The international trade activities of MNCs have grown in importance over time. This trend is attributable to the increased globalization of the world economies and the availability of trade finance from the international banking community. Although banks also finance domestic trade, their role in financing international trade is more critical due to the additional complications involved. First, the exporter might question the importer’s ability to make payment. Second, even if the importer is creditworthy, the government might impose exchange controls that prevent payment to the exporter. Third, the importer might not trust the exporter to ship the goods ordered. Fourth, even if the exporter does ship the goods, trade barriers or time lags in international transportation might delay arrival time. Financial managers must recognize methods that they can use to finance international trade so that they can conduct exporting or importing in a manner that maximizes the value of an MNC.

The specific objectives of this chapter are to:
- describe methods of payment for international trade,
- explain common trade finance methods, and
- describe the major agencies that facilitate international trade with export insurance and/or loan programs.

Payment Methods for International Trade

In any international trade transaction, credit is provided by either the supplier (exporter), the buyer (importer), one or more financial institutions, or any combination of these. The supplier may have sufficient cash flow to finance the entire trade cycle, beginning with the production of the product until payment is eventually made by the buyer. This form of credit is known as supplier credit. In some cases, the exporter may require bank financing to augment its cash flow. On the other hand, the supplier may not desire to provide financing, in which case the buyer will have to finance the transaction itself, either internally or externally, through its bank. Banks on both sides of the transaction can thus play an integral role in trade financing.
In general, five basic methods of payment are used to settle international transactions, each with a different degree of risk to the exporter and importer (Exhibit 19.1):

- **Prepayment**
- **Letters of credit**
- **Drafts (sight/time)**
- **Consignment**
- **Open account**

### Prepayment

Under the **prepayment** method, the exporter will not ship the goods until the buyer has remitted payment to the exporter. Payment is usually made in the form of an international wire transfer to the exporter's bank account or foreign bank draft. As technology progresses, electronic commerce will allow firms engaged in international trade to make electronic credits and debits through an intermediary bank. This method affords the supplier the greatest degree of protection, and it is normally requested of first-time buyers whose creditworthiness is unknown or whose countries are in financial difficulty. Most buyers, however, are not willing to bear all the risk by prepaying an order.

### Letters of Credit (L/C)

A **letter of credit (L/C)** is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of shipping documents in compliance with the terms stipulated therein. In effect, the bank is substituting its
Credit for that of the buyer. This method is a compromise between seller and buyer because it affords certain advantages to both parties. The exporter is assured of receiving payment from the issuing bank as long as it presents documents in accordance with the L/C. An important feature of an L/C is that the issuing bank is obligated to honor drawings under the L/C regardless of the buyer’s ability or willingness to pay. On the other hand, the importer does not have to pay for the goods until shipment has been made and the documents are presented in good order. However, the importer must still rely upon the exporter to ship the goods as described in the documents, since the L/C does not guarantee that the goods purchased will be those invoiced and shipped. Letters of credit will be described in greater detail later in this chapter.

Drafts

A draft (or bill of exchange) is an unconditional promise drawn by one party, usually the exporter, instructing the buyer to pay the face amount of the draft upon presentation. The draft represents the exporter’s formal demand for payment from the buyer. A draft affords the exporter less protection than an L/C, because the banks are not obligated to honor payments on the buyer’s behalf.

Most trade transactions handled on a draft basis are processed through banking channels. In banking terminology, these transactions are known as documentary collections. In a documentary collection transaction, banks on both ends act as intermediaries in the processing of shipping documents and the collection of payment. If shipment is made under a sight draft, the exporter is paid once shipment has been made and the draft is presented to the buyer for payment. The buyer’s bank will not release the shipping documents to the buyer until the buyer has paid the draft. This is known as documents against payment. It provides the exporter with some protection, since the banks will release the shipping documents only according to the exporter’s instructions. The buyer needs the shipping documents to pick up the merchandise. The buyer does not have to pay for the merchandise until the draft has been presented.

If a shipment is made under a time draft, the exporter instructs the buyer’s bank to release the shipping documents against acceptance (signing) of the draft. This method of payment is sometimes referred to as documents against acceptance. By accepting the draft, the buyer is promising to pay the exporter at the specified future date. This accepted draft is also known as a trade acceptance, which is different from a banker’s acceptance (discussed later in the chapter). In this type of transaction, the buyer is able to obtain the merchandise prior to paying for it.

The exporter is providing the financing and is dependent upon the buyer’s financial integrity to pay the draft at maturity. Shipping on a time draft basis provides some added comfort in that banks at both ends are used as collection agents. In addition, a draft serves as a binding financial obligation in case the exporter wishes to pursue litigation on uncollected receivables. The added risk is that if the buyer fails to pay the draft at maturity, the bank is not obligated to honor payment. The exporter is assuming all the risk and must analyze the buyer accordingly.

Consignment

Under a consignment arrangement, the exporter ships the goods to the importer while still retaining actual title to the merchandise. The importer has access to the inventory but does not have to pay for the goods until they have been sold to a third party. The ex-
porter is trusting the importer to remit payment for the goods sold at that time. If the importer fails to pay, the exporter has limited recourse because no draft is involved and the goods have already been sold. As a result of the high risk, consignments are seldom used except by affiliated and subsidiary companies trading with the parent company. Some equipment suppliers allow importers to hold some equipment on the sales floor as demonstrator models. Once the models are sold or after a specified period, payment is sent to the supplier.

**Open Account**

The opposite of prepayment is the open account transaction in which the exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms. The exporter is relying fully upon the financial creditworthiness, integrity, and reputation of the buyer. As might be expected, this method is used when the seller and buyer have mutual trust and a great deal of experience with each other. Despite the risks, open account transactions are widely utilized, particularly among the industrialized countries in North America and Europe.

**Trade Finance Methods**

As mentioned in the previous section, banks on both sides of the transaction play a critical role in financing international trade. The following are some of the more popular methods of financing international trade:

- Accounts receivable financing
- Factoring
- Letters of credit (L/Cs)
- Banker's acceptances
- Working capital financing
- Medium-term capital goods financing (forfaiting)
- Countertrade

Each of these methods is described in turn.

**Accounts Receivable Financing**

In some cases, the exporter of goods may be willing to ship goods to the importer without an assurance of payment from a bank. This could take the form of an open account shipment or a time draft. Prior to shipment, the exporter should have conducted its own credit check on the importer to determine creditworthiness. If the exporter is willing to wait for payment, it will extend credit to the buyer.

If the exporter needs funds immediately, it may require financing from a bank. In what is referred to as accounts receivable financing, the bank will provide a loan to the exporter secured by an assignment of the account receivable. The bank's loan is made to the exporter based on its creditworthiness. In the event the buyer fails to pay the exporter for whatever reason, the exporter is still responsible for repaying the bank.

Accounts receivable financing involves additional risks, such as government restrictions and exchange controls, that may prevent the buyer from paying the exporter. As a
result, the loan rate is often higher than domestic accounts receivable financing. The length of a financing term is usually one to six months. To mitigate the additional risk of a foreign receivable, exporters and banks often require export credit insurance before financing foreign receivables.

**Factoring**

When an exporter ships goods before receiving payment, the accounts receivable balance increases. Unless the exporter has received a loan from a bank, it is initially financing the transaction and must monitor the collections of receivables. Since there is a danger that the buyer will never pay at all, the exporting firm may consider selling the accounts receivable to a third party, known as a **factor**. In this type of financing, the exporter sells the accounts receivable without recourse. The factor then assumes all administrative responsibilities involved in collecting from the buyer and the associated credit exposure. The factor performs its own credit approval process on the foreign buyer before purchasing the receivable. For providing this service, the factor usually purchases the receivable at a discount and also receives a flat processing fee.

**Factoring** provides several benefits to the exporter. First, by selling the accounts receivable, the exporter does not have to worry about the administrative duties involved in maintaining and monitoring an accounts receivable accounting ledger. Second, the factor assumes the credit exposure to the buyer, so the exporter does not have to maintain personnel to assess the creditworthiness of foreign buyers. Finally, by selling the receivable to the factor, the exporter receives immediate payment and improves its cash flow.

Since it is the importer who must be creditworthy from a factor’s point of view, **cross-border factoring** is often used. This involves a network of factors in various countries who assess credit risk. The exporter’s factor contacts a correspondent factor in the buyer’s country to assess the importer’s creditworthiness and handle the collection of the receivable. Factoring services are usually provided by the factoring subsidiaries of commercial banks, commercial finance companies, and other specialized finance houses. Factors often utilize export credit insurance to mitigate the additional risk of a foreign receivable.

**Letters of Credit (L/C)**

Introduced earlier, the letter of credit (L/C) is one of the oldest forms of trade finance still in existence. Because of the protection and benefits it accords to both exporter and importer, it is a critical component of many international trade transactions. The L/C is an undertaking by a bank to make payments on behalf of a specified party to a beneficiary under specified conditions. The beneficiary (exporter) is paid upon presentation of the required documents in compliance with the terms of the L/C. The L/C process normally involves two banks, the exporter’s bank and the importer’s bank. The issuing bank is substituting its credit for that of the importer. It has essentially guaranteed payment to the exporter, provided the exporter complies with the terms and conditions of the L/C.

Sometimes the exporter is uncomfortable with the issuing bank’s promise to pay because the bank is located in a foreign country. Even if the issuing bank is well known worldwide, the exporter may be concerned that the foreign government will impose exchange controls or other restrictions that would prevent payment by the issuing bank.
For this reason, the exporter may request that a local bank confirm the L/C and thus assure that all the responsibilities of the issuing bank will be met. The confirming bank is obligated to honor drawings made by the beneficiary in compliance with the L/C regardless of the issuing bank’s ability to make that payment. Consequently, the confirming bank is trusting that the foreign bank issuing the L/C is sound. The exporter, however, need worry only about the credibility of the confirming bank.

Nike can attribute part of its international business growth in the 1970s to the use of L/Cs. In 1971, Nike (which was then called BSR) was not well known to businesses in Japan or anywhere else. Nevertheless, by using L/Cs, it was still able to subcontract the production of athletic shoes in Japan. The L/Cs assured the Japanese shoe producer that it would receive payment for the shoes it would send to the United States and thus facilitated the flow of trade without concern about credit risk. Banks served as the guarantors in the event that the Japanese shoe company was not paid in full after transporting shoes to the United States. Thus, because of the backing of the banks, the L/Cs allowed the Japanese shoe company to do international business without having to worry that the counterparty in its agreement would not fulfill its obligation. Without such agreements, Nike (and many other firms) would not be able to order shipments of goods.

**Types of Letters of Credit.** Trade-related letters of credit are known as commercial letters of credit or import/export letters of credit. There are basically two types: revocable and irrevocable. A revocable letter of credit can be canceled or revoked at any time without prior notification to the beneficiary, and it is seldom used. An irrevocable letter of credit (see Exhibit 19.2) cannot be canceled or amended without the beneficiary’s consent. The bank issuing the L/C is known as the “issuing” bank. The correspondent bank in the beneficiary’s country to which the issuing bank sends the L/C is commonly referred to as the “advising” bank. An irrevocable L/C obligates the issuing bank to honor all drawings presented in conformity with the terms of the L/C. Letters of credit are normally issued in accordance with the provisions contained in “Uniform Customs
and Practice for Documentary Credits,” published by the International Chamber of Commerce.

The bank issuing the L/C makes payment once the required documentation has been presented in accordance with the payment terms. The importer must pay the issuing bank the amount of the L/C plus accrued fees associated with obtaining the L/C. The importer usually has established an account at the issuing bank to be drawn upon for payment, so that the issuing bank does not tie up its own funds. However, if the importer does not have sufficient funds in its account, the issuing bank is still obligated to honor all valid drawings against the L/C. This is why the bank’s decision to issue an L/C on behalf of an importer involves an analysis of the importer’s creditworthiness and is analogous to the decision to make a loan. The documentary credit procedure is depicted in the flowchart in Exhibit 19.3. In what is commonly referred to as a refinancing of a sight L/C, the bank arranges to fund a loan to pay out the L/C instead of charging the importer’s account immediately. The importer is responsible for repaying the bank both the principal and interest at maturity. This is just another method of providing extended payment terms to a buyer when the exporter insists upon payment at sight.

The bank issuing the L/C makes payment to the beneficiary (exporter) upon presentation of documents that meet the conditions stipulated in the L/C. Letters of credit are payable either at sight (upon presentation of documents) or at a specified future date. The typical documentation required under an L/C includes a draft (sight or time), a commercial invoice, and a bill of lading. Depending upon the agreement, product, or country, other documents (such as a certificate of origin, inspection certificate, packing list, or insurance certificate) might be required. The three most common L/C documents are as follows.

**Draft.** Also known as a bill of exchange, a draft (introduced earlier) is an unconditional promise drawn by one party, usually the exporter, requesting the importer to pay the face amount of the draft at sight or at a specified future date. If the draft is drawn at sight,
it is payable upon presentation of documents. If it is payable at a specified future date (a time draft) and is accepted by the importer, it is known as a trade acceptance. A banker’s acceptance is a time draft drawn on and accepted by a bank. When presented under an L/C, the draft represents the exporter’s formal demand for payment. The time period, or tenor, of most time drafts is usually anywhere from 30 to 180 days.

**Bill of Lading.** The key document in an international shipment under an L/C is the bill of lading (B/L). It serves as a receipt for shipment and a summary of freight charges; most importantly, it conveys title to the merchandise. If the merchandise is to be shipped by boat, the carrier will issue what is known as an ocean bill of lading. When the merchandise is shipped by air, the carrier will issue an airway bill. The carrier presents the bill to the exporter (shipper), who in turn presents it to the bank along with the other required documents.

A significant feature of a B/L is its negotiability. A straight B/L is consigned directly to the importer. Since it does not represent title to the merchandise, the importer does not need it to pick up the merchandise. When a B/L is made out to order, however, it is said to be in negotiable form. The exporter normally endorses the B/L to the bank once payment is received from the bank.

The bank will not endorse the B/L over to the importer until payment has been made. The importer needs the original B/L to pick up the merchandise. With a negotiable B/L, title passes to the holder of the endorsed B/L. Because a negotiable B/L grants title to the holder, banks can take the merchandise as collateral. A B/L usually includes the following provisions:

- A description of the merchandise
- Identification marks on the merchandise
- Evidence of loading (receiving) ports
- Name of the exporter (shipper)
- Name of the importer
- Status of freight charges (prepaid or collect)
- Date of shipment

**Commercial Invoice.** The exporter’s (seller’s) description of the merchandise being sold to the buyer is the commercial invoice, which normally contains the following information:

- Name and address of seller
- Name and address of buyer
- Date
- Terms of payment
- Price, including freight, handling, and insurance if applicable
- Quantity, weight, packaging, etc.
- Shipping information

Under an L/C shipment, the description of the merchandise outlined in the invoice must correspond exactly to that contained in the L/C.

**Variations of the L/C.** There are several variations of the L/C that are useful in financing trade. A *standby letter of credit* can be used to guarantee invoice payments to a supplier. It promises to pay the beneficiary if the buyer fails to pay as agreed. Internationally, standby L/Cs often are used with government-related contracts and serve as
bid bonds, performance bonds, or advance payment guarantees. In an international or domestic trade transaction, the seller will agree to ship to the buyer on standard open account terms as long as the buyer provides a standby L/C for a specified amount and term. As long as the buyer pays the seller as agreed, the standby L/C is never funded. However, if the buyer fails to pay, the exporter may present documents under the L/C and request payment from the bank. The buyer's bank is essentially guaranteeing that the buyer will make payment to the seller.

A transferable letter of credit is a variation of the standard commercial L/C that allows the first beneficiary to transfer all or a part of the original L/C to a third party. The new beneficiary has the same rights and protection as the original beneficiary. This type of L/C is used extensively by brokers, who are not the actual suppliers.

The broker asks the foreign buyer to issue an L/C for $100,000 in his favor. The L/C must contain a clause stating that the L/C is transferable. The broker has located an end supplier who will provide the product for $80,000, but requests payment in advance from the broker. With a transferable L/C, the broker can transfer $80,000 of the original L/C to the end supplier under the same terms and conditions, except for the amount, the latest shipment date, the invoice, and the period of validity. When the end supplier ships the product, it presents its documents to the bank. When the bank pays the L/C, $80,000 is paid to the end supplier and $20,000 goes to the broker. In effect, the broker has utilized the credit of the buyer to finance the entire transaction.

Another type of L/C is the assignment of proceeds. In this case, the original beneficiary of the L/C pledges (or assigns) the proceeds under an L/C to the end supplier. The end supplier has assurance from the bank that if and when documents are presented in compliance with the terms of the L/C, the bank will pay the end supplier according to the assignment instructions. This assignment is valid only if the beneficiary presents documents that comply with the L/C. The end supplier must recognize that the issuing bank is under no obligation to pay the end supplier if the original beneficiary never ships the goods or fails to comply with the terms of the L/C.

**Banker’s Acceptance**

Introduced earlier, a banker’s acceptance (shown in Exhibit 19.4) is a bill of exchange, or time draft, drawn on and accepted by a bank. It is the accepting bank’s obligation to pay the holder of the draft at maturity.

In the first step in creating a banker’s acceptance, the importer orders goods from the exporter. The importer then requests its local bank to issue an L/C on its behalf. The L/C will allow the exporter to draw a time draft on the bank in payment for the exported goods. The exporter presents the time draft along with shipping documents to its local bank, and the exporter’s bank sends the time draft along with shipping documents to the importer’s bank. The importer’s bank accepts the draft, thereby creating the banker’s acceptance. If the exporter does not want to wait until the specified date to receive payment, it can request that the banker’s acceptance be sold in the money market. By doing so, the exporter will receive less funds from the sale of the banker’s acceptance than if it had waited to receive payment. This discount reflects the time value of money.

A money market investor may be willing to buy the banker’s acceptance at a discount and hold it until payment is due. This investor will then receive full payment be-
cause the banker’s acceptance represents a future claim on funds of the bank represented by the acceptance. The bank will make full payment at the date specified because it expects to receive this amount plus an additional fee from the importer.

If the exporter holds the acceptance until maturity, it provides the financing for the importer as it does with accounts receivable financing. In this case, the key difference between a banker’s acceptance and accounts receivable financing is that a banker’s acceptance guarantees payment to the exporter by a bank. If the exporter sells the banker’s acceptance in the secondary market, however, it is no longer providing the financing for the importer. The holder of the banker’s acceptance is financing instead.

A banker’s acceptance can be beneficial to the exporter, importer, and issuing bank. The exporter does not need to worry about the credit risk of the importer and can therefore penetrate new foreign markets without concern about the credit risk of potential customers. In addition, the exporter faces little exposure to political risk or to exchange controls imposed by a government because banks normally are allowed to meet their payment commitments even if controls are imposed. In contrast, controls could prevent an importer from paying, so without a banker’s acceptance, an exporter might not receive payment even though the importer is willing to pay. Finally, the exporter can sell the banker’s acceptance at a discount before payment is due and thus obtain funds up front from the issuing bank.

The importer benefits from a banker’s acceptance by obtaining greater access to foreign markets when purchasing supplies and other products. Without banker’s acceptances, exporters may be unwilling to accept the credit risk of importers. In addition, due to the documents presented along with the acceptance, the importer is assured that goods have been shipped. Even though the importer has not paid in advance, this assurance is valuable because it lets the importer know if and when supplies and other products will arrive. Finally, because the banker’s acceptance allows the importer to pay at a later date, the importer’s payment is financed until the maturity date of the banker’s acceptance. Without an acceptance, the importer would likely be forced to pay in advance, thereby tying up funds.

The bank accepting the drafts benefits in that it earns a commission for creating an acceptance. The commission that the bank charges the customer reflects the customer’s perceived creditworthiness. The interest rate charged the customer, commonly referred to as the all-in-rate, consists of the discount rate plus the acceptance commission. In
general, the all-in-rate for acceptance financing is lower than prime-based borrowings, as shown in the following comparison:

<table>
<thead>
<tr>
<th></th>
<th>Loan</th>
<th>Acceptance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount:</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Term:</td>
<td>180 days</td>
<td>180 days</td>
</tr>
<tr>
<td>Rate:</td>
<td>Prime + 1.5%</td>
<td>BA rate + 1.5%</td>
</tr>
<tr>
<td></td>
<td>10.0% + 1.5% = 11.5%</td>
<td>7.60% + 1.5% = 9.10%</td>
</tr>
<tr>
<td>Interest cost:</td>
<td>$57,500</td>
<td>$45,500</td>
</tr>
</tbody>
</table>

In this case, the interest savings for a six-month period is $12,000. Since the banker’s acceptance is a marketable instrument with an active secondary market, the rates on acceptances usually fall between the rates on short-term Treasury bills and the rates on commercial paper. Investors are usually willing to purchase acceptances as an investment because of their yield, safety, and liquidity. When a bank creates, accepts, and sells the acceptance, it is actually using the investor’s money to finance the bank’s customer. As a result, the bank has created an asset at one price, sold it at another, and retained a commission (spread) as its fee.

Banker’s acceptance financing can also be arranged through the refinancing of a sight letter of credit. In this case, the beneficiary of the L/C (the exporter) may insist on payment at sight. The bank arranges to finance the payment of the sight L/C under a separate acceptance-financing agreement. The importer (borrower) simply draws drafts upon the bank, which in turn accepts and discounts the drafts. The proceeds are used to pay the exporter. At maturity, the importer is responsible for repayment to the bank.

Acceptance financing can also be arranged without the use of an L/C under a separate acceptance agreement. Similar to a regular loan agreement, it stipulates the terms and conditions under which the bank is prepared to finance the borrower using acceptances instead of promissory notes. As long as the acceptances meet one of the underlying transaction requirements, the bank and borrower can utilize banker’s acceptances as an alternative financing mechanism. The life cycle of a banker’s acceptance is illustrated in Exhibit 19.5.

**Working Capital Financing**

As just explained, a banker’s acceptance can allow an exporter to receive funds immediately, yet allow an importer to delay its payment until a future date. The bank may even provide short-term loans beyond the banker’s acceptance period. In the case of an importer, the purchase from overseas usually represents the acquisition of inventory. The loan finances the working capital cycle that begins with the purchase of inventory and continues with the sale of the goods, creation of an account receivable, and conversion to cash. With an exporter, the short-term loan might finance the manufacture of the merchandise destined for export (pre-export financing) or the time period from when the sale is made until payment is received from the buyer. For example, the firm may have imported foreign beer, which it plans to distribute to grocery and liquor stores. The bank can not only provide a letter of credit for trade finance, but it can also finance the importer’s cost from the time of distribution and collection of payment.
Medium-Term Capital Goods Financing (Forfaiting)

Because capital goods are often quite expensive, an importer may not be able to make payment on the goods within a short time period. Thus, longer-term financing may be required here. The exporter might be able to provide financing for the importer but may not desire to do so, since the financing may extend over several years. In this case, a type of trade finance known as forfaiting could be used. Forfaiting refers to the purchase of financial obligations, such as bills of exchange or promissory notes, without recourse to the original holder, usually the exporter. In a forfait transaction, the importer issues a promissory note to pay the exporter for the imported goods over a period that generally ranges from three to seven years. The exporter then sells the notes, without recourse, to the forfaiting bank.
In some respects, forfaiting is similar to factoring, in that the forfaiter (or factor) assumes responsibility for the collection of payment from the buyer, the underlying credit risk, and the risk pertaining to the countries involved. Since the forfaiting bank assumes the risk of nonpayment, it should assess the creditworthiness of the importer as if it were extending a medium-term loan. Forfait transactions normally are collateralized by a bank guarantee or letter of credit issued by the importer’s bank for the term of the transaction. Since obtaining financial information about the importer is usually difficult, the forfaiting bank places a great deal of reliance on the bank guarantee as the collateral in the event the buyer fails to pay as agreed. It is this guarantee backing the transaction that has fostered the growth of the forfait market, particularly in Europe, as a practical means of trade finance.

Forfaiting transactions are usually in excess of $500,000 and can be denominated in most currencies. For some larger transactions, more than one bank may be involved. In this case, a syndicate is formed wherein each participant assumes a proportionate share of the underlying risk and profit. A forfaiting firm may decide to sell the promissory notes of the importer to other financial institutions willing to purchase them. However, the forfaiting firm is still responsible for payment on the notes in the event the importer is unable to pay.

Countertrade

The term countertrade denotes all types of foreign trade transactions in which the sale of goods to one country is linked to the purchase or exchange of goods from that same country. Some types of countertrade, such as barter, have been in existence for thousands of years. Only recently, however, has countertrade gained popularity and importance. The growth in various types of countertrade has been fueled by large balance-of-payment disequilibriums, foreign currency shortages, the debt problems of less developed countries and stagnant worldwide demand. As a result, many MNCs have encountered countertrade opportunities, particularly in Asia, Latin America, and Eastern Europe. The most common types of countertrade include barter, compensation, and counterpurchase.

Barter is the exchange of goods between two parties without the use of any currency as a medium of exchange. Most barter arrangements are one-time transactions governed by one contract. An example would be the exchange of 100 tons of wheat from Canada for 20 tons of shrimp from Ecuador.

In a compensation or clearing-account arrangement, the delivery of goods to one party is compensated for by the seller’s buying back a certain amount of the product from that same party. The transaction is governed by one contract, and the value of the goods is expressed in monetary terms. The buy-back arrangement could be for a fraction of the original sale (partial compensation) or more than 100 percent of the original sale (full compensation). An example of compensation would be the sale of phosphate from Morocco to France in exchange for purchasing a certain percentage of fertilizer. In some countries, this is also referred to as an industrial cooperation arrangement. Such arrangements often involve the construction of large projects, such as power plants, in exchange for the purchase of the project’s output over an extended period of time. For example, Brazil sold a hydroelectric plant to Argentina and in exchange purchased a percentage of the plant’s output under a long-term contract.

The term counterpurchase denotes the exchange of goods between two parties under two distinct contracts expressed in monetary terms. Delivery and payment of both goods are technically separate transactions.
Despite the economic inefficiencies of countertrade, it has become much more important in recent years. The primary participants are governments and MNCs, with assistance provided by specialists in the field, such as attorneys, financial institutions, and trading companies. The transactions are usually large and very complex. Many variations of countertrade exist, and the terminology used by the various market participants is still forming as the countertrade market continues to develop.

**Agencies That Motivate International Trade**

Due to the inherent risks of international trade, government institutions and the private sector offer various forms of export credit, export finance, and guarantee programs to reduce risk and stimulate foreign trade.

Three prominent agencies provide these services in the United States:

- Export-Import Bank of the United States (Ex-Imbank)
- Private Export Funding Corporation (PEFCO)
- Overseas Private Investment Corporation (OPIC)

Each of these agencies is described in turn.

**Export-Import Bank of the United States**

The Export-Import Bank was established in 1934 with the original goal of facilitating Soviet-American trade. Its mission today is to finance and facilitate the export of American goods and services and maintain the competitiveness of American companies in overseas markets. It operates as an independent agency of the U.S. government and, as such, carries the full faith and credit of the United States.

**Engelhard’s Selection of a Bank to Service Export Collections**

Engelhard Corp. is a large chemical manufacturer in New Jersey. It is one of the largest exporters in the United States and frequently uses banks to facilitate its trade. On a typical day, it may have 15 to 20 letters of credit (L/Cs). As it searched for a bank to facilitate its international trade financing, Engelhard established a set of requirements that the bank must meet:

- The bank must provide a workstation where L/Cs are stored as separate records.
- The bank must be capable of electronically transferring L/C information to various sites and to the workstation.
- The workstation must be accessible so that the firm can check payment information on a timely basis.

- The workstation must be able to retrieve L/C information pertaining to Engelhard’s business with any firm over any particular period.

Several banks bid for Engelhard’s business and assured the company that they could provide the services needed. As a result of Engelhard’s efforts to communicate its needs, it now has electronic access to much more information and can easily monitor its trade financing positions with each of its importers. This allows it to make more informed decisions about the terms of trade that it negotiates with each customer and thus enables it to maximize its value.
The Ex-Imbank's programs are typically designed to encourage the private sector to finance export trade by assuming some of the underlying credit risk and providing direct financing to foreign importers when private lenders are unwilling to do so. To satisfy these objectives, the Ex-Imbank offers programs that are classified as (1) guarantees, (2) loans, (3) bank insurance, and (4) export credit insurance.

**Guarantee Programs.** The two most widely used guarantee programs are the Working Capital Guarantee Program and the Medium-Term Guarantee Program. The Working Capital Guarantee Program encourages commercial banks to extend short-term export financing to eligible exporters by providing a comprehensive guarantee that covers 90 to 100 percent of the loan’s principal and interest. This guarantee protects the lender against the risk of default by the exporter. It does not protect the exporter against the risk of nonpayment by the foreign buyer. The loans are fully collateralized by export receivables and export inventory and require the payment of guarantee fees to the Ex-Imbank. The export receivables are usually supported with export credit insurance or a letter of credit.

The Guarantee Program encourages commercial lenders to finance the sale of U.S. capital equipment and services to approved foreign buyers. The Ex-Imbank guarantees 100 percent of the loan’s principal and interest. The financed amount cannot exceed 85 percent of the contract price. This program is designed to finance products sold on a medium-term basis, with repayment terms of generally between one and five years. The guarantee fees paid to the Ex-Imbank are determined by the repayment terms and the buyer’s risk. The Ex-Imbank now offers a leasing program to finance capital equipment and related services.

**Loan Programs.** Two of the most popular loan programs are the Direct Loan Program and the Project Finance Loan Program. Under the Direct Loan Program, Ex-Imbank offers fixed rate loans directly to the foreign buyer to purchase U.S. capital equipment and services on a medium-term or long-term basis. The total financed amount cannot exceed 85 percent of the contract price. Repayment terms depend upon the amount but are typically one to five years for medium-term transactions and seven to ten years for long-term transactions. The Ex-Imbank’s lending rates are generally below market rates.

The Project Finance Loan Program allows banks, the Ex-Imbank, or a combination of both to extend long-term financing for capital equipment and related services for major projects. These are typically large infrastructure projects, such as power generation projects, whose repayment depends on project cash flow. Major U.S. corporations are often involved in these types of projects. The program typically requires a 15 percent cash payment by the foreign buyer and allows for guarantees of up to 85 percent of the contract amount. The fees and interest rates vary depending on the project risk.

**Bank Insurance Programs.** The Ex-Imbank offers several insurance policies to banks. The most widely used is the Bank Letter of Credit Policy. This policy enables banks to confirm letters of credit issued by foreign banks supporting a purchase of U.S. exports. Without this insurance, some banks would not be willing to assume the underlying commercial and political risk associated with confirming an L/C. The banks are insured up to 100 percent for sovereign (government) banks and 95 percent for all other banks. The insurance premium is based on the type of buyer, repayment term, and country.

The Financial Institution Buyer Credit Policy is issued in the name of the bank. This policy provides insurance coverage for loans by banks to foreign buyers on a short-term basis. A variety of short-term and medium-term insurance policies are available to ex-
porters, banks, and other eligible applicants. Basically, all the policies provide insurance protection against the risk of nonpayment by foreign buyers. If the foreign buyer fails to pay the exporter because of commercial reasons such as cash flow problems or insolvency, the Ex-Imbank will reimburse the exporter between 90 and 100 percent of the insured amount, depending on the type of policy and buyer.

If the loss is due to political factors, such as foreign exchange controls or war, the Ex-Imbank will reimburse the exporter for 100 percent of the insured amount. Exporters can use the insurance policies as a marketing tool because the insurance enables them to offer more competitive terms while protecting them against the risk of nonpayment. An exporter can also use the insurance policy as a financing tool by assigning the proceeds of the policy to a bank as collateral. Certain restrictions may apply to particular countries, depending on the Ex-Imbank’s experience, as well as existing economic and political conditions.

Export Credit Insurance. The Small Business Policy provides enhanced coverage to new exporters and small businesses. The policy insures short-term credit sales (under 180 days) to approved foreign buyers. In addition to providing 95 percent coverage against commercial risk defaults and 100 percent against political risk, the policy offers lower premiums and no annual commercial risk loss deductible. The exporter can assign the policy to a bank as collateral.

The Umbrella Policy operates in a slightly different manner. The policy itself is issued to an “administrator,” such as a bank, trading company, insurance broker, or government agency. The policyholder administers the policy for multiple exporters and relieves the exporters of the administrative responsibilities associated with the policy. The short-term insurance protection is similar to that provided by the Small Business Policy and does not have a commercial risk deductible. The proceeds of the policy may be assigned to a bank for financing purposes.

The Multi-Buyer Policy is used primarily by experienced exporters. It provides insurance coverage on short-term export sales to many different buyers. Premiums are based on an exporter’s sales profile, credit history, terms of repayment, country, and other factors. Based on the exporter’s experience and the buyer’s creditworthiness, the Ex-Imbank may grant the exporter authority to preapprove specific buyers up to a certain limit.

The Single-Buyer Policy allows an exporter to selectively insure certain short-term transactions to preapproved buyers. Premiums are based on repayment terms and transaction risk. There is also a Medium-Term Policy to cover sales to a single buyer for terms of between one and five years.

The Ex-Imbank has also entered into partnership arrangements with more than 30 states to disseminate government trade promotion services to a broader audience. For example, in Florida, the Florida Export Finance Corp. provides export credit insurance consulting, trade finance, and guarantees to exporters based in Florida.

Several private insurance carriers, such as AIG, also provide various types of insurance policies that may be used to mitigate risk. They are frequently employed when Ex-Imbank insurance is not available or desirable.

Private Export Funding Corporation (PEFCO)

PEFCO, a private corporation, is owned by a consortium of commercial banks and industrial companies. In cooperation with the Ex-Imbank, PEFCO provides medium- and long-term fixed rate financing to foreign buyers. The Ex-Imbank guarantees all export
loans made by PEFCO. Most PEFCO loans are to finance large projects, such as aircraft and power generation equipment, and as a result have very long terms (5 to 25 years). Since commercial banks usually do not extend such long terms, PEFCO fills a void in the market. PEFCO also serves as a secondary market buyer of export loans originated by U.S. banks. PEFCO raises its funds in the capital markets through the issuance of long-term bonds. These bonds are readily marketable since they are in effect secured by Ex-Imbank-guaranteed loans.

**Overseas Private Investment Corporation (OPIC)**

OPIC, formed in 1971, is a self-sustaining federal agency responsible for insuring direct U.S. investments in foreign countries against the risks of currency inconvertibility, expropriation, and other political risks. Through the direct loan or guaranty program, OPIC will provide medium- to long-term financing to U.S. investors undertaking an overseas venture. In addition to the general insurance and finance programs, OPIC offers specific types of coverage for exporters bidding on or performing foreign contracts. American contractors can insure themselves against contractual disputes and even the wrongful calling of standby letters of credit.

### SUMMARY

- The common methods of payment for international trade are (1) prepayment (before goods are sent), (2) letters of credit, (3) drafts, (4) consignment, and (5) open account.
- The most popular methods of financing international trade are (1) accounts receivable financing, (2) factoring, (3) letters of credit, (4) banker’s acceptances, (5) working capital financing, (6) medium-term capital goods financing (forfaiting), and (7) countertrade.
- The major agencies that facilitate international trade with export insurance and/or loan programs are (1) Export-Import Bank, (2) Private Export Funding Corporation, and (3) Overseas Private Investment Corporation.

### POINT COUNTER-POINT

**Do Agencies That Facilitate International Trade Prevent Free Trade?**

**Point** Yes. The Export-Import Bank of the United States provides many programs to help U.S. exporters conduct international trade. The government is essentially subsidizing the exports. Governments in other countries have various programs as well. Thus, some countries may have a trade advantage because their exporters are subsidized in various ways. These subsidies distort the notion of free trade.

**Counter-Point** No. It is natural for any government to facilitate exporting for relatively inexperienced exporting firms. All governments provide a variety of services for their firms, including public services, and tax breaks for producing products that are ultimately exported. There is a difference between facilitating the exporting process and protecting an industry from foreign competition. The protection of an industry violates the notion of free trade, but facilitating the exporting process does not.

**Who Is Correct?** Use InfoTrac or some other search engine to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.
SELF TEST

Answers are provided in Appendix A at the back of the text.

1. Explain why so many international transactions require international trade credit facilitated by commercial banks.

2. Explain the difference in the risk to the exporter between accounts receivable financing and factoring.

3. Explain how the Export-Import Bank can encourage U.S. firms to export to less developed countries where there is political risk.

QUESTIONS AND APPLICATIONS

1. Banker’s Acceptances.
   a. Describe how foreign trade would be affected if banks did not provide trade-related services.
   b. How can a banker’s acceptance be beneficial to an exporter, an importer, and a bank?

2. Export Financing.
   a. Why would an exporter provide financing for an importer?
   b. Is there much risk in this activity? Explain.

3. Role of Factors.
   a. What is the role of a factor in international trade transactions?

   a. What is the role today of the Export-Import Bank of the United States?
   b. Describe the Direct Loan Program administered by the Export-Import Bank.

5. Bills of Lading. What are bills of lading, and how do they facilitate international trade transactions?

6. Forfaiting. What is forfaiting? Specify the type of traded goods for which forfaiting is applied.

7. PEFCO. Briefly describe the role of the Private Export Funding Corporation (PEFCO).

8. Government Programs. This chapter described many forms of government insurance and guarantee programs. What motivates a government to establish so many programs?

9. Countertrade. What is countertrade?

10. Impact of September 11. Every quarter, Bronx Co. ships computer chips to a firm in central Asia. It has not used any trade financing because the importing firm always pays its bill in a timely manner upon receipt of the computer chips. After the September 11, 2001 terrorist attack on the United States, Bronx reconsidered whether it should use some form of trade financing that would ensure that it would be paid for its exports upon delivery. Offer a suggestion to Bronx Co. on how it could achieve its goal.


13. OPIC. Describe the role of the Overseas Private Investment Corporation (OPIC).

ADVANCED QUESTIONS

14. Letters of Credit. Ocean Traders of North America is a firm based in Mobile, Alabama, that specializes in seafood exports and commonly uses letters of credit (L/Cs) to ensure payment. It recently experienced a problem, however. Ocean Traders had an irrevocable L/C issued by a Russian bank to ensure that it would receive payment upon shipment of 16,000 tons of fish to a Russian firm. This bank backed out of its obligation, however, stating that it was not authorized to guarantee commercial transactions.
   a. Explain how an irrevocable L/C would normally facilitate the business transaction between the Russian importer and Ocean Traders of North America (the U.S. exporter).
   b. Explain how the cancellation of the L/C could create a trade crisis between the U.S. and Russian firms.
assessments of international trade financing in Thailand

Blades, Inc., has recently decided to establish a subsidiary in Thailand to produce “Speedos,” Blades’ primary roller blade product. In establishing the subsidiary in Thailand, Blades was motivated by the high growth potential of the Thai roller blade market. Furthermore, Blades has decided to establish a subsidiary, as opposed to acquiring an existing Thai roller blade manufacturer for sale, in order to maintain its flexibility and control over the operations in Thailand. Moreover, Blades has decided to issue yen-denominated notes to partially finance the cost of establishing the subsidiary. Blades has decided to issue notes denominated in yen instead of baht to avoid the high effective interest rates associated with the baht-denominated notes.

Currently, Blades plans to sell all roller blades manufactured in Thailand to retailers in Thailand. Furthermore, Blades plans to purchase all components for roller blades manufactured in Thailand from Thai suppliers. Similarly, all of Blades’ roller blades manufactured in the United States will be sold to retailers in the United States and all components needed for Blades’ U.S. production will be purchased from suppliers in the United States. Consequently, Blades will have no exports and imports once the plant in Thailand is operational, which is expected to occur early next year.

Construction of the plant in Thailand has already begun, and Blades is currently in the process of purchasing the machinery necessary to produce Speedos. Besides these activities, Ben Holt, Blades’ chief financial officer (CFO), has been actively lining up suppliers of the needed rubber and plastic components in Thailand and identifying Thai customers, which will consist of various sports product retailers in Thailand.

Although Holt has been successful in locating both interested suppliers and interested customers, he is discovering that he has neglected certain precautions for operating a subsidiary in Thailand. First, although Blades is relatively well known in the United States, it is not recognized internationally. Consequently, the suppliers Blades would like to use in Thailand are not familiar with the firm and have no information about its reputation. Moreover, Blades’ previous activities in Thailand were restricted to the export of a fixed number of Speedos annually to one customer, a Thai retailer called Entertainment Products. Holt has little information about the potential Thai customers that would buy the roller blades produced by the new plant. He is aware, however, that although letters of credit (L/Cs) and drafts are usually employed for exporting purposes, these instruments are also used for trade within a country between relatively unknown parties.

Of the various potential customers Blades has identified in Thailand, four retailers of sports products appear particularly interested. Because Blades is not familiar with these firms and their reputations, it would like to receive payment from them as soon as possible. Ideally, Blades would like its customers to prepay for their purchases, as this would involve the least risk for Blades. Unfortunately, none of the four potential customers have agreed to a prepayment arrangement. In fact, one potential customer, Cool Runnings, Inc., insists on an open account transaction. Payment terms in Thailand for purchases of this type are typically “net 60,” indicating that payment for the roller blades would be due approximately two months after a purchase was made. Two of the remaining three retailers, Sports Equipment, Inc., and Major Leagues, Inc., have indi-

\textbf{INTERNET APPLICATION}

15. Trade and the Import-Export Bank. The website of the Export-Import Bank of the United States offers information about trade financing. Its address is \url{http://www.exim.gov}. Summarize what the Ex-Im bank does to facilitate trade by businesses.

\textbf{DISCUSSION IN THE BOARDROOM}

This exercise can be found in Appendix E at the back of this textbook.

\textbf{RUNNING YOUR OWN MNC}

This exercise can be found on the Xtra! website at \url{http://maduraxtra.swlearning.com}.
cated that they would also prefer an open account transaction; however, both of these retailers have indicated that their banks would act as intermediaries for a time draft. The fourth retailer, Sports Gear, Inc., is indifferent as to the specific payment method but has indicated to Blades that it finds a prepayment arrangement unacceptable.

Blades also needs a suitable arrangement with its various potential suppliers of rubber and plastic components in Thailand. Because Blades’ financing of the Thai subsidiary involved a U.S. bank, it has virtually no contacts in the Thai banking system. Because Blades is relatively unknown in Thailand, Thai suppliers have indicated that they would prefer prepayment or at least a guarantee from a Thai bank that Blades will be able to make payment within 30 days of purchase. Blades does not currently have accounts receivable in Thailand. It does, however, have accounts receivable in the United States resulting from its U.S. sales.

Ben Holt would like to please Blades’ Thai customers and suppliers in order to establish strong business relationships in Thailand. However, he is worried that Blades may be at a disadvantage if it accepts all of the Thai firms’ demands. Consequently, he has asked you, a financial analyst for Blades, Inc., to provide him with some guidance regarding international trade financing. Specifically, Holt has asked you to answer the following questions for him:

1. Assuming that banks in Thailand issue a time draft on behalf of Sports Equipment, Inc., and Major Leagues, Inc., would Blades receive payment for its roller blades before it delivers them? Do the banks issuing the time drafts guarantee payment on behalf of the Thai retailers if they default on the payment?

2. What payment method should Blades suggest to Sports Gear, Inc.? Substantiate your answer.

3. What organization could Blades contact in order to insure its sales to the Thai retailers? What type of insurance does this organization provide?

4. How could Blades use accounts receivable financing or factoring, considering that it does not currently have accounts receivable in Thailand? If Blades uses a Thai bank to obtain this financing, how do you think the fact that Blades does not have receivables in Thailand would affect the terms of the financing?

5. Assuming that Blades is unable to locate a Thai bank that is willing to issue an L/C on Blades’ behalf, can you think of a way Blades could utilize its bank in the United States to effectively obtain an L/C from a Thai bank?

6. What organizations could Blades contact to obtain working capital financing? If Blades is unable to obtain working capital financing from these organizations, what are its other options to finance its working capital needs in Thailand?

**SMALL BUSINESS DILEMMA**

**Ensuring Payment for Products Exported by the Sports Exports Company**

The Sports Exports Company produces footballs and exports them to a distributor in the United Kingdom. It typically sends footballs in bulk and then receives payment after the distributor receives the shipment. The business relationship with the distributor is based on trust. Although the relationship has worked thus far, Jim Logan (owner of the Sports Exports Company) is concerned about the possibility that the distributor will not make its payment.

1. How could Jim use a letter of credit to ensure that he will be paid for the products he exports?

2. Jim has discussed the possibility of expanding his export business through a second sporting goods distributor in the United Kingdom; this second distributor would cover a different territory than the first distributor. The second distributor is only willing to engage in a consignment arrangement when selling footballs to retail stores. Explain the risk to Jim beyond the typical types of risk he incurs when dealing with the first distributor. Should Jim pursue this type of business?