to the exporter, which stipulates that if the importer defaults, the factor pays the bill.

Factors give two types of credit approvals: order approvals and revolving credit lines. With an order approval, the factor provides the approval for a specific shipment by the exporter to an importer. With a revolving credit line, the exporter obtains advance approval for what is anticipated to be the maximum shipment to an importer for a given period of time. If the factor buys the receivables of the exporter at a discount, it is the responsibility of the factor to collect payment from the importer. The factor's local affiliate adheres to the standard collection practices in the particular countries involved.

If an exporter is small, a factor can also perform various accounting functions for the exporter. These include providing a monthly statement of cash flows, including all sales to the factor, commissions paid, and other debits and credits. The factor also provides statements of the credit lines outstanding for various importers, notices of disputes with any importers over specific invoices, and reports on outstanding risk exposures classified by importer and whether the factor guarantees the invoice.

### **Methods of Payment**

Factors pay exporters in a variety of ways. One is on a collection basis. Under this arrangement, the exporter gets paid when the factor receives funds from the importer. Exporters also get paid by factors when the importer is declared insolvent or when a specific political event in the contract occurs that prevents the importer from paying.

The exporter may also receive payment on an average collection basis, which reflects the past experience of the factor collecting from an importer. The factor calculates the average number of days that a particular exporter's customers have taken to pay and remits payment to the exporter in the following month, based on that average experience. For example, if an importer pays earlier or later than average, the exporter receives interest from or pays interest to the factor.

Funds can also be remitted on a maturity basis. Under this method, the factor calculates the weighted-average maturity date of all invoices maturing in a particular month, adds a specified number of collection days, and pays the sum of that month's invoices on that date. For example, suppose Invoice A for \$50,000 is due on September 1, Invoice B for \$25,000 is due on September 30, and 10 days are added for collection. Then, the exporter would receive \$75,000 on September 21 because the weighted average of the payments times is

$$(50/75) \times (1 \text{ day}) + (25/75) \times (30 \text{ days}) + 10 \text{ days} = 20.67 \text{ days}$$

Past-due interest is charged to the exporter for any receivable outstanding at the end of the month.

An exporter can arrange for financing either through the factor handling the servicing of the exports or from another financial intermediary, such as a commercial bank. Factors structure their lines of credit somewhat differently than do commercial banks. Factors agree with exporters on a percentage of exports that will be advanced to the exporter, in contrast to the set credit limit established by a commercial bank. The percentage advanced from factors to exporters varies between 70% and 90%, depending on the financial characteristics of the exporter. Exporters like this arrangement because it gives them additional capital to exploit growth opportunities without having to recontract with a financial intermediary. Exporters pay for this growth option, however, because factors charge slightly higher interest rates than banks.

In addition, exporters and factors can involve a second financial intermediary in a **tripartite arrangement**. Under a tripartite arrangement, the factor services the exporter, which assigns any credit balances due from the factor to a financial intermediary that provides funds to the exporter.

## Government Sources of Export Financing and Credit Insurance

The governments of countries that have substantial export sectors have developed specialized financial intermediaries to provide export finance, insurance, and possibly subsidies to their exporters. In trade finance, they are known as export credit agencies (ECA). The Export-Import Bank of the United States is discussed in the following section. Other examples include China Eximbank, the Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE), the Japan Bank for International Cooperation, and the Export-Import Bank of India.

Export subsidies serve several purposes: They provide credit to exporters or their customers when private markets fail; they offer loans to exporters at below-market interest rates; and they provide insurance or guarantees at below-market prices. Ultimately, the subsidies are paid by the taxpayers of the country. Governments justify these subsidies by claiming that they are designed to promote employment and to keep their exporters technologically competitive, especially in light of the subsidies that other countries offer their exporters. Some criticize ECAs as providers of corporate welfare.

### *Ex-Im Bank*

The Export-Import Bank of the United States, commonly called **Ex-Im Bank**, is an independent U.S. government corporation involved in financing and facilitating U.S. exports. Ex-Im Bank offers a variety of guarantees and financing for short-term (180 days or less), medium-term (181 days to 5 years), and long-term (more than 5 years) export transactions.

Ex-Im Bank's charter requires that it not compete with private-sector lenders. Rather, it provides export financing that private-sector lenders do not offer. For example, Ex-Im Bank assumes credit risks and country risks that the private sector is unwilling to accept. It also provides working capital guarantees that help exporters with their financing prior to their shipping products abroad. In addition, it provides export credit insurance and offers loan guarantees and direct loans to importers of U.S. products.

The majority of Ex-Im Bank's resources are devoted to long-term financing. Its two major programs involve direct loans and financial guarantees. These programs facilitate the export of construction projects, such as power plants, and the production of other long-term capital goods, such as commercial aircraft and locomotives. Ex-Im Bank's medium-term programs primarily benefit the exporters of agriculture, construction, general aviation, mining, and refining equipment; its short-term programs primarily benefit producers of small manufactured goods, such as consumer goods and replacement parts.

Ex-Im Bank operates under a number of political and economic constraints. Its long-term loans are made directly to foreign borrowers wanting to purchase long-lived U.S. exports. The maturity of the credit cannot be longer than the economic life of the export good. The loans are dollar denominated, and principal and interest must be repaid in dollars. Repayment typically occurs semi-annually, with the first payment due after delivery of the goods or start-up of the project.

Ex-Im Bank typically deals in amounts of \$5 million or more, and all Ex-Im Bank loans are required to have "reasonable assurance of repayment." Ex-Im Bank consequently may require a foreign borrower to obtain an unconditional guarantee from its government or an internationally respected bank. Ex-Im Bank also requires a borrower to demonstrate that its project is technically feasible.

### *PEFCO*

Ex-Im Bank often works in cooperation with the **Private Export Funding Corporation (PEFCO)**, which is a private corporation whose mission is to make dollar loans to foreign purchasers of U.S. exports. PEFCO was created in 1971 by a consortium of private banks, an investment bank, and several large industrial firms. PEFCO acts either as a direct lender or as a secondary market buyer of export loans originated by lenders. Its programs cover short-term,

medium-term, and long-term export finance. To be eligible for financing by PEFCO, loans must be protected against nonpayment under an appropriate guarantee or insurance policy issued by Ex-Im Bank or by a guarantee issued by the U.S. Small Business Administration. Because PEFCO loans are insured by Ex-Im Bank and because the attorney general of the United States has ruled that Ex-Im Bank's liabilities are general obligations of the United States backed by the full faith and credit of the federal government, PEFCO can borrow at interest rates close to U.S. Treasury rates. However, PEFCO's rates are set higher than those on U.S. Treasury bonds to reflect both the cost of PEFCO's funds and a margin for risk. For example, with typical PEFCO financing, an importer of, say, U.S. airplanes, borrows from a commercial bank at short-term maturities, from Ex-Im Bank at long-term maturities, and from PEFCO at medium-term maturities.

### **Export Credit Insurance**

Although exporters who offer more favorable credit terms to importers are more likely to win business, exporters and their banks want to be repaid. Thus, if the commercial or political risk of a deal is too large, the private credit market may not finance the deal.

Because the extension of credit to importers is often an important part of a deal, governments have stepped in to provide insurance to cover export financing. The insurance protects an exporter or an exporter's bank against losses due to commercial and political risks. Of course, here, again, it is ultimately the taxpayers of the exporter's country who are subsidizing the export market. In the United States, the Ex-Im Bank offers a variety of ways to insure exports. In China, the China Export & Credit Insurance Corp., or **SINOSURE**, was established in 2001 to insure exports. Over the last 10 years, SINOSURE has supported exports, domestic trade, and investments with a total value of more than USD290 billion involving thousands of policyholders and hundreds of medium- and long-term projects.

## **The Global Financial Crisis and the Trade Finance Gap<sup>4</sup>**

During the 2007 to 2010 financial crisis, global trade collapsed as exports fell over 20% from peak (early 2008) to trough (early 2009). The main factor behind the collapse was undoubtedly the global recession accompanying the crisis, which reduced overall demand. Creeping protectionism may also have played a role. Several studies have argued that the collapse was made worse by a fall in the supply of trade finance (the trade finance gap): Stress in the financial system caused financial institutions to cut back on trade finance to exporting firms. Trade finance has proved vulnerable in earlier crises, such as the Southeast Asia crisis in the late 1990s and the Argentina crisis in 2001. Surveys suggest that the supply of trade finance decreased during the recent crisis (although by far less than the volume of trade) and its price (that is, the credit spreads charged) increased, with emerging markets being most affected. In fact, the uncertainty brought about by the crisis likely increased the demand for trade finance, as trading partners resorted

to more formal bank-intermediated instruments in order to reduce the higher expected probability of default in open account trades, where exports are fully exposed to the credit risk of the importer.

There are several reasons why the crisis may have caused the supply of trade finance to decrease, including increased uncertainty about the credit risk of counterparties, the liquidity crisis causing banks to cut trade finance credit lines, which are short term in nature, and the moral suasion of authorities on banks to lend their funds domestically. Showing that there is an actual decrease in the supply of trade finance in the face of large demand shocks is actually quite difficult to do. Yet, a number of careful academic studies strongly suggest the supply of trade credit was indeed a critical factor during the crisis. Chor and Manova (2010) show that countries with tighter credit conditions suffered a larger decline in exports to the United States during the crisis, and these effects were most apparent in sectors that had

<sup>4</sup>See Wynne (2009) and Chauffour and Farole (2009) for more details.

the least access to trade credit from trade partners, controlling for other factors. Paravisini et al. (2010) use detailed data from Peru, allowing them to compare firms exporting the same product to the same destination but borrowing from different banks. Banks that relied heavily on foreign currency-denominated loans reduced the supply of credit, causing their client firms to export less (accounting for 15% of the reduction in exports) and some firms to exit certain product-destination markets.

In any case, governments and international organizations were keenly aware of the potentially dire consequences of a collapse in trade finance and intervened through a

variety of channels. Most notably, the London summit of the G20 in April 2009 offered \$250 billion in support for trade finance through export credit and investment agencies and multilateral development banks. The International Finance Corporation (IFC) doubled its Global Trade Finance Program (which provides guarantees) and offered substantial additional liquidity support. Many individual countries took unilateral actions, such as Norway's government pumping \$7.2 billion into its cash-strapped export credit institution, Eksportfinans. It seems that governments have learned the lesson of the Great Depression in the 1930s, when protectionist trade policy exacerbated the downturn.

## POINT-COUNTERPOINT

### On Bicycles and Countertrade

Ante and Freedy are in Vienna, Austria, visiting their Aunt Helga. After the collapse of the former Soviet Union, Helga realized that the central European and eastern European regions would see a big increase in international trade. Along with German and English, Helga had learned Polish and Russian, which allowed her to move comfortably around the region as a consultant, setting up trading operations for corporations in these emerging markets.

Helga wanted some advice from Ante and Freedy: "I've gotten a call from a Ukrainian bicycle manufacturer that wants to import some gears from the Italian company Campagnolo. I called Campagnolo, and they said they don't export to such companies unless the importer gets a documentary credit from a major international bank. I checked with the Ukrainians, and they said their banks charge too much for a D/C. Do you have any suggestions?"

Ante said, "Yeah, let them pay cash in advance. That'll make Campagnolo happy."

Freedy seized the moment to squash his brother. "Oh sure, these Ukrainians have mountains of hard currency sitting around, waiting to be paid to their shareholders, so the bicycle company will just dip into its massive stockpile of cash and buy the gears. Silly me!"

Ante felt embarrassed when he realized how impractical his suggestion was, but he tried again, "Okay, cash in advance is impractical, and a D/C is too expensive. Maybe the Italians will accept a documentary collection."

Helga interjected, "I've already been down that route with Campagnolo's CFO, and he said no dice. He thinks the credit risk is too high. I think these Ukrainian bikes are really high quality. There has got to be another way to do this deal."

Of course, Suttle Trooth was traveling with his cousins, and he had been listening in. Suttle offered the following insight: "Helga, there is always another way. Why don't you contact a major importer of bicycles here in Vienna or up in Berlin, and get them to look at the Ukrainian bikes? If they like the quality, they can contract with the Ukrainians to buy the bicycles, but part of the contract will pay Campagnolo for the gears that will be exported to the Ukraine. In fact, a major bicycle distributor probably even has an open account with Campagnolo. Gears will go to the Ukraine, bikes will go to Berlin, and Campagnolo will increase its accounts receivable from the Berlin bike distributor. It's easy." Helga was impressed with Suttle's assessment of the situation. She asked, "Does that transaction have a name?"

Suttle replied, "Yes, it's a form of countertrade."

## 18.5 COUNTERTRADE

**Countertrade** emerged in the 1960s as a way to facilitate East–West trade, and its complexity continues to evolve to this day. Countertrade makes it possible for exporters and importers to exchange goods and services without necessarily having to use money as a medium of exchange. Countertrade does not describe one particular type of international transaction, however, but a related set of activities that encompasses various types of barter. It can occur between two or more parties, involve one or more contracts, and use money or not.

The United Nations estimates that at least 25% of all international trade involves some form of countertrade. The **Global Offset and Countertrade Association (GOCA)** holds semi-annual conferences and supports a Web site ([www.globaloffset.org](http://www.globaloffset.org)) devoted to the practice. Some representative member companies of the GOCA include Boeing, Cisco Systems, Embraer, General Dynamics, General Electric, Motorola, and Raytheon.

One quintessential example of an early countertrade involved PepsiCo, which began operating in the Soviet Union in 1974. PepsiCo agreed to license several Soviet-owned bottling plants and to supply them with cola concentrate. In return for its concentrate, PepsiCo agreed to become the exclusive importer to the United States of the Soviet Union’s Stolichnaya vodka.

Exhibit 18.7 lists the specific types of countertrade, of which there are two broad categories (see Hammond, 1990). Within each category are three subcategories. The first category contains transactions that are designed to avoid the use of money. These include barter, clearing arrangements, and switch trading. The second category of transactions uses money or credit and is designed to impose commitments on the exporter. These transactions include buybacks, counterpurchases, and offsets. We examine each of the six types of countertrade in turn.

### Transactions Without Money

#### *Barter and Clearing Arrangements*

**International barter** involves the transfer of goods or services from a party in one country to a party in another country in return for some other good or service. Trade is balanced in the sense that the value of what is being exported equals the value of what is being imported. Although money is not involved, money may be the numeraire that determines the values of the goods. However, the difficulty in valuing various goods and the disagreements that can ensue about their equivalence have led to the decline of barter as an instrument of international trade.

**Clearing arrangements** allow barter to be conducted on credit. Under a clearing arrangement, each of the two parties to a transaction agrees to import a certain value of goods and services from the other. A clearing account is established, and imports and exports are debited and credited over time. If the contract has a specified end date, the two parties can settle any nonzero, residual balance with a final shipment of goods or a money payment at the end of the specified period.

#### Exhibit 18.7 Types of Countertrade

Trades Without Money	Trades Involving Money or Credit
Barter	Buybacks
Clearing arrangements	Counterpurchases
Switch trading	Offsets

### Switch Trading

**Switch trading** involves a third party, a switch trader, who facilitates the eventual clearing of an imbalance of trade between two partners to a bilateral clearing arrangement. Often, governments are involved in the creation of a clearing arrangement. If one of the countries generates an imbalance of trade, and no hard currency is available to offset the imbalance, it may be sold at a discount to a switch trader, who uses the account to purchase goods in the country that has run the trade balance deficit. The switch trader then resells the goods on world markets.

For example, Brazil and Romania might agree to exchange Brazilian coffee for Romanian fertilizer during the coming year, with the intention of balancing trade by year end. If the value of Romania's coffee imports exceeds the value of its fertilizer exports, a switch trader could purchase the clearing balance from Brazil with hard currency. The switch trader would then have the right to purchase other Romanian goods with the clearing balance, and these goods would be exported to the world market.

Some critics of switch trading note that there is no guarantee that Romania would not be dumping its manufactured goods, where *dumping* is defined as selling goods internationally for less than they cost to produce. If dumping is occurring, though, it is being done indirectly by a third party, the switch trader, and not directly by the manufacturer. Other critics note that by failing to establish a foreign distribution network, countries such as Romania, in our example, never learn how to make their products more attractive to foreign buyers.

## Countertrade Involving Money or Credit

### Buybacks

A **buyback** involves an agreement in which an exporter of physical capital agrees to accept payment in the form of the output of a plant that the exporter helps to construct and equip in a foreign country. There are three varieties of buybacks. In one, the exporter receives products directly from the factory that was constructed, and these products may be similar to what the exporter also produces. The exporter must be aware that the increased supply of the foreign product could drive down its world price, with adverse consequences on the exporter's other markets. This is what PepsiCo realized would happen with its deal in the Soviet Union if it accepted cola produced in the Soviet Union. Hence, the company bought back vodka instead. In another variety of buyback, the exporter receives resultant products that are unrelated to the exporter's industry. Here the problem is that the exporter has less ability to assess the value of the products and no marketing network. In a third type of buyback, the exporter receives a mix of resultant products and other products of the country.

A famous example of a buyback is the agreement by several western European countries to supply the Soviet Union with the pipe, compressors, controls, and other equipment necessary to build a natural gas pipeline from the Soviet Union to western Europe. The payment for the pipeline was natural gas delivered through the pipeline to western Europe over several years.

### Counterpurchases

A **counterpurchase** is similar to a buyback, except the exporter purchases totally non-resultant products from the importer. For example, in 2010, Venezuela and Belarus entered into a bilateral country deal in which billions of dollars of oil and natural gas would be sent from Venezuela to Belarus in future years and Belarus would in turn build public housing complexes and a factory to manufacture tractors and trucks in Venezuela.

### Offsets

An **offset** is a requirement of an importing country that the price of its imports be offset in some way by the exporter. Offsets are common in contracts for weapons and contracts for other large expenditures, such as power-generating facilities. The exporter agrees to purchase

goods in the importer's country, to increase its imports from that country, to transfer technology to the country, or to conduct additional direct foreign investment in the country in return for setting up the facility. For example, in a multiyear contract, signed in 2004, the Lockheed Martin Corporation of Fort Worth, Texas entered into an offset trade with the United Arab Emirates (UAE), which purchased 80 F16 fighter planes called Desert Falcons—a deal worth \$6.4 billion. The offset included Lockheed agreeing to invest \$160 million in a gas pipeline running from Qatar to UAE and then on to Pakistan.

The set of issues involved in various forms of countertrade has expanded to the point where some people now prefer to talk in terms of **compensatory trade**, or “mandated reciprocity.” For example, the Web site for the Beijing Investment Guide ([www.chinavista.com/beijing/invest/invest-types.html](http://www.chinavista.com/beijing/invest/invest-types.html)) describes compensatory trade in the following way:

Compensatory trade enterprises are ones in which overseas partners provide equipment and technology and are bound to purchase a certain quantity of the finished products for exportation. Purchase of the equipment and technology can be made on the installment plan. Agreed upon negotiation by both parties of the compensatory trade enterprises, the loans for purchasing and importing the equipment and technology can be paid back in kind with other products as well as the finished equipment and technology as approved of when forming the compensatory trade enterprises.

Clearly, this is countertrade, and as such, parties involved in these complex international trade deals must understand that they may be entering into a long-term deal that will involve many future rounds of not only trade but additional negotiations.

## 18.6 SUMMARY

This chapter examines some of the institutional details related to how international trade is conducted and financed. The main points in the chapter are as follows:

1. The shipping documents of international trade include bills of lading, commercial invoices, packing lists, insurance certificates, consular invoices, and certificates of analysis.
2. A straight bill of lading instructs a common carrier to deliver merchandise to a designated party, known as the consignee. An order bill of lading transfers the title of goods. An on-board bill of lading indicates that goods have been placed on a particular vessel for shipment, whereas a received-for-shipment bill of lading indicates only that the merchandise is at the dock awaiting transport. A clean bill of lading indicates that a carrier believes the merchandise in question was received in good condition, whereas a foul bill of lading indicates that a carrier's initial inspection of the merchandise in question uncovered some damage before the merchandise was received for shipment.
3. Exporters issue to importers commercial invoices that provide a description of the merchandise, including the unit prices of the items, the number of items shipped, and the financial terms of the sale, including the amount due from the buyer and any charges to the buyer arising from insurance and shipping. A packing list indicates how the specific goods are stored in various containers.
4. A firm that does a substantial amount of exporting can purchase open, or floating, insurance policies that automatically cover all of the firm's exports. This eliminates the need for the exporter to arrange insurance coverage for each order.
5. A consular invoice, filled out by an exporter in consultation with the consulate of the importing country, provides information to customs officials that prevents false declarations of the value of the merchandise.
6. Certificates of analysis are sometimes required by documentary credits to assure an importer that a shipment meets certain standards of purity, weight, sanitation, or other measurable characteristics.
7. The different methods of payment available for an importer include cash in advance, open account, documentary collections, and documentary credits.
8. Cash in advance requires an importer to pay an exporter before the goods in question are shipped.

- The importer must finance the purchase of the goods and must bear the risk that the goods will not be exactly what is ordered.
9. An open account arrangement allows an importer to order goods and pay an invoiced amount at some time in the future. The exporter extends trade credit to the importer, which finances the importer's purchase.
  10. A documentary collection is an instrument that allows an exporter to retain control of the goods until the importer has paid for them or is legally bound to pay for them and that involves a bank in the collection process.
  11. With a documentary credit, also called a letter of credit, banks stand between the importer and the exporter, and the exporter must assess the credit risk of the international banks. Because the involvement of banks in the transaction is extensive, the documentary credit is the most expensive of the methods of payment, but a confirmed irrevocable documentary credit is also the safest for the exporter.
  12. A banker's acceptance is a document, tradable in financial markets, that is created when a bank stamps and signs a time draft indicating that the bank will pay the face value of a draft at maturity.
  13. Exporters can obtain financing through a bank line of credit, through the discounting of a banker's acceptance, by setting up a buyer credit, by arranging a receivables purchase, from limited-recourse financing, and through export factoring.
  14. Major exporting countries have export-import banks that offer a variety of programs that subsidize the exports of their countries. The subsidies include providing credit either directly to an exporter or its customers when the private market fails to do so, loans at below-market interest rates, and credit insurance or guarantees at below-market prices.
  15. Countertrade refers to various trade agreements that involve contractual links between exports of a good or service and imports of a good or service. The various forms of countertrade include barter, clearing arrangements, switch trading, buybacks, counterpurchases, and offsets.

## QUESTIONS

1. What is the fundamental financing problem in international trade?
2. What is a bill of lading? Explain the difference between a straight bill of lading and an order bill of lading.
3. What is the difference between a clean bill of lading and a foul bill of lading?
4. What are the purposes of a commercial invoice and a packing list?
5. What do the INCOTERMS acronyms FOB, FAS, CFR, and CIF mean?
6. How can an exporter insure against the loss of value of goods while they are being shipped internationally?
7. Why might a country require an exporter to acquire a consular invoice in order to clear the customs of an importing country?
8. Why would a certificate of analysis be important for shipping goods internationally?
9. What are four different methods by which an importer can pay an exporter? List them in increasing order of risk to the exporter.
10. True or false: In a documentary collection, the remitting bank is the agent of the importer.
11. What is the difference between a documents against payment collection and a documents against acceptance collection?
12. How is a trade acceptance created? Whose liability is it? Can it be sold in the international money market?
13. What is meant by a document discrepancy? How might one arise? How can it be resolved?
14. How is a documentary credit created, and what are its advantages to exporters and importers?
15. What is a confirmed documentary credit? Why would an exporter demand a confirmed, irrevocable documentary credit? What are the costs of using a documentary credit?
16. What is the most straightforward way for an exporter to finance its accounts receivable?
17. What is a banker's acceptance? How is one created? Whose liability is it?
18. What is the difference between an eligible and an ineligible banker's acceptance, and what are the eligibility requirements?
19. How is a buyer credit arranged?
20. What is forfaiting? How does it work? Why did it arise?
21. What is export factoring? What services does a factor perform for an exporter?
22. What are the differences between receiving payment on a collection basis, on an average collection basis, and on a maturity basis?

23. How does an export–import bank work? Who ultimately pays for the services of an export–import bank?
24. What are the major programs of the U.S. Ex-Im Bank?
25. What are the six different types of countertrade? Describe them.
26. How would a clearing arrangement work between the Ukraine and Lithuania, whereby the Ukraine exports grain and Lithuania exports shoes?
27. There are major natural resource deposits in the People’s Republic of China (PRC). How might a buyback arrangement work in which the PRC purchases earthmoving equipment from the Japanese firm Komatsu?
28. The Indonesian government is concerned that it may contribute to the country’s balance-of-trade deficit if it follows through with plans to import a large order of trucks from Germany that will be used to develop Indonesian timber resources. How might the Indonesian government use a counterpurchase to its advantage?
29. Web Question: Go to the Trade Finance magazine Web site at [www.tradefinancemagazine.com](http://www.tradefinancemagazine.com) and report on the latest innovations in trade finance.
30. Web Question: Visit the following Web site: [www.pitc.gov.ph/contracts/qinetiq.pdf](http://www.pitc.gov.ph/contracts/qinetiq.pdf). What type of international trade is described in this contract? What is the rationale for such a contract?

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