Chapter 19

Financing International Trade

Lecture Outline

Payment Methods for International Trade
  Prepayment
  Letters of Credit
  Drafts
  Consignment
  Open Account

Trade Finance Methods
  Accounts Receivable Financing
  Factoring
  Letters of Credit
  Banker’s Acceptances
  Working Capital Financing
  Medium-Term Capital Goods Financing (Forfaiting)
  Countertrade

Agencies that Motivate International Trade
  Export-Import Bank of the U.S.
  Private Export Funding Corporation (PEFCO)
  Overseas Private Investment Corporation (OPIC)
Chapter Theme

This chapter first suggests why international trade can be difficult. Then, it explains the various ways in which banking institutions can facilitate international trade by resolving problems faced by the exporter and importer.

Topics to Stimulate Class Discussion

1. Assume that you receive a call from an old friend who has set up a computer parts store. He says that he plans to begin exporting these parts soon. What potential complications should he consider?

2. Why do exporters sometimes sell off their banker’s acceptances? Would they be better off obtaining a short-term loan instead? What information is necessary to answer this question?

3. What is the common role of a banking institution in international trade besides financing?

POINT/COUNTER-POINT: Do Agencies that Facilitate International Trade Prevent Free Trade?

POINT: Yes. The Export-Import Bank of the U.S. 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 versus 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 the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

ANSWER: This issue will lead to many conflicting answers. Students will vary in what they perceive as free trade. Is it appropriate for a country to promote free trade while it indirectly subsidizes some firms that export products? Every country could be criticized for subsidizing its exporters in some way. There is no perfect answer but students should realize that governments subsidize firms but simultaneously complain if other governments use a similar strategy.
Answers to End of Chapter Questions

1. Banker’s Acceptances.
   a. Describe how foreign trade would be affected if banks did not provide trade-related services.

   Answer: Foreign trade would be reduced without the trade-related services by banks, because some trade can only occur if banks back the transaction with bankers’ acceptances.

   A banker’s acceptance guarantees payment to the exporter so that credit risk of the importer is not worrisome. It allows the importers to import goods without being turned down due to uncertainty about their credit standing. It is a revenue generator for the bank since a fee is received by the bank for this service.

2. Export Financing.
   a. Why would an exporter provide financing for an importer?

   Answer: An exporter could increase sales by allowing the importer to pay at a future date. There may be high credit risk incurred by the exporter here, especially if the importer is an unknown small firm.

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

   Answer: A factor can relieve the exporter of the worry about the credit risk of the importer. In return, the factor is rewarded by being able to purchase the accounts receivables at a lower price than their cash value.

   a. What is the role today of the Export-Import Bank of the U.S.?

   Answer: The role today is to finance and facilitate the export of American goods and to strengthen the competitiveness of U.S. industries involved in foreign trade.

   b. Describe the Direct Loan Program administered by the Export-Import Bank.

   Answer: Under the Direct Loan Program, the Eximbank provides long-term loans to foreign buyers to purchase U.S. goods. The loan rates are channeled through banks, which serve as the intermediaries.

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

   Answer: Bills of lading provide a receipt for shipment, a summary of freight charges, and convey title to the merchandise.
6. Forfaiting. What is forfaiting? Specify the type of traded goods for which forfaiting is applied.

ANSWER: A forfaiting transaction involves an importer that issues a promissory note to pay for the imported capital goods over a period of three to seven years or so. Notes are extended to the exporter who sells them at a discount to a forfaiting bank.

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

ANSWER: PEFCO provides medium- and long-term credit to importers of U.S. goods and services.

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

ANSWER: Governments may be able to boost exports by establishing policies that either protect the exporters from various types of risk or encourage lenders to provide financing to the exporters.

9. Countertrade. What is countertrade?

ANSWER: Countertrade involves the sale of goods to one country in exchange for goods from that country.

10. Impact of September 11. Every quarter, Bronx Co. ships computer chips to a firm in central Asia. It had 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 U.S., it 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.

ANSWER: It could use banker’s acceptances in which a bank would guarantee the payment by the importer.


ANSWER: The Working Capital Guarantee Program allows exporters to obtain short-term loans from commercial banks that are guaranteed by the Eximbank. This protects the commercial banks against default risk of the exporter and makes it easier for exporters to obtain loans.


ANSWER: The Small Business Policy provides enhanced coverage against credit risk to new exporters and small businesses.
13. **OPIC.** Describe the role of the Overseas Private Investment Corporation (OPIC).

**ANSWER:** The OPIC insures direct U.S. investments in foreign countries against the risks of currency inconvertibility, expropriation, and other potential risks; it also offers insurance coverage for exporters that bid on foreign contracts.

**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).

**ANSWER:** The letter of credit was issued by a Russian bank to guarantee payment for the goods to be exported by 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.

**ANSWER:** If exporting firms can not rely on letters of credit, they must resort to trusting the counterparty in the trade agreement. This will reduce trade, because exporters frequently do not know much about the counterparty.

c. Why do you think situations like this (the cancellation of the L/C) are rare in industrialized countries?

**ANSWER:** Governments or regulators have a vested interest in ensuring that banks follow through on letters of credit. Otherwise, there would be a reluctance to conduct trade in any country that does not back its guarantees.

d. Can you think of any alternative strategy that the U.S. exporter could have used to protect itself better when dealing with a Russian importer?

**ANSWER:** The U.S. exporter could have attempted to obtain a letter of credit from a U.S. bank, with the responsibility placed on the U.S. bank to guarantee payment. In this case, the U.S. bank would have been put in a position to demand payment from the Russian importer or the importer’s Russian bank.

**Solution to Continuing Case Problem: Blades, Inc.**

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?

ANSWER: No, Blades would not receive payment before it delivers roller blades to Sports Equipment Inc. and Major Leagues Inc. if banks in Thailand issue a time draft on the retailers’ behalf. The usual time of payment under a time draft is the maturity of the draft, and Blades relies on the retailers to pay the drafts at maturity.

No, the banks issuing the time drafts do not guarantee payment on behalf of the Thai retailers if they default on the payment. The draft merely represents Blades’ formal demand for payment from the buyer and affords Blades’ less protection than a letter of credit, since the banks are not obligated to honor payments on the buyer’s behalf.

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

ANSWER: Blades should suggest to Sports Gear Inc. that its bank issue a letter of credit on its behalf. In a letter of credit, the bank is substituting its credit for that of the buyers, and Blades would be assured of receiving payment from the issuing bank as long as it presents the necessary documents in accordance with the L/C. The issuing bank is then obligated to honor drawings under the L/C. On the other hand, Sports Gear Inc. does not have to pay for the goods until shipment has been made and documents are presented in good order.

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

ANSWER: Blades could contact the Export-Import Bank of the U.S. (Eximbank), which provides insurance protection against the risk of nonpayment by foreign buyers. Under such insurance coverage, Eximbank will reimburse Blades between 90 and 100 percent of the insured amount, depending on the type of policy and buyers.

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?

ANSWER: Blades could use accounts receivable financing and factoring using its accounts receivable in the U.S. Using accounts receivable financing, Blades could obtain a loan from a bank that would be secured by an assignment of the accounts receivables. Using factoring, Blades could sell the U.S. accounts receivable to a factor. Either approach is probably available to Blades if it decides to use a U.S. bank. However, it could also attempt to conduct accounts receivable financing of factoring of its U.S. receivables using a bank in Thailand.

Thai banks may consider the assignment of foreign receivables less attractive than the assignment of domestic receivables and may require high interest rates (accounts receivable financing) or discount the receivables heavily (factoring).

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 U.S. to effectively obtain an L/C from a Thai bank?
ANSWER: Blades could inquire whether its U.S. bank has a correspondent bank in Thailand. In that case, the Thai bank may be willing to accept a letter of credit issued by Blades’ U.S. bank on Blades’ behalf.

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?

ANSWER: There are several organizations Blades could contact to obtain working capital financing. For example, the Eximbank’s Working Capital Guarantee Program encourages commercial banks to extend short-term financing by providing a comprehensive guarantee that covers 100 percent of the loan’s principal and interest. Furthermore, the Overseas Private Investment Corporation (OPIC) will provide medium- to long-term financing to U.S. investors undertaking an overseas venture.

If Blades is unable to obtain working capital financing from these organizations, it could ask its bank for a short-term loan that 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.

Solution to Supplemental Case: Ryco Chemical Company

a. Ryco could attempt to work out a countertrade agreement. Ryco could provide chemicals that Concellos needs in exchange for the chemicals that Ryco normally purchases from Concellos. Ryco could benefit because its cost of importing some chemicals would no longer be tied to Brazilian inflation. Instead its cost would be tied to its own cost of producing the chemicals it must exchange for the imports. If Concellos would agree to the countertrade agreement, Ryco may be able to stabilize its cost of imports, which could reduce the uncertainty surrounding cash flows and profitability.

b. Concellos is exposed to the weak currency (called the real). If it purchases the chemicals used in production from Ryco, its cost will not be affected by the real’s exchange rate (as it could purchase the U.S. goods through a countertrade agreement). Thus, it may be able to stabilize its cost of imports in this matter.

c. Concellos’ cost of obtaining imports is the cost of producing the chemicals it uses for exchange (based on the countertrade agreement). Given high inflation in Brazil, these production costs will rise. However, it may be able to raise its prices on its final products by the inflation rate to cover its higher costs of production. Overall, it will be able to offset these higher costs easier than offsetting the higher costs that would result from exchange rate effects. Since its competitors base their prices on local cost of production (as they are not exposed to a weak exchange rate risk), Concellos would now incur costs that are more similar to those of its competitors.
Small Business Dilemma

Ensuring Payment for Products Exported by the Sports Exports Company

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

   ANSWER: A letter of credit could be issued by a bank on behalf of the distributor promising to pay the Sports Exports Company upon presentation of shipping documents. In this way, the letter of credit substitutes its credit standing for that of the distributor.

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. This 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?

   ANSWER: With a consignment arrangement, the Sports Exports Company would retain title to the merchandise. Thus, it would not receive payment until after the second distributor sold the footballs. Also, even if the second distributor does sell the footballs but fails to pay for them, the Sports Exports Company has limited recourse.

   Jim should probably avoid the consignment arrangement because of the risk involved.