1. PREDNÁŠKA (12/2/2001)

1. THEORY OF TRADE

Theory of Absolute Advantage
Theory of Comparative Advantage
Theory of Factor Proportions
Retailing
Wholesaling

What gave rise to a trade? - extended division of labour and production of goods
TRADE = specific economic activity joining production with consumption

- is a part of reproduction
- buying and selling goods and services

In the very beginning – simple exchange "exchange in kind" (goods were exchanged in/for goods) characteristic for less developed societies that were able to produce products in limited amounts (required).
Advanced developed society – elaborate network of trade among individuals, companies, countries; depending on producing particular products. Money facilitates / enables exchange of goods in which the value of a product modifies to its monetary equivalent.

Commerce is a specific business activity
Commerce establishments make it possible for shop assistants to buy goods from producers.
Trade went through a complex evolution up to a present form and according to the criteria (see below) trade is divided into different forms of trade.

CRITERIA	CLASSIFICATION
1. according to territory	home trade, foreign trade, international & world trade
2. division of labor in a trade activity	wholesale, retail, middlemen (in indirect business matters – EXP/IMP transactions)
3. legality	legal trade, illicit trade, grey trade
4. place of business	in the country, in a town
5. commodity	trade with goods, food – stuff, services

Statistics considers 2 main categories of trade – retailing & wholesale.

1.1. RETAILING covers all of the activities involved in the sale of products to final consumers for their personal usage (not for their entrepreneurial purpose). Retailing takes place in retailing shops that consider being an organisation units of so-called retail network/system. Except retail shops (organisation unit of a retail system), retail network encompasses also different retail business/buildings that provide special services to public. Retailer takes over entrepreneurial risk of goods haven't been sold.

1.2. WHOLESALING

selling to retailers as well as delivery of goods to institutions or many other users. In the main wholesale covers activity to deliver goods to retailers, institutions, etc.

W provides part of the buying functions = offer products to potential customers so they don't have to look for supplying sources.
W carries stocks = they carry inventory so customers don't have to store a large inventory
W deliver goods = provide prompt delivery at low costs
W grants credit = give credit to customers. These financing functions may be very useful/important to small customers
W anticipates needs = forecast customer's demands & buy accordingly
W owns & transfers title to products = help complete a sale without the need for other agent / middlemen, speeding the whole buying & selling process
W provides information & advisory service = supply price & technical information as well as suggestion on how to install & sell products.

Trade supports circulation of products, which starts at the ramp of plan (in a factory) & ends at the counter (taken by s customer).

FOREIGN TRADE

First theory emerged in England in 16th century & referred as to a mercantilism. The principle of M was that gold & silver were the main stains of national prosperity / wealth. G&S were the currencies used for mutual trading among countries.
Mercantilists argued that it is beneficial for the country to keep to a favourable balance of payments (= pozitívna platobná bilancia / nie deficit) & the source was export (to decrease import & increase export by different import restrictions that involved quotas, taxis, charges, tariffs, etc.). But this doctrine was attack by A.Smith in his book "The Wealth Of Nations" (1776) where he explained why it was beneficial (unrestricted / free trade) for countries – THEORY OF ABSOLUTE ADVANTAGE".
19th century "THEORY OF COMPARATIVE ADVANTAGE" in "Principles of political economy" by D.Ricardo – the country should specialise in the production of goods, which they produce more efficiently than other countries.
THEORY OF FACTOR PROPORTIONS emerged in Sweden (1919 – Eli Heckscher; 1930 – his student Bertil Ohlin). Country's engagement in FO depends upon their having (abundance) of factors needed for production of goods (if it is produced from scare factors, it is better to import). The factors involve capital, labour, other sources.

2. CROSS – BORDER TRADE

2.1. The Significance of Cross-border Trade

Cross-border trade is a part of reproduction – it is irreplaceable in every economy. Country's engagement in foreign trade depends upon the endowment of sources, additionally of technical development, economic, political, natural, historic conditions.
Country that joins FT activity is significant by open economy whereas closed economy is typical for ...

Useful measures (ratios): EXPORT / GDP
IMPORT / GDP

International division of labour & work - corporation based on specialisation that increases the national prosperity.
In a long run international trade can negatively influence domestic macro & micro economy

The total income (Y) in a close economy:
Y = Consumption + Investments + Government expenses

In an open economy we also have to take in consideration also EXP & IMP:
Y = Consumption + Investments + Government expenses + net EXPORT
E – I = net EXPORT (positive / negative)

2.2. Economics Basis of Foreign Trade
Countries find it beneficial because the diversity in production sources, because of decreasing costs of production, differences in consumer's tastes.

2.3. Functions Of Foreign Trade
FUNCTION OF TRANSFORMATION expresses that FT transforms the structure of domestic production or personal consumption (to a structure necessary in the usage).
FUNCTION OF GROWTH expresses how international trade influences the effective exploitation of domestic economic resources (producing together - higher living standard)

3. TRADE & INCOME

Income depends on real income of consumer's income & production possibility.
Export is possible only when somebody ...
Nation's willing to buy our products – only if they come in crisis.
When demand rises → by increased prices
→ by hiring more people → increasing production → ↑ capital (e.growth)
The higher the EXP the higher the IMP.
Export brings the currency into the country (with real income rises also demand) & Import as leakage of foreign currency brings less economical effects of multiplying process.
Marginal proposity to I in the fraction of each additional (marginal) financial unit of disposable income spent on imports.

$MPM = \Delta M / \Delta Y$ $\qquad\qquad$ $MPS = \Delta S / \Delta Y$

Keynessian (generalised) multiplier = 1 / leakage fraction
In a closed & private economy the multiplier takes the familiar Keynessian form.
Closed economy multiplier (without taxes) = 1 / MPS
In the open economy = 1 / (MPS + MPM)

4. INTENSITY OF FOREIGN TRADE

- expresses the rate of country's openness to the external relations.
Intensity of FT can be expressed in:

- share of EXP in GDP (index of country's competence & technical development)
- share of EXP in SKK per capita (index both the inhabitant's qualification structure & the inner economy structure)

5. FOREIGN TRADE POLICY

- is needed to obtain the goals (liberalistic / restricted)

Means & principles:

- CONTRACTING – trade agreements, contracts
- AUTONOMOUS

Trade contracts – serve for establishing bilateral or multilateral trade contracts between countries. It specifies the trade & political relations between partners with validity over 2 years & automatic prolongation. This contract is signed by head of state – president, Prime Minister & ratified by parliament.

Trade agreements – concretise conditions for mutual exchange of goods & services on the basis of TC. They are signed by the minister responsible for foreign trade department. In Slovakia it is the Minister of Economy.

Payment & credit agreements – had a considerable significance mostly in the past when trading was based upon clearing settlement. Payment agreement predetermines the currency in which the payment & settlement are realised. Credit agreements regulates the possibilities & methods for using credits in foreign trade.

Agreement for economic, industrial & scientific – technological co-operation is the result of work in mutual commission between SR & EU. There were following mutual agreements signed with EU in the past:

- The agreement in exporting our metallurgical products to the European Economic Community being annually agreed & negotiated.
- The agreement on exporting textile products to EU based upon validity & acceptance of Multifibre agreement (MFA) from 0974 periodically prolonged.

General Agreement in Tariffs & Trade. The GATT is a multilateral agreement objective of which is to liberalise trade by climbing tariffs, subsidies, import quotas, etc.
Promoted free trade by limiting the ability of national governments to adopt policies restricting import.
WTO – liberalisation of services (not only goods)

INTERNATIONAL TRADE involves the exchange of goods & services of some countries within some economic integration (NAFTA, EU)

FOREIGN TRADE relates to 1 or a group of countries towards the rest of the world.

WORLD TRADE comprises the foreign trade of all countries participating in the world division of labour (= all foreign trade activities)

Aims set in FT policy can be reached by:
LIBERALISM = is free trade without any state intervention
PROTECTIONISM = any state policy adopted by country in order to protect domestic market that is domestic producers & consumers.

6. ORGANISATIONAL STRUCTURE OF FOREIGN TRADE

- companies involved in E/I transactions

1948 – international FT & forwarding were nationalised. It was under the law 119/49 Zb. that established state **monopoly of FT & forwarding.** Only companies appointed by state (had permission from state) could join E/I transactions. These companies were engaged in FT activities & they served as middlemen between producers (our territory) & customers (abroad). In many cases they were not able to respond quickly enough to their needs .....
Situation changes in 60s – these companies change to stock companies. Stocks were holding producers, middlemen (establishments of ŠKODA EXPORT, JABLONEX, etc.)
1990 – state monopoly was abolished (cancelled) under the law 113/90 Zb. & everybody can enter E/I.

7. INSTITUTIONAL REGION OF FT

= INSTITUTIONS CONCERNING & SUPPORT EXPORT ACTIVITIES OF OUR BUSINESS COMPANIES. The department of FT in previous ČSFR was conducted by Federal Ministry of FT in Prague. Ministry of Economy in SR was established in 1990. Since 1993 competencies were divided among the Ministry of Foreign Affairs, Ministry of Economy & Slovak Chamber of Commerce & Industry.

8. DEVELOPMENT OF SLOVAK TRADE

INDEX	93	95	97	98
export in mil.SKK				337.8
%	100			225.3
import				460.7
%	100			228.6
balance of trade	**-34.3**	**-5.7**	**-69.9**	**-82.9**
turnover	368.7	515.9	717.9	888.5

DEFICIT OF BALANCE OF TRADE negatively influence the balance of payment & currency (due to external & internal factors – low machine performance, increased domestic consumption (70% a year)...then started imposing of restrictions to protect home economy).

9. TERRITORIAL STRUCTURE OF EXP/IMP

Up to 1989 the most frequent trading countries were joining CMEA (countries for mutual economic aim – RVHP countries).
Situation changes in 1990 towards the EU & OECD countries. But the balance of trade was still negative.
Customs union between CR & SR (separate from EU statistics).

2. PREDNÁŠKA (19/2/2001)

1. INTRODUCTION

FT was influenced by globalisation = process in which the W economy is becoming more closely integrated & such terms as globalisation, integration, etc. are frequently used nowadays.

GLOBALISATION OF MARKETS – we are leaving the economic system in which nations / markets were distinct entities. They were isolated from each other by trade barriers, barriers in distance, in time, culture & history. We are moving to a system in which national markets / nations are merging to one huge global nation/ market. Globalisation is criticised, because economic power of nations is shifting (moving) to supranational organisations (World Trade Organisation, EU, United Nations Organisation). But according to the statistics performed by WTO it is evident that the trade we mergendised grown consistently faster than the world output since the 1950s. Between 1950 – 1994 the volume of merchandised trade grew at slightly more than 6% p.a. on average, while the volume of world output grew at around 4% p.a. The most recent published statistics indicate that in 1995 the volume of world surged by 8%, considerably above the historic trend line (output by 6%)

2. CLASSIFICATION OF FT OPERATIONS

- CLASSICAL TYPES – Export, Import
- SPECIAL TYPES – Countertrade, Exchange Contracts, Others

Countertrade

- counter purchase – parallel contract /2/
- advance purchase
- buy back /3/
- industrial offset /1/
- reexport

Exchange Contracts

- compensation
- bartering (commodity & service exchange for commodities) /4/

Others

- switch /5/
- swap
- auction contracts
- stock contracts
- licensing
- franchising

/1/ - /5/ ...popularity / using of instruments of financing WT

The advantage of focusing on export market is twofold:
1 - Every country needs foreign exchange (hard economy) & exports are the way to earn it.
2 - Export tap a ready markets. World export markets are larger than domestic ones.

....
Nonconvertibility implies exporter not being able to pay his home currency → SPECIAL TYPES enable country / exporter to engage in foreign trade even if it lacks (shortage) of foreign currency. Special types rose in 1960s & 20 years later these techniques became very popular in less developed countries (3rd world).

According to some estimates, more than 20% of WT by value in 0992 was in the form of countertrade, up from only 2% in 1975.
Predictions – by 2000 ....

Countertrade presents serious constrains to the exporter, relative to means of trade financing:
a) there is the problem of trying to value the products to be received in payment
b) there is the problem of disposing these goods
c) if payment is not simultaneous with the exporter's shipment, then some other form of financing will be necessary
d) the exporter assumes all of the political risk of dealing with the importer

Reasons for this business activity:
a) where many countries continue to face balance of payment problems (especially deficits that use up available foreign exchange reserves) these countries look for means of obtaining desired
b) given, that firms from many countries do not have experience in selling goods abroad, countertrade requirements can force F multinational enterprises to do the international marketing to them & thus gain access to new markets
c) when goods are sold in countertrade deals, they may not be priced explicitly in currency terms. This fact may permit a country to sell goods at discount or dumping prices.
d) because of protectionist pressures in many countries, countertrade can be used to force importers to accept the country's export, thus maintaining jobs & income in the host country. These & other factors are resulting in increased countertrade at the same time as international business is becoming more open around the world
e) political & economic situation an trading countries. Countertrade can eliminate some political & commercial risks.

The Pros & Cons of Countertrade

COUNTERPURCHASE – PARALLEL CONTRACT
Parallel contract is reciprocal (mutual) buying agreement that takes place if country / firm agrees a certain amount of materials or other commodity from a country to which a sale is made.

ADVANCED PURCHASE
This type of operation is an analogy to the parallel purchase, the only difference is that import is followed by export.

BUY BACK agreement involves long term repayment & often compensation with industrial products. The compensation may be raw materials or intermediate goods (semiproducts).

OFFSET is similar to counterpurchase insofar as one party agrees to purchase goods & services with a special percentage of the proceeds (obtain) from the original sale. The difference is that this party can fulfil the obligation with any firm in the country to which the sale is being made.
Offsets are the practise by which the award of contracts by foreign governments to provide industrial compensation. In defence trade, offsets include mandatory coproduction, licensed production, subcontractor production, technology transfer, countertrade & foreign investment.

Countries require offsets for a variety of reasons:
- to ease the burden of large defence purchases on their economy,
- to increase or preserve domestic employment,
- to obtain desired technology,

- to promote targeted industrial sectors.

↑ based on tender (state invitation)

Types of offsets – direct, indirect, combination of both

Direct offsets refer to compensation such as co/production or subcontracting, directly related to the system being exported.
Indirect offsets apply to compensation unrelated to the export item, such as foreign investment or countertrade.

REEXPORT involves exporting of imported goods. There are 2 basic forms as to reexport transaction:

- direct
- indirect

Direct reexport is considered to be a direct export of goods from the producer's country to the country of destination.

Indirect reexport proceeds as follows:

Reexport transactions are often used for surmounting different barriers to trade.

COMPENSATION (only goods no cash payment cross the borders)

Total value of mutual deliveries must equal. Every participant in compensation pays & is paid in domestic currency.

"Compensation itself"

“Triangle compensation” (3 countries)

“Global compensation” ...more than 3 countries are involved. Compensator (hired person) .... conducts / co-ordinates the whole operation.

BARTERING is indirect exchange of goods & / or services between 2 parties without a cash transaction (in compare to buy – back it is prompt exchange) ... in buy - back operation the contraction goods are the same kind.

SWITCH is similar to reexport.

- currency conversion ...based on currency exchange where switcher is responsible only for currency conversion (not for goods)
- commodity switch – switcher takes responsibility for goods (payment, delivery, insurance,..). Buying for nonconvertible currency & selling into convertible currency what means paying to switcher in this currency.

Switch is a conversion of one currency to another one. In commodity switch, switcher is buying goods, paying & selling them again.

“Common switch”

SWAP is an agreement to sell a currency at a stated price & then purchase it as a stated price on a special future date, with the difference between the sale (spot price) & repurchase price (forward price) called the swap rate.
Swaps are mostly used among large banks, consortiums, etc.

AUCTION is a public place for buying & selling commodities (must be physically present) & offer a price ...... to those persons who offer the highest price.
Auctioneer – the person who conducts the auction.

EXCHANGE is place / organisation of individuals buying / selling securities (bonds, stocks / CP) to public. The securities express the right to own some property.

- commodity E
- stock E
- derivates E (options, futures, forwards)

Securities don't have to be necessarily present (in compare to auction).

LICENSING is selling the right to use some process, trademark, patent, selling product or other right for a fee or royalty (used mostly for producing companies).
Licensee = a person to whom official permission is given.
Licenser / licensor = a person giving the permission to a licensee.
In a licensing agreement one firm (the licensor) agrees to allow another firm (the licensee) to sell the licensor's product & use its brand name. In return, the licensee pays the licensor a commission or royalty.

FRANCHISING is employed mostly in service companies. It is longer term agreement than licensing.
A franchise is the right to use a business name & sell products or services in a specific geographical teritory. Franchiser is a system for the distribution of goods & / or services under a band name through outlets owned by independent businessmen called "franchisees".
Franchiser supplies the franchisee with know-how, training or band identification, the franchiser controls his activity - the distribution of his goods & / or services through a contract which regulates the activities of franchisees, in order to achieve standardisation in providing customers with services or production of products. It also provides capital for starting.
Crucial elements of a franchising:

a) a contractual agreement between the franchisee (person) & franchiser (company)
b) a branded good or service
c) operation by a business person for the ....
d) controlling – so that certain products & services are the same in all outlets

3. PREDNÁŠKA (26/2/2001)

1. PRECONDITIONS OF RISK OCCURANCE

It is indisputable, that every business organisation involved in selling on global market has to cope with differences in – financial, currency, tax, political system, culture, language, etc.
Domestic as well as foreign business organisation when evaluating trade operation follows the same reasoning through additional variables & risks are to be considered. Specifically, foreign projects must be evaluated for exchange risk, political risk, different financing cost & any problems associated with the transfer of products, services, or funds due to government controls in any of the relevant countries. In order to eliminate the possible foreign trade risks, it is necessary for all the parties involved in the foreign trade operation to get credible infos

about the trading countries (political situation, economic development, legislation, culture, geographical, demographic infos, as well as infos concerning their business partner – reliability, settlement of his financial liabilities in the past, etc.

Credible infos can be obtained from:

- specialised agencies (Dun & Bradstreet sells infos on companies concerning their credit history & financial infos)
- Chambers of Commerce
- banks, insurance companies, factoring or forfaiting comp.
- exchange & exchange indexes (as indicators of necessary infos on a country's economy development)
- publications issued by international organisations (Statistical yearbook of MMF, WTO, WBank)

Risks at FT are more complex & have higher intensity as in the past & are a subject to global development.

The problem of risks is rather broad & complex in the external economic relations. Nowadays the world economy is characterised by (factors):

a) exchange rate volatility, relative stability of the IMS (International Monetary System)
b) rather higher interest on loans & international credit that negatively influence debt & solvency of some countries
c) necessity for special solution (credit restructuralisation) of high debt rate of some less developed countries within some international grouping such as the Paris club & IMF
d) speculative & risky transactions on the world, regional & national financial markets that require additional emission of financial sources
e) speculations in trading with some commodities because of conjunctive fluctuation as to their supply & demand. As a result of this, world prices are changing, inflation is rising thus disturbing relative currency & financial stability

2 basic theories concerning economic stability:

- Keynessians argue that economic stability can be achieved by fiscal steps (orientation on interest rates)
- Monetarists (Friedman) say that monetary policy has more direct & complex impact upon the countries stability through the supply of money

2. CLASSIFICATION OF FT RISKS

3 main groups of risks:

I. **political**
II. **commercial**
III. **special**

2.1. POLITICAL RISKS

Political risks (war, strikes, unrests) can influence company value (increase / decrease) because of unexpected changes in external, political environment. Political risks include the risks that a government may alter its policies toward the firm or its products (e.g.through price control) thus lowering or raising profitability or asset values.

- **TRANSFER RISK** – importer has paid to his bank, but was prohibited (his payment cannot be either partly or fully transferred abroad since the importer's country doesn't allow this transfer due to economic & political reasons).
- **EXCHANGE RISK** – importer has already paid his bank but is not allowed to convert the payment to another foreign exchange / currency because of other state measures imposed by the importer's country or due to the lack of foreign exchange.
- **MORATORIUM** is a state measure when the paying & transfer of payment is not allowed on the claim's maturity, or the debt is only partially paid, or payment is postponed.

Macrorisk relate to all foreign business in a particular country (the changes in taxation or profit remittance rules that often occur in less developed countries generally apply to all the foreign firms in those countries)
Microrisk relates only to a group of enterprises / one firm (1974 – oil industry was nationalized)

<u>POLITICAL RISK MANAGEMENT - methods for dealing with political risk:</u>
- avoidance – by minimizing activities in or with countries that are perceived to be highly risky
- risk transfer – the company has 2 option to cover risk:

a) from its own funds
b) to transfer the possibility of occurring the risk to a 3rd party (insurance company / insurer) acting in compliance with conditions stated in the written contract (insurance agreement) between insurer & insured that has to pay fee "premium".
Most developed countries offer political risk insurance to their exporters & their direct investors.
USA – Eximbank, Overseas Private Investment Corporation offer policies to exporters that cover such political risks as war, civil unrest, currency inconvertibility.
UK – Export Credit Guarantee Department
Germany – Hermes
At the multilateral level – The World Bank operates a Multilateral Investment Guarantee Agency which offers insurance policies analogous to those of OPIC.

- adaptation of the firm's activities to reduce the risk. Just as assets in a country exposed to exchange risk can be hedged by incurring liabilities in the same currency, so assets exposed in a given country can be hedged with liabilities in the same country (by financing operation through local borrowing).
- diversification – spreading activity across national borders, so that problems in one country do not debilitate the firm. Then, if a strike or a war causes the firm to cease operations in one country, facilities in other countries will still allow it to remain in business.
If taxes are raised in one country, production or funds may be moved to another country to avoid extra costs. Diversification doesn't reduce the political risk in any given country. It just allows the firm to survive politically risky events by operating in other countries & reduces the overall risk.

2.2. COMMERCIAL RISKS

Commercial risks are the risks of unexpected changes in future cash-flows from foreign operations.

- **MARKET RISK** is the risk of finding or not finding suitable market or meeting consumers' requirements:
  - risk of selling = the possibility of an exporter taking loss due to an unsalable product
  - risk of buying = the danger to a buyer of not obtaining the required product (raw materials, spare parts, etc.)
  - price changing risk = possible changing of price terms (between signing the contract & delivering goods), changes in interest rates on capital markets.
- **RISK FROM NOT TAKING OVER** – either documents or the whole consignment won't be accepted by the importer (can happen in documentary collection)
- **TRANSPORT** – damage, loss, stolen goods, delays during transport to the country of destination (Incoterms)
- **GOODS RISK** – the possibility not to obtain goods, services or payments as mutually agreed in the contract owing to production or financial difficulties, delays in transportation or unreliability of the business partner
- **DUBIOUS RISK / DELCREDERE RISK** – when setting the rate of the risk of non-payment, such terms as goodwill, liquidity, CF are to be considered.
  There are 7 levels of as to goodwill – highest, high, above average, below average, low, lowest.

In dealing with this kind of risk, the short-term solvency or long-term solvency of a firm must be taken into account. To be able to understand the following ratios one must be familiar with a balance sheet of a firm.

A) BALANCE SHEET reflects the financial situation, indicates a firm's ability to pay its debts as they come due - it states the assets, liabilities & owner's equity of the firm.

Assets are resources owned by a business & used in its operations.
They are classified according to liquidity:

- fixed assets – land, building, machinery, vehicle, etc.
- current assets – cash, accounts receivable & inventory

Liabilities are amounts owed by a company to its creditors, including obligations to perform services in the future. Liabilities are listed in the order in which they fall due. Current L are debts the firm must repay within 1 year. long-term L are obligations such as bonds that have to be repaid in full more 1 year from the balance sheet date.

Owner's equity shows the claims of the owners (proprietor, partners or shareholders) on the firm's assets.

The retained earnings accounts shows the total of all profits not distributed to shareholders as dividends – retained earnings are reinvested profits.

B) SHORT-TERM SOLVENCY = liquidity measures

Short-term solvency ratios as a group are intended to provide information about a firm's liquidity, and these ratios are sometimes called liquidity measures. The primary concern is the firm's ability to pay its bill over the short run without undue stress.

- **Current ratio** – one of the best known & most widely used ratios

To a creditor, particularly a short-term creditor such as a supplier, the higher the current ratio, the better. To the firm, a high current ratio indicates liquidity.

- **Quick ratio** – inventory is often the least liquid current asset. It is relatively illiquid compared to cash.

- **Cash ratio** – every short term creditor might be interested in cash ratio.

C) LONG-TERM SOLVENCY MEASURES

- **Total debt ratio** – takes into account all debts of all maturities to all creditors.

- **Long-term debt ratio**

The total long-term debt & equity is sometimes called the firm's total capitalization, & the financial manager will frequently focus on this quantity rather than total assets.

D) TURNOVER MEASURES

- **Inventory turnover**

- **Daily sale in inventory**

Total asset turnover expresses the amount for every dollar in assets, how much we generate in sales.

- **Return on assets**

- **Return on equity**

4. PREDNÁŠKA (5/3/2001)

2.3. SPECIAL RISKS

- **EXCHANGE RATE RISK**

International operations are increasingly important to all businesses. Consequently, the exchange rates & exchange rate volatility have also become increasingly important. The reason for the increase in exchange rate volatility is breakdown of the so/called Bretton Woods accord. Under the Bretton Woods system, exchange rates were fixed for the most part & significant changes occurred only rarely. As a result, importers & exporters could predict with relative certainty what exchange rates were likely to be in the future. In today's post-Bretton Woods era, exchange rates are set by market forces, and the future exchange rates are very difficult to predict with precision. The rate which one country's currency is exchanged for that of another country is called the exchange rate. Exchange rate risk is the natural consequence of international operations in world where relative currency values move up & down. Managing exchange rate risk is an important part of international finance.

For common commercial transactions there are three basic decisive factors influencing the exchange rate risks:

- the time of payment
- currency of invoicing
- currency of payment

In fact, firms invoicing & paying in convertible currency assume a different approach to the intensity of exchange rate risks:

- some of them assume a purposeful speculative attitude trying to earn maximum profit from exchange rate fluctuation
- some are looking for precautious strategy toward exchange rate risks
- some assume a passive attitude being satisfied with expected maturity & then when collecting payment earn profit or take loss.

There are two different types of exchange rate risk or exposure:

1. SHORT RUN EXPOSURE – the day-to-day fluctuations in exchange rates create short run risks for international firms.
2. LONG RUN EXPOSURE – in the long run, the value of a foreign operation can fluctuate because of unanticipated changes in relative economic conditions. Hedging long run exposure is more difficult than hedging short term risks. A firm selling in a foreign country can reduce its long run exchange risk concentrating its raw material purchases & labor expenses in that country. That way, the SKK value will move up & down together. Similarly, a firm can reduce its long run exchange risk by borrowing in the foreign country. Exchange rate risk is a very real concern for financial managers, whether or not their firms are directly involved in international business. The fact that the prices of imported products & services often vary with the exchange rate means that a local firm's costs may depend on the exchange rate. Similarly, if any of the firm's sales are exported, its earnings may vary as foreign sales change due to exchange rate changes.

There are various techniques & instruments at exporter's & importer's disposal such as:

- price adjustment (setting the price in a stable currency of a third country, or SDR, EURo)
- insurance of exchange rate risk on partner's account
- currency – insurance clause, exchange rate clause, valorization clause, currency clause
- hedging with options, forward & futures

Hedging exchange rate risk with options

There are futures options available on foreign currencies as well as commodities. Firms with significant exposure to exchange rate risk will frequently purchase put options to protect against adverse exchange rate changes.

An option contract is an agreement that gives the owner the right, but not the obligation, to buy or sell (depending on the option type) some asset at a specified price for a specified time. Options come in two flavours, put & call options. The owner of a call option has the right, but not the obligation, to buy an underlying asset at a fixed price, called the strike price or exercise price, for a specified time. The owner of a put option has the right, but not the obligation, to sell an underlying asset at a fixed price for a specified time. The act of buying or selling the underlying asset using option contract is called exercising the option. Some options (American options) can be exercised anytime up to & including the expiration date (the last day), other options (European) can only be exercised on the expiration date. Because the buyer of a call option has the right to buy the underlying asset by paying the strike price, the seller of a call option is obliged to deliver the asset & accept the strike price if option is exercised. Similarly, the buyer of the put option has the right to sell the underlying asset & receive the strike price. In this case, the seller of the put option must accept the asset & pay the strike price.

Hedging exchange rate risk with forward

A forward trade is an agreement to exchange currency at some time in the future. The exchange rate that will be used is agreed upon today & is called the forward exchange rate. A forward trade will normally be settled sometimes in the next 12 months.

E.g. The spot exchange rate for SKK is 40 equals USD. The 180-day forward exchange rate is 40 SKK equals 0,997 at that time. Notice, that SKK is less expensive in the future then it is today, it is said to be selling at a discount relative to the dollar. For the same reason, the dollar is said to be selling at a premium relative to SKK. Why does a forward market exist? One answer is that it allows businesses & individuals to lock in future exchange rate today, thereby eliminating any risk from unfavorable shifts in the exchange rate.

Hedging exchange rate risk with futures

A futures contract is exactly the same as a forward contract with one exception. With a forward contract, the buyer & seller only realise gains or loses on the settlement date. With a futures contract, gains & loses are realised on a daily basis. If a futures contract is bought on oil, then, if oil prices rise today, there is a profit for the buyer & a loss for the seller of the contract. The seller pays up, & it starts again tomorrow with neither party owing the other. The daily resettlement feature found in future contracts is called market-to-market.

Hedging exchange rate risk with conversion

Conversion is a simple currency exchange.

Hedging exchange rate risk with arbitrage

Foreign exchange arbitrage involves simultaneous contracting in two or more foreign exchange markets to buy & sell foreign currency, profiting from exchange rate differences. Foreign exchange arbitrage may be two-way, three-way, or intertemporal. and it is generally undertaken by large commercial banks that can exchange large quantities of money to exploit small rate differentials.

- **LEGISLATIVE RISK**

The basic problem is, law of which country should be applied in international relations? These questions should be discussed before putting one's signature to a contract of purchase.

- **RISK OF NATURAL OR TECHNICAL DISASTERS**

These risks are hard to predict. The threat of technical disasters is growing with the progress achieved in science & technology.

3. RISK MANAGEMENT

The environment of modern business, particularly the large industrial unit, is becoming increasingly complex. Most large corporations & many smaller ones employ specialized managers to grapple with the problems of increased risk. They are called RISK MANAGERS or INSURANCE MANAGERS, being important members of the top management team in may companies.
RISK MANAGEMENT is the executive function of planning, organizing & controlling those activities in the firm dealing with specified types of risk.
E.g. The risk manager may be called upon to examine the risk aspects when the firm is planning a merger with another corporation or is planning to build a new factory. At first, the dapartment manager was usually known as the insurance buyer. Later the title was changed to insurance manager or risk manager.

FUNCTIONS OF RISK MANAGEMENT
In general, the functions of the risk manager include the following:
1. to recognize & identify exposures to loss. This is a fundamental duty that must precede all other functions.
2. to estimate the frequency & size of loss, that is, to estimate the probability of loss from various sources.
3. to decide the best & most economical method of handling the risk of loss by e.g. assumption, avoidance, self insurance, transfer, commercial insurance or soem combination of these methods.
4. to administer the programs of risk management, including the tasks of constant reevaluation of the programs, record keeping, etc.
5. to review & evaluate the risk management program on the regular basis.

Risk might be insured only if likeness of the loss may be calculated.

<u>BASIC INSURANCE TYPES:</u>
1. **CARGO** (transport insurance)
    - insurance of foreign goods transport
    - subsidiary insurance (Incoterms)
    - forwarding insurance
    - FPA (Free of Particular Average), WPA (With particular Average), AAR (Against All Risks) insurance
    - marine insurance
    - insurance of a ship charterer
2. **CASCO** (insurance of transport facilities) depends upon
    - type of transport facilities (sea vesels, river boats, ...)
    - special types of insurance (AAR insurance)
3. **INSURANCE OF RESPONSIBILITY TO 3rd PARTY**

Liability insurance (insurance of responsibility) covers losses resulting from injury to another individual or from damage to other people's property (charterer's responsibility, carrier's & shipper's responsibility, responsibility for a low quality performance)

4. **INSURANCE OF PRODUCT LIABILITY** protects against claims for damages resulting from the use of a company's products. To stay competitive & successful, business must be inovative, yet inovative items are the ones most susceptible to liability claims
    - insurance against damage caused by usage of poor quality products
    - liability insurance of additional damages toward a 3rd party caused by products & installation
5. **INVESTMENT INSURANCE**
6. **INSURANCE OF EXPOSITION & TRADE FAIR**
    - insurance of delivery & storage of exhibits
    - insurance of exhibits installation
    - insurance against abstraction of exported exhibits
7. **INSURANCE OF NON-PAYMENT** is protection against some losses from insolvency of customers to whom they have delivered goods or extended credit.
    - insurance of Documentary Collection
    - insurance against insolvency
    - insurance of export credit
    - insurance of political risks
    - insurance quarantees for export credits
8. **INSURANCE OF EXCHANGE RATE RISK**

INSURANCE OF SLOVAK FOREIGN TRADE – EXIMBANK playes an important role in insuring commercial credits. At present, it covers political, economic risks, provides the banks with quarantee in case of insolvency of foreign importer.

- offers global insurance of short term export contracts against commercial risks,
- offers insurance of short term export contracts against political risks,
- offers insurance of medium & long term export contracts against political & commercial risks,
- offers insurance of medium & long term loans against political & commercial risks.

Pure risk – threat of loss, no profit (disasters)

PAYMENT & SETTLEMENT IN INTERNATIONAL TRADE

1. **Payment & Settlement**
2. **Clean Payments**
3. **Documentary Payments**
4. **SWIFT**

One of many preconditions to stimulate the dynamic development of the enterpreneurial sector in Slovakia and in the rest of the world alike are the available banking services. An effective banking system might serve as a motivation for enterpreneurial subjects to continue or engage in the business activities and to exploit services offered and provided by banks.

At present, banks are cognizant of the fact that only prompt and reliable realization of every payment transaction is decisive for keeping up and getting new clients.
Payment & Settlement is a system organized by banks & financial institutions that enables the cash & non-cash financial transfers among subjects of economic life – legal entities, physical entities. It comprises different instruments for performing financial transactions resulting from foreign trade exchange.
Payment & Settlement is characterized by:

a) **its types**
b) **its technique**
c) **its forms**
d) **its means of payment**

TYPES – nowadays, there are **2 basic types of Payment & Settlement – contracting & non-contracting.**
With contracting payment system, the way of its carrying out is defined by international, inter-bank & other agreements, or obligatory arrangements whereas the non-contracting type is not determined by any agreements or arrangements international or inter-bank alike. Financial transactions are realized in free convertible currency.
TECHNIQUE – international Payment & Settlement technique are **the rules necessary for carrying out the payment process** (e.g. orders for money transfer, Letter of Credit issuing, Documentary Collection issuing etc.). In addition to it, ways for sending messages & inter-bank communication also belong to the technique of Payment & Settlement.
FORMS are **methodical &technical payment arrangements used with given method of payment.** There are **Documentary & Clean Payments.**
MEANS OF PAYMENT – their movement is **the basis of the IPS**. They are used to settle the accounts receivable & accounts payable.
Means of payment:

- gold
- free convertible currency
- clearing currency
- foreign exchanges & currencies / SFR
- artificial currency
- forms of different special trade transactions (countertrade, etc.)

According to the means of payment – 2 forms of payment – cash & non-cash:
CASH PAYMENT is exceptional. It is carried out by gold or foreign currency transfer in its paper or coin form.
NON-CASH PAYMENT is based upon a world-wide networks of correspondent banks holding vostro & loro accounts (SR – vostro of the Slovak bank & loro of the foreign bank).

METHODS OF PAYMENT IN INTERNATIONAL TRADE

Before looking at the different types of payment methods in International trade let's examine the factors which influence the decision of a buyer & exporter to prefer one method over another.

1. Sometimes the domestic regulations in one or other of the countries involved will dictate that a particular method must be used.
2. The most influential factor is the degree of trust which exists between the principals in the transaction, since different methods of settlement provide correspondingly different degrees of protection to the interest of one nor the other of them.

TERMS OF PAYMENT: In addition to the terms of agreement that appear in contract, the ways in which a buyer will pay for the goods or services received, must be also stated in the contract. It expresses the time, place, payment method for paying the price.

- TIME – price can be paid:
    - after shipment
    - in advance
    - with accepting documents or goods
- PLACE – banks & banks accounts the price is to be paid at.
- PAYMENT METHOD / WAYS for paying the price – Documentary or Clean payments.

Documentary payments involve Documentary Letter of Credit & Documentary Collection. To carry out the Documentary payments, a substantial amount of documents are required. The Documentary payments are at present used with overseas & previous socialist countries. Within the economic & monetary unions, trade with goods, services & capital export are carried out by clean payments. About 85% of world's trade is performed by clean payments.

Clean payments involve Bill of Exchange (Draft), check, bank transfer. Clean payments are used in situation where the level of trust between trading partners is high. The sellers are in no doubt that they will receive payment when due, and the buyers are confident that the goods, when received, will be correct 7 of any dispute will be replaced or taken back & the money refunded without question.
Clean payments – single & quick

PAYMENT ORDER – items of the payment order!

<u>PAYMENT ON OPEN ACCOUNT</u>
In domestic sales transaction, potential buyers can easily satisfy themselves as to the quality of goods, either by physical examination of them before purchase or by reliance upon the reputation of the seller. In international trade, however, the limitations of geography generally prevent such a mutually desirable situation from being possible. Physical examination of goods is expensive & inconvenient, & in any case is rarely a guarantee that those will be the goods which actually arrive. It can of course, be delegated to an agent, but there is often the difficulty in identifying a suitable person in another country to fulfil this role. OPEN ACCOUNT is used:

- when buyers or sellers have been dealing together for a long time & have developed the kind of relationship which engenders absolute trust,
- or buyers or sellers are constituent parts of the same international group.

Like any other trade account, it is an agreement whereby goods up to an agreed limit can be ordered & will be dispatched, settlement being made by means of a single payment at an agreed time to cover all goods for which invoice/s/ have been received from the seller. The sellers are in no doubt that they will receive payment when due, & the buyers are confident that the goods when received, will be correct & of the quality required, or in the case of any dispute will be replaced or taken back & the money refunded without question. However strong the relationship, where an open account system of settlement is in use there is no excuse for complacency in either party, since the potential risk is obviously high. Changes in market conditions or ownership, political or economic developments – any of these can effect the underlying basis for the trust which gave rise to the relationship. International traders have to be in touch with the world situation & to be capable of assessing the likely effects of developments on their own business. If for instance, suppliers in Canada export to a manufacturer in West Germany whole principal market place for the finished product is in

Turkey, then any events in Turkey may effect the German's ability to meet their obligations to Canada. The fullest financial information on the strength of a trading partner should therefore be obtained & regularly updated.
OPEN ACCOUNT is a credit instrument. In this case, the only formal instrument of credit is the invoice which is sent with the shipment of goods & which the customer signs as evidence that goods have been received.

PAYMENT IN ADVANCE
This is also situation where the level of trust between trading partners is high. It is also a credit instrument for an exporter. The use of cash in advance in international trade as a method of settlement is relatively rare. Sometimes small percentages are payable in advance under major capital contracts. Obviously, under this system of settlement the sellers are under no risk whatever, the buyers, however, must have absolute trust in the sellers.

BILL OF EXCHANGE – draft
If immediate payment on the draft is required, it is called a SIGH DRAFT. If immediate payment is not required, then the draft is a TIME DRAFT.
With a bill, the creditor (drawer), can order the customer (debtor / drawee), to pay a stated sum on presentation, or at a future specified date, to the creditor's order (the payee), to the order of someone else (a payee) or to the bearer (also a payee). A clean bill is made payable to a bearer when no particular payee is named. For the drawee, a bill is a bill payable, while for the payee it is a bill receivable. When a debtor (drawee) is presented with a bill, he may accept or refuse it. If he accepts, he writes "accepted" & signs across the face of the bill. The holder of the accepted bill (payee) may keep it until it matures or endorse it to someone else (endorsee) by signing on the back of the bill. He is the endorser. This transfers the property to the endorsee. If the debtor does not accept the bill presented to him, or does not pay after previously accepting, then the drawer can initiate legal action. He begins by making a declaration in writing, stamped by a notary, protesting against all parties for loss or damage by non-acceptance or non-payment of the bill. When the draft is presented & the buyer accepts it, meaning that the buyer promises to pay it in the future, then it is called a TRADE ACCEPTANCE & is sent back to the selling firm. If a bank accepts the draft, meaning that the bank is guaranteeing payment, then the draft becomes a BANKER'S ACCEPTANCE. Banker's acceptances are traded in the money market. Both sight & time drafts accompanied by instructions & other documents are called DOCUMENTARY DRAFTS.

Paying by draft:

1. **BANK GUARANTEE**
2. **NEW FORMS FOR FINANCING FT**
3. **FACTORING**
4. **FORFEITING**
5. **LEASING**
6. **SUPPLIER CREDIT**
7. **BUYER CREDIT**

<u>70 – 80s of the 20th century</u>
70s were marked by brakedown of Bretton-Woods system → creating floating currency, exchange-rate unstability, share of finished products grows faster than raw materials, penetration of Asia foreign markets, etc.
The political as well as commercial risks have substantially increased.
80s – huge dead crisis
Because the common (old) forms for financing the foreign trade were to a certain extent insufficient to the present unstable development there were new forms for foreign trade financing.

OLD FORMS – bank loans, bill of exchange, documentary payments (DC, L/C), buyer credit, supplier credit
NEW FORMS – factoring, forfeiting, leasing

These types enables exporter to obtain cash immediately & importers to obtain credit. There are short-term, medium-term & long-term forms for trade financing.
SHORT-TERM FORMS:
- short-term bank loans OLD
- drafts (discount, rediscount) OLD
- documentary payments (DC, L/C) OLD
- export factoring NEW

MEDIUM-TERM & LONG-TERM FORMS:
- suppliers credit
- forfeiting
- customer's (buyer's) credit
- leasing
- consortium banking loans
- state guarantee or subsidiaries
- special forms (countertrade, compensation, etc.)

There are 2 forms of **CREDIT**, the <u>private</u> & the <u>state</u> credit. The PRIVATE CREDITS are not so advantageous as the state ones, for:
- the credit currency faces the exchange rate risks
- floating interest rates
- evaluation of financial ability of an applicant
- evaluation of economic-political factors of a country where the applicant for a credit has his seat

OECD CONSENSUS (1976) is replaced by EXPORT CREDIT ARRANGEMENT (1978). Most of the OECD Member countries (Australia, Canada, The European Community including all 15 Member states, Japan, New Zealand, Norway, Switzerland & USA) agreed upon the settlement (unification of conditions for export credits) developed (guaranteed & subsidized) in the framework of the OECD (governmental authorities) called "The Export Credit Arrangements".
Arrangement specifies / involves the following conditions:

a) **minimum cash-down payment required by importer** (15% of export price in advance) – when granting officialy supported loans tha A is 15% from the contract value that has to be paid in advance
b) **repayment period** (maturity of loan) – countries are divided into 2 groups – tha maximum repayment terms are 5 years for **Category 1** countries & 10 years for **Category 2** countries. Countries are classified under 2 categories based on World Bank thereshold – those that are graduated by The IBRD /GNP p.c. 5 055$ based on 1994 data/ are Category 1 & Category 2 consits of all other countries.
c) **minimum interest rate** (advantageous interest rate stated according to the country classification). Minimum interest rates that may be supported by the Participants ...re Commercial Interest Reference Rates (CIRRS). For each currency a CIRR is ...vailable. Member countries select the basis for their own CIRR. CIRRs are adjusted monthly & intended to reflect "fine" commercial rates in the domestic market of the currency.
d) **concessional financing / Tied Aid Credits** (goods & services being realized from a granted loan). Tied aid is an aid which is tied to the purchase of goods &/or services from the donor country.

FACTORING

For financing the period between the shipment of the merchandise & payment by the importer, an exporter may turn to a factoring company, or a factor. A factor will buy the exporter's receivables at a discount & assume the risk of non-payment by the importer, as well as the right to payment of the receivables. Factoring was initially applied in the field of consumer goods industries & food industry. Later it penetrated into other branches as well.
FACTORING *is a contractual arrangement between the exporter & the factor. The factor agrees to buy all export accounts receivable from the exporter at a specified discount & to assume all of the responsibility for collecting from the importer. The factor also charges a fee for performing this service.*

Factoring Commission – fee

Recourse Factoring Agreement is an agreement between the factoring company & supplier when factoring is performed on a recourse basis. In this case the factor does not assume any risk against non-payment of invoices & the seller is responsible for its enforcement.
Non-Recourse Factoring Agreement is an agreement between the factoring company & supplier when factoring is performed on non-recourse basis. In this case the factor assumes the risk against non-payment of invoices through customer insolvency.

The choice to an exporter between use of a factor & the use of a bank as intermediary in the export-import transaction depends on:

1. the cost of using each intermediary (intermediaries' services)
2. the amount of business being committed
3. the flexibility of desired

Factoring offers to an exporter different services (e.g. estimation & covering of credit risk, collection of account receivables, financing). Exporters usually apply to factors if short-term trade financing forms are impossible or not suitable. Factoring provides an exporter with financing & credit.

Factoring proceeds as follows:

1. exporter supplies his goods/services to importer & invoices them
2. exporter sells his account receivables (invoice) to a factor
3. factor collects the invoices from a debtor (buyer, importer) with the risk of non-payment

Factoring fulfils following **functions**:

a) financing
b) offering services
c) delcredere, insurance

The basic function is financing, since the factor pays the receivables to his client (exporter) before it is payable (the maturity). There are 2 basic **types of financing**: