Financial managers of multinational firms must understand how to document and finance imports and exports. This requires a detailed knowledge of international trade practices and institutions which have evolved over many centuries.

**THE BASIC IMPORT/EXPORT DILEMMA**

A fundamental dilemma exists in international trade. Imagine an importer and an exporter who would like to do business with each other. Also, however, imagine that they live in different countries that are located far apart. They have never met. They speak different languages. They operate in different political environments. They worship different Gods (each capitalizes “God” in the home religion and uses a lower-case “god” for foreign religions!). They come from cultures that have different standards for honoring obligations to other persons. Each knows that if he or she defaults on an obligation, the other will have a hard time catching up with him or her. While it might be too harsh to say they don’t trust each other, each has perfectly valid reasons for being very cautious about the other.

Because of the distance between the two, it is not possible to simultaneously hand over the goods with one hand and accept payment with the other. The importer’s
In this simplified view, the importer obtains the bank’s promise to pay on its behalf, knowing that the exporter will trust the bank. The bank’s promise to pay is called a letter of credit.

The exporter ships the merchandise to the importer’s country. Title to the merchandise is given, in due course, to the bank on a document called an order bill of lading. The exporter requests the bank to pay for the goods, which the bank does. The document to request payment is a sight draft. The bank, having paid for the goods, now passes title to the importer, whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank.

The three key documents and their interaction will be described in the following pages. They constitute a system which evolved over centuries to protect both importer and exporter from (1) the risk of noncompletion, (2) foreign exchange risk, and (3) to provide a means of financing.

**Risk of Noncompletion**
Once importer and exporter agree on terms, the seller usually wants to maintain legal title to the goods until paid, or at least until assured of payment. The buyer, however, is reluctant to pay before receiving the goods, or at least before receiving title to them. Each wants assurance that the other party will complete its portion of the transaction. The three key documents that we will be examining—the letter of credit, the draft, and the bill of lading—are part of a carefully constructed system to determine who will bear the financial loss if one of the parties defaults at any time.

**Protection Against Foreign Exchange Risk**
In international trade, foreign exchange risk arises from transaction exposure. If the transaction requires payment in the exporter’s currency, the importer carries the foreign exchange risk. If the transaction calls for payment in the importer’s currency, the exporter has the foreign exchange risk.

Transaction exposure can be hedged by the techniques described in Chapter 8, but to do this the exposed party must be certain that payment of a specified amount will be made on a particular date. The three key documents described in this chapter assure both amount and time of payment, and thus lay the groundwork for effective hedging.

**Financing the Trade**
Most international trade involves a time lag because funds are tied up while the merchandise is in transit. Once the risks of noncompletion and of exchange rate changes are disposed of, banks are willing to finance goods in transit. A bank can deal with the financial aspects of a trade, as evidenced by the key documents, without exposing itself to questions about the quality of the merchandise or other physical aspects of the shipment.

**Traditional Trade Versus Multinational Sourcing**
The risk of noncompletion and foreign exchange risk are most important when the international trade is episodic, with no outstanding agreement for recurring shipments and
no sustained relationship between buyer and seller. When the import/export relationship is of a recurring nature, as in the case of manufactured goods shipped weekly or monthly to a final assembly or retail outlet in another country, and when it is between countries whose currencies are considered strong, the exports may well be billed on open account after a normal credit check. Banks provide credit information and collection services outside of the system of processing drafts drawn against letters of credit.

In the remainder of this chapter we will examine the letter of credit, the draft, the bill of lading, and a few additional documents that support these key documents. We will also discuss countertrade, which is a nonfinancial system to carry out international trade. Forfaiting, which is related to international trade, was discussed in Chapter 10 on banking.

**LETTER OF CREDIT**

A letter of credit, abbreviated L/C, is an instrument issued by a bank at the request of an importer, in which the bank promises to pay a beneficiary upon presentation of documents specified in the letter of credit. A letter of credit reduces the risk of noncompletion, since the bank agrees to pay against documents rather than actual merchandise. The relationship between the three parties can be seen in Exhibit 18.1.

In international trade a letter of credit is sometimes referred to as a *commercial letter of credit*, a *documentary letter of credit*, or simply a *credit*. A commercial letter of credit

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**Exhibit 18.1** Parties to a Letter of Credit

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is somewhat different from a traveler's letter of credit, since the latter is normally used for noncommercial transactions. Traveler's letters of credit usually call for clean (nondocumentary) drafts—a distinction that will be explained later in this chapter. Payment under a commercial letter of credit is usually by documentary drafts.

Normally a commercial letter of credit is used as part of the financing of a commercial transaction. Although details vary, depending on the type of letter of credit and its provisions, the following transaction is typical. An importer (buyer) and exporter (seller) agree on a transaction. The importer applies to its local bank for the issuance of a letter of credit on a form such as shown in Exhibit 18.2. In Exhibit 18.2 a U.S. importer, XYZ, Inc., of Torrance, California, is applying to Security Pacific National Bank for a letter of credit good up to the amount of $7,690.20, to be issued to Japanese exporter, ABC Co., Ltd., of Tokyo.

The importer's bank, Security Pacific in Exhibit 18.2, will issue the letter of credit according to its assessment of the importer's creditworthiness, or the bank might require a cash deposit or other collateral from the importer in advance. The importer's bank will want to know the type of transaction, the amount of money involved, and what documents must accompany the draft that will be drawn against the letter of credit. The application in Exhibit 18.2 is for the importation of PVC blue discharge hose, and the draft is to be payable 90 days after sight.

If the importer's bank is satisfied with the credit standing of the applicant, it will issue a letter of credit guaranteeing to pay for the merchandise if shipped in accordance with the instructions and conditions contained in the credit. Exhibit 18.3 shows the letter of credit issued by Security Pacific National Bank for the import of PVC blue discharge hose. The credit specifies exactly what documents must accompany the draft drawn against the credit: commercial invoice, customs invoice, packing list, insurance policy or certificate, and a clean-on-board ocean bill of lading.

At this point the credit of the bank has been substituted for that of the importer, and the letter of credit becomes a financial contract between the issuing bank and the designated beneficiary, ABC Co., Ltd., of Tokyo. This financial contract is a separate transaction from the sale of the merchandise. If the terms of the letter of credit are met, any payment problems that develop at a later date are of concern only to the importer and the issuing bank. All other parties to the transaction may rely on the bank's credit without concern about the financial status of the importer.

The importer's bank issuing the letter of credit sends the document to a correspondent in the exporter's country, or to the exporter's bank, which advises the exporter (the beneficiary) of the establishment of a letter of credit in its name.

After shipping the merchandise, the exporter draws a draft against the issuing bank in accordance with the terms of the letter of credit, attaches the required documents, and presents the draft to its own bank for payment. At this point different combinations of events are possible. Let us assume that the exporter's bank has not itself confirmed the credit. That is, the exporter's bank has not added its own promise to pay to the promise of the issuing bank. In this case the exporter's bank will receive the draft and accompanying documents and forward them to the bank of the importer, which issued the credit. If all the
terms and conditions expressed on the letter of credit have been complied with and the required documents are attached, the importer’s bank will honor the draft. In this instance it will pay the exporter’s bank. When the exporter’s bank receives the funds, it pays the exporter.

The importer’s bank, in turn, collects from the importer in accordance with the terms agreed upon at the time the letter of credit was opened. The importer might have to pay at once in order to obtain the documents, including the order bill of lading that is needed to obtain the physical possession of the merchandise. Alternatively, the bank may release the documents to the importer and the importer may promise to pay at some later date, usually under a trust receipt arrangement.

In the previous example the importer’s bank decided to pay after inspecting the documents, and the exporter’s bank functioned only as a collection organization. An alternative procedure would have been for the exporter’s bank to confirm the letter of credit. The exporter’s bank would then itself honor drafts drawn against the credit when first presented and obtain reimbursement from the importer’s bank. The distinction between confirmed and unconfirmed letters of credit will be explained more fully later in this section.

We emphasize here that a letter of credit is a promise to pay against specified documents, which must accompany any draft drawn against the credit. The letter of credit is not a guarantee of the underlying commercial transaction. To constitute a true letter of credit transaction, the following five elements must all be present with respect to the issuing bank:

1. The issuing bank must receive a fee or other valid business consideration for the letter of credit.
2. The bank’s letter of credit must contain a specified expiration date or be for a definite term.
3. The bank’s commitment must have a stated maximum.
4. The bank’s obligation to pay must arise only on the presentation of specific documents, and the bank must not be called on to determine disputed questions of fact or law.
5. The bank’s customer must have an unqualified obligation to reimburse the bank on the same condition as the bank has paid.

Types of Letters of Credit
Most commercial letters of credit are documentary, meaning that certain documents must be included with any drafts drawn under the terms of the credit. Documents required usually include an order bill of lading, a commercial invoice, and any of the following: consular invoice, insurance certificate or policy, certificate of origin, weight list, certificate of analysis, packing list. Commercial letters of credit are also classified as follows.

Irrevocable Versus Revocable. An irrevocable letter of credit obligates the issuing bank to honor drafts drawn in compliance with the credit and can be neither canceled nor modified without the consent of all parties, including in particular the beneficiary (exporter). A revocable letter of credit can be canceled or amended at any time before payment; it is intended to serve as a means of arranging payment but not as a guarantee of payment.
**Confirmed Versus Unconfirmed.** A letter of credit issued by one bank can be confirmed by another, in which case both banks are obligated to honor drafts drawn in compliance with the credit. An unconfirmed letter of credit is the obligation only of the issuing bank. An exporter is likely to want a foreign bank’s letter of credit confirmed by a domestic bank when the exporter has doubts about the foreign bank’s ability to pay. Such doubts may arise if the exporter is unsure of the financial standing of the foreign bank, or if political or economical conditions in the foreign country are unstable.

The desirability of confirmation was apparent from an event in 1975. The Bank of Nigeria, that country’s central bank, refused to pay on irrevocable letters of credit that it had issued for the import of material ordered for Nigeria’s development. Flush with income earned as a member of OPEC and desirous of furthering its economic development, Nigeria ordered more cement and other items than could be unloaded by available port facilities. By October 1975, some 400 ships were backed up in Lagos harbor, and the estimated delay for a newly arriving ship was 450 days. The governor of the Bank of Nigeria lamented (*Business Week*, November 3, 1975): “It is the exporters and shipowners who are making things difficult.” The bank refused to honor its supposedly irrevocable letters of credit. Bankers termed the event virtually unprecedented in international trade. Exporters to Nigeria suffered major losses. Had the exporters insisted that their own banks confirm the Bank of Nigeria’s “irrevocable” letters of credit, the losses would have been borne by the confirming bank rather than the exporters. An underlying assumption is that a confirming bank is better able to judge the credibility of a bank issuing a letter of credit than is a merchant.

**Revolving Versus Nonrevolving.** Most letters of credit are nonrevolving; they are valid for one transaction only. Under some circumstances, a revolving credit is issued. A $10,000 revolving weekly credit means that the beneficiary is authorized to draw drafts up to $10,000 each week until the credit expires. The period of a revolving credit might be daily, weekly, or monthly. Because the maximum exposure under an irrevocable revolving credit is very great (the buyer cannot stop its obligation to pay for future shipments even if it is dissatisfied with the merchandise), most revolving credits are issued in revocable form. A revolving credit may be *noncumulative*, in which case any amount not used by the beneficiary during the specified period may not be drawn against in a later period; or it may be *cumulative*, in which case undrawn amounts carry over to future periods. Under a cumulative revolving credit of, say, $10,000 per week, a beneficiary who drew only $7,000 in one week could draw up to $13,000 the following week.

**Issuers of Letters of Credit**

From an exporter’s point of view a documentary letter of credit is one of the following:

1. An irrevocable letter of credit issued by a foreign bank and confirmed irrevocably by a domestic bank. (On occasion the credit may be confirmed by a third-country foreign bank. For example, a U.S. exporter might receive a letter of credit from an African bank confirmed by a French or English bank.)
preference is as follows:

1st: Exporter ships the goods.

2nd: Importer pays after goods received.

The exporter has an opposite set of preferences:

1st: Importer pays for goods.

2nd: Exporter ships the goods after being paid.

The dilemma of not trusting a stranger in a foreign land is solved by using a bank as an intermediary. A greatly simplified view is the following:

1st: Importer obtains bank's promise to pay on importer's behalf.

2nd: Bank promises exporter to pay on behalf of importer.

3rd: Exporter ships "to the bank," trusting bank's promise.

4th: Bank pays exporter.

5th: Bank "gives merchandise" to the importer.
2. An irrevocable letter of credit issued by a domestic bank.
3. An irrevocable letter of credit issued by a foreign bank without the responsibility or endorsement of a domestic bank. In this situation the domestic bank transmits information (when the letter is opened) and forwards drafts for collection but does not lend its guarantee.
4. A revocable letter of credit established to arrange for payment.

Exporters generally prefer types 1 and 2 above, since they need look no further than a bank in their own country for compliance with the terms of the letter of credit. Although a letter of credit issued by a foreign bank alone (type 3) might well be of the highest esteem, most exporters are not in a position to evaluate or deal with foreign banks directly should difficulties arise.

Every irrevocable letter of credit must indicate an expiration date beyond which documents for payment or acceptance will not be accepted. Documents, such as drafts or bills of lading, must be presented within a reasonable time after issue, for if there is undue delay, the bank may refuse to accept them.

**Advantages and Disadvantages of Letters of Credit**

The primary advantage of a letter of credit is that it facilitates international trade. The exporter gains because it can sell against the promise to pay of a bank rather than of a commercial firm. The exporter is also in a more secure position as to the availability of foreign exchange to pay for its sale. If the letter of credit is confirmed by a bank in the exporter's country, the problem of blocked foreign exchange is eliminated. Even if the letter of credit is not confirmed, the issuing foreign bank is more likely to be aware of foreign exchange conditions and rules than is the importing firm itself. Last, should the importing country change its foreign exchange rules, it is likely to allow already outstanding bank letters of credit to be honored for fear of throwing its own domestic banks into international disrepute.

An exporter may find that an order backed by an irrevocable letter of credit will facilitate obtaining domestic pre-export financing. If the exporter’s reputation for delivery is good, a local bank may lend funds to process and prepare the merchandise for shipment. Once the merchandise is shipped in compliance with the terms and conditions of the credit, payment for the business transaction is made and funds will be generated to repay the pre-export loan.

The major advantage to the importing firm of a letter of credit is that the firm need not pay out funds until the documents have arrived and unless all conditions stated in the credit have been fulfilled. The main disadvantages are the fee charged by the importer’s bank for issuing its letter of credit, and the likelihood that the letter of credit reduces the importer’s borrowing line of credit from the importer’s bank.

**Liabilities of Banks under Letters of Credit**

When banks issue letters of credit they incur certain obligations that are specified in detail in *Uniform Customs and Practices for Documentary Credits*, published by the United States Council of the International Chamber of Commerce.¹
The basic nature of a letter of credit is that the bank is obligated to pay against documents, not actual goods. Thus banks must carefully examine all documents to be sure that they are in accordance with the original terms and conditions of the letter of credit. However, banks are not liable for defects in the documents themselves, as long as any defect was not apparent on the face of the document. Thus, for example, the bank is not responsible for detecting false documents; for verifying that the quantities, quality, weights, or condition of the goods is other than what is stated on the documents; or for validating the good faith and performance of any of the parties to the underlying transaction. The bank is not responsible if messages are delayed or lost, or mistranslated; and it is not responsible for the consequences of such events as strikes, lockouts, riots, or war.

A draft, sometimes called a bill of exchange (B/E), is the instrument normally used in international commerce to effect payment. A draft is simply an order written by an exporter (seller) instructing an importer (buyer) or its agent to pay a specified amount of money at a specified time. (A personal check is another type of draft; the drawer writes an order to a bank to pay a specified amount of money on demand to the order of a designated beneficiary.)

The person or business initiating the draft is known as the maker, drawer, or originator. Normally this is the exporter who sells and ships the merchandise. The party to whom the draft is addressed is the drawee. The drawee is asked to honor the draft, that is, to pay the amount requested according to the stated terms. In commercial transactions the drawee is either the buyer, in which case the draft is called a trade draft, or the buyer’s bank, in which case the draft is called a bank draft. Bank drafts are usually drawn according to the terms of a letter of credit. A draft may be drawn as a bearer instrument, or it may designate a person to whom payment is to be made. This person, known as the payee, may be the drawer itself or it may be some other party such as the drawer’s bank.

International practice is to use drafts to settle trade transactions. This differs from domestic custom in which sellers usually ship merchandise on open account, followed by a commercial invoice indicating the amount due and terms for payment. In domestic practice the buyer usually obtains possession of the merchandise without signing a formal document directly indicating its obligation to pay. International practice, in contrast, often requires payment or a formal promise to pay before the buyer can obtain the merchandise.

**Negotiable Instruments**

Because drafts can become negotiable instruments, they provide a convenient instrument for financing the international movement of the merchandise. To become a negotiable instrument, a draft or bill of exchange must conform to the following requirements:

- It must be in writing and signed by the maker or drawer.
- It must contain an unconditional promise or order to pay a definite sum of money.
- It must be payable on demand or at a fixed or determinable future date.
- It must be payable to order or to bearer.

If the draft is drawn in conformity with the above requirements so as to be a negotiable instrument, a person receiving it is a *holder in due course*. This is a privileged legal status that enables the holder to receive payment despite any personal disagreements between drawee and maker because of controversy over the underlying commercial transaction. If the drawee dishonors the draft, payment must be made to any holder in due course by any prior endorser or by the maker. This clear definition of the rights of parties who hold a negotiable instrument as a holder in due course has contributed significantly to the widespread acceptance of various forms of drafts, including personal checks.

**Types of Drafts**

Drafts are of two types: *sight drafts* and *time drafts*. A sight draft is payable on presentation to the drawee; the drawee must pay at once or dishonor the draft. A time draft, also called a *usance draft*, allows a delay in payment. It is presented to the drawee, who accepts it by writing or stamping a notice of acceptance on its face. Once accepted, the time draft becomes a promise to pay by the accepting party. When a time draft is drawn on and accepted by a bank, it becomes a *banker’s acceptance*. When a time draft is drawn on and accepted by a business firm, it becomes a *trade acceptance*.

A time draft drawn by ABC Co., Ltd., of Tokyo for its export of PVC blue discharge hose against the letter of credit shown earlier is illustrated in Exhibit 18.4. ABC Co., Ltd., is instructing Security Pacific National Bank to pay to the Commercial Bank, Ltd. (ABC’s bank), the sum of $7,690.20 ninety days after the draft is first presented to Security Pacific. When the draft is presented to Security Pacific, that bank will check to see that all terms of the letter of credit have been complied with and will then stamp the face of the draft with the acceptance inscription shown with the draft in Exhibit 18.4. A bank officer will sign, and the draft becomes a bankers’ acceptance maturing in 90 days. Because the draft in Exhibit 18.4 was accepted on October 11, it will mature on January 9.

Because payment on an acceptance is not made at the time of presentation, the acceptance serves as a device to finance merchandise in transit or held in inventory prior to sale. In practice, most time drafts are made payable 30, 60, 90, or some other specified number of days after (1) the date of the draft, or (2) the date of acceptance. Bankers’ acceptances are usually sold in the short-term money market at a discount from face amount, thus providing a short-term liquid security for investors. The investor relies on the bank’s promise to pay.

Depending on the quality of drawee, trade acceptances may not be as marketable as bankers’ acceptances. However, they do constitute a written promise by the drawee to pay on a specific date. On due date the holder (usually the exporter) can present the trade acceptance for collection through the accepting firm’s bank. The bank itself is not obligated to pay, but when the drawee is asked for payment by its own bank, the pressure to pay is great. A trade acceptance can be viewed as a documented, written account receivable, as compared with an open-book account receivable.
**Exhibit 18.4** Time Draft and Stamp Including Acceptance by Bank

<table>
<thead>
<tr>
<th>SECURITY PACIFIC NATIONAL BANK</th>
<th>NO. TKT61037</th>
<th>Tokyo, Japan (City &amp; State)</th>
<th>October 4, 19xx</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Bill of Exchange</td>
<td>S</td>
<td>PAY TO THE ORDER OF The Commercial Bank, Ltd</td>
<td>$7,690.20</td>
</tr>
<tr>
<td>(Second Unpaid)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value received and charged to account of XYZ, Inc. California, U.S.A. Drawn under Security Pacific National Bank Letter of Credit # 308590 dated September 22, 19xx</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To Security Pacific National Bank</td>
<td>International Banking Group</td>
<td>Managing Director</td>
<td></td>
</tr>
<tr>
<td>Los Angeles, California</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The transaction which gives rise to this instrument is the **importation** of **PVC blue discharge hose** from **NAGOYA, JAPAN** to **LOS ANGELES, CALIFORNIA**. No $7,690.20 accepted October 11, 19xx payable at **International Banking Group**, **Security Pacific National Bank**, **Los Angeles, California**.

*Source: Security Pacific National Bank.*

The time period of a draft is referred to as its *tenor* or *usance*. To qualify as a negotiable instrument, and so be attractive to a holder in due course, a draft must be payable on a fixed or determinable future date. For example, 60 days after sight is a determinable date, such a maturity being established precisely at the time the draft is accepted. However, payment "on arrival of goods" is not determinable since the date of arrival cannot be known in advance. Indeed, there is no assurance that the goods will arrive at all. Third parties would have no interest in investing in it because they could not be certain they would ever be paid. However, even a nonnegotiable acceptance can function as a device to obtain payment, since it is a legal obligation to pay unless there is some defect in the underlying commercial transaction.
Drafts are also classified as *clean* or *documentary*. A clean draft is an order to pay unaccompanied by any other documents. When it is used in trade, the seller has usually sent the shipping documents directly to the buyer, who thus obtains possession of the merchandise independent of its payment (on a clean sight draft) or acceptance (on a clean time draft). Clean drafts are often used by multinational firms shipping to their own affiliates, because matters of trust and credit are not involved. Clean drafts are also used for nontrade remittances, for example, when collection of an outstanding debt is sought. Use of a clean draft puts pressure on a recalcitrant debtor by forcing it to convert an open-account obligation into documentary form. Failure to pay or accept such a draft when presented through a local bank can damage the drawee’s reputation.

Most trade drafts are documentary, which means that various shipping documents are attached to the draft. Payment (for sight drafts) or acceptance (for time drafts) is required to obtain possession of the documents, which are in turn needed to obtain the goods involved in the transaction. If documents are to be delivered to the buyer on payment of the draft, it is known as a “D/P draft”; if the documents are delivered on acceptance, the draft is called a “D/A draft.”

If no letter of credit exists but the exporter wants to control the merchandise until payment is made, the exporter will use a documentary sight draft drawn directly on the importer. However, this instrument does not eliminate all risk. An irresponsible buyer may refuse to accept the shipment for such reasons as a drop in prices or a loss of the market in which the buyer intended to resell. Then the exporter will have to find another buyer or pay to have the merchandise shipped back to the exporter’s plant.

**Bankers’ Acceptances**

When a draft is accepted by a bank, it becomes a *bankers’ acceptance*. As such it is the unconditional promise of that bank to make payment on the draft when it matures. In quality the bankers’ acceptance is practically identical to a marketable bank certificate of deposit (CD). The holder of a bankers’ acceptance need not wait until maturity to liquidate the investment, but it may sell the acceptance in the money market, where constant trading in such instruments occurs.

The first owner of the bankers’ acceptance created from an international trade transaction will be the exporter, who receives the accepted draft back after the bank has stamped it “accepted.” The exporter may hold the acceptance until maturity and then collect. On an acceptance of, say, $100,000 for six months the exporter would receive the face amount less the bank’s acceptance commission of 1.5% per annum:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount of the acceptance</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less 1.5% per annum commission for 6 months</td>
<td>– 750</td>
</tr>
<tr>
<td>Amount received by exporter in 6 months</td>
<td>$ 99,250</td>
</tr>
</tbody>
</table>

Alternatively, the exporter may “discount”—that is, sell at a reduced price—the acceptance to its bank in order to receive funds at once. The exporter will then receive the face amount of the acceptance less both the acceptance fee and the going market rate of
discount for bankers’ acceptances. If the discount rate were 7% per annum, the exporter would receive the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face amount of the acceptance</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less 1.5% per annum commission for 6 months</td>
<td>-750</td>
</tr>
<tr>
<td>Less 7% per annum discount rate for 6 months</td>
<td>-3,500</td>
</tr>
<tr>
<td>Amount received by exporter at once</td>
<td>$ 95,750</td>
</tr>
</tbody>
</table>

The discounting bank may hold the acceptance in its own portfolio, thus earning for itself the 7% per annum discount rate, or the acceptance may be resold in the acceptance market. At present 10 to 15 acceptance dealers in New York City buy and sell acceptances at a spread (between buying and selling price) of 1/8% to 1/4%. The dealers may hold the acceptances themselves, but more frequently they resell them to investors.

**BILL OF LADING**

The third key document for financing international trade is the bill of lading, or B/L. The bill of lading is issued to the exporter by a common carrier transporting the merchandise. It serves three purposes: a receipt, a contract, and a document of title.

As a receipt, the bill of lading indicates that the carrier has received the merchandise described on the face of the document. Exhibit 18.5 shows a bill of lading issued by Mitsui O.S.K. Lines, Ltd., for shipment on the vessel America Maru of 90 rolls of PVC blue discharge hose from Nagoya, Japan, to Los Angeles, California. The carrier is not responsible for ascertaining that the containers hold what is alleged to be their contents, so descriptions of merchandise on bills of lading are usually short and simple. If shipping charges are paid in advance, the bill of lading will usually be stamped “freight paid” or “freight prepaid.” If merchandise is shipped collect—a less common procedure internationally than domestically—the carrier maintains a lien on the goods until freight is paid.

As a contract, the bill of lading indicates the obligation of the carrier to provide certain transportation in return for certain charges. Common carriers cannot disclaim responsibility for their negligence through inserting special clauses in a bill of lading. The bill of lading, as a contract, may specify alternative ports in the event that delivery cannot be made to the designated port, or it may specify that the goods will be returned to the exporter at the exporter’s expense.

As a document of title, the bill of lading can be used to obtain payment or a written promise of payment before the merchandise is released to the importer. The bill of lading can also function as collateral against which funds may be advanced to the exporter by its local bank prior to or during shipment and before final payment by the importer.

**Characteristics of the Bill of Lading**

Bills of lading are either straight or to order. A straight bill of lading provides that the carrier deliver the merchandise to the designated consignee. A straight bill of lading is not
Exhibit 18.5 Bill of Lading

Shippers

ABC Co., Ltd
No. 10 Mori Bldg
1-18-1 Toranomon, Minato-ku
Tokyo, 105, Japan

Notify Party

XYZ, Inc
55555 Hawthorne Boulevard
Suite 400-14
Torrance, California 90503

Ocean vessel

AMERICA MARU
NAGOYA, JAPAN

Fiscal destination for the Merchant's reference

LOS ANGELES, CALIFORNIA, U.S.A.
LOS ANGELES C.F.S.

Container No.

MOLU2850842
CTIU2565602

No. of Cons.

90 ROLLS

Kind of packages: description of goods

PVC BLUE DISCHARGE HOSE

Made in Japan

Remark:

L/C No. 308,590

NINETY (90) ROLLS ONLY

Freight and charges

6,836 M3
C.A.F.
C.F.S. CHARGE

$77.00/M3
$531.54

12,650/M3

US$525.60
US$557.14

86,475

8.267.75

Prepaid at
TOKYO, JAPAN

Prepaid at
167,263

Prepaid at
MITSUI O.S.K. LINES, LTD.

LADEN ON BOARD THE VESSEL

Exhibit 18.3 Letter of Credit

IRREVOCABLE DOCUMENTARY LETTER OF CREDIT

SECURITY PACIFIC NATIONAL BANK
INTERNATIONAL BANKING GROUP

Advised by AIRMAILABLE through

Post Office Box 7637
San Francisco, California 94120

Head Office - Post Office Box 92890
Los Angeles, California 90009

Post Office Box 1971
San Diego, California 92112

¥ ABC Co., Ltd.
¥ No. 10 Mori Bldg 1-18-1 Toramon, Minato-Ku
¥ Tokyo, 105, Japan
¥ Security Pacific National Bank
¥ International Banking Office
¥ Tokyo, Japan

WE ESTABLISH OUR IRREVOCABLE LETTER OF CREDIT NUMBER UC 308,590 DATE 9-22-xx IN YOUR FAVOR

FOR THE ACCOUNT OF XYZ, Inc., 55555 Hawthorne Blvd., Suite 400-14 Torrance, California 90503

UP TO THE AGGREGATE SUM OF SEVEN THOUSAND SIX HUNDRED NINETY AND 20/100 UNITED STATES DOLLARS ($7,690.20)

AVAILABLE BY YOU DRAFT(S) AT 90 days SIGHT FOR 100 % INVOICE DRAWN ON US

AND ACCOMPANIED BY THE FOLLOWING DOCUMENTS:

1. Signed Commercial Invoices in triplicate, certifying that goods are in accordance with buyer's purchase order No. 2944.
2. Special Customs Invoices in triplicate.
3. Packing List in triplicate.
5. Full set of clean on board Ocean Bills of Lading to the order of shipper, blank endorsed, showing "Freight Prepaid", marked Notify: XYZ, Inc., 55555 Hawthorne Blvd., Suite 400-14 Torrance, California 90503.

EVIDENCE SHIPMENT OF PVC Blue Discharge Hose

FROM Nagoya, Japan TO CIF, Los Angeles, California

TRANSHIPMENT IS not PERMITTED. INSURANCE IS to BE EFFECTED by Seller

LATEST NEGOTIATION DATE OF THIS LETTER OF CREDIT IS November 10, 19xx

DRAFTS DRAWN AND NEGOTIATED UNDER THIS LETTER OF CREDIT MUST BE ENDORSED HEREON AND MUST BEAR THE CLAUSE: "DRAWN UNDER SECURITY PACIFIC NATIONAL BANK LETTER OF CREDIT NUMBER 308,590 DATED 9-22-xx"

WE HEREBY ENGAGE WITH THE BONA FIDE HOLDERS THAT DRAFTS DRAWN STRICTLY IN COMPLIANCE WITH THE TERMS OF THIS CREDIT AND AMENDMENTS SHALL MEET WITH DUE HONOR UPON PRESENTATION.

This credit is subject to the Uniform Customs and Practice for Documentary Credits (1974 Revision), International Chamber of Commerce Publication Number 290.

*TO THE DRAWEE BANK

Authorized Signature

When opened by cable, this credit is only available if attached to our correspondent's advice of cabled credit. The two constituting evidence of the outstanding amount of this credit.

# Exhibit 18.2 Application for Letter of Credit

TO: SECURITY PACIFIC NATIONAL BANK

LETTER OF CREDIT APPLICATION AND SECURITY AGREEMENT

INTERNATIONAL BANKING GROUP

PLEASE ISSUE YOUR IRREVOCABLE LETTER AND ADVISE THE BENEFICIARY BY ☐ AIRMAIL ☐ CABLE SHORT DETAILS ☐ CABLE FULL DETAILS

IN FAVOR OF: ABC Co., Ltd. No. 10 Mori Bldg 1-81-1, Toranomon, Minato-ku, Tokyo, 105, Japan

FOR ACCOUNT OF: XyZ, Inc. 55555 Hawthorne Blvd., Suite 400-14 Torrance, California 90503

UP TO THE AGGREGATE SUM OF US$7,690.20

OF INVOICE VALUE ACCOMPANIED BY THE FOLLOWING DOCUMENTS INDICATED BY ☐

- SIGNED COMMERCIAL INVOICE (S) ☐ 3
- SPECIAL CUSTOMS INVOICE (S) ☐ 3
- PACKING LIST ☐ 3

NEGOTIABLE MARINE & WARE RISK INSURANCE POLICY CERTIFICATE FOR ☐ 110 %

OF CIF VALUE WITH CLAIMS PAYABLE IN THE UNITED STATES

☐ OTHER DOCUMENTS

FULL SET OF CLEAN ON BOARD ☐ OCEAN BILLS OF LADING ☐ TO ORDER OF SHIPPER BLANK ENDORSED ☐ TO ORDER

AIRWAY BILL AIR CONSIGNED TO ☐ NOTE CONSIGNED TO ☐ RAILROAD/TRACT BILL OF LADING CONSIGNED TO ☐

SHIPPING MARKED FRED PREPAID CO. MARRIOTT XyZ, Inc. 55555 Hawthorne Blvd., Suite 400-14 Torrance, California 90503

EVIDENCE OF SHIPMENT OF PVC Blue Discharge Hose

(SPECIFY COMMODITY ONLY OMITTING DETAILS AS TO GRADE, QUALITY, PRICE, ETC.)

FROM Nagoya, Japan TO CIF, Los Angeles, Calif. SHIPMENT ☐ FOR ☐ CIF ☐ C&F

(PORT OF SHIPMENT) (DESTINATION) ☐ OTHER

LATEST SHIPMENT DATE IS Oct. 30, 19xx PARTIAL SHIPMENTS PERMITTED ☐ YES ☐ NO TRANSSHIPMENT PERMITTED ☐ YES ☐ NO

LATEST NEGOTIATION DATE IS Nov. 10, 19xx INSURANCE TO BE EFFECTED BY ☐ SELLER

SPECIAL INSTRUCTIONS (INDICATE HERE ANY SPECIAL INSTRUCTIONS YOU WISH INCLUDED IN THE LETTER OF CREDIT)

COMMERCIAL INVOICE MUST CONTAIN SHIPPER'S SIGNED ☐ CERTIFICATION THAT GOODS ARE IN ACCORDANCE WITH BUYER'S PURCHASE ORDER NO. 2944 PROFORMA INVOICE NO ☐ DATED ☐

☐

ADVISE CREDIT THROUGH BENEFICIARY'S BANK NAMED HERE ☐ Security Pacific National Bank, Tokyo, Japan

(IF BENEFICIARY IS UNKNOWN WE WILL USE OUR CORRESPONDENT BANK)

DEBIT OFFICE TO: NAME ☐ ACCOUNT NUMBER ☐

MAIL SHIPMENT DOCUMENTS TO ☐ DEF Co., Customs Broker, San Pedro

DIRECT INQUIRIES TO OUR MR. ☐ J. Smith ☐ NUMBER ☐

WE AND EACH OF US AGREE THAT THE TERMS AND CONDITIONS SET FORTH ON THIS AND THE REVERSE HEREOF ARE HEREBY MADE A PART OF THIS APPLICATION AND ARE ACCEPTED AND AGREED TO BY US

FIRM NAME: XyZ, Inc. 55555 Hawthorne Blvd., Torrance

AUTHORIZED SIGNATURE (S)

02203-1 5' 19' 50' 10' Y

EXHIBIT 14.6
One Type of International Transaction

Country of Export

1. Importer orders goods

2. Exporter agrees to fill order

3. Importer arranges L/C with Bank I

4. Bank I sends L/C to Bank X

5. Bank X pays Exporter

6. Exporter ships goods to Importer

7. Exporter presents draft and documents to Bank X

8. Bank X presents draft and documents to Bank I

9. Bank I accepts draft, promising to pay in 90 days, and returns accepted draft to Bank X

10. Bank X sells acceptance to Investor

11. Bank X advises Exporter of L/C

12. Bank I obtains Importer's note and releases shipment

13. Importer pays Bank I

14. Investor presents acceptance and is paid by Bank I

Public Investor

Country of Import

Bank I (Importer's Bank)

Bank X (Exporter's Bank)

Exporter (Seller)

Importer (Buyer)
title to the goods and is not required for the consignee to obtain possession. Because a straight bill of lading is not title, it is not good collateral for loans. Therefore, a straight bill of lading is used when the merchandise has been paid for in advance, when the transaction is being financed by the exporter, or when the shipment is to an affiliate.

An order bill of lading directs the carrier to deliver the goods to the order of a designated party. An additional inscription may request the carrier to notify someone else of the arrival. The order bill of lading grants title to the merchandise only to the person to whom the document is addressed, and surrender of the order bill of lading is required to obtain the shipment.

The order bill of lading is typically made payable to the order of the exporter, who thus retains title to the goods after they have been handed to the carrier. Title to the merchandise remains with the exporter until payment is received, at which time the exporter endorses the order bill of lading (which is negotiable) in blank or to the party making the payment, usually a bank. The most common procedure would be for payment to be advanced against a documentary draft accompanied by the endorsed order bill of lading. After paying the draft, the exporter's bank forwards the documents through bank clearing channels to the bank of the importer. The importer's bank, in turn, releases the documents to the importer after payment (sight drafts), after acceptance (time drafts addressed to the importer and marked D/A), or after payment terms have been agreed (drafts drawn on the importer's bank under provisions of a letter of credit).

**Variations in the Bill of Lading**

A *clean* bill of lading indicates that the goods were received by the carrier in apparently good condition. The carrier is not obligated to check the condition of the merchandise beyond external visual appearance. A *foul* bill of lading indicates that the merchandise appeared to have suffered some damage before being received for shipment. A foul bill of lading lacks complete negotiability.

An *on-board* bill of lading indicates that the merchandise has been placed on board the vessel whose name is designated on the document. This form is preferred to a *received-for-shipment* bill of lading, which allows for the possibility that the goods are sitting on the dock and might remain there for some time. A received-for-shipment bill of lading is not an acceptable document unless it has been specifically authorized in the letter of credit. Similarly, unless authorized otherwise by the letter of credit, banks will refuse to accept *on-deck* bills of lading, indicating that the goods have been stowed on deck. Received-for-shipment bills of lading may be issued when goods are first received on the carrier's premises; they can be converted to an on-board form by an appropriate stamp showing the name of the vessel, the date, and the signature of an official of the carrier.

**Additional Documents**

The draft, the bill of lading, and the letter of credit are the major documents required in most international transactions. However, additional documents may be needed as a
condition of the letter of credit for honoring a draft. The more common additional documents include those described below.

A signed commercial invoice is issued by the seller and contains a precise description of the merchandise. Unit prices, financial terms of sale, and amount due from the buyer are indicated, as are shipping conditions related to charges, such as “FOB” (free on board), “FAS” (free alongside), “C & F” (cost and freight), or “CIF” (cost, insurance, freight).

Insurance documents must be as specified in the letter of credit and must be issued by insurance companies or their agents. The insurance may be issued to the exporter, who must then endorse the policy to the importer, or it may be issued in the name of the importer. The document must be expressed in the same currency as the credit and must not be dated later than the date of shipment carried on the face of the shipping documents. Insurance must be of types and for risks specified in the letter of credit.

Consular invoices are issued by the consulate of the importing country to provide customs information and statistics for that country and to help prevent false declarations of value. The consular invoice may be combined with a certificate of origin of the goods.

Certificates of analysis may be required to ascertain that certain specifications of weight, purity, sanitation, etc., have been met. These conditions may be required by health or other officials of the importing country—especially in the case of foods and drugs—or they may be insisted on by the importer as assurance that it is receiving what it ordered. The certificates may be issued by government or private organizations, as specified in the letter of credit.

Packing lists may be required so that the contents of containers can be identified, either for customs purposes or for importer identification of the contents of separate containers.

An export declaration is a document prepared by the exporter to assist the government to prepare export statistics.

**DOCUMENTATION IN A TYPICAL TRADE TRANSACTION**

A trade transaction could conceivably be handled in many ways. The transaction that would best illustrate the interactions of the various documents would be an export financed under a documentary commercial letter of credit, requiring an order will of lading, with the exporter collecting via a time draft accepted by the importer’s bank. Such a transaction is illustrated in Exhibit 18.6:

1. Importer places an order for the goods with Exporter, inquiring if Exporter would be willing to ship under a letter of credit.
2. Exporter agrees to ship under a letter of credit and specifies relevant information such as prices, terms, etc.
3. Importer applies to its bank, Bank I, for a letter of credit to be issued in favor of Exporter for the merchandise Importer wishes to buy.
4. Bank I issues the letter of credit in favor of Exporter and sends it to Bank X, Exporter’s bank, or to a correspondent bank in the country of export.
5. Bank X advises Exporter of the opening of a letter of credit in the Exporter's favor. Bank X may or may not confirm the letter of credit to add its own guarantee to the document.

6. Exporter ships the goods to Importer.

7. Exporter presents a 90-day time draft to Bank X, drawn on Bank I in accordance with Bank I's letter of credit and accompanied by such other documents as required, including the order bill of lading. Exporter endorses the order bill of lading in blank so that title to the goods goes with the holder of the documents—Bank X at this point in the transaction.

8. Bank X presents the draft and documents to Bank I. Bank I accepts the draft, taking possession of the documents and promising to pay the now-accepted draft in 90 days.

Exhibit 18.6 Typical Trade Transaction
9. Bank I returns the accepted draft to Bank X. Alternatively, Bank X could have asked Bank I to accept and discount the draft; then Bank I would have returned cash less a discount fee rather than the accepted draft to Bank X.

10. Bank X, having received back the accepted draft, now a bankers' acceptance, must choose between several alternatives. Bank X may sell the acceptance in the open market at a discount to a public investor. The investor will typically be a corporation or financial institution with excess cash it wants to invest for a short period of time. Bank X may also hold the acceptance in its own portfolio.

11. If Bank X has discounted the acceptance with Bank I (mentioned in step 8 above) or has discounted it in the local money market, Bank X will transfer the proceeds less any fees and discount to Exporter. Another possibility would be for Exporter itself to take possession of the acceptance, hold it for 90 days, and present it for collection. Normally, however, exporters prefer to receive the discounted cash value of the acceptance at once rather than wait for the acceptance to mature and receive a slightly greater amount of cash.

12. Bank I notifies Importer of the arrival of the documents. Importer signs a note or makes some other agreed plan to pay the bank for the merchandise in 90 days, and Bank I releases the underlying documents so that Importer can obtain physical possession of the shipment.

13. In 90 days Bank I receives from Importer funds to pay the maturing draft.

14. On the same day—the 90th day after acceptance—the holder of the matured acceptance presents it for payment and receives its face value. The holder may present it directly to Bank I, as in the diagram, or return it to Bank X and have Bank X collect it through normal banking channels.

**EXPORT CREDIT INSURANCE**

The exporter who insists on cash or letter of credit payment for foreign shipments is likely to lose orders to competitors from other countries that provide more favorable credit terms. Better credit terms are often made possible by means of export credit insurance, which provides assurance to the exporter or the exporter’s bank that, should the foreign customer default on payment, the insurance company will pay for a major portion of the loss. Because of the availability of export credit insurance, commercial banks are willing to provide medium- to long-term financing (five to seven years) for exports.

Since credit has become an increasingly competitive component of the terms of export selling, governments of at least 35 countries have established entities that insure credit risks for exports. Details of these systems appear in the various editions of the World's Principal Export Credit Insurance Systems published by the International Export Credits Institute, New York.

Competition between nations to increase exports by lengthening the period for which credit transactions can be insured could lead to a credit war and to unsound credit decisions. To prevent such an unhealthy development, a number of leading trading nations...
joined together in 1934 to create the Berne Union (officially, the Union d’Assureurs des Crédits Internationaux) for the purpose of establishing a voluntary international understanding on export credit terms. The Berne Union recommends maximum credit terms for many items including, for example, heavy capital goods (five years), light capital goods (three years), and consumer durable goods (one year).

Export Credit Insurance in the United States

In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA). This is an unincorporated association of private commercial insurance companies operating in cooperation with the Export-Import Bank, an independent agency of the U.S. government.

The FCIA provides policies protecting U.S. exporters against the risk of nonpayment by foreign debtors as a result of commercial and political risks. Losses due to commercial risk are those that result from the insolvency or protracted payment default of the buyer. Political losses arise from actions of governments beyond the control of buyer or seller. FCIA political coverage generally protects against the following events:

- A buyer’s inability to legally obtain U.S. dollars or other approved currencies and to transfer those funds to the insured.
- Loss of transportation or insurance charges incurred after shipment because of the politically-caused interruption of a voyage outside the United States, when it is not practical to recover the charges from the buyer.
- The occurrence after shipment of any of the following, when it is not the fault of the buyer, issuing bank, or the insured or its agents:
  1. Cancellation or nonrenewal of an export license, or the imposition of restrictions on the export of products that were not subject to license or restriction prior to shipment.
  2. Cancellation of authority to import the products of the buyer’s country.
  3. Imposition of laws that prevent import of the products into the buyer’s country, or that prevent exchange of local currency into U.S. dollars or some other approved currency.
- The occurrence of any of the following after shipment but on or before the date of default:
  1. War, hostilities, civil war, rebellion, revolution, insurrection, civil commotion, or similar disturbances.
  2. Governmentally authorized requisition, expropriation, confiscation of, or intervention in, the specific business of the buyer, issuing bank, or guarantors.

FCIA Policies

The FCIA offers short-term policies, involving payment terms up to 180 days, and medium-term policies, with payment terms from 181 days to five years. Coverage up to seven years may be arranged on a case-by-case basis for aircraft, marine, and other sales,
if necessary to meet government-supported foreign competition. Coverage is for U.S. goods produced and shipped from the United States during the policy period, and applies to credit sales to a foreign buyer or to export letters of credit opened by a foreign issuing bank.

Generally, commercial coverage ranges from 90% to 95% and political coverage ranges from 95% to 100%, depending on the type of policy and options chosen by the exporter. Premiums depend on a number of variables, including the length of credit terms being offered, the exporter's previous experience with export sales, the risk associated with the countries to which goods are shipped or services are rendered, and the spread of risk covered by the policy. Details of the provisions of various types of policies can be obtained from the Foreign Credit Insurance Association at 40 Rector Street, 11th Floor, New York, New York 10006.

GOVERNMENT PROGRAMS TO HELP FINANCE EXPORTS

Governments of most export-oriented industrialized countries have special financial institutions that provide some form of subsidized credit to their own national exporters. These export finance institutions offer terms that are better than those generally available from the competitive private sector. Thus domestic taxpayers are subsidizing lower financial costs for foreign buyers in order to create employment and maintain a technological edge.

In the United States the chief government agency is the Export-Import Bank of the United States, headquartered in Washington, D.C. Other organizations include the Overseas Private Investment Corporation (OPIC) and the Private Export Funding Corporation (PEFCO).

Export-Import Bank

The Export-Import Bank (also called Eximbank) is an independent agency of the U.S. government, established in 1934 to stimulate and facilitate the foreign trade of the United States. Interestingly, the Eximbank was originally created primarily to facilitate exports to the Soviet Union.

In 1945 the Eximbank was rechartered "to aid in financing and to facilitate exports and imports and the exchange of commodities between the United States and any foreign country or the agencies or nationals thereof." The bank has $1 billion of nonvoting stock paid in by the U.S. Treasury and has the option of borrowing an additional $6 billion from the Treasury if and when needed.

The Eximbank facilitates the financing of U.S. exports through various loan guarantee and insurance programs. The Eximbank guarantees repayment of medium-term (181 days to five years) and long-term (five years to ten years) export loans extended by U.S. banks to foreign borrowers.

The Eximbank's medium- and long-term, direct-lending operation is based on participation with private sources of funds. Essentially the Eximbank lends dollars to borrowers outside the United States for the purchase of U.S. goods and services. Proceeds
of such loans are paid to U.S. suppliers. The loans themselves are repaid with interest in dollars to the Eximbank. The Eximbank requires private participation in these direct loans in order to: (1) ensure that it complements rather than competes with private sources of export financing; (2) spread its resources more broadly; and (3) ensure that private financial institutions will continue to provide export credit.

The Eximbank also guarantees lease transactions, finances the costs involved in the preparation by U.S. firms of engineering, planning, and feasibility studies for non-U.S. clients on large capital projects, and supplies counseling for exporters, banks, or others needing help in finding financing for U.S. goods.

**Private Export Funding Corporation (PEFCO)**

The Private Export Funding Corporation, or PEFCO, is a private corporation formed in 1970 to help finance U.S. exports by making U.S. dollar loans to foreign purchasers of goods or services manufactured or originated in the United States. PEFCO was established, with the support of the U.S. Department of the Treasury and of Eximbank, to mobilize private capital to supplement financing already available through Eximbank, commercial banks, and other lending institutions. PEFCO’s loans are repayable in U.S. dollars and are unconditionally guaranteed by Eximbank. The attorney general of the United States, in turn, has ruled that all obligations of Eximbank are general obligations of the United States, backed by the government’s full faith and credit. Because all PEFCO’s loans are guaranteed by Eximbank, PEFCO itself does not evaluate credit risks, appraise economic conditions in foreign countries, or review other factors that might affect the collectibility of its loans.

Impetus for the formation of PEFCO came from the Bankers’ Association for Foreign Trade. PEFCO’s stockholders are 49 U.S. commercial banks from all regions of the country, one investment banking firm, and seven manufacturing companies. The manufacturing firms are major U.S. exporters, with aircraft manufacturers and suppliers playing a prominent part.

PEFCO’s capital comes primarily from long-term secured notes sold in the open market, short-term notes payable sold in the open market, and shareholders’ equity.

**COUNTERTRADE**

The word *countertrade* refers to a variety of international trade arrangements “in which the sale of goods and services by a producer is linked to an import purchase of other goods and services.” In other words, an export sale is tied by contract to an import. The countertrade may take place at the same time as the original export, in which case credit is not an issue; or the countertrade may take place later, in which case financing becomes important.

Countertrade became popular in the 1960s and 1970s as a way for the Soviet Union and the Eastern European communist countries to manage foreign exchange risk by ensuring that imports today would be matched by present or future exports. In the last decade the technique has been used by noncommunist less developed nations for much the same reason.
Jean-François Hennart, who classified countertrade practices according to the diagram in Exhibit 18.7, points out that there are two broad categories, each of which has three subcategories: 4

1. Transactions which avoid the use of money:
   a) Simple barter.
   b) Clearing arrangements.
   c) Switch trading.

2. Transactions which use money or credit but impose reciprocal commitments.
   a) Buyback.
   b) Counterpurchase.
   c) Offset.

**Simple Barter**

Simple barter is a direct exchange of physical goods between two parties. It is a one-time transaction carried out under a single contract that specifies both the goods to be delivered and the goods to be received. The two parts of the transaction occur at the same time, and no money is exchanged. Money may be used as the numeraire by which the two values are established and the quantities of each good are determined.

A famous example of classical barter was an 18-year agreement whereby Pepsico sent Pepsi syrup to 37 bottling plants in the Soviet Union in return for Stolichnaya vodka which Pepsi then marketed in the United States. In a recent extension of that agreement involving Pepsico's Pizza Hut subsidiary, Moscow agreed to compensate Pepsico with ten Soviet-made freighters to sell on the international market. 5

A more complicated deal involves Philip Morris shipping cigarettes to the Russian Republic, for which it receives urea for use in making fertilizer. Philip Morris ships the urea to China, and China in turn ships glassware to North America for retail sale by Philip Morris.6

**Clearing Arrangements**

In a clearing arrangement, each party agrees to purchase a specified (usually equal) value of goods and service from the other, with the cost of the transactions debited to a special account. At the end of the trading period any residual imbalances may be cleared by shipping additional goods or by a hard currency payment. In effect, the addition of a clearing agreement to a barter scheme allows for a time lag between barter components. Thus credit facilitates eventual matching of the transactions.

**Switch Trading**

Switch trade involves transferring use of bilateral clearing balances from one country to another. For example, an original export from Canada to Romania is paid for with a balance deposited in a clearing account in Romania. Although the clearing account may be measured in Canadian dollars (or in any other currency), the balance can be used only to purchase goods from Romania.
Exhibit 18.7 Classification of Forms of Countertrade

Does the transaction involve reciprocal commitments? (other than cash payments)

Yes

Countertrade

No

Straight sales (cash or credit)

Does the transaction involve the use of money?

Yes

Counterpurchase, buyback, or offset

No

Barter-type

Reciprocal commitment limited to purchase of goods?

Yes

Buyback and counterpurchase

No

Clearing arrangement

Does the transaction extend over long time periods and involve a basket of goods?

Yes

Clearing arrangement

No

Switch trading

Are third parties involved?

Yes

Clearing arrangements

No

Simple barter

Are the goods taken back by the exporter the resultant output of the equipment sold?

Yes

Buyback

No

Counterpurchase

Offset

Switch trading

Clearing arrangements

The original exporter from Canada might buy unrelated goods from Romania or it might sell the clearing balance at a substantial discount to a "switch trader," often located in Vienna, who in turn purchases goods from Romania for sale elsewhere. The Canadian exporter in effect exchanges the blocked clearing balance for hard currency at a substantial discount with a specialist firm equipped to export merchandise from Romania. The Romanian goods themselves are quite cheap, given the discount, so the switch trader can resell the merchandise at a low price in world markets. Those who oppose this practice note that it is in effect dumping below true cost, which hurts competing manufacturers in other countries. However, because the "dumping" is not done by the original country of manufacture it escapes international agreements on dumping.

An example of a switch trade is a Polish/Greek clearing agreement that existed before Greece joined the EEC. Poland had sold Greece more goods than it had purchased, and so ended up with a dollar-denominated clearing balance in Greece. A switch trader bought the right to 250,000 clearing dollars from Poland for $225,000 and then resold them for $235,000 to a European sultana merchant, who in turn used them to purchase Greek sultanas through the Greek Foreign Trade Bank. (A sultana is a small white seedless grape used for both raisins and wine making.)

**Buyback, or Compensation Agreement**

A compensation agreement or buyback transaction is an agreement by an exporter of plant or equipment to take compensation in the form of future output from that plant. A buyback contract is essentially two parallel money transactions, and the seller is fully compensated by receipts of output from the plant and equipment. Such an arrangement has attributes that make it, in effect, an alternative form of direct investment. The value of the buyback usually exceeds the value of the original sale, as would be appropriate to reflect the time value of money.

An example of a buyback is the agreement by several Western European countries to provide steel pipe and compressors for a gas pipeline from the Soviet Union to Europe, with compensation from gas delivered through that pipeline. Another example is an agreement between Occidental Petroleum and the Soviet Union under which Occidental supplies the Soviet Union with one million tons of U.S. superphosphoric acid per year for 20 years and in turn receives 4 million tons of Soviet ammonia, urea, and potash. Occidental helped construct the extra ammonia production and pipeline capacity in the Soviet Union.

*Production sharing* is the term used for a similar arrangement involving natural resources or energy projects.

**Counterpurchase**

A counterpurchase transaction involves an initial export, but with the exporter receiving back merchandise that is unrelated to items the exporter manufactures. The importer provides a "shopping list" for the exporter. One example of counterpurchase is an agreement between McDonnell Douglas and Yugoslavia in 1966 under which McDonnell
Douglas sold DC-9’s to Yugoslovenski Aerotransport for $199 million cash and $26 million in Yugoslav goods. The Yugoslav products, imported into the United States over the subsequent decades, have included Zagreb hams, wines, dehydrated vegetables, and even some power transmission towers that were retransferred to the Los Angeles Department of Water and Power. McDonnell Douglas reportedly houses a Yugoslav trading firm at one of its aircraft plants to deal with the goods acquired in countertrade.

Other counterpurchase examples are the pre-German reunification purchase by West Germany’s Volkswagenwerk of coal, oil, and machinery from then East Germany in return for selling 10,000 automobiles to East Germany; and Rolls Royce’s sales of jet parts to Finland in return for Rolls Royce’s marketing Finnish TV sets and other consumer durables in the United Kingdom.

**Offset**

*Offset* refers to the requirement of importing countries that their purchase price be offset in some way by the seller. Offset is common in the purchase of weapons and other large-ticket items. Reciprocal concessions may involve agreement to source some of the production locally, to increase imports from the buying country, or to transfer technology.

**Reasons for the Growth of Countertrade**

In theory, countertrade is a movement away from free multilateral trade. It is a slow, expensive, and convoluted way of conducting trade that often forces firms (such as McDonnell Douglas) to set up operations to deal in products very remote from their expertise. The basic problem is that the agreement to take back goods in some form of barter suggests that these goods cannot be sold in the open market for as high a price as is being locked into the countertrade agreement.

Nevertheless, several reasons are advanced in support of countertrade. First, from the perspective of a centrally planned economy, countertrade reduces the risk of fluctuations in export receipts by assuring that future exports will provide foreign exchange roughly equivalent to the cost of the original import. Centrally planned economies have never been competent at marketing their products in foreign countries, perhaps because marketing was not needed at home. In these countries, production plans are made by a central authority, and the production system does not respond well to sudden changes in export demand. Countertrade provides an assured market for a period of time, and can be negotiated by governmental officials who set economic production quotas, rather than by the managers of individual plants who do not control the availability of resources.

Second, countertrade exports avoid domestic price controls and base prices set by international cartels or commodity agreements. In the case of barter, goods change hands without the explicit use of prices. Consequently any domestic price controls are passed over. Goods can be “sold” abroad at “prices” that are substantially below those charged local customers. Nigeria, Iran, Libya, Indonesia, Iraq, Qatar, and Abu Dhabi are reported to have used barter deals to sell oil below the OPEC cartel agreed-upon price.
Third, because foreign exchange is not created, it need not be turned over to a central bank. Yet the entity that pays for its original imports with mandated countertrade exports in effect earns foreign exchange which it is able to keep to itself to pay for the import.

Fourth, countertrade enables a country to export merchandise of poor design or quality. The merchandise is often sold at a major discount in world markets. Whether or not this constitutes a discount on the original sale, or even dumping, depends on how that original sale was priced. To the extent that communist and former communist countries have a reputation for poor quality, the fact that the goods are marketed in foreign countries by reputable firms gives buyers some assurance of quality and after-sale service.

Donald Lecraw found that countertrade was most successful for large firms experienced in exporting large, complex products; for firms vertically integrated or that could accommodate countertrade take backs; and for firms that traded with countries having inappropriate exchange rates, rationed foreign exchange, and import restrictions. Importers who were relatively inexperienced in assessing technology or in export marketing also enjoyed greater success.

**SUMMARY**

- Over many years, established procedures have arisen to finance international trade. The basic procedure rests on the interrelationship between three key documents, the letter of credit, the draft, and the bill of lading. Variations in each of these three key documents provide a variety of ways to accommodate any type of transaction.

- In the simplest transaction, in which all three documents are used and in which financing is desirable, an importer applies for and receives a letter of credit from its bank. In the letter of credit, the bank substitutes its credit for that of the importer and promises to pay if certain documents are submitted to the bank. The exporter may now rely on the promise of the bank rather than on the promise of the importer.

- The exporter typically ships on an order bill of lading, attaches the order bill of lading to a draft ordering payment from the importer’s bank, and presents these documents, plus any of a number of additional documents, through its own bank to the importer’s bank. If the documents are in order, the importer’s bank either pays the draft (a sight draft) or accepts the draft (a time draft). In the latter case the bank promises to pay in the future. At this step the importer’s bank acquires title to the merchandise through the bill of lading, and it then releases the merchandise to the importer against payment or promise of future payment.

- If a sight draft is used, the exporter is paid at once. If a time draft is used, the exporter receives the accepted draft, now a bankers’ acceptance, back from the bank. The exporter may hold the bankers’ acceptance until maturity or sell it at a discount in the money market.

- The process of international trade is facilitated by various national programs to provide export credit insurance and direct financial support.