QUESTIONS

1. Discuss some of the reasons why international trade is more difficult and risky from the exporter’s perspective than is domestic trade.

Answer: International trade is more difficult and risky for a firm than is domestic trade. In foreign trade, the exporter may not be familiar with the buyer, and thus not know if the importer is creditworthy. If merchandise is exported abroad and the buyer does not pay, it may prove difficult, if not impossible, for the exporter to have any legal recourse. Additionally, political instability makes it risky to ship merchandise abroad to certain parts of the world.

2. What three basic documents are necessary to conduct a typical foreign commerce trade? Briefly discuss the purpose of each.

Answer: The three basic documents necessary to conduct a typical foreign commerce trade are: letter of credit, time draft, and a bill of lading. A letter of credit (L/C) is a guarantee from the importer’s bank that it will act on behalf of the importer and pay the exporter for the merchandise if all relevant documents specified in the L/C are presented according to the terms of L/C. A time draft is a written order instructing the importer or his agent, the importer’s bank, to pay the amount specified on its face on a certain date. A bill of lading (B/L) is a document issued by the common carrier specifying that it has received the goods for shipment; it can serve as title to the goods.

3. How does a time draft become a banker’s acceptance?

Answer: When the goods are shipped by the exporter via common carrier, the exporter’s bank presents the shipping documents and the time draft to the importer’s bank. After taking title to the goods via the bill of lading, the importer’s bank accepts the time draft, creating at this point a banker’s acceptance (B/A). A B/A is a money market instrument for which a secondary market exists.
4. Discuss the various ways the exporter can receive payment in a foreign trade transaction after the importer’s bank accepts the exporter’s time draft and it becomes a banker’s acceptance.

Answer: The exporter can hold the B/A until maturity and present it to the importer’s bank for payment at face value. Alternatively, the exporter can receive the discounted value at inception from its bank, or sell it at its current discounted value in the money market prior to maturity.

5. What is a forfaiting transaction?

Answer: Forfaiting is a form of medium-term trade financing used to finance the sale of capital goods. A forfaiting transaction involves the sale by the exporter of promissory notes signed by the exporter in favor of the importer. The forfait, usually a bank, buys the notes at a discount from face value. The forfait does not have recourse against the exporter in the event of default by the importer. The promissory notes typically extend out in a series over a period of three to five years, with a note in the series maturing every six months.

6. What is the purpose of the Export-Import Bank?

Answer: The Export-Import Bank (Eximbank) of the United States was founded as an independent government agency to facilitate and finance U.S. export trade. Eximbank’s purpose is to provide financing in situations where private financial institutions are unable or unwilling because: i) the loan maturity was too long; ii) the amount of the loan was too large; iii) the loan risk was too great; and, iv) where the importing firm had difficulty obtaining hard currency for payment. To meet its objectives, Eximbank provides service through three types of programs: direct loans to foreign borrowers, loan guarantees, and credit insurance.
7. Do you think that a country’s government should assist private business in the conduct of international trade through direct loans, loan guarantees, and/or credit insurance?

Answer: When a country’s government offers below-market financing directly to foreign importers, or offers loan guarantees to domestic banks financing the foreign import, or provides low cost credit insurance to U.S. exporters to alleviate the commercial and political risk in the sale, it is using taxpayers’ money to subsidize foreign trade. Consequently, the foreign trade is not paying for itself. Nevertheless, if most governments of developed countries offer such assistance to their domestic exporters, it is difficult for one to refuse if the country desires to have its export-oriented industries remain competitive.

8. Briefly discuss the various types of countertrade.

Answer: *Countertrade* is an umbrella term used to describe six types of international trade: barter, clearing arrangement, switch trading, buy-back, counterpurchase, and offset. The first three do not involve the use of money, whereas the later three do.

*Barter* is the direct exchange of goods between two parties. While money does not exchange hands in a barter transaction, it is common to value the goods each party exchanges in an agreed-upon currency. A *clearing arrangement* is a form of barter in which the counterparties contract to purchase a certain amount of goods and services from one another. Both parties set up accounts with each other that are debited whenever one country imports from the other. The clearing arrangement introduces the concept of credit to barter transactions, and means bilateral trade can take place that does not have to be immediately settled. A *switch trade* is the purchase by a third party of one country’s clearing agreement imbalance for hard currency, which is in turn resold. The second buyer uses the account balance to purchase goods and services from the original clearing agreement counterparty that had the account imbalance.
A *buy-back transaction* involves a technology transfer via the sale of a manufacturing plant. As part of the transaction, the seller agrees to purchase a certain portion of the plant output once it is constructed. First, the plant buyer borrows hard currency in the capital market to pay the seller for the plant. Second, the plant seller agrees to purchase enough of the plant output over a period of time to enable the buyer to pay back the borrowed funds. A *counterpurchase* is similar to a buy-back transaction, but with some notable differences. The major difference between a buy-back and a counterpurchase transaction is that in the latter, the seller agrees to purchase unrelated merchandise that has not been produced on the exported equipment. The seller agrees to purchase goods from a list drawn up by the importer at prices set by the importer. The list frequently includes items the buyer may be experiencing difficulty in selling. An *offset transaction* can be viewed as a counterpurchase trade agreement involving the aerospace/defense industry.

9. Discuss some of the pros and cons of countertrade from the country’s perspective and the firm’s perspective.

Answer: Arguments both for and against countertrade transactions can be made. There are both negative and positive incentives for a country to be in favor of countertrade. Negative incentives are those that are forced upon a country or corporations whether or not they desire to engage in countertrade. Negative reasons include: the conservation of cash and hard currency, the improvement of trade imbalances, and the maintenance of export prices. Positive reasons from both the country and corporate perspectives include: enhanced economic development, increased employment, technology transfer, market expansion, increased profitability, less costly sourcing of supply, reduction of surplus goods from inventory, and the development of marketing expertise.

Those against countertrade transactions claim that such transactions tamper with the fundamental operation of free markets, and therefore, resources are used inefficiently. Opponents claim that transaction costs are increased, that multilateral trade is restricted through fostering bilateral trade agreements, and that, in general, transactions that do not make use of money represent a step backwards in economic development.
10. What is the difference between a buy-back transaction and a counterpurchase?

Answer: A buy-back transaction involves a technology transfer via the sale of a manufacturing plant. As part of the transaction, the seller agrees to purchase a certain portion of the plant output once it is constructed to enable the buyer to pay back the borrowed funds. In a counterpurchase, the seller agrees to purchase unrelated merchandise that has not been produced on the exported equipment. Generally, the seller agrees to purchase goods from a list drawn up by the importer at prices set by the importer. The list frequently includes items the buyer may be experiencing difficulty in selling.

PROBLEMS

1. Assume the time from acceptance to maturity on a $2,000,000 banker’s acceptance is 90 days. Further assume that the importing bank’s acceptance commission is 1.25 percent and that the market rate for 90-day B/As is 7 percent. Determine the amount the exporter will receive if he holds the B/A until maturity and also the amount the exporter will receive if he discounts the B/A with the importer’s bank.

Solution: The exporter will receive $1,993,750 = $2,000,000 x [1 - (.0125 x 90/360)] if he holds the B/A to maturity. The acceptance commission is $6,250. The exporter will receive $1,958,750 = $2,000,000 x [1 - ((.0700 + .0125) x 90/360)] if he discounts the B/A with the importer’s bank.

2. The time from acceptance to maturity on a $1,000,000 banker’s acceptance is 120 days. The importer’s bank’s acceptance commission is 1.75 percent and the market rate for 120-day B/As is 5.75 percent. What amount will the exporter receive if he holds the B/A until maturity? If he discounts the B/A with the importer’s bank? Also determine the bond equivalent yield the importer’s bank will earn from discounting the B/A with the exporter. If the exporter’s opportunity cost of capital is 11 percent, should he discount the B/A or hold it to maturity?

Solution: If the exporter holds the B/A until maturity, he will receive $994,166.67 = $1,000,000 x [1 - (.0175 x 120/360)]. Thus, the acceptance commission is $5,833.33. 

If the exporter discounts the B/A he will receive $975,000 = $1,000,000 x [1 - ((.0575 + .0175) x 120/360)].
The importer’s bank receives a discount rate of interest of 7.5 percent (= 5.75 + 1.75 percent) on its investment. At maturity it will receive $1,000,000 from the importer. The bond equivalent yield the importer’s bank earns on its investment is 7.8 percent, or .078 = ($1,000,000/$975,000 - 1) x 365/120.

The exporter pays the acceptance commission regardless of whether he discounts the B/A or holds it to maturity. The bond equivalent rate the exporter receives from discounting the B/A is 5.98 percent, or .0598 = ($994,166.67/$975,000 - 1) x 365/120. Since the exporter’s opportunity cost of capital is 11 percent, which is greater than 5.98 percent compounded tri-annually (an effective annual rate of 6.10 percent), he should discount the B/A.

MINI CASE: AMERICAN MACHINE TOOLS, INC.

American Machine Tools is a mid-western manufacturer of tool-and-die-making equipment. The company has had an inquiry from a representative of the Estonian government about the terms of sale for a $5,000,000 order of machinery. The sales manager spoke with the Estonian representative, but he is doubtful that the Estonian government will be able to obtain enough hard currency to make the purchase. While the U.S. economy has been growing, American Machine Tools has not had a very good year. An additional $5,000,000 in sales would definitely help. If something cannot be arranged, the firm will likely be forced to lay off some of its skilled workforce.

Is there a way that you can think of that American Machine Tools might be able to make the machinery sale to Estonia?

Suggested Solution to American Tools, Inc.

American Machine Tools needs a manager in charge of countertrade. This manager would be skilled in negotiating trades for his firm’s machine tools. Since the U.S. economy is fairly strong, there are two types of countertrades that might work with the Estonian government and help American Machine Tools consummate the sale: a buy-back transaction or a countertrade.

In a buy-back transaction, the Estonian government would issue debt denominated in a hard currency to obtain the funds to purchase the equipment from American Machine Tools. It should be able to obtain hard currency debt financing if it is likely that it can service the debt. American Machine Tools, in turn, would agree to buy in dollars from the Estonian tool and die manufacturer enough of the output produced on the machinery to enable it to meet the debt service obligations. A countertrade works similarly, except that American Machine Tools would agree to purchase enough other goods produced in
Estonia to enable the hard currency debt service obligations to be met. Either of these two types of countertrade would work if American Machine Tools has the sales ability to market the Estonia output in the U.S., or elsewhere.