«КROК» University

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Foreign Trade Techniques

Lecture Notes

Kyiv – 2018

Університет економіки та права «КРОК»

Г.П. Оласюк

Інструменти зовнішньої торгівлі

Курс лекцій

Київ – 2018

УДК 339.5
О 58

Рекомендовано до друку Вченою радою
Університету економіки та права «КРОК»
(протокол № 5 від 29.03.2018 р.)

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Оласюк Г.П.
О 58 Інструменти зовнішньої торгівлі: навчальний посібник / Г.П. Оласюк. – К.: Університет економіки та права «КРОК», 2018. – 83 с.

ISBN 978-966-170-023-8

В посібнику висвітлено методи та інструменти ведення зовнішньої торгівлі в еру глобалізації світового господарства. Розкрито теоретичні засади здійснення зовнішньої торгівлі, висвітлено способи виходу компаній на закордонні ринки й особливості ведення експортно-імпортних операцій на них. Системно описано методи розрахунків за зовнішньоторговельними угодами, регулювання торговельних потоків на національному, регіональному та глобальному рівнях. Акцент посібника зроблено на характеристиці програм та інституцій зі сприяння міжнародної торгівлі й розвитку проектного фінансування.

Посібник містить 15 тем, кожана з яких супроводжується питаннями для самоперевірки. Англомовне видання розраховане для самостійного опанування означених проблем та як посібник для закріплення лекційного матеріалу здобувачами вищої освіти у сфері міжнародних економічних відносин.

ISBN 978-966-170-023-8

CONTENTS

Introduction

The course aims to give an extensive overview of theoretical foundations of foreign trade, comprehend on foreign trade regulation practices and stimulation policies, will master in formulating and executing corporate expansion strategies and tactics to seize foreign markets.

Learning Outcomes / Course Objectives

To develop an understanding of the overall international framework within which export companies including their multi-domestic set-ups act when doing export business, with a special emphasis on commercial-, financial- and risk-related issues, techniques and tools mainly focusing on export transactions. Upon completion of the course students will have acquired know-how in the field of export commercial framework, for instance of specific risk-management techniques, commercial terms, contracts, insurance, export finance.

After the completion of this course undergraduates in International Economic Relations will be able to:

- Comprehend on modern issues of foreign trade, its cultural, political and socio-economic limitations
- Understand and describe the possible risk types occur in international business
- Define and identify the most important elements of contract of international sales including the applied documents
- Explain the major payment options for international business, e. g. L/C
- Explain the major security instruments for international trademajor export finance instruments
- Apply and distinguish the optimal risk mitigation options based on the identified risk profile of an export deal
- Describe and compare the major global trade institutions and national trade regulation policies.
- Employ and calculate the basic instruments in export finance

Teaching Methods

The contents of the course will be a combination of: lectures by the instructor, self and group study sections including presentations and documentations, quizzes.

Evaluation:Group assignments, quizzes, cases, final written exam.

Topic 1

Globalization and foreign trade

Globalization — the shift toward a more interdependent and integrated global economy — creates greater opportunities for international business. Such **globalization** can take place **in terms of markets**, where **trade barriers are falling and buyer preferences are changing.** Remember, globalization refers to the shift toward a more interdependent and integrated global economy.

This shift is fueled largely by: (1) declining trade and investment barriers and (2) new technologies, such as the Internet. **The globalization debate surrounds whether and how fast markets are actually merging together.**

In a truly global industry, the core product is standardized, the marketing approach is relatively uniform, and competitive strategies are integrated in different international markets.

Factors Favoring Industry Globalization are following:

1. **Markets**

- Homogeneous customer needs
- Global customer needs
- Global channels
- Transferable marketing approaches

2. **Costs**

- Large-scale and large-scope economies
- Learning and experience
- Sourcing efficiencies
- Favorable logistics
- Arbitrage opportunities
- High research-and-development (R&D) costs

1. Governments

- Favorable trade policies
- Common technological standards
- Common manufacturing and marketing regulations

2. Competition

- Interdependent countries

- Global competitors

Flat-world view– a metaphor for viewing the world as a level playing field in terms of commerce, where all competitors have an equal opportunity. The flat-world view is largely credited to Thomas Friedman and his 2005 bestseller, *The World Is Flat*. An alternative way of thinking about world is multidomestic view.

Multidomestic view– a metaphor for viewing the world's markets as being more different then similar, such that the playing field differs in respective markets. Many people consider globalization a modern phenomenon, but according to Friedman, **this is its third stage. "Globalization 1.0,"** started with Columbus's discovery of the New World and ran from 1492 to about 1800. Driven by nationalism and religion, this lengthy stage was characterized by how much industrial power countries could produce and apply. **In Globalization 1.0**, **nations** dominated global expansion.

"Globalization 2.0," from about 1800 to 2000, was disrupted by the Great Depression and both World Wars and was largely shaped by the emerging power of huge, multinational corporations. **Globalization 2.0 grew** with the European mercantile stock companies as they expanded in search of new markets, cheap labor, and raw materials. It continued with subsequent advances in sea and rail transportation. This period saw the introduction of modern communications and cheaper shipping costs. **Globalization 2.0 was driven** by the ascension of multinational companies, which pushed global development.

In today's global economy, everyone is accustomed to buying goods from other countries—electronics from Taiwan, vegetables from Mexico, clothing from China, cars from Korea, and skirts from India. Most modern shoppers take the "Made in [a foreign country]" stickers on their products for granted. **Long-distance commerce wasn't always this common,** although foreign trade—the movement of goods from one geographic region to another—has been a key factor in human affairs since prehistoric times. **Thousands of years ago, merchants transported only the most precious items—** silk, gold and other precious metals and jewels, spices, porcelains, and medicines—via ancient, extended land and sea trade routes, including the famed Silk Road through central Asia.

Moving goods great distances was simply too hard and

costly to waste the effort on ordinary products, although people often carted grain and other foods over shorter distances from farms to market towns.

“Globalization 3.0” began around 2000, with advances in global electronic interconnectivity that allowed individuals to communicate as never before.

In Globalization 3.0, major software advances have allowed an unprecedented number of people worldwide to work together with unlimited potential.

Multidomestic view can be disclosed by “CAGE” analysis. **The CAGE framework covers these four factors:** Culture, Administration, Geography, Economics.

Generally, cultural differences between two countries reduce their economic exchange. Some products have a strong national identification, such as the Molson beer company in Canada (see Molson’s “I am Canadian” ad campaign). **http://www.youtube.com/watch?v=BRI-A3vakVg**. **Conversely**, genetically modified foods (GMOs) are commonly accepted in North America but highly disdained in Western Europe. Such cultural distance for GMOs would make it easier to sell GMO corn in the United States but impossible to sell in Germany. **Some differences are surprisingly specific** (such as the Chinese dislike of dark beverages, which Coca-Cola marketers discovered too late).

Administration. Bilateral trade flows show that administratively similar countries trade much more with each other. Administrative distance refers to historical governmental ties, such as those between India and the United Kingdom. This makes sense; they have the same sorts of laws, regulations, institutions, and policies. Membership in the same trading block is also a key similarity.

Geography. Generally, as distance goes up, trade goes down, since distance usually increases the cost of transportation. **Geographic differences also include** time zones, access to ocean ports, shared borders, topography, and climate. You may recall from the opening case that even Google was affected by geographic distance when it felt the speed of the Internet connection to Google.com was slowed down because the Chinese were accessing server farms in other countries, as none were set up in China (prior to the setup of Google.cn).

Economics. Economic distance refers to differences in demographic and socioeconomic conditions. The most obvious economic difference between countries is size (as compared by gross domestic product, or GDP). Another is per capita income.

This distance is likely to have the greatest effect when: (1) the nature of demand varies with income level, (2) economies of scale are limited, (3) cost differences are significant, (4) the distribution or business systems are different, or (5) organizations have to be highly responsive to their customers' concerns.

Concepts Review Questions

1. Describe the concept of globalization. What two opposite views exists in science?

2. Discuss how factors can affect industry globalization. What factor in your opinion plays the most important role in this process?

3. What main purpose and practical application of CAGE model?

Topic 2

Classical and modern theories of international trade

International trade theories are simply different theories to explain international trade. **Trade** is the concept of exchanging goods and services between two people or entities. *International trade* is then the concept of this exchange between people or entities in two different countries. People or entities trade because they believe that they benefit from the exchange.

To better understand how modern global trade has evolved, it's important to understand how countries traded with one another historically. **Over time, economists have developed theories to explain the mechanisms of global trade.** The main historical theories are called *classical* and are from the perspective of a country, or **country-based**. By the mid-twentieth century, the theories began to shift to explain trade from a firm, rather than a country, perspective. These theories are referred to as *modern* and are firm-based or **company-based.** Both of these categories, classical and modern, consist of several international theories.

Developed in the sixteenth century, **mercantilism** was one of the earliest efforts to develop an economic theory. This **theory stated that a country's wealth was determined by the amount of its gold and silver holdings**. In it's simplest sense, mercantilists believed that a country should increase its holdings of gold and silver by promoting exports and discouraging imports. In other words, if people in other countries buy more from you (exports) than they sell to you (imports), then they have to pay you the difference in gold and silver. **The objective** of each country was to have a **trade surplus**, or a situation where the value of exports are greater than the value of imports, and to avoid a **trade deficit**, or a situation where the value of imports is greater than the value of exports.

In 1776, Adam Smith questioned the leading mercantile theory of the time in *The Wealth of Nations* Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* Smith offered a new trade theory called absolute advantage, which focused on the ability of a country to produce a good more efficiently than another nation. Smith reasoned that trade between countries shouldn't be regulated or restricted by government policy or intervention.

He stated that trade should flow naturally according to market forces. In a hypothetical two-country world, if Country A could produce a good cheaper or faster (or both) than Country B, then Country A had the advantage and could focus on specializing on producing that good.

The challenge to the absolute advantage theory was that some countries may be better at producing both goods and, therefore, have an advantage in *many* areas. In contrast, another country may not have *any* useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the **theory of comparative advantage** in 1817 Ricardo reasoned that even if Country A had the absolute advantage in the production of *both* products, specialization and trade could still occur between two countries.

The theories of Smith and Ricardo didn't help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to determine which goods they could produce more efficiently. **In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin**, focused their attention on how a country could gain comparative advantage by producing products that utilized factors that were in abundance in the country. **Their theory is based on a country's production factors**—land, labor, and capital, which provide the funds for investment in plants and equipment.

Their theory, also called the **factor proportions theory**, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand. **In the early 1950s,** Russian-born American economist Wassily W. Leontief studied the US economy closely and noted that the United States was abundant in capital and, therefore, should export more capital-intensive goods.

However, his research using actual data showed the opposite:

the United States was importing more capital-intensive goods. According to the factor proportions theory, the United States should have been importing labor-intensive goods, but instead it was actually exporting them. His analysis became known as the **Leontief Paradox** because it was the reverse of what was expected by the factor proportions theory.

In contrast to classical, **country-based trade theories, the category of modern, firm-based theories emerged after World War II and was developed in large part by business school professors, not economists.** The firm-based theories evolved with the growth of the multinational company (MNC). **The country-based theories** couldn't adequately address the expansion of either MNCs or intra-industry trade, which refers to trade between two countries of goods produced in the same industry. *For example*, Japan exports Toyota vehicles to Germany and imports Mercedes-Benz automobiles from Germany.

Swedish economist Steffan Linder developed the country similarity theory in **1961**, as he tried to explain the concept of intra-industry trade. **Linder's theory proposed** that consumers in countries that are in the same or similar stage of development would have similar preferences. In this **firm-based theory**, Linder suggested that companies first produce for domestic consumption. When they explore **exporting**, the companies often find that **markets that look similar to their domestic** one, in terms of customer preferences, offer the most potential for success. **Linder's country similarity theory** then states that most trade in manufactured goods will be between countries with similar per capita incomes, and intra-industry trade will be common.

Raymond Vernon, a Harvard Business School professor, developed the product life cycle theory in the 1960s. The theory, originating in the field of marketing, stated that a product life cycle has three distinct stages: (1) new product, (2) maturingproduct, and (3) standardized product.

The theory assumed that production of the new product will occur completely in the home country of its innovation. **In the 1960s this was a useful theory** to explain the manufacturing success of the United States. US manufacturing was the globally dominant producer in many industries after World War II.

It has also been used to describe how the personal computer (PC) went through its product cycle. **The PC was a new product** in the 1970s and developed into a mature product during the 1980s and 1990s.**Today, the PC** is in the standardized product stage, and the majority of manufacturing and production process is done in low-cost countries in Asia and Mexico. **The product life cycle theory has been less able** to explain current trade patterns where innovation and manufacturing occur around the world. Even though **R&D** is typically associated with the first or new product stage and therefore completed in the home country, these developing or emerging-market countries, **such as India and China**, offer both highly skilled labor and new research facilities at a substantial cost advantage for global firms.

Global strategic rivalry theory emerged in the **1980s** and was based on the work of economists **Paul Krugman and Kelvin Lancaster**. **Their theory focused on MNCs** and their efforts to gain a competitive advantage against other global firms in their industry. Firms will encounter global competition in their industries and in order to prosper, they must develop competitive advantages. The critical ways that firms can obtain a sustainable competitive advantage are called the barriers to entry for that industry. The **barriers to entry** refer to the obstacles a new firm may face when trying to enter into an industry or new market.

The barriers to entry that corporations may seek to optimize include: (1) research and development,(2) the ownership of intellectual property rights, (3) economies of scale, (4) unique business processes or methods as well as extensive experience in the industry, and (5) the control of resources or favorable access to raw materials.

In the continuing evolution of international trade theories, **Michael Porter of Harvard Business School** developed a new model to explain national competitive advantage in **1990**. **Porter's theory stated that a nation's competitiveness** in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified four determinants that he linked together. **The four determinants are** (1) local market resources and capabilities, (2) local market demand conditions, (3) local suppliers and complementary industries, and (4) local firm characteristics.

1. Local market resources and capabilities (factor conditions). Porter added to these basic factors a new list of advanced factors, which he defined as skilled labor, investments in education, technology, and infrastructure.

2. Local market demand conditions. Porter believed that a sophisticated home market is critical to ensuring ongoing innovation, thereby creating a sustainable competitive advantage. Companies whose domestic markets are sophisticated, trendsetting, and demanding forces continuous innovation and the development of new products and technologies.

3. Local suppliers and complementary industries. To remain competitive, large global firms benefit from having strong, efficient supporting and related industries to provide the inputs required by the industry.

4. Local firm characteristics. Local firm characteristics include firm strategy, industry structure, and industry rivalry. Local strategy affects a firm's competitiveness. A healthy level of rivalry between local firms will spur innovation and competitiveness.

Concepts Review Questions

1. What is international trade?

2. Summarize the classical, country-based international trade theories. What are the differences between these theories, how did the theories evolve?

3. What are the modern, firm-based international trade theories?

4. Describe how a business may use the trade theories to develop its business strategies. Use Porter's four determinants in your explanation.

5. Define the differences between the classical, country-based trade theories and the modern, firm-based trade theories. If you were a manager for a large manufacturing company charged with developing your firm's global strategy, how would you use these theories in your analysis? Which theories seem most appealing to you and which don't seem to apply?

Topic 3

Cultural dimensions of international business

Culture– the beliefs, values, mind-sets, and practices of a specific group of people.**Culture**, in the broadest sense, refers to how and why we think and function.

It encompasses all sorts of things–how we eat, play, dress, work, think, interact, and communicate.

Geert Hofstede, sometimes called the father of modern cross-cultural science and thinking, is a social psychologist who focused on a comparison of nations using a statistical analysis of two unique databases.

The first and largest database composed of answers that matched employee samples from forty different countries to the same survey questions focused on attitudes and beliefs.

The second consisted of answers to some of the same questions by Hofstede's executive students who came from fifteen countries and from a variety of companies and industries.

He developed a framework for understanding the systematic differences between nations in these two databases.

This framework focused on value dimensions

1. Power distance
2. Individualism
3. Masculinity
4. Uncertainty avoidance (UA)
5. Long-term orientation
6. Indulgence/Restraint

Power distance refers to how openly a society or culture accepts or does not accept differences between people, as in hierarchies in the workplace, in politics, and so on. For example, **high power distancecultures** openly accept that a boss is "higher" and as such deserves a more formal respect and authority.

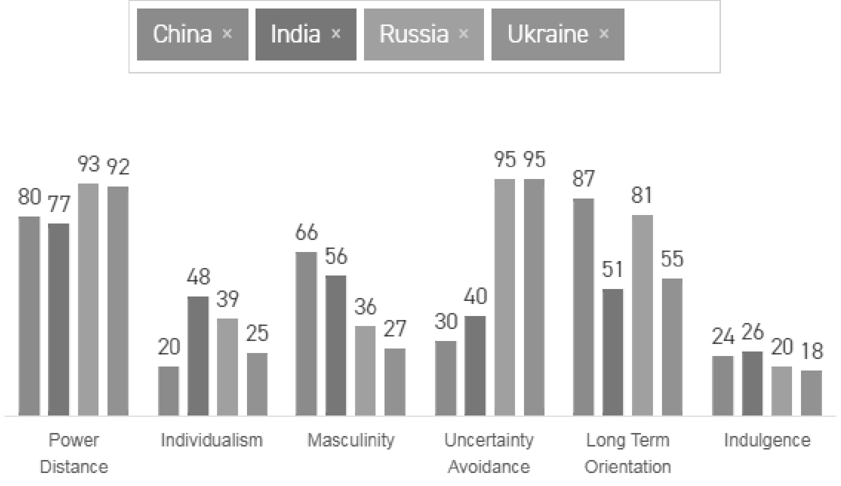
Examples of these cultures include Japan, Mexico, and the

Philippines. In Japan or Mexico, the senior person is almost a father figure and is automatically given respect and usually loyalty without questions.

In Southern Europe, Latin America, and much of Asia, power is an integral part of the social equation. Subordinates expect to be told what to do and will not take initiative or speak their minds unless a manager explicitly asks for their opinion.

At the other end of the spectrum are **low power distance cultures**, in which superiors and subordinates are more likely to see each other as equal in power.

Countries found at this end of the spectrum include Austria and Denmark. To be sure, not all cultures view power in the same ways. In Sweden, Norway, and Israel, for example, respect for equality is a warranty of freedom.



Individualism referring to people's tendency to take care of themselves and their immediate circle of family and friends, perhaps at the expense of the overall society.

In individualistic cultures, what counts most is self-realization.

Initiating alone, sweating alone, achieving alone – not necessarily collective efforts – are what win applause.

In **individualistic cultures**, competition is the fuel of success. The United States and Northern European societies are often labeled as individualistic. In the United States, individualism is valued and promoted – from its political structure (individual rights and democracy) to entrepreneurial zeal (capitalism). Other examples of high-individualism cultures include Australia and the United Kingdom.

Masculinity refers to how a culture ranks on traditionally perceived "masculine" values: assertiveness, materialism, and less concern for others.

In **masculine-oriented cultures**, gender roles are usually crisply defined. Men tend to be more focused on performance, ambition, and material success. They cut tough and independent personas, while women cultivate modesty and quality of life.Cultures in Japan and Latin American are examples of masculine-oriented cultures.

In **feminine-oriented cultures**, both genders swap roles, with the focus on quality of life, service, and independence. The Scandinavian cultures rank as femininecultures, as do cultures in Switzerland and New Zealand. The United States is actually more moderate, and its score is ranked in the middle between masculineand feminine classifications. For all these factors, it's important to remember that cultures don't necessarily fall neatly into one camp or the other.

The next dimension is **uncertainty avoidance** (UA). This refers to how much uncertainty a society or culture is willing to accept. It can also be considered an indication of the risk propensity of people from a specific culture.

People who have **high uncertainty avoidance** generally prefer to steer clear of conflict and competition. They tend to appreciate very clear instructions. At the office, sharply defined rules and rituals are used to get tasks completed.

Stability and what is known are preferred to instability and the unknown. Company cultures in these countries may show a preference for low-risk decisions, and employees in these companies are less willing to exhibit aggressiveness. Japan and France are often considered clear examples of such societies.

In countries **with low uncertainty avoidance**, people are more willing to take on risks, companies may appear less formal and structured, and "thinking outside the box" is valued.

Examples of these cultures are Denmark, Singapore, Australia, and to a slightly lesser extent, the United States. Members of these cultures usually require less formal rules to interact.

The fifth dimension is **long-term orientation**, which refers to whether a culture has a long-term or short-term orientation. The long-term orientation values persistence,perseverance, thriftiness, and having a sense of shame. These are evident in traditional Eastern cultures. Based on these values, it's easy to see why a Japanese CEO is likely to apologize or take the blame for a faulty product or process.

The **short-term orientation values** tradition only to the extent of fulfilling social obligations or providing gifts or favors. These cultures are more likely to be focusedon the immediate or short-term impact of an issue. Not surprisingly, the United Kingdom and the United States rank low on the long-term orientation.

Indulgence stands for a society that allows relatively free gratification of basic and natural human drives related to enjoying life and having fun. Restraint stands for a society that suppresses gratification of needs and regulates it by means of strict social norms.

Concepts Review Questions

1. Why culture is important for international trade relations. What cultural aspects should export-import managers keep in mind while dealing with foreign partners?

2. Identify two national cultures among your classmates. Visit http://www.geert-hofstede.com and research Hofstede's five value dimensions for each country. If you were working for a company from one of the two countries selected, how would you advise the senior management on the compatibility of the two cultures? Are the cultures individualistic or collectivist? Do they have a high or low tolerance for risk? Do they have similar or opposite approaches to long-term orientation?

3. Pick a country that Dunkin' Brands is not currently operating in. Outline key cultural issues that management should consider before entering that market. Use the cultural methodologies and determinants that this chapter discusses.

Topic 4

International Expansion, Global Market Opportunity Assessment and International Business Risks

Companies embark on an expansion strategy for one or more of the following reasons:

- To improve the cost-effectiveness of their operations
- To expand into new markets for new customers
- To follow global customers

International market due diligence involves analyzing foreign markets for their potential size, accessibility, cost of operations, and buyer needs and practices to aid the company in deciding whether to invest in entering that market.

Common mistakes that firms make when entering a new market include not doing thorough research prior to entry, not understanding the competition, and not offering a truly targeted value proposition for buyers in the new market.

PESTEL as important analytical tool in business. PESTEL analysis is an important and widely used tool that helps show the big picture of a firm's external environment, particularly as related to foreign markets.

PESTEL is an acronym for the political, economic, sociocultural, technological, environmental, and legal contexts in which a firm operates.

A **PESTEL** analysis helps managers gain a better understanding of the opportunities and threats they face; consequently, the analysis aids in building a better vision of the future business landscape and how the firm might compete profitably.

1. Political

- How stable is the political environment in the prospective country?
- What are the local taxation policies? How do these affect your business?

- Is the government involved in trading agreements, such as the European Union (EU), the North American Free Trade Agreement (NAFTA), or the Association of Southeast Asian Nations (ASEAN)?
- What are the country's foreign-trade regulations?
- What are the country's social-welfare policies?

2. Economic

- What are the current and forecast interest rates?
- What is the current level of inflation in the prospective country? What is it forecast to be? How does this affect the possible growth of your market?
- What are local employment levels per capita, and how are they changing?
- What are the long-term prospects for the country's economy, gross domestic product (GDP) per capita, and other economic factors?
- What are the current exchange rates between critical markets, and how will they affect production and distribution of your goods?

3. Sociocultural

- What are the local lifestyle trends?
- What are the country's current demographics, and how are they changing?
- What is the level and distribution of education and income?
- What are the dominant local religions, and what influence do they have on consumer attitudes and opinions?
- What is the level of consumerism, and what are the popular attitudes toward it?
- What pending legislation could affect corporate social policies (e.g., domestic-partner benefits or maternity and paternity leave)?
- What are the attitudes toward work and leisure?

4. Technological

- To what level do the local government and industry fund research, and are those levels changing?
- What is the local government's and industry's level of interest and focus on technology?
- How mature is the technology?

- What is the status of intellectual property issues in the local environment?
- Are potentially disruptive technologies in adjacent industries creeping in at the edges of the focal industry?

5. Environmental

- What are the local environmental issues?
- Are there any pending ecological or environmental issues relevant to your industry?
- How do the activities of international activist groups (e.g., Greenpeace, Earth First!, and People for the Ethical Treatment of Animals [PETA]) affect your business?
- Are there environmental-protection laws?
- What are the regulations regarding waste disposal and energy consumption?

6. Legal

- What are the local government's regulations regarding monopolies and private property?
- Does intellectual property have legal protections?
- Are there relevant consumer laws?
- What is the status of employment, health and safety, and product safety laws?

International-Expansion Entry Modes

Type of Entry	Advantages	Disadvantages
Exporting	Fast entry, low risk	Low control, low local knowledge, potential negative environmental impact of transportation.
Licensing and Franchising	Fast entry, low cost, low risk	Less control, licensee may become a competitor, legal and regulatory environment (IP and contract law) must be sound
Partnering and Strategic Alliances	Shared costs reduce investment needed, reduced risk, seen as local entity.	Higher cost than exporting, licensing, or franchising; integration problems between two corporate cultures

Acquisition	Fast entry; known, established operations	High cost, integration issues with home office
Greenfield Venture (Launch of new wholly owned subsidiary)	Gain local market knowledge; can be seen as insider who employs locals maximum control.	High cost, high risk due to unknowns, slow entry due to sup time.

Specialized Entry Modes. Contractual Licensing is defined as the granting of permission by the licenser to the licensee to use intellectual property rights, such as trademarks, patents, brand names, or technology, under defined conditions.

For a multinational firm, the advantage of licensing is that the company's products will be manufactured and made available for sale in the foreign country (or countries) where the product or service is licensed.

Similar to a **licensing** agreement, under a **franchising** agreement, themultinational firm grants rights on its intangible property, like technology or abrand name, to a foreign company for a specified period of time and receives aroyalty in return.

An **equity joint venture** is a contractual, strategic partnership between two or more separate business entities to pursue a business opportunity together. The partners in an **equity joint venture** each contribute capital and resources in exchange for an equity stake and share in any resulting profits. (In a nonentity joint venture, there is no contribution of capital to form a new entity.)

Equity joint ventures pose both opportunities and challenges for the companies involved.First and foremost is the challenge of finding the right partner—not just in terms of business focus but also in terms of compatible cultural perspectives and management practices. **Second**, the local partner may gain the know-how to produce its own competitive product or service to rival the multinational firm.

This is what's currently happening in China. To manufacture cars in China, non-Chinese companies must set up joint ventures with Chinese automakers and share technology with them. Once the contract ends, however, the local company may take the knowledge it gained from the joint venture to compete with its former partner.

Companies seeking to enter a foreign market need to do the following: Research the foreign market thoroughly and learn about the country and its culture. Understand the unique business and regulatory relationships that impact their industry. Use the Internet to identify and communicate with appropriate foreign trade corporations in the country or with their own government's embassy in that country. Each embassy has its own trade and commercial desk.

For example, the US Embassy has a foreign commercial desk with officers who assist US companies on how best to enter the local market. These resources are best for smaller companies. Larger companies, with more money and resources, usually hire top consultants to do this for them. They're also able to have a dedicated team assigned to the foreign country that can travel the country frequently for the later-stage entry strategies that involve investment.

Business risk implies the possibility of some unfavorable happening. It is the possibility of loss due to same uncertain future occurrence.

International business risk may be defined as the possibility of loss caused by some unfavorable or undesirable event in international business operations.

The degree of such risk differs from one company to another company and from one country to another country.

There are The Four Types of Risks in International Business:

1. Cross-cultural risk: a situation or event where a cultural miscommunication puts some human value at stake

2. Country risk: potentially adverse effects on company operations and profitability holes by developments in the political, legal, and economic environment in a foreign country

3. Currency risk: risk of adverse unexpected fluctuations in exchange rates

4. Commercial risk: firms' potential loss or failure from poorly developed or executed business strategies, tactics, or procedures.

Cultural Risk covers following aspects:

- Differences in language, lifestyles, attitudes, customs, and religion, where a cultural miscommunication jeopardizes a culturally valued mindset or behavior.
- Cultural blunders- hinder the effectiveness of foreign managers.

- Language- critical dimension of culture- a window to people's values
- Language differences impede effective communication.
- Cultural differences may lead to suboptimal business strategies.

The Meaning of Country (Political) Risk

Exposure to potential loss or adverse effects on company operations and profitability caused by developments in a country's political and/or legal environments.

Every country is characterized by diverse political and legal systems that pose significant challenges for company strategy and performance, as managers must adhere to business laws and regulations.

Preferential subsidies, government incentives, and protection from competition reduce business costs and influence strategic decision-making. Governments encourage domestic investment from foreign MNEs by offering tax holidays and cash incentives to employ local workers.

Protectionism refers to national economic policies designed to restrict free trade and protect domestic industries from foreign competition. Government intervention arises typically in the form of **tariffs** (duty), **nontariff trade barriers** (e.g. quota), and **investment barriers** (target FDI). **Tariff** is a tax imposed on imports, effectively increasing the cost to the buyer. A **nontariff trade barrier** refers to a government policy, regulation, or procedure that impedes trade. **Quota** is a quantitative restriction placed on imports of a specific product over a specified period.

Currency Risk (Financial Risk)it is arisk of adverse exchange rate fluctuations, inflation and other harmful economic conditions create uncertainty of returns.When currencies fluctuate significantly, the value of the firm's assets, liabilities and/or operating income may be substantially reduced.

Currency risk arises from changes in the price of one currency relative to another → complicates cross-border transactions → impacts firms with foreign currency obligations (one of the four types of risks in international business

– If supplier's currency appreciates; you may need to hand over a larger amount of your currency to pay for your purchase.

– If buyer's currency depreciates, you may receive a smaller payment amount in your currency (sales price was expressed in the customer's currency).

Commercial Risk:

- Less than optimal formulation and/or implementation of strategies, tactics or procedures, e.g. partnering selections, market entry timing, pricing, product features, and promotional themes
- Failures in international markets are far more costly than domestic business blunders.

Concepts Review Questions

1. What are the risks and benefits associated with exporting?

2. Name two contractual modes of entry into a foreign country. Which do you think is better and why?

3. Why would a company choose to use contractual mode of entry rather than an investment mode?

4. What are the advantages to a company using a joint venture rather than buying or creating its own wholly owned subsidiary when entering a new international market?

5. Pick a country as a potential new market for your firm's operations. Using what you have learned in this chapter and from online resources https://www.cia.gov/library/publications/resources/the-world-factbook/ assess the local political, economic, and legal factors of the country. Would you recommend to your senior management that your firm establish operations and invest in this country? Which factors do you think are most important in this decision?

Topic 5

Exporting, Importing, and Countertrade as main forms of international trade

The history of importing and exporting dates back to the Roman Empire, when European and Asian traders imported and exported goods across the vast lands of Eurasia.

Trading along the Silk Road flourished during the thirteenth and fourteenth centuries. Caravans laden with imports from China and India came over the desert to Constantinople and Alexandria. From there, Italian ships transported the goods to European ports.

For centuries, importing and exporting has often involved intermediaries, due in part to the long distances traveled and different native languages spoken. The spice trade of the 1400s was no exception. Spices were very much in demand because Europeans had no refrigeration, which meant they had to preserve meat using large amounts of salt or risk eating half-rotten flesh.

Spices disguised the otherwise poor flavor of the meat. Europeans also used spices as medicines. **The European demand for spices gave rise to the spice trade**. The trouble was that spices were difficult to obtain because they grew in jungles half a world away from Europe. The overland journey to the spice-rich lands was arduous and involved many middlemen along the way.

Each middleman charged a fee and thus raised the price of the spice at each point. By the end of the journey, the price of the spice was inflated 1,000 percent.

Exporting is defined as the sale of products and services in foreign countries that are sourced or made in the home country. **Importing is the flipside of exporting. Importing** refers to buying goods and services from foreign sources and bringing them back into the home country. Importing is also known as global sourcing.

Exporting is an effective entry strategy for companies that are just beginning toenter a new foreign market. It’s a **low-cost,**

low-risk option compared to the otherstrategies. These same reasons make **exporting** a **good** strategy for **small and midsize companies** that can't or won't make significant financial investment in the international market.

Companies can sell into a foreign country either **through a local distributor** or through **their own salespeople**. Many **government export-trade offices** can help a company find a local distributor.

Increasingly, the **Internet** has provided a more efficient way for foreign companies to find local **distributors** and enter into commercial transactions. **Distributors**are export intermediaries who represent the company in the foreign market. Often, distributors represent many companies, acting as the "face" of the company in that country, selling products, providing customer service, and receiving payments. In many cases, the distributorstake title to the goods and then resell them. Companies use distributors because distributors know the local market and are a cost-effective way to enter that market. **Using distributors** to help with export can have its own challenges. For example, some companies find that if they have a **dedicated salesperson** who travels frequently to the country, they're likely to get more sales than by relying solely on the distributor. Often, that's because **distributors sell multiple products** and sometimes even competing ones. **Making sure** that the distributor favors one firm's product over another product can be **hard to monitor.**

An **export partner in the form** of either a **distributor** or an **export management company** can facilitate this process. An **export management company** (EMC) is an independent company that performs the duties that a firm's own export department would execute. The **EMC handles** the necessary documentation, finds buyers for the export, and takes title of the goods for direct export. In return, the EMC charges a fee or commission for its services.

Benefits of Exporting: Vitrac. Egyptian company Vitrac was founded by MounirFakhry Abdel Nour to take advantage of Egypt's surplus fruit products. At its inception, Vitrac sourced local fruit, made it into jam, and exported it worldwide. Vitrac has acquired money, market, and manufacturing advantages from exporting. **Market.** The company has access to a new market, which has brought added revenues. **Money.** Not only has Vitrac earned more revenue, but it has also gained access to foreign currency, which benefits companies located in certain regions of the world, such as in Vitrac's home country of Egypt. **Manufacturing.** The cost to manufacture a given unit decrease because Vitrac has been able to manufacture at higher volumes and buy source materials in higher volumes, thus benefitting from volume discounts.

Risks of Exporting. There are risks in relying on the export option. If you merely export to a country, the distributor or buyer might switch to or at least threaten to switch to a cheaper supplier in order to get a better price. Or someone might start making the product locally and take the market from you.

Also, local buyers sometimes believe that a company which only exports to them isn't very committed to providing long-term service and support once a sale is complete. Thus, they may prefer to buy from someone who's producing directly within the country. At this point, many companies begin to reconsider having a local presence, which moves them toward one of the other entry options.

Some countries limit the profits (currency) a company can take out of a country. As a result, many companies resort to countertrade10, where companies trade goods and services for other goods and services; actual monies are involved only to a lesser degree, if at all. You can imagine that limitations on transferring profits would make the world less flat; so too would the absence of countertrade opportunities in situations where currency transfer limitations are in place.

Countertrade is also a resourceful way for exporters to sell their products and services to foreign companies or countries that would be unable to pay for them using hard currency alone.

One reason that companies engage in this practice is that some governments mandate countertrade on very large-scale (over $1 million) deals or if the deal is in a certain industry. **For example, South Korea** mandates countertrade for government telecommunications procurement over $1 million. When governments impose **counter purchase obligations**, firms have no choice but to engage in countertrade if they wish to sell goods into that country.

Countertrade also can mitigate the risk of price movements or currency-exchange rate fluctuations. Because both sides of a countertrade deal in real goods, not financial instruments, countertrade can solve the inflation risk involved in foreign currency procurement. In effect, countertrade can be a better mechanism than financial instruments as a way to hedge against inflation or currency fluctuations.

Concepts Review Questions

1. *Define concepts of exporting and importing, their possible risks and benefits.*
2. *What are the reasons the companies embark on an expansion strategy?*
3. *What are the Factors Favoring Industry Globalization?*

Topic 6

WTO: history, structure and functions

The WTO was born out of negotiations, and everything the WTO does is the result of negotiations.

The bulk of the WTO's current work comes from the 1986–94 negotiations called the Uruguay Round and earlier negotiations under the General Agreement on Tariffs and Trade (GATT).

The WTO is currently the host to new negotiations, under the 'Doha Development Agenda' launched in 2001.

Purpose of the WTO:

1. It is an organization for trade opening.
2. It is a forum for governments to negotiate trade agreements.
3. It is a place for them to settle trade disputes.
4. It operates a system of trade rules.
5. The WTO is a place where member governments try to sort out the trade problems they face with each other.

The WTO is run by its member governments. All major decisions are made by the membership as a whole, either byministers (who usually meet at least once every two years) or by their ambassadors or delegates (who meet regularly in Geneva).

The Secretariat employs over 600 staff, and its experts — lawyers, economists, statisticians and communications experts — assist WTO members on a daily basis to ensure that negotiations progress smoothly, and that the rules of international trade are correctly applied and enforced.

Decisions in the WTO are generally taken by consensus of the entire membership.

The highest institutional body is the Ministerial Conference, which meets roughly every two years.

A General Council conducts the organization's business in the intervals between Ministerial Conferences.

Both of these bodies comprise all members.

Specialized subsidiary bodies (Councils, Committees, Sub-committees), also comprising all members, administer and monitor the implementation by members of the various WTO agreements.

The WTO's 10th Ministerial Conference was held in Nairobi, Kenya, from 15 to 19 December 2015. It culminated in the adoption of the "Nairobi Package", a series of six Ministerial Decisions on agriculture, cotton and issues related to least-developed countries (LDCs).

Main fields of the WTO's activity:

(1) Trade negotiations

- The **WTO agreements cover goods, services and intellectual property**. They spell out the principles of liberalization, and the permitted exceptions.
- They **include individual countries' commitments** to lower customs tariffs and other trade barriers, and to open and keep open services markets.
- **They set procedures for settling disputes**.
- These agreements are not static; they are renegotiated from time to time and new agreements can be added to the package.

(2) Implementation and monitoring

- **WTO agreements require** governments to make their trade policies transparent by **notifying the WTO about laws in force and measures adopted**.
- Various **WTO councils and committees** seek to ensure that these requirements are being followed and that WTO agreements are being properly implemented.
- **All WTO members must undergo** periodic scrutiny of their trade policies and practices, each review containing reports by the country concerned and the WTO Secretariat.

(3) Dispute settlement

- The WTO's **procedurefor resolving trade quarrels** under the Dispute Settlement Understanding is vital for enforcing the rules and therefore for ensuring that trade flows smoothly.
- **Countries bring disputes to the WTO** if they think their rights under the agreements are being infringed.
- **Judgements** by specially appointed independent experts **are based on interpretations** of the agreements and individual **countries' commitments**.

(4) Building trade capacity

- **WTO agreements contain special provision for developing countries**, including **longer time periods to implement** agreements and commitments, measures to **increase their trading opportunities**, and **support** to help them build their trade capacity, to **handle disputes** and **to implement technical standards**.
- The **WTO organizes** hundreds of **technical cooperation missions to developing countries** annually.
- It also **holds** numerous **courses** each year in Geneva **for government officials**.
- **Aid for Trade** aims to help developing countries develop the skills and infrastructure needed to expand their trade.

(5) Outreach

- The **WTO** maintains regular **dialogue** with **non-governmental** organizations, parliamentarians, other international organizations, the media and the general public on various aspects of the WTO and the ongoing Doha negotiations, with the aim of enhancing cooperation and increasing awareness of WTO activities.

Fundamental principles of the WTO:

Non-discrimination (1)

- A **country should not discriminate** between its **trading partners** and it should not discriminate between its **own and foreign products, services or nationals**.

More open (2)

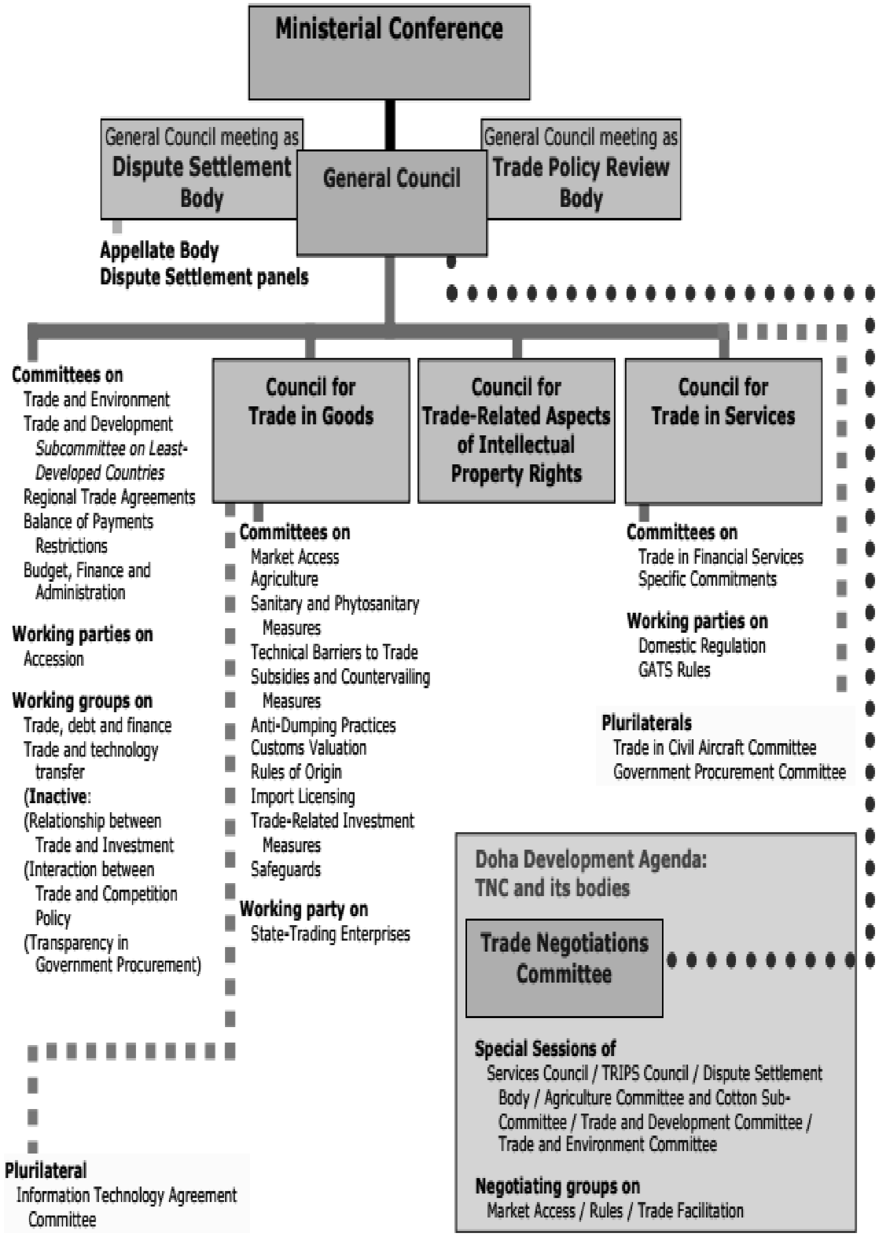
- **Lowering trade barriers** is one of the most obvious ways of encouraging trade; these **barriers include** customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively.

Predictable and transparent (3)

- **Foreign companies, investors and governments should be confident** that trade barriers should not be raised **arbitrarily**. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices.

More competitive (4)

- **Discouraging 'unfair' practices**, such as **export subsidies and dumping products** at below cost to gain market share; the


Ministerial Conference
General Council meeting as Dispute Settlement Body
General Council
General Council meeting as Trade Policy Review Body
Appellate Body
Dispute Settlement panels
Committees on
Trade and Environment
Trade and Development
Subcommittee on Least-Developed Countries
Regional Trade Agreements
Balance of Payments Restrictions
Budget, Finance and Administration
Working parties on
Accession
Working groups on
Trade, debt and finance
Trade and technology transfer
(Inactive:
(Relationship between Trade and Investment
(Interaction between Trade and Competition Policy
(Transparency in Government Procurement)
Council for Trade in Goods
Council for Trade-Related Aspects of Intellectual Property Rights
Council for Trade in Services
Committees on
Market Access
Agriculture
Sanitary and Phytosanitary Measures
Technical Barriers to Trade
Subsidies and Countervailing Measures
Anti-Dumping Practices
Customs Valuation
Rules of Origin
Import Licensing
Trade-Related Investment Measures
Safeguards
Working party on
State-Trading Enterprises
Committees on
Trade in Financial Services
Specific Commitments
Working parties on
Domestic Regulation
GATS Rules
Plurilaterals
Trade in Civil Aircraft Committee
Government Procurement Committee
Doha Development Agenda:
TNC and its bodies
Trade Negotiations Committee
Special Sessions of
Services Council / TRIPS Council / Dispute Settlement Body / Agriculture Committee and Cotton Sub-Committee / Trade and Development Committee / Trade and Environment Committee
Negotiating groups on
Market Access / Rules / Trade Facilitation
Plurilateral
Information Technology Agreement Committee

issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular **by charging additional import duties** calculated to compensate for damage caused by **unfair trade.**

More beneficial for less developed countries (5)

- **Giving** them **more time** to adjust, greater flexibility and special privileges;
- Over **three-quarters** of WTO **members** are **developing** countries and countries in transition to market economies.
- The WTO agreements give them transition periods to adjust to the more unfamiliar and, perhaps, difficult WTO provisions.

Protect the environment (6)

- The WTO's agreements **permit** members to take **measures** to **protect** not only the environment but also **public health, animal health and plant health**.
- However, these measures must be **applied** in the same way to **both national and foreign businesses**.
- Members **must not use** environmental protection measures as a means of disguising protectionist policies.

Concepts Review Questions

1. Why does the WTO play an important role in global trade development?

2. Describe organizational structure of the WTO.

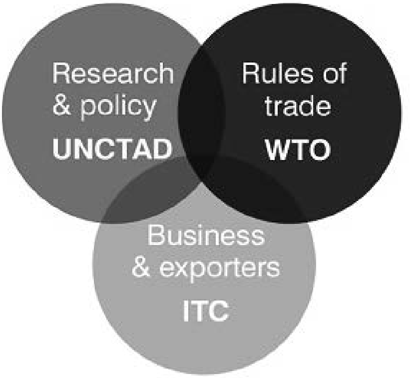
3. In which way does the WTO can assist in trade dispute resolution?

Topic 7

International Trade Center, UNCTAD UNCITRAL and UNCTAD organizations

Formed in 1964, ITC has been the focal point within the United Nations system for trade related technical assistance (TRTA).

Working together



Their work focuses on the areas of expertise where ITC can have the greatest impact:

- Strengthening the **integration of the business sector** of developing countries and economies in transition into the global economy,
- Improving the **performance of trade and investment support institutions** for the benefit of SMEs, and enhancing the abilities of trade support institutions to better support them
- Improving the **international competitiveness of SMEs.**

Along with United Nations family and partner organizations, ITC continues to connect ITC projects and programs with global efforts to achieve UN Global

ITC remains the **only international organization** focused solely on trade development for developing and transition economies.

UNCTAD supports developing countries, especially least Developed Countries (LDCs) in their efforts to formulate strategies and policies to respond to the challenges and opportunities of commodity markets.

BioTraderefers to those activities of collection, production, transformation, and commercialization of goods and services derived from native biodiversity under the criteria of environmental, social and economic sustainability.

Since its launch by UNCTAD in 1996, the **BioTrade Initiative**has been promoting sustainable BioTrade in support of the objectives of the Convention on Biological Diversity. The Initiative has developed a unique portfolio of regional and country programs.

Since 2003 the BioTrade Initiative has also hosted the **BioTrade Facilitation Programme (BTFP)**which focuses on enhancing sustainable bio-resources management, product development, value adding processing and marketing.

The BTFP complements the UNCTAD BioTrade Initiative activities. It is currently in its third phase (BTFP III), with various partners implementing its objectives.

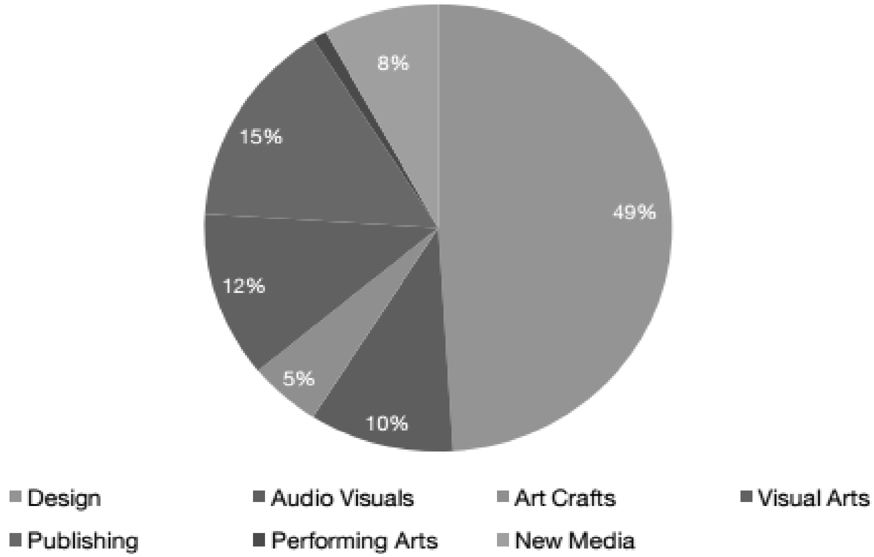
UNCTAD has introduced the topic of the "**creative economy**" in the world economic and development agenda.

The creative economy is an emerging concept dealing with the interface between creativity, culture, economics and technology in a contemporary world dominated by images, sounds, texts and symbols.

Today, the creative industries are among the most dynamic sectors in the world economy providing new opportunities for developing countries to leapfrog into emerging high-growth areas of the world economy.

UNCTAD's work on harnessing international trade in promoting sustained growth and inclusive development includes as a key aspect, support to developing countries in taking advantages of emerging opportunities for **trade associated with the protection, promotion and preservation of the environment and sustainable development** objectives generally, while minimizing potential adverse impacts. This work is carried out by the Trade,

Chart 6. Creative goods exports, Developed country by group, 2012



Source: UNCTAD Global database on creative economy

Environment, Climate Change and Sustainable Development Branch of DITC.

UNCTAD is supporting developing countries to identify the opportunities and challenges that the oceans economy can bring. It also supports national trade and other competent authorities to design and create an enabling policy and regulatory environment that promotes the development and emergence of sustainable oceans economic sectors through the definition and implementation of national and regional oceans economy and trade strategies.

The UNCTAD Automated System for Customs Data (ASYCUDA) is an integrated customs management system for international trade and transport operations in a modern automated environment.

Advanced software applications are designed and developed for customs administrations and the trade community to comply with international standards when fulfilling import, export and transit related procedures.

Through its ASYCUDA Programme, UNCTAD aims at:

- Modernizing customs operations and helping to improve revenue collection

- Facilitating trade efficiency and competitiveness by substantially reducing transaction time and costs
- Improving security by streamlining procedures of cargo control, transit of goods and clearance of goods
- Helping fight corruption by enhancing the transparency of transactions
- Promoting sustainable development by cutting down on the use of paper, through the use of electronic transactions and documents

Long waiting times at borders, inappropriate fees, cumbersome formalities, and inadequate or unclear rules and regulations, can all become serious obstacles to trade, and consequently adversely affect investment, employment and trade-led development.

UNCTAD assists developing countries in identifying their particular trade and transport facilitation needs and priorities, and helps them program the implementation of specific trade and transport facilitation measures.

UNCTAD organizes workshops and seminars at the regional and national levels, publishes relevant information and training material, and provides technical assistance through numerous projects.

In the years since its establishment, **UNCITRAL** has been recognized as the core legal body of the United Nations system in the field of international trade law. A legal body with universal membership specializing in commercial law reform worldwide for over 40 years, UNCITRAL's business is the modernization and harmonization of rules on international business.

Trade means faster growth, higher living standards, and new opportunities through commerce. In order to increase these opportunities worldwide, UNCITRAL is formulating modern, fair, and harmonized rules on commercial transactions.

These include:

- Conventions, model laws and rules which are acceptable worldwide
- Legal and legislative guides and recommendations of great practical value
- Updated information on case law and enactments of uniform commercial law
- Technical assistance in law reform projects

- Regional and national seminars on uniform commercial law

In UNCITRAL there are six working groups and their current topics are as follows:

- Working Group I - Micro, Small Medium-sized Enterprises
- Working Group II - Dispute Settlement
- Working Group III
- Working Group IV - Electronic Commerce
- Working Group V - Insolvency Law
- Working Group VI - Security Interests

The mission of the **Organization for Economic Co-operation and Development** (OECD) is to promote policies that will improve the economic and social well-being of people around the world.

The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. We work with governments to understand what drives economic, social and environmental change. We measure productivity and global flows of trade and investment. We analyze and compare data to predict future trends. We set international standards on a wide range of things, from agriculture and tax to the safety of chemicals.

The OECD's origins date back to 1960, when 18 European countries plus the United States and Canada joined forces to create an organization dedicated to economic development. Today, 35 Member countries span the globe, from North and South America to Europe and Asia-Pacific. They include many of the world's most advanced countries but also emerging countries like Mexico, Chile and Turkey. They also work closely with emerging economies like the People's Republic of China, India and Brazil and developing economies in Africa, Asia, Latin America and the Caribbean. Together, their goal continues to be to build a stronger, cleaner and fairer world.

Concepts Review Questions

1. *What are the main functions of the WTO?*
2. *Give the difference between GATT and WTO?*
3. *What are the main principles of the WTO trading system?*

Topic 8

Import procedures and documents in Ukraine

According to article 7 of the **Law of Ukraine on Foreign Economic Activity** Ukraine's tariff schedule includes three rates of import duties:

Full – The full rate of import duties can be from 2 to 10 times higher than the MFN rate

Most Favored Nation (MFN) - Upon becoming a WTO member in 2008, Ukraine applied new, lower MFN rates to all goods originating from WTO members, in accordance with Article I of the 1994 GATT,

Preferential – Preferential rates (lower than the MFN rates) are applied to imports from countries with which Ukraine has a **Free Trade Agreement (FTA)** or other preferential trade agreement, i.e., imports primarily from CIS countries.

Exports to Ukraine usually receive the **MFN** rate if the following three criteria are met:

- 1) the company is registered in the WTO member country;
- 2) the goods have a certificate to prove origin from WTO member country ; and
- 3) the goods are imported directly from the WTO member country.
- Most customs tariffs are levied at ad valorem rates, and only 1.5 percent of tariff line items are subject to specific or combined rates of duty.
- The average applied tariff rate fell to 4.95 percent after WTO accession and further decreased to 4.8 percent in 2011.

Current customs duty rates are set by two Supplements to the Law on Customs Duty Rates of Ukraine № 584-VII.

Interested exporters can learn about current Ukrainian customs duty rates by first browsing the Harmonized Tariff Schedule of the WTO country member for the specific numeric code(s) for the product being exported, and then match the code(s) to the Ukrainian Customs Tariff Schedule.

In addition **to customs duties**, the following goods are also subject to **excisetax** from 01-01-2016 pursuant to the Law of Ukraine of 24.12.2015 №909 “On Amendments to the Tax Code of Ukraine and certain laws of Ukraine to ensure the balance of budget revenue in 2016”

These are:

- Ethyl alcohol and other distillates, alcoholic beverages, beer
- Tobacco products, tobacco and manufactured tobacco substitutes
- Fuel
- Passenger cars, body thereto, trailers, motorcycles, vehicles designed for transportation of 10 persons or more, goods-carrying vehicle
- Electricity

Excise duties are assessed as a percentage of the sum of the declared customs value, customs duties, and fees paid for importing products. Excise rates can be found in the Article 215 of the Tax Code of Ukraine № 2755-VI. Tariffs and excise payment must be made in Ukrainian currency at the Ukrainian National Bank exchange rate effective on the day of payment.

The **VAT(Value Added Tax)**rate is 20 percent on most goods. Because **VAT** repayments have historically been a contentious issue, with many foreign companies owed millions of dollars in **VAT** refunds in 2015, significant changes were introduced to the procedure of VAT refunds.

On January 1, 2016, Law of Ukraine No. 909-VIII “On Amendments to the Tax Code of Ukraine and Some Other Legislative Acts of Ukraine on Provision of Balance of Budget Revenues in 2016” (the “Law”) entered into effect. This law introduced two registers for VAT refund applications and also mandates that VAT shall be refunded automatically in a chronological order depending on the date the VAT refund applications are recorded in a respective register.

There are tariff and non-tariff barriers that foreign companies face when exporting to Ukraine.While the Ukrainian business environment is improving, many **trade barriers** in Ukraine persist, including 1) **unpredictable discriminatory fees** and 2) **product certification procedures**.

Non-tariff barriers include 1) non-transparent standards and 2) certification requirements, 3) cumbersome procedures for phytosanitary certifications, 4) import licenses, and 5) labeling requirements.

Over the past few years the Government of Ukraine occasionally temporarily restricted imports of U.S. agricultural products, allegedly because of food safety concerns.

In addition, in November 2010, the Ministry of Health of Ukraine signed Order #971, approving a **list of food products that require monitoring for genetically engineered or genetically modified organism** (GMO) content.

Among the groups of **products to be tested and monitored** are soybeans and soybean products, corn and products made with corn, potatoes and potato-derived products, tomatoes, and tomato products, rice and rice products, wheat and products made of wheat, baby food made with such products, food additives.

Despite some procedural improvements made by Ukraine's State Customs Service, foreign companies exporting goods to Ukraine experience working bureaucracy and a large volume of paperwork when dealing with Ukraine's State Customs Service.

Because of this many firms choose to use **licensed customs brokers** to navigate through the often-changing and seemingly inconsistent customs clearance procedures. For a list of licensed customs brokers contact the Association of Customs Brokers of Ukraine.

Import licenses are required for some goods. The list of goods covered by the licensing regime and the license terms are reconsidered annually by the Cabinet of Ministers.

As of January 1, 2016, the list includes: printers' ink, paper with watermarks, optical media production inputs such as polycarbonate; equipment for CD production; pharmaceuticals, paints and lacquers, dyes, hygiene products, cosmetic products, pedicure and manicure products, shaving aerosols and deodorants; lubricants, waxes, shoe polishes, insecticides, solvents, silicone, fire extinguishers and the chemicals that fill extinguishers; refrigerators and freezers, air-conditioners, humidifiers, and other selected industrial chemical products; poultry meat and products (Harmonized Schedule Line 0105), pig and poultry fat; fungicides, insecticides, herbicides, and plant growth adjusters.

Most import licenses granted through the Ministry of Economic Development and Trade. Other import licenses or approvals issued by:

- **Ministry of Internal Affairs** – sporting weapons and self-defense articles
- **Ministry of Agriculture and Food Industry** – agricultural chemicals, seeds, veterinary medicines
- **State Chemical Commission** – agricultural chemicals
- **Ministry of Health** – pharmaceutical products, cosmetics, and hygiene products
- **Ministry of Education and Science** – matrix forms used in the manufacturing of audio production; and
- **Ministry of Environmental Protection** – ozone-depleting chemical substances including propellants, paint-solvents, fire extinguishers and refills, oil-sprays, air-conditioners and refrigerating equipment, refrigerated vending machines; agricultural chemicals contained in sprays; and pharmaceutical products, cosmetics, and hygiene products contained in sprays.

In accordance with Article 335 of the Customs Code of Ukraine the following documents are required for customs clearance procedures:**For goods moving via road transportation:**

1. documents for the vehicle, including those containing information about its state registration (nationality)
2. travel (transportation) documents (international consignment note)
3. documents defined by the Universal Postal Union to accompany international postage (if any postage is present)
4. commercial documents (if any) for transported goods that contain information including the name and address of the carrier, the name of the country of departure and country of destination of goods, the name and address of the sender (or seller) and the recipient of the goods
5. information on the number of packages and type of packaging;
6. name of the goods
7. gross weight of goods (in kilograms) or volume of goods (in cubic meters), except for bulky cargo;

Labels on food items as stipulated in Article 1 of the law of Ukraine “On Safety and Quality of Foodstuffs” № 771/97-BP of

December 23, 1997 and in Technical Guideline on Food Labeling Regulations (Order of the State Committee of Ukraine for Technical Regulation and Consumer Policy of 28.10.2010 N 487) must include:

1. The name of the product;
2. Food contents (name of basic ingredients/additives/preserves/scents and other substances;
3. Amount of certain ingredients stipulated in the respective article of the law;
4. The weight/volume of the product in defined measurement units;
5. The expiration date (or production date and period of storage);
6. The conditions for storage;
7. The terms and conditions of use.
8. The name, address and telephone number of the official importer;
9. The name, address and telephone number of an authorized company to be addressed for complaints;
10. The serial number of the product batch;
11. Goods containing Genetically Modified Organisms (GMOs) and GMO-free goods must be labeled accordingly;
12. The country of origin;
13. The nutritional value and content of proteins, carbohydrates and fats per 100 grams of the product and calories expressed in kJ or kcal per 100 grams (100 ml) of product;
14. Warning information with regard to consumption of product by certain category of consumers (children, pregnant women, elderly people, sportsmen, allergic individuals), if consumption of such product may affect their health; and
15. The mark for goods and services (if any) under which the product is sold.

The Ukrainian government strictly controls and restricts the transit, import, and export of **weapons, narcotics, chemical and hazardous substances, and certain pharmaceutical and communications products.**

Licensing of prohibited and restricted imports is regulated by the law of Ukraine “On State Control for International Transfer of Military and Dual-Use Goods” № 549-IV, which; outlines the conditions and terms of licensing; names the control agencies in charge of transit; and sets criteria for the transit, import, and export of military or dual-use goods.

The approval of the transit, import, or export of military or dual-use goods can take up to 90 days from the time of application and receipt of the necessary supporting documentation.

These documents must be submitted in person to the State Service of Export Control of Ukraine and companies or the respective Ukrainian trading partner of the end-user goods wishing to import these goods should contact the State Service of Export Control of Ukraine in advance, before shipment of any prohibited or restricted goods are shipped to Ukraine.

Ukraine has passed several new laws and governmental decrees in recent years aimed at bringing Ukrainian practices in this area into line with the WTO Agreement on Technical Barriers to Trade (TBT), but significant problems remain.

Currently, the Ukrainian technical regulations system is based on 27,000 local technical standards, but only 6,000 of these standards are functioning in compliance with those of the EU. With the move towards Europe and OECD countries, Ukraine is currently developing its standards to match them with the EU's, in 2015 Ukraine has cancelled 15.000 old technical regulations when it adopted the following laws and regulations:

The Law of Ukraine "On Standardization" of June 05, 2014 № 1315-VIIhttp://zakon4.rada.gov.ua/laws/show/1315-18

The Decree of the Cabinet of Ministers of Ukraine On Standardization and Certification of May 10, 1993 № 46-93 http://zakon5.rada.gov.ua/laws/show/46-93valid till January 1, 2018

The Law of Ukraine "On Technical Regulations and Conformity Assessment" of January 15, 2015 № 124-VIII http://zakon5.rada.gov.ua/laws/show/124-19

Ukrainian technical regulations compiled in compliance with the EU Council Directives for conformity of industries and products, international standards, and Ukrainian domestic standards.

The United States has a bilateral investment treaty (BIT) with Ukraine, which took effect in 1996. The BIT guarantees U.S. investors non-discriminatory treatment, the right to make financial transfers freely and without delay, international legal standards for expropriation, including compensation, and access to international arbitration in the event of an investment dispute.

The “United States Income Tax Treaties – Convention” between the U.S. and Ukraine regarding the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital became effective January 1, 2001.

The United States and Ukraine signed a Trade and Investment Cooperation Agreement (TICA) on April 1, 2008. The TICA established a joint U.S.-Ukraine Council on Trade and Investment, which addresses a wide range of trade and investment issues including market access, intellectual property, labor, and environmental issues.

On May 16, 2008, Ukraine became the 152nd member of the World Trade Organization (WTO). Upon becoming a member of the WTO Ukraine became subject to the requirements of the Agreement of the World Trade Organization on Trade Related Aspects of Intellectual Property Rights “TRIPS Agreement”.

In March 2016 Ukraine officially joined the WTO Agreement on Government Procurement. This gives Ukrainian companies the right to participate in public procurement of 45 countries participating in the WTO agreement on government procurement (GPA), including EU countries, Japan, the United States, Korea, Taiwan, Singapore, Hong Kong and Canada. In addition to opening foreign government procurement markets, this agreement will also requires Ukraine to follow WTO rules for government procurement.

Although Ukraine was one of the three founding countries and ratified the Creation Agreement in December 1991, Ukraine did not choose to ratify the CIS Charter. In 1993 Ukraine became an “Associate Member” of CIS. Ukraine has signed Free Trade Agreements (FTA) with 9 CIS countries: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Uzbekistan, Russia.

On March 14, 2014 a bill was introduced to Ukraine’s parliament to withdraw from CIS following the annexation of Crimea by Russia.

Ukraine has a **Partnership and Cooperation Agreement** (PCA) with the European Union. Under the terms of the agreement, Ukraine enjoys most favored nation status with the EU, but is not required to bind its own tariffs.

On March 21, 2014 the European Union and Ukraine signed the core elements of a political association agreement precursor to the Deep and Comprehensive Free Trade Agreement (DCFTCA) which they started applying on January 1, 2016.

Ukraine has concluded trade agreements with 20 countries - Austria, Argentina, Armenia, Bulgaria, Canada, Estonia, Finland, Georgia, Iceland, Kyrgyzstan, Latvia, Liechtenstein, Macedonia, Moldova, Montenegro, Norway, Russia, Switzerland, Turkmenistan, and Switzerland.

The Canada-Ukraine Free Trade Agreement (CUFTA) was announced by Prime Minister Stephen Harper and Ukrainian Prime Minister on July 14, 2015.These agreements grant, on a reciprocal basis, most favored nation (MFN) status on the exports -imports with signatory countries.

As in the case of the PCA, Ukraine benefits via these agreements from the tariff concessions made by its partner countries who are WTO members without binding its own tariffs. Ukraine is negotiating the creation of free trade zones with Turkey and Israel.

Concepts Review Questions

1. Describe Ukraine's membership in international trade blocks and organizations?

2. How does standardization affect foreign trade?

3. Select one regional trading bloc Ukraine is a member and discuss the economic motivations for that group of countries to form an agreement. Use Hofstede cultural dimensions at http://www.geert-hofstede.com/geert_hofstede_resources.shtml. Do you think the countries in the trading bloc you selected are likely to have cross-cultural similarities or differences?

Topic 9

Exchange rate risk management in international trade operations

Firms are commonly subject to the following forms of exchange rate exposure:

- **Transaction Risk** – The risk of changes in the expected value of a contract between its signing and its execution due to unexpected changes in foreign exchange rates.
- **Translation Risk**– Gains or losses from exchange rate changes that occur as a result of converting financial statements from one currency to another in order to consolidate them.
- **Economic Risk**– Changes in competitive position because of permanent changes in exchange rates.

In order to assess **transaction exposure**, an MNC must

(1) estimate its net cash flows in each currency and

(2) measure the possible effects of its exposure to those currencies.

Because we manufacture and sell products in a number of countries throughout the world, we are exposed to the impact on revenue and expenses of movements in currency exchange rates.

- Procter & Gamble Co.

Increased volatility in foreign exchange rates … may have an adverse impact on our business results and financial condition.

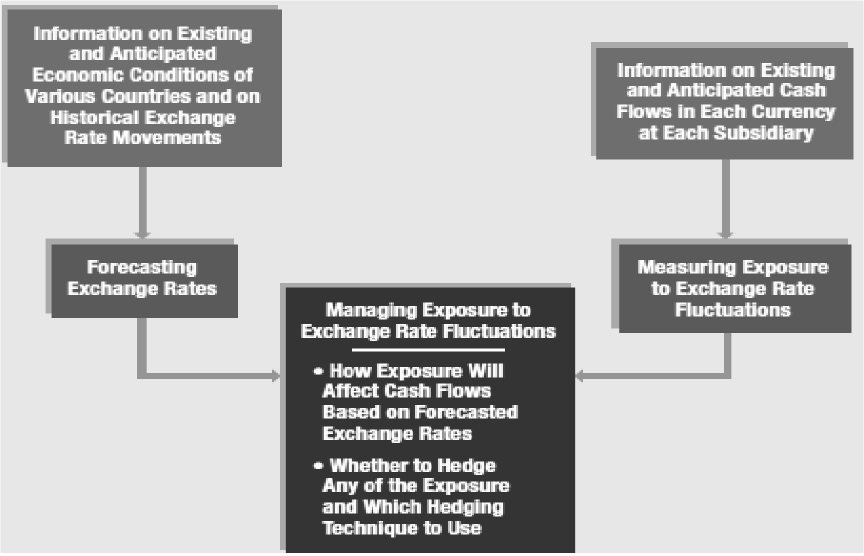
- Pepsi. Co.

When Facebook went public in 2012, its registration statement explained its exposure as follows.

In general, we are a net receiver of currencies other than U.S. dollar.

Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, will negatively affect our revenue and other operating resulting as expressed in U.S. dollars.

Managing Exposure to ER fluctuations



FORECAST TECHNIQUE	FACTORS CONSIDERED	SITUATION	FORECAST
Technical	Recent movements in peso.	The peso's value declined below a specific threshold level in the last few weeks.	The peso's value will continue to fall now that it is beyond the threshold level.
Fundamental	Economic growth inflation, interest rates, interest rates.	Mexico's interest rates are high, and inflation should remain low.	The peso's value will rise as U.S. investors capitalize on the high interest rates by investing in Mexican securities.
Marked-based	Spot rate, forward rate	The peso's forward rate exhibits a significant discount, which is attributed to Mexico's relatively high interest rates.	Based on the forward rate, which provides a forecast of the future spot rate, the peso's value will decline.

The **value of a firm's cash flows** can be affected by exchange rate movements if it executes transactions in foreign currencies, receives revenue from foreign customers, or is subject to foreign competition. The sensitivity of the firm's cash flows to exchange rate movements is referred to as **economic exposure** (also sometimes referred to as operating exposure).

The following comments in PepsiCo's annual report summarize the dilemma faced by many MNCs that assess economic exposure.

The economic impact of currency exchange rates on us is complex because such changes are often linked to variability in real growth, inflation, interest rates, governmental actions, and other factors. These changes, if material, can cause us to adjust our financing and operating strategies.

- PepsiCo

Nike's economic exposure comes in various forms. First, it is subject to transaction exposure because of its numerous purchase and sale transactions in foreign currencies, and this transaction exposure is a subset of economic exposure. Second, any remitted earnings from foreign subsidiaries to the U.S. parent also reflect transaction exposure and therefore reflect economic exposure. Third, a change in exchange rates that affects the demand for shoes at other athletic shoe companies (such as Adidas) can indirectly affect the demand for Nike's athletic shoes. Even if Nike could eliminate its transaction exposure, it cannot perfectly hedge its remaining economic exposure; it is difficult to determine exactly how a specific exchange rate movement will affect the demand for a competitor's athletic shoes and, therefore, how it will indirectly affect the demand for Nike's shoes.

Translation exposure can be reduced by selling forward the foreign currency used to measure a subsidiary's income.

If the foreign currency depreciates against the home currency, the adverse impact on the consolidated income statement can be offset by the gain on the forward sale in that currency.

If the foreign currency appreciates over the time period of concern, there will be a loss on the forward sale that is offset by a favorable effect on the reported consolidated earnings. However, many MNCs would not be satisfied with a "paper gain" that offsets

TECHNIQUES FOR HEDGING TRANSACTION EXPOSURE

TECHNIQUE	TO HEDGE PAYABLES	TO HEDGE RECEIVABLES
Futures hedge	Purchase a currency future contract (or contracts) representing the currency and amount related to the payables.	Sell a currency futures contract (or contracts) representing the currency and amount related to the receivables.
Forward hedge	Negotiate a forward contract to purchase the amount of foreign currency needed to cover the payables.	Negotiate a forward contract to sell the amount needed to cover the receivables.
Money market hedge	Borrow local currency and convert to the currency denominating payables. Invest these funds until they are needed to cover the payables.	Borrow the currency denominating receivables, convert to the local currency and invest it. Then pay off the loan with cash inflows from the receivables.
Currency option hedge	Purchase a currency call option (or options) representing the currency and amount related to the payables.	Purchase a currency put option (or options) representing the currency and amount related to the receivables.

a "cash loss."

When a perfect hedge is not available (or is too expensive) to eliminate transaction exposure, the firm should consider methods that can at least reduce exposure. Such methods include: leading and lagging, cross-hedging, and currency diversification.

Concepts Review Questions

1. Should the firm attempt to increase or reduce sales in new or existing foreign markets?

2. Should the firm increase or reduce its dependency on foreign suppliers?

3. Should the firm establish or eliminate production facilities in foreign markets?

4. Should the firm increase or reduce its level of debt denominated in foreign currencies?

Topic 10

Payments methods in foreign trade operations

International trade takes place between **three categories of relationships**:

1) unaffiliated unknown parties,

2) unaffiliated known parties, and

3) affiliated parties.

International trade transactions between **affiliatedparties** typically do not require contractual arrangements or external financing.

Trade transactionsbetween **unaffiliated parties** typically require contracts and some type of external financing, such as thatavailable through letters of credit.

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

There are four principal payment terms:

Cash in Advance: With cash-in-advance payment terms, the exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. Cash in Advance delivers minimal risk to exporter. It can be used where there are: a) Political unrest; b) Goods made to order; c) New unfamiliar customer.

Documentary Collections: A documentary collection is a trade transaction in which the exporter hands over the task of collecting payment for goods supplied to his or her bank, which sends the shipping documents to the importer's bank together with payment instructions. A documentary collection (D/C) is so-called because the exporter receives payment from the importer in exchange for the shipping documents, with the funds and documents channeled through their respective banks. While D/Cs are less complicated and cheaper than letters of credit, they are riskier for exporters because they do not have a verification process and offer limited recourse if the importer does not pay. They are only recommended in situations where the exporter and importer have a long-standing trade relationship.A key document in documentary collections is the bill of exchangeor draft, which is a formal demand for payment from the exporter to importer.

D/Cs can be classified into two types, depending on when payment is sought by the exporter: 1) documents against payment (D/P), which requires the importer to pay the face amount of the draft at sight, or 2) documents against acceptance (D/A), which requires the importer to pay on a specified future date.

Drafts have following features: - unconditional order in writing; - exporter's order for importer to pay at once (sight draft) or in future (time draft). Types of Drafts: a) sight; b) time; c) clean (no documents needed); d) documentary.

Open account: An open account transaction is a sale where the goods are shipped and delivered before payment is due.Open account: 1.Creates a credit sale; 2.To importer's advantage; 3.More popular lately because: a)major surge in global trade; b) credit information improved; c) more global familiarity with exporting.

Benefits of Open Accounts: a) greater flexibility in making a trade; b) lower transactions costs. **Major disadvantage:** highly vulnerable to government currency controls.

Letters of Credit: Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents.

Letter of Credit addressed to seller: a) written and signed by buyer's bank; b) promising to honor seller's drafts. C) Bank substitutes its own commitment; d) Seller must conform to terms.

Advantages of an L/C to Exporter: a) eliminates credit risk**;** b) reduces default risk**;** c) payment certainty**;** d) prepayment risk protection**;** e) financing source.

Advantages of L/C to Importer: a) shipment assured; b) documents inspected; c) may allow better sales terms; d) relatively low-cost financing; e) easy cash recovery if discrepancies.

Procedure for a Letter of Credit

1. **Opening**. Upon opening a letter of credit the bank undertakes an obligation on behalf of the buyer to pay the seller. To this end the buyer must have sufficient assets/credit with the issuing bank.

2. **Notification/confirmation** Upon receipt of the notification the bank sends the letter of credit to the seller without incurring any liability for its part. However, the bank must take reasonable care to check that the credit appears authentic. When confirmation is requested the bank sends the letter of credit to the seller with its own promise to pay.

3. **Amendment.** If the wording of the letter of credit does not reflect the requirements of both parties the letter of credit can be adjusted by means of an amendment. Using and Honoring Letters of Credit Before they can be submitted, all required documents must be available and must comply with the UCP (Uniform Customs and Practice for Documentary Credits) and documentary credit terms and conditions, and be consistent amongst each other. If the document submission is compliant with the letter of credit, it is honored in accordance with the conditions set out in the letter of credit.

Types of Letters of Credit

1. Sight Under a sight letter of credit, payment is made to the seller immediately after the required documents have been submitted to the authorized bank, provided the conditions in the letter of credit have been met. Banks are, however, allowed a reasonable period of time for checking purposes (not more than five working days after they receive the documents). Deferred Payment In the case of a letter of credit with deferred payment, the payment to the seller is not made when the documents are submitted, but instead at a later time defined in the letter of credit.

2. Deferred. Payment In the case of a letter of credit with deferred payment, the payment to the seller is not made when the documents are submitted, but instead at a later time defined in the letter of credit. In the Far East, this kind of documentary credit is also known as a “usance L/C.”

3. Acceptance. In the case of an acceptance L/C, the payment to the seller is not made when the documents are submitted, but instead at a later time defined in the letter of credit. The seller can request a discount from the bank that accepted the bill of exchange, or from another bank, and thus draw the amount of the bill minus the discount at any time after the documents have been submitted.

4. Negotiable L/C. Under UCP 600 (Uniform Customs and Practice for Documentary Credits, 2007 revision, article 2) negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank. Unfortunately, the term “negotiable credit” is understood and applied in different ways in different parts of the world.

Particular Types of Letters of Credit

Transferable L/C. Transferable letters of credit are particularly well adapted to the requirements of international trade. They allow an intermediary to transfer a letter of credit to a supplier, thus enabling the intermediary to reduce the extent to which it uses its own funds to process business transactions.

Standby L/C. Standby letters of credit are similar to guarantees. Due to their documentary nature, they fall under the UCP (Uniform Customs and Practice for Documentary Credits). Standby letters of credit can also be issued under ISP98 (International Standby Practices). If the guaranteed service/payment is not provided, the seller can invoke the bank’s obligation to pay by submitting, together with any other documents that the letter of credit might require, a declaration stating that the letter of credit customer has failed to meet his obligations/payment.

Revolving L/C. If the buyer requests partial deliveries of the ordered goods at specific intervals (contract for delivery by installments), payment can be made under the terms of a revolving letter of credit that covers the value of each consecutive installment. The bank is normally liable for the total value of all agreed partial deliveries. However, the second partial payment is not effective until the first installment has been paid, and so forth.

Red Clause L/C. In the case of a red clause credit (letter of credit with advance payment), the seller can request an advance for an agreed amount (defined in the terms and conditions of the letter of credit) from the correspondent bank. This advance is basically intended to finance the manufacture or purchase of the goods to be delivered under the letter of credit. The advance is normally paid against receipt and a written undertaking from the seller to subsequently deliver the transportation documents before the credit expires.

Green Clause L/C. Unlike the red clause letter of credit, in the case of a green clause letter of credit, the advance is normally paid not only against receipt and a written undertaking from the seller to subsequently deliver the transportation documents before the credit expires, but also against receipt of an additional document providing proof that the goods to be shipped have been warehoused.

Forms of Letters of Credit

Unconfirmed. In the case of an unconfirmed letter of credit, the correspondent bank merely notifies the seller that a letter of credit has been opened. In this case, it makes no promise to pay and is therefore not required to honor documents presented by the seller. As a result, the seller may rely exclusively on the issuing bank (letter of credit bank) and therefore bears the collection risk of the issuing bank and the country risk – according to their domicile – as well as the transfer risk.

Confirmed. If the correspondent bank confirms the letter credit (on behalf of the issuing bank), then it is committing itself towards the seller to honor documents that are in compliance with the documentary credit terms and presented on time. In this case, the seller receives not only an obligation by the issuing bank but also a legally equivalent and independent promise of payment on the part of the correspondent bank. The seller then bears the collection risk of the confirming bank and, if this bank is not domiciled in his country, the corresponding country risk – according to its domicile – as well as the transfer risk.

Revocable. All letters of credit subject to the current “Uniform Customs and Practice for Documentary Credits” (UCP 600), which is effectively the norm nowadays, are regarded as irrevocable. It is possible in theory to open a revocable letter of credit, but this is no longer done in practice for various reasons (difficult wording/ insufficient security [revocation]).

Irrevocable. An irrevocable letter of credit is a firm commitment by the issuing bank to make payment if the documentary credit conditions are fulfilled. It may not be amended or canceled without the consent of the seller and all obligated banks. If the seller wishes to amend or cancel individual conditions of the letter of credit, then he must ask the buyer to issue an instruction to the issuing bank in this respect.

Concepts Review Questions

1. Consider what the key elements of an import or export transaction are in business?

2. Discover how the three key documents in import/export, the letter of credit, the draft, and the bill of lading, combine to both finance the transaction and to manage its risks?

3. Identify what the documentation sequence is for a typical international trade transaction?

4. Imagine that you are the finance managerin control of purchasing for a small manufacturing company. Your supplier in Russia tells you that there are two quotes, one for payments in US dollars by wire transfer or check and one for a US dollar cash-like transaction. The cash transaction is almost 10 percent cheaper, which could earn your firm a nice profit and a potential year-end bonus for you. How do you handle the phone call and the decision?

5. Discuss the ethical and business issues involved. If you decide against the cash-like transaction, do you tell your senior management? What do you recommend to your management about future dealings with this supplier?

6. Russia is one of the most corrupt countries for businesses. What options does your firm have if it needs to source from Russia? Use fxstreet.com (http://www.fxstreet.com/rates-charts/) to research and discuss more.

Topic 11

Commercial and transport documents in foreign trade operations

Commercial Invoices The commercial invoice is the accounting document which shows the financial claim of the seller against the buyer. A customs invoice is often required in addition to a commercial invoice to document the value of the goods for import clearance.

Packing List, Weight List. Packing lists, weight lists, and official accompanying documents or permits required by certain countries for export and/ or import (such as EUR, ATR, “Clean Report of Findings”) are not covered in the UCP (Uniform Customs and Practice for Documentary Credits); they must be issued under the conditions stipulated by the letter of credit.

Certificates of quality, analysis and inspection, etc., are not covered in detail in the UCP (Uniform Customs and Practice for Documentary Credits); they must be issued under the conditions stipulated by the letter of credit. Certificates must be signed by the issuer.

Certificate of Origin. A certificate of origin is a document that confirms the origin of the goods. It may be issued by an official organization, such as a chamber of commerce, or by the beneficiary or the manufacturer (but always as per the terms and conditions of the L/C). A Certificate of Origin (CO) is an important international trade document that certifies that goods in a particular export shipment are wholly obtained, produced, manufactured or processed in a particular country. They also serve as a declaration by the exporter.

Virtually every country in the world considers the origin of imported goods when determining the duty that will be applied or, in some cases, whether the goods may be legally imported at all.

There are two types of CO’s that chambers can issue:

- **Non-Preferential Cos**, which certify that the goods’ country of origin does not qualify for any preferential treatment. These are the main type of Cos that chambers issue and are also known as "ordinary Cos."

- **Preferential Cos**, which certify that goods are subject to reduced tariffs or exemptions when they are exported to countries extending these privileges. Cos may be needed to comply with Letters of Credit, foreign Customs requirements or a buyer's request.

Bill of Lading (B/L) The bill of lading is a transportation document issued by the carrier, or by the carrier's authorized agent, for the consignment to be shipped. This document states the main shipping terms for the consignment.

There Are Three Different Kinds of Bills of Lading

- The on-board bill of lading is issued after the consignment has been loaded onto the ship. It states the loading date and the name of the ship.
- The received-for-shipment bill of lading merely confirms that the carrier has received the goods designated for shipping.
- The through bill of lading covers the entire journey of the goods, whether they are transshipped or carried by different means of transport.

A Bill of Lading Is a Security Only the holder of the bill of lading can take possession of the goods.

The bill of lading can be issued (addressed) as follows:

- To the order of a natural or legal person (order bill of lading): Entitlement to the goods can be transferred by endorsement.
- A "straight consignment" to a natural or legal person ("straight bill of lading"): Transfer can be effected only by assignment.
- An "order" (bearer bill of lading): Whoever has possession of the original bill of lading is entitled to the goods. The bill of lading is transferred on the release of the document.

Insurance Documents. If the agreed delivery terms are CIF or CIP, it is up to the seller to arrange insurance. The insurance document (policy or certificate) is the proof that he has done so. According to UCP (Uniform Customs and Practice for Documentary Credits), the insurance document must cover a minimum of 110% of the CIF value of the goods and the risks defined in the letter of credit, unless stated otherwise.

Forwarder's Certificate of Receipt. A document issued by a forwarding agency confirming receipt of the goods for shipment/ dispatch and dispatch instructions. The forwarder's certificate of receipt (FCR) does not fall under the UCP (Uniform Customs and Practice for Documentary Credits) and is not recognized as a valid transportation document.

Sea Waybill. A non-negotiable sea waybill certifies that goods have been loaded on board a ship, but the document itself does not have the properties of a security. It is not necessary to present this document in order to take possession of the goods.

Courier Delivery Slip. This certifies that goods have been accepted and forwarded by a courier service.

Air Waybill. An air waybill confirms the conclusion of a contract between carrier and consignor, and sets out the conditions with respect to handling, flight route and delivery of the goods.

Road Waybill. This certifies that a contract has been signed between the consignor and the carrier concerning the transportation of goods by road (by truck). Inland Waterways B/L This certifies that a contract has been signed between the consignor and the carrier concerning the transportation of goods by inland waterways.

Postal Delivery Slip This certifies that goods have been accepted and forwarded by a postal service.

Concepts Review Questions

1. Outline the purpose and features of commercial documents.

2. Describe various kinds of transportation documents used in foreign trade.

Topic 12

Trade Facilitation Programs and Institutions

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 private sector. Thus, domestic taxpayers are subsidizing sales to foreign buyers in order to create employment and maintain a technological edge. The most important institutions usually offer export credit insurance and a government supported bank for export financing

Export Credit Insurance. The exporter who insists on cash or an L/C 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. Importers prefer that the exporter purchase export credit insurance to pay for nonperformance risk by the importer. In this way, the importer does not need to pay to have an L/C issued and does not reduce its credit line. Competition between nations to increase exports by lengthening the period for which credit transactions can be insured may 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 Credits 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 (see below). 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 riskare 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.

Export-Import Bank and Export Financing. The Export-Import Bank (also called Eximbank) is another independent agency of the U.S. government, established in 1934 to stimulate and facilitate the foreign trade of the UnitedStates. 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 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.

Japan External Trade Organization (JETRO) An organization that assists foreign companies in exporting their products to Japan by providing free-market entry information and business partner matching as well as some subsidies.

- Also works to attract foreign direct investment into Japan
- The JETRO was originally established in the 1950s to help the war-torn Japanese economy by promoting export of Japanese products to other countries.
- By the 1980s, Japan had massive export surpluses and began to feel the need to promote imports.

JETROoffers subsidies to potential companies, free offices for up to four months while the foreign firm researches the Japanese market, and exhibition space when the company is ready to display their products to prospective Japanese importers.

Concepts Review Questions

1. Compare and contrast the roles of the SBA, Ex-Im Bank, OPIC, and JETRO. When would a company seek out these organizations? Could a bank or EMC take on the role that these other organizations provide? Are these organizations better for small businesses or larger corporations?

2. Elaborate on possibilities of foundation of such types of organizations in Ukraine? How companies can benefit from these institutions?

Topic 13
Key legal aspects of international commercial contracts

When corporations and individuals want to do business in other nations, they often make commercial contracts. Major types of international commercial activity in which contracts occur include: <u>sales</u>, which may involve contracts for the sale of goods or services; <u>licensing</u>, which basically involves contracts in which one party allows another party the right to make, use or sell a product under certain conditions; and <u>investment</u> activity, which may involve the formation and operation of a joint venture, or a foreign branch or subsidiary of a company.

The international contract is a contract that contains a foreign element, meaning it is a contact with one or more foreign legal systems. Specifically, the foreign element may be a resident abroad, a party involved in the contract, a nationality, the location where the contract was formalized, etc.

The commercial contract is a contract for a commercial transaction or a contract made by a trader for the purposes of his trade.Therefore, an international commercial contract signifies the addition of foreign elements in a commercial contractual relationship. For example, a contract between a French commercial agent and an American entrepreneur constitutes an international contract. It may also be a contract between a French company and a provider of electronics in China.

The principle of contractual freedom:

In contract law, there is a general principle of contractual freedom. This principle allows contracting parties to choose the law applicable to such relationships, but also in the event of disagreement, to appoint the judge (by a jurisdictional clause) or the appropriate arbitrator. Freedom of contract applies to international commercial contracts.

This freedom of contract maintains that it will consider the provisions of the contract as the law of parties.However, contractual freedom has limits: mandatory rules. These are mandatory internal legislative rules; therefore, they are compulsory on the international level as well. If either party violates these regulations, the obligatory laws take precedence over the law chosen and applied to the contract.

They thus represent a constraint on the parties entering into a contract with these intricate regulations. But in what ways is this legislation mandatory? We can mention certain subjects carrying policing laws in French and European law: consumer law and insurance law (provisions relating to the insured).

For example, Article 7 of the Rome Convention of 1980 on the Law Applicable to Contractual Obligations states that:

1. When applying under this Convention the law of a particular country, may be given precedence to the mandatory provisions of the law of another country with which the situation has a close connection, if and since, under the law of that country, such provisions shall apply whatever the law governing the contract.

2. The provisions of this Convention shall restrict the application of the rules of law of the mandatory governing forum in the situation regardless of which law is applicable to the contract.

Occasionally, the parties fail to specify this in their contract and discourse.

Absence of choice by the parties:

In this case, you will find the law of the contract and the court having jurisdiction in any dispute. However, international contracts, and therefore the international commercial contracts are subject to the rules of Private International Law (PIL). This will help determine which law will apply to the international situation and which will be the appropriate court to hear the situation in case of dispute.

In Private International Law, the regulations can be roughly categorized into 3 types:**International substantive rules:** These give a direct solution to the question without going through the resolution of conflict of laws specific to the public international law. For example, in international trade law, it is important to mention the Vienna Convention of 1980 on the International Sale of Goods.

The rule on conflicting laws: These are international (conventions) and national (internal rules for each state) rules. Where international substantive rule exists, it follows that laws are applicable to international commercial contracts through the first of an international carrier of conflict of laws, and failing such agreement, through the conflict rules of domestic laws of States.

Among the international conventions bearing on conflicting laws, rules may include: The Hague Convention of June 15, 1955 regarding the law applicable to international sale of goods, the Hague Convention of March 14, 1978 regarding the law applicable to agency and representation, the Rome Convention of 1980 regarding the law applicable to contractual obligations etc.

The rules developed by private actors themselves: Firstly, this is part of usages and customs relating to international trade (lexmercatoria). Secondly, the arbitral jurisprudence is tied to international trade laws. Note in this connection the considerable efforts of the Chamber of Commerce (ICC) which brings together and organizes the practices and customs of the international trading community.

Because of the intricate interactions between the principles of contractual freedom, respect of mandatory rules, and the principles of private international law, all parties involved in an international commercial contract should be vigilant. The technicality of the subject is difficult to understand, and whether at the stage of negotiating the contract to its conclusion or at its execution, the advice of a multi-skilled lawyer specializing in business and international law is necessary. In addition, it should be noted that international trade and contract law are often subject to various national rules that differ from one state to another. Therefore, with these variations in mind, the ICC seeks to promote international practices and customs, including international arbitration as an alternative to the diversity of global legal systems.

Concepts Review Questions

1. *Discuss main conventions regulating international trade.*
2. *What regulations exist in international trade law?*

Topic 14
Principles of project finance

Project finance is a method of raising long-term debt financing for major projects through ‘financial engineering,’ based on lending against the cash flow generated by the project alone. It depends on a detailed evaluation of a project’s construction, operating and revenue risks, and their allocation between investors, lenders, and other parties through contractual and other arrangements. In 2012, at least $375 billion of investments in projects around the world were financed or refinanced using project-finance techniques.

‘Project finance’ is not the same thing as ‘financing projects,’ because projects may be financed in many different ways. Traditionally, **large scale public-sector projects** in developed countries were financed by public-sector debt; **private-sector projects** were financed by large companies raising corporate loans.

In developing countries, projects were financed by the government borrowing from the international banking market, development-finance institutions such as the World Bank, or through export credits.

The Export-Import Bank of the United States defines project finance as: “…the financing of projects that are dependent on project cash flows for repayment, as defined by the contractual relationships within each project. By their very nature, these types of projects rely on a large number of integrated contractual arrangements for successful completion and operation.

The contractual relationships must be balanced with risks distributed to those parties best able to undertake them, and should reflect a fair allocation of risk and reward. All project contracts must fit together seamlessly to allocate risks in a manner which ensures the financial viability and success of the project.”

The rating agency Standard & Poor’s defines it as:Project-finance transactions typically are comprised of a **group of agreements and contracts between lenders, project sponsors, and other interested parties** who combine to create a form of business organization that will issue a finite amount of debt on inception, and will operate in a focused line of business over a finite period.

An ‘official’ definition of project finance was provided by the Basel C Committee on Banking Supervision in the context of the ‘Basel II’ rules. “Project finance is **a method of funding in which the lender looks primarily to the revenues** generated by a single project, both as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure.

The Organization for Economic Cooperation and Development (OECD) provides another ‘official’ definition of project finance in the context of the Export Credit ConsensusThe financing of a particular economic unit in which a lender is satisfied to consider the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.

Principles of project finance can be summarized as:

1. The project usually relates to major infrastructure with a long construction period and long operating life.

1.1. So the financing must also be for a long term (typically 15–25 years).

2. Lenders rely on the future cash flow projected to be generated by the project to pay their interest and fees, and repay their debt.

2.1. Therefore the project must be ‘ring-fenced’ (i.e. legally and economically self-contained).

2.2. So the project is usually carried out through a special-purpose legal entity (usually a limited company) whose only business is the project (the ‘Project Company’).

3. There is a high ratio of debt to equity (‘leverage’ or ‘gearing’)—roughly speaking, project finance debt may cover 70–90% of the capital cost of a project.

3.1. The effect of this high leverage is to reduce the blended cost of debt and equity, and hence the overall financing cost of the project.

4. The Project Company’s physical assets are likely to be worth

much less than the debt if they are sold off after a default on the financing—and in projects involving public infrastructure they cannot be sold anyway.

4.1. So the main security for lenders is the Project Company's contracts, licenses, or other rights, which are the source of its cash flow.

4.2. Therefore lenders carry out a detailed analysis of the project's risks, and how these are allocated between the various parties through these contracts.

5. The project has a finite life, based on such factors as the length of the contracts or licenses, or reserves of natural resources.

5.1. So the project-finance debt must be fully repaid by the end of the project's life.

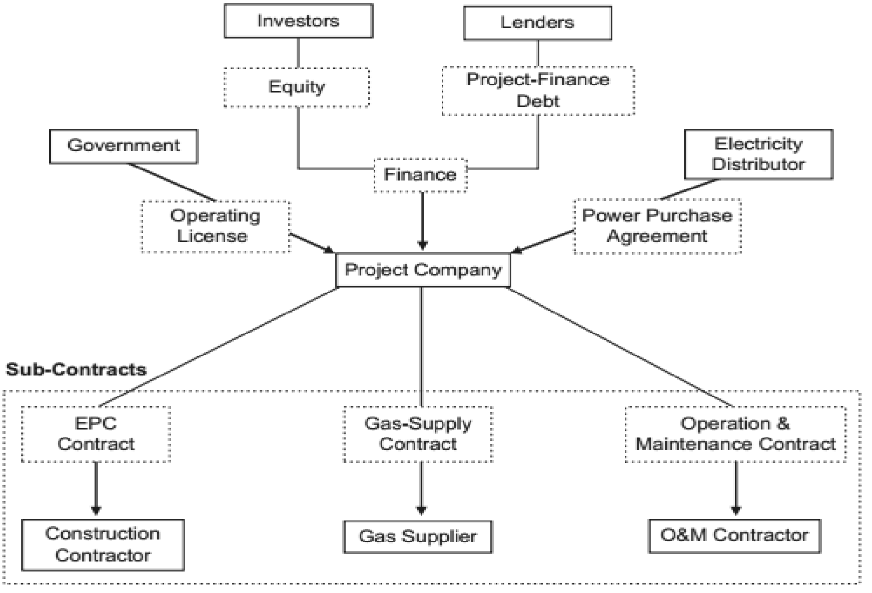
5.2. There are no guarantees from the investors in the Project Company for the project-finance debt.

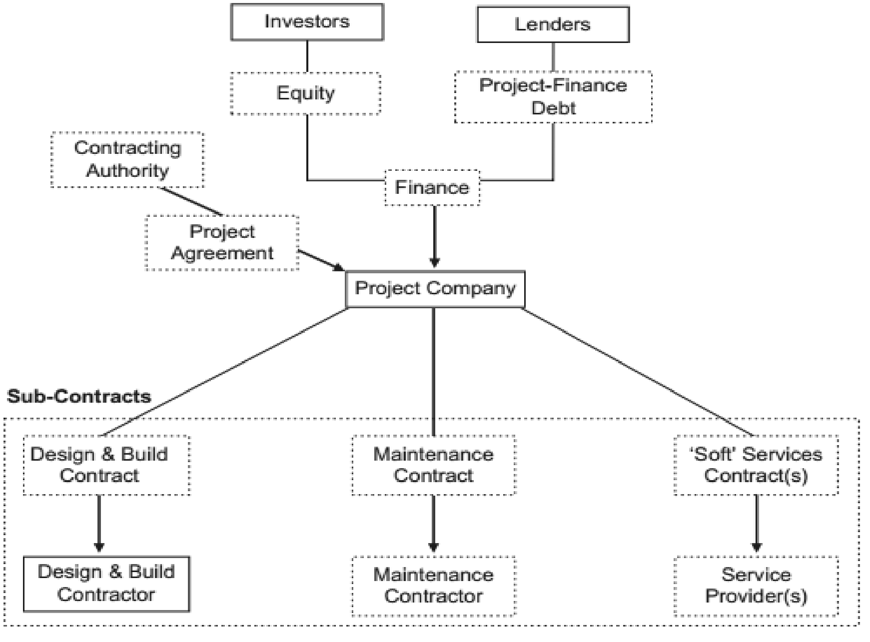
5.3. So this is 'non-recourse' finance.

Private-Sector Project-Finance Commitments, 2000–2012

($ millions)	2000	2007	2008	2009	2010	2011	2012
Power	56,512	76,518	90,236	57,642	78,177	85,947	73,416
Natural resources – of which:	16,518	56,432	67,859	38,005	50,589	59,756	75,485
Mining	629	4,607	11,486	4,071	10,858	11,158	4,745
Oil & gas	12,552	34,311	42,960	31,137	28,425	43,983	66,139
Petrochemicals	3,337	17,519	13,413	2,797	11,306	4,615	4,601
Infrastructure – of which:	16,755	67,620	65,212	40,233	64,998	56,676	65,610
Transportation		44,027	54,789	25,451	52,315	43,607	40,467
Other Infrastructure		16,423	6,940	8,890	9,838	11,348	21,060
Waste & recycling		2,989	550	1,194	1,267	724	842
Water and sewerage		4,181	2,933	4,699	1,578	997	3,241
Industry	3,538	17,473	11,979	3,454	6,306	12,155	6,833
Leisure and property	1,638	22,759	20,836		14,424	15,439	
Telecommunications	36,735	5,556	6,260	8,118	13,383	5,314	1,529
Agriculture		452	61		86	479	
Total	**131,696**	**246,809**	**262,442**	**147,452**	**227,964**	**235,766**	**222,873**

Project-Finance Structure





Top 20 financial advisors – signed projects, 2012

Advisor	Type	Country	Amount (US$ million)
Crédit Agricole	Bank	France	41,270
Mizuho	Bank	Japan	40,000
Royal Bank of Scotland	Bank	Britain	16,625
Macquarie	Bank	Australia	13,392
HSBC	Bank	Britain	12,053
KPMG	Accountants	Britain	9,830
Rothschild	Investment bank	Britain	9,570
Société Générale	Bank	France	9,470
Ernst & Young	Accountants	Britain	9,915
PwC	Accountants	Britain	8,439
Sumitomo Mitsui Banking Corp	Bank	Japan	8,065
BNP Paribas	Bank	France	4,696
ING	Bank	Netherlands	4,000
State Bank of India	Bank	India	3,342
Citigroup	Bank	U.S.A.	3,109
Natixis	Bank	France	2,468
Green Giraffe Energy Bankers	Advisory boutique	France	1,745
Bank of Tokyo-Mitsubishi UFJ	Bank	Japan	1,600
Unicredit	Bank	Italy	1,238

Source: *Project Finance International*, issue 496 (January 16, 2013).

The financial advisor's scope of work under an advisory agreement includes:

1. advising on the optimum financial structure for the project;
2. preparing a financial model for the project;
3. assisting in the preparation of a financial plan;
4. advising on sources of debt and likely financing terms;
5. advising on the financing implications of Project Contracts and assisting in their negotiation;
6. preparing an information memorandum to present the project to the financialmarkets;
7. advising on evaluating proposals for financing;
8. advising on selection of commercial-bank lenders or placement of bonds;assisting in negotiation of financing documentation.

The project finance markets. Private-sector project-finance debt has traditionally been mainly provided from two sources —

commercial banks and bonds. Commercial banks provide long-term loans to Project Companies. Bondholders (typically life-insurance companies and pension funds, which need long-term cash flows) purchase long-term bonds (tradable debt instruments) issued by Project Companies.

Recently these non-bank lenders have also begun to make direct loans to projects, and participate in debt funds. Other types of private-sector finance are sometimes also usedin projects.Although the financial and legal structures and procedures are different, the criteria under which debt is raised in each of these markets are much the same. Sources of finance for developing countries, including DFIs (such as the WorldBank) and ECAs such as U.S. Eximbank, and particular issues which arise whenconsidering project finance in such markets**.**Commercial banks are the largest providers of project-finance—nearly 90% of theprivate-sector project finance debt raised in 2012.

Most commercial banks in the project-finance field have specialist departments that work on putting project-finance deals together. There are three main approaches to organizing such departments:

Project-Finance Department. The longest-standing approach is to have a department purely specializing in project-finance transactions. Larger departments are divided into industry teams, covering sectors such as infrastructure, energy and natural resources. Concentrating all the project-finance expertise in one department ensures an efficient use of resources and good cross-fertilization, using experience of project finance for different industries; however, it may not offer clients the best range of services.

Structured-Finance Department. Divisions between project finance and other types of structured finance have become increasingly blurred, and therefore project finance often forms part of a larger structured-finance operation. Again there may be a division into industry teams. This approach may offer a more sophisticated range of products, but there is some danger that project finance may not fit easily into theoperation if other business is based on a much shorter time horizon—*e.g.* if LBOs (see below) are also dealt with in the same department.

Industry-Based Departments. Another approach is to combine all financing for aparticular industry sector (*e.g.* electricity, natural resources, or infrastructure) inone department; if this industry makes regular use of project finance, project finance experts form part of the team. This provides one-stop services to thebank's clients in that particular industry, but obviously may diminish cross-fertilization between project-finance experience and different industries.

Concepts Review Questions

1. Give examples of project finance structures

2. What is the importance and necessity of using project finance?

3. Classify the types of sponsors and investors in project finance.

4. Describe the role of advisors in project finance.

5. Main features and activities of Project Company, Commercial Banks in Project Finance.

7. Discuss bonds as a tool of collecting debt in Project Finance

8. Characteristics of Non-bank lenders and other sources of private-sector debt.

Topic 15

International commodity exchanges and auctions

A commodities exchange is an entity, usually an incorporated non-profit association that determines and enforces rules and procedures for the trading of commodities and related investments, such as commodity futures. Commodities exchange also refers to the physical center where trading takes place.

A commodity exchange is an organized, regulated market that facilitates the purchase and sale of contracts stipulating the delivery of commodities. Commodity exchanges are responsible for creating, maintaining and enforcing the rules of trade for all those involved in the market. They are responsible for ensuring that the price limits set each day for each commodity promote fair treatment to the participants in the commodities exchange. Despite this, however, commodity exchanges do not determine the prevailing prices or the general trends and behavior of the market. A **commodities exchange** is an exchange where various commodities and derivatives products are traded. Most commodity marketsacross the world trade in agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milkproducts, pork bellies, oil, metals, etc.) and contracts based on them.

Top 10 Agricultural Futures and Options Contracts

Rank	Contract	Jan-Dec 2015	Jan-Dec 2014	% Change
1	Soybean Meal Futures, Dalian Commodity Exchange	289 496 780	204 988 746	41.2%
2	Rapeseed Meal (RM) Futures, Zhengzhou Commodity Exchange	261 487 209	303 515 966	-13.8%
3	White Sugar (SR) Futures, Zhengzhou Commodity Exchange	187 323 456	97 726 662	91.7%

4	RBD Palm Olein Futures, Dalian Commodity Exchange	111 515 010	79 996 388	39.4%
5	Soybean Oil Futures, Dalian Commodity Exchange	92 504 264	64 082 631	44.4%
6	Corn Futures, Chicago Board of Trade	83 094 271	69 437 304	19.7%
7	Rubber Futures, Shanghai Futures Exchange	83 067 547	88 631 586	-6.3%
8	Soybean Futures, Chicago Board of Trade	54 095 051	49 169 361	10.0%
9	Corn Futures, Dalian Commodity Exchange	42 090 235	9 329 939	351.1%
10	Sugar #11 Futures, ICE Futures U.S.	34 394 482	29 396 597	17.0%

Source: Futures Industry Association

These contracts can include spot prices, forwards futures and options on futures. Other sophisticated products may include interest rates, environmental instruments, swaps, or ocean freight contracts.

Global Futures and Options Volume by Category

Category	Jan-Dec 2015	Jan-Dec 2014	% Change
EquityIndex	8 342 860 438	7 338 870 063	13.7%
IndividualEquity	4 927 935 476	4 931 561 737	-0.1%
Interest	3 251 257 586	3 293 164 521	-1.3%
Currency	2 784 884 902	2 122 783 609	31.2%
Agriculture	1 639 668 492	1 387 993 407	18.1%
Energy	1 407 235 307	1 160 869 956	21.2%
Non-PreciousMetals	1 280 935 517	872 626 126	46.8%
Other	819 713 435	353 997 195	131.6%
PreciousMetals	321 272 201	371 064 966	-13.4%
Total	24 775 761 354	21 832 931 580	13.5%

Source: Futures Industry Association

Commodities exchanges usually trade futures contracts on commodities, such as trading contracts to receive something, say corn, in a certain month. A farmer raising corn can sell a future contract on his corn, which will not be harvested for several months, and guarantee the price he will be paid when he delivers; a breakfast cereal producer buys the contract now and guarantees the price will not go up when it is delivered. This protects the farmer from price drops and the buyer from price rises.

Speculators and investors also buy and sell the futures contracts in attempt to make a profit and provide liquidity to the system. However, due to the financial leverage provided to traders by the exchange, commodity futures traders face a substantial risk.

The operation of a commodity exchange is similar to that of the stock markets. At the center of the exchange lies the exchange trading floor, where all non-electronic commodity trading takes place. These exchange floors are divided into several sections, each devoted to the trading of a single commodity. These sections are known as either a pit or a ring. In these pits traders stand facing each other, and subsequently make bids and offers to one another. ‘Bids’ here refers to making a proposition to buy a set amount of a certain commodity at a set price, and ‘offers’ is the proposition to sell a set amount of a certain commodity at a set price. When a successful transaction is made between traders, the information is immediately transferred on to the massive trading floor quotation board while simultaneously being distributed to the relevant trading centers worldwide. In order to ensure the transaction has proceeded smoothly and correctly, the participants involved in the particular transaction record all the pertinent details such as amount sold, price and when the transaction took place. This is for two reasons: it allows traders to check and recheck all their transactions, and every trade must be concluded on the same day that it has been initiated. The traders on the exchange floor who embark on these deals must be members of the commodity exchange, else they must conduct their business by way firm of commodity brokers trading on their behalf. This is frequently the case with commodity producers and traders.

Top Derivatives Exchanges

Rank	Exchange	Jan-Dec 2015 Volume	Jan-Dec 2014 Volume	Annual % Change
1	CME Group	3 531 760 591	3 442 770 984	2.6%
2	National Stock Exchange of India	3 031 892 784	1 880 363 732	61.2%
3	Eurex	2 272 445 891	2 097 975 470	8.3%
4	Intercontinental Exchange	1 998 810 416	2 215 559 295	-9.8%
5	Moscow Exchange	1 659 441 584	1 413 222 196	17.4%
6	BM&FBovespa	1 358 592 857	1 420 479 205	-4.4%
7	CBOE Holdings	1 173 934 104	1 325 391 523	-11.4%
8	Dalian Commodity Exchange	1 116 323 375	769 637 041	45.0%
9	Zhengzhou Commodity Exchange	1 070 335 606	676 343 283	58.3%
10	Shanghai Futures Exchange	1 050 494 146	842 294 223	24.7%
11	Nasdaq	1 045 646 992	1 147 450 449	-8.9%

Source: Futures Industry Association

Top Commodity Exchanges

- **Chicago Mercantile Exchange (CME):** A financial and commodity derivatives trading platform headquartered in Chicago. Originally founded in 1898 as the Chicago Butter and Egg Board, the CME has one of the largest options and futures line-up of any exchange in the world. The CME offers contracts of all kinds including agriculture, credit, economic events, equity index, FX, interest rates and other futures/options investments. The CME is owned and operated under the CMEGroup.
- **Chicago Board of Trade (CBOT):** Established in 1848, the CBOT ranks as the oldest futures/options trading exchange in the world. The exchange offers more than 50 different futures and option contracts for investors stretching across a number of asset classes. As of 2007, the CBOT operates as a subsidiary of the CME group.
- **New York Mercantile Exchange (NYMEX):** The NYMEX is the world's largest physical commodity futures exchange, offering

exposure to a wide variety of products. Commodity Exchange Inc. (COMEX) also operates as a division of the NYMEX and is best known for offering exposure to various metals contracts. The two divisions joined in late 2006, and were acquired by the CME Group in early 2008.

- **London Metal Exchange (LME):** Stationed in the United Kingdom, the LME is a major exchange that offers exposure to futures and options of a wide variety of base metals and other commodity products. Some of the metals traded include aluminum, copper, tin, nickel, zinc, and lead. Though founded in 1877, the exchange can trace its roots all the way back to 1571, when the Royal Exchange in London was opened, only trading copper at that time.
- **Intercontinental Exchange Inc. (ICE):** The Intercontinental Exchange is a U.S.-based company that operates futures and over-the-counter contracts via internet marketplaces. The company was originally focused on energy contracts but has widened its scope by offering exposure to a number of commodities including cocoa, cotton, sugar, iron ore, natural gas and crude products. The platform is much more focused on just a select few commodities and may be a good fit for traders looking to single out just one or two.
- **Multi Commodity Exchange (MCX):** The MCX is a private commodity exchange based in Mumbai, India. The company was founded in 2003 and ranks as one of the top 10 commodity exchanges in the world. Traders can gain access to a number of the usual suspects like gold and silver, but also have the option to trade a number of commodities focused on the Indian economy like pepper, cashew kernel, yellow peas, and a number of other futures that would be difficult if not impossible to find within U.S. borders.

Classification of auctions. In general, an auction can be classified as English, Dutch, or sealed-bid (silent), depending on the auction’s mechanism design. An **English** auction is a commonly used auction mechanism where the auctioneer starts with some price. For an agent selling a commodity, this price is a seller’s **reservation price,** the lowest pricea seller is willing to accept for the commodity. (In contrast, for a buyer offering to purchase a commodity, this price is the maximum price the buyer is willing to pay for the commodity). In an auction for an agent selling a commodity, buyers openly outcry (bid) their willingness to purchase the commodity at this reservation price. Assuming at least one buyer bids, the auctioneer accepts one of the bids, and then increases the price by some increment and solicit bids from the other buyers at the higher price.As long as at least one buyer makes a bid at the higher price, the auctioneer will continue to increase the price. When no other buyer is willing to make a bid at the auctioneer's higher price, the commodity is sold to the buyer whose last bid was accepted by the auctioneer. This is a fully transparent auction where all bidders' bids are disclosed throughout the whole bidding process. Generally, an auction mechanism is an English auction if it is an interactive price-adjusting process in the direction unfavorable to the bidders.

A **Dutch auction** works in the reverse way. Instead of starting at a seller's reservation price and increasing the price, the auctioneer starts at a price somewhere above the willingness of any buyer to pay for the commodity and then decreases the price. As the price declines, the firs buyer willing to purchase the commodity at the current offered price acquires the commodity for that price. A Dutch auction only requires one bid, so it is efficient in terms of auctioning commodity quickly. One problem with the Dutch auction is determining the initial price above buyers' willingness to pay. In particularly thin markets, such as for famous artworks, determining this price may be difficult. Generally, an auction mechanism is a Dutch auction if it is an interactive price-adjusting process in the direction favorable to the bidders.

A **sealed-bid auction** is where bidders submit one bid in a hidden fashion. There is no open outcry. Such auctions are commonly used when it is difficult or undesirable for bidders simultaneously participate in the auction. Bidders individually submit written bids prior to some deadline. In the case of an auction selling a commodity, these bids are at or above the stated seller's reservation price. In contrast, the bids are below the buyers' reservation price in the case of an auction offering sellers the opportunity to bid on the ability to supply a commodity. At some point past the deadline, the bids are revealed (read) and the buyer (seller) who submitted the highest (lowest) bid purchases (sells) the commodity. An auction where the bid is the commodity's purchased price is called **a first-bid auction.** Sealed bids using first-bid pricing are commonly employed in the awarding of construction contracts, where the construction firm with the lowest bid receives the contract for its bid price. In this case, the construction firm is the seller of the commodity and the auctioneer is representing the buyer.

An important variant of the sealed-bid auction is the **second-bid auction** or **Vickrey auction**, named for the 1996 Nobel Laureate William Vickrey (1914-1996) who was one of the first to theoretically investigate auctions. In a second-bid auction, the buyer with the highest wins and receives the auctioned commodity but only has to pay the second highest bid price. The second-bid mechanism results in agents bidding their true value of the commodity. One of the first uses of the second-bid auction was by stamp collectors (philatelists).

Considering the characteristics of the English, Dutch, first-bid, second-bid auctions, the English auction is equivalent to a second-bid auction and the Dutch auction is equivalent to a first-bid auction.

Concepts Review Questions

1. Describe main features of international commodity exchanges?

2. What the role of derivatives in modern exchange trade?

3. When you are the last bidder in an auction, do you only pay the second highest bid?

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Навчально-методичне видання

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«Foreign Trade Techniques»

Lecture Notes

Комп'ютерна верстка: *В.І. Гришаков*

Підписано до друку 15.05.2018 р. Формат 60х84/16
Ум.друк. арк. 4,88. Обл.-вид. арк. 3.45.
Наклад 100 прим. Зам. № 170.

ВНЗ «Університет економіки та права «КРОК»
Свідоцтво про внесення суб'єкта видавничої справи
до Державного реєстру ДК № 613 від 25.09.2001 р.

Надруковано департаментом поліграфії
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