THIRD EDITION

EXPORT-IMPORT THEORY, PRACTICES, AND PROCEDURES

BELAY SEYOUM

Export-Import Theory, Practices, and Procedures

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Belay Seyoum is Professor of International Business Studies at Nova Southeastern University in Fort Lauderdale, Florida, where he teaches a variety of courses in international business and economics. Prior to coming to Nova Southeastern, Dr. Seyoum taught international business at Concordia University and at McGill University, in Montreal, Canada. Dr. Seyoum has published two books, as well as numerous articles in the area of international trade in several prestigious academic journals, such as the *International Business Review*, *Journal of World Trade*, the *International Trade Journal*, the *Journal of World Business*, and the *Journal of Global Business*.

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3rd Edition

BELAY SEYOUM

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Introduction
A Brief History of International Trade

Ancient Period

International trade based on the free exchange of goods started as early as 2500 BC. Archaeological discoveries indicate that the Sumerians of Northern Mesopotamia enjoyed great prosperity based on trade by sea in textiles and metals. The Greeks profited by the exchange of olive oil and wine for grain and metal somewhere before 2000 BC.

By around 340 BC, many devices of modern commerce had made their appearance in Greece and its distant settlements: banking and credit, insurance, trade treaties, and special diplomatic and other privileges.

With the decline of Greece, Rome became powerful and began to expand to the East. In the first century AD, the Romans traded with the Chinese along the Silk Road and developed many trade routes and complex trading patterns by sea. However, the absence of peace made traveling unsafe and discouraged the movement of goods, resulting in the loss of distant markets.

By the time of the breakup of the Roman Empire in the fifth century, the papacy (papal supremacy) had emerged as a strong institution in a new and unstable world. The Church's support (sponsorship) for the crusades (eleventh century) revived international trade in the West through the latter's discovery and introduction of new ideas, customs, and products from the East. New products such as carpets, furniture, sugar, and spices brought from Egypt, Syria, India, and China stimulated the markets and the growing commercial life of the West. This helped Italian cities such as Venice and Genoa to prosper and to replace Constantinople as the leading center of international commerce. Letters of credit and bills of exchange and insurance of goods in transit were extensively used to accommodate the growing commercial and financial needs of merchants and travelers.

By the end of the fifteenth century, the center of international commerce had moved from the Mediterranean to Western Europe. Spain, Portugal, and, later, Holland became the focal points of international commercial activity. The more developed areas of Europe were

changing from a subsistence economy to one relying heavily on imports paid by money or letters of credit.

Colonial Period (1500–1900)

With the discovery of America in 1492 and of sea routes to India in 1498, trade flourished, and luxury goods and food products such as sugar, tobacco, and coffee became readily available in the markets of Europe.

The principal motivations behind global expansion (colonization) in the fifteenth century had been to enhance national economic power (mercantilist policy) by exploiting the colonies for the exclusive benefit of the mother country. Colonies were regarded as outposts of the home economy that would reduce trade dependence on rival nations and augment national treasure through exports as well as discoveries of precious metals. This first phase of colonization, which lasted until the advent of the Industrial Revolution in England (1750), was characterized by the following general elements with respect to commerce:

1. All commerce between the colonies and the mother country was a national monopoly, meaning all merchandise exports/imports had to be carried by ships of the mother country and pass through specified ports.
2. Little encouragement was provided for the development or diversification of indigenous exports. For example, in 1600, precious metals constituted 90% of colonial exports to Spain. In the mid-1650s, British imports from its colonies were mainly concentrated in three primary products: sugar, tobacco, and furs. To protect domestic producers, competing colonial exports were restricted or subject to special duties. The patterns of economic relations were fashioned on the basis of dissimilarity, that is, noncompetitiveness of colonial and metropolitan production.
3. Certain enumerated products could be exported only to the mother country or another colony. The policy ensured a supply of strategic foodstuffs and raw materials.
4. Private companies in the metropolis received a charter from the government that granted them (i.e., the companies) a monopoly of trade in the colonies. In most cases, the charter also granted complete local administrative authority, ranging from the making of laws and administration of justice to the imposition of taxes. Examples of this include the British East India Company (1600), the Dutch West India Company (1621), and Hudson's Bay Company (1670).

The second historical phase of overseas expansion (1765–1900) was dictated more by commercial considerations than by the desire for mere territorial gains. Britain emerged as the dominant colonial power and by 1815 had transformed its empire into a worldwide business concern. By the 1860s, the Industrial Revolution had transformed the social and economic structure of England, and mass production dictated an expansion of the market for goods on an international scale. The political economy of mercantilism that had proliferated over the preceding century was gradually replaced by that of free trade. By 1860, Britain had unilaterally repealed the Corn Laws, abolished the Navigation Act restrictions (foreign ships were now permitted to take colonial goods anywhere), as well as the commercial monopolies given to particular companies. Preferential duties on empire goods were gradually abolished. In trade, as in foreign policy, Britain led the free trade ideology based on nondiscrimination.

At the time, Britain was most likely to benefit from free trade because of its industrial and commercial lead over other nations.

1900 to the Present

The major characteristics of economic relations from 1900 until the outbreak of World War I were the further development of trade and the emergence of a world economy. These were also the result of the international migration of people and capital from Europe, particularly Britain, beginning in the 1850s, to other countries such as the United States, Australia, Argentina, Brazil, and Canada. This pattern of world economy provided the industrial economies with new sources of food and raw materials and new markets for exports of manufactures. For example, by 1913, Brazil was the source of two thirds of German coffee imports, whereas North Africa supplied more than half of French imports of wine. However, much of the import trade in Europe was subject to trade restrictions, such as tariffs, to secure home markets for local producers. Even within Britain, there were mounting pressures for the abolition of free trade.

The post–World War I recovery was further delayed by the disruption of trading links, as new nations were created and borders were redrawn. State intervention and restrictive economic policies had been consolidated in Europe and other countries by the end of the war. The U.S. government introduced the Fordney-McCumber Tariff, which imposed high tariffs on agricultural imports, in 1922 and, later, in 1930, the Smoot-Hawley Tariff, which provoked widespread retaliation. Britain imposed high duties on various industrial products, such as precision instruments and synthetic organic chemicals, to encourage domestic production under the Safeguarding of Industries Act, 1921. The volume of world trade in manufactures fell by 35% between 1929 and 1932, and prices also fell by a similar amount. The volume of trade in primary products fell by 15%, but prices fell by about 50%. To alleviate the worst effects of the Depression, countries resorted to more protectionism. This wave of protectionism produced a massive contraction of international trade and further aggravated the Depression. Many of the barriers placed on trade included tariffs and quotas, a variety of price maintenance schemes, as well as arbitrary currency manipulation and foreign exchange controls and management.

To avoid a repetition of the economic situation of the previous two decades, Allied countries met even before the outbreak of World War II to discuss the international financial arrangements that should govern trade and capital movements in the postwar world. In 1944, they established the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The IMF was to be concerned with facilitating the growth and expansion of global trade through the system of fixed exchange rates, while IBRD was established to promote long-term investment. This was followed by an agreement (the General Agreement on Tariffs and Trade, or the GATT) in 1948 to permit the free flow of goods among nations.

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Section I

Overview of International Trade

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Growth and Direction of International Trade

International trade is the exchange of goods and services across national boundaries. It is the most traditional form of international business activity and has played a major role in shaping world history. It is also the first type of foreign business operation undertaken by most companies because importing or exporting requires the least commitment of and risk to the company's resources. For example, a company could produce for export by using its excess production capacity. This is an inexpensive way of testing a product's acceptance in the market before investing in foreign production facilities. A company could also use intermediaries, who will take on import-export functions for a fee, thus eliminating the need to commit additional resources to hire personnel or maintain a department to carry out foreign sales or purchases (Daniels, Radebaugh, and Sullivan, 2013).

The rate of growth in the dollar value of world merchandise exports in 2012 was two tenths of one percent (0.2 percent) mainly due to fiscal consolidation in the United States and the sovereign debt crisis in Europe. This contrasts with the stronger growth rates of 22 percent in 2010 and 20 percent in 2011. The slower growth in the dollar value of world trade compared to trade in volume terms (growth of 2.1 percent in 2012) (Tables 1.1 and 1.2) is explained by falling prices for traded goods. Some of the biggest price declines were recorded for commodities such as coffee (–22 percent), cotton (–42 percent), iron ore (–23 percent), and coal (–21 percent) (WTO, 2013). Meanwhile, world commercial services exports in 2012 were only 2 percent higher than in 2011 at $4.3 trillion. Commercial services accounted for roughly 19 percent of total world trade in 2012.

TABLE 1.1 Real GDP and Merchandise Trade Volume Growth by Region, 2010–2012 (annual % change)

	GDP (annual % change)			Exports (imports) (annual % change)		
	2010	**2011**	**2012**	**2010**	**2011**	**2012**
World	3.80	2.40	2.10	14.1 (13.6)	5.2 (5.1)	2.1 (1.9)
North America	2.60	2.00	2.30	15 (15.7)	6.60 (4.4)	4.5 (3.1)
South & Central America	6.20	4.30	2.60	5.2 (22.7)	6.1 (12)	1.4 (1.8)
European Union	2.10	1.50	–0.30	11.7 (9.1)	5.7 (2.4)	0.3 (–2.0)
Africa	4.50	0.70	9.30	5.4 (8.1)	–8.5 (4.5)	6.1 (11.3)
Middle East	4.90	5.20	3.30	7.5 (8.2)	5.5 (5.1)	1.2 (7.9)
Asia	6.70	3.30	3.80	22.7 (18.2)	6.4 (6.7)	2.8 (3.7)
United States	2.40	1.80	2.20	15.4 (14.8)	7.1 (3.8)	4.1 (2.8)
China	10.40	9.20	7.80	28.1 (22)	8.8 (8.8)	6.2 (3.6)
Japan	4.50	–0.60	1.90	27.5 (10.1)	–0.6 (4.3)	–0.1 (3.7)
India	10.10	7.90	5.20	25.70 (22.7)	15.0 (9.7)	–0.5 (7.2)

Source: WTO, 2013; http://www.wto.org/english/news_e/pres13_e/pr688_e.htm

TABLE 1.2 World Exports of Merchandise and Commercial Services (2005–2012) ($ billions and % change)

	Value	Annual % change (2010–12)			
	2012	**2010**	**2011**	**2012**	**2005–12**
Merchandise	**18,323**	**22**	**20**	**0**	**8**
Commercial services	**4,345**	**10**	**11**	**2**	**8**
Transport services	885	16	9	2	7
Travel services	1,105	9	12	4	7
Other commercial services	2,350	8	12	1	10
Goods and commercial services	**22,520**	**19**	**18**	**1**	**8**

Source: WTO (2013)

Importance of International Trade to the Global Economy

International trade allows manufacturers and distributors to seek out products and services produced in foreign countries. Companies acquire them because of cost advantages or in order to learn about advanced technical methods used abroad, for example, methods that help reduce the cost of production, lower prices, and in turn, induce more consumption, thus producing increased profit. Trade also enables firms to acquire resources that are not available at home. Besides providing consumers with a variety of goods and services, international trade increases incomes and employment. In 2012, the number of U.S. jobs supported

by exports ($2.2 trillion) to all foreign markets reached 9.8 million. Many studies show the positive role of international trade in raising employment and wages.

- Case studies reviewing the experience of the twelve most rapidly growing countries over the past sixty years shows the important contribution of trade in raising employment and incomes (OECD, 2012).
- A survey of 3,032 small and medium-size manufacturing enterprises in Canada over a three-year period (1994–1997) strongly indicates that growth in exports is associated with an increase in jobs (Lefebvre and Lefebvre, 2000).

Even though imports are associated with loss of jobs due to plant closings or production cutbacks of domestic industries, the export-job-generation effect is about 7.5 percent larger than the import-job-loss effect (Belous and Wyckoff, 1987). Most occupations show a net job gain from an equal amount of exports and imports except for blue-collar occupations, which are shrinking in most developed countries due to increasing pressure from low-wage imports.

Exports create high-wage employment. Exporters in the United States, for example, on average pay wages that are some 6 percent higher than nonexporters (Bernard, Jensen, Redding, and Schott, 2007). Imports are also found to have a strong positive effect on wages through their positive effects on productivity. A study led by the Organization for Economic Cooperation and Development (OECD) that looked at a broad sample of countries (1970–2000) shows that workers in the manufacturing sector in open economies benefited from pay rates that were between three and nine times greater than those in closed economies (depending on the region) (Flanagan and Khor, 2012). Another study on wages and trade also finds a strong positive correlation between export intensity and wages. This could be partly explained by the fact that export-intensive sectors tend to show higher levels of productivity than other sectors. It is also consistent with economic theory, which states that industries in which a nation enjoys comparative advantage are likely to be those where workers are more productive and therefore receive higher wages. It also shows that greater import penetration is associated with greater demand elasticity, which reduces workers' bargaining power (Harless, 2006).

Determinants of Trade

Why do some countries export or import more than others? Several studies have been conducted to establish major factors that influence exports. The trade and exchange-rate regime (import tariffs, quotas, and exchange rates), presence of an entrepreneurial class, and efficiency-enhancing government policy, as well as secure access to transport (and reasonable transport costs) and marketing services are considered to be important influential factors of export behavior (Fugazza, 2004; Kaynak and Kothavi,1984). A study on the nature, composition, and determinants of Singapore's technology exports suggests that the country's open trade and investment regime and development-oriented economic policy have been the key factors in enhancing the country's exports. Singapore's economy has shown continued and remarkable growth in exports for more than thirty years, with only two brief and mild recessions in the mid-1970s and mid-1980s. Its total trade as a proportion of GDP remains one of the highest in the world, approximately 416 percent in 2012 (WTO, 2013). A recent study on

the determinants of export performance underlines the importance of foreign direct investment (FDI) and the general quality of the institutional framework. FDI contributes to capital formation and helps promote the development and export of knowledge-based industries (Fugazza, 2004).

Much of the research literature on imports underlines the importance of high per capita incomes, price of imports, and the exchange rate in determining import levels (Lutz, 1994). For developing countries, however, determinants of import demand also include factors such as government restrictions on imports and availability of foreign exchange. A study examining the factors influencing import demand in Pakistan from 1959 to 1986 found that the policy of devaluation and raising tariffs was not significant in reducing imports except in the case of imports of machinery and equipment (Sarmand, 1989).

Volume and Direction of Trade

In 1990, the world reached a milestone when the volume of international trade in goods and services measured in current dollars surpassed $4 trillion. By 2012, the volume of exports of goods and services was more than four times the 1990 levels, approaching $19 trillion. The dollar value of total world trade in 2012 was greater than the gross national product of every nation in the world including the United States. Another measure of the significance of world trade is that one fourth of everything grown or made in the world is now exported.

The rapid increase in the growth of world trade after World War II can be traced to increased consumption of goods and services as more people joined the middle class in many countries of the world. Trade liberalization, at both the regional and the international level, has created a global environment that is conducive to the growth and expansion of world trade. New technologies such as computers, telecommunications, and other media also assisted in the physical integration of world markets.

Small countries tend to be more dependent on international trade than larger ones because they are less able to produce all that they need. Larger countries (in terms of population) import fewer manufactured goods on a per capita basis because such countries tend to have a diversified economy that enables them to produce most of their own needs. This is exemplified by the case of the United States, Japan, India, and China, which have low import propensities compared to countries such as Belgium or the Netherlands.

Merchandise trade currently accounts for about four fifths of world trade. The top 10 exporters accounted for just over one half of world merchandise exports (China, United States, Germany, Japan, Netherlands, France, South Korea, Italy, Russia, and Belgium) (Table 1.3). Merchandise trade includes three major sectors: agriculture, mining, and manufactures. Trade in manufactured goods has been the most dynamic component of world merchandise trade. In 2012, the value of world merchandise exports was estimated at $18 trillion (U.S.) compared to that of $4 trillion (U.S.) for services (WTO, 2013).

Industrial market economies account for the largest part of world trade. Trade among these countries is estimated to be approximately 52 percent of global merchandise trade. Over the past few decades, one observes shifting patterns of trade as evidenced by a steady growth in the role of developing countries especially that of emerging economies and increasing levels of trade among developing nations.

TABLE 1.3 Leading Exporters and Importers of Merchandise and Commercial Services, 2011 ($ billions)

Merchandise exporters		Merchandise importers		Service exporters		Service importers	
	Value		Value		Value		Value
China	1898	United States	2266	Untied States	581	United States	395
United States	1480	China	1743	United Kingdom	274	Germany	289
Germany	1472	Germany	1254	Germany	253	China	237
Japan	823	Japan	855	China	182	United Kingdom	170
Netherlands	661	France	714	France	167	Japan	166
France	596	United Kingdom	638	Japan	142	France	143
South Korea	555	Netherlands	599	Spain	140	India	124
Italy	523	Italy	557	India	137	Netherlands	118
Russia	522	South Korea	524	Netherlands	134	Ireland	114
Belgium	477	Hong Kong	511	Singapore	129	Italy	114

Source: WTO, 2012

Important Developments in Trade

Multilateral and Regional Trade Agreements

- After the implementation of the Uruguay Round, members of the World Trade Organization (WTO) launched a subsequent round in Doha, Qatar, in 2001 to further reduce trade barriers. The focus of this round has been on the reduction of trade-distorting agricultural subsidies provided by developed countries and the introduction of equitable trade rules for developing nations. The negotiations are at a complete stalemate with no prospect of success in spite of considerable progress on specific issues. In a multipolar world, there are a number of power centers and a proliferation of national interests that erode international consensus across many areas. This is going to impede the development of international trade rules and standards and undermine the role of the WTO as a forum for trade negotiations.
- The current irreconcilable deadlock in the Doha Round has provided additional motivation for countries to engage in bilateral and regional trade agreements. Bilateral and regional agreements require less time to negotiate and provide opportunities for deeper trade policy integration. The United States, for example, has recently launched trade agreements with Asia and European countries (the Trans-Pacific partnership for Asia and the Transatlantic Trade and Investment Partnership with Europe). Many developing countries also perceive such agreements to be the most feasible means for gaining market access as the prospects for completing the Doha negotiations seem more remote. The share of trade among bilateral and regional trade partners is likely to grow in the next few decades.
- Many scholars believe that such bilateral/regional agreements are inferior to the multilateral, nondiscriminatory approach of the WTO. Bilateral/regional trade arrangements

discriminate against nonmembers and create a maze of trade barriers that vary for every exporting country: rules of origin, tariff schedules, nontariff barriers such as quotas, and so on. There are concerns that such agreements also work in favor of powerful nations that will sneak in reverse preferences such as protection of intellectual property rights or labor standards.

Global Trade Imbalances

- The U.S. current account deficit reached 5 percent of GDP in the last quarter of 2012. Imports exceed exports by about $780 billion (2012). At the same time, the East Asian economies (including Japan) held about $6.1 trillion (U.S.) in official foreign exchange reserves out of a global total of $9.2 trillion in 2012. China's foreign currency reserves alone was estimated at $3.31 trillion (U.S.) by the end of 2012. The Southeast Asian countries' heavy reliance on exports as a way of sustaining domestic economic growth, weak currencies, and high savings rates has resulted in unsustainable global imbalances. Global imbalances cannot diminish without, inter alia, reducing such excess savings through currency adjustments and/or increased imports in the surplus countries.
- Export-led growth in surplus countries feeds (and is dependent on) debt-led growth in deficit countries. It is impossible for all countries to run surpluses, just as it is impossible for all to run deficits. A country's trade balance is a reflection of what it spends minus what it produces. In surplus countries, income exceeds their spending, so they lend the difference to countries where spending exceeds income, accumulating international assets in the process. Deficit countries are the flip side of this. They spend more than their income, borrowing from surplus countries to cover the difference, in the process accumulating international liabilities or debts.
- So long as trade deficits remain modest and economies invest the corresponding capital inflows in ways that boost productivity growth, such imbalances are sustainable. But the imbalances we see today are of a different character. First, they are much bigger. The most egregious is that between China and the United States, where China is running a huge trade surplus with the United States ($334 billion in 2012). Many of the other imbalances are between countries of broadly similar levels of economic development, such as those between members of the euro zone or that between Japan and the United States.
- Trade imbalances lead to destabilizing capital flows between economies. For example, the global financial crises of 2007 and the subsequent euro-zone crisis were basically the result of capital flows between countries. Overleveraged banks amplified the problem, but the underlying cause was outflows of capital from economies with excess savings in search of higher returns. The deficit countries that attracted large-scale capital inflows struggled to find productive uses for them: rather than boosting productivity, the inflows pumped up asset prices and encouraged excessive household borrowing.

Developing Countries in World Trade

- There has been a steady growth in the role of developing countries in world trade. Between 1995 and 2011, the share of developed nations (value share) in world merchandise trade declined from 69 to 52 percent while that of developing nations increased

from 29 percent to 48 percent. Over this period, China's share alone increased from 2.6 percent to 11 percent. The share of Latin America and the Caribbean also increased from 4.5 percent to 6.2 percent.

- China joined the WTO in 2001. Within three years, its exports doubled, and the country is now the world's largest merchandise exporter ($1.9 trillion in 2011) and second largest importer of goods ($1.74 trillion in 2011).
- Only a few developing nations have managed to climb up the value chain and diversify their export base to cater to the expanding global market. About 83 percent of the increase in the share of developing countries' total trade (1995–2010) accrued to a small number of emerging economies: the BRICs (Brazil, Russia, India, and China), Mexico, and South Korea. India, China, and South Korea accounted for about one third of world exports and about two thirds of developing-country exports in 2011.
- Such shifting patterns of trade and the increased demand for primary commodities from rapidly growing economies have strengthened South-South (trade among developing countries) trade and economic cooperation. South-South trade increased at a rate of 14 percent per year (1995–2010) compared to the world average of 9 percent. During the same period, merchandise exports from the developing countries to the developed nations increased by 10 percent per year.

Transportation and Security

- About 60 percent (by value) of total world merchandise trade is carried by sea. In volume terms, 75 percent of world merchandise trade is carried by sea, whereas 16 percent is by rail and road (9 percent by pipeline and 0.3 percent by air). Increases in fuel prices could act as a disincentive to exports by raising transportation costs. In air transportation (which is more fuel sensitive than shipping), rising oil prices could severely damage trade in time-sensitive products such as fruits and vegetables and parts in just-in-time production. Faster economic growth in emerging economies is also putting pressure on the limited supply of other raw materials such as copper and coal.
- World air cargo traffic has grown during the past decade due to increased trade in high-value-low-weight cargo, globalization, and associated just-in-time production and distribution systems.
- In light of increasing threats of terrorism, countries have put in place procedures to screen cargo across the entire supply chain. There is an overall attempt to facilitate international trade without compromising national security.

Chapter Summary

Major benefits of international trade	To acquire a variety of goods and services, to reduce cost of production, to increase incomes and employment, to learn about advanced technical methods used abroad, and to secure raw materials.

(*Continued*)

Determinants of trade	*Major determinants of exports:* Presence of an entrepreneurial class, access to transportation, marketing, and other services, exchange rates and government trade and exchange rate policies. *Major determinants of imports:* Per capita income, price of imports, exchange rates, government trade and exchange rate policies, and availability of foreign exchange.
Value and volume of trade	1. World trade approached $19 trillion (U.S.) in 2012. 2. Services trade accounts for about 19 percent of total trade. 3. Merchandise trade accounts for 81 percent of world trade. 4. The industrial market economies account for 52 percent of world merchandise trade.
Major developments in trade	1. The absence of any meaningful progress in the Doha negotiations of the WTO. 2. Proliferation of bilateral and regional trade agreements. 3. Growing role of developing countries in world trade. 4. The increasing U.S. current account deficit and global imbalances. 5. Fast economic growth in many countries and pressure on limited resources. 6. Business adjustment to security costs after 9/11.

Review Questions

1. Discuss the importance of international trade to national economies.
2. What are the major determinants of exports? Why do some countries trade more than others?
3. What is the volume of trade?
4. What are some of the major developments in trade over the past two decades?
5. What are the implications of the increasing U.S. trade deficit for global production and exports?
6. What is the reason behind the increase in common markets and free-trade areas over the last few decades?
7. What are the limitations of export led growth?
8. Why are small countries more dependent on international trade than larger ones?

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Case 1.1 The Limitations of Export-Led Growth

International trade played an important role in the economic development of North America and Australia in the nineteenth century and that of East Asian economies in the second half of the twentieth century. East Asia's growth contributed to increased living standards and reduced inequality as the new prosperity was widely shared among its population. In Malaysia and Thailand, for example, the level of poverty was reduced from almost 50 percent in the 1960s to less than 20 percent by 2000.

Central to the success of these countries is the promotion of exports. Governments provided credits, restricted competing imports, and developed export marketing institutions. As they increased their exports to wealthy countries, their economies grew at 7 to 8 percent per year.

The export-led model may have worked for a few countries during the time when most developing countries pursed import-substitution policies—substituting domestic production for manufactured goods for the exportation of raw materials. There are a number of limitations to export-led growth when many countries, including China, begin to use it. Here are some of its potential limitations:

- It is difficult for all countries to increase exports by 8 to10 percent per year when the world economy grows at 2 or 3 percent per year. It is not possible for every country to have a trade surplus.

- The major importing nation, the United States, cannot continue to run large trade deficits. Other potential destinations for global exports, South Korea, Japan, and Germany, also rely on an export-promotion policy to sustain economic growth and are not willing to run large deficits.
- China and other East Asian economies have not taken measures to open their markets in order to absorb increasing exports from the rest of the world. In the absence of other sources of economic growth, focusing on the U.S. market is unsustainable in the long run.
- Many multinational corporations are already experiencing flat or shrinking revenue growth due to reduced demand reflecting the natural limitations of export growth (see Table 1.4).

TABLE 1.4 Average Rate of Revenue Growth for Selected Sectors in the 1990s and 2000s (%)

Sectors	Industries	Average rate of growth, 1990s	Average rate of growth, 2000s
Consumer goods	Beverages, tobacco, food items, personal care products	4.98	1.95
Technology	Software, hardware, semiconductors	13.59	3.67
Communications	Telephone service, equipment, cellular/ wireless, long distance	12.53	1.53
Health care	Biotechnology, pharmaceuticals, medical products	14.3	9.82
Financial	Banks, investment brokerages	22.64	5.37
Energy	Oil, drilling	2.21	–0.39
Transport	Air freight, rail, airlines	5.08	2.44
Capital goods	Equipment, aerospace, manufacturing	9.84	1.92
Basic materials	Chemicals, paper, aluminium	7.53	4.69
Utilities	Electric, gas, water	7.48	6.39

Sources: SEC Filings, *Moody's Industrial manuals* (2004)

Questions

1. Do you agree with the author's view regarding the limitations to export-led growth?
2. What other alternatives are available to export-led growth?

Case 1.2 The Impact of the Financial Crisis on Exports

In view of the higher risk and working-capital needs of exporting, firms rely more on banks for their exports than for their domestic sales. As a consequence, financial crises are likely to affect exports more negatively than domestic sales.

One of the most striking features of the financial crisis of 2008 was the collapse in international trade. The decline in world exports was much greater than the decline in world GDP. Between the first quarter of 2008 and the first quarter of 2009, the real value of GDP fell 4.6 percent while exports plunged 17 percent, which amounts to a decline of $761 billion in nominal terms.

Exports are more sensitive to financial shocks due to the higher default risk and higher working-capital requirements associated with international trade. The need to insure against credit default risk arises because exporters rarely have the capacity or willingness to evaluate default risk and usually turn to banks to provide payment insurance and guarantees. In addition, exporters need more working-capital financing than firms engaged in domestic transactions because of the longer time lags associated with international trade, especially when firms ship by sea. The fact that exporters depend so heavily on financial institutions for working capital and risk insurance suggests that if a credit crunch causes banks to limit trade finance, exports are likely to be affected more than domestic sales. Djankov, Freund, and Pham (2006) found in a sample of 180 countries that the median amount of time it takes from the moment the goods are ready to ship from the factory until the goods are loaded on a ship is twenty-one days. Much of this time is spent dealing with the paperwork and procedures associated with getting goods ready to ship overseas. Similarly, the median amount of time it takes from the moment a typical good arrives in a port until the good arrives in the purchaser's warehouse is twenty-three days. If we couple this finding with Hummels's (2001) estimate that the typical good imported into the United States by sea spends twenty days on a vessel, we can see that it is not uncommon for goods to spend approximately two months in transit. Even in OECD countries, which have the most streamlined procedures, it takes eleven days for a good to reach a port or arrive from a port.

These data suggest that firms engaged in international trade are likely to be more reliant than domestic firms on working-capital financing to cover the costs of goods that have been produced but not yet delivered. More than 90 percent of trade transactions involve some form of credit, insurance, or guarantee issued by a bank or other financial institution. Given that banks are the principal suppliers of trade finance, the supply of such financing is likely to be closely tied to the health of the banks. In particular, as the health of banks deteriorates, these financial institutions find it increasingly difficult to raise funds either through interbank borrowing or through the issuance of new bonds or equity.

As these sources of liquidity diminish, unhealthy institutions cut back on their lending. These cutbacks are likely to have a particularly large impact on trade finance because the short maturities of trade finance and its need for constant renewal make it particularly sensitive to a bank's ability to extend new credit. Moreover, since exports are much more dependent on finance than domestic sales for the reasons already outlined, exports are likely to be harder hit by financial

shocks. In the 2008 crisis, the standard measure of the risk premium charged to banks (the difference between interbank offer rates charged to banks and the overnight indexed swap rate [OIS]) jumped sharply, reflecting higher bank borrowing costs. Eighty-eight banks in forty-four countries revealed that the average spreads on letters of credit, export credit insurance, and short- to medium-term trade-related lending rose by 70, 107, and 99 basis points, respectively, in the second quarter of 2009 relative to the fourth quarter of 2007.

The decline in trade finance transactions was caused by a tightening of credit availability at their own institution. The deteriorations in the financial health (or outright bankruptcy) of major players in the trade finance world, including Lehman, AIG, CIT Group, Citigroup, Bank of America, and Wells Fargo, may have made it difficult for these banks to raise money to finance their export clients' trade credit default risk. The simultaneous collapse in the commercial paper market may have left exporters with few options other than cutting exports if their trade finance providers ran into trouble.

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Question

1. What is the effect of the financial crisis on exports?

two International and Regional Agreements Affecting Trade

The GATT and the WTO

The General Agreement on Tariffs and Trade (GATT) was established in 1945 as a provisional agreement pending the creation of an International Trade Organization (ITO). The ITO draft charter, which was the result of trade negotiations at the Havana Conference of 1948, never came into being due to the failure of the U.S. Congress to approve it. Other countries also declined to proceed with the ITO without the participation of the United States. Thus, the GATT continued to fill the vacuum as a de facto trade organization, with codes of conduct for international trade but with almost no basic constitution designed to regulate its international activities and procedures. The GATT, in theory, was not an "organization," and participating nations were called "Contracting Parties" and not members (Hoekman and Kostecki,1995; Jackson, 1992).

Since its inception, the GATT has used certain policies to reduce trade barriers between contracting parties (CPs):

- *Nondiscrimination:* All CPs must be treated in the same way with respect to import-export duties and charges. According to the most favored nation treatment, each contracting party (CP) must grant to every other CP the most favorable tariff treatment (most-favored nation, or MFN) that it grants to any country with respect to imports and exports of products. Certain exceptions, however, are allowed, such as free-trade areas, customs unions, and other preferential arrangements in favor of developing nations. Once imports have cleared customs, a CP is required to treat foreign imports the same way it treats similar domestic products (the national treatment standard).
- *Trade liberalization:* The GATT has been an important forum for trade negotiations. It has sponsored periodic conferences among CPs to reduce trade barriers (see International Perspective 2.1). The Uruguay Round (1986–1993) gave rise to the establishment of a permanent trade organization (World Trade Organization or WTO). The

most recent round (Doha Round) hopes to reach agreement on other trade distortions such as agricultural subsidies and trade barriers imposed by developing countries on imports of manufactured goods.

- *Settlement of trade disputes:* The GATT/WTO has played an important role in resolving trade disputes between CPs. In certain cases where a party did not follow GATT's recommendations, it ruled for trade retaliation that is proportional to the loss or damage sustained. It is fair to state that the existence of the GATT/WTO has been a deterrent to damaging trade wars between nations.
- *Trade in goods:* The GATT rules apply to all products both imported and exported, although most of the rules are relevant to imports. It was designed primarily to regulate tariffs and related barriers to imports such as quotas, internal taxes, discriminatory regulations, subsidies, dumping, discriminatory customs procedures, and other nontariff barriers. The Uruguay Round (1986–1994) resulted in a new general agreement on trade in services, trade-related aspects of intellectual property (TRIPs), and trade-related investment measures (TRIMs). Thus, CPs have moved beyond the original purpose of the GATT to achieve unrestricted trade in goods, to reduce barriers to trade in services, investment, and to protect intellectual property (Collins and Bosworth, 1994).

INTERNATIONAL PERSPECTIVE 2.1

GATT Negotiations (1947–2001)

GATT Round	Explanation
Geneva (1947)	Twenty-three countries participated in establishing the GATT in 1947. Average tariff cut of 35 percent on trade estimated at $10 billion.
Annecy, France (1949)	Thirty-three countries participated in tariff reductions.
Torquay, U.K. (1951)	Thirty-four countries participated in tariff reductions.
Geneva (1956)	Twenty-two countries participated in tariff reductions on trade estimated at $2.5 billion.
Dillon (1960–61)	Forty-five countries participated in tariff reductions on trade estimated at $5 billion.
Kennedy (1962–67)	Forty-eight countries participated in tariff reductions on trade estimated at $40 billion.
Tokyo (1973–79)	Ninety-nine countries participated in reductions of tariff and nontariff barriers on trade valued at $155 billion.
Uruguay (1986–94)	Broadening of the GATT to include services, intellectual property, and investment. It also resulted in the establishment of the WTO. One hundred twenty-four countries participated on reductions of tariff and nontariff barriers on trade valued at $300 billion.

Doha (2001–)	Reduction of agricultural subsidies and other trade barriers on agricultural exports, broadening of international rules in services, lowering of trade barriers by developing nations. More than 124 countries participate in this round.

The Uruguay Round and WTO

In 1982, the United States initiated a proposal to launch a new round of GATT talks. The major reasons behind the U.S. initiative were (1) to counter domestic pressures for protectionism precipitated by the strong dollar and a rising trade deficit; (2) to improve market access for U.S. products by reducing existing tariff and nontariff barriers to trade; (3) to reverse the erosion of confidence in the multilateral trading system; (4) to extend GATT coverage to important areas such as services, intellectual property, and investment; and (5) to bring developing nations more effectively into the international trading system.

Despite the initial reluctance of many developing nations, the effort culminated in the conclusion of a successful trade negotiation (the Uruguay Round) in 1994. The results of the Uruguay Round can be summarized as follows.

Trade Liberalization

Significant progress was made toward reducing trade barriers in the areas of agriculture and textiles that had long been resistant to reform. Tariff reductions of about 40 percent were achieved. The agreement also opened access to a broad range of government contracts (Government Procurement Agreement). It also provided for the liberalization of the textiles and apparel sector by the end of 2004. Textiles quotas have been removed except for occasional safeguards used to protect a sudden increase in imports.

Trade Rules

The Uruguay Round added new rules relating to unfair trade practices (dumping, subsidies) and the use of import safeguards.

New Issues

The agreement broadened the coverage of the GATT to include areas such as trade in services (General Agreement on Trade in Services, GATS), trade-related aspects of intellectual property (TRIPs), and trade-related investment measures (TRIMS). The GATS establishes rules to liberalize trade in services, which in 2012 was estimated to be almost $4.3 trillion (WTO, 2013). The TRIPs agreement establishes new trade disciplines with regard to the protection and enforcement of intellectual property rights. TRIMs provides for the elimination

of trade-distorting investment requirements such as local content, limitation of ownership, and exports of certain shares of domestic production.

Institutional Reforms

In the area of institutional reform, the Uruguay Round strengthened the multilateral dispute settlement mechanism and established a new and permanent international institution, the World Trade Organization, responsible for governing the conduct of trade relations among its members. The new dispute settlement procedure instituted an appeals procedure, expedited decision making, and encouraged compliance with GATT decisions. Members of the WTO are required to comply with the GATT rules as well as various agreements (rounds) negotiated under GATT auspices.

Regional Integration Agreements (RIAs)

WTO members are permitted to enter into RIAs under specific conditions. RIAs must be consistent with the WTO rules, which require that the parties to the agreement (1) establish free trade on most goods in the regional area within 10 years, and (2) refrain from raising their tariffs against countries outside the agreement.

The number of RIAs and their share in global trade has been steadily rising over the past decade (Table 2.1). Since January 1995, about 546 RIAs have been reported to the WTO, with 354 currently in effect. A large percentage of these agreements (more than 80 percent) are mostly bilateral free-trade deals (free-trade agreements) intended for market access and do not require a high degree of policy coordination between participating countries. Fewer than 10 percent of the agreements provide for high levels of integration as well as harmonization of trade policies (customs union). (International Perspective 2.2)

Small countries enter into RIAs not only for market access but also to deal more effectively with larger economies in multilateral trade talks and other areas. Although RIAs are not often considered a potential threat to multilateralism, some scholars believe that (1) they lead to large volumes of trade diversion, often leading to substantial welfare losses; (2) they create lobbies and interest groups against multilateral trade liberalization; and (3) their differing regulatory regimes, including rules of origin, pose a challenge to the multilateral trading system (Das, 2004).

TABLE 2.1 Notifications of RIAs in force to GATT/WTO (January 2013)

	Accessions	New RIAs	Total
Free-Trade Areas	1	201	202
Customs Union	6	10	16
Enabling Clause*	2	34	36
Free Trade in Services	3	109	112
Total	12	354	366

* Agreements between developing countries

Source: WTO, 2013

The major drivers of RIAs are stated as follows:

- Consolidation of peace, regional security and free market reforms in many countries
- Promotion of deeper levels of economic integration than is available under the WTO (issues pertaining to competition, investment, labor, and the environment)
- Market access and a means of attracting Foreign Direct Investments (FDI). Discriminatory liberalization in favor of partner countries is likely to provide firms (from these countries) with competitive advantages.
- Sluggish progress in multilateral trade talks.

The North American Free Trade Agreement (NAFTA)

The North American Free Trade Agreement (NAFTA) established a free-trade area for Canada, the United States, and Mexico. The agreement came into effect on January 1, 1994, after a difficult ratification by the U.S. Congress and approval by the Canadian and Mexican legislatures. The North American Free Trade Agreement gave rise to the second largest free-trade zone (in terms of population) in the world after the European Union—465 million people and a joint gross domestic product exceeding $18 trillion. The agreement constitutes one of the most comprehensive free-trade pacts ever negotiated among regional trading partners. It is also the first reciprocal free-trade pact between a developing nation and industrial countries (Hufbauer and Schott, 1994). Canada and the United States agreed to suspend the operation of the Canada-U.S. Free Trade Agreement so long as both countries are parties to NAFTA and to establish certain transitional arrangements.

Negotiating Objectives

The United States

Since World War II, the United States has advocated trade liberalization and the elimination, on a reciprocal and nondiscriminatory basis, of measures that restrict commercial transactions across national boundaries. To achieve this, it had relied on the GATT, now the WTO, and had demonstrated its commitment through its active participation in the successive rounds of trade negotiations under the GATT framework. However, the GATT process has been slow and ineffective in liberalizing trade, particularly in certain sectors such as agriculture. The regional approach was thus considered an attractive alternative to the multilateral framework for achieving rapid progress in trade liberalization. Second, the proliferation of regional common markets and the continued expansion of the European Union are considered to be important factors in influencing the United States to enter into a regional free-trade agreement as a response to the prevailing trend in international economic relations. Third, it was logical to embark on a free-trade arrangement with Canada and Mexico not only due to their geographical proximity but also because they are the most important trading partners of the United States. The United States is the destination for more than 70 percent of Canadian and Mexican exports. Both countries also import about one third of U.S exports. The United States is also the largest investor in both countries. It was in the interest of the United States to maintain and expand existing trade and investment opportunities through a regional trade arrangement (Table 2.2).

TABLE 2.2 Merchandise Exports, 1993, 2011 ($ billions U.S.)

Source	Destination	1993	2011
U.S. exports to	Canada	100	281
	Mexico	42	197
Canadian exports to	United States	117	332
	Mexico	0.64	5.5
Mexican exports to	United States	42	274
	Canada	1.57	11
Total intra-NAFTA trade		303.82	1111
NAFTA trade with rest of world		535.68	3144

Source: U.S. Census Bureau, 1993–2011

Canada

The North American Free Trade Agreement permits Canadian firms to achieve economies of scale by operating larger and more specialized plants. It also provides secure access to a large consumer market. Even though tariff rates between the United States and Canada have declined over time, there had been an increase in protectionist sentiment and use of aggressive trade remedies to protect domestic industries in the United States. These measures created uncertainty for producers with respect to investment in new facilities. The North American Free Trade Agreement reduces this uncertainty since it provides rules and procedures for the application of trade remedies and the resolution of disputes.

Mexico

The North American Free Trade Agreement provides secure access to the U.S. and Canadian markets for Mexican goods and services. Its low labor costs and access to the U.S. market attracts FDI to Mexico (Echeverri-Carroll, 1995; Lederman, Maloney, and Serven, 2005). In view of the adverse impact of its import substitution policy in the 1980s and the debt crisis, trade liberalization was considered to be an effective means of fostering domestic reform and achieving sustainable growth. Ostry briefly describes Mexico's objectives:

> So NAFTA is a means of consolidating an export-led growth path both by improving secure access to the U.S. market and encouraging a return of flight capital as well as new investment. (Quoted in Randall, Konrad, and Silverman, 1992, pp. 27–28)

Overview of NAFTA

Market Access for Goods

The North American Free Trade Agreement incorporates the basic national treatment obligation of the GATT. This means that goods imported from any member country will not be subject to discrimination in favor of domestic products. It provides for a gradual elimination

over fifteen years of tariffs for trade between Mexico and Canada as well as between Mexico and the United States except for certain agricultural products. Under the Canada-U.S. Free Trade Agreement, tariffs between the two countries were eliminated in January 1998.

By January 1998, tariffs had been phased out on about 65 percent of all U.S. exports to Mexico. For certain import-sensitive sectors in which quotas are imposed, the agreement provides for a replacement with a sliding tariff quota over ten or fifteen years. The North American Free Trade Agreement also provides for a gradual elimination of nontariff barriers such as customs user fees, import licenses, export taxes, and duty drawbacks on NAFTA-made goods. Since NAFTA would gradually phase out tariffs within the free-trade area, such drawbacks will no longer be necessary. To qualify for preferential market access, however, goods must be wholly or substantially made or produced within the member countries. For example, farm goods wholly grown or substantially processed within the NAFTA region would qualify for NAFTA treatment.

Services

The agreement governs financial, telecommunications, trucking, and rail services. With respect to financial services, NAFTA commits each party to treat service providers such as banks and insurance companies from other NAFTA parties no less favorably than its own service providers in like circumstances. It also commits members to gradually phase out, during the transition period, limits on equity ownership by foreign individuals or corporations and on market share by foreign financial institutions. Mexico was allowed to put temporary capital limits for banks, securities firms, and insurance companies during the transition period. The agreement allows members to take prudential measures to protect the integrity of the financial system or consumers of financial services. It includes a freeze on restrictions governing cross-border trade in financial services and also provides for consultations, as well as a dispute settlement mechanism.

The North American Free Trade Agreement commits members to impose no conditions (i.e., reasonable and nondiscriminatory terms) on access to or use of public telecommunication networks unless they are necessary to safeguard the public service responsibilities of the network operators or the technical integrity of the networks. It also imposes an obligation to prevent anticompetitive conduct by monopolies in basic services.

The agreement (1) removes most limitations on cross-border trucking and rail and liberalizes Mexican investment restrictions in these sectors, and (2) preserves existing cabotage laws, that is, laws that allow a truck to carry goods to and from a given destination but not to make additional stops unless the vehicle and cargo are registered in the country.

Investment

Investment includes majority-controlled or minority interests, portfolio investments, and investments in real property from member countries. All three countries agree to (1) provide national treatment to investors from member countries, a treatment that is not less favorable than that given to an investor from a non-NAFTA country; (2) prohibit the imposition and enforcement of certain performance requirements in connection with the conduct or operation of investments, such as export requirements or domestic content; (3) severely restrict or prohibit investment in their most strategic industries, such as energy (Mexico), cultural

industries (Canada), and nuclear energy and broadcasting (all three countries). Both Canada and Mexico reserve the right to screen potential investors in certain cases. The parties also agree to subject disputes raised by foreign investors to international arbitration.

Intellectual Property

The North American Free Trade Agreement mandates minimum standards for the protection of intellectual property rights (IPRs) in member countries and requires each country to extend national treatment to IPRs owned by nationals of other countries. The scope of IPR protection includes patents, trademarks, trade secrets, copyright, and industrial designs. It also extends to semiconductors, sound recordings, and satellite broadcast signals. Patents are to be provided for products or processes that are new, useful, and nonobvious. They are valid for twenty years from the date of filing or seventeen years from the date of grant. The agreement permits the use of compulsory licensing (i.e., a requirement to grant licenses to local companies or individuals if the patent is not used in the country) in limited circumstances. The North American Free Trade Agreement protects registered trademarks for a term of no fewer than seven years, renewable indefinitely. It harmonizes members' laws on trademark protection and enforcement. The agreement prohibits "trademark-linking" requirements in which foreign owners of trademarks are to use their mark in conjunction with a mark owned by a national of that country. The North American Free Trade Agreement requires adequate protection for trade secrets and does not limit the duration of protection. Copyright protection is extended to computer software and provides owners of computer programs and sound recordings with "rental rights" (i.e., the right to authorize or prohibit the rental of programs or recordings). It ensures protection of copyright for a minimum period of fifty years and gives effect to the 1971 Berne Convention on artistic and literary works.

Government Procurement

Purchase of goods and services by government entities in member countries is estimated at more than $1 trillion. The North American Free Trade Agreement extends the national treatment standard (equal treatment to all member country providers) for all goods and services procured by federal government entities unless specifically exempted. Procurement contracts must, however, meet certain minimum value thresholds: $50,000 for contract of goods and/or services and $6.5 million for construction contracts procured by federal government entities. For government enterprises, the threshold is $250,000 for contract of goods and/or services and $8 million for construction services. For U.S. and Canadian entities, the Canada-U.S. Free Trade Agreement maintains the threshold at $25,000 for goods contracts. It provides tendering procedures and bid-challenging mechanisms to seek a review of any aspect of the procurement process by an independent authority.

Safeguards

If a surge in imports causes serious injury to domestic producers, a member country is allowed to take emergency action temporarily, for up to four years, to protect the industry.

A request for emergency action is usually initiated by a domestic industry. A number of factors are considered by the investigating tribunal in arriving at a decision on injury: the level of increase in imports, market share of the imports, changes in sales, production, profits, and employment, and other pertinent variables.

Technical and Other Standards

The North American Free Trade Agreement requires a member to provide sixty days' notice before adopting new standards to allow for comments before implementation. It prohibits members from using standards as a disguised restriction to trade. Working groups are established to adopt or harmonize technical and other standards pertaining to specific sectors.

Other Areas

The agreement (1) requires members to create and maintain rules against anticompetitive business practices; (2) allows for temporary entry of businesspersons and certain professionals who are citizens of another member country (NAFTA does not create a common market for the movement of labor); (3) establishes institutions such as the Free Trade Commission (FTC) to supervise the implementation of the agreement and resolve disputes; and (4) creates a secretariat, composed of national offices in each country, to support the commission. The agreement also allows any country or group of countries to join NAFTA, subject to approval by each member country and on such terms as agreed upon by the Free Trade Commission.

Dispute Settlement

Disputes arising over the implementation of the agreement may be resolved through (1) consultations; (2) mediation, conciliation, or other means of dispute resolution that might facilitate an amicable resolution; or (3) a panel of nongovernmental experts. If the decision is made by a binding panel (binding dispute settlement), the parties are required to comply within thirty days, or else compensation/retaliation may result. If the decision is reached by a nonbinding panel, parties shall comply or agree on another solution within thirty days, or else compensation/retaliation may result. Panel reports are not automatically enforceable in domestic law.

There are separate dispute settlement mechanisms for certain specialized areas such as financial services, investment, environment, standards, and private commercial disputes, as well as dumping and subsidies.

Preliminary Assessment of NAFTA

The full impact of NAFTA can only be determined in the long term after the necessary economic adjustments have taken place. Although a short-term assessment of such a comprehensive agreement is often inadequate and sometimes misleading, a cursory discussion of economic conditions since NAFTA will be presented.

Overall Increase in Trade between Members

There has been a marked increase in trade among the three member countries since the agreement went into effect, in January 1994. Intra-NAFTA trade jumped from $304 billion in 1993 to $1.1 trillion in 2011, while NAFTA's trade with the rest of the world increased from $536 billion to $3.14 trillion during the same period. An increasing portion of Canadian and Mexican trade is conducted with the United States. The United States accounted for 74 percent of Canadian exports (62 percent of its imports) and 78 percent of Mexican exports (56 percent of its imports) in 2011. During the same year, the two countries accounted for about 32 percent of U.S exports (19 percent for Canada and 13 percent for Mexico).

Increase in the U.S. Trade Deficit

The U.S. merchandise trade deficit with Canada and Mexico quadrupled since the inception of NAFTA. U.S. merchandise (services) exports to Canada and Mexico grew from $142 ($27) billion in 1993 to $478 ($82) billion in 2011. However, this was not sufficient to offset the growing trade deficit with both countries. U.S. merchandise trade deficit with Canada and Mexico stood at $38 billion and $67 billion (U.S.), respectively, in 2011. A substantial part of the deficit is attributed to imports of crude oil from Canada and Mexico. In services, the United States has a trade surplus of $28 billion with Canada and $12 billion with Mexico. In agriculture and manufactured products, the United States also registered a trade surplus of $2.6 billion and $14.5 billion with Canada and Mexico, respectively, in 2011.

NAFTA's Uncertain Impact on Jobs

There is no conclusive evidence on the effect of NAFTA on jobs. There are certain indications, however, that NAFTA may have had a negative effect on jobs. Between 1994 and 2002, the U.S. Department of Labor certified 525,000 workers for income support and training due to loss of jobs arising from shifts in production to Mexico or Canada. In view of its narrow eligibility criteria, the program covers a small number of workers who lost their jobs due to NAFTA. The Economic Policy Institute contends that 682,900 U.S. jobs have been lost or displaced due to NAFTA and the resulting trade deficit (Scott, 2011). Most of the job dislocations appear to be concentrated in apparel and electronic industries. This may be attributed to the growing trade deficit with both countries that often leads to declines in production and employment. There are also some studies that show the negative effects of NAFTA on agricultural employment and real wages in manufacturing in Mexico. The Canadian Center for Policy Alternatives states that the Canadian government reduced social spending (such as qualification for unemployment insurance) to enhance its competitiveness (Campbell, 2006).

The U.S. Chamber of Commerce study (2012), however, shows that trade with the two countries supports nearly 14 million jobs, of which five million are attributed to the increase in trade generated by NAFTA.

Substantial Increase in Foreign Investment in All Countries

Since NAFTA, there has been a substantial growth in inward FDI in member countries (Weintraub, 2004) (Table 2.3).

TABLE 2.3 Gross Inward FDI Flows 1994, 2011 ($ billions U.S.)

Country	1994	% of world FDI flows	2011	% of world FDI flows
Canada	8.2	3.2	40.93	2.70
Mexico	10.64	4.2	19.55	1.28
United States	45.1	17.6	227	14.90

Source: UNCTAD, 2012

INTERNATIONAL PERSPECTIVE 2.2

Stages of Economic Integration

Preferential Trade Arrangements: Agreement among participating nations to lower trade barriers. *Example:* British Commonwealth preference scheme (1934).

Free-Trade Area: All barriers are removed on trade among members, but each nation retains its own barriers on trade with nonmembers. *Example:* The European Free Trade Area (EFTA), formed in 1960 by Austria, Denmark, Norway, Portugal, the United Kingdom, Sweden, and Switzerland.

Customs Union: In addition to an agreement to lower or remove trade barriers, members establish a common system of tariffs against nonmembers (common external tariff). *Example:* The Andean Common Market, MERCOSUR.

Common Market: A common market includes all the elements of a customs union and allows free movement of labor and capital among member nations. *Example:* The European common market achieved common-market status in 1970.

Economic Union: Economic union goes beyond a common market and requires that members harmonize and/or unify monetary and fiscal policies of member states. *Example:* Benelux, which includes Belgium, the Netherlands, and Luxembourg, formed in the 1920s and also part of the European Union (EU).

The European Union

The European Union (EU) is the oldest and most significant economic integration scheme, involving twenty-eight Western and Eastern European countries: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. One of the most important developments is the recent EU enlargement from fifteen to twenty-five countries in May 2004 with the admission of Cyprus, Malta, and eight East European countries. In January 2007, Bulgaria and Romania became EU members and in July, 2013, Croatia joined the EU, increasing the number of members to twenty-eight countries. Turkey and other East European countries will be considered for admission in the coming years on the basis of certain criteria such as having stable democratic institutions, a free market, and the ability to assume EU treaty obligations (Poole, 2003; Van Oudenaren, 2002).

TABLE 2.4 NAFTA and EU: Major Differences

NAFTA	EU
NAFTA does not provide for a common external tariff.	EU has a common external tariff.
NAFTA has no provision for economic assistance or economic/monetary union.	EU provides for economic assistance to members and economic/monetary union.
NAFTA does not provide for free movement of labor.	EU allows for free movement of labor.

Even though the European economic integration dates back to the Treaty of Rome in 1957, the European Union is the outcome of the Maastricht treaty of 1992. The European Union has an aggregate population of about 503 million people and a total economic output (GDP) of $16 trillion (U.S.) (2012), and the agreement involves the largest transfer of national sovereignty to a common institution (International Perspective 2.3). In certain designated areas, for example, international agreements can be made only by the European Union on behalf of member states (Wild, Wild, and Han, 2006).

The pursuit of such integration was party influenced by the need to create a lasting peace in Europe as well as to establish a stronger Europe that could compete economically against the United States and Japan (Table 2.4). Since the countries were not large enough to compete in global markets, they had to unite in order to exploit economies of large-scale production.

The objectives of European integration as stated in the Treaty of Rome (1957) are as follows:

- To create free trade among member states and to provide uniform customs duties for goods imported from outside the EU (common external tariff).
- To abolish restrictions on the free movement of all factors of production, that is, labor, services, and capital. Member states are required to extend the national treatment standard to goods, services, capital, and so on from other member countries with respect to taxation, and other matters (nondiscrimination).
- To establish a common transport, agricultural, and competition policy.

A number of the objectives set out in the Treaty of Rome were successfully accomplished. The Common Agricultural Policy (CAP) was established in 1962 to maintain common prices for agricultural products throughout the community and to stabilize farm incomes. Tariffs between member nations were eliminated and a common external tariff established in 1968. However, efforts to achieve the other objectives, such as a single internal market (elimination of nontariff barriers), free movement of services and capital, and so forth was slow and difficult. Coordinated or common policies in certain areas such as transport simply did not exist (Archer and Butler, 1992).

The European Commission presented a proposal in 1985 to remove existing barriers to the establishment of a genuine common market. The proposal, which was adopted and entitled The Single European Act (SEA), constitutes a major revision to the Treaty of Rome. The Single European Act set the following objectives for its members:

- To complete the single market by removing all the remaining barriers to trade such as customs controls at borders, harmonization of technical standards, liberalization of public procurement, provision of services, removal of obstacles to the free movement

of workers, and so on. In short, efforts involved the removal of physical, technical, and fiscal (different excise and value added taxes) barriers to trade.

- To encourage monetary cooperation leading to a single European currency. The Maastricht Treaty of 1992 further reinforced this and defined plans for achieving economic and monetary union.
- To establish cooperation on research and development (R&D) and to create a common standard on environmental policy.
- To harmonize working conditions across the community and to improve the dialogue between management and labor.

The Single European Act established a concrete plan and timetable to complete the internal market by 1992. It is fair to state that most of the objectives set out under the SEA were accomplished: border checks are largely eliminated, free movement of workers has been achieved through mutual recognition of qualifications from any accredited institution within the EU, free movement of capital (banks, insurance and investment services) has been made possible with certain limitations, and the single currency (the euro) was introduced in 1999. The euro has helped reduce transaction costs by eliminating the need to convert currencies and made prices between markets more transparent. There still exist a number of challenges in completing and sustaining the single market, expanding EU policy responsibilities in certain controversial areas such as energy policy, and undertaking appropriate structural reforms to take advantage of the economic and monetary union.

INTERNATIONAL PERSPECTIVE 2.3

Institutions of the European Union

The European Council: Composed of representatives (ministers) of member states, the council sets out general direction of the union. The council approves legislation and international agreements, acting on a proposal from the commission and after consulting with the European Parliament.

The European Commission: Members of the commission are chosen by the mutual agreement of national governments and serve four-year terms. Larger nations appoint two commissioners, while smaller nations appoint one. They neither represent nor take orders from member states. The commission initiates policies and ensures members' compliance with the treaty.

The European Parliament: Composed of 732 directly elected representatives, the European Parliament supervises the commission, adopts the community budget, and influences the legislative process. Any agreement concerning international cooperation must be reviewed and accepted by Parliament before it is concluded. Parliament, however, does not have express legislative powers.

The Court of Justice: Settles disputes arising from the treaty (i.e., interprets and applies the EU treaty). The judges are appointed by mutual agreement of member states and serve six-year terms. The court ensures uniform interpretation and application of community law, evaluates legality of legislation adopted by the council and the commission, and provides rulings on community law when requested by national courts in member states.

TABLE 2.5 Other Major Regional Trade Agreements

The European Free Trade (EFTA, 1960)	*Members:* Iceland, Liechtenstein, Norway, Switzerland *Objectives:* Removal of customs barriers and differing technical standards. Free trade with EU strictly limited to commercial matters.
The Preferential Area for Eastern and Southern American Common Market (MERCOSUR, 1991)	*Members:* Argentina, Brazil, Paraguay, Uruguay, Venezuela. Chile and Bolivia joined as associate members. *Objectives:* Free trade and industrial cooperation.
The Central American Common Market (CACM, 1960)	*Members:* Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua *Objectives:* Free trade and a common external tariff.
The Andean Pact, 1969	*Members:* Bolivia, Colombia, Ecuador, Peru, Venezuela *Objectives:* Free trade and industrial development.
The Association of Southeast Asian Nations (ASEAN, 1967)	*Members:* Brunei, Cambodia, Indonesia, Laos, Malaysia, Mynamar, Philippines, Singapore, Thailand, Vietnam *Objectives:* Reduction of trade barriers, industrial cooperation.
The Caribbean Common Market (CARICOM, 1973)	*Members:* Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Haiti, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St.Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, Suriname *Objectives:* Political unity, economic cooperation.
The Southern African Customs Union (SACU, 1969)	*Members:* Botswana, Lesotho, Namibia, South Africa, Swaziland *Objectives:* Free movement of goods, common external tariff.
The Economic Community of West African States (ECOWAS, 1974)	*Members:* Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, the Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo *Objectives:* Economic and monetary union.
Asia Pacific Economic Cooperation (APEC, 1989)	*Members:* Australia, Brunei, Canada, Chile, China, Japan, South Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Phillippines, Peru, Russia, Singapore, Taiwan, Thailand, United States, Vietnam *Objectives:* Strengthen the multilateral trading system, simplify and liberalize trade and investment procedures among members.

Chapter Summary

The GATT/WTO	*Principal objectives of the GATT:* Nondiscrimination, trade liberalization, and settlement of trade disputes between members

The Uruguay Round of the GATT and the birth of the WTO	*Important results of the Uruguay Round trade negotiations (1986–1994):* Reductions in tariffs, adoption of new trade rules on unfair trade practices, extension of GATT coverage to trade in services, intellectual property, and trade-related investment measures, the birth of WTO.
The North American Free Trade Agreement (NAFTA)	*Scope of coverage:* Market access for goods, services, investment, protection of intellectual property, government procurement, safeguards, standards, dispute settlement.
NAFTA: Preliminary assessment	Increases in overall trade among members, increase in the U.S. trade deficit on merchandise trade with members, and a rise in foreign investment.
The European Union (EU)	*Major objectives of the EU:* To create free trade and a common external tariff among members, to abolish restrictions on the free movement of all factors of production, to establish common policies in the area transport, agriculture, competition, among others. *Institutions of the EU*: The European Council, the European commission, the European Parliament, the Court of Justice.
Other regional trade agreements	The European Free Trade Area (EFTA), MERCUSOR, the Central American Common Market (CACM), the Andean Pact, the Association of Southeast Asian Nations (ASEAN), the Caribbean Common Market (CARICOM), the Southern African Customs Union (SACU), the Economic Community of West African States (ECOWAS)

Review Questions

1. What were the major achievements of the Uruguay Round of the GATT/WTO?
2. Distinguish between the most-favored nation and national treatment standard in international trade.
3. Discuss the major drivers of regional trade agreements.
4. Compare and contrast the negotiating objectives of Canada and Mexico in agreeing to NAFTA.
5. Discuss NAFTA as it pertains to services and investment. Has it increased trade among the member countries?
6. What are the various stages of economic integration?
7. What are the objectives of European integration? Which countries joined the EU in 2004?
8. Discuss the major differences between NAFTA and the EU.
9. What were the major achievements of the Single European Act?
10. What is the role of the EU Commission?

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World Wide Web Resources

The European Union

Information on EU and its institutions: http://europa.eu.int/institutions/council/index_en.htm

NAFTA: Economic and Commercial Information

NAFTA (the complete agreement): http://www-tech.mit.edu/Bulletins/nafta.html

http://www.policyalternatives.ca/MonitorIssues/2006/07/MonitorIssue1415/

This site provides an analysis of NAFTA: http://www.dfait-maeci.gc.ca/nafta-alena/menu-en.asp

World Trade Organization

Basic information about the WTO, its agreements and activities: http://www.wto.org

Case 2.1 The Euro Crisis and Implications

Serious intraregional divergences in competitiveness and the related buildup of regional imbalances have been the root cause of the crisis in the euro zone. The Maastricht treaty of 1992, which created the European Union and led to the creation of a single European currency (the euro), established criteria for EU member states that included the following conditions: Inflation rates below 1.5 percent, budget deficits not to exceed 3 percent of GDP, and public debt not to exceed 60 percent of GDP. Since wages are an important determinant of prices, wage rates corrected for productivity growth (unit labor costs) were expected to remain aligned to keep the union in a sustainable position.

While Germany restrained wages, other member countries such as Greece and Portugal failed to limit the continued rise in wages and inflation, which affected their overall competitiveness. Trade imbalances built up as low-inflation countries began to gain in competitiveness over those with high wage and price inflation. Trade deficits in crisis-affected countries were financed by debt as banks in surplus countries such as Germany lent to borrowers and spenders in deficit countries. Borrowed funds were used to finance consumption and speculation (e.g., to build houses) and not to improve productivity or competitiveness.

When the investors who bought the bonds by lending to these countries realized that these countries were unable to repay the loans, they became nervous and started to sell off the bonds. Government bonds that were considered risky were subject to speculative attack, and their risk premiums rose dramatically. This rendered insolvent commercial banks whose balance sheets were loaded with these bonds. The banking crisis morphed into a sovereign debt crisis. Banks began to demand higher interest rates to lend to weaker countries. *Rising borrowing costs for weaker countries and trouble for banks that loaned money to these countries constitute the root causes of the crisis.*

In essence, all new initiatives continue to follow the old blueprint. Measures are mainly focused on strengthening the so-called Stability and Growth Pact and on aligning policies with the latest version of the EU's long-standing structural reform agenda—the Europe 2020 strategy. Europe continues to ignore the vital issues of domestic demand management and proper policy coordination for internal balance, including the need for upward adjustment of wages and prices in surplus countries.

Questions

1. What are the major causes of the euro-zone crisis?
2. To what extent does international trade play a role in the crisis?

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Section II

Export Marketing and Strategy

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three
Setting Up the Business

Whether it is a new or existing export-import business, the legal form or structure will determine how the business is to be conducted, its tax liability, and other important considerations. Each form of business organization has its own advantages and disadvantages, and the entrepreneur has to select the one that best fulfills the goals of the entrepreneur and the business (for questions to consider before starting a business, see International Perspective 3.1).

Selection of an appropriate business organization is a task that requires accounting and legal expertise and should be done with the advice of a competent attorney or accountant.

INTERNATIONAL PERSPECTIVE 3.1

Establishing an Appropriate Business Organization: Pointers

- Does the entrepreneur intend to be the sole owner of the export-import business? If not, how many people have an ownership interest?
- Does the entrepreneur need additional capital and/or expertise?
- What legal form provides the greatest flexibility for management?
- What legal form affords the most advantageous tax treatment for the business concern and for individual entrepreneurs?
- Which legal structure is easy and least expensive to establish and subject to a low degree of government regulation?
- How important is it to limit personal liability of owners?
- Which legal structure is the most appropriate in light of the goals and objectives of the export-import business?

Ownership Structure

In this section, we examine different forms of business organizations: sole proprietorships, partnerships, corporations, and limited-liability companies.

Sole Proprietorships

A sole proprietorship is a firm owned and operated by one individual. No separate legal entity exists. There is one principal in the business who has total control over all export-import operations and who can make decisions without consulting anyone. The major advantages of sole proprietorships are as follows:

1. They are easy to organize and simple to control. Establishing an export-import business as sole proprietorship is simple and inexpensive and requires little or no government approval. At the state level, registration of the business name is required, while at the federal level, sole proprietors need to keep accurate accounting records and attach a profit or loss statement for the business when filing individual tax returns (schedule C, Internal Revenue Service Form 1040). They must operate on a calendar year and can use the cash or accrual method of accounting.
2. They are more flexible to manage than partnerships or corporations. The owner makes all operational and management decisions concerning the business. The owner can remove money or other assets of the business without legal or tax consequences. The owner can also easily transfer or terminate the business.
3. Sole proprietorships are subject to minimal government regulations compared to other business concerns.
4. The owner of a sole proprietorship is taxed as an individual, at a rate lower than the corporate income tax rate. Losses from the export-import business can be applied by the owner to offset taxable income from other sources. Sole proprietors are also allowed to establish tax-exempt retirement accounts (Cheeseman, 2006a; Mallor, Barnes, Bowers, and Langvardt, 2013).

The major disadvantage of running an export-import concern as a sole proprietorship is the risk of unlimited liability. The owner is personally liable for the debts and other liabilities of the business. Insurance can be bought to protect against these liabilities; however, if insurance protection is not sufficient to cover legal liability for defective products, or debts, judgment creditors' next recourse is the personal assets of the owner. Another disadvantage is that the proprietor's access to capital is limited to personal funds plus any loans that can be obtained. In addition, very few individuals have all the necessary skills to run an export-import business, and the owner may lack certain skills. The business may also terminate upon the death or disability of the owner.

Partnerships

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. "Persons" is broadly interpreted to include corporations, partnerships, or other associations. "Co-ownership" refers to a sharing of ownership of the business and is

determined by two major factors: share of the business profits and management responsibility. The sharing of profits creates a rebuttable presumption that a partnership exists. The presumption about the existence of a partnership is disproved if profits are shared as payment of a debt, wages to an employee, interest on a loan, or rent to a landlord.

Example: Suppose Gardinia Export Company owes Kimko Realty $10,000 in rent. Gardinia promises to pay Kimko Realty 20 percent of its business profits until the rent is fully paid. Kimko Realty is sharing profits from the business but is not presumed to be a partner in the export business.

Although a written agreement is not required, it is advisable for partners to have some form of written contract that establishes the rights and obligations of the parties. Since partnerships dissolve upon the death of any partner that owns more than 10 percent interest, the agreement should ascertain the rights of the deceased partner's spouse and that of surviving partners in a way that is least disruptive of the partnership.

A partnership is a legal entity only for limited purposes, such as the capacity to sue or be sued, to collect judgments, to have title of ownership of partnership property, or to have all accounting procedures in the name of the partnership. Federal courts recognize partnerships as legal entities in such matters as lawsuits in federal courts (when a federal question is involved), bankruptcy proceedings and the filing of informational tax returns (profit and loss statement that each partner reports on individual returns). The partnership, however, has no tax liability. A partner's profit or loss from the partnership is included in each partner's income tax return and taxed as income to the individual partner (Cooke, 1995; Cheeseman, 2006b; Mallor et al., 2013).

Partners are personally liable for the debts of the partnership. However, in some states, the judgment creditor (the plaintiff in whose favor a judgment is entered by a court) must exhaust the remedies against partnership property before proceeding to execute against the individual property of the partners.

What are the duties and powers of partners? The fiduciary duty that partners owe the partnership and the other partners is a relationship of trust and loyalty. Each partner is a general agent of the partnership in any business transaction within the scope of the partnership agreement. For example, when a partner in an import business contracts to import merchandise, both the partner and the partnership share liability unless the seller knows that the partner has no such authority. In the latter case, the partner who signed the contract will be personally liable but not the partnership. A partner's action can bind the partnership to third parties if his or her action is consistent with the scope of authority, that is, expressed or implied authority provided in the partnership agreement (Cheeseman, 2006a; Mallor et al., 2013).

Limited Partnerships

A limited partnership is a special form of partnership that consists of at least one general (investor and manager) partner and one or more limited (investor) partners. The general partner is given the right to manage the partnership and is personally liable for the debts and obligations of the limited partnership. The limited partner, however, does not participate in management and is liable only to the extent of his or her capital contribution. Any person can be a general or limited partner, and this includes natural persons, partnerships,

or corporations. Limited partners have no right to bind the partnership in any contract and owe no fiduciary duty to that partnership or the other partners due to the limited nature of their interest in the partnership.

Whereas a general partnership may be formed with little or no formality, the creation of a limited partnership is based on compliance with certain statutory requirements. The certificate of limited partnership must be executed and signed by the parties. It should include certain specific information and be filed with the secretary of state and the appropriate county to be legal and binding. The limited partnership is taxed in exactly the same way as a general partnership. A limited partner's losses from an export-import business could be used to offset income generated only by other passive activities, that is, investments in other limited partnerships (passive loss rules). They cannot be used against salaries, dividends, interest, or other income from portfolio investments. Both types of partnership can be useful in international trade. They bring complementary assets needed to distribute and/or commercialize the product or service. The combination of skills by different partners usually increases the speed with which the product/service enters a market and generally contributes to the success of the business. Limited partners may also be useful when capital is needed by exporters or importers to prepare a marketing plan, expand channels of distribution, increase the scope and volume of goods or services traded, and so on. However, potential exists for conflict among partners unless a partnership agreement exists that eliminates or mitigates any sources of conflict. If limited partners become involved in marketing or other management decisions of the export-import firm, they are considered general partners and, hence, assume unlimited risk for the debts of the partnership (Anderson and Dunkelberg, 1993; Cheeseman, 2006a; Mallor et al., 2013).

Corporations

A corporation is a legal entity separate from the people who own or operate it and is created pursuant to the laws of the State in which the business is incorporated. Many export-import companies prefer this form of business organization due to the advantage of limited liability of shareholders. This means that shareholders are liable only to the extent of their investments. These companies can be sued for any harm or damage they cause in the distribution of the product, and that incorporation limits their liability to the assets of the business. Other advantages of incorporation are *free transferability of shares, perpetual existence, and ability to raise additional capital by selling shares in the corporation.* However, most of these companies are closely held corporations; that is, shares are owned by few shareholders who are often family members, relatives, or friends and are not traded on national stock exchanges.

Export-import corporations as legal entities have certain rights and obligations: they can sue or be sued in their own names, enter into or enforce contracts, and own or transfer property. They are also responsible for violation of the law. Criminal liability includes loss of a right to do business with the government, a fine, and any other sanction.

If an export-import company that is incorporated in one state conducts intrastate business (transacts local business in another state), such as selling merchandise or services in another state, it is required to file and qualify as a "foreign corporation" to do business in the other state. Conducting intrastate business usually includes maintaining an office to conduct such business. Using independent contractors for sales, soliciting orders to be accepted outside the state, or conducting isolated business transactions do not require qualification to do business in another state. The qualification procedure entails filing certain information

with the secretary of state, paying the required fees, and appointing a registered agent that is empowered to accept service of process on behalf of the corporation.

The process of forming a corporation (incorporating) can be expensive and time consuming. A corporation comes into existence when a certificate of incorporation, signed by one or more persons, is filed with the secretary of state. The corporation code in every state describes the types of information to be included in the articles of incorporation. Generally, it includes provisions such as the purpose for which the corporation is organized, its duration, and powers of the corporation.

Many businesses incorporate their companies in the state of Delaware even when it is not the state in which the corporation does most of its business. This is because Delaware has laws that are very favorable to businesses' internal operations and management. It is even more ideal for companies that plan to operate with little or no surpluses or that have a large number of inaccessible shareholders, making it difficult to obtain their consent when needed.

One of the main disadvantages of a corporation as a form of business organization is that its profits are subject to double taxation. Tax is imposed by federal and state governments on profits earned by the company, and, later, those profits are taxed as income when distributed to shareholders. Companies often avoid this by increasing salaries and bonuses for their owners and reporting substantially reduced profits. In this way, the income will be subject to tax when the owners or shareholders receive it rather than at the corporate level.

It is important that export-import companies maintain a separate identity from that of their owners. This includes having a separate bank account, preparing export/distributor contracts in the name of the company, holding stockholders meetings, and so on. In circumstances in which corporations are formed without sufficient capital or when there is a nonseparation of corporate and personal affairs, courts have disregarded the corporate entity. The implication of this is that shareholders may be found personally liable for the debts and obligations of the company. The corporate entity is also disregarded in cases in which the corporation is primarily used to defraud others and for similar illegitimate purposes, such as money laundering, trading in narcotics, or funneling money to corrupt officials (bribery).

Directors and officers of export-import companies owe a duty of trust and loyalty to the corporation and its shareholders. Directors and officers must act within their scope of authority (duty of obedience) and exercise honest and prudent business judgement (duty of care) in the conduct of the affairs of the corporation. In the absence of these, they could be held personally liable for any resultant damages to the corporation or its shareholders. Breach of duty of obedience and care by directors and officers of an export-import company could include one or more of the following:

- *Investment of profits:* Investing profits from export-import operations in a way that is not provided in the articles of incorporation or corporate bylaw
- *Corporate decisions:* Making export-import decisions without being adequately informed, in bad faith, and at variance with the goals and objectives of the company.

S Corporations

The Subchapter S Revision Act of 1982 divides corporations into two categories: S corporations and C corporations, that is, all other corporations. If an export company elects to be an S corporation, it has the best of advantages of a corporation and a partnership. Similar to a

corporation, S corporations offer the benefits of limited liability but still permit the owner to pay taxes as an individual, thereby avoiding double taxation. One advantage of paying taxes at the level of the individual shareholder is that export-import companies' losses can be used to offset shareholders' taxable income from other sources. It is also beneficial when the corporation makes a profit and when a shareholder falls within a lower income tax bracket than the corporation. However, the corporation's election to be taxed as an S corporation is based on the following preconditions (Mallor et al., 2013):

1. *Domestic entity:* The corporation must be a domestic entity, that is, it must be incorporated in the United States.
2. *No membership in an affiliated group:* The corporation cannot be a member of an affiliated group (not part of another organization).
3. *Number of shareholders:* The corporation can have no more than seventy-five shareholders.
4. *Shareholders:* Shareholders must be individuals or estates. Corporations and partnerships cannot be shareholders. Shareholders must also be citizens or residents of the United States.
5. *Classes of stock:* The corporation cannot have more than one class of stock.
6. *Corporate income:* No more than 20 percent of the corporation's income can be from passive investment income (e.g., dividends, interest, royalties, rents, annuities).

Failure to maintain any one of these conditions will lead to cancellation of the S corporation status. Another election after cancellation of status cannot be made for five years.

Limited-Liability Companies

This form of business organization combines the best of all the other forms. It has the advantages of limited liability and no restrictions on the number of owners or their nationalities (as is the case of S corporations). It is taxed as a partnership, and, unlike limited partnerships, it does not grant limited liability on the condition that the members refrain from active participation in the management of the company. To be taxed as a partnership, a limited-liability company (LLC) can possess any of the following attributes: two or more persons as associates, objectives to carry on business and divide gains, limited liability, centralized management and continuity, and free transferability of interests (Cheeseman, 2006b; Mallor et al., 2013). Such a company can be formed by two or more persons (natural or legal) and its articles of incorporation filed with the appropriate state agency. Limited-liability companies provide the advantage of limited liability, management structure (participation in management without being subject to personal liability), and partnership tax status. It has become a popular form of business for subsidiaries of foreign corporations as well as small-scale and medium-size businesses (August, 2004) (Table 3.1).

Business or Trade Name

A sole proprietorship or partnership that is engaged in an export-import business can operate under the name of the sole proprietor or one or more of the partners. There are no registration requirements with any government agency. However, if the sole proprietorship or partnership operates under a fictitious name, it must file a fictitious business name statement

TABLE 3.1 Forms of Business

	Formation	Duration	Management	Owner liability	Transferability of owners' interest	Federal income taxation
Sole proprietorship	One person owns business; no Corporation or LLC formed	Terminates on death or withdrawal of owner	By sole proprietor	Unlimited	None	Only sole proprietor taxed
partnership	By agreement of owners or by default when two or more owners conduct business together without creating another business form	Usually unaffected by death or withdrawal of partner	By partners	Unlimited	Limited	Only partners taxed
Limited liability partnership	By agreement of owners; must comply with limited liability partnership statute	Usually unaffected by death or withdrawal of partner	By partners	Limited to capital contribution, except for owner's individual torts	Limited	Usually only partners taxed; may elect to be taxed like a corporation
Limited partnership	By agreement of owners; must comply with limited partnership statute	Unaffected by death or withdrawal of partner	By general partners	Unlimited for general partners; limited to capital contribution for limited partners	Limited, unless agreed otherwise	Usually only partners taxed; may elect to be taxed like a corporation
Limited liability limited partnership	By agreement of owners; must comply with limited liability limited partnership statute	Unaffected by death or withdrawal of partner	By general partners	Limited to capital contribution, except for owner's individual torts	Limited, unless agreed otherwise	Usually only partners taxed; may elect to be taxed like a corporation
Corporation	By agreement of owners; must comply with corporation statute	Unaffected by death or withdrawal of shareholder	By board of directors	Limited to capital contribution, except for owner's individual torts	Freely transferable, although shareholders may agree otherwise	Corporation taxed; shareholders taxed on dividends (double tax)
S Corporation	By agreement of owners; must comply with corporation statute; must elect S Corporation status under Internal Revenue Code	Unaffected by death or withdrawal of shareholder	By board of directors	Limited to capital contribution, except for owner's individual torts	Freely transferable, although shareholders usually agree otherwise	Only shareholders taxed
Limited liability company	By agreement of owners; must comply with limited liability company statute	Usually unaffected by death or withdrawal of member	By members, unless choose to be manager-managed	Limited to capital contribution, except for owner's individual torts	Limited, unless agreed otherwise	Usually only members taxed; may elect to be taxed like a corporation

with the appropriate government agency. Most states also require publication of the trade name in a local newspaper that serves the area where the business is located.

> *Example:* Suppose John Rifkin wants to operate an export-import business (sole proprietorship) under the name "Global." This is commonly stated as "John Rifkin doing business as Global."

Corporations are required to register their business name with the state. It is important to obtain permission to use a trade name before incorporation. This is intended to ensure that (1) the trade name does not imply a purpose inconsistent with that stated in the articles of incorporation, and (2) the trade name is not deceptively similar to registered and reserved names of other companies incorporated to do business in the state. The secretary of state or other designated agency will do a search before authorizing the party to use the name (Cheeseman, 2006a; Mallor et al., 2013).

Unlike the effect of corporate name registration, registration of fictitious names does not prevent the use of the same name by others. This is because most states do not have a central registry of fictitious business names and registration of such names is simply intended to indicate the person doing business under the trade name. To avoid registration of a similar trade name, it is advisable to check records of counties as well as local telephone directories for existing fictitious business names (McGrath, Elias, and Shena, 1996).

Another important issue is the potential problems that ensue when such names are used as trademarks to identify goods or services. Suppose John Rifkin intends to use the trade name "Global" to market his perfume imports. It is important to ensure that the same or a similar name is not being used or registered with the U.S. Patent and Trademarks Office by another party prior to Rifkin's use of "Global" as a mark. The basic principles also apply in the case of corporations. If Rifkin uses "Global" as a trademark in connection with his trade or business for some time, he acquires exclusive use of the mark regardless of whether the same or a similar mark has previously been registered by others. Once a trader acquires a reputation in respect of his mark, then it becomes part of his goodwill, which is regarded by law as part of personal property that may be sold or licensed.

Bank Accounts, Permits, and Licenses

An export-import firm must open a bank account with an international bank that can accommodate specialized transactions such as letters of credit, foreign exchange payments, forfeiting, and so on. Some international banks have subsidiaries in importing countries that can verify the creditworthiness of foreign buyers. Sole proprietors and partnerships can open a bank account by submitting an affidavit of the fictitious business name statement to the bank with the initial deposit. In the case of a corporation, banks often require articles of incorporation, an affidavit that the company exists, and its tax identification number. It is important to check with the city or county to determine whether permits or business licenses are required.

Location and Use of Professional Services

When the export-import business is small, it is economical to use one's home as an office during the early phase of the operations. Besides saving money and travel time, using a portion of a home provides opportunities for deduction of expenses related to the business.

All of the direct expenses for the business part of the home, such as painting or repairs, are deductible expenses. The business use of a home may, however, provide the wrong impression to credit-rating agencies or clients, who may decide to pay an impromptu visit. Another problem with using one's home is that it may violate a city's bylaws that prohibit the conduct of any trade or business in an area that is zoned strictly for residential purposes. Homeowner's insurance coverage may not cover business equipment, merchandise, or supplies. It may be advisable to rent from a company with extra space or rent an office with basic services.

The use of professional services (use of attorneys, accountants, and consultants) is important not only during the early stages of the business but throughout its operation as an informal source of guidance on liability, expansion, taxes, and related matters. If the entrepreneur does not have sufficient resources to pay for such services, many professionals are willing to reduce rates, defer billing, or make other arrangements.

Organization for Export: Industry Approach

The Small Business Administration (SBA) states that, besides multinational firms such as General Motors or IBM, there are many small-scale industries that export their output. For many of these companies, there are a number of organizational issues that need to be addressed to achieve an optimal allocation of resources. Some of the issues include (1) the level at which export decisions should be made; (2) the need for a separate export department; and (3) if the decision is made to establish a separate department, its organization within the overall structure of the firm, including coordination and control of several activities. Such organizational issues involve three related areas:

1. *Subdivision of line operations based on certain fundamental competencies:* This relates to functional (e.g., production, finance), product, and geographical variables. A firm's organizational structure is often designed to fit its corporate strategy, which is, in turn, responsive to environmental realities (Albaum, Stradskov, Duerr, and Dowd, 2002).
2. *Centralization or decentralization of export tasks and functions:* Centralization is generally advantageous for firms with highly standardized products, product usage, buying behavior, and distribution outlets. Advantages from centralization also tend to accrue to firms (1) with few customers and large multinational competitors, and (2) with high R&D to sales ratio and rapid technological changes.
3. *Coordination and control:* Coordination and control of various activities among the various units of the organization is determined by the information-sharing needs of central management and foreign units.

Conventional business literature suggests that the choice of organizational structure determines export performance. The development of formal structures becomes important as the firm grows in size and complexity and to facilitate responses to internal and external changes. The adoption of flexible organizational structure can partly offset the disadvantage arising from formal organizational structure (Enderwick and Ranayne, 2004).

A study by Beamish, Karavis, Goerzon, and Lane (1999) shows that the organizational structure within which a firm manages its exports has a significant impact on export performance. It also suggests that management commitment to internationalize by establishing a separate export department increases firms' export performance.

Organizational Structures

An international company can organize its export-import department along functional, product, market, or geographical lines. Some firms organize their international division at headquarters on the basis of functional areas. Under this arrangement, functional staff located at the head office (e.g., marketing, finance) serve all regions in their specialties. Such a structure is easy to supervise and provides access to specialized skills. However, it could lead to coordination problems among various units as well as duplication of tasks and resources. It is generally suitable for companies that produce standardized products during the early stages of international operations.

Organization of export operations along product lines is suitable for firms with diversified product lines and extensive R&D activities. Under this structure, product division managers become responsible for the production and marketing of their respective product lines throughout the world. Even though this structure poses limited coordination problems and promotes cost efficiency in existing markets, it leads to duplication of resources and facilities in various countries and inconsistencies in divisional activities and procedures.

Organization along geographical lines is essentially based on the division of foreign markets into regions that are, in turn, subdivided into areas or subsidiaries. The regions are self-contained and obtain the necessary resources for marketing and research. This structure is suitable for firms with homogenous products that need efficient distribution and product lines that have similar technologies and common end-use markets (Albaum et al., 2002). It allows firms to respond to the changing demands of the market. This organizational approach makes coordination of tasks difficult when new and diverse products are involved. It also leads to duplication of certain tasks at the regional level. Certain companies adopt a mixed structure to manage international marketing activities. This structure combines two or more competencies on a worldwide basis. This approach is described as follows:

> Instead of designating international boundaries, geographical area divisions or product divisions as profit centers, they are all responsible for profitability. National organizations are responsible for country profits, geographical area divisions for a group of national markets and product divisions for worldwide product profitability. (Albaum et al., 1994, pp. 469–470)

A separate export department within a firm may become necessary as overseas sales volume increases. However, the provision of additional resources for a separate department is not warranted at the early phase of market entry, since such activities can often be handled by domestic marketing units.

General Principles of Taxation

The United States levies taxes on the worldwide income of its citizens, residents, and business entities. The United States, the Netherlands, and Germany are some of the few countries that impose taxes on the basis of worldwide income; most other countries tax income only if it is earned within their territorial borders. For U.S. tax purposes, an individual is considered a

U.S. resident if the person (1) has been issued a resident alien card (green card); (2) has been physically present in the United States for 183 days or more in the calendar year; or (3) meets the cumulative presence test: this test may be met if the foreign individual was present in the United States for at least 183 days out of the three-year period ending in the current year. In establishing cumulative presence, days present in the current year are added to one third of the days present in the preceding year and one sixth of the days in the second preceding year. An alien is treated as a resident if the total equals or exceeds 183 days.

Example of cumulative presence test: If Jim (a U.K. citizen) was in California for 66 days in 2010, 33 days in 2011, and 162 days in 2012, he would be considered a U.S. resident for 2012 (162 + 33/3 + 66/6 = 184 days). Jim may, however, rebut this presumption by showing that he has a closer connection to the United Kingdom than the United States or that his regular place of business is in the United Kingdom.

A company incorporated in the United States is subject to tax on its worldwide income, as are U.S. citizens and residents. A partnership is not treated as a separate legal entity, and, hence, it does not pay taxes. Such income is taxed in the hands of the individual partners, whether natural or legal entities.

Example 3.1

Suppose Joan, a U.S. citizen, has an export-import business as a sole proprietor and also works as manager in a fast-food restaurant. The profit from the business is added onto her employment income. If the business operates at a loss, the loss will be subtracted from her employment or other income, thus reducing the tax payable.

Example 3.1A: Joan's Income Tax Liability as Sole Proprietor

	Year 1	Year 2
Joan's salary	30,000	31,500
Export-import profit (loss)	12,000	(8,500)
Total income	42,000	23,000
Personal exemption	(2,500)	(2,500)
Itemized deduction	(10,000)	(10,000)
Taxable income	29,500	10,500

Example 3.1B: Joan's Income Tax under a Corporation

Taxable income of export-import company	48,000
Less corporate income tax (15%)	(7,200)
Distributed dividend to Joan	40,800
Dividend tax on Joan's individual tax return	(11,887)
Total corporate and individual income tax	19,087

As illustrated in example 3.1B, a corporation's income is subject to double taxation, first at the corporate level and then on the individual income tax return. Such incidences of double taxation are often reduced when deductions and other allowances are applied against taxable income. If earnings are left in the business, the tax rate may be lower than what would be paid by a sole proprietor. If the export-import business is incorporated as an S corporation, earnings are taxed only once, at the owner's individual tax rate. Payment of Social Security tax is also avoided by withdrawing profits as dividends.

Taxation of Export-Import Transactions

Taxation of U.S. Resident Aliens or Citizens

U.S. citizens and resident aliens are taxed on their worldwide income. In general, the same rules apply irrespective of whether the income is earned in the United States or abroad. Foreign tax credits are allowed against U.S. tax liability to mitigate the effects of taxes by a foreign country on foreign income. This also avoids double taxation of income earned by a U.S. citizen or resident, first in a foreign country where the income is earned (foreign source income) and then in the United States. Such benefits are available mainly to offset income taxes paid or accrued to a foreign country and may not exceed the total U.S. tax due on such income.

Example: Nicole, who is a U.S. resident, has a green card. She exports appliances (e.g., washers, dryers, stoves) to Venezuela and occasionally receives service fees for handling the maintenance and repairs at the clients' locations in Caracas and Valencia. Last year, she received $9,000 in export revenues (taxable income) and $3,500 in service fees (taxable income). No foreign tax was imposed on Nicole's export receipt of $9,000. However, she paid $2,200 in taxes to Venezuela on the service fees. Nicole also received $15,000 from her part-time teaching job at a community school (taxable income). Assume a 30 percent U.S. tax rate.

Source of income	Taxable income	Tax liability
Venezuela	9,000	2,700
Venezuela	3,500	2,200
United States	15,000	4,500
Total income	**27,500**	**9,400**

$$\text{Foreign tax limit} = \text{U.S. tax liability} \times \frac{\text{Taxable income from all foreign sources}}{\text{Total taxable worldwide income}}$$

The credit is the lesser of creditable taxes paid ($2,200) or accrued to all foreign countries (and U.S. possessions) or the overall foreign tax credit limitation ($3,750). The foreign tax credit limitation = 30 percent (27,500) x 12,500/27,500 = $3,750.

If the foreign tax credit limitation is lower than the foreign tax owed (i.e., suppose the foreign tax is greater than $3,750), the excess amount can be carried back two years and forward five years to a tax year in which the taxpayer has an excess foreign credit limitation.

Taxation of Foreign Persons in the United States (Nonresident Aliens, Branches, or Foreign Corporations)

Foreign firms use different channels when marketing their products in the United States. They often begin selling goods through independent distributors until they gain sufficient resources and experience. As their export volume grows, they may wish to directly export to their U.S. customers and market their products by having their employees occasionally travel to the United States in order to contact potential clients, identify growing markets, or negotiate sales contracts. As the company becomes more successful in the market, it may decide to establish a branch or subsidiary in the United States.

Foreign persons engaged in U.S. trade or business are subject to U.S. taxation on the income that is "efficiently connected" with the conduct of U.S. trade or business. This includes U.S.-source income derived by a nonresident alien, foreign corporation, or U.S. branch from the sale of goods or provision of services. "Effectively connected income" may be extended beyond U.S.-source income to include certain types of foreign-source income that was facilitated by use of a fixed place of business or office in the United States.

> *Example:* Amin, a Brazilian software exporter, opens a small sales office in Hammond, Indiana, in order to sell in the United States and Canada. Canadian sales (foreign-source income) in this case are generally considered "effectively connected," since income is produced through the U.S. sales office in Indiana. Amin's sales in the United States (through a U.S. branch or subsidiary) are also subject to U.S. tax because they result from permanent establishment in the United States or income from U.S. trade or business.

A foreign corporation or nonresident alien that exports goods or services to the United States through a fixed place of business or office can claim deductions for expenses, losses, and foreign taxes or can claim a tax credit for any foreign income taxes, such as foreign- and U.S.-source effectively connected income. The credits are not used to offset U.S. withholding or branch profits tax and are allowable only against U.S. taxes on "effectively connected income." While a tax deduction reduces taxable income by the amount of a given expense, tax credits are a dollar-for-dollar reduction of U.S. income tax by the amount of the foreign tax.

Model tax treaties that the United States entered into with many trading nations contain the following common provisions:

- Foreign person's (nonresident alien, foreign corporation, U.S. branch) export profits are exempt from U.S. tax unless such profits are attributable to a permanent establishment maintained in the United States, that is, a fixed place of business, or when U.S.-dependent agents have authority to conclude sales contracts on behalf of the company.

Example: Donga Inc., a trading company incorporated in Monaco, exports ceiling fans to the US. Its sales agents spend two months of every year traveling across the US to market/promote sales with major clients. When they receive orders, they forward them to the home office for final approval. The agents do not sign purchase orders or sales contracts.

Donga Inc. is not subject to U.S. taxes since (a) the agents do not have contracting authority and (b) the company does not have a permanent establishment in the United States.

- Marketing products in the United States through independent agents or distributors does not create a permanent establishment and thus there is no tax liability in the United States.
- Income from personal services provided by nonresident aliens in the United States are normally exempt unless the employee is present in the United States for more than 183 days or paid by a U.S. resident. Income derived by professionals (e.g., accountants, doctors) are exempt unless attributable to a fixed place of business in the United Sates.

Taxation of U.S. Exports

In general, U.S. companies that export their goods overseas will incur no tax liability in the importing country if:

1. They undertake their exports through independent distributors (they have a nontaxable presence in the importing country).
2. Their agents/employees overseas do not have authority to conclude sales contracts on behalf of the U.S. exporter.
3. The services performed are not attributable to a fixed place of business in the host country.

An export-import firm may enter a foreign market by establishing a branch in a foreign country. Branches are often used to retain exclusive control of overseas operations or to deduct losses on initial overseas activities. However, they can be incorporated abroad when such operations become profitable to enable the firm to defer any U.S. income taxes owed on profits until they are remitted to the United States. A branch is not a separate corporation; it is considered an extension of the domestic corporation. One of the major disadvantages of operating a branch is that it exposes the domestic firm to liability in a foreign country. Foreign branch taxes are paid when they are earned (not when remitted to the United States, as in the case of a foreign corporation), and losses are reported when incurred. Foreign taxes paid or accrued on branch profits are eligible for foreign tax credits (Figure 3.1).

An export-import firm can enter a foreign market by establishing a separate corporation (subsidiary) to conduct business. The parent corporation and the subsidiary are separate legal entities, and their individual liabilities are limited to the capital investment of each respective firm. Foreign taxes are paid when the subsidiary receives the income, but U.S. taxes are paid when distributed to shareholders as a dividend. Foreign taxes paid (a ratable share) are eligible for a tax credit at the time of distribution of dividend to the U.S. taxpayer. A U.S. shareholder (parent firm) can also claim a proportional share of a dividends-received deduction.

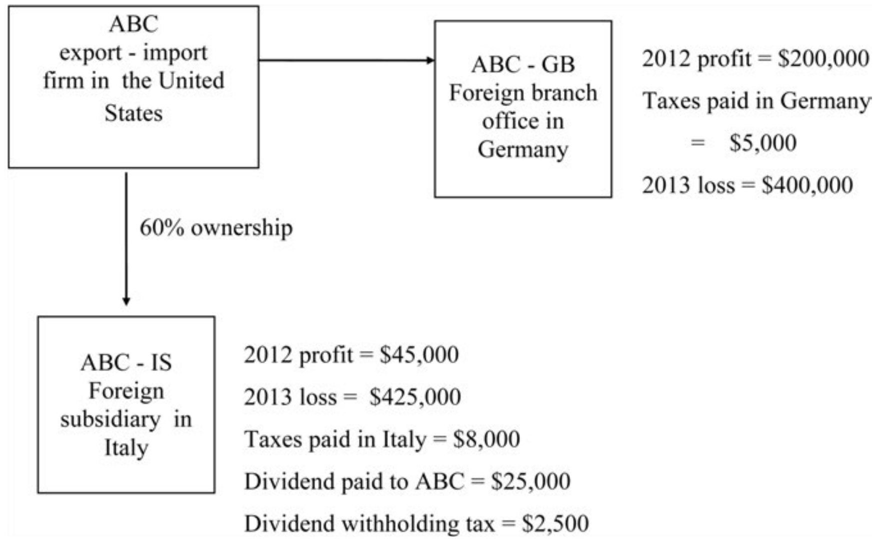

FIGURE 3.1 Taxation of Foreign Subsidiaries and Branches

1. The 2012 profit ($200,000) of the German Branch is taxable to ABC export-import firm in 2012. Remittance of reported earnings to the United States is not required for tax purposes. However, 2012 profits earned by the Italian subsidiary are subject to tax in the United States only when remitted; that is, taxes can be deferred until remitted to the U.S. parent.
2. The 2013 losses by ABC-GB can be used to offset ABC's 2013 taxable income from its U.S. operations. However, ABC-IS's losses cannot be used to reduce ABC's 2013 taxable income. The $425,000 loss incurred can be used only to reduce profits earned in other years and distributed as dividend to ABC Company.
3. Taxes paid by ABC-GB to Germany can be claimed to offset ABC's U.S. taxes due on its profits. In the case of ABC-IS's taxes paid on its profits to Italy, ABC can claim a foreign tax credit for the taxes withheld on its dividend receipts for the given year. This does not reduce all or most of the foreign taxes incurred or paid on the subsidiary's profits, since it is limited only to taxes withheld from a foreign subsidiary's dividend remittances. The introduction of the "deemed paid foreign tax credit" was intended to remedy this inequity. Under this method, the U.S. shareholder (ABC) will be deemed to have paid a portion of ABC-IS's foreign taxes corresponding to the proportion of dividends received and not on any withholding taxes on the dividends distributed. However, the deemed paid foreign tax credit is available to U.S. companies that own at least 10 percent of the foreign subsidiary's voting stock at the time of distribution and is based only on actual dividends paid. It is also limited only to corporate U.S. shareholders.

   Deemed paid tax credit (DPTC) is calculated as follows:

$$\frac{\text{Dividends paid to U.S. corporate shareholder from post-1986 undistributed earnings}}{\text{Accumulated post-1986 undistributed earnings}} \times \text{Post-1986 creditable taxes paid or accrued by foreign subsidiary}$$

$$\text{DPTC} = \frac{\$25{,}000}{\$45{,}000} \times 8{,}000 = \$4{,}444$$

ABC's U.S. Tax Liability:

Dividend	$25,000
DPTC	$4,444
Gross income	$29,444
Corporate tax (35%)	$10,305
Gross U.S. tax liability	$10,305
Less DPTC	($4,444)
Less dividend tax withheld	$2,500
Net ABC tax liability	$3,361.00

Taxation of Controlled Foreign Corporations

A controlled foreign corporation (CFC) is a foreign corporation in which U.S. shareholders own more than 50 percent of the voting stock or more than 50 percent of the value of the outstanding stock in any of the foreign corporation's tax year. Rules governing CFCs are concerned with preventing U.S. businesspersons from escaping high marginal tax rates in the United States by operating through controlled corporations in a foreign country that imposes little or no tax. The parent company could sell goods or services to a foreign subsidiary and manipulate prices so that most of the profits are allocated to the subsidiary in a country that imposes little or no tax, thus avoiding U.S. and foreign taxes. The CFC could also be used as a base company to make sales outside its country of incorporation or as a holding company to accumulate passive investment income such as interest, dividends, rent, and royalties.

U.S. shareholders must report their share of CFC's subpart F income each year. Subpart F income includes foreign base company income (foreign base sales, services, shipping, and personal holding company income), CFC's income from insurance of U.S. and foreign risks, boycott-related income and bribes, and other illegal payments.

A U.S. shareholder is subject to tax on the subpart F income only when the foreign corporation is a CFC for at least thirty days during its tax year. A U.S. shareholder of a CFC must then include his or her pro rata share of the subpart F income as a deemed dividend that is distributed on the last day of the CFC's tax year or the last day on which CFC's status is retained (McDaniel et al., 1981; Ogley, 1995).

Example: Monaco corporation, located in Hong Kong, is a CFC owned by XYZ Company of San Diego, California. Monaco corporation buys computer parts from XYZ Company and sells about 80 percent of the parts in other Asian countries. The remainder is sold to retailers in Hong Kong. Profits earned from sales in foreign countries are foreign base sales income, that is, subpart F income, and taxable to XYZ Company during the current year. Sales to foreign countries of goods manufactured by Monaco in Hong Kong would not constitute foreign base sales income.

Taxation of Domestic International Sales Corporations

Taxation of domestic international sales corporations (DISCs) is discussed in chapter 15.

Deductions and Allowances

Export-import businesses may deduct ordinary and necessary expenses. Ordinary and necessary expenses are defined by the Internal Revenue Service as follows:

> An ordinary expense is one that is common and accepted in your type of business, trade or profession. A necessary expense is one that is helpful and appropriate for your trade, business, or profession. An expense does not have to be indispensable to be considered necessary. (Internal Revenue Service, 2012a, p. 6)

When one starts the export-import business, all costs are treated as capital expenses. These expenses are a part of the investment in the business and generally include:

1. The cost of getting started in the business before beginning export-import operations such as market research, expenses for advertising, travel, utilities, repairs, employees' wages, salaries, and fees for executives and consultants.
2. Business assets such as building, furniture, and trucks and the costs of making any improvements to such assets, for example, a new roof or new floor. The cost of the improvement is added to the base value of the improved property.

The cost of specific assets can be recovered through depreciation deductions. Other startup costs can be recovered through amortization; that is, costs are deducted in equal amounts over 60 months or more. Organizational costs for a partnership (expenses for setting up the partnership) or corporation (e.g., costs of incorporation, legal and accounting fees) can be amortized over sixty months and must be claimed on the first business tax return. Once the business has started operations, standard business deductions are applied against gross income. Standard business deductions include the following:

1. *General and administrative expenses:* Office expenses such as telephones, utilities, office rent, legal and accounting expenses, salaries, professional services, and dues. These also include interest payments on debt related to the business, taxes (real estate and excise taxes, estate and employment taxes), insurance, and amortization of capital assets.
2. *Personal and business expenses:* If an expense is incurred partly for business and partly for personal purposes, only the part that is used for business is deductible. If the export-import business is conducted from one's home, part of the expense of maintaining the home could be claimed as a business expense. Such expenses include mortgage interest, insurance, utilities, and repairs. To successfully claim such limited deductions, part of the home must be used exclusively and regularly as the principal place of business for the export-import operation or as a place to meet customers or clients. Similarly, automobile expenses to conduct the business are deductible. If the car is used for both business and family transportation, only the miles driven for the business are deductible as business expenses. Automobile-related deductions also include depreciation on the car; expenses for gas, oil, tires, and repairs; and insurance and registration fees (Internal Revenue Service, 2012b).
3. *Entertainment, travel, and related business expenses:* Expenses incurred entertaining clients for promotion, travel expenses (the cost of air, bus, taxi fares), as well as other related expenses (dry cleaning, tips, subscriptions to relevant publications, convention expenses) are tax deductible (Internal Revenue Service, 2012c).

If deductions from the export-import business are more than the income for the year, the net operating loss can be used to lower taxes in other years. All of these expenses have to be specifically allocated and apportioned between foreign- and domestic-source income.

International Transfer Pricing

Transactions between unrelated parties and prices charged for goods and services tend to reflect prevailing competitive conditions. Such market prices cannot be assumed when transactions are conducted between related parties, such as a group of firms under common control or ownership. If a parent company sells its output to a foreign marketing subsidiary at a higher price, it moves overall gains to itself. If it charges a lower price, it shifts more of the overall gains to the subsidiary. Even though transfer prices do not affect the combined income or absolute amount of gain or loss among related persons or "controlled group of corporations," they do shift income among related parties in order to take advantage of differences in tax rates (International Perspective 3.2).

In the example, the combined income remains at $1,000 for the steel export regardless of the transfer price used to allocate income between the parent and the subsidiary. If the tax rate is 30 percent in the United States and 40 percent in Spain, the U.S. parent company can use the higher transfer price for its controlled sale (Option B) to reduce its world wide taxes:

Option A: 1000 × 40% = $400 (Spain's rate)
Option B: 1000 × 30% = $300 (U.S. rate)

In cases where U.S. companies operate in low-tax jurisdictions, income can be shifted to a low-tax subsidiary. This has the advantage of deferring the U.S. tax until the foreign subsidiary repatriates its earnings through dividend distribution.

Example

	U.S. Parent Co. (Steel Co.) in Detroit, Michigan	**U.S. Subsidiary in Madrid, Spain**
Option A	Production Cost = $1,000	Cost of sales = $1,000
		Selling expense = $200
	Sale to subsidiary = $1,000	Sales revenue = $2,200
	Net Profit = $0	Net Profit = $1,000
Option B	Production cost = $1,000	Cost of sales = $2,000
		Selling expense = $200
	Sales to subsidiary = $2,000	Sales revenue = $2,200
	Net Profit = $1000	Net Profit = $0

U.S. regulation (Section 482) on transfer pricing is largely intended to ensure that taxpayers report and pay taxes on their actual share of income arising from controlled transactions. The appropriateness of any transfer price is evaluated on the basis of the arm's-length or market-value standard. For example, in the case of loans extended by a U.S. parent company

to its overseas subsidiary, the Internal Revenue Service has successfully imposed an arm's-length interest charge (a charge that would be paid by unrelated parties under similar circumstances).

INTERNATIONAL PERSPECTIVE 3.2

Transfer Pricing Methods

A number of factors are considered in the determination of comparable prices between parties dealing in arm's-length transactions: contractual terms, such as provisions pertaining to volume of sales, warranty, duration or extension of credit, functions performed (e.g., marketing, R&D), and risks assumed, including responsibility for currency fluctuations, credit collection, or product liability. Other factors include economic market conditions (also geographical market and competitive conditions in the industry and the market), as well as the nature of property or services transformed.

In the case of sale of tangible goods between related parties, the arm's-length charge is determined by using the following methods:

- Comparable uncontrolled price method: uses prices on the sale of similar goods to unrelated parties
- Resale price method: uses resale price to unrelated parties using gross profit margin
- Cost-plus method: used in situations in which products are manufactured and sold to related parties
- Comparable-profits method: uses profit-level indicators such as rate of return on operating assets of uncontrolled parties to adjust profit levels of each group
- Profit split method: allocates profit between related parties on the basis of the relative value of the contribution to the profit of each party.

In the performance of services to related parties, the regulations do not require that a profit be made on the change for services unless the services are an integral part of the business activity of the providing party, that is, the principal activity of the service provider is that of rendering such services to related or unrelated parties.

Tax Treaties

Income tax treaties are entered into by countries to reduce the burden of double taxation on the same activity and to exchange information to prevent tax evasion. Tax-treaty partners generally agree on rules about the types of income that a country can tax and the provision of a tax credit for any taxes paid to one country against any taxes owed in another country.

The United States has entered into a number of tax treaties with about sixty countries. They include Canada, China, EU countries, India, Japan, South Korea, Mexico, New Zealand, South Africa, and many of the transition economies of Central and Eastern Europe. In most countries, the treaty prevails over domestic law. In the United States, if there is a conflict between a treaty provision and domestic law, whichever is the most recently enacted governs the transaction.

The following are some of the common treaty provisions with regard to business profits:

- The export profits of an enterprise of one treaty country shall be taxable only in that country unless the enterprise carries on business in the other treaty country through a permanent establishment situated therein. The importing country may tax the enterprise's profits that are attributable to that permanent establishment (U.S. Government, 1966, Part 7.1).
- Permanent establishment is meant to describe a fixed place of business through which the business of an enterprise is wholly or partially discharged. It includes a place of management, a branch, an office, a factory, a workshop, a mine, or any other place of extraction of natural resources. It is assumed to be a permanent establishment only if it lasts or the activity continues for a period of more than twelve months (U.S. Model Income Tax Treaty, 5.3).
- Permanent establishment shall not include certain auxiliary functions such as purchasing, storing, or delivering inventory (U.S. Model Income Tax Treaty, 5.4).
- An enterprise is deemed to have a permanent establishment in a treaty country if its employees conclude sales contracts in its name. If a Canadian exporter sends its sales agents to enter into a contract with a U.S. firm in New York, the Canadian company shall be deemed to have a permanent establishment in the United States. even if it does not have an office in the United States (U.S. Model Income Tax Treaty, 5.5).
- Permanent establishment is not imputed in cases where a product is exported through independent brokers, or distributors regardless of whether these independent agents conclude sales contracts in the name of the exporter (U.S. Model Income Tax Treaty, 5.6).

Chapter Summary

Ownership structure	The forms of business organizations are sole proprietorship, partnership, and corporation.
Business or trade name	Corporations are required to register their trade name with the state. Sole proprietorships and partnerships are required to register with the appropriate government agency if they operate under a fictitious name.
Bank accounts, permits, and licenses	1. Opening a bank account: It is advisable to open an account with an international bank. 2. An export/import firm can be operated from a home during the early phase of the business. All direct expenses related to the business are tax deductible. 3. The use of professional services is important as a source of guidance on liability, taxes, expansion, and related matters. 4. Permits and licenses: It is important to check with the city or country to determine whether permits or business licenses are required.

Organizational issues	Common issues include the level at which export decisions should be made, the need for a separate export department, coordination and control of various activities, and the organizational structure of the export-import department.
Common organizational structures	Organizations can be structured along functional lines, along geographical lines, or on the basis of product or market.
Taxation of export-import business	Foreign persons export profits are exempt from U.S. tax unless such profits are attributable to a permanent establishment maintained in the United States. Similarly, U.S. exports will not be subject to tax in the importing country unless the firm has a fixed place of trade or business in the importing country or its agents in the latter country have authority to conclude contracts on behalf of the U.S. exporter. Deductions and allowances: organizational costs, general and administrative expenses, personal and business expenses, entertainment, travel, and other related business expenses. Transfer pricing is intended to ensure that taxpayers report and pay tax on their actual share of income arising from controlled transactions. There are several methods used to estimate an arms-length charge for transfers of tangible property: the comparable uncontrolled price method, the resale price method, the cost-plus method, the comparable-profits method and the profit split method.

Review Questions

1. What are the major disadvantages of running an export-import business as a partnership?
2. Are partnerships recognized as legal entities? Discuss.
3. Both general and limited partnerships may be useful forms of organization for export-import businesses. Why/why not?
4. What is an S corporation?
5. What types of professional services are needed when you start an export-import business?
6. State three typical organizational structures of firms that are engaged in international trade. Is a separate export department necessary for a manufacturing firm with limited exports?
7. ABC Company is incorporated in Florida, although all its business activities are done in France. Its management office is located in Amsterdam, where the board of directors holds its regular meeting. The shareholders are from the United Kingdom and Denmark and hold their annual meeting in Vienna. What is ABC's residence for tax purposes?
8. Are U.S. exporters subject to income tax in importing countries? What are the tax implications of establishing a trading firm as a branch (as opposed to a subsidiary) in foreign countries?

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World Wide Web Resources

Fictitious Business Names

Fictitious Business Names: Information on filing fictitious business names: http://www.sba.gov/content/register-your-fictitious-or-doing-business-dba-name
Tips on choosing a business name: http://www.sba.gov/content/how-name-business
Seven secrets of great business names: http://www.entrepreneur.com/article/223694
Information on assumed business names: http://www.leg.state.or.us/ors/648.html

Starting a Business

Starting a business: provides answers to frequently asked questions about starting a business: http://www.irs.gov/businesses/small/article/0,,id = 99336,00.html

Case 3.1 Globalization and the Shrinking Tax Base

Many developed countries are faced with declining tax revenues from multinational corporations. A recent European Commission proposal attempts to harmonize the tax base in the EU to limit the shrinking corporate tax yield. In view of the pressure to increase shareholder value, multinationals feel obligated to use complex tax avoidance strategies. In high-tax jurisdictions, such as the United Kingdom, for example, investment inflows tend to lead to an increase in debt and a reduction in equity of the acquired firms. This often leads to large payments in tax-allowable interest to foreign parent companies, thereby reducing taxable income. Thin capitalization rules intended to limit repatriation of profits through high interest charges on intragroup borrowings do not appear to be effective. These rules have not been able to prevent multinationals from transforming preinterest profits into pretax losses in high-tax jurisdictions.

A study by the *Financial Times* noted that 8 of the top twenty nonoil multinationals operating in the United Kingdom paid little or no tax to the U.K. treasury in 2002. It indicates that in many cases, profits are being reduced by transfer pricing and intergroup charges. This includes but is not limited to overinvoicing imports and underinvoicing exports. A multinational, for example, sells goods to other group companies at below-market prices while the subsidiary resells the goods at market prices, thereby ensuring that profits are made in low-tax jurisdictions. Enforcement of existing rules has proven difficult. Comparing operating margins between sister companies and other competitors is often difficult because of the multinational company's different regional structures and mixes of product. Tax authorities do not have sufficient information relative to their multinational clients to effectively enforce the rules. One study estimates the total tax losses to the U.S. Treasury from artificial transfer pricing at about $53 billion in 2001 (see Tables 3.2 and 3.3).

Here are other examples:

- The Asda Group, which was acquired by Walmart (U.K.) declared pretax profits of £608 million in 2002. This shrinks at Asda's parent (Walmart [U.K.]) to £209 million due to interest and amortization of goodwill on the acquisition. Not taking into account deferred taxation, the tax charge was at £88 million despite Asda's profits of more than £405 million.
- Deferred tax assets of the four largest investment banks in the United Kingdom amounted to more than $1.1 billion in 2002. This allows them to pay less tax in the future by carrying forward their losses.
- In January 2002, Glaxo Smith Kline, the pharmaceutical firm, was presented with $5.2 billion bill for extra taxes (not paid due to transfer pricing) and interest by the U.S. government pertaining to revenues owed since the late 1980s.
- In 2012, Starbucks had paid just £8.6 million in the United Kingdom since it opened its first British store in 1998. It had sales estimated at £3 billion since 1998. Starbucks has more than 600 stores in the United Kingdom. In view of the negative publicity created by this news, the company pledged to pay £20 million over the next two years.

TABLE 3.2 Top Ten Sources of Lost U.S. Taxes Due to Overinvoicing of Imports/Underinvoicing of Exports, 2001

U.S. Export (Import)	Tax loss at 34% ($ million U.S.)	Income Shifted ($ million U.S.)
Japan	10,154 (2,591)	29,864 (7,622)
Germany	3,475 (2,072)	10,221 (6,093)
Netherlands	2,484 (1,446)	7,299 (4,254)
Canada	2,375 (1,164)	6,987 (3,425)
Mexico	2,365 (1,095)	6,954 (3,220)
United Kingdom	2,237 (767)	6,578 (2,255)
Philippines	1,451 (653)	4,269 (1,921)
France	1,217 (537)	3,579 (1,578)
South Korea	1,039 (465)	3,055 (1,368)
China	970 (449)	2,853 (1,322)

TABLE 3.3 Selected List of Abnormally Low Export/High U.S. Import Prices (2001)

U.S. Export	Destination	Price
Bovine animals (live)	Mexico	$20.65/unit
Multivitamins	Finland	$1.34/kg
Dynamite	Canada	$1.24/kg
Radial tires (bus/truck)	United Kingdom	$11.74/unit
Diamonds	India	$13.45/carat
Aluminum ladders	Hong Kong	$1.75/unit
U.S. Import	**Source**	**Price**
Multivitamins	China	$1,868.77/kg
Plastic buckets	Czech Republic	$973/unit
Fence posts (treated)	Canada	$1,853.50/meter
Wood moldings	Bolivia	$1,124/meter
Toilet/facial tissue	China	$4,121/kg
Briefs and panties	Hungary	$739/dozen

Sources: Pak and Zdanowicz (2002); Plender (2004).

Questions

1. Do you think countries' efforts to limit transfer pricing are effective?
2. What other ways are available to limit transfer pricing?

four
Planning and Preparations for Export

Assessing and Selecting the Product

Although the basic functions of exporting and domestic selling are the same, international markets differ widely because of great variations in certain uncontrollable environmental forces. These include currency exchange controls/risks, taxation, tariffs, and inflation, which happen to originate outside the business enterprise. Such variations require managers who are aware of global threats and opportunities.

If a company already manufactures a product or service, it is reasonable to assume that its product or service is what will be exported. However, companies must first determine the export potential of a product or service before they invest their resources into the business of foreign trade. To establish the export potential of a product, firms must consider the following factors: *the success of the product in domestic markets, participation in overseas trade shows, advertising, and market data.*

If a product is successful in the domestic market, there is a good chance that it will be successful in markets abroad. However, a careful analysis of a product's overseas market potential is needed. One could start by assessing the demand for similar products domestically and abroad, as well as determining the need for certain adaptations or improvements. Trade statistics provide a preliminary indication of markets for a particular product in most countries. For products or services that are not new, low-cost market research is often available that can help determine market potential. Products that are less sophisticated and for which there is declining demand in developed countries' markets often encounter a healthy demand in developing nations because the goods are less expensive and easy to handle (Weiss, 2007).

Participation in overseas trade shows is a good way to test the export potential of products or services. A recent study commissioned by America Business Media found that seven out of ten business executives purchased or recommended the purchase of a product or service after looking at an advertisement or promotion at a trade show (Schwartz, 2006). However, if an assessment of the actual and potential uses of the product or service indicates that it satisfies

TABLE 4.1 The Export Decision: Management Issues

Experience

- *With what countries is trade being conducted?*
- *Which product lines are most in demand, and who are the buyers or likely buyers?*
- *What is the trend in sales?*
- *Who are the main domestic and international competitors?*
- *What lessons have been learned from past experience?*

Management and Personnel

- *Who will be responsible for the export department's organization and staff?*
- *How much management time should or could be allocated?*
- *What organizational structure is suitable?*

Production Capacity

- *What is the firm's production capacity?*
- *What is the effect of exports on domestic sales and production capacity and cost?*
- *Is a minimum order quantity required?*
- *What are the design and packaging requirements for exports?*

Financial Capacity

- *What amount of capital is tied up in exports?*
- *What level of export department operating costs can be supported?*
- *What are the initial expenses of export efforts to be allocated?*
- *When should the export effort pay for itself?*

certain basic needs in the market place, initial sales can be made to establish demand as well as to determine potential improvements.

To achieve success, there must be a strong and lasting management commitment to the export business. The long-term commitment is necessary to ensure the recovery of high market-entry costs related to product modification, legal representation, and advertising, as well as the development of an agent/distributor network (see Table 4.1).

Companies already operating in the domestic market need to consider the development of export markets through the allocation of financial and personnel resources or through the use of outside experts. In the absence of sufficient knowledge about exporting, it is often advisable for companies to hire consultants who would be engaged in the establishment of the department and the training of personnel.

An individual entrepreneur, acting as a middleman between the manufacturer and the importer, can pick any product or service. There are two approaches to selecting a product or service the systematic and the reactive.

Systematic Approach

The systematic approach involves selection of a product or service based on overall market demand. An individual entrepreneur often selects a product line or service on the basis of

demand and growth trends by observing trade flows. A variety of statistical sources provide data (for products and services) pertaining to the major export markets, projected total demand, and U.S. exports in each market, along with the rank of the countries based on the projected import value. This process of collecting and analyzing information enables the potential exporter to draw conclusions on the best line of products or services as well as promising markets. It is, however, important to select products or services on the basis of familiarity and skill. A computer technician is in a more advantageous position to export computers, computer parts, software, and computer services than a graphic designer because of the former's prior knowledge about the product/service. This individual is more likely to be familiar with product- and/or service-specific issues such as quality, technical specifications, adaptability to overseas requirements, and maintenance or after-sales service.

Other important factors to consider in product/service selection include proximity of the producer or manufacturer to one's home or office in order to maintain close personal contact and closely monitor and discuss product quality, production delays, order processing, and other pertinent matters. Once a potential product (service) for export has been identified, the individual must undertake market research to select the most promising markets on the basis of import value and growth trends. Both manufacturing companies and individuals must consider whether a given product has export potential before investing substantial time, effort, and capital (Ball, Geringer, Minor and McNett, 2013).

Reactive Approach

The reactive approach involves selecting a product on the basis of immediate market need. Even though it is quite common to select the product and identify possible markets, certain exporters initially identify the consumer need and then select a product or service to satisfy the given market demand. A plethora of publications advertise products/services (exporters can also advertise) that are needed in foreign countries by public- or private-sector importers. The first step would be to contact potential importers to indicate one's interest in supplying the product and to obtain other useful information. Once there is a reasonable basis to proceed (based on the importer's response), potential suppliers of the product/service can be identified from the various directories of manufacturers. In the United States, for example, the *Thomas Register of Manufacturers* is considered to be a comprehensive source of U.S. manufacturers.

In both cases (systematic or reactive), selection of the manufacturer depends on a number of factors, including price, quality, and proximity to home or office, as well as the manufacturer's commitment to export sales. There must be a long-term commitment from management to encourage the development of export markets, and this cannot be motivated by occasional needs to dispose of surplus merchandise. It is also important to consider the existence of export restrictions that limit the sale of these products to specific countries and their implications for sales and profits. Manufacturers may also impose certain restrictions when they have an agent/distributor or a subsidiary producing the goods in the market (International Perspective 4.1).

The reactive approach to selecting a product has certain disadvantages for the individual entrepreneur who acts as an intermediary between the manufacturer and importer:

1. *Lack of focus on a given product or market:* Chasing product orders in different markets impedes the development of a systematic export strategy. This approach ignores the idea

of niche exporting, which is critical to the success of any export-import enterprise. It leads to exports of unfamiliar products and/or sales to difficult markets, which hampers the long-term growth and profitability of export businesses.

2. *Absence of long-term relationship with the importer:* Selling different products to different markets impedes the development of a long-term relationship with importers. It also creates suspicion on the part of importing firms about the long-term reliability and commitment of the firm to exporting.

INTERNATIONAL PERSPECTIVE 4.1

Important Factors to Consider in Selecting the Export Product

Shifting spending patterns*:* Basic determinants of how much a consumer buys of a product are the person's taste and preference, as well as the price of the product (relative to the price of other products). Another major influence is the consumer's income. If the consumer's income increases, demand for most goods will rise. However, the demand for goods that people regard as necessities, such as fuel, tobacco, bread, or meat, tends to decline, and exporters of such products are not likely to greatly benefit from rising consumer incomes in other countries. The demand for luxuries, such as new cars or expensive food, expands even more rapidly. Therefore, exporters should generally put more emphasis on goods that consumers regard as "luxuries" due to shifting spending patterns in response to rising incomes.

Products to be excluded from the list: Individuals starting an export-import trade should initially work with small to medium-size manufacturers because large companies, such as GE, have their own export departments or overseas subsidiaries that produce the goods in those markets. Products that compete with such large companies should not be considered at this stage. It is also important to avoid product/services that require too many export/licensing requirements as a condition of executing an international business transaction. Also, the fashion-oriented market is too volatile and unpredictable to warrant a full commitment until a later stage. This also extends to multimillion-dollar contracts for overseas government projects, as well as sophisticated products that often require the development of training facilities and a network of technicians for after-sales service.

Emphasis on quality and niche marketing: Several studies on export-import trade indicate that firms that have shown a sustained increase in their sales and overall profits have often emphasized quality and concentrated on niches. In this age of diversity, marketers are being awakened to the erosion of the mass market. Traditional marketing methods are no longer as effective as they used to be, and a new emphasis on quality and niche marketing is proving successful. Even after the elimination of textile quotas in 2005, many European textile producers have maintained steady growth in their exports because of their emphasis on high-fashion items with special brand identity.

International Market Research

International market research deals with how business organizations engaged in international trade make decisions that lead to the allocation of resources in markets with the

greatest potential for sales (Ball et al., 2013). This process of market screening helps to maximize sales and profits by identifying and selecting the most desirable markets.

Why Conduct International Market Research?

International market research is needed because export/investment decisions are often made without a careful and objective assessment of foreign markets and with a limited appreciation for different environments abroad. This is often a result of the perception of other markets as an extension of the domestic market and the belief that methods/ practices which work at home also work abroad. The cost of conducting international research is seen as prohibitively high, and managers make export decisions on the basis of short-term and changing market needs (reactive approach). Environmental scanning is viewed as a prerequisite for the successful alignment of competitive strategies (Beal, 2000; Subramanian, Fernandes and Harper, 1993).

The purpose of international marketing research is to (1) identify, evaluate, and compare the size and potential of various markets and select the most desirable market(s) for a given product or service, and (2) reassess market changes that may require a change in a company's strategy. A firm may research a market by using either primary- or secondary-data sources.

Primary research (using primary data) is conducted by collecting data directly from the foreign marketplace through interviews, focus groups, observation, surveys, and experimentation with representatives and/or potential buyers. It attempts to answer certain questions about specific markets such as sales potential or pricing. Primary research has the advantage of being tailored to the company's market and therefore provides specific information. However, collection of such data is often expensive and time consuming.

Secondary market research is based on data previously collected and assembled for a certain project other than the one at hand. Such information can often be found inside the company or in the library, or it can be purchased from public or private organizations that specialize in providing information, such as overseas market studies, country market surveys, export statistics profiles, foreign trade reports, or competitive assessments of specific industries. Although such data are readily available and inexpensive, certain limitations apply to using secondary sources:

1. The information often does not meet one's specific needs. Because these materials are collected by others for their own purpose, they may be too broad or too narrow in terms of their scope of coverage as to be of much value for the research at hand. Also, such information is often out of date.
2. There could be differences in definition of terms or units of measure that make it difficult to categorize or compare the research data.
3. It is difficult to assess the accuracy of the information because little is known about the research design or techniques used to gather the data.

International Market Assessment

International market assessment is a form of environmental scanning that permits a firm to select a small number of desirable markets on the basis of broad variables. Companies must determine where to sell their products or services because they seldom have enough

resources to take advantage of all opportunities. Not using scanning techniques may create the tendency to overlook growing markets. For example, European companies have often neglected the fastest-growing markets in Southeast Asia while expanding their traditional markets in North America. Assessment of foreign markets involves subjecting countries to a series of environmental analysis with a view to selecting a handful of desirable markets for exports. In the early stages of assessment, secondary data are used to establish market size and level of trade, as well as investment and other economic and financial information.

Preliminary Screening (Basic Need and Potential)

The first step in market assessment is the process of establishing whether there is a basic need for the company's products or services in foreign markets. Basic need potential is often determined by environmental conditions such as climate, topography, or natural resources. In situations in which it is difficult to determine potential need, firms can resort to foreign trade and investment data to establish whether the product and/or service has been previously imported, its volume, its dollar value, and the exporting countries.

After establishing basic need potential, it is important to determine whether the need for the product or service has been satisfied. Needs may be met by local production or imports. If there are plans for local production by competitors, imports may cease or be subject to high tariffs or other barriers. Market opportunities still exist for competitive firms if a growing demand for the product cannot be fully met by local production insofar as governments do not apply trade restrictions in favor of local producers or imports from certain countries. If the research indicates that market opportunities exist, it is pertinent to consider the market's overall buying power by examining country-specific factors such as population, gross domestic product, per capital income, distribution of wealth, and exports and imports. While considering these factors, one should note that (1) per capita income might not be a good measure of buying power unless the country has a large middle class and no profound regional disparities, and (2) imports do not always indicate market potential. Availability of foreign currency, as well as change in duties and trade policies, should be monitored to ensure that they are conducive to the growth of imports in the country.

Secondary Screening (Financial and Economic Conditions)

Secondary screening involves the evaluation of financial and economic conditions such as trends in inflation, interest rates, exchange rate stability, and availability of credit and financing. Countries with high inflation rates (as well as controlled and low interest rates) should be carefully considered because they may limit the volume of imports by restricting the availability of foreign exchange. There is also a need to verify the availability of commercial banks that can finance overseas transactions and handle collections, payments, and money transfers.

Economic data are also used to measure certain indicators such as market size (relative size of each market as percentage of total world market), market intensity (degree of purchasing power), and growth of the market (annual increase in sales). Countries with advanced economies, such as the United States and Germany, account for a large percentage of the world market for automobiles, computers, and televisions. Their high per capita incomes reflect the attractiveness of the market and the degree of purchasing power. Such information will help in selecting countries with rapidly growing markets and high concentrations of purchasing power.

Third Screening (Political and Legal Forces)

It is important to assess the type government (democratic/nondemocratic) and its stability. Countries with democratic governments tend to be politically stable, favor open trade polices, and are less likely to resort to measures that restrict imports or impede companies' abilities to take certain actions. Political instability may also lead to damage to property and/or disruption of supplies or sales, as a result of wars, insurrections, takeover of property, and/or change of rules. Consideration should also be given to legal forces in these countries that affect export/import operations. These include the following:

- *Entry barriers:* Product restrictions, high import tariffs, restrictive quotas, import licenses, special taxes on imports, product labeling, and other restrictive trade laws
- *Limits on profit remittances and/or ownership:* Imposition of strict limits on capital outflows in foreign currencies, restrictions on or delays in remittance of profits, and ownership requirements to establish a business
- *Taxes and price controls and protection of intellectual property rights:* The existence of high taxes, price controls, and lack of adequate protection for intellectual property rights.

Fourth Screening (Sociocultural Forces)

This involves consideration of sociocultural forces such as customs, religion, and values that may have an adverse effect on the purchase or consumption of certain products. Examples include sales of pork and its derivatives or alcohol in Muslim countries.

Fifth Screening (Competitive Forces)

It is important to appraise the level and quality of competition in potential markets. The exporter has to identify companies competing in the markets and the level of their technology, the quality and price of the products and/or services, and their estimated market shares, as well as other pertinent matters.

Final Selection (Field Trip)

This stage involves a visit to the markets that appear to be promising in light of the market assessment technique. Such visits could be in the form of trade missions (a group of business and government officials who visit a market in search of business opportunities) or trade fairs (a public display of products and services by firms of several countries to prospective customers). The purpose of such visit is to:

- Corroborate the facts gathered during the various stages of market assessment
- Supplement currently available information by doing research in the local market, including face-to-face interviews with potential consumers, distributors, agents, and government officials.

This will facilitate final selection of the most desirable markets as well as the development of a marketing plan, product modification, pricing, promotion, and distribution.

Developing an International Business Plan

A business plan involves a process in which an entity puts together a given set of resources (people, capital, materials) to achieve defined goals and objectives over a specific period of time. In addition to providing the direction necessary for success, a sound business plan should be flexible to take advantage of new opportunities or to allow adjustments when certain assumptions or conditions change. This plan should be reviewed and progress assessed (perhaps once every three or four months) to ensure that implementation is consistent with overall goals and objectives laid out in the business plan.

Developing a business plan is an important factor for success regardless of the size, type, or time of establishment of the business. Even though some export-import companies start a business plan after they have reached a certain stage, planning is needed at all stages of business development from inception to maturity (Hisrich, Peters, and Shepherd, 2009; Williams and Manzo, 1983). It is a roadmap to one's targeted destination. By allowing for critical evaluation of different alternatives, a business plan forces entrepreneurs to set realistic goals, predict resource allocation, and project future earnings. Such a practice assists in avoiding costly mistakes and enhances the decision-making abilities of businesses (Hisrich et al., 2009; Silvester, 1995). A written business plan is the basis upon which other parties (e.g., bankers, potential partners) assess the overall business concern. It is used for obtaining bank financing, seeking investment funds, obtaining large contracts to supply governments or companies, or arranging strategic alliances to conduct joint marketing and other activities.

The structure of a typical business plan includes the following components (see Figure 4.1): executive summary, description of the industry and company, target market, present and future competition, marketing plan and sales strategy, management and organization, long-term development and exit plan, and the financial plan (Cohen, 1995; Hisrich et al., 2009). Some plans also include critical risks/problems and community benefits.

Export Counseling and Assistance

A number of assistance sources are available to U.S. exporters.

The U.S. Department of Commerce

Through the local district office, the exporter has access to all assistance available through the International Trade Administration (ITA) and to trade information gathered overseas by the U.S. and foreign commercial services. The U.S. Trade Information Center serves as a single source of research support, trade information counseling, and industry consultation. A valuable source of trade information while conducting foreign market research is the National Trade Data Bank (NTDB). The NTDB provides specific product and country information as well as a list of foreign importers in specific product areas. U.S. exporters can also advertise in *Commercial News USA,* a bimonthly magazine that promotes U.S. products and services overseas. It is distributed by U.S. embassies and consulates in more than 152 countries (International Perspective 4.2).

The following is a list of some of the major programs offered by the Department of Commerce (U.S. Department of Commerce, 2011).

FIGURE 4.1 Structure of an International Business Plan

- *Market Access and Compliance (MAC):* MAC specialists monitor foreign-country trade practices and help U.S. exporters deal with foreign trade barriers.
- *U.S. and Foreign Commercial Service (U.S. & FCS):* U.S. commercial officers in foreign countries provide important trade and investment information on foreign companies. This includes but is not limited to conducting market research and finding foreign representatives.
- *Trade Development:* This unit offers extensive support to U.S. exporters by providing critical information on market and trade practices overseas, including industry analysis and trade policy. Industry-specific trade development includes aerospace, automotive,

consumer goods, e-commerce, and energy. Industry officers identify trade opportunities by product or service, develop export marketing plans, and conduct trade missions.

- *Gold Key Service:* This services U.S. exporters by prescreening potential distributors and professional associations. It is available in many countries.
- *Trade events:* The Department of Commerce organizes various trade events (e.g., trade fairs, trade missions, international catalog exhibitions) in order to help market U.S. products or locate representatives abroad.

Small Business Administration (SBA)

The SBA provides free export counseling services to potential and current small business exporters (through its field offices) throughout the United States.

- *SCORE/ACE programs:* Members of the Service Corps of Retired Executives (SCORE) and the Active Corps of Executives (ACE), with years of practical experience in international trade, assist small firms in evaluating export potential, developing and implementing export marketing plans, identifying problem areas, and so on. SCORE has a new acronym, Counselors to America's Small Business or CASB. Since its inception, the organization has worked with more than seven million entrepreneurs.
- *Small Business Development Centers (SBDCs):* Additional export counseling and assistance are offered through the Small Business Development Centers (SBDCs), which are located within some colleges and universities. The centers are intended to offer technical help to exporters by providing, for example, an export marketing feasibility study and an analysis for client firms. There is also an initial legal assistance program for small exporters on the legal aspects of exporting.
- *U.S. Export Assistance Centers (EACs):* These are intended to deliver a comprehensive array of export counseling and trade finance services to U.S. firms. They integrate the export marketing know-how of the Department of Commerce with the trade finance expertise of the Small Business Administration and the Export-Import Bank. EAC trade specialists help U.S. firms enter new markets and increase market share by identifying the best markets for their products; developing an effective marketing strategy; advising on distribution channels, market entry, promotion, and export procedures; and assisting with trade finance. They are generally located within state promotion agencies, local chambers of commerce, and other local export-promotion organizations.

U.S. Department of Agriculture

The U.S. Department of Agriculture (USDA) provides a wide variety of programs to promote U.S. agricultural exports. Some of the trade assistance programs include promotion of U.S. farm exports in foreign markets, services of commodity and marketing specialists, trade fairs, and information services. Programs are available to expand dairy product exports, provide technical assistance for specialty crops, and so on.

State Government and City Agencies

Many states, cities, and counties have special programs to assist their own exporters. Such programs generally include export education, marketing assistance, trade missions, and trade shows.

TABLE 4.2 Private Sources of Export Assistance

Private Sources	Services
Commercial banks	Advice on export regulations, exchange of currencies, financing exports, collections, credit information and assistance.
Trading companies	Market research and promotion, shipping and documentation, financing sales, facilitating prompt payment, appointing overseas distributors, and other services.
World trade clubs	Education programs on international trade and organization of promotional events.
Chambers of commerce and trade associations	Chambers of commerce provide the following services: export seminars, trade promotion, contacts with foreign companies and distributors, issuance of certificates of origin, transportation routing and consolidating shipments. U.S. chambers of commerce abroad are also a valuable source of marketing information. Trade associations provide information on market demand and trends and other information on pertinent trade issues through newsletters.
Trade consultants	Advise on all aspects of exporting ranging from domestic/ foreign regulations to market research and risk analysis.

Private Sources of Export Assistance

Commercial banks, trading companies, trade clubs, chambers of commerce, and trade associations, as well as trade consultants, provide various forms of export assistance (see Table 4.2).

INTERNATIONAL PERSPECTIVE 4.2

Programs for U.S. Exporters

The U.S. government provides several services to U.S. exporters. The business contact programs provided by the Department of Commerce include the following:

- **International Partner Search (IPS):** The U.S. Commercial service's IPS program uses its resources in different countries to find U.S. businesses the most suitable strategic partners (prequalified partners). U.S. businesses can obtain:

  (a) Information on the marketability and sales potential for their products and services
  (b) Contact information on key officers of each potential partner, along with information on their size, sales, number of employees, and other data.

- **Commercial News USA (CNUSA):** The CNUSA program allows U.S. firms to receive global exposure through its catalogs, magazines, and electronic resources. The catalog and magazines are distributed by U.S. embassies and consulates in 152 countries,

specifically for business readers. All published products must be 51 percent U.S.-made (parts), with 51 percent U.S. labor. The leads obtained by the program are redirected to the U.S. exporting firms and include detailed contact information, including sales, representation, distributorships, and joint ventures or licensing agreements that help these firms identify potential markets. Inquiries from abroad do not come through the CNUSA channels, as they are directly reached to the exporting firms.

- **Gold Key Service:** The Gold Key Service is a matching service that sets appointments in foreign markets with prescreened partners for U.S. exporters. The service provides orientation briefing, market research, and a debriefing with trade professionals after meetings to discuss the results of the meetings. It also offers assistance in generating follow-up strategies for exporting firms. The service is offered by the Commercial Service for a fee.
- **International Company Profiles (ICP):** The commercial officers of the ICP prepare background reports of foreign firms that are interested in working with U.S. exporters. Each report includes information on a foreign organization's bank and trade references, principals, key officers and managers, product lines, number of employees, financial data, sales volume, reputation, and market outlook. The ICP is offered only to countries that are in need of providers who offer background information on local companies in the private sector. Credit reports from private-sector resources are generally available on nearly all foreign firms.
- **Trade Events Program (TEP):** The Department of Commerce organizes trade shows, fairs, and trade missions overseas. It also has the International Buyer Program (IBP), under which it recruits qualified foreign buyers, sales representatives, and business partners to U.S. trade shows each year, providing U.S. exhibitors with good opportunities to expand business globally.
- **BuyUSA.GovMatchmaking:** This is a convenient online program that matches U.S. exporters with buyers in overseas markets. When an importer registers with a profile that matches a U.S. exporter's activities, the service automatically notifies the U.S. exporter.

Overseas Travel and Promotion

Once market research is conducted and the target countries are selected, the next step is to visit the countries in order to locate and cultivate new customers or to develop and maintain relationships with foreign distributors. As we enter the twenty-first century, the world has become one market, and this has naturally given rise to more intercultural encounters. The exporter has to be aware of certain important factors before embarking on a trip, not only to avoid embarrassment but also to be able to conclude a successful business arrangement (International Perspective 4.3).

Planning and Preparing for the Trip

Making Prior Arrangements

The most important meetings should be confirmed before leaving the United States. One should avoid traveling during national holidays or political elections in the host

countries. Contacts can be made with the Department of Commerce country desk officers in Washington, DC, and/or U.S. embassies abroad to obtain current and reliable information about the target countries.

Acquiring Basic Knowledge of the Host Country

Exporters should know some basic facts about the history, culture, and customs of the host countries. Several books and magazines cover business manners, customs, dietary practices, humor, and acceptable dress in various countries. It is essential to exercise flexibility and cultural sensitivity when doing business abroad. The exporter should also obtain prior information on such important areas such as weather conditions, health care, currency exchanges, and visa requirements. Various travel publications provide such information (for export procedures, see International Perspective 4.4).

Obtaining the ATA Carnet

For exporters who take product samples, duties and burdensome customs formalities can be avoided by obtaining the ATA (Admission Temporaire) carnet. The United States is a member of the ATA carnet system, which permits U.S. commercial and professional travelers to take material to member countries of the ATA carnet system for a temporary period of time without paying duty. An exporter should check whether a host country is member of the ATA convention. The U.S Council for International Business handles applications for carnets. A bond, a letter of credit, or a cash equivalent (as guarantee for 40 percent of the value) will, however, be required to cover outstanding duties in case the samples are not returned to the United States.

Business Negotiations

Negotiations should be entered into with sufficient planning and preparation. The exporter should establish the line or boundary below which he or she is not willing to concede. It is also advisable to draft the agreements, since it will enable the exporter to include terms and conditions with important implications into the contract.

Documentation

The exporter should document the various meetings at the end of the day to avoid confusing one market with another. Such a summary also provides a record for company files. Once the trip is over and the exporter returns home, there should be an immediate follow-up, with a letter confirming the commitments and a timetable for implementation of these commitments.

Overseas Promotion

Overseas promotion of exports is often designed to open new markets, maintain and increase existing market share, and obtain market intelligence. Such efforts must meet strategic marketing goals and achieve the greatest impact at the lowest possible cost. Effective promotion

should go beyond enabling the potential buyer to receive the desired information. It must be strong enough to motivate the buyer to react positively. This requires the conveying of a message that does not offend cultural sensibilities and one that is uniquely designed for each market. The exporter can choose one or a combination of promotional tools: direct mail, advertising, trade fairs/missions, and publicity. The choice will depend on the target audience, company objectives, the product or service exported, and the availability of internal resources, as well as the availability of the tool in a particular market (Czinkota, Ronkainen and Moffett, 2010). Exporters may use the same promotional strategy in different foreign markets if the target markets vary little with respect to product use and consumer attitudes. In some cases, the product and/or promotional strategy must be adapted to foreign market conditions. For example, Tang sold in Latin America is especially sweetened and promoted as a drink for mealtime. In the United States, people drink it in the morning, and the product is promoted as a drink for breakfast (Ball et al., 2013).

In certain developing countries where the rate of illiteracy is high, advertising in periodicals does not reach a broad audience. However, if the product or service marketed is intended for a small part of the population, such as middle- or high-income consumers, using periodicals could be an effective way of reaching the target market. For products that are intended for a broader audience, such as soap or cooking oil, radios or billboards could be an effective way of reaching many consumers in these countries.

It is often stated that adapting a product to local conditions and accentuating the local nature of a certain aspect of the product in the promotional material tend to create a favorable image among the public and stimulate product sales. This means that exporters should consider ways and means of localizing a certain part of their activity, such as product adaptation to local conditions or assembly of parts in the host countries. Such activities not only increase product sales but also create employment opportunities in the local economy. For less sophisticated products, a firm could export the necessary ingredients or components into a host country, preferably into a free-trade zone, and use local labor to produce or assemble the final product. In addition to being a good promotional tool for the product, such localization will enhance the competitiveness of the product by reducing cost.

Advertising

Advertising is any paid form of nonpersonal presentation and promotion of ideas, goods, or services by an identified sponsor. Typically, no one vehicle reaches an entire target audience, and, thus, exporters must evaluate the many alternatives so as to meet their desired objectives. One or a combination of vehicles can be used (magazines, newspapers, TV, radio, direct mail, or billboards) to carry the advertisements to target audiences.

Exporters should be aware of regulations in various countries that govern advertising. In some European countries, for example, television stations allow only a certain percentage (12 to 18 percent) of advertising per hour. In many developed countries, the advertising of tobacco and alcoholic beverages is heavily regulated. In some Latin American countries, such as Peru, commercial advertising on national television should be domestically produced.

The advertising process involves (1) budgeting (how much it will cost and how much the exporter can afford); (2) determining the most effective and least expensive media to reach the potential customer; and (3) preparing an appropriate advertising package that emphasizes the important but minimal number of points.

Small exporters often use direct mail (correspondence and brochures) to reach their overseas customers. In Southeast Asian markets, direct mail is the most effective way of promoting the sale of industrial goods. Brochures have to be translated into the local language, and accurate mailing lists have to be obtained. Mailing lists can be purchased from private firms. Most libraries have various resources, such as trade publications, and journals of various trade associations, from which a list of potential overseas customers can be obtained. In addition, such lists are available from the directories and catalogs of trade shows and from other government publications, such as *Foreign Trades Index,* the *Export Contact List Service,* and the *World Traders Data Reports* (WTDR).

The exporter can use one or a combination of the following media to advertise the product or service:

Foreign media: A product can be advertised in an overseas retailer's or distributor's catalog or trade publication. Cooperative advertising, that is, a group advertising program, can be arranged by business associations and local chambers of commerce. Cooperative advertising is more effective for noncompeting and/or complementary products. The advantage of such advertising is that it reduces expenses, especially for small exporters, and also enables exporters to combine advertising budgets to reach a larger audience than is normally possible individually.

Government-supported advertising: There are many government supported (federal and state) promotional programs for U.S. exporting firms that facilitate the marketing of U.S. products overseas.

Commercial publications: Many U.S. trade publications are widely read in many parts of the world. Advertising in such journals or magazines will enable the exporter to reach a broader market. Some of these publications include *Showcase U.S.A.*, *Export,* and *Automobile and Truck International.*

The Internet: The Internet provides the exporter with an additional global medium. Potential consumers can be reached through websites in key languages and e-mails. A number of products are being made available online. Data collected from customers can also be used for future marketing efforts.

INTERNATIONAL PERSPECTIVE 4.3

The Twelve Most Common Mistakes of Potential Exporters

- Failing to obtain qualified export counseling and to develop a master international marketing plan before starting an export business
- Obtaining insufficient commitment by top management to overcome the initial difficulties and financial requirements of exporting
- Using insufficient care in selecting overseas distributors
- Chasing orders from around the world instead of establishing a basis for profitable operations and orderly growth
- Neglecting export business when the U.S. market booms
- Failing to treat international distributors on an equal basis with domestic counterparts

- Assuming that a given market technique and product will automatically be successful in all countries
- Being unwilling to modify products to meet regulations or cultural preferences of other countries
- Failing to print service, sale, and warranty messages in locally understood languages
- Failing to consider use of an export management company
- Failing to consider licensing or joint venture agreements
- Failing to provide readily available servicing for the product

Personal Selling

Personal selling is often used during the first stages of internationalization. It is also used for the marketing of industrial, especially high-priced goods. Personal selling entails oral presentations by sales personnel of the organization or agents to prospective overseas purchasers. Salespeople also collect information on competitive products, prices, services, and delivery problems that assist exporters in improving quality and service. In short, such media are used in cases in which advertising does not provide an effective line with target markets, the price is subject to negotiation, and the product/service needs customer application assistance. Avon and Unilever, for example, use personal sellers in rural villages in many developing countries to market their products.

Sales Promotion

Sales promotion refers to marketing activity other than advertising, personal selling, or publicity. It includes trade shows, trade fairs, demonstrations, and other nonrecurrent selling efforts not in the ordinary routine (Asheghian and Ibrahimi, 1990). Trade shows are events at which firms display their products in exhibits at a central location and invite dealers or customers to visit the exhibits. Such shows are a cost-effective way of reaching a large number of customers who might otherwise be difficult to reach. Adding to their benefit, from a cost and efficiency standpoint, is that trade shows help exporters to contact and evaluate potential agents and distributors. Trade fairs also provide an important opportunity for exporters to introduce, promote, and demonstrate new products, cultivate new contacts, and collect market intelligence, as well as to close deals with a number of attendees who often have direct responsibility for purchasing products and services.

Trade fairs can be organized by certain industries, trade associations, or chamber of commerce. For example, the Hanover trade fair in Germany organizes regional and national fairs and exhibitions in various product sectors targeted at specialized audiences as well as the general public. Every year it organizes around fifty trade fairs and exhibitions that attract more than 28,000 exhibitors and 2.5 million visitors from more than 100 countries around the world. The Seoul International Gift and Accessories show is one of the largest trade fairs for gift and fashion accessories in Asia. It attracts about 32,000 local and overseas visitors, resulting in about $15 million in sales.

Trade shows are also supported or organized by governments in order to promote exports. In the United States, the Department of Commerce (DOC) organizes various export-promotion events such as exhibitions, seminars, trade missions, and other customized

promotions for individual U.S. companies. Under the International Buyer program, the DOC selects leading U.S. trade exhibitions each year in industries with high export potential. DOC offices abroad recruit foreign buyers and distributors to attend these shows, while program staff help exhibiting firms make contact with international visitors at the show to achieve direct export sales and/or international representation. The DOC, through the certified trade fair program, supports private-sector organized shows. Exhibitors use U.S. pavilions to create enhanced visibility and also receive the support of commercial services from U.S. embassies and consulates. The DOC and state agencies also jointly organize U.S. company catalogs and product literature to present to potential customers abroad and send the trade leads directly to participating U.S. firms. Many developed countries have similar programs to promote the sale of their products abroad.

Trade missions are another export sales promotion tool. Under a trade mission, a group of business people and/or government officials visits foreign markets in search of business opportunities. Missions typically target specific industries in selected countries. Events are also organized by private organizations or government agencies so that foreign buyer groups can come to the United States to meet individually with U.S. companies, exporters, or relevant trade associations. At these events, foreign businesses buy U.S. products, negotiate distributor agreements, find joint venture partners, or learn about current industry trends.

Publicity

Publicity is communicating with an audience by personal or nonpersonal media that are not explicitly paid for delivering the messages. This is done by planting commercially significant news about the exporter and/or products in a published medium or by obtaining favorable presentation on the local media without sponsoring it. A carefully managed advertising and public relations program is essential to the long-term success of an export firm. The public relations (publicity) program could include charitable donations to schools, hospitals, and other social causes; sponsorship of youth athletic teams; participation in local parades; and invitations to the media to cover special events sponsored or supported by the export company.

INTERNATIONAL PERSPECTIVE 4.4

A Typical Export Transaction

Step 1: The exporter establishes initial contact by responding to an overseas buyer's advertisement for a product that the exporter can supply. Such ads are available in various trade publications. The exporter's letter briefly introduces the company and requests for more information on the product needed as well as bank and trade references.

Step 2: The prospective buyer responds to the exporter's letter or fax by specifying the type and quantity of product needed, with a sample where appropriate. The potential importer also sends trade references.

Step 3: The exporter checks with the consulate of the importer's country to determine (1) whether the product can be legally imported and whether any restrictions may apply, and (2) any requirements that need to be met. The consulate may

indicate that a certificate of origin is needed to clear shipment at the foreign port. The exporter also verifies the buyer's bank and trade references through its bank and other U.S. government agencies, such as the Department of Commerce.

Step 4: The exporter (if an agent) contacts manufacturers of the product to (1) establish if the given product is available for export to the country in question, and (2) obtain and compare price lists, catalogs, and samples.

Step 5: The exporter selects the product from responses submitted by manufacturers on the basis of quality, cost, and delivery time. The sample selected is sent by airmail to the overseas customer to determine if the product is acceptable to the latter. In the meantime, the exporter prepares and sends a price quotation suggesting the mode of transportation and letter of credit terms. The price quotation should include commission and markup.

Step 6: The exporter obtains a positive response from the overseas customer and is requested to send a pro forma invoice to enable the buyer to obtain an import and foreign exchange permit. The exporter sends the pro forma invoice.

Step 7: The overseas customer receives the pro forma invoice, opens a confirmed irrevocable letter of credit for the benefit of the exporter, and sends an order to the latter to ship the merchandise.

Step 8: The exporter verifies with its bank the validity of the letter of credit and finds that it meets the agreed conditions in the export contract and that it will be honored by the bank if the exporter meets the terms. The exporter ships the merchandise and submits the required documents (such as bill of lading, commercial invoice, consular invoice, certificate of origin, packing list) to the bank with a request for payment. The exporter is paid, the merchandise is on transit, and the transaction is completed.

Chapter Summary

Assessing and selecting the product

In order to establish market potential for a product/service, it is important to consider: the success of the product in the domestic market, participation in overseas trade shows, advertising in foreign media, market data.

Approaches to selecting a product for exports:

1. *Systematic approach:* Product selection based on overall market demand.
2. *Reactive approach:* Selection of a product based on immediate (short-term) market need

International Market Research (IMR)

IMR helps business organizations in making business decisions that lead to the proper allocation of resources in markets with the greatest potential for sales.

It involves five steps: preliminary screening (basic need and potential); secondary screening (financial and economic conditions); third screening (political and economic forces); fourth screening (sociocultural forces); fifth screening (competitive forces); final selection (field trip).

Developing an export/import business plan	*Typical structure of a business plan:* executive summary, general description of industry and company, target market, marketing plan and sales strategy, management and organization, long-term development plan, financial plan.
Sources of export counseling	*Public sources:* U.S. Department of Commerce, U.S. Export Assistance Centers, Small Business Administration. *Private sources:* commercial banks, trading companies, world trade clubs, chambers of commerce and trade associations, trade consultants.
Business travel and promotion abroad	*Planning and preparing for the trip:* Making prior arrangements, acquiring basic knowledge of host country, using the ATA carnet, preparing for business negotiations, preparing documentation. *Overseas promotion:* advertising, personal selling, sales promotion, publicity.

Review Questions

1. Discuss the two major approaches to selecting a product for exports. Why is it important to participate in overseas trade shows?
2. What are the disadvantages of the reactive approach to selecting a product for exports?
3. Explain the importance of the following factors in the selection of products for exports: shifting spending patterns, quality, and niche marketing.
4. Do a country's imports completely measure the market potential for a product? Discuss.
5. Why should an export firm consider financial and economic conditions in importing countries?
6. What is the importance of political and legal forces in international market assessment?
7. Identify the public sources of export counseling in the United States.
8. Discuss three private sources of export assistance. What is the Gold Key Service?
9. Explain the steps involved in a typical export transaction.
10. What is SCORE?

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World Wide Web Resources

Small Business

http://www.entrepreneur.com/article/0,4621,324792,00.html

SBA information on starting, financing, and expanding a small business: http://www.sba.gov/

U.S. Export Inc.

Export assistance to small and medium-size firms:

http://www.export.gov/

http://www.trade.gov/mas/

http://www.usda.gov/wps/portal/usdahome

Case 4.1 Developing Export Markets

A recent survey by Babson College and the London Business School on entrepreneurship noted that middle-income countries have a larger share of individuals engaged in business ventures with high growth potential than high-income countries. The study also noted that the countries have higher percentages of people starting businesses. This is partly attributed to the deployment of existing technologies to exploit their comparative advantages. High rates of early-stage entrepreneurship, however, do not necessarily translate into high rates of established business. Rich countries such as Japan, for example, have low levels of early-stage entrepreneurial activity but a large number of established businesses. This is because the start-ups are opportunity-driven companies with lower rates of business failures than those in middle-income or poor countries that are largely motivated by the necessity to earn a living. In rich countries, there is also a tendency for entrepreneurial activity to shift from consumer-oriented areas such as retailing to business services.

Export of luxury tea from Argentina. During the worst financial crisis in Argentina (2001), three young entrepreneurs founded a luxury tea business with just $10,000. They focused on quality with a view to selling in high-value export markets. The bags are a hand-tied sack of muslin (that does not alter the flavor of the tea) containing one of the five types of organic tea: cedron, black-leaf tea, peppermint, patagonian rosehip, and mate lightened for the overseas market. They traveled to different parts of Argentina to locate the best growers. After finding suitable suppliers, the partners agreed to create a premium product to be sold in up-market outlets and trendy stores. More than 75 percent of the output is sold in overseas markets: the United States, the United Kingdom, continental Europe, the Middle East, and Asia. Over the past few years, the company has registered substantial increases in sales.

The partners note that (1) exporting maximizes the benefits of selling from countries with weak currencies; (2) it is necessary to focus on quality materials,

production, and packaging to charge premium prices; (3) high-quality products should be sold in high-quality outlets; and (4) it is important to disprove national stereotypes such as a reputation for lack of punctuality or honesty with buyers and distributors.

Exports by Rwanda's nascent entrepreneurs. Rwanda is a small, landlocked country with a population of eight million, located in the Great Lakes Region of East-Central Africa. Despite the legacy of genocide and war, the country is showing signs of rapid development. J. Nkubana, one of a number of women entrepreneurs, sells more than 5,000 Christmas ornaments and baskets to Macy's in New York. Another rising entrepreneur, Beatrice Gakuba, founder of Rwanda Floral, is the nation's largest exporter of roses. She sells more than five tons of flowers a week at auctions in Amsterdam. Exporters, however, face a number of challenges in Rwanda: (1) regular electricity outages, resulting in lost productivity; (2) Rwanda's landlocked status, which requires use of ports in neighboring countries, delaying shipments and delivery of exports; (3) high borrowing costs (17 percent interest on loans) and bank requirements of 100 percent collateral. Public funding to promote exports is almost nonexistent.

Questions

1. Comment on the statement "exporting maximizes the benefits of selling from countries with weak currencies."
2. On the basis of the information provided, what is your advice to the government of Rwanda to increase exports?

Case 4.2 Strategies for Entering New Markets

A. Picking the right country

- Select a country that understands the value of your product.
- Target a country with growth potential.
- Start with homogeneous markets or markets of strong trading partners.
- Target a country where you can sell at a competitive price.

B. Understanding the overseas market

- Be flexible and open minded in establishing the needs of overseas consumers, that is, unmet needs that can be satisfied by your product.
- Determine the skills you need to meet customer needs.
- Position your company to deliver superior value to your consumers.
- Design products tailored to each market.

C. Dealing with the competition

- Pick the right market segment.
- Invest in product attributes that will keep you ahead of the competition.
- Build an effective global supply chain.

D. Enhancing capabilities

- Identify core capabilities that enable you to compete overseas.
- Partner to augment your capabilities.

E. Bridging the cultural gap

- Establish rapport before getting down to business.
- Learn about society's concept of value, time, punctuality, taste, dress code, and so on.

Question

1. Think of any additional advice for the exporter who plans to venture into a new export market in Central America.

five
Export Channels of Distribution

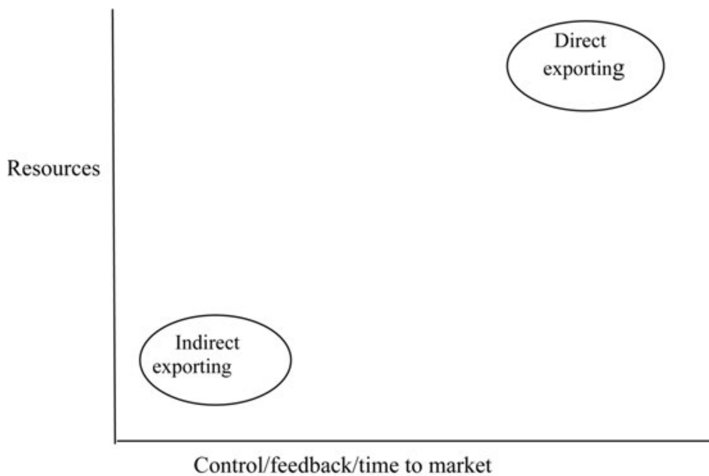
Global competition is motivating firms to seek innovative ways of entering new markets. Export managers have to decide which marketing functions are to be delegated to other intermediaries or partners and which are to be performed internally. Selecting and managing the right distribution systems is the key to successful internationalization. They provide a competitive advantage in global markets by helping identify market opportunities. Channels are also more difficult to change and thus require careful planning.

Williamson (1991) argues that contracting is determined by the governance mechanism that seeks to minimize transaction costs. He states that "assets specificity, uncertainty and frequency" determine the efficient transaction governance form. Specific assets are involved in investments made in market research, branding, product design, and human assets. "Uncertainty" refers to changes in market forces stemming from individuals' limited information or opportunistic motives of other actors. "Frequency" concerns frequency and volume of transactions. Studies indicate that asset specificity, uncertainty, and frequency in volume of transactions are associated with direct forms of market entry (vertical integration). There is an incentive to integrate distribution channels to minimize transaction costs (McNaughton, 1996; Tesfom, Lutz, and Ghauri, 2004). In many developing countries, direct entry may be needed, in spite of their limited market size, due to the problem of asset specificity, and lack of contract enforcing institutions.

Export firms can be involved in two principal channels of distribution when marketing abroad.

Indirect Channels

With indirect channels, the firm exports through an independent local middleman that assumes responsibility for moving the product overseas. Indirect exporting entails reliance on another firm to act as a sales intermediary and to assume responsibility for marketing and



- *Indirect exporting is associated with poor control, inadequate feedback, and shorter time to market than does direct exporting.*
- *Direct exporting requires a higher level of investment in financial, technical, and other resources than indirect exporting.*

FIGURE 5.1 Direct and Indirect Channels

shipping the product overseas. The manufacturer incurs no start-up cost, and this method provides small firms with little experience in foreign trade access to overseas markets without their direct involvement. However, using indirect channels has certain disadvantages: (1) the manufacturer loses control over the marketing of its product overseas, and (2) the manufacturer's success totally depends on the initiative and efforts of the chosen intermediary. The latter could provide low priority to or even discontinue marketing the firm's products in cases in which a competitor's product provides a better sales or profit potential (Figure 5.1).

Direct Channels

With direct channels, the firm sells directly to foreign distributors, retailers, or trading companies. Direct sales can also be made through agents located in a foreign country. Direct exporting can also be expensive and time consuming. However, it offers manufacturers opportunities to learn about their markets and customers in order to forge better relationships with their trading partners. It also allows firms greater control over various activities. Heli Modified Inc. of Maine, USA, which manufactures custom-made handles for motorcycles, attributes much of its export success to U.S. government agencies as well as to its international network of sales agents and distributors. The company now exports to about twenty-five countries on four continents.

The decision whether to market products directly or to use the services of an intermediary is based on several important factors.

TABLE 5.1 Pricing Under Domestic Sales and Indirect Exporting

	Price/Cost		Price/Cost
Price to domestic distributor (Manufacturer's price to distributor)	***1,000***	Price to indirect exporter (20% discount)	***800***
Direct costs (material/labor)	*–400*	Direct costs (material/labor)	*–400*
Manufacturing overhead (15% direct costs)	*–60*	Manufacturing overhead	*–60*
Total manufacturing cost	***–460***	**Total manufacturing cost**	***–460***
Manufacturing gross profit	***540***	**Manufacturing gross profit**	***340***
Corporate overhead (20% direct costs)	*–80*	Corporate overhead (20% direct costs)	*–80*
Net profit	***460***	**Net profit**	***260***

* Profit under indirect exporting may be higher if manufacturing and corporate overhead are taken out. Such expenses are borne by the indirect exporter. Indirect exporters also require a deeper discount.

International Marketing Objectives of the Firm

The marketing objectives of the firm with respect to sales, market share, profitability, and level of financial commitment will often determine channel choice. Direct exporting is likely to provide opportunities for high profit margins, even though it requires a high degree of financial commitment (Figure 5.1 and Table 5.1).

Manufacturer's Resources and Experience

A direct-channel structure may be neither feasible nor desirable in light of the firm's limited resources and/or commitment. Small to medium-size firms appear to use indirect channels due to their limited resources and small export volumes, whereas large firms use similar channels because of trade barriers in the host country that may restrict or prohibit direct forms of ownership (Kogut, 1986). Firms in the early phases of their internationalization efforts tend to use independent intermediaries more than those with greater experience (Anderson and Coughlin, 1987; Kim, Nugent, and Yhee, 1997).

Availability and Capability of Intermediary

Every country has certain distribution patterns that have evolved over the years and that are complemented by supportive institutions. Firms that have used specific types of distribution channels in certain countries may find it difficult to use similar channels in other countries. This occurs in cases in which distributors have exclusive arrangements with other suppliers/competitors or when such channels do not exist.

Customer and Product Characteristics

If the number of consumers is large and concentrated in major population centers, the company may opt for direct or multiple channels of distribution. In Japan, for example, more

than half of the population lives in the Tokyo-Nagoya-Osaka market area (Cateora, Gilly, and Graham, 2010). Another factor is that customers may also have developed a habit of buying from a particular channel and may be reluctant to change in the short term.

Direct exporting is often preferable if customers are geographically homogeneous, have similar buying habits, and are limited in number, which allows for direct customer contact and greater control (Seifert and Ford, 1989). The choice of channel structure is primarily dictated by market considerations. However, in certain situations, the nature of the product determines channel choice. In a study on export channels of distribution in the United States, 52.7 percent of the respondents indicated that the distribution was primarily dictated by the market, while 15.5 percent stated that the choice was dictated by the nature of the product exported (Seifert and Ford, 1989). For example, industrial equipment of considerable size and value that requires more after-sales service is usually exported to the user or through the use of other direct channels. Direct channels are also frequently used for products of a perishable nature or high unit value (since it will bring more profit) or for products that are custom made or highly differentiated. Smaller equipment, industrial supplies, and consumer goods, on the other hand, tend to have longer channels. In Canada, for example, consumer goods are purchased by importing wholesalers, department stores, mail-order houses, chain stores, and single-line retailers.

Marketing Environment

The use of direct channels is more likely in countries that are similar in culture to the exporter's home country. For example, U.S. sales to Canada are characterized by short (direct) marketing channels, unlike the indirect channels used in Japan and Southeast Asia. In certain cases, firms have limited options in the selection of appropriate channels for their products. In the lumber industry, the use of export intermediaries is the norm in many countries. In Finland, more than 90 percent of distribution of nondurable consumer goods is handled by four wholesale chains. Exporters have to use these distribution channels to gain a significant penetration of the market (Czinkota, Ronkainen, and Moffett, 2010). Legislation in certain countries requires that foreign firms be represented by local firms that are wholly owned by nationals of the country. Exporters must market their goods indirectly by appointing a local agent or distributor. Some studies support the use of direct/integrated channels when there is a high degree of environmental uncertainty. The establishment of integrated channels is intended to place the firm closer to the market so that it can react and adapt to unforeseen circumstances (Klein, Frazier, and Roth, 1990).

Control and Coverage

A direct or integrated channel affords the manufacturer more control over its distribution and its link to the end user. However, it is not a practical option for firms that do not have adequate foreign market knowledge or the necessary financial, operational, and strategic capabilities.

Firms that use indirect channels are still able to exercise control mechanisms to coordinate and influence foreign intermediary actions. Two types of controls are available for the manufacturer/exporter: *process controls* and *output controls.* Under process controls, the

manufacturer's intervention is intended to influence the means intermediaries use to achieve desirable ends (e.g., selling technique, servicing procedure, promotion). Output controls are used to influence indirectly the ends achieved by the distributor. The latter includes monitoring sales volume, profits, and other performance-based indicators (Bello and Gilliland, 1997). It is important to note the following salient points with respect to manufacturers' coordination and control of independent foreign intermediaries:

- Manufacturers must rely on both unilateral and bilateral (collaboration) control mechanisms in order to organize and manage their export relationships with independent foreign intermediaries.
- The use of output controls tends to have a positive impact on foreign intermediaries' overall performance. Process controls, however, do not appear to account for performance benefits, largely due to manufacturers' inadequate knowledge of foreign marketing procedures.
- Firms that export highly technical and sophisticated products tend to exercise high levels of control (process and output controls) over foreign intermediaries in order to protect their proprietary rights (trade secrets/know-how), as well as to address unique customer needs.

In terms of coverage, firms that use longer channels tend to use different intermediaries (intensive coverage). However, recent studies show a positive relationship between channel directness and intensive coverage. This means that firms that employ direct methods to reach their overseas customers tend to use a large number of different types of channel intermediaries.

Types of Intermediaries

One of the distinguishing features of direct and indirect channel alternatives is the location of the second channel. If the second channel is located in the producer's country, it is considered an indirect channel, whereas if it is located in the buyer's country, it is assumed to be a direct channel. This means that agents, distributors, and other middlemen could be in either category, depending on whether they are located in the buyer's or the seller's country.

Channel alternatives are also defined on the basis of ownership of the distribution channel. A direct channel is one owned and managed by the company, as opposed to one in which distribution is handled by outside agents and middlemen. A firm's channel structure is also defined in terms of the percentage of equity held in the distribution organization: majority ownership (greater than 50 percent) is treated as a direct or integrated channel, while less than majority ownership is considered an indirect channel. The first definition of channel alternatives is used in this chapter.

Indirect Channels

Several types of intermediaries are associated with indirect channels, and each type offers distinct advantages. Indirect channels are classified here on the basis of their functions.

Exporters That Sell on Behalf of the Manufacturer

Manufacturer's Export Agents (MEAs)

Manufacturer's export agents usually represent various manufacturers of related and noncompeting products. They may also operate on an exclusive basis. It is an ideal channel to use especially in cases involving a widespread or thin overseas market. It is also used when the product is new and demand conditions are uncertain. The usual roles of the MEA are as follows:

- Handle direct marketing, promotion, shipping, and sometimes financing of merchandise. The agent does not offer all services.
- Take possession but not title to the goods. The MEA works for commission; risk of loss remains with the manufacturer.
- Represent the manufacturer on a continuous or permanent basis as defined in the contract.

Export Management Companies (EMCs)

EMCs act as the export department for one or several manufacturers of noncompetitive products. More than 2,000 EMCs in the United States provide manufacturers with extensive services that include but are not limited to market analyses, documentation, financial and legal services, purchase for resale, and agency services (locating and arranging sale). An EMC often does extensive research on foreign markets, conducts its own advertising and promotion, serves as a shipping/forwarding agent, and provides legal advice on intellectual property matters. It also collects and furnishes credit information on overseas customers.

Most EMCs are small and usually specialize by product, foreign market, or both. Some are capable of performing only limited functions such as strategic planning or promotion. Export management companies solicit and carry on business in their own name or in the name of the manufacturer for a commission, salary, or retainer plus commission. Occasionally, they purchase products by direct payment or financing for resale to their own customers. Export management companies may operate as agents or distributors. The following are some of the disadvantages of using EMCs:

- Manufacturer may lose control over foreign sales. To retain sufficient control, manufacturers should ask for regular reports on marketing efforts, promotion, sales, and so forth. This right to review marketing plans and efforts should be included in the agreement.
- Export management companies that work on commission may lose interest if sales do not come immediately. They may be less interested in new or unknown products and may not provide sufficient attention to small clients.
- Exporters may not learn international business since EMCs do most of the work related to exports.

Despite these disadvantages, EMCs have marketing and distribution contacts overseas and provide the benefit of economies of scale. Export management companies obtain low freight rates by consolidating shipments of several principals. By providing a range of services, they also help manufacturers to concentrate on other areas.

International Trading Companies (ITCs)

Trading companies are the most traditional and dominant intermediary in many countries. In Japan they date back to the nineteenth century, and in Western countries their origins can be traced back to colonial times. They are also prevalent in many less-developed countries. They are demand driven; that is, they identify the needs of overseas customers and often act as independent distributors linking buyers and sellers to arrange transactions. They buy and sell goods as merchants taking title to the merchandise. Some work on a commission. They may also handle goods on consignment.

In the United States, an ETC is a legally defined entity under the Export Trading Company Act. It is difficult to set up ETCs unless certain special certifications and requirements are met. The U.S. Export Trading Act (ETC) allows bank participation in trading companies, thus facilitating better access to capital and more trading transactions. Antitrust provisions were also relaxed to allow firms to form joint ventures and share the cost of developing foreign markets. Since 2002, more than 186 individual ETCs covering more than 5,000 firms have been certified by the U.S. Department of Commerce. Trade associations often apply for certification for their members. To be effective, ETCs must balance the demands of the markets and the supply of the members (trade association; see International Perspective 5.1).

Trading companies offer services to manufacturers similar to those provided by EMCs. However, there are some differences between the two channels:

- Trading companies offer more services and have more diverse product lines than export management companies. Trading companies are also larger and better financed than EMCs.
- Trading companies are not exclusively restricted to export-import activities. Some are also engaged in production, resource development, and commercial banking. Korean trading companies, such as Daewoo and Hyundai, for example, are heavily involved in manufacturing. Some trading companies, such as Mitsubishi (Japan) and Cobec (Brazil), are affiliated with banks and engaged in extension of traditional banking into commercial fields (Meloan and Graham, 1995).

The disadvantages of ITCs are similar to the ones mentioned for EMCs.

INTERNATIONAL PERSPECTIVE 5.1

Export Trading Companies in Global Markets

Trading companies have been the most traditional channels for international commercial activity. Trading companies supported by governments, such as the English East India Company (1600), the Dutch East India Company (1602), and the French Compagnie des Indes Orientales (1664), were established and enjoyed not only exclusive trading rights but also military protection in exchange for tax payments. Today, trading companies also perform the important function of exporting, importing, investing, and counter trading. In Japan, for example, the Sogo Shosha, which includes the top nine trading companies, such

as Mitsubishi, and Mitsui, conducts about two thirds of the country's imports and half of its exports. In South Korea, trading companies similar in scope to the Sogo Shosha (Daewoo, Hyundai, Samsung) are responsible for a substantial part of the country's exports and imports. In addition to trade, trading companies in these countries are involved in megaprojects, participate in joint ventures, and act as financial deal makers. The success of these conglomerates is due to: (1) extensive market information that allows for product or area diversification; (2) economies of scale that allow them to obtain preferential freight rates and so forth; and (3) preferential access to capital markets that makes it easy to undertake large or risky transactions.

In view of the success of these trading companies, Brazil, Turkey, and the United States have enacted domestic legislation that allows the establishment of trading companies. The Brazilian Decree (No. 1298) of 1972, for example, sets up conditions for the registration of new enterprises with the government and allows local producers to export by selling to a trading company without losing their export incentives. In the United States, the Export Trading Company Act of 1982 allows businesses to join together to export goods and services or to assist unrelated companies to export their products without fear of violating antitrust legislation. Bank participation in trading companies was permitted to enable better access to capital. The legality of any action can be ascertained by precertification of planned activities with the U.S. Department of Commerce.

Exporters That Buy for Their Overseas Customers

Export Commission Agents (ECAs)

Export commission agents represent foreign buyers such as import firms and large industrial users and seek to obtain products that match the buyer's preferences and requirements. They reside and conduct business in the exporter's country and are paid a commission by their foreign clients. In certain cases, ECAs may be foreign government agencies or quasi-government firms empowered to locate and purchase desired goods. They can operate from a permanent office location in supplier countries or undertake foreign government purchasing missions when the need arises. In some countries, the exporter may receive payment from a confirming house when the goods are shipped. The confirming house may also carry out some functions performed by the commission agent or resident buyer (e.g., making arrangements for the shipper). For the exporter, this is an easy way to access a foreign market. There is little credit risk, and the exporter has only to fill the order.

Another variation of the ECA is the resident buyer. The major factor that distinguishes the resident buyer from other ECAs is that in the case of the former, a long-term relationship is established in which the resident buyer not only undertakes the purchasing function for the overseas principal at the best possible price but also ensures timely delivery of merchandise and facilitates principals' visits to suppliers and vendors. This allows foreign buyers to maintain a close and continuous contact with overseas sources of supply. One disadvantage of using such channels is that the exporter has little control over the marketing of products (Onkvisit and Shaw, 2008).

Exporters That Buy and Sell for Their Own Accounts

Export Merchants

Export merchants purchase products directly from manufacturers, pack and mark them according to their own specifications, and resell to their overseas customers. They take title to the goods and sell under their own names and thus assume all risks associated with ownership. Export merchants generally handle undifferentiated products or products for which brands are not important. In view of their vast organizational networks, they are a powerful commercial entity, dominating trade in certain countries.

When export merchants, after receiving an order, place an order with the manufacturer to deliver the goods directly to the overseas customer, they are called export drop shippers. In this case, the manufacturer is paid by the drop shipper, who, in turn, is paid by the overseas buyer. Such intermediaries are commonly used to export bulky (high-freight), low-unit value products such as construction materials, coal, and lumber.

Another variation of export merchant is the export distributor (located in the exporter's country). Export distributors have exclusive rights to sell manufacturers' products in overseas markets. They represent several manufacturers and act as EMCs.

The disadvantage of export merchants as export intermediaries relates to lack of control over marketing, promotion, or pricing.

Cooperative Exporters (CEs)

These are manufacturers or service firms that sell the products of other companies in foreign markets along with their own (Ball et al., 2013). This generally occurs when a company has a contract with an overseas buyer to provide a wide range of products or services. Often, the company may not have all the products required under the contract and so turns to other companies to provide the remaining products. The company (providing the remaining products) could sell its products without incurring export marketing or distribution costs. This helps small manufacturers that lack the ability/resources to export. This channel is often used to export products that are complementary to those of the exporting firm. A good example of this is the case of a heavy-equipment manufacturer that wants to fill the demand of its overseas customers for water-drilling equipment. The heavy-equipment company exports the drilling equipment along with its product to its customers (Sletten, 1994). Companies engage in cooperative exporting in order to broaden the product lines they offer to foreign markets or to bolster decreasing export sales. In the 1980s, for example, the French chemical company Rhone-Poutenc sold products of several manufacturers through its extensive global sales network.

Export Cartels

These are organizations of firms in the same industry that exist for the sole purpose of marketing their products overseas. They include the Webb Pomerene associations (WPAs) in the United States, as well as certain export cartels in Japan. The WPAs are exempted from antitrust laws under the U.S. Export Trade Act of 1918 and are permitted to set prices, allocate

orders, sell products, negotiate, and consolidate freight, as well as arrange shipment. There are WPAs in various areas such as pulp, movies, and sulphur. Webb Pomerene associations are not permitted for services and the arrangement is not suitable for differentiated products because a common association label often replaces individual product brands. In addition to member firms' loss of individual identity, WPAs are vulnerable to lack of group cohesion, similar to other cartels, which undermines their effectiveness. Under the Export Trade Act, the only requirement to operate as a WPA is that the association must file with the Federal Trade Commission within thirty days after formation (see International Perspective 5.2).

INTERNATIONAL PERSPECTIVE 5.2

Indirect Channel Structures

Advantages

- Little or no investment or marketing experience needed. Suitable for firms with limited resources or experience.
- Help increase overall sales and cash flow.
- Good way to test-market products, develop goodwill, and allow clients to become familiar with firm's trade name or trademark before making substantial commitment.

Disadvantages

- Lower profit margin due to commissions and other payments to foreign intermediaries.
- Limited contact/feedback from end users.
- Loss of control over marketing and pricing. Firm totally dependent on the marketing initiative and effort of foreign intermediary. Product may be priced too high or too low.
- Lack of product support by foreign intermediary or may damage market potential.
- Limited opportunity to learn international business know-how and develop marketing contacts. Creates difficulty in taking over the business after the relationship has ended.

Direct Channels

A company can use different avenues to sell its product overseas by employing the direct-channel structure. Direct exporting provides more control over the export process, potentially higher profits, and a closer relationship to the overseas buyer and the marketplace (Table 5.1). However, the firm needs to devote more time, personnel, and other corporate resources than in the case of indirect exporting.

Direct Marketing from the Home Country

A firm may sell directly to a foreign retailer or end user, and this is often accomplished through catalog sales or traveling sales representatives who are domestic employees of the

exporting firm. Such marketing channels are a viable alternative for many companies that sell books, magazines, housewares, cosmetics, travel, and financial services. Foreign end users include foreign governments and institutions such as banks, schools, hospitals, or businesses. Buyers can be identified at trade shows, through international publications, and so on. If products are specifically designed for each customer, company representatives are more effective than agents or distributors. The growing use of the Internet is also likely to dramatically increase the sale of products and/or services directly to the retailer or end user. For example, Amazon.com has become one of the biggest bookstores in the United States, with more than 2.5 million titles. Its books are sold through the Internet. Direct sales can also be undertaken through foreign sales branches or subsidiaries. A foreign sales branch handles all aspects of the sales distribution and promotion, displays manufacturer's product lines, and provides services. The foreign sales subsidiary, although similar to the branch, has broader responsibilities. All foreign orders are channeled through the subsidiary, which subsequently sells to foreign buyers. Sales subsidiaries are often used for lucrative markets with growth potential or products with high intellectual-property content, as well as those that require sophisticated training and after-sales service. This approach may raise issues of transfer pricing.

Direct marketing is also used when the manufacturer or retailer desires to increase its revenues and profits while providing its products or services at a lower cost. The firm can also provide better product support services and further enhance its image and reputation.

A major problem with direct sales to consumers results from duty and clearance problems. A country's import regulations may prohibit or limit the direct purchase of merchandise from overseas. Thus, it is important to evaluate a country's trade regulations before orders are processed and effected.

Marketing through Overseas Agents and Distributors

Overseas Agents

Overseas agents are independent sales representatives of various noncompeting suppliers. They are residents of the country or region where the product is sold and usually work on a commission basis, pay their own expenses, and assume no financial risk or responsibility. Agents rarely take delivery of and never take title to goods and are authorized to solicit purchases within their marketing territory and to advise firms on orders placed by prospective purchasers. The prices to be charged are agreed upon between the exporters and the overseas customers. Overseas agents usually do not provide product support services to customers. Agency agreements must be drafted carefully so as to clearly indicate that agents are not employees of the exporting companies because of potential legal and financial implications, such as payment of benefits upon termination. In some countries, agents are required to register with the government as commercial agents.

Overseas agents are used when firms intend to (1) sell products to small markets that do not attract distributor interest; (2) market to distinct individual customers (custom made for individuals or projects); (3) sell heavy equipment, machinery, or other big-ticket items that cannot be easily stocked; or (4) solicit public or private bids. Firms deal directly with the customers (after agents inform the firms of the orders) with respect to price, delivery, sales, service, and warranty bonds. Given their limited role, agents are not required to have

extensive training or to make a substantial financial commitment. They are valuable for their personal contacts and intelligence and help reach markets that would otherwise be inaccessible. The major disadvantages of using agents are these: (1) There may be legal and financial problems in the event of termination (local laws in many countries discriminate against alien firms [principals] in their contractual relationships with local agents); (2) firms assume the attendant risks and responsibilities, ranging from pricing and delivery to sales and services including collections; and (3) agents have limited training and knowledge about the product, and this may adversely impact product sales.

Overseas Distributors

These are independent merchants that import products for resale and are compensated by the markup they charge their customers. Overseas distributors take delivery of and title to the goods and have contractual arrangements with the exporters as well as the customers. No contractual relationships exist between the exporters and the customers, and the distributors may not legally obligate exporters to third parties. Distributors may be given exclusive representation for a certain territory, often in return for agreeing not to handle competing merchandise. Certain countries require the registration and approval of distributors (and agents) as well as the representation agreement.

Distributors, unlike agents, take possession of goods and also provide the necessary pre- and postsales services. They carry inventory and spare parts and maintain adequate facilities and personnel for normal service operations. They are responsible for advertising and promotion. Some of the disadvantages of using distributors are: (1) loss of control over marketing and pricing (they may price the product too high or too low); (2) limited access to or feedback from customers, (3) limited opportunity to acquire international business know-how and to learn about developments in foreign markets; and (4) dealer protection legislation in many countries that may make it difficult and expensive to terminate relationships with distributors (International Perspectives 5.3 and 5.4).

Selecting the Right Channel

No single distribution channel may be appropriate for a product in all markets. The choice is often based on a market-by-market basis. Here are some relevant points to consider:

- A firm may use direct channel for its lucrative markets or markets where it has some internal strength and experience. It will use indirect channels for unfamiliar, small, or risky markets.
- A firm may use both channels if it has different product lines with different customer profiles. It can use direct channels for the product in which it has a good network of resources and customers and use indirect channels such as cooperative exporting for other product lines where certain advantages do not exist.
- Indirect channel options should not be ignored just because the firm has long-term plans to go direct. Early indirect entry could facilitate the product's success (when it goes direct) if good product image and customer support have been created by the indirect partner.

INTERNATIONAL PERSPECTIVE 5.3

The Japanese Distribution System

Distribution channels in Japan are very different from those used in the United States; they are as inefficient as they are complex. The system is characterized by multiple layers of wholesalers who have developed close, personal relationships with other wholesalers, manufacturers, importers, and retailers. Moreover, these intimate relationships often serve as an informal barrier to U.S. companies wishing to sell directly to end users or retailers.

Many American exporters find retailers/end users unwilling to disrupt their long-standing, personal relationships with Japanese suppliers even when the U.S. company can offer a product of superior or equal quality at a cheaper price. Many Japanese retailers/end users are unwilling to make the switch to an "unreliable" foreign supplier. They fear that a lack of commitment on the part of the foreign supplier will lead to problems. This system, although inefficient, does offer some important advantages for the participants. First, these close business relationships make it far easier for retailers/distributors to suggest product modifications and improvements. Second, this system encourages the sharing of information on product trends, innovations, competition, and overall market opportunities. Third, it contributes to a more cooperative business relationship.

The number of retail outlets in Japan is nearly the same as in the United States, despite the fact that the population of Japan is roughly half that of the United States and even though Japan is slightly smaller in geographical size than California. Distribution channels vary considerably from industry to industry and product to product, with particular differences between consumer and industrial goods. A foreign firm must understand existing distribution channels in order to utilize them or develop an innovative approach.

Locating, Contacting, and Evaluating Agents and Distributors

Once the firm has identified markets in which to use agents and distributors, it can locate these intermediaries by using various sources: government trade offices (the Department of Commerce in the United States), chambers of commerce, trade shows, international banks and other firms, trade and professional associations, and advertisements in foreign trade publications. After identifying potential agents and distributors in each desired market, the firm should write directly to each, indicating its interest in appointing a representative and including a brochure describing the firm's history, resources, product line, personnel, and other pertinent information (Table 5.2).

Evaluation and selection of potential representatives (agents or distributors) is often based on some of the following factors: local reputation and overall background; experience with a similar product or industry and adequate knowledge of the market; commitment not to represent competing brands; and genuine interest and ability to devote sufficient time and effort to the product line. In the case of distributors, it is also important to evaluate sales organization; financial, marketing, and promotion capability; installation and after-sales service; timeliness of payments; and similar characteristics. Once the firm has selected an agent or distributor based on these criteria, the next step is to negotiate a formal agreement. Foreign

TABLE 5.2 Sourcing and Evaluating Overseas Agents and Distributors (OAD)

Sources to locate OAD	*Networking with industry groups and associations* *International Partner Search services of the U.S. Department of Commerce (USDOC)* *Customized Market Analysis Report (CMA) of USDOC* *Catalogue show (displayed at trade shows) and trade missions organized by USDOC or state agencies* *Chambers of Commerce* *State offices in foreign countries* *Existing list of OAD* *Internet sources: dandb.com; kompass.com; usgtn.net; exportzone.com.*
Evaluating and selecting OAD *(Evaluation criteria)*	***Background and experience*** *Years in business, sales volume, management structure, expertise, Financial strength (owneship, debts, bank references), reputation, profile of customers, product line, territory, industry focus or specialization* ***Knowledge of market and ability*** *Knowledge of market, contacts with the media* ***Logistics capability*** *Warehouse capability, shipping expertise, customer support* ***Infrastructure*** *Computer and other systems, resources to launch product, pricing ability, technical ability* ***Motivation/attitude*** *Professionalism, attitude, long-term plans*

representatives are also interested in firms that are committed to the market and willing to provide the necessary product support and training. They also want to protect their territory from sales by third parties or the firm itself.

Contracts with Foreign Agents and Distributors (Representatives)

It is estimated that about 50 percent of global trade is handled through overseas agents and distributors. Laws governing agents and distributors are complex and vary from country to country. In certain countries, protective legislation favors local representatives with respect to such matters as market exclusivity and duration or termination of contracts. In the event of termination without good cause, for example, a Belgian distributor is entitled to an indemnity.

Similar laws exist in France, Germany, and other countries. In Germany, maximum compensation payable to agents usually equals one year's gross commissions based on an average over the previous five years or the period of existence of the agency, whichever is shorter. In countries such as Egypt, Indonesia, Japan, and South Korea, representation agreements must be formally registered with and their contents approved by the appropriate authority. In many Latin American countries, local law governs service contracts if the services are to be performed in local jurisdictions, and any representative agreement that is not in conformity with local law will be invalid and unenforceable. Thus, it is important that in the negotiation and drafting of such agreements, sufficient attention be given to the impact of local laws and other pertinent issues.

INTERNATIONAL PERSPECTIVE 5.4

Parallel versus Multiple Exporters

Parallel (Gray) market goods are products that enter a country outside regular, authorized distribution channels. They differ from black market products since they often enter the market legally. Factors contributing to the rise of parallel exports include:

- Substantial differences in the prevailing prices of the same product between two national markets
- Differences in marketing and administrative expenses between the authorized distributor and the parallel distributor
- Sales of distressed merchandise at deep discount to overseas markets, sometimes giving rise to re-exports to the home market
- Price discounts given to distributors in the home market but not to nearby foreign markets
- Restrictive credit terms or inability (or unwillingness) on the part of the authorized foreign distributor to carry sufficient inventory to service the market.

There is a flourishing market in parallel market goods in the United States in cars, watches, and other goods, estimated at more than $6 billion (U.S.). The major problems created by parallel export channels are (a) reduction in sales and profits for the authorized distributor; (b) disruption in manufacturer-distribution relations; and (c) difficulty in maintaining a consistent image, quality, and reputation of a product.

Companies recognizing these problems should develop appropriate corporate policies such as the creation of product differentiation between the domestic and exported product and flexibility in the export price of the product sold to the foreign distributor.

Multiple channels are used by many firms in order to gain long-term sustainable advantages in global markets. A firm can supplement agents with its own salespersons to prevent lock-in and establish a credible alternative. A few strategic markets can be identified and developed by integration, while other markets are served by third parties, thus spreading the risk. Such channels are common in sectors where transaction costs and uncertainty are high (knowledge-intensive sectors like software development).

Major Clauses in Representation Agreements

Definition of Territory

The contract should define the geographical scope of the territory to be represented by the agent or distributor and whether the representative has sole marketing rights. In exclusive contracts, the agreement has to clearly specify whether the firm reserves the right to sell certain product lines to a specific class of buyers such as governments or quasi-government agencies. If agreements do not explicitly state that they are exclusive, they will often be deemed exclusive if no other representatives have been appointed within a reasonable time. The contract should also state whether the representative can appoint subagents or sub-distributors and the latter's status with relation to the firm. It is also important, because of financial and tax implications, to explicitly state the intention of the parties not to create an employer-employee relationship.

Definition of Product

The contract should identify those products or product lines covered by the agreement as well as the procedures for the addition of successive products. It should also provide for the alteration or deletion of certain product lines based on the exporter's continued production, representative's performance, or other events.

Representative's Rights and Obligations

The agreement should state that the representative will do its best to promote and market the product and cooperate to attain the objectives of the exporting firm. It should also include (1) the representative's commitment to periodically inform the exporter of all pertinent information related to market conditions and its activities; (2) the parties' agreement to provide due protection to each other's confidential information as defined in the contract, which often includes seller's patents, trade secrets, and know-how, as well as the representative's marketing information, including customer lists; (3) a provision as to whose responsibility it is to arrange for all the necessary approvals, licenses, and other requirements for the entry and sale of goods in the foreign country; and (4) the right of the representative to carry non-competitive and complementary products.

An agency agreement should state the nature and scope of an agent's authority to bind the exporter (which is often denied) as well as the agent's discretion with respect to pricing. All sales of products are to be in accordance with the price list and discount structure as established in the contract. The parties could also agree on mechanisms to implement changes in prices and terms. It is also important to stipulate the amount of compensation (commission), when it accrues to the account of the agent, and the time of payment. Most agreements state that all commissions shall not become due and payable until full settlement has been received by the firm. The agent could also be given the responsibility for collection with respect to sales it initiated.

Distributor agreements should state clearly that the overseas distributor acts as a buyer and not as an agent of the seller. The agreement could require the distributor to maintain

adequate inventories, facilities, and competent personnel. The exporter could sometimes stipulate that orders representing a minimum value or quantity shall be placed within a fixed time. The agreement also defines the advertising and promotion responsibilities of the distributor, including an undertaking to advertise in certain magazines or journals a minimum number of times a year at its own expense, for example:

> The distributor agrees during the lifetime of this contract to provide and pay for not less than seven full-page advertisements per year, appearing at regular monthly intervals in the national journals or magazines of the industry circulating generally throughout the territory.

Exporter's Rights and Obligations

In agency contracts, the exporter is often required to provide the agent with its price schedules and catalogs and brochures describing the company, its product, and other pertinent features. In distributor contracts, the exporter is required to provide the distributor and the distributor's personnel with training and technical assistance as are reasonably required in order to service, maintain, and repair products. In both agency and distributor agreements, the exporter should warrant only that the product complies with the specified standards of quality and also state the party that will be responsible for warranty service.

The exporter is also required to provide sufficient supplies of the product and new developments in products, as well as marketing and sales plans.

Definition of Price

In agency agreements, all sales of products are made in accordance with the price list and discount structure agreed upon by the parties. However, the seller reserves the right to change prices at any time, usually with thirty or sixty days' prior notice.

Distributor agreements also contain provisions relating to the price to be charged by the seller upon purchase of goods by the distributor. Any discounts available are also stated. In the case of products that are affected by inflation, the parties could set a definite price ruling on a specific date, such as the date of the sales contract or shipment. The parties could also agree that the exporter charge the distributor the best price it provides other customers at the time of sale (the most-favored-customer price) except for those products supplied to a holding company, subsidiary, or other associated companies of the supplier. The distributor agreement should also stipulate the terms of sale, such as FOB (free on board) or CIF (cost, insurance, and freight), as well as the method of payment (e.g.., open account, letter of credit), for example:

> The prices specified are in U.S. dollars, exclusive of taxes and governmental charges, freight, insurance and other transportation charges. Payment shall be on consignment. The product will be shipped FOB (Miami) to the buyer's address in Colombia.

Renewal or Termination of Contract

In many countries, issues relating to appointment, renewal, or termination of representatives are largely determined by local law. Many foreign representation agreements provide for a short trial period followed by a longer-term appointment if the representative's performance proves satisfactory. It is important to state the duration of appointment and the basis for renewal or termination. Any renewal or termination requires an act of notification to the representative.

In certain countries, the longer the period the representative has been appointed, the more difficult and expensive it is to terminate the contract. Representative agreements are terminated in cases when one of the parties is guilty of nonperformance or of not performing to the satisfaction of the other party, for example:

> In the event that either party should breach any term or condition of this agreement or fail to perform any of its obligations or undertakings, the other party may notify the defaulting party of such default, and if such default is not rectified within sixty days, the party giving notice shall have the right, at its election, to terminate the agreement.

The previous clause is often used to terminate nonperforming representatives. It is, however, important to set certain targets and objective performance criteria against which representative's performance will be measured: sales volume, inventory turnover rates, advertising, and market share. It is also advisable to include other causes of termination, such as the following:

Right to terminate without cause: A significant number of contracts allow for termination of the contract by either party with no prerequisite of action or omission by the other party upon giving advance notice, for example:

> Either party shall have the right to terminate the agreement at any time by giving not less than 180 days prior written notice of termination to the other party.

Force majeure: Most contracts state the occurrence of specific events beyond the control of the parties as a basis for termination of the contract. The enumerated actions or events fall into four major categories: (1) acts of God; (2) wars and civil disorder; (3) acts of government such as exchange controls or changes to host government regulations; and (4) other acts beyond the parties' control.

Other causes of termination: Some contracts provide for termination of the contract in cases such as bankruptcy or liquidation of either party, assignment of contractual rights or duties, change of ownership or management, and nonexclusivity, or the firm's decision to establish its own sales office or assembly operations.

In most countries, the exporter can terminate a representative in accordance with the contractual terms and without payment of indemnity. In situations lacking reasonable ground for termination, courts impose a liability for unjust termination that is often based on the volume of sales, goodwill developed by the representative, and duration of the contract. A typical formula is to award one year's profit or commission to the distributor or agent based on an average over the previous five years or the duration of the contract, whichever is shorter. It may also include cost of termination of the representative's personnel.

Applicable Law and Dispute Settlement

The parties are at liberty to agree between themselves as to what rules should govern their contract. Most contracts state the applicable law to be that of the manufacturer's home state. This indicates the strong bargaining position of exporters and the latter's clear preference to be governed by laws about which they are well informed, including how the contract will function and its repercussions on the whole commercial and legal situation of the parties. In cases with no express or implied choice of law, courts have to decide what law should govern the parties' contract on the basis of the terms and nature of the contract. Many factors are used to settle this issue in the absence of an express choice of law, including the place of contract, the place of performance, the location of the subject matter of the contract, and the place of incorporation and place of business of the parties. The contract should also provide for a forum (court) to settle the dispute relating to the validity, interpretation, and performance of the agreement.

Many representative contracts also provide that any dispute between the parties shall be submitted to arbitration for final settlement in accordance with the rules of the International Chamber of Commerce.

Maintaining and Motivating Overseas Representatives

Agents and distributors can be motivated in many ways to do the best possible job of marketing and promoting the firm's product. This could be accomplished by, for example, developing good communications through regular visits from the home office, the organization of conferences, or provision of inexpensive free trips for representatives during a given period. It is also important to inform representatives of the company's goals and principles and to keep them abreast of new developments in the product line, supplies, and promotion strategies and to assist in training and market development. Firms could also motivate representatives through provision of better credit terms or price adjustments based on sales volume or other performance-based criteria.

Chapter Summary

Export channels of distribution	*Channels of distribution used to market products abroad:* 1. *Indirect channels:* Exports through independent parties acting as sales intermediary 2. *Direct channels:* Direct sales to foreign distributors, retailers, or trading companies.
Determinants of channel selection to market products abroad	1. *International marketing objectives of the firm* 2. *Manufacturer's resources and experience* 3. *Availability and capability of intermediary* 4. *Customer and product characteristics* 5. *Marketing environment* 6. *Control and coverage*.

(*Continued*)

Indirect channels	*Types of indirect channels:* 1. *Exporters that sell on behalf of the manufacturer:* Manufacturer's export agents, export management companies, international trading companies 2. *Exporters that buy for their overseas customers:* Export commission agents 3. *Exporters that buy and sell for their own account:* Export merchants, cooperative exporters, Webb-Pomerene associations.
Direct channels	*Types of direct channels:* 1. Direct marketing from the home country 2. *Marketing through overseas agents and distributors:* Overseas agents, overseas distributors.
Major clauses in representation agreements	1. Definition of territory and product 2. Representative's rights and obligations 3. Exporter's rights and obligations 4. Definition of price 5. Renewal or termination of contract.

Review Questions

1. Distinguish between direct and indirect channels of distribution. What are the advantages and disadvantages of using indirect channels?
2. Discuss three major determinants of channel selection to market products abroad.
3. Do firms that export high-technology products exercise high levels of control?
4. Discuss the role and function of manufacturer's export agents.
5. Discuss the disadvantages of using export management companies.
6. What are the differences between export trading companies and export management companies?
7. Briefly describe Webb-Pomerene associations.
8. What are some of the disadvantages of using overseas distributors?
9. State some of the clauses (provisions) in representation agreements.
10. Briefly describe force majeure.

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World Wide Web Resources

Information on overseas distributors and other channels: http://www.unzco.com/basicguide/c4.html
Assistance with international trade for U.S. exporters: http://www.ita.doc.gov/td/oetca/
World Business Exchange (includes topics/assistance with exporting, channels of distribution, market research, service exports, pricing, documentation and financing): http://www.wbe.net/index.phtml
Information on channels of distribution for U.S. agricultural exports: http://www.usda.gov/wps/www.itu.int/osg/spu/publications
International Export Guide: A Guide to Exporting: http://www.unzco.com/basicguide/toc.html

Case 5.1 Export Channel Decisions of Two U.S. Companies

Wayne Engineering

Wayne Engineering is a leading manufacturer of side loaders, recycling vehicles, and recycling and garbage trucks. It uses Tradesur Inc. to handle the promotion, marketing, and distribution of its products in overseas markets.

TradeSur is an export management company (EMC) located in San Diego, California, with more than eighteen years of experience in the export market. It has established distribution channels in several countries. As a EMC, its major functions include the following: (1) promoting, marketing, and distributing U.S.-made construction equipment in Latin America and Europe; (2) handling complex logistics and outsourcing of various phases of the production process when necessary; (3) managing complex construction and infrastructure requirements by coordinating with multiple manufacturers of equipment worldwide and assembling the end product; (4) establishing links with several financial institutions to help overseas buyers to finance their purchases, enhance their cash flows, and expand U.S. exports; and (5) arranging independent financing of turnkey projects for qualified government agencies and corporations from eligible foreign countries.

Farouk Systems

Farouk Systems, Inc. (FS), a Houston-based manufacturer of natural hair care and spa products, wanted to get a foothold in the Southeast Asia, following its successful entry in more than sixty countries, including China. The company sought distributors in Singapore to market its products. With the help of the U.S. Commercial Service, which locates potential buyers and distributors for U.S. firms, the company was able to appoint a distributor from a list of prospective candidates.

Singapore was considered a good market for U.S. beauty care products because Singaporean women spend an average of nearly $80 a year on such goods, compared with 17 cents spent by women in China. There is, however, intense competition from various providers in the market.

Final selection of the distributor (True Line Beauty) was based on a number of factors: experience within the Southeast Asian market; solid foundations within the industry; experience in conducting hair shows and educational seminars; sound financial position; and personal chemistry and gut instinct. Farouk Systems also considered the extent to which the potential candidates were willing to look at the long-term perspective and invest in the brand.

The distributor, True-Line Beauty (TLB), was formed twelve years ago and has twenty employees. True-Line Beauty asked for and received exclusive distribution rights in a number of other countries, including Malaysia and Taiwan. Its sales force travel across the country explaining the benefits of the product (e.g., natural ingredients that are environmentally friendly) and offering incentives such as refunds if the product does not sell or one free bottle for every so many sold. Once a new beauty shop or spa has shown interest, TLB provides training for stylists and demonstrates new cutting and coloring techniques using FS products.

Efforts have been quite slow in developing markets outside Singapore. True-Line Beauty's approach appears to focus on tackling one market at a time. If certain specified performance benchmarks (e.g., sales, profit margins) as stated

in the contract remain unmet over a given period of time, the U.S. company has the option of finding another distributor with the requisite capability to do the job. However, flexibility is the key in evaluating performance expectations and establishing goodwill.

Case 5.2 The Internet and Exporting: A Focus on Developing Countries

A business that would like to succeed in export markets needs information about market prospects and must continually fine-tune its marketing skills, which includes the use of the Internet and Web-based resources to sell and promote products as well as generate new clients. For example, an export company that plans to participate in an international trade fair in an overseas market should do some Internet research on the prospective market to evaluate demand.

Analysts predict that about 10 percent of total business to consumer sales of U.S. retailers will be online in the next 5 to 10 years. Business-to-business sales volume is also expected to outpace business-to-consumer sales by a factor of 20 within the next few years. The Internet enables exporters to interact directly with overseas customers. Furthermore, it facilitates product customization and the provision of extended services. Even though these new possibilities pose a serious threat to export intermediaries, a virtual-market presence is not likely to be a substitute for existing networks, since physical distribution channels still have several positional advantages compared with virtually organized ones. A number of value-added services, for example, can be provided only via traditional distribution outlets. The Internet will not entirely replace the need for interpersonal relations and trust building. The Internet also poses organizational and managerial challenges (Peterson, Welch, and Liesch, 2002). It is plausible to contend that the Internet provides an infrastructure for carrying information and digital services, which is complementary to the existing marketing channel structure, improving performance (Anderson, 2005). In industries characterized by a high degree of information content such as publishing, travel, and financial services, export intermediation is undergoing a radical change. It has also given rise to new channels of export intermediation (e.g., e-Bay, Amazon) that were not previously available.

A study by Freund and Weinhold (2000) on the effect of the Internet on international trade shows its increasing and significant impact between 1997 and 1999. The study shows that a 10 percent increase in the relative number of Web hosts in one country would lead to about 1 percent greater trade. It also finds the effect of the Internet to be stronger for poor countries than for rich ones. However, the Internet does not seem to have reduced the impact of distance on trade. Clarke and Wallsten (2004) also find a positive correlation between Internet penetration in developing countries and those countries' increasing exports to developed countries.

In many countries, global business-to-business websites have already been set up in a number of industries. Daimler-Chrysler, GM, and Ford have started an Internet-based market (COVISINT) for car parts worldwide; e-steel is established to link buyers and sellers of steel products around the world. In Egypt, some seventy-five products are marketed on the Internet. Adelphi, a leather products maker in Kenya,

started a website with the intention of expanding into the global market. Global orders are executed through international courier firms such as DHL.

In spite of the increase in the number of users, Internet penetration rates in most developing countries remain low. Online trade is limited. Other factors contributing to lower than average e-commerce activity include low per capita incomes, low credit card usage, lack of relevant products or services, and poor logistics and fulfillment services.

In more advanced developing nations such as Taiwan, for example, the Internet is widely used in most sectors of the economy. Taiwanese firms are more concerned with improving forward linkages to their customers than improving backward linkages to their suppliers. In spite of the diffusion of the Internet, concerns over security and privacy in online trading represent the most significant barrier to its use in international business transactions.

Questions

1. Would you advise Wayne Engineering to use overseas distributors to market its products abroad?
2. What are some of the limitations of the Internet in facilitating the expansion of exports from developing countries?

six
International Logistics, Risk, and Insurance

International Logistics

Logistics is a total systems approach to management of the distribution process that includes the cost-effective flow and storage of materials or products and related information from point of origin to point of use or consumption.

There are two categories of business logistics:

1. *Materials management:* In the context of export-import trade, logistics applies to the timely movement or flow of materials/products from the sources of supply to the point of manufacture, assembly, or distribution (inbound materials). This includes the acquisition of products, transportation, inventory management, storage, and the handling of materials for production, assembly, or distribution. For example, products can be assembled in Canada for distribution in Canada and the United States.
2. *Physical distribution:* The second phase relates to the movement of the firm's product to consumers (outbound materials). It includes outbound transportation, inventory management, and proper packaging to reduce damage during transit and storage.

Materials management primarily deals with inbound flow, whereas physical distribution is concerned with the outbound flow of materials or products (David and Stewart, 2010; Guelzo, 1986). Both inbound and outbound activities are interdependent and influence the company's objective of reducing cost while conforming to customer needs. The interdependence of such activities can be illustrated by the example of U.S. flower imports from Latin America. Atlantic Bouquet, a U.S. company, purchases most of its flowers from its sister company, which has flower farms in Latin America. Continental Air freights the flowers from company-owned farms in Latin America to a warehouse in Miami before they are moved nationwide by air or by truck (for distances of less than 300 miles). A proper management

of the logistics system, that is, the unique combination of packaging, handling, storage, and transportation, will ensure that the product is imported and made available to the customer at the right time and place and in the right condition.

The interdependence of functional activities has been articulated through various new approaches or concepts:

1. *The systems approach:* The systems concept is based on the premise that the flow of materials within and outside the firm should be considered only in the context of their interaction (Czinkota, Ronkainen, and Moffett, 2010). This approach puts more emphasis on maximizing the benefits of the corporate system as a whole as opposed to that of individual units.
2. *Total-cost approach:* This is a logistics concept based on evaluation of the total cost implications of various activities.
3. *The opportunity-cost approach:* This approach considers the trade-off in undertaking certain logistic decisions (e.g., the benefits and costs of sourcing components abroad versus buying from domestic sources). Additional costs associated with transportation, increases in safety stock inventory, warehousing costs, and so forth are examined to ensure that the total opportunity cost of outsourcing abroad is not greater than other available options.

What is the importance of logistics to international trade? One of the major contributions of logistics to international trade is in the area of efficient allocation of resources. International logistics allows countries to export products in which they have a competitive advantage and import products that are either unavailable at home or produced at a lower cost overseas, thus allowing for efficient allocation of resources. For example, natural resource advantages and low-cost labor have enabled Colombia to export flowers to the United States and to import technology. Colombian flower exports have driven less-efficient U.S. producers out of their own markets and forced the Dutch out of the rose and carnation markets in the United States (Thuermer, 1998). Such advantages from international trade cannot be realized without a well-managed logistics system. To the extent that logistics facilitates international trade, it contributes to the expansion of economic growth and employment. As import firms expand their ability to procure needed raw materials or components for their customers, international logistics management becomes a critical source of competitive advantage for both the firms and the customers. Such material procurement and sourcing decisions include the number and location of warehouses, levels of inventory to maintain, as well as selection of the appropriate transportation mode and carrier (Christopher, 1992). The development of advanced logistics systems and capabilities has also increased the efficient production, transportation, and distribution of products. For example, by outsourcing logistics to third-party operators, pharmaceutical and health-care companies can reduce costs associated with inventory, overhead, labor, and warehousing. The use of various transportation modes facilitates rapid and consistent delivery service to consumers, which in turn reduces the need for safety stock inventory. Transportation cost is also reduced through shipment consolidation and special contracts with carriers for large shipments without adversely affecting delivery time. In short, a well-managed international logistics system can result in optimal inventory levels and optimal production capacity (in multiplant operations), thereby maximizing the use of working capital. All this helps to strengthen the competitive position of domestic companies in global trade.

External Influences on Logistics Functions

A number of external factors influence international logistics decisions: regulations, competition, and technology.

Regulations

Governments in many countries encourage their domestic carriers to handle their exports or imports since the provision of such transportation services contributes to the nation's balance of payments. This can be illustrated by U.S.-China trade, which is mostly transported by Chinese vessels. This occurs because the Chinese Foreign Trade Agency insists, whenever possible, on terms that allow it to control most of the transportation and thus use its state-run transport companies (Davies, 1987).

International logistics activity in the form of overseas transportation, handling of shipment, and distribution management also creates jobs. Besides the need to earn or save foreign currency and to create employment opportunities, governments have a third reason to support their national carriers: ensuring national shipping capacity during war or other emergencies. Governments also control or limit the export and import of certain commodities through a host of devices, such as export controls, import tariffs, and nontariff barriers, for example, quotas or cumbersome import clearance procedures. There are also bilateral negotiations between countries on airline routes and the provision of various services, such as insurance. All this has an influence on international logistics and transportation. The process of privatization and deregulation in transportation and communications has reduced shipping costs and increased productivity. This has also increased the possibilities for different prices and services, thus underscoring the need to integrate marketing and logistics functions.

Competition

The proliferation of new products and services and short product life cycles creates pressures on firms to reexamine their logistics systems. This often requires the need to reduce inventory, lower overall costs, and develop appropriate logistics networks and delivery systems to retain and enhance their customer base. Crucial to the success of any logistics system is also a holistic examination of the relationship among transportation, warehousing, and inventory costs in order to adapt to the changing competitive environment. Such a reexamination of its various logistics functions resulted in a substantial reduction in inventory costs and delivery time for Cisco Systems of San Jose, California, in 1997. The company ships routers to Europe and needed to let customers know when orders would arrive and to be able to reroute an order to fill urgent requests. It hired UPS Worldwide Logistics to handle the various logistics functions. Using its expertise, UPS can now track Cisco's routers from San Jose, California, to European customers in less than four days as opposed to three weeks. In cases in which UPS's planes or trucks cannot offer the quickest route, it subcontracts the job to other carriers such as KLM or Danzas, a European trucking firm. This resulted in more savings in inventories (Woolley, 1997).

Technology

Technology improvements, added to the deregulation of transportation and communications, have transformed the logistics industry. They have helped to increase logistics options, improve performance, and decrease costs. The use of communications technology has now integrated marketing and distribution activities with overseas customers, enabling the latter to know the date of shipment, the location of the cargo on transit, and the expected date of arrival. Importers have achieved total visibility of goods in transit and can make adjustments when a shipment is running late. Such tracking and tracing of cargo has the added advantage of synchronizing promotions and long-term inventory decisions for customers.

Typical Logistics Problems and Solutions

Each export-import firm must use a logistics system that best fits its product line and chosen competitive strategy (see Table 6.1 for differences between domestic and international logistics).

Example 1

Arturo Imports Incorporated, a firm based in Boca Raton, Florida, specializes in the importation of gift articles from South America and the Caribbean. It sells its products through company-owned retail stores in thirty U.S. states. The company has distribution centers in twenty locations all over the country and spends more than $650,000 a year in warehousing costs. Over the past few years, it has come under increasing attack from competitors and has lost about 20 percent of its market share. Its profits also declined by more than 15 percent in 2010 alone. The firm hired a consultant to advise it on how to reverse the situation. On the basis of the advice it received, Arturo Imports consolidated its operations in six distribution centers; reduced dead, obsolete, and slow-moving stock; and decreased the likelihood of stock-out (an item that is out of stock) for products customers want to buy. It centralized its purchasing functions and switched to an intermodal air and truck (from ocean and rail) combination to ensure rapid

TABLE 6.1 Differences between Domestic and International Logistics

Domestic logistics	International logistics
▪ Domestic currency used	▪ Different currency and exchange rates
▪ One national regulation on customs procedures, documentation, packaging, and labeling requirements	▪ Different national regulations and many intermediaries participating in the distribution channel (e.g., customs brokers, forwarders, banks)
▪ Most goods transported by truck or rail	▪ Most goods transported by air or sea
▪ Generally, short distances, short lead times, and small inventory levels	▪ Long distances, longer lead times, and the need for higher inventory levels

delivery. The company began to see its market share and profit margin grow six months after implementing its new logistics systems.

Example 2

A U.S.-owned export firm in Bangor, Maine, serves a narrow product line in eastern Canada from two distribution centers located in Montreal and Toronto. The company began to reexamine its logistical infrastructure in response to its loss of profits and market share to competitors. It increased the number of branch warehouses and level of fast-moving inventory while reducing the market area served by each warehouse. It also extended its product line. In spite of the additional expenses incurred, the company began to see a marked increase in its profits and sales volume.

The International Logistics Process

In export-import transactions, the following steps represent the approximate order of physical movement and distribution of goods to a foreign buyer.

Step 1

As a result of previous correspondence between the prospective seller and buyer, the prospective customer (buyer) places an order to purchase the desired merchandise, including such essential items as terms of sale, payment method, and other conditions. The parties must ensure that there are no restrictions on the export or import of the merchandise in question. The prospective exporter confirms receipt of the order and commits to fill the order on the basis of the given terms and conditions. The seller's acceptance without modification of the terms creates a binding contract. In the event of any modification by the prospective seller, a binding contract is created only upon acceptance of the proposed modification by the prospective customer. A pro forma invoice is then prepared by the exporter, stipulating the essential terms and conditions of sale; when accepted by the overseas customer, it may also serve as a contract. The prospective exporter must meet packaging, labeling, and other documentary requirements. In cases in which the exporter has inventory in different locations or countries, a determination has to be made as to which goods should be supplied on the basis of proximity to customer, tariff benefits, and so on. The exporter prepares the order for transportation. The order is then picked, packed, and labeled.

Step 2

A freight forwarder arranges for goods to be picked up and delivered to a carrier. The freight forwarder selects the transportation mode (e.g., airline, ship, truck) and the carrier and books the necessary space for the cargo. Such decisions influence packing and documentation requirements. The forwarder confirms booking with the supplier, who in turn confirms with the overseas customer. If the consignee is different from the buyer, the forwarder notifies the consignee.

Step 3

The carrier loads the cargo, and the merchandise is transported to the customer. Unless otherwise stipulated in the contract, the buyer is responsible for the cost of preshipment inspection. Many developing countries have adopted this practice primarily to conserve foreign currency earnings and to control illegal flights of currency through transfer pricing, that is, overinvoicing of imports and underinvoicing of exports. Preshipment inspection also ensures that the shipment conforms to the contract of sale. However, it is costly and time consuming for exporters and delays the physical movement and distribution of merchandise. Appropriate precautions should be taken to detect and control possible diversion of merchandise into the gray market. Export products may be sold below domestic prices if domestic advertising or R&D is not allocated to the export price. Such export products, if diverted to the domestic market, could potentially undermine the exporter's market position. Some of the warning signs of potential diversion include offers of cash payment when the terms of sale would normally call for financing, shippers with little or no background in the particular business, vague delivery dates, or shipping instructions to domestic warehouses. After the merchandise is transported, the forwarder sends the necessary documentation, that is, the commercial invoice, customs invoice, packing list, bill of lading or air waybill, and certificate of origin, to the customs broker, who clears goods for the overseas customer at the port of destination.

Step 4

The customs broker submits documents to customs to obtain release of the merchandise. In some countries, assessed taxes and duties have to be paid before release of the merchandise. Customs may also physically examine the merchandise. Penalties may be imposed if any serious errors or problems are found in the documentation or with the imported merchandise. The customs broker informs the forwarder of the release of the merchandise.

Step 5

If the terms of sale provide for the seller to obtain release of merchandise from customs and deliver to the consignee, the forwarder picks up the merchandise from customs and arranges for delivery to the consignee. This step depends on the terms of sale. The consignee signs the bill of lading or air waybill, noting any irregularities, and accepts the merchandise (see International Perspective 6.1).

INTERNATIONAL PERSPECTIVE 6.1

Attributes of a World-Class Logistics System: Denmark

Denmark holds the world's top spot in logistics. Its excellence in logistics is attributed to a number of factors:

- **Investment in infrastructure:** The international airport is within about thirty minutes of ten international ports and free-trade zones. It provides direct access to European rail and highway network with direct connections to many European cities.

It has international forwarders and integrators with bonded warehouse facilities. It provides substantial investment for infrastructure maintenance and development (bridges, airport, and seaport). It has an efficient air cargo handling facility. Customs clearance of goods is done before payment of duties, with minimum red tape. Information technology helps streamline procedures for exports or imports and links shippers and consumers.

- **Human resources:** Highly skilled and motivated labor force, twenty-four hour/seven-day operations and good management-labor relations (walkouts or strikes are virtually nonexistent).
- **Business environment:** Availability of free trade zones and bonded warehouses, low trade restrictions with a stable economic/political environment.

Logistics Functions

Labeling

Importers are required to comply with domestic labeling laws. Even though an imported product may comply with the labeling requirements of the country where it was manufactured, it may not comply with the labeling laws of the importing country. Labeling requirements are imposed in many countries to ensure proper handling (e.g., "Do Not Roll"; "Keep Frozen") or to identify shipments (e.g., "Live Animals"). Exporters need to be aware of certain labeling requirements to avoid unnecessary delays in shipping. The cartons or containers to be shipped must be labeled with the following: shipper's mark or purchase order number, country of origin, weight in both pounds and kilograms, the number of packages, handling instructions, final destination and port of entry, and whether the package contains hazardous material. Markings should appear on three faces of the container. It is also advisable to repeat the instructions in the language of the importing country.

Under the U.S. Clean Air Act (amended in 1990), all products containing ozone-depleting substances are required to be labeled. More detailed and specific regulations can be obtained from freight forwarders, since they keep track of changing labeling laws in various countries.

Packing

The rigors of long-distance transportation of goods require that merchandise be protected from possible breakage, moisture, or pilferage. This means that goods in transit must be packed not only to allow the overseas customer to take delivery of the merchandise but also to ensure the goods' arrival in a safe and sound condition. Consumers in many countries often prefer packaging with recyclable or biodegradable containers due to environmental concerns. For example, about 70 percent of packaging material used in any of the federal states in Germany must be recycled or reused. Packaging cost has an influence on product design. In certain cases, it is considered less costly to ship disassembled parts or dense cargo to save shipping cost.

Merchandise should be packed in strong containers, adequately sealed, and filled, with the weight evenly distributed. Goods should be packed on pallets if possible to ensure greater

ease in handling and containers should be made of moisture-resistant material. Packing must be done in a manner that will ensure safe arrival of the merchandise and facilitate its handling in transit and at its destination. (See International Perspective 6.2 for an example of product packing tips.)

Insufficient packing not only results in delays in the delivery of goods but also entitles the customer to reject the goods or claim damages. Export products must be packed to comply with the laws of the importing country. For example, Australia and New Zealand prohibit the use of straw or rice husk as packaging materials. The United Nations has adopted standards for packaging hazardous materials and provides for training of personnel, use of internationally accepted standards, and certain other conditions. Freight forwarders and marine insurance companies can advise on packaging.

Traffic Management

Traffic management is the control and management of transportation services. Such functions include selection of mode of transportation carriers, consolidation of small cargo, documentation, and filing of loss and damage claims. The international logistics manager's selection of a given mode of transportation depends on a number of factors. First, for products that are perishable, such as cut flowers, delivery speed is of the essence. Speed may also be required in cases involving important delivery dates or deadlines. In such cases, airfreight becomes the only viable mode of transport to successfully deliver the product to the overseas customer on time. Airfreight is also more reliable than other modes of transport that have more cumbersome unloading operations, which could expose the cargo to loss or damage. Second, the selection of transportation mode is influenced by cost considerations. Since airfreight is more expensive than other modes of transport, the international logistics manager has to determine whether such high costs are justified. Export firms tend to transport compact products or high-priced items by air because such products are more appropriate for airfreight or because the price justifies the cost. Third, government pressures could be imposed on exporters to transport by national carriers, even when other more economical alternatives exist. The choice of airport or port may be another important decision to be made. Such choices may be influenced by the desire to consolidate cargo or the presence of adjoining highways (to the port) on which weight limits are not rigorously enforced (David and Stewart, 2010; Guelzo, 1986).

Inventory and Storage

The proper management of an export-import firm's inventory is a critical logistics function. The costs associated with holding inventories can easily account for 25 percent or more of the value of the inventories themselves and could potentially create liquidity problems for many firms. In addition to this are the cost of storage, interest paid on borrowed money, and the risks of deterioration and obsolescence. It is important to establish certain guidelines with respect to such issues as maximum holding period, time of shipment of inventories to the supplier, and other related factors. Acceptable levels of inventory can still be maintained to serve overseas customers on time without unduly increasing costs and creating storage problems. To reduce warehousing costs, it may be necessary to store inventory in distribution centers according to customer needs. Inventories that are slow moving (no activity for six to twelve

months) can be shipped from the exporter or manufacturer. Appropriate inventory planning and control will reduce the number of storage facilities as well as carrying and freight costs.

In certain situations, accumulating inventories may have its own benefits. In countries that have certain macroeconomic problems, inventory may be a good edge against inflation and devaluation of currency.

INTERNATIONAL PERSPECTIVE 6.2

Packing Handicraft Exports: Important Pointers

Prior to packaging: Dust, clean, remove fingerprints, and dry items.

Major problems to consider in packaging: Tarnishing, corrosion, staining, decay, breakage, moisture.

Preventing moisture: Use a drying agent (silica gel) to reduce humidity; reduce surface area of package; dry items; and package materials in packages with a moisture-tight seal.

Preventing damage: Cushion fragile or high-cost handicrafts. Handicrafts exported in large quantities should be palletized when possible.

Heavy items: For heavy handicrafts, use wooden boxes.

Small items: Use bulk packaging with separators to protect individual items.

Outer packaging: Use corrugated fiber-board and wooden boxes.

Risks in Foreign Trade

Businesses conducting export-import trade face a number of risks that may adversely impact their operations, such as the following:

- *Political risk:* Actions of legitimate government authorities to confiscate cargo, war, revolution, terrorism, and strikes that impede the conduct of international business
- *Foreign credit risk:* Nonpayment or delays in payment for imports
- *Transportation risk:* Loss (partial/total) or damage to shipment during transit
- *Foreign exchange/transfer risk:* Depreciation of overseas customer's currency against the exporter's currency before payment or the nonavailability of foreign currency for payment in the buyer's country.

Political Risks

Many export-import businesses are potentially exposed to various types of political risks. Wars, revolution, or civil unrest can lead to destruction or confiscation of cargo. A government may impose severe restrictions on export-import trade, such as limitations on or control of exports or imports, restrictions on licenses, currency controls, and so on. Even though such risks are less likely in Western countries, they occur quite frequently in certain developing nations. Such risks can be managed by taking the following steps.

Monitoring Political Developments

Private firms offer monitoring assistance to assess the likelihood of political instability in the short and medium term. Such information can be obtained from specialized sources for specific countries such as political risk services (e.g., Political Risk Services of Syracuse, a unit of International Business Communications), the Economic Intelligence Unit, Euromoney, and Business International Corporation. Public agencies such as the Export-Import Bank of the United States (Eximbank) and the Department of Commerce also provide country risk reports.

Insuring Against Political Risks

Most industrialized nations provide insurance programs for their export firms to cover losses due to political risks. In the United States, Eximbank offers a wide range of policies to accommodate many different insurance needs of exporters. Private insurers cover ordinary commercial risk, but Eximbank assumes all liability for political risks. (See Chapter 14 on government export financing.)

Foreign Credit Risks

A significant percentage of export trade is conducted on credit. It is estimated that about 35 to 50 percent of exports of the United States and the United Kingdom are sold on open account and/or consignment (Seyoum and Morris, 1996). This means that the risk of delays in payment or nonpayment could have a crucial effect on cash flow and profits. Payment periods vary across countries, and even for countries that have close economic relations, such as those in the European Union, payment periods range from forty-eight days in the Netherlands to ninety days in Italy. Payments are, on average, eighteen days overdue in Germany, twenty-three in the United Kingdom, nineteen in France, and twenty in Italy (Luesby, 1994). Payment practices appear to be a function of the global/local economic conditions as well as the local business culture. In many developing countries, delays may be due to foreign exchange shortages, which in turn result in delays by central banks in converting local currencies into foreign exchange. The likelihood of bad debt from an overseas customer (0.5 percent of sales) is generally less than that for an American company. However, this does not provide comfort to an exporter whose cash flow and profit could be adversely affected by late payments and default. Beans Industries, once part of the British Leyland group, which makes automotive components, was taken into receivership in 1994 due to bad debts and late payments that had a dramatic effect on cash flow, despite increased demand for its products (Cheeseright, 1994). A default by an overseas customer is still costly even when the exporter has insurance to cover commercial credit risks. The exporter must follow strict procedures to obtain payment before insurance claims will be honored. The following measures will help export companies in dealing with problems of defaults and/or delays in payment.

Appropriate Credit Management

Appropriate credit management involves the review of credit decisions based on current and reliable credit reports on overseas customers. Credit reports on foreign companies can be

obtained from international banks that have affiliates in various countries and private credit information sources such as Dunn and Bradstreet, Graydon America, Owens Online, TRW Credit Services, and the National Association of Credit Management Corporation (NACM). A number of foreign credit information firms also provide accurate and reliable information on overseas customers. Government agencies such as the U.S. Department of Commerce, Eximbank, and the Foreign Credit Insurance Association (FCIA) also offer credit reporting services on foreign firms. Export firms also need to have a formal credit policy that will help them recover overdue or bad debts and substantially reduce the occurrence of such risks in future.

Requiring Letters of Credit and Other Conditions

A confirmed, irrevocable letter-of-credit transaction avoids risks arising from late payments or bad debts because it ensures that payments are made before the goods are shipped to the importer. However, such requirements (including advanced payments before shipment) do not attract many customers, and exporters seeking to develop overseas markets often have to sell on open account or consignment to enable the foreign wholesaler or retailer to pay only after the goods have been sold. The exporter can also require the payment of interest when payment is not made within the time period agreed or, failing that, within a given number of days. The introduction of a similar measure in Sweden in the mid-1970s is believed to have substantially reduced the delinquency of late payments to fewer than seven days. The European Commission submitted a draft recommendation to discourage late payments in cross-border trade (European Commission, 1994). Another safeguard would be to secure collateral to cover a transaction.

Insuring Against Credit Risks

Many export firms do not insure trade receivables, and yet, such cover is as necessary as fire or car insurance. It is estimated that in most developed countries, fewer than 20 percent of trade debts are insured. Credit insurers tend to have extensive databases that allow them to assess the creditworthiness of an insured's customer. This helps export companies to distinguish those buyers with the money to pay for their orders from those that are likely to delay payments or default. A credit insurance policy also provides confidence to the lender and may help exporters obtain a wide range of banking services and an improved rate of borrowing.

Few private insurance firms cover foreign credit risk; American Credit Indemnity, Continental Credit Insurance, Fidelity and Deposit Company, and American Insurance Underwriters are among those that provide such coverage. Such firms could be contacted directly or through brokers stationed in various parts of the country. Policies often cover commercial and political risks, although, in some cases, they are limited to insolvency and protracted default in eligible countries. Minimum premiums range from $1,250 to $10,000 per policy year.

Eximbank provides various types of credit insurance policies: credit insurance for small businesses (umbrella policy, small-business policy), single and multibuyer policies, Overseas Private Investment Corporation policies, bank letter-of-credit policies, and so on. Its major features are U.S. content requirements and restrictions on sales destined for military use or to communist nations. (See Chapter 14, "Government Export Financing Programs.")

Foreign Exchange Risks

Export-import firms are vulnerable to foreign exchange risks whenever they enter into an obligation to accept or deliver a specified amount of foreign currency at a future point in time. These firms could face a possibility that changes in foreign currency values could either reduce their future receipts or increase their payments in the foreign currency. Different methods are used to protect against such risks, for example, shifting the risk to third parties or to the other party in an export contract (for details, see Chapter 10 on exchange rates and trade).

Marine and Aviation Insurance

Export-import firms depend heavily upon the availability of insurance to cover against risks of transportation of goods. Risks in transportation are an integral part of foreign trade, partly due to our inability to adequately control the forces of nature or to prevent human failure as it affects the safe movement of goods. Insurance played an important part in stimulating early commerce. In Roman times, for example, money was borrowed to finance overseas commerce, and the lender would be paid substantial interest on the loan only if the voyage was successful. The loan was canceled if the ship or cargo was lost as a result of ocean perils. The interest charged in the event of a successful voyage was essentially an insurance premium (Greene and Trieschmann, 1984; Mehr, Cammack, and Rose, 1985).

The primary purpose of insurance in the context of foreign trade is to reduce the financial burden of losses arising from the movement of goods over long distances. In export trade, it is customary to arrange extended marine insurance to cover not only the ocean voyage but also other means of transport that are used to deliver the goods to the overseas buyer. There are five essential elements to an insurance contract:

1. The insured must have an insurable interest, that is, a financial interest based on some legal right in the preservation of the property. The insured must prove the extent of the insurable interest to collect, and recovery is limited by the insured's interest at the time of loss.
2. The insured is subjected to risk of loss of that interest by the occurrence of certain specified perils.
3. The insurer assumes the risk of loss.
4. This assumption is part of a general scheme to distribute the actual loss among a large group of persons bearing similar risks.
5. As a consideration, the insured pays a premium to a general insurance fund (Reuvid and Sherlock, 2011; Vance, 1951).

Since insurance is a contract of indemnity, a person may not collect more than the actual loss in the event of damage caused by an insured peril. An export firm, for example, is not permitted to receive payment from the carrier for damages for the loss of cargo and also recover for the same loss from the insurer. On paying the exporter's claim, the insurer stands in the position of the exporter (insured party) to claim from the carrier or other parties who are responsible for occasioning the loss or damage. This means that the insurer is subrogated to all the rights of the insured after having indemnified the latter for its loss. This is

generally described as the principle of subrogation. Another point to consider is whether an exporter, as an insured party, can assign the policy to the overseas customer. It appears that assignment is generally allowed insofar as there is an agreement to transfer the policy with the merchandise to the buyer and the seller has an insurable interest during the time when the assignment is made.

Marine Insurance

Marine policy is the most important type of insurance in the field of international trade. This is because (1) ocean shipping remains the predominant form of transport for large cargo, and (2) marine insurance is the most traditional and highly developed branch of insurance. All other policies, such as aviation and inland carriage, are largely based on principles of marine insurance. Practices and policies are also more standardized across countries in the area of marine insurance than in insurance of goods carried by land or air (Day and Griffin, 1993).

The different types of marine insurance include the following:

- *Marine cargo insurance:* Cargo insurance caters specifically to the cargo of the ship and also pertains to the belongings of a ship's voyagers. This chapter focuses on cargo insurance.
- *Hull insurance:* Hull insurance mainly caters to the torso and hull of the vessel, along with all the articles and pieces of furniture in the ship. This type of marine insurance is mainly taken out by the owner of the ship in order to avoid any loss to the ship in case of any mishaps.
- *Liability insurance:* Liability insurance provides compensation for any liability occurring on account of a ship's crashing or colliding or because of any other induced attacks.
- *Freight insurance:* Freight insurance offers and provides protection to merchant vessels' corporations that stand a chance of losing money in the form of freight in case the cargo is lost due to an accident involving the ship. This type of marine insurance solves the problem of companies losing money because of a few unprecedented events and accidents.

Developments in the Marine Insurance Market

- *Overcapacity in the shipping industry and consequences:* Ship owners ordered too many big ships to meet demand for container and bulk space over the past few years. This was accompanied by increasing outside investment in cargo and hull insurance that contributed to lower premiums for shippers. The insurance market has low entry barriers, and investors have entered the market hoping to get higher returns than the equity or bond markets could offer. The recent cargo and liability loss claims from tornadoes, storms, and other natural disasters are, however, likely to slow the decline in premiums. Cargo policies tend to show better results for insurance companies than hull coverage because claim subrogation, or the settlements of claims against other underwriters, tends to bring money back to the underwriters in years after they have paid out the initial claims.
- *Decline in the cost of piracy insurance:* A dramatic fall in pirate attacks off the Somali coast is forcing down the cost of piracy insurance for commercial ships. The use of

international navies to crack down on pirates, as well as armed guards and defensive measures taken on vessels, including barbed wire, as well as strikes on the pirates' coastal bases has dramatically reduced pirate attacks on ships. According to data from the International Maritime Bureau, there were only 63 pirate attacks during the first half of 2012 compared to 163 during the same period in 2011. In 2011, the ransom paid to pirates was estimated at $160 million (U.S.), costing the world economy some $7 billion. The decline in such attacks is likely to attract new entrants into the kidnap and ransom insurance market, which has grown from scratch to be worth about $250 million in little more than five years. In April 2010, President Barack Obama issued an executive order prohibiting the payment of any ransom to certain persons listed in an Annex to the Executive Order. It prevents ransom payments only if (a) it is made or facilitated by a person subject to U.S. jurisdiction, and (b) if it is paid to one of the persons listed on the Annex to the Executive Order, either directly or indirectly.

- *Popularity of trade disruption insurance (TDI):* There are two sides to the supply chain from the perspective of insurance cover. One deals with the protection of physical assets (goods) in transit, while the other protects revenue from supply-chain disruption. TDI covers, inter alia, losses from political, credit, and other supply-chain risks. A fuel supply company, for example, purchases TDI to cover alternative delivery costs if weather interrupts shipments to remote Alaskan facilities. Multinational food companies that sell fresh produce often purchase TDI to cover losses for spoilage because of supply-chain delays or disruption. In the event of a natural disaster—even if there is no physical damage—TDI covers losses incurred from plant downtime, storage costs, contractual penalties, or lost revenue. Companies can be protected from lost market share or new facility construction costs (Biederman, 2006). TDI is growing at about 14 percent a year.

Types of Marine Insurance Policies

Cargo policies may be written for a single trip or shipment (voyage policy), for a specified period (time policy), usually one year, or for an indefinite period (open policy), in which case the policy remains in effect until canceled by the insured or the insurer. The majority of cargo policies are written on open contracts. Under the latter policy, shipments are reported to the underwriter as they are made, and a premium is paid monthly based on the shipment actually made. The time policy differs from the open contract not just in the term of the policy but also with respect to the premium payment method. Under the time policy, the shipper pays a premium deposit on an estimated future shipment, and adjustments are later made by comparing the estimates with the actual shipment. Another version of open policy is one that is generally available to exporters/importers with larger shipments. It covers most of the shipper's needs and has certain deductibles (blanket policy). Under a blanket policy, the insured is not required to advise the insurer of the individual shipments, and one premium covers all shipments.

Coverage Under Marine Cargo Insurance Policy

There are two general types of marine cargo insurance policies: perils-only policy and all-risks policy.

The *perils-only policy* generally covers extraordinary and unusual perils that are not expected during a voyage. The standard perils-only policy covers loss or damage to cargo

attributable to fire or explosion, stranding, sinking, collision of the vessel, general average sacrifice, and so on. Such policies do not generally cover damage due to unseaworthiness of the vessel or pilferage. An essential feature of such a policy is that underwriters indemnify for losses that are attributable to expressly enumerated perils. The burden is on the cargo owner to show that the loss was due to one of the listed perils.

Export-import companies have the option of purchasing additional coverage (e.g., to include risk of water damage, rust, or contamination of cargo from oil) or taking all-risks policy that provides broader coverage.

Marine insurance policies generally specify the extent of coverage provided under the policy. Levels of cargo coverage fall into two broad categories: with average (WA) and free of particular average (FPA). This indicates whether the policy covers less than total losses (WA) or only total losses (FPA).

With average policy cover (WA): With average policy covers total as well as partial losses. Most with average policies limit coverage to those losses that exceed 3 percent of the value of the goods. A standard WA coverage may read:

> Subject to particular average if amounting to 3%, unless general or the vessel and/or craft is stranded, sunk, burnt, on fire and/or in collision, each package separately insured or on the whole.

This policy provides protection against partial losses by sea perils if the damage amounts to 3 percent or more of the value of the shipment. If the vessel is stranded or sunk or is damaged by other covered conditions, the percentage requirement is waived and the losses are recovered in full.

Free of particular average (FPA): Free of particular average (FPA) provides limited coverage. This clause provides that, in addition to total losses, partial losses from certain specified risks such as stranding or fire are recoverable. A standard FPA clause reads:

> Free of particular average (unless general) or unless the vessel or craft be stranded, sunk, burnt, on fire or in collision with another vessel.

The *all-risks policy* provides the broadest level of coverage except for those expressly excluded in the policy. A typical clause reads:

> To cover against all risks of physical loss or damage from any external cause irrespective of percentage, but excluding, nevertheless, the risk of war, strikes, riots, seizure, detention, and other risks excluded by the F.C & S (free of capture and seizure) (losses due to war, civil strife, or revolution) warranty and the S.R & C.C (strikes, riots, and civil commotion) warranty, excepting to the extent that such risks are specifically covered by endorsement.

In the case of an all-risks policy, the burden to prove that the loss was due to an excluded clause rests with the underwriter. Additional coverage can be provided through an endorsement on the existing all-risks policy or through a separate war-risks policy. The following types of loss are not usually covered by the all risks and other policies: (1) loss of market as well as loss, damage, or deterioration arising from delay; (2) loss arising from inherent vice of the goods (e.g., steel showing rust from exposure to air and moisture) as well as ordinary leakage (ordinary loss of weight or volume and wear and tear; (3) loss or damage arising

from strikes, riots, civil commotions, or acts of war; (4) insufficient packing; (5) unseaworthy vessel (this exclusion applies if at the start of the voyage the vessel was unseaworthy or unfit to go to sea and the insured or its employees were aware of this situation) (Malbon and Bishop, 2006).

Exporters that sell on credit and use terms of sale where the buyer is responsible for insurance (FAS, FOB, and so on) should consider taking out contingency insurance for the benefits of the overseas buyer in case the latter's insurance becomes inadequate to cover the loss. By paying a small premium for such insurance, the exporter creates a favorable condition for the buyer to pay for the shipment. Contingency insurance is supplementary to the policy taken out by the overseas buyer, and recovery is not made under the policy unless the buyer's policy is inadequate to cover the loss.

Marine cargo insurance covers only the period when the goods are on the ship. The marine extension (warehouse-to-warehouse clause) extends the standard marine coverage to the period before the loading of the goods and the period between offloading and delivery to the consignee.

The policies described (all-risks, with average, free of particular average) are mostly written by U.S.-based insurance companies. A similar set of standard terms (Institute of Cargo Clauses or ICC Clauses) are used by LIoyd's insurers and insurers that are members of the Institute of London underwriters (most of the U.K. insurance market). The A clauses in the ICC are equivalent to all-risks clauses, while the B and C clauses are equivalent to with average and free of particular average clauses, respectively (Table 6.2).

Insurance Policy versus Certificates

An insurance company may issue an insurance policy (policy) or a certificate. If the insurer issues only policies, an application must be completed by the insured for each shipment and delivered to the insurer or agent before a policy is prepared and sent to the former. This can be time consuming. However, in the case of certificates, the insurer provides a pad of insurance certificates to the exporter or importer, and a copy of the completed certificate (with details of goods, destination, type and amount of insurance required, and so on) is mailed to the insurance company whenever a shipment is made. Certificates save time and facilitate a more efficient operation of international business transactions.

Open policies for import/export shipments are often reported by using declaration forms that require the completion of certain particulars such as points of shipment and destination, description of units, amount of insurance, and so on. When full information is not available at the time a declaration is made, a provisional report may be submitted to the insurance agent (this is closed when the value is finally known). They are prepared by the assured and forwarded daily or weekly or as shipments are made. The premium is billed monthly based on the schedule of rates provided in the policy.

Insurance policies or certificates are often used in the case of exports, since the exporter must provide evidence of insurance to banks, customers, or other parties in order to permit the collection of claims abroad. Besides what is often included in declarations, policies/certificates include additional information such as names of beneficiary (usually assured or "order"), thus making the instrument negotiable upon endorsement by the assured. Whether the policy/certificate is prepared by the assured, freight forwarder or agent, it is important to describe the shipment in sufficient detail (see International Perspective 6.3).

TABLE 6.2 Comparing Cargo Policy Coverage

Peril	All risk	WA	FPA	ICC-A	ICC-B	ICC-C
Collision	Y	Y	Y	Y	Y	Y
Discharge of cargo at port	Y	Y	Y	Y	Y	Y
Cost of general average and salvage	Y	Y	Y	Y	Y	Y
Jettison	Y	Y	Y	Y	Y	Y
Overturning or derailment of land conveyance	Y	Y	Y	Y	Y	Y
Vessel grounded, sunk, or stranded	Y	Y	Y	Y	Y	Y
Earthquake, volcano, lightning	Y	Y	N	Y	Y	N
Entry of sea, lake, or river water into vessel or place of storage	Y	Y	N	Y	Y	N
Total loss of cargo overboard or during loading or unloading	Y	Y	N	Y	Y	N
Washing overboard	Y	Y	N	Y	Y	N
Breakage, loss, or damage from any external cause	Y	N	N	Y	N	N
Contact with other cargo	Y	N	N	Y	N	N
Deliberate damage or destruction	Y	N	N	Y	N	N
Fresh water	Y	N	N	Y	N	N
Hook damage, mud grease	Y	N	N	Y	N	N
Improper stowage by shipowner	Y	N	N	Y	N	N
Nondelivery	Y	N	N	Y	Y	Y
Pilferage	Y	N	N	Y	N	N
Ship sweat, steam of hold	Y	N	N	Y	N	N
Theft	Y	N	N	Y	Y	Y

* WA: With average; FPA: Free of particular average; ICC-A: Institute of Cargo Clauses, clause A; ICC-B: Institute of Cargo Clauses, clause B; ICC-C: Institute of Cargo Clauses, clause C.

General Average: Illustration

A vessel carrying a cargo of copper was stranded, and part of the cargo had to be sacrificial (thrown away) to lighten the vessel. The vessel had sustained certain damage, and a salvage vessel was employed to refloat it. Adjustment of the general average will be as follows:

Example 6.1

Value of the Cargo (thrown away) less duty and handling charges		10,000
Cost of repairs for vessel (chargeable to general average)	40,000	
Services for salvaging vessel	35,000	

Disbursement at port and other charges	15,000	
Total "vessel" Sacrifice		*90,000*
Amount to be allowed in general average		100,000
Value of cargo (including sacrifice)	100,000	
Value of vessel (including sacrifice)	300,000	
Total Contributory Value		*400,000*
Rate of general average contribution	$\frac{100,000}{400,000}$	
Cargo's contribution	25% (100,000) = 25,000	
Vessel's contribution	25% (300,000) = 75,000	

Cargo owner's liability = Assigned contribution – value of cargo sacrificed

Thus, 25,000 – 10,000 = 15,000 (to be paid)

Vessel's liability = Assigned contribution – vessel's sacrifice

Thus, 75,000 – 90,000 = 15,000 (to receive)

INTERNATIONAL PERSPECTIVE 6.3

Typical Clauses in Cargo Insurance Contracts

1. **Inchamaree clause:** This clause covers any loss or damage to cargo due to the bursting of boilers, the breakage of shafts, or any latent defect in the machinery, as well as from negligence of the captain or crew when it is the proximate cause of a loss.
2. **Free of particular average clause***:* This relieves the insurer of liability for partial cargo losses, except for those caused by the stranding, sinking, burning, or collision of the vessel.
3. **The labels clause:** In the case of damage to labels, capsules, or wrappers, the insurer is not liable for more than the cost of the new items and the cost of reconditioning the goods.
4. **The delay clause:** This relieves the insurer of liability for loss of market due to delay in the delivery of the cargo.
5. **The general average clause:** A general average loss occurs when a sacrifice is voluntarily made or an expense is incurred in times of imminent peril to preserve the common interest from disaster. Payments of apportioned losses are secured by a general average deposit before goods are released by the carrier. When the actual shipper's share is established, appropriate adjustments are made and any excess is returned. A general average clause covers the amount of the insured shipper's contribution.
6. **Craft and lighter clause:** In this clause, the insurer agrees to provide lighters or other craft to deliver cargo within the harbor limits.
7. **Marine extension clause:** Under this clause, no time limit is to be imposed on the insurance coverage at the port of discharge while goods are delayed in transit to final destination insofar as the delay is occasioned by circumstances beyond the control of the insured.

8. **Shore clause:** This covers certain risks to cargo, such as collision, hurricane, floods, and so on, while the goods are on docks, wharves, or elsewhere on shore.
9. **Warehouse-to-warehouse clause:** This covers cargo while on transit between the initial point of shipment and the point of destination, subject to terms of sale and insurable interest requirement. The policy is effective from the time the goods leave the warehouse/store named in the policy for the commencement of transit to the final warehouse at the point of destination stated in the policy.

Air Cargo Insurance: A modified form of marine insurance coverage is issued for air cargo insurance. Some airlines sell their own coverage.

Claims and Procedures

Claims

Shippers can claim from carriers or insurers with respect to loss or damage to their cargo. Shippers often attempt to recover from carriers when they have a reasonable basis to believe that the loss or damage was caused by the negligent act or omission of the carriers that was easily preventable through exercise of due diligence in the transportation and handling of the cargo. Another motivating factor for the insured to obtain a satisfactory settlement with carriers could be to maintain a healthy loss to premium and keep premiums low. It could also be that the loss or damage is not covered by the insurance policy. However, in most cases, shippers claim from their insurers partly because carriers reject claims received from the insured or because the shippers find that the adjustment for loss or damage is inadequate due to liability limitations. It may also be that some shippers find it more convenient and efficient to handle claims with insurance companies.

Settling losses under insurance contracts is the function of claims management. Claims management is often accomplished through employed (in-house) or independent adjusters who negotiate settlement with the insured. The claims department is responsible for ascertaining the validity of the loss, investigating, estimating the extent and amount of the loss, and finally approving payment of the claim. It is important to note the following in relation to insurance claims:

- To be recoverable, the loss or damage incurred by the insured must be covered by the insurance policy. The insurer will avoid liability if the particular risk is specifically excluded or is not reasonably attributable to the risk insured against.
- The burden of proof falls on the insured to show that the loss or damage to the cargo is covered by the policy.
- The insured must take prudent measures to protect the merchandise from further loss or damage. Under the sue and labor clause that is incorporated in most cargo insurance contracts (see International Perspective 6.3 for other typical clauses), the insured is required to take all necessary steps to safeguard the cargo and save it from further damage, without in any way prejudicing its rights under the policy. The underwriter agrees to pay any resulting expense (Tables 6.2 and 6.3 and International Perspective 6.4).

TABLE 6.3 Types of Losses

Total Loss	
1. Actual total loss	Goods are completely damaged or destroyed or so changed in their nature as to be unmarketable.
2. Constructive total loss	Actual loss is inevitable (such as frustration of voyage for an indefinite time), or damaged cargo can be saved only at considerable cost (i.e., cost greater than its value).
Partial Loss	
1. General average loss	These are goods sacrificed as part of a general average act or as a cargo owner's contribution for the general average loss of others.
2. Particular charges	These are expenses incurred to prevent loss or damage to insured cargo from risk that is insured against. Example: expenses for extra fodder for a cargo of horses while the ship is under repair for hurricane damage that was covered under the policy.
3. Particular average loss	This includes partial losses that are not covered by general average and particular charges.

- Once the insurance company settles the insured's claim, it could exercise its subrogation right to claim from parties responsible for the loss or damage. Under the principle of subrogation, the right to recover from carriers and other parties who are responsible for the loss or damage passes from the insured to the insurer on payment of the insurance money. Since the insurer stands in the shoes of the insured in claiming from third parties, the insurer does not have a better right than the insured possessed. Any payments obtained by the insured shipper from the carrier or other parties must be transferred to the insurer (after settlement with insurer) because, under the principle of subrogation, the insured is not allowed to recover more than once for the same loss.

Claims are generally valid for two years from the date of arrival for air shipments and one year in the case of ocean shipments. Claims are invalid if not initiated within this period unless legal action is pursued.

Typical Steps in Claim Procedures

Step 1

Preliminary notice of claim. The export-import firm (insured) must file a preliminary claim by notifying the carrier of a potential claim as soon as the loss is known or expected. A formal claim may follow when the nature and value of the loss or damage is ascertained.

Step 2

Formal notice of claim. The consignee must file a formal claim with the carrier and the insurance company once the damage or loss is ascertained. The claim should include costs such as the value of the cargo, inland freight, ocean/airfreight, documentation, and other items. If

the insurance policy is 110 percent of the cost in freight (CIF) value, the insured could add 10 percent of the value of the goods to the claim. Assuming that the insured intends to claim from the insurer (not the carrier), the insured should arrange for a survey with the claims agent of the insurance company. The formal claim form should be submitted with certain documents: a copy of the commercial invoice; a signed copy of bill of lading/air waybill; the original certificate of insurance; a copy of the claim against the carrier, or reply thereto; the survey report, if done by the surveyor; the packing list; and a copy of the receipt given to the carrier on delivery of the merchandise. It could also include photographs, repair invoice, and an affidavit from the carrier, if possible.

Step 3

Settlement of claim. If the claim is covered by the policy and claims procedures are appropriately followed, the insurance company will pay the insured. If the insurance company declines to approve payment, the insured could pursue arbitration or other dispute settlement procedures as provided in the insurance contract.

The claim is filed by the party that assumes the risk of loss on transit. For example, in CIF contracts, the exporter takes out an insurance policy for the benefit of the buyer and the risk of loss is transferred to the buyer once goods are put on board the vessel at the port of shipment. The exporter will send the necessary documents and detailed instructions to the overseas customer (consignee) to follow in the event of loss or damage. The consignee should be instructed to examine the goods upon delivery to determine any apparent or concealed loss or damage to cargo. Any loss or damage discovered upon such inspection should be noted on the carrier's delivery receipt or air waybill. Once the carrier obtains a clean receipt from the consignee, it becomes difficult for the latter to successfully make a claim.

The best way to deal with claims is to prevent the occurrence of loss or damage to cargo as much as is practically feasible. It is estimated that proper packing, handling, and stowage can prevent about 70 percent of cargo loss or damage. The frequent occurrence of damage or loss to cargo not only becomes a source of friction or suspicion on the part of insurance companies but also discourages the growth and expansion of trade. It could also have the effect of reducing sales abroad if overseas customers are discouraged by the frequency of such occurrences, since it could consume the parties' time and effort. If payment has already been made to the exporter, the buyer's capital is tied up with merchandise that cannot be sold.

INTERNATIONAL PERSPECTIVE 6.4

Common Perils of the Air and Sea

Perils of the Air

- **Cargo movement:** Inadequate packing and improper marking of cargo are the leading causes of air cargo losses. Rough or "bumpy" flight conditions and improper handling and storage of cargo before, during, and after flight often give rise to damage to cargo.
- **Theft and pilferage:** High-value cargo is particularly susceptible to theft when not in the aircraft or the terminal.

- **Exposure to the weather:** Inadequate coverage of cargo could lead to water damage.
- **Inadequate packing and handling:** Inadequate preparation for the toughest leg of the journey—trucking to air terminal, handling in terminals, stowing in aircraft, in-flight, unloading aircraft, transfer to terminals, trucking to consignee—can lead to damage. Special packing and handling for different types of goods such as large or liquid cargo are needed.

Perils of the Sea

- **Cargo movement:** Damage to cargo during multiple handlings at various legs of the journey. Cargo is subject to the constant movement and stress of maritime transport. In heavy seas, the cargo is exposed to compressive forces due to pitching and rolling. Effective securing of the load throughout the entire transport process is important.
- **Theft and pilferage:** Theft and pilferage account for about 20 percent of cargo loss.
- **Damage from water or fire:** Improper packing can lead to damage to the cargo. Cargo stowed over the deck could be subject to water damage in a stormy sea. Some cargo may also fall overboard. Improper packing and handling of flammable products such as chemicals, fireworks, and compressed gases could also lead to fire damage to cargo.
- **Sinking or stranding of ship:** Bad weather and collision could cause sinking of the ship. The vessel may accidentally run aground and suffer considerable damage.
- **Contamination:** Cargo contamination due to contact with other cargo can arise. Food products could acquire the smell of the cargo hold of the vessel or if stowed close to spices or gasoline.
- **Jettison:** This refers to throwing a part of the goods overboard to lighten the ship and residue of the cargoes in an emergency.
- **Barratry:** Barratry is a wrongful act willfully committed by the captain or crew in contravention of their duties, thereby causing prejudice to the owners, such as intentionally setting fire to ship or running aground the ship.
- **Abandonment:** Abandonment of ship by owners due to bankruptcy or other factors could create problems for crew and delivery of cargo.
- **Improper equipment:** Inadequate equipment to load or unload cargo could damage cargo.

Chapter Summary

Logistics	*Logistics:* The process of planning, implementing, and controlling the flow and storage of materials from the point of origin to the point of consumption.
Two categories of logistics	1. *Materials management:* The timely movement of materials from sources of supply to point of manufacture, assembly, or distribution 2. *Physical distribution:* Movement of a firm's products to consumers.

Logistics concepts	1. *The systems approach:* Emphasis on maximizing benefits of the corporate system as a whole as opposed to that of individual units. 2. *The total-cost approach* 3. *The opportunity-cost approach.*
Importance of logistics to international trade	1. Efficient allocation of resources 2. Expansion of economic growth and employment.
External influences on logistics decisions	1. *Regulations:* Export controls, tariffs, nontariff barriers, privatization and deregulation of transportation and communications 2. *Competition:* Competitive pressures on firms to examine logistics systems (e.g., to reduce costs) 3. *Technology:* Enables importers to know the date of shipment, location of cargo on transit, and expected date of arrival. It also handles other logistics functions.
Logistics functions	*Labeling, packing, traffic management, inventory, and storage.*
Risks in foreign trade	1. *Political risks:* Actions of government authorities, war, revolution, terrorism, strikes *Managing political risk:* Monitoring political developments, insuring against political risks 2. *Foreign credit risk:* Risks of buyer's default or delay in payment. *Managing foreign credit risk:* Appropriate credit management, letter of credit and other conditions, insurance 3. *Foreign exchange risk:* Changes in currency values that could reduce future exporter's receipts or increase importer's payments in foreign currency *Managing foreign exchange risk:* Shifting the risk to the other party or to third parties. 4. *Transportation risk:* Loss or damage to merchandise during transit.
Insurance	Two essential principles: 1. *The principle of insurable interest:* A financial interest based on some legal right in the preservation of the insured property 2. *The principle of subrogation:* On paying the insured's claim, the insurer stands in the position of the former (the insured) to claim from other parties who are responsible for the loss or damage.
Marine insurance	Types of policy: 1. *Perils-only policy:* Coverage for cargo loss/damage: a. *Free of particular average:* Policy covers total loss and partial loss from certain specified risks insured against b. *Within average policy:* Policy covers total loss and partial losses greater than a given percentage and insurer liable for the total amount lost 2. *All-risks policy:* Covers the broadest level of coverage except for those expressly excluded in the policy.
Claims and procedures	Claims for loss or damage to shipment on transit can be claimed from carriers or insurers. Most cargo claims are settled with insurance companies. *Typical claims procedures:* Preliminary notice of claim, formal notice and settlement.

Review Questions

1. Discuss the importance of logistics to international trade.
2. What is the systems approach to logistics?
3. State the external factors that influence international logistics decisions.
4. What is materials management, and how does it differ from physical distribution?
5. State some of the differences between domestic and international logistics.
6. What are political risks in foreign trade? How can they be managed?
7. What kinds of risks does marine insurance cover? How does an FPA policy differ from a WA policy?
8. A shipper obtains a marine policy covering the shipment of textiles from China to Poland. The declared value of the shipment is $15,000 although the real (market) value of the merchandise is $7,500. If the goods are lost at sea, is the insurance company liable for $15,000?
9. How does actual total loss differ from constructive total loss? What is general average loss? You receive compensation from a marine insurance company because your goods were jettisoned from a ship as a general average act. Does the insurance company have a claim for general average against the ship owner and the other cargo owners?
10. Discuss typical steps followed in claims from carriers or insurers with respect to loss or damage to cargo.

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World Wide Web Resources

International logistics: Logistics World: http: //www.logisticsworld.com/, http://209.51.193.25/logtalk .aspSites on risks and insurance:
www.industryweek.com/companies-amp-executives/7-steps-prevent-cargo-theft (cargo theft)
www.duke.edu/~charvey/Country_risk/pol/pol.htm (political, economic and financial risk)
www.duke.edu/~charvey/Country_risk/pol/polappa.htm (country risk)
www.score.org/guest (credit insurance)

Case 6.1 Marine Insurance

Actual Total Loss versus Constructive Total Loss

Goods are regarded as having become an *actual total loss* as soon as they cease to be goods of the kind insured from a commercial point of view. This occurs when a ship or goods have been actually lost and the freight can no longer be recovered. The three elements that constitute actual total loss include the following:

1. *The subject matter is destroyed:* Destruction of cargo ship by fire, sinking or enemy attack.
2. *The subject matter ceases to be of the kind insured:* Example: A cargo of dates is damaged by water in the cargo hold that makes it unfit for human consumption. A cargo of tobacco is rendered worthless by the stench of rotten hides that are damaged by the entry of sea water into the cargo hold.
3. *The insured is deprived of the subject matter:* Example: Capture or seizure of a ship by an enemy could amount to irretrievable deprivation.

There is *constructive total loss,* where the subject matter insured is reasonably abandoned because its actual total loss appears to be unavoidable or because it could not be preserved from actual total loss without an expenditure that would exceed its value. Constructive total loss occurs under any of the following circumstances: (1) where the insured is deprived of the possession of the ship or goods by a peril insured against (Example: A cargo of goods is detained by the enemy and there is no likelihood of recovery within a reasonable time); (2) the cost of repair is in excess of the value of the property (in the case of damage to the ship, the cost of repairing the damage would exceed the value of the ship when repaired).

Example: An old cargo vessel was being towed to a particular location to be dismantled and broken apart. During the passage, the vessel ran aground on the Florida coast. The owner contends that it will be quite expensive to bring it to the shore. He intends to hire a company to rescue the cargo ship. The ship had no cargo on board when it ran aground.

Case 6.2 Marine Insurance: Inchmaree Clause

A forty-foot wooden hull fishing vessel sprang an unexpected leak a few days after leaving port. As more water entered the vessel, the engine was flooded, and the vessel eventually sank. Inspection of the vessel during the leak showed that the water was coming from underneath a refrigerated space in the front part of the vessel. In view of its construction style, the bilge underneath the vessel was inaccessible. The underwriter refused to indemnify the insured for the loss of the vessel by claiming that the latter had not exercised diligence to make the vessel seaworthy prior to the developing of the leak (as provided under the Inchmaree Clause). The owner/master of the ship had no knowledge of the leak before the ship started its voyage.

Questions

1. (Case 6.1) Is this actual or constructive total loss? Explain your answer.
2. In case 6.2, do you think the loss is covered under the policy (see International Perspective 6.3)?

Section III

Executing the Transactions

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seven
Pricing in International Trade

Price is an important factor in determining a firm's ability to compete in world markets. For many companies, pricing policies and procedures are secret information and not easily available to outsiders. Export prices should be high enough to make a reasonable profit and yet low enough to be competitive in the market. Products rarely sell on one factor alone, and the exporter should be competitive on nonprice factors of different kinds. Sources of nonprice competition include reliable delivery, short delivery time, product reliability, and product quality, as well as any other feature considered unique by customers. This form of product differentiation based on specific characteristics of a product or service gives firms a competitive advantage (Dussauge, Hart, and Ramanantsoa, 1987). Apple Computer increased its market share in Japan not only by slashing prices but also by broadening distribution outlets and through the addition of Japanese software packages.

The crucial element in determining price relates to the value consumers place on the product. Value results from consumers' perceptions of the total satisfaction provided by the product (Hiam and Schewe, 1992). Companies can charge high prices and manage to remain competitive if the price charged is lower than or in alignment with the perceived value of the product or service. In competitive markets, high prices represent an indication of the social desirability of producing the product or service. They may also be justified in export markets if the sale also involves transfers of technology or training.

Pricing in world markets is often used as an instrument of accomplishing the firm's marketing objectives. The firm could use price to achieve certain levels of market share, profits, or returns on investments or to reach some other specific goal. The following policies for pricing and markups generally apply to both domestic and export markets:

- High markups are common in industries with relatively few competitors. Markups are also higher in industries in which companies produce differentiated products rather than homogeneous ones. The high markups could be taken as rent arising from market power. For example, in the chemical industry, the biggest profits lie in specialty

chemicals designed and produced for particular industrial uses (Reich, 1991). High markups may also be due to R&D expenditures and costs of increasing the skills of the workforce.
- Export prices tend to be relatively low in sectors in which there is increased competition. Changes in competitors' prices or the state of demand are more likely to trigger a reduction in export prices. Markups are relatively low for textiles, food, electric machinery, and motor vehicles; they remain high in industries such as medicines, computers, industrial chemicals, and television and communications equipment (Martens, Scarpetta, and Pilat, 1996). The low markups for the former are due to the fragmented and nondifferentiated nature of these industries, which makes it difficult to exercise market power.

A company needs to develop a workable guideline with respect to pricing of its product or service in export markets. Its pricing policy should be firm enough to achieve the targeted level of profits or sales, while maintaining some flexibility to accommodate the overall marketing objectives of the firm. Flexibility is seen as an absolute necessity for optimizing profits, and a firm may use all pricing methods according to the type of product being sold, the class and type of customer, and the competitive situation in the marketplace. Mismanagement of export pricing often leads to pressures for price reductions or the development of parallel markets. Parallel or gray markets are created when the product is purchased at a low price in one market and sold in other markets enjoying higher prices. For example, an importer in Japan can purchase the product at a discount in a foreign country and sell it in the Japanese market at a price lower than that charged by authorized dealers. Appropriate pricing and control systems of quality and distribution outlets are important in reducing such incidences of parallel markets.

Determinants of Export Prices

A number of variables influence the level of export prices. Some of these are internal to the firm; others are factors that are external to the firm. A major internal variable is the cost that is to be included in the export price. The typical costs associated with exports include market research, credit checks, business travel, product modification, special packaging, consultants, freight forwarders, and commissions (Anonymous, 1993). An additional cost is the chosen system of distribution. The long distribution channels in many countries are often responsible for price escalation. The use of manufacturers' representatives offers greater price control to the exporter. Another internal variable is the degree of product differentiation, that is, the extent of a product's perceived uniqueness or continuance of service. Generally, the higher the product differentiation a firm enjoys, the more independent it can be in its price-setting activities.

The external forces that influence export pricing include the following:

- *Supply and demand:* The pricing decisions for exports are subject to the influence of the supply of raw materials, parts, and other inputs. In a competitive economy, any increase in demand is followed by a higher price, and the higher price should, in turn, moderate demand. It is often stated that exports of manufactured goods exhibit the same price characteristic as primary products, their prices varying with the state of world

demand and supply (Silberston, 1970). The classical supply-and-demand approach—whereby price acts as an allocating device in the economy and supply equals demand at an equilibrium price—is largely based on certain assumptions: perfect buyer information, substitutability of competing goods, and marginal cost pricing. The classical assumption that reducing prices increases demand ignores the interpretation of price changes by buyers. Studies have shown that consumers perceive price as an indicator of quality and may interpret lower product prices as a sign of poor quality (Piercy, 1982). If a product has a prestigious image, price can be increased without necessarily reducing demand.

- *Location and environment of the foreign market:* Climatic conditions often require product modification in different markets, and this is reflected in the price of the export product. Goods that deteriorate in high-humidity conditions require special, more expensive packaging. For example, engines that are to be exported to countries in the tropics require extra cooling capacity.
- *Economic policies such as exchange rates, price controls, and tariffs:* Exchange rate depreciation (a drop in the value of a currency) improves price competitiveness, thus leading to increased export volumes and market shares. For example, in 1984–1985, when the dollar had appreciated to roughly double its 1980 value against the German mark, luxury German cars were selling for lower prices in the United States than in Germany. In export markets where buyers are used to negotiating prices, a flexible price is preferable to one that uniformly applies to all buyers.
- *Government regulations in the home country:* Different regulations in the home country have a bearing on export pricing. For example, U.S. government action to reduce the impact of its antitrust laws on competition abroad has enhanced the price competitiveness of American companies.

Pricing in Export Markets

The export price decision is distinct from the price decision in the home market. The export decision has to consider variations in market conditions and the existence of cartels or trade associations, as well as the existence of different channels of distribution. The presence of different environmental variables in export markets militates against the adoption of a single export-pricing policy (ethnocentric pricing) around the world. Another factor against uniform pricing is that different markets may be at different stages in the life cycle of a product at any given time.

It is customary to charge a high price during the introduction and growth stages of a product and to progressively reduce the price as the product matures. Other pricing alternatives include (1) polycentric pricing, which is pricing sensitive to local conditions, and (2) geocentric pricing, whereby a firm strikes an intermediate position. There are five approaches to export pricing: cost-based pricing, marginal pricing, skimming and penetration pricing, and demand-based pricing.

Cost-Based Pricing

The most common pricing approach used by exporters is one that is based on full-cost-oriented pricing. Under this procedure, a markup rate on full cost is determined and

then added to the product's cost to establish the price. The markup rate could be based on the desired target rate of return on investment.

Marginal Pricing

Marginal pricing is more common in exporting than in domestic markets. It is often employed by businesses that have unused capacity or to gain market share. In this case, the price does not cover the product's total cost but instead includes only the marginal (variable) cost of producing the product to be sold in the export market. This results in the sale of a product at a lower price in the export market than at home and often leads to charges of dumping by competitors.

Skimming versus Penetration Pricing

Skimming, or charging a premium price for a product, is common in industries that have few competitors or in which the companies produce differentiated products. Such products are directed to the high-income, price-inelastic segment of the market.

Penetration-pricing policy is based on charging lower prices for exports to stimulate market growth. Increasing market share and maximizing revenues could generate high profits.

Demand-Based Pricing

Under this method, export prices are based on what consumers or industrial buyers are willing to pay for the product or service. When prices are set by demand, market surveys will help supply the data to identify the level of demand. The level of demand generally establishes the range of prices that will be acceptable to customers. Companies often test-market a product at various prices and settle on a price that results in the greatest sales.

A firm does not have to sell a product at or below market price to be competitive in export markets. A superior or unique product can command a higher price. Cartier watches and Levi's jeans are examples of products that, despite their high prices, generate enormous sales worldwide due to their reputation. These are products for which consumers feel a strong desire and for which there are few or no substitutes (products with inelastic demand). In cases in which demand for the product is elastic, consumers are sensitive to changes in price. For example, rebates and other discount schemes often revive lagging export sales in the auto industry (which is characterized by elastic demand). A few years ago, Toyota launched a special sales campaign in Tokyo to give away money (about one million yen to 100 customers) to some of the customers of the competitor car it sells in Japan on behalf of General Motors.

Competitive Pricing

Competitive pressures are important in setting prices in export markets. In this case, export prices are established by maintaining the same price level as the competition, reducing prices or increasing the price with some level of product improvement. However, price-cutting is generally a more effective strategy for small competitors than for dominant firms. An

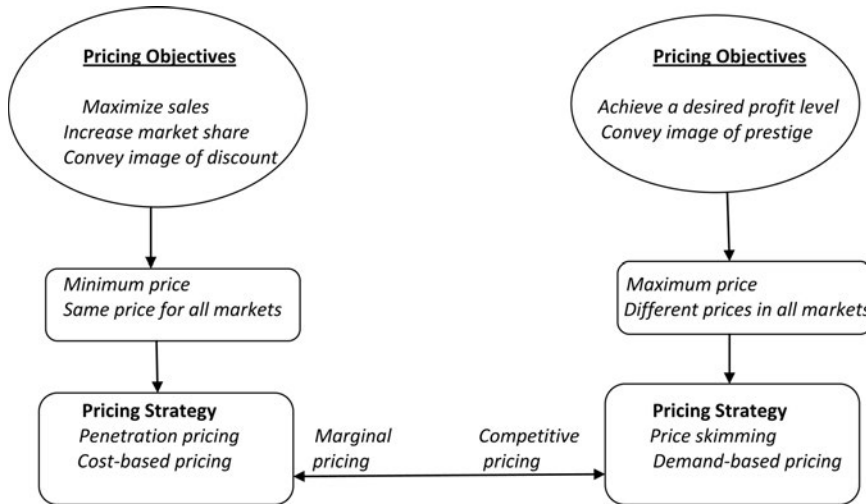

FIGURE 7.1 Pricing Objectives and Pricing Strategy

important factor in establishing a pricing strategy is also a projection of likely responses of existing and potential competitors (Oster, 1990).

Pricing Objectives

An exporter's pricing objectives have an important influence on its pricing strategy. If a firm prefers an aggressive expansion strategy into foreign markets, it may opt for a lower profit margin than it accepts for domestic sales. It will charge minimum prices in all markets to generate the highest volume of sales. This means that it will choose penetration pricing or cost-based pricing strategies to take high-volume, low-profit sales. Other export firms may prefer to achieve a high profit level by conveying an image of prestige and charge a high price in all markets. They could charge different prices based on what the market will bear. Such firms will opt for price skimming to take high-profit, low-volume sales. Between these two extremes, export firms use other pricing strategies such as marginal or competitive pricing (Figure 7.1).

Calculating the Export Price

Calculating Landed Cost and Distributor/Retail Price

There are two steps involved in calculating the export price:

- *Calculating the landed cost:* Landed cost is the total cost of a product once it has arrived at the buyer's door. It includes the original cost of the item, all brokerage and logistics fees, complete shipping costs, customs duties, taxes, insurance, currency conversion, crating costs, and handling fees. Not all of these components are present in every

TABLE 7.1 Export Price Calculation

Itemized cost	U.S. dollars
Ex-works price (Miami, Florida)	30,000.00
Freight to Port Manaus, Brazil	2,500.00
Insurance	750.00
CIF price	33,250.00
Landing charges	
Import duty (25% of CIF)	8,312.50
Marine tax (20% ocean freight)	500.00
Warehousing tax (0.65% of CIF)	216.13
Terminal handling charge ($350 per container)	350.00
Custom broker's union fee ($140.00)	140.00
Custom brokerage fee ($750)	750.00
Bank costs (2% ex works price)	600.00
Total landing charges	*10,868.63*
Landed cost at Port Manaus (without local taxes)	**44,118.63**
Cost to Brazilian distributor	44,118.63
Distributor markup (50%)	22,059.32
Cost to retailer	66,177.95
Retailer markup (60%)	39,706.77
Price to Brazilian consumer before local taxes	105,884.72
Local taxes (manufactures tax and local state tax: $6,500)	6,500.00
Price to Brazilian consumer after taxes	**112,384.72**

shipment. It is advantageous to reduce the cost of each or any component of landed cost. This will allow the seller to lower the final selling price or increase the margin associated with that sale (Table 7.1).

- *Calculating the distributor's and retailer's price:* Every industry has a standard markup from cost to price. In the gifts and house wares industry, for example, the standard markup is 100 percent. In other industries, it ranges from 35 percent to 60 percent (Table 7.1).

Illustrative Example

A U.S. manufacturer exports medical equipment from Miami, Florida, to a distributor in Brazil.

Selling price: $30,000
Terms of sale: Ex-works, Miami, Florida
Payment method: Open account

Assessing price competitiveness: This method compares the price competitiveness of the U.S. export item sold in Brazil with that of a similar (competing) product produced in Brazil

and Uruguay. Uruguay is a member of the MERCOSUR customs union, which also includes Brazil, Argentina, and Paraguay. The trade agreement eliminates all tariffs and nontariff barriers among member nations. This means that the exporters from Uruguay to Brazil do not pay import duties.

Assuming that both competitors can produce the product at $30,000, the Brazilian and Uruguayan producer will have a tremendous cost advantage over the U.S. exporter: a difference of $33,885 and $26,970, respectively. The price difference (between the U.S. and Brazilian product) is a result of freight costs and customs duties, while the price advantage enjoyed by the exporter from Uruguay is largely attributed to nonimposition of tariffs (Table 7.2).

TABLE 7.2 Export Price Comparisons

Itemized cost	U.S. dollars	Similar local product	Similar product from Uruguay
Ex-works price (Miami, Florida)	30,000.00	30,000.00	30,000.00
Freight to Port Manaus, Brazil	2,500.00	None	150.00
Insurance	750.00	None	175.00
CIF price	33,250.00	30,000.00	30,325.00
Landing charges			
Import duty (25% of CIF)	8,312.50	None	FTA, duty free*
Marine tax (20% ocean freight)	500.00	None	500.00
Warehousing tax (0.65% of CIF)	216.13	None	216.13
Terminal handling charge ($350 per container)	350.00	None	350.00
Custom broker's union fee ($140.00)	140.00	None	140.00
Custom brokerage fee ($750)	750.00	None	750.00
Bank costs (2% ex works price)	600.00	None	600.00
Total landing charges	*10,868.63*	None	2,556.13
Landed cost at Port Manaus (without local taxes)	**44,118.63**	**30,000.00**	**32,881.13**
Cost to Brazilian distributor	44,118.63	30,000.00	32,881.13
Distributor markup (50%)	22,059.32	15,000.00	16,440.57
Cost to retailer	66,177.95	45,000.00	49,321.70
Retailer markup (60%)	39,706.77	27,000.00	29,593.02
Price to Brazilian consumer before local taxes	105,884.72	72,000.00	78,914.72
Local taxes (manufacturers tax and local state tax: $6,500)	6,500.00	6,500.00	6,500.00
Price to Brazilian consumer after taxes	**112,384.72**	**78,500.00**	**85,414.72**

* Exporters from Uruguay to Brazil do not pay import duty since Uruguay has a free-trade agreement with Brazil.

Improving the odds and achieving export competitiveness: There are a number of potential options for U.S. exporters that find themselves in an uncompetitive position in foreign markets. With the assistance of their home government, they can devise strategies that will contribute to enhancing their competitiveness.

Long-term options:

- Free-trade agreements will help reduce or eliminate tariffs and nontariff barriers.
- Foreign direct investment will eliminate the additional cost of import duties. Locally produced components can be assembled into a final product in the export market.
- A manufacturer can license the use of its technology for production in the export market.

Short-term options:

- Long distribution channels contribute to price escalation. You can shorten the channel or export through an overseas representative.
- Product differentiation: Successful product differentiation creates a competitive advantage for the seller, as customers view these products as unique or superior. Product differentiation provides the firm some autonomy in its price-setting objectives.
- Discounts tied to promotions or quantity discounts can improve competitiveness.

Trade Terms

Despite wide differences among national laws, there is a high degree of uniformity in contract practices for the export and import of goods. The universality of trade practices, including terms of sale, is due to the development of the law merchant by international mercantile custom. The law merchant refers to the body of commercial law that developed in Europe during the medieval period for merchants and their merchandise (Brinton, Christopher, Wolff, and Winks, 1984).

Trade terms are intended to define the method of delivery of the goods sold and the attendant responsibilities of the parties. Such terms also help the seller in the calculation of the purchase price (Anonymous, 1993). A seller quoting the term of sale as FOB, for example, will evidently charge a lower price than one quoting CIF because the latter includes not only the cost of goods but also expenses incurred by the seller for insurance and freight to ship the goods to the port of destination.

The Purpose and Function of Incoterms

Incoterms (International commercial terms) comprise a body of predefined commercial terms that deal with the seller's delivery obligation under an international sales contract. The International Chamber of Commerce (ICC), a nongovernmental entity, has been responsible for the development of Incoterms and has undertaken seven revisions since 1936 (1953, 1967, 1976, 1980, 1990, 2000, and 2010) to make the terms adaptable to

changes in global trade, technology, and contemporary commercial practice. Incoterms are accepted by businesses and governments all over the world, thus setting the standard for the interpretation of trade terms used in domestic and international trade. The most recent revision (2010) was necessitated by certain significant and rapid changes in the global economy: (1) The need to adapt trade terms to domestic and international commercial practice as well as to developments in national accounting standards (GAAP or IFRS) and to domestic law in important trading nations such as the United States (Uniform Commercial Code, Sarbanes-Oxley); (2) the desire to increase participation and input from emerging nations that are significant players in global trade such as Brazil and China; (3) the increased importance of multimodal transportation and the need for a broader scope of shipping terms to address land, ocean, and air movements. The current revision of Incoterms was published and came into effect on January 1, 2011 (Reference Guide, Table 7.3).

Incoterms comprise a set of rules and not laws. It is neither national legislation nor an international treaty. However, when parties to an international sales contract agree to be governed by Incoterms, the terms take on the force of law and questions pertaining to delivery of goods will be interpreted according to Incoterms. If the parties do not explicitly agree to be governed by Incoterms, this could be made an implicit term of the contract as part of international custom.

Businesses that understand the implications of Incoterms excel at facilitating the movement of goods, stabilize lead times, and often reduce the landed cost of merchandise. This

TABLE 7.3 Incoterms 2010: Division of Costs, Licenses, and Formalities

Term	Transport	Transport insurance	Clearance	Taxes	Export license	Import license
EXW	Buyer	Buyer (although not obligated to insure)	Buyer	Buyer	Buyer	Buyer
FCA	Buyer	Buyer (although not obligated to insure)	Buyer	Buyer	Seller	Buyer
FAS	Buyer	Buyer (although not obligated to insure)	Buyer	Buyer	Seller	Buyer
FOB	Buyer	Buyer	Buyer	Buyer	Seller	Buyer
CFR	Seller	Buyer (although not obligated to insure)	Buyer	Buyer	Seller	Buyer
CIF	Seller	Seller	Buyer	Buyer	Seller	Buyer
CPT	Seller	Buyer	Buyer	Buyer	Seller	Buyer
CIP	Seller	Seller	Buyer	Buyer	Seller	Buyer
DAT	Seller	Seller	Buyer	Buyer	Seller	Buyer
DAP	Seller	Seller (although not obligated to insure)	Buyer	Buyer	Seller	Buyer
DDP	Seller	Seller (although not obligated to insure)	Seller	Seller	Seller	Seller

could serve as a source of competitive advantage (International Perspectives 7.1 and 7.2). In short, Incoterms accomplish the following objectives:

- Provide a set of international rules for the interpretation of the most commonly used terms of sale
- Reduce uncertainty arising from different interpretation of such terms in different countries
- Define the rights and obligations of the parties to the contract of sale pertaining to the delivery of goods sold
- Clearly delineate the tasks, costs, and risks associated with the transportation and delivery of goods.

The national laws of each country often determine the rights and duties of parties with respect to terms of sale. In the United States, the Revised American Foreign Trade Definitions (1941) and the Uniform Commercial Code govern terms of sale. Since 1980, the sponsors of the Revised American Foreign Trade Definitions recommend the use of Incoterms.

In order to avoid any misunderstanding, parties to export contracts should always state the application of the current version of Incoterms. The Uniform Commercial Code (UCC) and Incoterms complement each other in many areas. Trade terms are not understood in the same manner in every country, and it is important to explicitly state the law that governs the contract. For example, a contract should state FOB New York (Incoterms) or "CIF Liverpool (Uniform Commercial Code)."

All trade terms are classified into four groups based on the point of transfer of risk (delivery) from seller to buyer. They are displayed in order of increasing obligations for the seller. This means that the Group E term such as Ex-Works signifies the least obligation to the seller, whereas the Group D term imposes the maximum amount of responsibility on the seller (Tables 7.3 and 7.4).

1. *Group E term (Ex-Works):* This grouping has only one term and represents the seller's minimum obligation—to place the goods at the disposal of the buyer. There are no contractual arrangements between seller and buyer with regard to insurance, transportation or export.
2. *Group F terms (FCA, FAS, FOB):* The seller is expected to bear the risk and expense of delivery to a nominated carrier. It is the buyer's responsibility to arrange and pay for the main carriage to the point of destination.
3. *Group C terms (CFR, CIF, CPT, CIP):* C terms establish the point of delivery (transfer of risk) from seller to buyer at the point of shipment. It, however, extends the seller's obligation with regard to the costs of carriage and insurance up to the point of destination. This means that the seller bears certain costs even after the critical point for the division of the risk or damage to the goods. These are often referred to as shipment terms.
4. *Group D terms (DAT, DAP, DDP):* The seller's delivery obligation extends to the country of destination. This means that the seller could be held liable for breach of contract if the goods are lost or damaged after shipment but before arrival at the agreed point of destination. The seller may be required to provide substitute goods or other forms of restitution to the buyer. These are often referred to as arrival terms. It is not ideal for letter-of-credit transactions since the bill of lading or air waybill do not show actual arrival.

TABLE 7.4 Group of Incoterms 2010

Group (based on Incoterms 2000)	Any mode of transport	Maritime transport	Transfer of risk
Group E: Departure *Seller makes goods available to buyer at seller's premises.*	Ex-Works (EXW) *Maximum obligation to buyer*		**EXW:** When goods are placed at the disposal of the buyer
Group F: Main carriage unpaid *Seller delivers goods to a carrier nominated by buyer. Facilitates ISF (10+2) reporting for U.S. importers.*	Free Carrier (FCA)	Free Alongside Ship (FAS) Free On Board (FOB)	**FCA:** Upon seller's delivery to the carrier at the named place **FAS:** When goods are placed alongside the ship **FOB:** When goods are placed on board the vessel at the port of departure
Group C: Main carriage paid *Seller contracts for carriage of goods but does not assume the risk of loss/ damage after shipment. U.S. importers rely on supplier's forwarder for ISF documentation.*	Carriage Paid To (CPT) Carriage and Insurance Paid To (CIP)	Cost and Freight (CFR) Cost, Insurance, and Freight (CIF)	**CPT:** Upon seller's delivery to the main carrier at the place of departure **CIP:** Same as CPT **CFR:** When goods are placed on board the vessel at the port of departure **CIF:** Same as CFR
Group D: Arrival *Seller responsible for all costs and risks required to deliver the goods to destination. U.S. importers rely on supplier's forwarder for ISF documentation.*	Delivered At Terminal (DAT) Delivered At Place (DAP) Delivered Duty Paid (DDP) *Maximum obligation to seller*		**DAT:** When the goods are unloaded from the arriving vehicle (not cleared) and are at the buyer's disposal at the agreed place of destination **DAP:** When the goods are placed at the buyer's disposal at the agreed destination (not unloaded and not cleared) **DDP**: When goods cleared and duty paid (not unloaded) are placed at the buyer's disposal at the agreed destination.

Incoterms 2010 consists of eleven terms and are divided into two major groups:

- *Group for any mode of transport:* This includes trade terms used for carriage by road, rail, air, and multimodal: Ex-Works (EXW), Free Carrier (FCA), Carriage Paid To (CPT), Carriage and Insurance Paid To (CIP), Delivered At Terminal (DAT), Delivered At Place (DAP), and Delivered Duty Paid (DDP).
- *Group for maritime transport:* Trade terms under this group are used for carriage over water from port to port, including inland waterways. They include Free Alongside Ship (FAS), Free On Board (FOB), Cost and Freight (CFR), and Cost, Freight, and Insurance (CIF).

Incoterms and Scope of Coverage

Incoterms cover only the delivery-oriented aspects of an international sales contract. The seller's delivery obligations include responsibility for risk of loss or damage to the goods and transportation and customs-related costs, as well as other functional responsibilities (e.g., packaging, export clearance, contract of carriage). Incoterms, however, do not cover or address the following areas:

- *Transfer of title:* Incoterms do not deal with transfer of ownership of goods (Gardner, 2011)
- *Payment terms or methods:* Incoterms do not address matters pertaining to payment terms such as cash in advance or letter of credit. Such issues must be covered with a separate clause in the contract of sale.
- *Remedies for breach of contract:* Incoterms do not cover consequences for breach of contract.
- Any other nondelivery related issues: Incoterms are not a substitute for contracts of carriage or insurance. These questions must be addressed in a separate contract.

The Concept of Delivery Under Incoterms

Seller's delivery obligations under Incoterms do not always entail the physical transfer of possession of goods to the buyer (Chikwava, 2012). There are many cases where such delivery is completed well before the arrival of goods at destination. Incoterms links delivery to the risk of loss or damage to the goods. This means that seller's delivery obligation is completed at the point where risk of loss or damage to the merchandise is transferred from the seller to the buyer. In CIF contracts, for example, delivery takes place when the goods are placed on board the ship at the port of departure, while in FCA contracts such delivery (transfer of risk) takes place when the goods have been delivered to the carrier at the named place (Table 7.5).

Incoterms 2012: Trade Terms

All trade terms are classified into four groups based on the concept of progressive delivery responsibility of the seller. Such terms provide a standardized, universal set of shipping terms that is consistent with contemporary business practices and modes of transportation for domestic and international shipments (Roos, 2011).

Group E (Ex-Works [EXW])

Ex-Works, Ex-Warehouse, Ex-Store (named place): Under this term, the buyer or agent must collect the goods at the seller's works, warehouse, or store. The seller bears all risk and expenses until the goods are placed at the disposal of the buyer at the time and place agreed for delivery, normally the seller's premises, warehouse, or factory. The seller has no obligation to load the goods.

Risk is not transferred to buyer if damage or loss is attributed to the failure on the part of the seller to deliver the goods in conformity with the contract (e.g., damage due to inadequate packing of goods).

The buyer bears all risk and charges pertaining to preshipment inspection, export/import licenses, and customs duties/taxes needed for exportation. The buyer is also responsible for clearance of goods for exports, transit, and imports, since the seller makes the goods available to buyer in the country of export.

This term of sale is similar to a domestic sales transaction, although the product is destined for export. This term may be out of line with international business practice since many countries require exporters to be responsible for export clearance or compliance with export regulations. There may be concern with diversion of goods since the buyer is the party that is responsible for export and documentation. Furthermore, there is no standard as to what document constitutes evidence of delivery.

Group F (FCA, FAS, and FOB)

Free Carrier (FCA), named place: The seller bears the risk and costs relating to the goods until delivery to the carrier or any other person nominated by the buyer. The place of delivery could be the carrier's cargo terminal or a vehicle sent to pick up the goods at the seller's premises. In the latter case, the seller is responsible for loading the goods onto the buyer's collecting vehicle. If the place of delivery is the carrier's cargo terminal, the seller is required only to bring the goods to the terminal (but is not obligated to unload them). It is thought that the carrier is more likely to have the necessary personnel and equipment to unload the goods at its own terminal than is the seller.

The carrier nominated by the buyer could be a trucker, a freight forwarder, a steamship line, or an airline. The seller must fulfill the export formalities. FCA is suitable for carriage by road, rail, air, and multimodal transport, in particular when containers are being used.

Upon delivery of the goods to the carrier, the seller receives (from the carrier) a receipt that serves as evidence of delivery and contract of carriage made on behalf of the buyer. Neither party is required to insure under FCA. However, the seller must provide the buyer (upon request) with the necessary information for procuring insurance. When using full container load (FCL), risk of loss shifts to the buyer once the goods are loaded, primarily in the factory or on the seller's premises. In the case of less than full container load (LCL), risk is transferred after the goods are delivered to the groupage warehouse named by the buyer. Similar to FAS and FOB terms, FCA covers only pre-transport (main transport risk lies with buyer). If the seller arranges and pays for carriage and insurance, it turns into CIP (cost and insurance paid to) shipment (CPT without insurance) (Table 7.5).

Besides payment of the purchase price as provided in the contract, the buyer has the following obligations:

- Obtain at his or her own risk and expense any import license and other official authorization necessary for importation of the goods as well as for their transit through another country
- Contract at his or her own expense for carriage of the goods from the named place of delivery
- Pay the costs of any preshipment inspection except when such inspection is mandated by the exporting country.

TABLE 7.5 Price Determination Worksheet

Price (or cost) per unit _____ X ____ units = total	+
Profit (or markup)	+
Commissions	+
Financing costs	+
EX-FACTORY	**=**
Crating/containerization charges (if done at factory)	+
Labeling and marking costs (if done at factory)	+
Drayage charges (usually associated with movement of containers from railroad ramp to plant and back to ramp)	+
Loading charges, if applicable	+
Demurrage and detention charges, if applicable	+
Other charges (specify)	+
FREE CARRIER (FCA) TRUCK OR RAIL CAR AT POINT OF ORIGIN	**=**
Inland freight charges (including fuel surcharges)	+
Unloading charges at port facilities	+
Drayage to packer (crater/containerized), if applicable	+
Containerization/crating charges (if done at port)	+
Labeling and marking (if done at port)	+
Freight forwarding and documentation charges (includes charges associated with consular fees, export license, postage, telex, and telephone/telegram use and similar charges)	+
Drayage to warehouse and unloading, if applicable	+
Warehousing charges, if applicable	+
Loading and drayage to pier from packer or warehouse, if applicable	+
Wharfage charges	+
Terminal notification charges	+
Demurrage/detention at port	+
FREE ALONGSIDE VESSEL AT PORT OF _________	**=**
Vessel loading charges	+
Heavy lift or extra-length charges, if applicable	+
Other charges (specify)	+
FREE ON BOARD VESSEL AT PORT OF _________	**=**
Ocean freight charges	+
Bunker or other surcharges, if applicable	+
COST AND FREIGHT TO __________	**=**
Insurance	+
COST, INSURANCE, AND FREIGHT TO _________	**=**

TABLE 7.6 A Reference Guide To Incoterms 2010

Services	Party responsible for payment of services										
	Rules applicable to any mode of transport							Sea and inland waterway			
	EXW	**FCA**	**CPT**	**CIP**	**DAT**	**DAP**	**DDP**	**FAS**	**FOB**	**CFR**	**CIF**
Export packing	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*
Marking & labeling	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*
Block & brace	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*	*A*
Export clearance (license/EEI/AES)	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*
FF documentation fees*	*Buyer*	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Buyer*	*Buyer*	*Seller*	*Seller*
Inland freight to main carrier	*Buyer*	*B*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*
Original terminal charges	*Buyer*	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Buyer*	*Seller*	*Seller*	*Seller*
Vessel loading charges	*Buyer*	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Buyer*	*Seller*	*Seller*	*Seller*
Ocean or air freight	*Buyer*	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Buyer*	*Buyer*	*Seller*	*Seller*
Nominate export forwarder	*Buyer*	*Buyer*	*Seller*	*Seller*	*Seller*	*Seller*	*Seller*	*Buyer*	*Buyer*	*Seller*	*Seller*
Marine insurance	*C*	*C*	*C*	*Seller*	*C*	*C*	*C*	*C*	*C*	*C*	*Seller*
Unload main carrier charges	*Buyer*	*Buyer*	*D*	*D*	*Seller*	*Seller*	*Seller*	*Buyer*	*Buyer*	*D*	*D*

(*Continued*)

TABLE 7.6 (Continued)

Services	Party responsible for payment of services										
	Rules applicable to any mode of transport							Sea and inland waterway			
	EXW	**FCA**	**CPT**	**CIP**	**DAT**	**DAP**	**DDP**	**FAS**	**FOB**	**CFR**	**CIF**
Destination terminal charges	*Buyer*	*Buyer*	*D*	*D*	*D*	*Seller*	*Seller*	*Buyer*	*Buyer*	*D*	*D*
Nominate on-carrier	*Buyer*	*Buyer*	*E*	*E*	*E*	*E*	*Seller*	*Buyer*	*Buyer*	*Buyer*	*Buyer*
Customs broker clearance fees	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Seller*	*Buyer*	*Buyer*	*Buyer*	*Buyer*
Duty, customs fees, and taxes	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Seller*	*Buyer*	*Buyer*	*Buyer*	*Buyer*
Delivery to buyer Destination	*Buyer*	*Buyer*	*E*	*E*	*E*	*E*	*Seller*	*Buyer*	*Buyer*	*Buyer*	*Buyer*
Delivery carrier unloading	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*	*Buyer*

A: Matters relating to stowage within containers is dealt within the sales contract (not provided in Incoterms); B: FCA seller's facility; buyer pays inland freight; other FCA qualifiers; Seller arranges and loads precarriage carrier and pays inland freight to "F" delivery place; C: Insurance of goods not addressed by Incoterms; D: buyer or seller pays depending on the contract; E: Charges paid by seller if through bill of lading or door to door rate to buyer's destination.

Free Alongside Ship (FAS), named port of shipment: This term requires the seller to deliver the goods to a named port alongside a vessel to be designated by the buyer (International Chamber of Commerce, 2010). "Alongside the vessel" has been understood to mean that the goods must be within reach of a ship's lifting tackle. The risks to the goods pass to the buyer upon the seller's delivery alongside the ship. This implies that all charges and risks for the goods are borne by the buyer from the time they have been effectively delivered alongside the vessel.

The seller must obtain at his or her own risk and expense any export license and other official authorizations, including customs formalities, that are necessary for the export of the goods. The seller's obligation to clear the goods for export is similar to that in FOB contracts. There is an implied duty on the part of the seller to cooperate in arranging a loading and shipping schedule and to render at the buyer's request and expense every assistance in obtaining necessary documents for the import of the goods and their transit through another country. The seller must provide the buyer (at the seller's own expense) with the usual proof of delivery.

The buyer must contract (at his or her own expense) for the carriage of goods from the port of shipment. Since the buyer has to nominate the ship, the buyer has to pay any additional costs incurred if the named vessel fails to arrive on time or the vessel is unable to take the goods. In such cases, a premature passing of risk will occur. Costs of any preshipment inspection are borne by the buyer except when such inspection is mandated by the exporting country.

The use of FAS is appropriate in cases where sellers took their shipments to the pier and deposited it close enough for loading. However, nowadays most of the outbound cargo is delivered to ship lines days before placement alongside the vessel. It is also not applicable in cases of rolling cargo (cars, trucks) that can be driven aboard vessel or for ports with shallow harbors that do not allow for vessels to come alongside the pier. FAS terms are often used for oversized cargo such as heavy equipment in oil and gas or mining that require special handling during loading or transit. The seller does not wish to assume the risk of loss during loading of the vessel.

Free On Board (FOB), named port of shipment: The central feature of FOB contracts is the notion that the seller undertakes to place the goods on board the ship designated by the buyer. This includes responsibility for all charges incurred up to and including delivery of the goods over the ship's rail at the named port of shipment (ICC, 2010). The buyer has to nominate a suitable ship and inform the seller of its name, as well as the loading point and delivery time. If the ship that was originally nominated is unable or unavailable to receive the cargo at the agreed time for loading, the buyer has to nominate a substitute ship and pay all additional charges. Once the seller delivers the goods on board the ship, the buyer is responsible for all subsequent charges such as freight, marine insurance, unloading charges, import duties, and other expenses due on arrival at the port of destination. Unless otherwise stated in the contract of sale, it is customary in FOB contracts for the seller to procure the export license and other formalities necessary for the export of the goods since the seller is more familiar with licensing practices and procedures in the exporting country than the buyer. Transfer of risk occurs upon seller's delivery of the goods on board the vessel. The seller and buyer need to agree on what constitutes loading on board the vessel since different products are loaded differently. The seller is responsible for performance of the carrier loading the ship even though the latter is chosen by the buyer (ICC, 2010).

The seller's responsibility for loss or damage to the goods terminates on delivery to the carrier.

FOB does not appear to be consistent with current practice except for shipments of non-containerized or bulk cargo as well as shipments by chartered vessel. In many other cases,

sellers are required to deliver their outbound cargo to ship lines days before actual loading of the cargo. It is a common term used with letter-of-credit transactions.

INTERNATIONAL PERSPECTIVE 7.1

Incoterms: Salient Features

A. **Incoterms 2000 versus Incoterms 2010—important differences:**

- Incoterms 2010 rules are divided into two broad categories: rules for any mode of transport and rules for sea and inland waterway transport. Rules under Incoterms 2000 were divided into four categories: departure, main carriage unpaid, main carriage paid, and arrival.
  (1) The rules for "any mode of transport" are designed for any mode of transport and can be used where more than one of transport is employed to transport the goods. They can be used where a ship is used for all or part of the carriage and where transport is entirely over land.
  (2) The rules for "sea and inland waterway transport" are specific to contracts where both the point of delivery and the destination of the goods are ports.
- Incoterms 2000 refers to the "ship's rail" as the reference point of delivery, while Incoterms 2010 provides that delivery occurs when the goods are "on board the vessel" to reflect commercial practice.
- Incoterms 2010 includes changes in relation to insurance cover, security-related clearances, and string sales (multiple sales during transit).
- Eleven terms in Incoterms 2010: Incoterms 2010 has eleven terms, whereas Incoterms 2000 had thirteen terms. Incoterms 2010 introduced two new terms, DAT and DAP, which replaced four terms used in Incoterms 2000: Delivered At Frontier (DAF), Delivered Ex-Ship (DES), Delivered Ex-Quay (DEQ), and Delivered Duty Unpaid (DDU)

B. **The limitation of Incoterms:** Incoterms deal only with matters pertaining to the interpretation of terms of delivery. The rules do not deal with transfer of property rights in the goods, exemptions from liability, or consequences in cases of breach of contract. They deal with obligations in connection with delivery, provision of documents, insurance, and clearance of goods for export/import operations.

C. **Insurance:** The seller's obligation to take out insurance to the benefit of the buyer applies only under CIP and CIF terms. Parties have to arrange insurance as they see fit under all other terms.

Group C (CFR, CIF, CPT, CIP)

Cost, insurance, and freight (CIF), named port of destination: The CIF contract places upon the seller the obligation to arrange for shipment of the goods. The seller has to ship goods described under the contract to be delivered at the destination and arrange for insurance to be available for the benefit of the buyer or any other person with insurable interest in the goods. In the absence of express agreement, the insurance shall be in accordance with minimum of

cover provided under the Institute of Cargo Clauses or similar set of guidelines. The cost of freight is borne by the seller (ICC, 2010). The seller must notify the buyer that the goods have been delivered on board the vessel to enable the buyer to receive the goods.

The seller has to tender the necessary documents (commercial invoice, bill of lading, and policy of insurance) to the buyer so that the latter can obtain delivery upon arrival of the goods or recover for their loss. The buyer must accept the documents when tendered by the seller when they are in conformity with the contract of sale and pay the purchase price. Import duties and licenses, consular fees, and charges to procure a certificate of origin are the responsibility of the buyer, while export licenses and other customs formalities necessary for the export of the goods have to be obtained by the seller.

The CIF contract may provide certain advantages to the overseas customer because the seller often possesses expert knowledge and experience to make favorable arrangements with respect to freight, insurance, and other charges. This could be reflected in terms of reduced import prices for the overseas customer.

Under a CIF contract, risk passes to the buyer upon delivery, that is, when the goods are put on board the ship at the port of departure.

Rejection of documents versus rejection of goods: When proper shipping documents that are in conformity with the contract are tendered, the buyer must accept them and pay the purchase price. The right to reject the goods arises when they are landed and, after examination, are found not to be in conformity with the contract. The buyer can claim damages for breach of contract relating to the goods. The buyer's acceptance of conforming documents does not impair subsequent rejection of the goods and recovery of the purchase price if upon arrival the goods are not in accordance with the terms of sale. It may also happen that while the goods conform to the contract, the documents are not in accordance with the contract of sale (discrepancies between documents such as bill of lading, commercial invoice, draft, and the letter of credit or contract of sale). In this case, the buyer may waive the discrepancies and agree to accept the goods. Thus, under a CIF contract, the right to reject the documents is separate and distinct from the right to reject the goods.

Payment is often made against documents. Tender of the goods cannot be an alternative to tender of the documents in CIF contracts.

Loss of goods: If the goods shipped under a CIF contract are destroyed or lost during transit, the seller is entitled to claim the purchase price against presentation of proper shipping documents to the buyer. Since insurance is taken for the benefit of the buyer, the buyer can claim against the insurer insofar as the risk is covered by the policy. If the loss is due to some misconduct on the part of the carrier that is not covered by the policy, the buyer can recover from the carrier. CIF is better suited for bulk cargo but not for containerized shipments, since the latter are delivered at port terminal and not loaded onto the vessel by the seller. CIF is a common term used with letter of credit transactions (seller keeps control of shipping terms specified in the letter of credit).

The only difference between CIF and CFR term is that the latter does not require the seller to obtain and pay for cargo insurance.

Carriage Paid To (CPT), named place of destination: This is similar to the CFR term, except that it may be used for any other type of transportation. Even though the seller is obligated to arrange and pay for the transportation to a named place of destination, he or she completes delivery obligations and thus transfers risk of loss or damage to the buyer when the goods are delivered to the first carrier (named by the seller) at the place of shipment. The seller pays the main carriage to destination but does not carry the transport risk.

The seller must notify the buyer that the goods have been delivered to the carrier (first carrier in the case of multimodal transportation) and also give any other notice required to enable the buyer to take receipt of the goods. The term is appropriate for multimodal transportation. When several carriers are involved (precarriage by road or rail from the seller's warehouse for further carriage by sea to the destination), the seller has fulfilled his or her delivery obligation under the CPT term when the goods have been handed over for carriage to the first carrier. In CFR and CIF contracts, delivery is not completed until the goods have reached a vessel at the port of shipment.

In the absence of an explicit agreement between the parties, there is no requirement to provide a negotiable bill of lading (to enable the buyer to sell the goods in transit). The buyer must pay the costs of any preshipment inspection unless such inspection is mandated by the exporting country. The CPT term is similar to the CIP term, except that the seller is not required to arrange or pay for insurance coverage of the goods during transportation. CPT is the nonmaritime counterpart of CFR and is better suited to container transport.

INTERNATIONAL PERSPECTIVE 7.2

Incoterms and Business Strategies

- **Which Incoterms are appropriate?** The choice is dependent on the type of cargo and the buyer's intention to sell the goods in transit. It also depends on the ability of the parties to obtain the most favorable contract of carriage.
- **Appropriateness of C versus F term:** In cases where the seller can procure marine insurance at a competitive price and where there are government regulations to use national shipping lines, it may be appropriate to use CFR and CIF. If the parties prefer the seller to procure carriage (CPT) and insurance, CIP may be appropriate. When the buyer can procure insurance at a competitive rate, the parties may prefer to use FAS or FOB.
- **Manufactured goods:** Exporters of manufactured goods often sell on extended terms using DDP (seller makes goods available to buyer at destination) to remain competitive. Since such goods are normally containerized, the parties can also use FCA, CPT, or CIP.
- **Use of Ex-works, FCA:** Large buyers such as wholesalers and department stores may find it advantageous to arrange for transportation in order to ensure just-in-time deliveries.

Group D (DAT, DAP, DDP)

All Group D terms can be used with all modes of transport. These terms share certain common features:

1. They are arrival/destination terms.
2. The seller is required to arrange for transportation, pay the freight, and bear the risk of loss to a named point of destination.
3. The seller must place the goods at the disposal of the buyer (varies according to term).
4. There is no requirement for use of negotiable bill of lading, and delivery occurs only after arrival of the goods.

5. Incoterms do not require insurance during transportation. The seller may have to arrange and pay for insurance or act as self-insurer during transportation.
6. The buyer must pay the costs of any preshipment inspection except when such inspection is mandated by the exporting country. There are no provisions for postshipment inspection.

Delivered At Terminal (DAT) (named terminal at port or place at destination): DAT is a new addition to Incoterms 2010 and applies to all modes of transport. It replaces the DEQ (delivery ex-quay) term and provides more flexibility. Risk of loss is transferred to the buyer when goods are delivered at a named terminal, yard, or warehouse (offloaded) at the named port or place of destination. The seller is responsible for export clearance and transport costs up to the named place of destination. The customer is responsible for customs clearance, duties, and taxes. This term is included in light of the recognition that most air and ocean shipments are offloaded to a secondary location at destination. It works well for LCL or consolidation shipments (International Perspective 7.3).

Delivered At Place (DAP) (named place of destination): DAP term is similar to DAT except that in the case of DAP the buyer is responsible for unloading the goods at the named place of destination. DAP is used when buyer provides equipment such as forklifts for unloading.

Delivery Duty Paid (DDP) (named place of destination): DDP is similar to DAP except that the seller bears the costs and risks involved to bring the goods, including duties and taxes for import in the country of destination. It is suitable for courier shipments of low value. It is risky for exporters since they have to deal with foreign customs practices that are not familiar to them.

The major differences between arrival contracts and CIF contracts are as follows:

- In arrival contracts, delivery is effected when the goods are placed at the disposal of the buyer. In CIF term, delivery is effected upon loading the goods on board the vessel at the port of departure.
- In arrival contracts, the buyer is under no obligation to pay the purchase price if the goods are lost in transit. In CIF contracts, the buyer is required to pay against documents. However, the loss of goods gives the buyer the right of claim from the carrier or the insurance company, depending on the circumstances.

INTERNATIONAL PERSPECTIVE 7.3

Application of Incoterms

Parties to a business transaction that intend to use Incoterms should consider the following steps before they apply Incoterms to their transaction:

- **Select the appropriate Rule:** It is important to consider carefully which of the rules is appropriate to the type of goods being delivered, the means of transport used, and the allocation of responsibilities, costs, and risks desired by the parties.
- **Use a formal sales contract:** Incoterms cannot be a substitute for a sales contract as they do not provide a comprehensive set of terms. Consequently, Incoterms need

to be incorporated into a formal sales contract that deals with the areas on which Incoterms are silent, such as specifications of the goods, price, payment, transfer of title to the goods, tax, warranties, consequences of breach, governing law, and dispute resolution.

- **Expressly incorporate the rule into the sales contract:** For Incoterms to apply to a transaction, they need to be expressly incorporated into the sales contract by specific reference to the relevant rule chosen from Incoterms. Care should be taken to reference the appropriate version and year of Incoterms to be applied.
- **Specify the place or port for delivery as precisely as possible:** The more precisely the place or port for delivery is specified, the less room there is for confusion or disputes between the parties.

Chapter Summary

Sources of export competitiveness	Price and nonprice factors such as reliable delivery, short delivery time, product reliability, product quality, design flexibility, support services, financial services.
Export pricing objectives	Market share, profits, a targeted level of return on investment.
Pricing and markup policy	1. High markups are common in industries with relatively few competitors and that produce differentiated products. 2. Low markups are common in sectors of increased competition.
Determinants of export prices	*Internal variables*: Cost of production, cost of market research, business travel, product modification and packing, consultants, freight forwarders, and level of product differentiation. *External variables*: Supply and demand, location and environment of foreign market, home country regulations.
Approaches to export pricing	1. *Cost-based pricing*: Export price is based on full cost and markup or full cost plus a desired amount of return on investment. 2. *Marginal pricing*: Export price is based on the variable cost of producing the product. 3. *Skimming versus penetration pricing*: Price skimming is charging a premium price for a product; penetration pricing is based on charging lower prices for exports to increase market share. 4. *Demand-based pricing*: Export price is based on what the market could bear. 5. *Competitive pricing*: Export prices are based on competitive pressures in the market.

Group of terms of sale, 2010	**Rules for any mode of transport** 1. *Ex-Works (named place of delivery)*: Buyer or agent must collect the goods at the seller's works or warehouse. 2. *FCA, free carrier (named place of delivery)*: Place of delivery could be the carrier's cargo terminal (seller not obligated to unload) or a vehicle sent to pick up the goods at the seller's premises (seller required to load the goods on the vehicle). 3. *CPT, carriage paid to (named place of destination)*: Seller delivers goods to the carrier nominated by him or her and also pays the cost of carriage necessary to deliver the goods to the named destination. 4. *CIP, carriage and insurance paid to (named place of destination)*: Similar to CPT term except that the seller is required to arrange and pay for insurance. 5. *DAT, Delivered At Terminal (named terminal at port or place of destination)*: Seller delivers and unloads the goods at agreed destination, place, quay, warehouse, container yard, or road, rail, or air cargo terminal. 6. *DAP, Delivered At Place (named place of destination)*: Seller delivers goods at an agreed place still loaded but ready for unloading at an agreed place of destination in buyer's country. 7. *DDP, Delivery Duty Paid (named place of destination)*: Seller delivers goods at an agreed place still loaded but ready for unloading at an agreed place of destination. Seller bears all costs and risks to bring the goods, including duties and taxes for import in country of destination. **Rules for sea and inland waterway transport** 1. F*AS, free alongside ship (named port of shipment)*: Requires the seller to deliver goods to a named port alongside a vessel to be designated by the buyer. Seller's responsibilities end upon delivery alongside the vessel. 2. *FOB, free on board (named port of shipment)*: Seller is obliged to deliver the goods on board a vessel to be designated by the buyer. 3. *CIF cost, insurance, freight*: This term requires the seller to arrange for carriage by sea and to pay freight and insurance to a port of destination. Seller's obligations are complete (transfer of risk) when the goods are put on board the ship at the port of departure. 4. *CFR, Cost and freight*: Similar to CIF term except that the seller is not obligated to arrange and pay for insurance.

Review Questions

1. High markups are common in industries with relatively few competitors. Discuss and provide examples.
2. The large influx of shrimp imports into the United States from Asia and Latin America depressed whole sale prices by more than 40 percent between 1997 and 2002. Despite such lower prices, shrimp entrées at some sea food restaurants in the United States rose by about 28 percent during the same period. Discuss why prices (shrimp prices at seafood restaurants) are not aligned with costs.
3. What is the difference between marginal and cost-based pricing?
4. Seller agrees to deliver 300 tons of coffee to buyer FOB port of Montreal, Canada. The goods are transported and unloaded at the port and kept at the customs shed for inspection and payment of duties. The buyer is notified of the arrival of the merchandise and its location. Before the buyer picks up the goods, the customs shed (including the merchandise in it) is destroyed by fire. The buyer claims refund of the purchase price, stating that she did not receive the goods. Is the seller responsible?
5. In reference to Q. 4, would the outcome be different if the contract had been DAT port of Montreal?
6. Seller in New York agrees to ship goods to buyer in Lima, Peru, under a CIF contract. The goods are loaded on the ship, and seller tenders the necessary documents to buyer for payment (in New York). The buyer refuses payment, claiming that it will pay only after inspection upon arrival of the goods at the port of destination. Is the seller entitled to payment before arrival of the goods?
7. Discuss the major differences between CIF and arrival contracts such as DDP.
8. State the major differences between Incoterms 1990 and Incoterms 2000.
9. What are the limitations of Incoterms? Compare and contrast Incoterms 2000 with Incoterms 2010.
10. In what cases would export-import managers prefer to use FAS (shipment) term?

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World Wide Web Resources

Export pricing: http://sominfo.syr.edu/facstaff/fgtucker/
Pricing for profits: http://www.smartbiz.com/sbs/arts/ieb6.htm (information on pricing for an export-import business)
INCOTERMS 2010: http://export-importtradecenter.com (terms of sale)

Case 7.1 Incoterms (CIF)

A contract of sale was entered between an American company, BAT Inc., of Calumet City, Illinois (buyer), and a German scientific equipment manufacturing firm, Tola (seller), for the sale of a mobile MRI machine. Tola (the German corporation) sent the requested MRI machine, in good working condition, to the buyer aboard the ship, Superior Carrier. However, when it reached its final destination, it had been damaged and was in need of extensive repair. The buyer and its insurance company believe that the MRI machine was damaged in transit. BAT's insurance company, St. Guardian Insurance, covered the cost of the damage, which was $350,000. In turn, the insurance company intends to recover from Tola. However, Tola claims that, since the goods were shipped under CIF (New York) term, it is under no obligation for the loss and that its contractual obligation with regard to risk of loss ended when it delivered the machine to the vessel at the port of shipment. The buyer's insurance company contends that Incoterms were inapplicable since they were not specifically incorporated into the contract. They also argue that the seller's explicit retention of title modified the risk of loss.

Question

1. Do you agree with BAT and Guardian Insurance? Why or why not?

Case 7.2 Incoterms (C&F)

In August 2006, International Commodities Export Corporation (ICEC) entered into an agreement for the sale of 230 tons of Chinese white beans to North Pacific Lumber company (NPL). According to the agreement, the beans were to conform to sample pc-16 and the shipment was to be made on the basis of C&F. Thirteen separate containers of beans were loaded on board two vessels at the port of Hong Kong for shipping to Portland, Oregon. An independent surveyor of quality

found the bean quality to be in conformity with the description of the goods in the shipper's invoice.

The U.S. Food and Drug Administration (FDA) detained the shipment on arrival in Portland, Oregon, on the ground that the goods contained filth and were unfit for human consumption. The beans were stored in a warehouse under federal government detention. After efforts to obtain release of the cargo, the buyer rejected the shipments for failure to conform to the contract (sample pc-16).

Questions

1. Did title pass from seller to buyer? If so, when?
2. Is the seller responsible for the goods under C&F when the goods are onboard the vessel? How about after delivery to buyer?

eight
Export Sales Contracts

Harmonization of Contract Law

Export sales contracts are central to international commercial transactions, and around them revolve a series of connected but distinct relationships, including cargo insurance, transportation, and payment arrangements. The rules and practices governing such contracts vary from one export transaction to another, based on the agreement of the parties as well as the legal system. National legal systems on contracts may differ, but the basic principles of contracts, such as good faith and consideration, are generally recognized and accepted in many countries. There is also a movement toward convergence among the world's different legal systems in the area of international commercial law (DiMatteo, 1997; DiMatteo and Dhooge, 2006; Lubman, 1988). Today, it is not easy to identify any examples of substantial divergence that produce important and predictable differences in the outcome of commercial disputes (Rosett, 1982). Certain differences in theory or approach are often offset by the countervailing force of international usage or custom, which brings about a predictable and harmonious outcome in commercial dispute resolution. It is pertinent to identify the motives behind the move toward harmonization of international contract law:

- *Increase in trade and other economic relations between nations*
- *The growth of international customary law:* Commercial custom and usage have often been used in the drafting and interpretation of commercial law. Today, certain customs and practices, derived from merchants in Europe, regarding documentary drafts, letters of credit, and so forth, are universally accepted and form the basis for domestic and international commercial law.
- *The adoption of international conventions and rules:* There have been several attempts at unification of international contract law. The most recent attempt at progressive

harmonization of the law of international trade is one undertaken by the United Nations Commission on International Trade Law (UNCITRAL). UNCITRAL produced a set of uniform rules (Convention on International Sale of Goods or CISG) on international trade that are a product of different national legal systems. CISG, which entered into force on January 1, 1988, governs the formation of international sales contracts and the rights and obligations of parties under these contracts. Many important trading nations, such as France, Germany, Italy, the Netherlands, Singapore, and the United States, have signed or ratified the convention (United Nations, 1984). As of September 2004, sixty-three countries accounting for more than two thirds of world trade have adopted the convention. CISG is largely identical to the provisions of the U.S. Uniform Commercial Code. However, there are several important distinctions (see Table 8.1). CISG applies to contracts for the commercial sale of goods between parties whose "places of business" are in different nations that have agreed to abide by the convention. "Place of business" is often interpreted to mean the country that has the closest relationship to the contract and is closest to where it will be performed, for example, the place where the contract is to be signed or the goods delivered. Parties to a sales contract are at liberty to specify the application of a law of some third country that recognizes the convention in the event of a dispute. CISG does not apply to certain types of contracts, such as sales of consumer goods, securities, labor services, electricity, ships, vessel, or aircraft, or to the supply of goods for manufacture if the buyer provides a substantial part of the material needed for such manufacture or production. CISG is intended to supersede the two Hague conventions (UNIDROIT rules) on international sales.

TABLE 8.1 CISG versus Uniform Commercial Code

	CISG convention	Uniform commercial code
Oral testimony	The provisions of a written contract can be modified by a prior or contemporaneous oral agreement.	A written sales contract between the parties cannot be modified by prior or contemporaneous written or oral agreement.
Enforceability of oral contracts	CISG does not require that contracts for sale of goods be in writing to be enforceable. For example, agreements made on the phone or in a meeting are enforceable.	Oral contracts for the sale of goods worth $500 or more are not enforceable unless the existence of contract is admitted or there has been payment or delivery and acceptance.
Perfect tender rule	A buyer may not reject the goods or cancel the contract unless the nonconformity constitutes a fundamental breach of the contract. Buyer can demand substitute goods in the event of a fundamental breach of contract by seller.	A buyer may reject the goods and cancel the contract even if the defects are not serious and the buyer would have received substantial performance.

Specification of quantity/price	A contract is not sufficiently definite if it fails to indicate the goods and does not expressly or implicitly fix or make provisions for determining the quantity and price.	A contract is valid despite missing terms on provisions pertaining to performance and price insofar as the parties intend to be bound by the contract.
Revocability of an offer/ terms of acceptance	An offer to sell goods becomes irrevocable if it indicates a fixed time for acceptance or states that it is irrevocable or someone acts by relying on the statement. Acceptance of sale offer by buyer/seller occurs upon receipt by seller/buyer, respectively.	A firm offer to buy or sell goods made in writing, promising to keep the offer open for a period (no longer than three months) is valid and enforceable. Acceptance of sales offer by buyer/seller occurs when it is mailed or transmitted by seller/buyer, respectively.
Additional terms	Expression of acceptance of the contract by buyer or seller that has additions, limitations, or other modifications is considered to be a rejection and a counteroffer.	Expression of acceptance by buyer or seller of contract terms is valid even if it contains additional terms beyond those expressed in the offer. In the absence of any objections, the additional terms that do not materially alter the offer (other than quantity, price, and warranty) become part of the contract.

CISG: Essential Elements

Oral Contracts/Statements

A contract need not be concluded in or evidenced in writing. Import companies that negotiate contracts by phone may be under the impression that the agreement will not be enforceable since it is not made in writing. However, they could be held liable under CISG if they verbally accept an offer or their verbal offer is accepted by the other party. CISG, however, allows members to opt out of this provision (in favor of domestic law that requires a statement in writing).

Example: ABC Inc., a cellular phone manufacturer in Florida, contacts various suppliers of semiconductors. The import manager negotiated an oral contract with suppliers in Italy and Germany. Both suppliers orally accepted the offer made by ABC Inc. (type, quality, quantity, price of semiconductors). A few days later, the import manager was advised that a Russian company makes similar goods at lower prices and that the price includes transportation costs to ABC Inc. in Florida. The import manager of ABC Inc. called the suppliers in Italy and Germany to cancel the contract. He thought that oral contracts are not valid and

thus are unenforceable. Since each party is located in a different CISG country, CISG applies. The oral contracts with the German and Italian suppliers are enforceable. This means that ABC Inc. is obligated to buy the semiconductors or pay damages.

Parol Evidence

Prior oral statements (including witness testimony) are potentially enforceable and can be used to challenge the provisions of a written contract. Thus, exporters-importers have to be cautious about representations made during the negotiations that are not intended to be part of the written contract, since oral statements could be construed as part of the written contract (if used to prove intent). One solution is to include an integration clause that states that the written contract is the entire agreement and that no other agreements or evidence that is contradictory is admissible.

Example: An Australian supplier of dairy products orally agreed to pay the cost of insurance during transportation of the goods to the buyer's warehouse in Portland, Oregon. However, the written terms of the contract explicitly provided for payment by the U.S. buyer.

The prior oral statement by the supplier is admissible and can be used to modify the terms of the written contract. The supplier would be obligated to pay the cost of insurance.

Battle of the Forms

A reply to a sales offer that purports to be an acceptance but contains additions or modifications is a rejection of the offer and constitutes a counteroffer. However, if the counteroffer does not materially alter the terms of the offer, it constitutes an acceptance unless the seller objects and notifies the offerer. Material terms include price, payment, quantity and quality of goods, place and time of delivery, and liability.

Example: A manufacturer of leather shoes in Italy sent a purchase order for 500 pounds of polished leather from New Zealand at $10 per pound and three-year warranty. The supplier in New Zealand accepted the order but modified the terms: "$12 per pound and two-year warranty." The terms added by the supplier are material to the contract and hence constitute rejections of the offer or considered a counteroffer.

Duty to Inspect and Proper Notice

In the event that the buyer receives nonconforming goods, he or she must give timely (within a short period as is practicable) and effective notice of nonconformity (specifying the nature of nonconformity). The buyer's notice such as "the goods are rancid" or "poor workmanship and improper fitting of the goods" were considered by courts as being insufficiently specific and not regarded as notice (see International Perspective 8.1).

Right to Remedy Deficiencies

CISG permits the seller to remedy the delivery of defective goods after the time of performance has expired unless such delivery would cause the buyer "unreasonable inconvenience and uncertainty." The buyer reserves the right to sue for damages caused by the delay or to buy the initial delivery of nonconforming goods.

Exemptions from Liability

CISG exempts a party from liability for failure to perform any of his or her obligations due to reasons beyond his or her control that were not foreseeable at the time of the contract formation. Prompt notice of the impediment is required to avoid damages. The following circumstances do not give rise to exemptions from liability: financial difficulties of seller's supplier, buyer's inability to obtain foreign currency, increases in the cost of goods, and delivery problems due to production stoppages.

Limitation Period

There are no provisions in CISG on limitation period (the time within which a buyer must bring a court action or seek arbitration). Another United Nations (UN) convention, Convention on the Limitation Period in the International Sale of Goods, provides rules on limitation periods and has been ratified by eighteen countries, including the United States in 1994. The convention provides a four-year limitation period for most claims.

The International Chamber of Commerce (ICC) has also published several valuable documents on international trade. The Uniform Rules for Contract Guarantees (1978) deals with the issue of performance and bank guarantees supporting obligations arising in international contracts. The ICC also has rules on adaptation of long-term contracts to changing economic and political circumstances.

Standard contract forms are often used in certain types of international commercial transactions, such as trade in commodities or in capital goods. These contracts are prepared by trade associations, such as the Cocoa Association of London, the Refined Sugar Association, or certain agencies of the United Nations (model contracts for supply of plant, equipment, and machinery for export or for the export of durable consumer goods and engineering articles) (see International Perspective 8.2).

Pertinent Clauses in Export Contracts

An export contract is an agreement between a seller and an overseas customer for the performance, financing, and other aspects of an export transaction. An export transaction is not just limited to the sale of final products in overseas markets but extends to supply contracts for manufacture or production of the product within a given time period. Parties should have a well-drafted and clear contract that properly defines their responsibilities and provides for any possible contingencies. This is critical in minimizing potential conflicts and allowing for a successful conclusion of the transaction (see International Perspective 8.1).

Although many export contracts are concluded between the seller and an overseas buyer (the main contract), the buyer may also enter into a contract with an independent consultant for technical assistance and with a lender for financing in the case of complex projects. The exporter as prime contractor may enter into joint venture agreements with other firms, such as subcontractors or suppliers, to bid on and perform on a project. Parties could also establish a partnership, corporation, or consortium in order to bid on and undertake different aspects of the transaction while assuming joint responsibility for the overall project. Such collaboration is common when one firm lacks the financial or technical resources to perform the contract.

INTERNATIONAL PERSPECTIVE 8.1

Tendering for Export Contracts

In many countries, government purchases over a certain size are required to be awarded under tender. Purchase of goods under tender is common in cases involving goods and services purchased in large volumes and the likelihood of price competition. Tenders are also offered in the case of contracts for purchase or installation of complex projects that involve the purchase of goods and services. Tenders provide the purchaser the unique advantage of selecting the best supplier from among a large pool of bidders in terms of quality, price, and other factors, allowing the purchaser to avoid charges of patronage and favoritism.

The tendering process begins when a purchaser of goods and services invites potential suppliers to submit tenders (bids). However, with important projects, bidders are prequalified before submitting tenders to ensure that they satisfy the basic criteria that are critical for awarding the contract: necessary technical qualifications and compliance with local laws in submitting the bid. The invitation to submit bids (for prequalification or final selection) is usually announced in newspapers, and this guarantees a fair, competitive, and transparent tendering process and affords some protection against corruption and nepotism by civil servants.

The invitation to submit tenders is announced in the newspapers to the public or to selected bidders who are prequalified. This stage in the tendering process is often called a request for proposal (RFP). At this stage, potential bidders are invited to submit tenders with certain conditions (e.g., technical specifications, commercial terms) that are to be included in the proposal. Suppliers may be requested to submit bid bonds to ensure that a supplier will not decline to sign the contract when the bid is accepted

Once a proposal is accepted, the successful supplier is awarded the contract. In most cases, however, the award is just a first step prior to negotiation of the contract. In the event of failure to conclude the final contract, the customer would have to negotiate with the second bidder on the list.

It is relevant to state briefly how these joint venture arrangements differ from one another. Members may form a partnership for the purpose of undertaking the export contract. Each of the members remains responsible for the entire transaction even though the parties may be carrying out different portions of the export transaction. Parties could also establish a

new corporation to act as exporters or prime contractors. In the case of a consortium, each partner of the venture has a separate contract with the customer for performance of a portion of the work and thus is not responsible to the other members.

Scope of Work Including Services

The goods to be sold should be clearly spelled out in the contract. There is also a need to include the scope of work to be performed by the exporter, such as installation, training, and other services. The scope of work to be performed is usually contained in the technical specification, which should be incorporated into the main contract (by listing it with the other documents intended to form the contract). It is also important to specify whether the agreed price covers certain services, such as packaging, special handling, or insurance. Any contribution by the overseas customer should be explicitly stated along with the consequences of the failure to perform those services necessary to enable the exporter to complete the transaction on time. Such contributions could include provision of office space and other support services, such as secretarial and translation, government licenses, permits, and personnel necessary for the performance of the contract.

INTERNATIONAL PERSPECTIVE 8.2

Chicago Prime Packers versus Northern Trading Co.

Chicago Prime, a Colorado Corporation (seller), and Northam Trading, a partnership under the laws of Ontario, Canada (buyer), entered into an agreement for the sale of pork back ribs. In March 2001, Chicago Prime contracted to sell 40,500 pounds of pork back ribs to Northam for $178,200 with payment due within seven days of the shipment. Chicago Prime purchased the ribs specified in the contract from Brookfield Farms (Brookfield), and Northam's carrier (Brown Trucking was hired by Northam) picked up the ribs from Brookfield and signed a bill of lading acknowledging that the goods were in apparent good order. The bill of lading also indicated that the "contents and condition of contents of packages were unknown." Brown Trucking delivered the goods to Northam's customer, Beacon Premium Meats, which also signed a second bill of lading indicating that they had received the shipment in "apparent good order."

As Beacon Premium Meats noticed some unusual conditions with the quality of the meat, it requested inspectors at the U.S. Department of Agriculture (USDA) to examine the product. The inspectors concluded that the inspected product was rotten (that it arrived to Beacon in rotten condition) and condemned the entire shipment. Even after Northam informed Chicago Prime of the results of the USDA's inspection, Chicago Prime continued to demand payment and later filed suit. At trial, Northam submitted that it was relieved of its payment obligation because the product was spoiled when Brown Trucking received it for delivery to Beacon Prime Meats. The district court awarded Chicago Prime the contract price on grounds that the damage to the goods occurred after the risk had passed to the buyer. It also held that the contract was governed by CISG. Northam appealed, stating that (1) the court erred in placing the burden of proof on Northam to show that the ribs were spoilt at the time of transfer, and (2) the evidence did not support the court's finding.

The court of appeals affirmed the ruling of the district court. It agreed that the contract at issue was governed by CISG. Second, it stated that CISG did not clearly provide as to which party bore the burden of proving that the product conformed to the contract. Given the similarity of CISG and the provisions of the UCC, the court interpreted CISG by comparing it with the general principles of the UCC. It stated that, as the buyer bears the burden of proving breach of implied warranty of fitness under the UCC, the buyer needs to prove nonconformity at the time of transfer to Brown Trucking. Also, Northam did not provide credible evidence to show that the ribs were spoiled at the time of delivery to the trucking company. (408 F. 3rd 894. 2005 U.S. App.)

Price and Delivery Terms

The total price can be stated at the time of the contract, with a price escalation clause that provides for increases in the price if certain events occur. Such provisions are commonly used with goods that are to be manufactured by the exporter over a certain period of time and when inflation is expected to affect material and labor costs. Such a clause also extends to increases in costs arising from delays caused by the overseas customer. It is important to draft the contract with a clear understanding between the parties as to whether such a clause applies when there is an excusable delay. In many contracts, the price escalation clause is in force in cases of excusable delay in performance by the exporter.

The contract should also specify the currency in which payment is to be made. Foreign exchange fluctuations could adversely affect a firm's profit. In addition, government exchange controls in the buyer's country may totally or partially prevent the exporter from receiving payment for goods and services. Thus, it is important to provide the necessary protection against such contingencies. The following contract provisions would be helpful to the exporter.

Shifting the Risk to the Overseas Customer

An exporter may shift the risk by providing in the contract that payment is to be made in the exporter's country and currency. This ensures protection against currency fluctuations and exchange controls.

Payment in Importer's Currency

Even though the seller will generally prefer payment in U.S. dollars, such a requirement may be difficult to comply with if U.S. dollars are not readily available in the buyer's country. The exporter may have to accept payment in the importer's currency. In such a situation, the exporter could fix the exchange rate in the invoice and thus be compensated in the event of devaluation. Suppose Smith, Inc., of California, exports computers to Colombia; the price could be stated as follows: "300 million Colombian pesos at the exchange rate of $1 = 1,000 pesos. The importer will compensate the exporter for any devaluations in the peso from the rate designated in the contract."

Another method of protection against fluctuations in the importer's currency is to add a risk premium to the price at the time of the contract. Yet another method is to establish an

escrow account in a third country in an acceptable (more stable) currency from which payments would be made under the contract.

The contract should clearly indicate the delivery term (e.g., FOB, New York, or CIF, London), since there are different implications in terms of risk of loss, insurance, ownership, and tax liability. The seller would ideally prefer to be paid cash in advance (before delivery of goods or transfer of title) in its own currency or by using a confirmed irrevocable letter of credit. The buyer often desires payment in its own currency on open account or consignment. Hence, the provision to be included in the contract has to accommodate the competing interests of both parties.

Delivery, Delay, and Penalties

The most common type of clause included in export contracts is one that provides for a fixed or approximate delivery date and that stipulates the circumstances under which the seller will be excused for delay in performance and even for complete inability to perform. Most contracts state that either party has the right to cancel the contract for any delay or default in performance if it is caused by conditions beyond its control, including but not limited to acts of God and government restrictions, and that neither of the parties shall be liable for damages (force majeure clause). The force majeure clause may also cover a number of specified events, including the inability of the exporter to obtain the necessary labor, material, information, or other support from the buyer to effect delivery. It should also include certain warranty obligations, such as delays in manufacture of replacement components. It is important to state that the force majeure (excusable delay) clause will apply even though any of the causes existed at the time of bidding, were present prior to signing the contract, or occurred after the seller's performance of its obligations was delayed for other causes. Some force majeure clauses provide for the temporary suspension of the contract until the causes for the nonperformance are removed; others state that the agreement will be terminated at the option of either of the parties if performance remains impossible for some stated period.

Contracts often provide for damages if the delay is caused by one of the parties. In the event that the delay is caused by the exporter (i.e., unexcused delay), some contracts specify that the importer will be entitled to recover liquidated damages (even in the absence of actual damages), whereas others provide that payment would be limited to damages actually incurred by the buyer (see International Perspective 8.3).

The converse of the seller's obligation to deliver is the buyer's obligation to accept delivery as stipulated in the contract. If delay in delivery is caused by the buyer, most contracts provide that the seller will be entitled to direct damages incurred during the delay, such as warehousing costs, salaries and wages for personnel kept idle, or loss of profit. Some contracts even provide for payment of indirect (consequential) damages, such as loss of productivity or loss of future profits due to delays caused by the buyer. Both parties can possibly eliminate or reduce potential risks of excusable delay by inserting (1) a best-efforts clause, without expressly providing for consequences in the event of delay, or (2) an overall limitation-of-liability clause. In cases in which the contract does not expressly impose the previous obligation on the customer, the customer remains responsible for delays caused personally or by someone for whom the customer is responsible. In most legal systems, a party has an implied duty to cooperate in the performance of the work by the other party or not to interfere with the performance of the other party.

Quality, Performance, and Liability Limitations

Most contracts state that the seller warrants to the buyer that the goods manufactured by the seller will be free from defects in material, workmanship, and title and will be of the kind and quality described in the contract. It is not uncommon to find deficiencies in performance, even when the exporter provides a product with state-of-the-art design, material, and workmanship. Therefore, it is advisable to use certain approaches to limit risk exposure:

- Specify in the contract the performance standards that are to be met, and provide warranties for those that can be objectively tested, such as machine efficiency, for a specified period, usually a year.
- Stipulate the kinds of damages that may be suffered by the buyer for which the seller is not responsible, such as loss of profit for machine downtime, extra costs of acquiring substitute services, as well as other damages that are incidental or consequential.
- Limit the liability, especially in exports of machinery and equipment, to a specific amount expressed either in reference to the total contract price or as a certain sum of money. This limit should cover all liability or liabilities arising from product quality or performance.
- Carefully evaluate the cost implications of an extended warranty or an evergreen warranty provision before agreeing to include it in the contract. An evergreen warranty is automatically renewed each time a failure protected under the warranty provision is corrected.

Taxes and Duties

In the United States, Canada, and other developed countries, an exporter will not be subject to any taxes (i.e., when products are exported to these countries) if business is not performed through an agent, a branch, or a subsidiary. However, when the price includes a breakdown for installation and other services to be performed in the importing country, such income could be taxable as earnings from services. In some cases, it may be advisable to reserve the right to perform these services through a local affiliate to restrict exposure to foreign taxes. It is thus important to consider the tax and customs duty implications of one's pricing and other export decisions relating to shipment of components or assembly of (final) products. It is also helpful to evaluate the impact of tax treaties with importing countries.

Guarantees and Bonds

It is quite common for overseas importers to require some form of guarantee or bond against the exporter's default. Public agencies in many countries are often prohibited from entering into major contracts without some form of bank guarantee or bond. Guarantees are more commonly used than bonds in most international contracts. These are separate contracts and independent of the export agreement.

Bid guarantees or bonds are often provided at the first stage of the contract from all bidders (potential exporters) to provide security to the overseas customer. Then, performance guarantees or bonds are provided by the successful bidder(s) to protect the overseas customer against damages resulting from failure of the seller to comply with the export contract.

Finally, payment guarantees or bonds are provided so that the importer can secure a refund of the advance payment in case of the exporter's default.

In the case of a bank guarantee, a standby letter of credit is issued by a bank, under which payment is made to the importer on demand upon failure of the exporter to perform its obligation under the export contract. Most importers favor a contract provision that allows them to obtain payment from the bank by simply submitting a letter that the exporter has defaulted and demanding payment. However, it may be advisable to stipulate in the standby credit that the amount of the credit becomes payable to the importer only upon the finding by a court or arbitration tribunal that the supplier of goods or services is in default of the contract.

A bank guarantee (standby credit) and a bond are similar in that both instruments are a form of security provided by a third party (a bank in the case of a guarantee, a surety company in the case of a bond) to the importer against the exporter's default. Both instruments are issued only if the exporter has a good credit standing, and both specify the amount payable in the event of default, the period within which such claims can be made, and the fee charged for such services.

In export trade, there is a tendency to make standby credits payable on the submission of a letter by the importer that simply alleges default by the exporter and demands payment. This is not usually the case with bonds, which are payable only when the importer has shown that the exporter is in default under the export contract. Bonds also usually require that the importer have met its obligations under the contract before realizing any benefits from the bond. In short, the surety company will conduct an investigation on the conduct of the parties before making a decision about payment. Second, the bank in the case of a standby letter of credit does not have the option of performing the contract (e.g., completing delivery of goods not made by exporter, paying losses incurred by exporter), as does a surety company. The bank guarantor is required to pay the full amount of the standby credit without regard to the actual damages suffered. Under a bond, the surety is obliged to make good on only the actual damages suffered by the overseas buyer. In both cases, the exporter has to reimburse the bank or the surety company for any payments made under the guarantee or bond, respectively. In view of the widespread use of guarantees (standby credits) in international trade and the possibility of abuse, many countries provide an insurance program for their exporters that protects them against wrongful drawing on the credit. In 1978, the International Chamber of Commerce adopted the Uniform Rules for Contract Guarantees, which deals with guarantees, bonds, and other undertakings given on behalf of the seller and applies only if the guarantee or bond explicitly states the intentions of the parties to be governed by these rules. In view of the limited acceptance of the Uniform Rules for Contract Guarantees, the ICC adopted, in 1992, the Uniform Rules for Demand Guarantees, which attempt to standardize existing guarantee practice. As in the case of contract guarantees, the parties have to state their intention to be subject to these rules.

Applicable Law and Dispute Settlement

The fundamental principle of international contract law is that of freedom of contract. This means that the parties are at liberty to agree between themselves what rules should govern their contract. Most contracts state the applicable law to be that of the exporter's country.

This indicates the strong bargaining position of exporters and their clear preference to be governed by laws about which they are well informed. It may be possible to arrange a split jurisdiction, whereby the portion of the contract to be performed in the customer's country will be interpreted under the importer's laws and the portion to be performed in the exporter's country will be governed by the laws of that country.

In cases where there is no express or implied choice of law, it may be the role of the courts to decide what law should govern the contract based on the terms and nature of the contract. The factors to be considered often include the place of negotiation of the contract, the place of performance, location of the subject matter, place of business, and other pertinent matters.

For several reasons, a large and growing number of parties to export contracts provide for arbitration to settle disputes arising under their contracts. Despite the wide use of arbitration clauses, the superiority of arbitration over judicial dispute resolution is not clear-cut, and parties considering arbitration should also be aware of the disadvantages in this choice, such as lack of mandatory enforcement mechanisms and difficulty obtaining recognition and enforcement of the award, which requires a separate action of law. It is also stated in some contracts that the parties agree to abide by the award and that the award is binding and final and enforceable in a court of competent jurisdiction.

INTERNATIONAL PERSPECTIVE 8.3

Acceptance of Standard International Contracts

In 1982, a buyer in Indonesia contracted to buy from a seller in England 400,000 metric tons of white sugar (C&F, Indonesian port for delivery in 1983–1984). The contract provided for payment under an irrevocable letter of credit against shipping documents in London. The contract was to be governed by English law and provided for arbitration of disputes in London under the Rules of the Refined Sugar Association. It was also expressly stated in the contract that the buyer was to be totally responsible for obtaining the necessary license and that failure to obtain the license was not to be considered sufficient ground for invoking force majeure.

As sugar prices collapsed during 1982–1983, the buyer declined to open a letter of credit in order to pay the seller in London. In June 1984, the seller commenced arbitration proceedings in London, as provided in the contract claiming damages for breach of contract. The buyer initiated two lawsuits against the seller in London, asking the court to declare the contracts to be illegal since the Indonesian government declined to buy the sugar and refused to provide an import license. The seller was awarded $27 million in damages to be paid in three installments. The buyer paid the first installment and brought a lawsuit against the seller in Indonesia, seeking a court order declaring the contract illegal because it violated a decree stating that only the government agency could import sugar into Indonesia. The Indonesian court held that the contract violated the decree (local law) and was therefore illegal. The court ignored the following:

1. The contracts provided only for shipment to an Indonesian port, not importation into Indonesia, and the risk of not being able to import was expressly assumed in the contract by the buyer.

2. Under English law, delivery of shipping documents does not require that the goods be imported into the country of destination.

Source: Adapted from Hornick, 1990, pp. 8–10.

Chapter Summary

Export contract	An export contract is an agreement between a seller and an overseas customer for the performance, financing, and other aspects of an export transaction. It also includes supply contracts for the manufacture of a product within a given period.
Factors behind the move toward harmonization of international contract/ commercial law	1. Increases in global trade and economic relations between nations 2. The growth of international customary law 3. The adoption of international convention and rules ▪ The Vienna Convention on international sale of goods ▪ The ICC rules on contract agreements ▪ Standard contracts developed by trade associations. *CISG Essential elements:* (a) oral contracts, (b) parol evidence, (c) battle of the forms, (d) duty to inspect and proper notice, (e) right to remedy deficiencies and (f) limitation period.
Major clauses in export contracts	▪ Scope of work ▪ Price and delivery terms ▪ Quality, performance, and liability ▪ Taxes and duties ▪ Guarantees and bonds ▪ Applicable law and dispute settlement.

Review Questions

1. What are some of the factors that militate in favor of harmonization of international contract law?
2. Discuss the major differences between CISG and the Uniform Commercial Code.
3. In certain transactions involving transfer of technology, the contract provides for the sale of goods and services. Does CISG apply to such contracts?
4. CISG does not apply to certain types of contracts. Discuss.
5. An Italian seller agreed to produce and supply 250 pieces of leather furniture to a buyer in the United States. The contract included certain specifications and was signed by the

parties. It also stated that any changes could be modified only by a written addendum signed by both parties. A few days after the contract was signed, both parties agreed by phone to change the specifications. A couple of months later, when the seller delivered the furniture with the modified specifications, the buyer refused to accept them, stating that the latest agreement was not binding since it was not part of the written (original) contract. Does CISG apply? If it does, is the buyer obligated to accept the furniture?

6. A manufacturer in California and distributor in British Columbia, Canada, reached an agreement on the delivery of routers. The contract choice of law clause adopted "California law." In the event of a dispute, does this mean that CISG will not apply?
7. What is the battle of the forms under CISG?
8. Discuss a typical tendering process for export contracts.
9. Discuss three provisions in a typical export contract.
10. How does an exporter protect against foreign exchange fluctuations? What contract clauses can be included to limit such risk that could adversely affect a company's future receipts?

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World Wide Web Resources

General Legal Information
Information on trade agreements and commercial treaties:
http://fletcher.tufts.edu/multi/secretariatslinks.html
http://fletcher.tufts.edu/inter_resources/intertrade.htm

International Commercial Law
Information on electronic commerce:
http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce.html
Information on international commercial law and electronic commerce:
http://www.jus.uio.no/lm/

Information is also provided on treaties, rules, and other laws pertaining to international business.
Information on international trade law: http://www.law.cornell.edu/wex/index.php/International_trade
Guide to international economic law: http://www.asil.org/resource/iel1.htm

Case 8.1 CISG

Wombat, Inc., is a Florida corporation engaged in the rental and sale of tiles, while Pinochet, Inc., is an Italian corporation engaged in the manufacture of ceramic tiles. Representatives of Wombat negotiated an agreement with Pinochet to purchase tiles based on samples examined at a trade show in Bologna, Italy. After finalizing an oral agreement on important terms of the contract such as price, quality, delivery, and payment, the parties recorded these terms on one of Pinochet's preprinted order forms, and the president of Wombat signed the contract. The agreement provided for the sale of high-grade ceramic tiles at specific discounts as long as Wombat purchased sufficient quantities.

Wombat delayed payments for some of the shipments since it was not satisfied with the quality of the tiles. Pinochet stopped shipments and canceled the contract with Wombat, claiming that the provisions on the printed form gave him the right to cancel or suspend the contract in the event that the buyer defaulted or delayed payment. Pinochet was not informed of the defects in writing. The contract provided for notification of any defects in writing by means of certified letter no later then ten days after receipt of the merchandise. Wombat argues that the parties never intended the terms printed on the reverse of the order form to apply to the agreement. It also submitted affidavits from translators and Pinochet's representatives that the parties subjectively intended not to be bound by the terms on the reverse of the order form.

Questions

1. Is the contract governed by CISG?
2. Are the parties bound by the terms on the reverse side of the print form?

Case 8.2 China National Products versus Apex Digital, Inc.

China National is a Beijing-based corporation organized under the laws of China with specific foreign trading rights. It facilitates the import and export of goods between Chinese and foreign companies. Apex is a company incorporated in Ontario, California, which engaged in the import and distribution of consumer electronic goods. In 2000, China National entered into a purchase agreement with Apex for the export of DVD players. The purchase agreement was formalized with the conclusion of several substantially identical written contracts for the different types of players. Each contract contained two significant provisions:

1. In the event of nonconformity of the goods with the contract, Apex should claim for quality discrepancy within thirty days after arrival of the goods at the port of destination.
2. All disputes arising from the contract shall be submitted to certain arbitration tribunal specified in the contract and the award is final and binding on both parties.

Apex imported and sold the products to major retailers such as Best Buy, and K-Mart. Soon after distribution of the imported goods, Apex began receiving reports from its retailers that consumers were dissatisfied with the quality of the DVD players: disk loaders did not open; they did not load after the disk was inserted and did not recognize certain music files; the front panel of the loader fell off, and so on. Some were returned. In spite of these problems, Apex continued to place more orders with China National. It did, however, express its concerns to China National. Apex declined to pay China National, claiming “financial troubles” and citing China National’s refusal to correct the defects. In an effort to obtain payment, China National wrote several letters to Apex threatening legal action. It eventually filed suit in California.

The central issue to be decided by the court was whether Apex rejected the goods or, if it did not, whether it later would be relieved of liability. The court stated that if buyers accept nonconforming goods and do nothing, the law deems them to have accepted those goods. Apex’s actions in continuing to order and sell goods known to be defective constituted an acceptance of those goods. Such conduct of ordering and selling of defective goods was inconsistent with the seller’s ownership and acceptance. It ordered Apex to pay for all unpaid invoices. (141 F. Supp. 2nd 1013. 2001 U.S. Dist.)

Questions

1. Is the contract governed by CISG?
2. Do you agree with the decision of the court? Why or why not?

nine
Trade Documents and Transportation

Documentation in Export-Import Trade

A number of documents are used in export-import trade. The completion and submission of required documents is critical to the successful shipment, transportation, and discharge of cargo at the port of destination. The documents used depend on the requirements of both the exporting and the importing countries. Much of the documentation is routine for freight forwarders or customs brokers acting on the firm's behalf, but the exporter is ultimately responsible for the accuracy of the documentation. Information on documentation requirements in importing countries can be obtained from overseas customers, foreign government embassies and consulates, and various export reference books, such as the *Export Shipping Manual* and *Air Cargo Tariff Guide.* In the United States and other developed countries, government departments have specialists on individual foreign countries and can advise on country conditions and documentation requirements.

Air Waybill

The air waybill is a contract of carriage between the shipper and air carrier. It is issued by the air carrier and serves as a receipt for the shipper. When the shipper gives the cargo to a freight consolidator or forwarder for transportation, the air waybill is obtained from the consolidator or forwarder. Air waybills are nonnegotiable and cannot be issued as a collection instrument. Air waybills are not particular to a given airline and can be from any other airline that participates in the carriage (Wood, Barone, Murphy, and Wardlow, 1995).

Bill of Exchange (Draft)

A bill of exchange is an unconditional written order by one party (the drawer) that orders a second party (the debtor or drawee) to pay a certain sum of money to the drawer (creditor)

or a designated third party. For example, Hernandez Export, Inc., of Lawton, Oklahoma, sends an importer in Uzbekistan a draft for $30,000 after having shipped a truckload of auto parts. The company's draft orders the overseas buyer in Uzbekistan to pay $30,000 to its agent, Expotech, in Uzbekistan. In this scenario, Hernandez, Inc., is the drawer, the importer is the drawee, and Expotech is the payee. In many cases, the drawee is the overseas buyer and the drawer/payee is the exporter. When a draft is payable at a designated future date, it is a time draft. If it is payable on sight, it is a demand or sight draft.

Bill of Lading (B/L)

A bill of lading is a contract of carriage between the shipper and the steamship company (carrier). It certifies ownership and receipt of goods by the carrier for shipment. It is issued by the carrier to the shipper. A straight bill of lading is issued when the consignment is made directly to the overseas customer. Such a bill of lading is not negotiable. An order bill of lading is negotiable, that is, it can be bought, sold, or traded. In cases in which the exporter is not certain about payment, the exporter can consign the bill of lading to the order of the shipper and endorse it to the buyer on payment of the purchase price. When payment is not a problem, the bill of lading can be endorsed to the consignee (Wells and Dulat, 1996; Zodl, 1995).

Clean/Claused Bill of Lading

The bill of lading form is normally filled out in advance by the shipper. The carrier will check the goods loaded on the ship to ensure that they comply with the goods listed (e.g., quantity, condition) on the bill of lading. If all appears proper, the carrier will issue a clean bill of lading certifying that the goods have been properly loaded on board the ship. However, if there is a discrepancy between the goods loaded and the goods listed on the bill, the carrier will issue a claused bill of lading to the shipper. Such a bill of lading is normally unacceptable to third parties, including the buyer under a CIF contract or a bank that is expected to pay under documentary credit on receipt of the bill of lading and other documents.

Inland Bill of Lading

An inland bill of lading is a bill of lading issued by the railway carrier or trucking firm certifying carriage of goods from the place where the exporter is located to the point of exit for shipment overseas. This document is issued by exporters to consign goods to a freight forwarder who will transport the goods by rail to an airport, seaport, or truck for shipment.

Through Bill of Lading

A through bill of lading is used for intermodal transportation, that is, when different modes of transportation are used. The first carrier will issue a through bill of lading and is generally responsible for the delivery of the cargo to the final destination.

Consular Invoice

Certain nations require a consular invoice for customs, statistical, and other purposes. It must be obtained from the consulate of the country to which the goods are being shipped and usually must be prepared in the language of that country (U.S. Department of Commerce, 2008).

Certificate of Origin

A certificate of origin is required by certain countries to enable them to determine whether the product is eligible for preferential duty treatment. It is a statement as to the origin of the export product and usually is obtained from local chambers of commerce.

Inspection Certificate

Some purchasers and countries may require a certificate attesting to the specifications of the goods shipped, usually performed by a third party. Such requirements are usually stated in the contract and quotation. Inspection certificates are generally requested for certain commodities with grade designations, machinery, equipment, and so forth.

Insurance Certificate

When the exporter provides insurance, it is necessary to furnish an insurance certificate that states the type, terms, and amount of insurance coverage. The certificates are negotiable and must be endorsed before presentation to the bank.

Commercial Invoice

A commercial invoice is a bill for the merchandise from the seller to the buyer. It should include basic information about the transaction: description of the goods, delivery and payment terms, order date, and number. The overseas buyer needs the commercial invoice to clear goods from customs, prove ownership, and arrange payment. Governments in importing countries also use commercial invoices to determine the value of the merchandise for assessment of customs duties.

Dock Receipt

This receipt is used to transfer accountability when the export item is moved by the domestic carrier to the port of embarkation and left with the international carrier for export. The international carrier or agent issues it after delivery of the goods at the carrier's dock or warehouse. A similar document, when issued upon receipt of cargo by a chartered vessel, is called a mate's receipt.

Destination Control Statement (DCS)

This statement appears on the commercial invoice, bill of lading, air waybill, and shipper's export declaration. It is intended to notify the carrier and other parties that the item may be exported only to certain destinations.

Shipper's Export Declaration (SED)

A shipper's export declaration (SED) is issued to control certain exports and to compile trade data. It is required for shipments valued at more than $2,500. Carriers and exporters are also required to declare dangerous cargo.

Pro Forma Invoice

A pro forma invoice is a provisional invoice sent to the prospective buyer, usually in response to the latter's request for a price quotation. A quotation usually describes the product and states the price at a specific delivery point, time of shipment, and the terms of payment. A pro forma invoice is also needed by the buyer to obtain a foreign exchange or import permit. Quotations on such invoices are subject to change without notice partly because there is a lag between the time when the quotation is prepared and the time the shipment is made to the overseas customer.

Export Packing List

An export packing list itemizes the material in each individual package and indicates the type of package (e.g., box, carton). It shows weights and measurements for each package. It is used by customs in the exporting and importing countries to check the cargo and by the exporter to ascertain the total cargo weight, the volume, and shipment of the correct merchandise. The packing list should be either included in the package or attached to the outside of a package in a waterproof envelope marked "packing list enclosed."

Manifest

A manifest is a detailed summary of the total cargo of a vessel (by each loading port) for customs purposes. It covers condition of the cargo and summarizes heavy lifts and their location.

Transportation

Three modes of transportation are available for exporting products overseas: air, water (ocean and inland), and land (rail and truck). Whereas inland water, rail, and truck are suitable for domestic transportation and movement of goods between neighboring countries (e.g., the United States to Canada, France to Germany), air and ocean transport are appropriate for long-distance transportation between countries that do not share a common boundary.

Export-import firms may use a combination of these methods to deliver merchandise in a timely and cost-efficient manner. The exporter should consider market location (geographical proximity), speed (e.g., airfreight for perishables or products in urgent demand), and cost when determining the mode of transportation. Even though air carriers are more expensive, their cost may be offset by reduced packing, documentation, and inventory requirements. It is important to establish with the importer the destination of the goods, since the latter may wish the goods to be shipped into a free-trade zone that allows for exemption of import duties while the goods are in the zone.

Air Transportation

Airfreight accounts for less than 3 percent of world trade by weight and approximately 40 percent of world trade by volume. Demand for airfreight is correlated with world economic growth, fuel prices, and availability/competitiveness of surface transport options. (See Table 9.1 for advantages and disadvantages of this transportation type.)

Air cargo traffic has shown slower growth since 2004 (3.7% between 2004 and 2011) compared to its historic growth trend of 6.7% (1981–2004). The major factors contributing to this slowdown include the global economic downturn of 2008 and 2009, rising fuel prices, and overall restrained consumer spending. For example, rising fuel prices have diverted air cargo to land and maritime modes, which are less sensitive to fuel costs. In spite of these challenges, Boeing forecasts that world air cargo traffic is likely to grow by 5.2 percent over the next twenty years (2011–2031) (Boeing Company, 2012). Worldwide airfreight is expected to more than double, increasing from 195 billion revenue ton kilometers (RTKs) in 2011 to 550 billion RTKs in 2031 (Table 9.2). A number of factors are likely to contribute to such growth in airfreight:

1. *The world economy:* Global economic growth is expected to return to its long-term historic growth trend. Long-term growth rates are favorable for both advanced and developing nations. For example, GDP growth rates for African, Latin American, and Asian countries are expected to be more than 4 percent for 2011 through 2031. Oil and jet fuel prices are forecast to remain at mid-2012 levels or even decline.
2. *Infrastructure investment in developing countries:* In view of the heavy infrastructure investment being made in many developing countries, there is a potential need for imports of heavy equipment and services. It is estimated that such imports could amount to about $17.8 billion in surface transport, sea, and airport projects in South America alone. Certain types of equipment exports to these countries, such as bulldozers, buses, or oil-drilling equipment, often do not fit in a standard ocean container (Anonymous, 1998a; Reyes and Gilles, 1998).
3. *Just-in-time deliveries:* Since many of these projects are built from supplies shipped to the sites on a just-in-time basis, delays in delivering cargo can lead to heavy financial losses or penalties for the suppliers. Such needs cannot be accommodated by using the traditional modes of carriage for heavy freight. Airfreight becomes the only viable means of moving such cargo to ensure timely delivery.
4. *Changes in technology:* Technological changes over the past few decades have significantly altered the size and design of aircraft to handle heavy cargo. For example, the recent version of the Boeing 747 (747–8 freighter) has more cargo volume than the 747–400 and can carry more freight (even with passengers) than all-cargo versions of the previous generation of jets. The all-cargo plane has a payload capacity of about 148 tons and offers an additional 4,225 cubic feet of volume accommodating four additional main-deck pallets and three additional lower-hold pallets. Furthermore, improvements in terminal facilities in many countries have also contributed to increased speed and better handling and storage of shipments at airports, thus minimizing loss or damage to merchandise (International Perspective 9.1).
5. *The role of integrators and forwarders:* The development of air carriers that provide integrated services (DHL, UPS) has increased the amount of air cargo. For example, UPS

Sonic Air Service offers a guaranteed door-to-door service to most international destinations, regardless of size or weight limitations, within twenty-four hours. In addition, the role of forwarders as consolidators of small shipments makes it easier for shippers to send their merchandise by air without being subject to the minimum charge for small shipments. The forwarder consolidates various small shipments and tenders them to the airline in volume in exchange for a bill of lading furnished as the shipper of the cargo. The role of a forwarder is similar to that of a nonvessel-operating carrier in ocean freight.

TABLE 9.1 Advantages and Disadvantages of Air Transportation

Advantages	Disadvantages
■ Allows faster delivery of perishable commodities, production parts, and so on. Well suited for commodities that have a high value-to-weight ratio, are required on short notice, or can become quickly obsolete. ■ Ideal for products when demand is unpredictable, infrequent, or seasonal. ■ Does not require heavy packing (standard domestic packing is sufficient). ■ Reduces inventory and storage costs. ■ Reduces insurance cost and documentation. ■ Achieves savings in total transportation cost and provides reliability of service.	■ Generally expensive for high-bulk freight. Value must be high enough to justify higher freight cost. ■ Inefficient for shorter distances, which are handled faster by trucks. Only the express air services, such as UPS or DHL, have competitive services. ■ Requires shipping containers small enough to fit into an air carrier. ■ Not suitable for products that are sensitive to low pressures and variations in temperature.

TABLE 9.2 Air Cargo Growth Rates and Forecast to 2031

Markets	2001–2011	2011–2031
World	3.70%	5.20%
Intra North America (NA)	–1.5	2.3
Asia-North America	4.3	5.8
Latin America-NA	1.8	5.6
Latin America-Europe	3.2	5.3
Intra Europe	1.6	2.4
Europe-North America	1.5	3.5
Europe-Asia	6.2	5.7
Middle East-Europe	9.5	5.7
Africa-Europe	3.2	4.8
Intra-Asia	4.5	6.9
South Asia-Europe	6.1	5.8
Domestic China	11	8

Source: Boeing Company (2012).

Airfreight Calculations

Airfreight rates are based on a "chargeable weight" because the volume or weight that can be loaded on an aircraft is limited. The chargeable weight (CW) will be either the "actual weight" or the "volumetric weight," whichever is the highest. It is calculated as follows:

Hypothetical example

Actual weight: Take cargo weight in pounds, divided by 2.2046 to convert the weight into kilos = actual kilos
Volume: Multiply cargo measurements in inches divided by 366 = volume kilos

Sample shipment:

Medical equipment, with dimensions of 45 × 45 × 60 inches/Weight: 1,500 lb.
Actual weight: 1,500 lbs./2.2046 = 680 kilos
Volume weight: 45 × 45 × 60 inches/366 = 322 kilos
Freight charges would be assessed on the actual weight
IATA's standard dimensional weight is based on 6,000 cubic centimeters per one physical kilogram (length in cm x width in cm x height in cm)/6,000 = volume kilos.

Air Cargo Rates

Determinants of Air Cargo Rates

Distance to the point of destination as well as weight and size of the shipment are important determinants of air cargo rates. The identity of the product (commodity description) and the provision of any special services also influence freight rates. If a product is classified under a general cargo category (products shipped frequently), a lower rate applies.

Products can also be classified under a special unit load (for shipments in approved containers) or a commodity rate (negotiated rates for merchandise not classified as general cargo). Special services such as charter flight or immediate transportation could substantially increase the freight rate.

Rate Setting

The International Air Transport Association (IATA) is the forum in which fares and rates are negotiated among member airlines. Over the past few years, such fares and rates have been set by the marketplace, and tariff conference proposals have tended to become reference points. IATA's cargo service conferences also promote among members the negotiation of certain standards and procedures for cargo handling, documentation and procedures, shipment of dangerous goods, and so on.

International Air Express Services (Integrators)

The big carriers are under increasing competitive pressure from the integrated air service providers such as Federal Express and UPS. While the traditional carriers provide airport-to-airport service, the integrators have the added advantage of furnishing direct delivery services to customers, including customs clearance and payment of import duties at foreign destinations. Even though the strength of integrators had been in the transportation of smaller packages, they are now offering services geared to heavyweight cargo.

INTERNATIONAL PERSPECTIVE 9.1

Types of Aircraft and Air Services

Types of Aircraft

- **Passenger aircraft:** Passenger operators offer freight capacity in the bellyhold of their aircrafts. Freight services are usually secondary and represent a source of additional income. Low-cost carriers do not provide cargo freight services.
- **Combination carriers:** These are designed to carry both passengers and cargo on the main deck of the aircraft. Examples include the Boeing 737, 747, and 757 and the Airbus 330 and 340.
- **Airfreighters:** Airfreighters are entirely dedicated to the transportation of cargo. For example, Airbus A-330–200F's large main deck cargo door allows the aircraft to accept all pallets and containers and ensures loading and unloading using roller decks. Other examples include the Belugas, produced by Airbus and used for transportation of **military and satellite launch vehicles.**
- **Quick-change aircraft:** Some aircraft can be quickly converted between passenger and freight operations. The Airbus 330–200 and 300 versions are eligible for passenger-to-freight conversions for aircraft that have completed their useful operational service as passenger aircraft.

Types of Air Services

- **Airmail services:** Air mail services now accounts for a small share (less than 4 percent) of airline revenue.
- **Express freight services:** Express cargo has a guaranteed predetermined delivery date and time. Such services account for more than 13 percent of airline cargo traffic. Major players in this market include FedEx, UPS, DHL, and TNT.
- **Scheduled freight services:** Services are delivered on a published schedule (specific dates and times). Passenger airlines, freighters, and integrators provide such services. The majority of air cargo traffic is handled through such services.
- **Charters and leased cargo services:** Charter companies provide individual private aircraft for specific itineraries, urgent or time-sensitive cargo, air ambulance, and any other form of ad hoc air transportation. Aircraft can also be leased with or without

crew and insurance. Freight carriers are increasingly attracted to leasing because they do not have to pay cash for purchasing the plane and the lease terms are subject to negotiation.

- **Airfreight forwarder services:** Forwarders provide a number of services such as consolidating shipments and buying space. Many of the integrators such as UPS also provide such services.

Carriage of Goods by Air

The international transportation of goods by air is governed by the original Warsaw Convention of 1929 and the amended convention of 1955. The Warsaw convention and its subsequent amendments are generally known as the Warsaw regime. Despite various efforts to modernize the Warsaw regime, it was still unable to accommodate the dynamic requirements of the airline industry and that of shippers. For example, some of its provisions were out of date, and liability limits were too low and often confusing. In view of this, member countries adopted a new treaty in 1999 (the Montreal Convention) to govern international carriage of goods by air. The treaty became effective in 2003, and as of February, 2013, 103 countries had ratified it, including the United States, all members of the European Union (EU), Australia, Canada, China, India, Japan, South Korea, and Mexico.

The Convention re-establishes urgently needed uniformity and predictability of rules relating to the international carriage of passengers, baggage, and cargo. Whilst maintaining the core provisions of the Warsaw System, which have successfully served the international air transport community for several decades, the new convention achieves the required modernization in a number of key areas. It protects passengers by introducing a two-tier liability system and by facilitating the swift recovery of proved damages without the need for lengthy litigation. The major changes introduced in the Montreal Convention include the following:

- A strict liability standard is imposed under the Montreal Convention; air carriers can be held liable without proof of fault once the goods are in their control (there are limited exceptions such as defective packing, act of war, or inherent defect of the goods). Unlike under the Warsaw regime, the party claiming damages does not have to prove negligence on the part of the carrier (Carr, 2010).
- Increased air carrier liability limits apply for proved damages (up to 113,100 Special Drawing Rights [SDRs]), and such liability can be increased if negligence is proved.
- Carriers face unlimited liability in the event of death or injury to passengers.
- There are advanced liability limits in the event of delay.
- The Convention requires modernization of transport documents (electronic airway bills and tickets).

The important aspects of the Montreal Convention are detailed in the following material.

Scope of the Convention

The convention governs the liability of the carrier while the goods are in its charge, whether at or outside an airport. It applies when the departure and destination points set out in the contract of carriage are in two countries that subscribe to the Convention. The convention applies to only those passengers ticketed for international travel.

Air Consignment Note (Air Waybill)

A consignment note (air waybill) is a document issued by the air carrier to a shipper that serves as a receipt for goods and evidence of the contract of carriage. However, it is not a document of title to the goods, as in the case of a bill of lading. The carrier requires the consignor to make out and hand over the air waybill with the goods.

One part of the air waybill (made out by consignor in three original parts) is to be signed by the carrier, which shall hand it to the consignor after the cargo has been accepted. The second part is marked for the carrier (signed by consignor), and the third one is marked for the consignee (signed by consignee and carrier). If, at the request of the consignor, the carrier makes out the air waybill, the carrier shall be deemed, subject to proof to the contrary, to have done so on behalf of the consignor.

The Montreal Convention encourages carriers to use electronic records and requires only three things to appear on the waybill that accompanies a consignment of goods: (1) the place of departure and destination; (2) an intermediate stopping place in a different state (if the places of departure and destination are in the same state); and (3) the weight of the consignment (Carr, 2010).

Liability of Carrier

The carrier is liable for damages sustained to cargo under its control up to 19 SDRs per kilo unless the shipper has declared a higher value on the waybill. Liability for baggage losses is limited to 1,131 SDRs for each passenger unless a higher value was declared. Airlines may be liable for delays up to 4,694 SDRs per passenger (Schaffer, Augusti, Dhoogie, and Earle, 2012).

Limitation of Liability

The liability of the carrier with respect to loss or damage to the goods or delay in delivery is limited to the sum specified under the Convention unless the consignor has declared a higher value and paid a supplementary charge.

Limitation of Action

The right to damages will be extinguished if an action is not brought within two years after the actual or supposed delivery of cargo. Notice of complaint (of damage) must be made within fourteen days from the date of receipt of cargo (seven days in the case of checked baggage) and, in the case of delay, twenty-one days from the actual date of delivery of cargo or baggage (Schaffer et al., 2012).

International Air Cargo Security

Potential risks associated with air cargo security include introduction of explosive and incendiary devices in cargo placed aboard aircraft; shipment of undeclared or undetected hazardous materials aboard aircraft; cargo crime, including theft and smuggling; and aircraft hijackings and sabotage by individuals with access to aircraft. Current aviation security regulations require that each passenger aircraft operator and indirect air carrier develop a security program for acceptance and screening of cargo to prevent or deter the carriage of unauthorized explosives. However, the volume of air cargo handled and the distributed nature of the air cargo system present significant challenges for screening and inspecting air cargo.

Presently, in the United States, about fifty air carriers transport air cargo on passenger aircraft handling cargo from nearly two million shippers per day (Elias, 2007). About 80 percent of these shippers use freight forwarders, who operate about 10,000 facilities across the country. Analysts warn that the cost of screening every piece of air cargo that enters the shipping system in a bid to prevent terror gangs from downing airliners might bankrupt international shipping companies and hobble the already weakened airlines and still wouldn't provide comprehensive protection. However, efforts are being made to increase airline security without putting undue financial burden on the private sector.

Security guidelines are constantly changing in view of technological developments as well as the unpredictable nature of terrorism. Furthermore, security requirements are different for cargo shipped on freighters and for cargo shipped on passenger aircraft.

The U.S. Transportation Security Administration (TSA) (part of the U.S. Department of Homeland Security) secures the nation's airports and screens all commercial airline passengers and baggage. The air cargo division of the TSA is responsible for the security of the air cargo supply chain. TSA uses a multilayered approach that includes vetting companies that ship and transport cargo on passenger planes to ensure that they meet TSA security standards, establishing a system to enable Certified Cargo Screening Facilities (CCSFs) to physically screen cargo using approved screening methods and technologies, employing random and risk-based assessment to identify high-risk cargo that requires increased scrutiny, and inspecting industry compliance with security regulations through the deployment of TSA inspectors (TSA, 2012).

A number of programs have been introduced to enhance air cargo security.

- *Customs-Trade Partnership Against Terrorism (C-TPAT):* C-TPAT is a partnership of more than 10,000 importers, freight forwarders, carriers, and other entities. It establishes clear supply-chain security criteria for members to meet and in return provides incentives and benefits such as expedited processing. When they join the antiterror partnership, companies sign an agreement to work with Customs and Border Protection (CBP) to protect the supply chain, identify security gaps, and implement specific security measures and best practices. Additionally, partners provide CBP with a security profile outlining the specific security measures the company has in place. C-TPAT members are considered low risk and are therefore less likely to be examined. This designation is based on a company's past compliance history and security profile and on the validation of a sample international supply chain.
- *Air Cargo Advanced Screening (ACAS):* Airlines send manifest data of inbound cargo to CBP several hours before departure. By analyzing these data in advance, TSA and CBP

have a fast and efficient way to screen vast amounts of cargo and to zero in quickly on the precise items requiring further scrutiny. ACAS may request additional information or require the air carrier or its authorized representative to screen or hold identified shipments. Screening requests from ACAS require the air carrier or its authorized representative to screen identified shipments according to current TSA Standard Security Programs. It targets high-risk shipments for enhanced screening (TSA, 2012).

- *Certified Cargo Screening Program (CCSP):* This program requires air carriers to screen 100 percent of all cargo aboard international inbound passenger flights. The law requires the Department of Homeland Security to establish a system to screen all cargo transported on passenger aircraft at a level "commensurate" with the level of security used for checked baggage. The program was designed to enable TSA-vetted, -validated, and -certified facilities to screen air cargo prior to delivering the cargo to the air carrier. Each facility that successfully completes the TSA certification process (include an onsite assessment of the facility) will be designated a Certified Cargo Screening Facility (CCSF). CCSFs must adhere to TSA-mandated security standards, including the employment of secure chain-of-custody methods to establish and maintain the security of screened cargo throughout the supply chain. TSA will certify only those facilities that demonstrate adherence to these requirements through the TSA certification process.
- *Indirect Air Carrier Program:* An Indirect Air Carrier (IAC) is any person or entity within the United States not in possession of a Federal Aviation Administration air carrier operating certificate that undertakes to engage indirectly in air transportation of property and that uses for all or any part of such transportation the services of a passenger air carrier. Each Indirect Air Carrier must adopt and carry out a security program that meets current TSA requirements. The Indirect Air Carrier Regional Compliance Coordinators are responsible for the application process for freight forwarders working to become classified as Indirect Air Carriers. These coordinators complete annual renewals for current Indirect Air Carriers and provide assistance with program compliance.
- *International collaboration:* TSA's efforts to harmonize activities with foreign partners will increase global air cargo security and reduce burdens on trade. TSA's agreements with the European Commission as well as with Canada, Australia, and European Union member states, signed in 2008, will facilitate common and practical solutions to air cargo screening. This harmonization will contribute greatly to achieving the 100 percent screening requirement of the Recommendations of the 9/11 Commission Act, 2007.

Ocean Freight

Ocean shipping is the least expensive and the dominant mode of transportation in foreign trade. It is especially suitable for moving bulk freight such as commodities and other raw materials. Today, an increasing part of ocean freight travels by containers, which results in minimal handling at ports. In terms of value, containerized cargo accounts for the largest share of global trade (more than 50 percent), followed by tanker trade (25 percent) and general and dry cargo (20 percent). If a full-container-load cargo is to be shipped, a freight forwarder arranges for

TABLE 9.3 World Fleet by Vessel Types 2011–2012 (thousands of deadweight [dwt], % share)

Vessel Types	2011	2012	% Change
Oil tankers	474,846 (34%)	507,454 (33.1%)	6.90
Bulk carriers	532,039 (38.1%)	622,536 (40.6%)	17
General cargo ships	108,971 (7.8%)	106,385 (6.9%)	–2.40
Container ships	183,859 (13.2%)	198,002 (12.9%)	7.70
Other vessel types	96,028 (6.9%)	99,642 (6.5%)	3.80
World Total	**1,395,743 (100%)**	**1,534,019 (100%)**	**9.90**

Source: UNCTAD (2012).

TABLE 9.4 World Seaborne Trade in Dwt Miles (bill. Dwt miles)

Vessel type	2008	2009	2010	2011
Container	*18,400*	*15,313*	*16,508*	*18,756*
General cargo	*2,800*	*2,366*	*2,457*	*2,472*
RoRo	*1,812*	*1,217*	*1,468*	*1,578*
Reefer	*496*	*405*	*333*	*356*
Dry bulk	*25,606*	*24,550*	*26,784*	*31,788*
Oil	*29,310*	*26,228*	*27,787*	*28,181*
Gas	*2,538*	*2,344*	*3,322*	*3,816*
World total	*80,962*	*72,423*	*78,659*	*86,947*

Source: Lloyd's List Intelligence (2012), www.Lloydslistintelligence.com.

the container to be delivered to the shipper's premises. Once the container is fully loaded, it is moved by truck to a port to be loaded onto a vessel. Less-than-container-load freight is usually delivered at the port for consolidation with other shipments (Tables 9.3 and 9.4).

Important Developments in International Maritime Trade

- *Continued growth in world seaborne trade:* International seaborne trade grew by 4 percent in 2011 due to strong growth in container and dry bulk trades. The total volume of goods loaded worldwide reached 8.7 billion tons (United Nations Conference on Trade and Development [UNCTAD], 2012).
- *Growth in world shipping fleet:* The world fleet continued to expand reaching more than 1.5 billion deadweight tons (dwt) in 2012, an increase of more than 37 percent in just four years. However, new orders for ships are much lower than previous years due to uncertainty in the global economy and continuing unrest in the Middle East. China, Japan, and South Korea built more than 93 percent of the tonnage delivered in 2011 (UNCTAD, 2012). Oversupply of ships poses a serious challenge for profitability of shipping companies while benefiting importers and exporters.

- *Developing nations in the maritime sector:* One third of the world fleet is owned by ship owners in developing nations, and twelve of the top twenty container operators are from developing nations. The top twenty container ports accounted for about 52 percent of world container throughput in 2011. The leading role of Asian countries shows the importance of the region as a center of international trade and the subsequent demand and growth for container ports (Tables 9.5 and 9.6)
- *Freight rates and transportation costs:* Freight rates declined during 2011 and 2012 mainly due to vessel oversupply. Such declines are prominent in three segments: *dry bulk, liquid bulk,* and *containerized cargo.* For many developing nations of Asia and the Americas, shipping costs (as a percentage of the value of goods imported) continue to drop. Rates for African countries have not declined due to port congestion, low productivity, and high charges.
- *Environmental initiatives:* A set of measures to increase energy efficiency and reduce greenhouse gas emissions from international shipping was adopted in 2011 and entered into force in 2013. Members include the USA, UK, Japan, Germany, and several developing nations.

TABLE 9.5 Share of World Fleet (dwt) and Global Seaborne Commerce ($, %) by Country and Vessel Type

Countries	Center Container	Dry bulk	Tankers	General cargo
Germany	*37 (19.2)*	*4.8 (0.3)*	*4.6 (1.0)*	*13.3 (2.7)*
Japan	*8.8 (4.6)*	*22.7 (1.4)*	*12.5 (2.7)*	*12.4 (2.5)*
Greece	*6.8 (3.5)*	*19.9 (1.2)*	*20.8 (4.6)*	*2.4 (0.5)*
China	*6.3 (3.3)*	*14 (0.8)*	*5.2 (1.1)*	*11 (2.2)*
Denmark	*8.8 (4.6)*	*1.1 (0.1)*	*3.4 (0.7)*	*1.1 (0.2)*
Taiwan	*4.8 (2.5)*	*3.4 (0.2)*	*1.7 (0.4)*	*1.6 (0.3)*
Norway	*0.3 (0.2)*	*1.4 (0.1)*	*3.4 (0.7)*	*12 (2.4)*
South Korea	*3.2 (1.7)*	*6.3 (0.4)*	*2.8 (0.6)*	*2.3 (0.5)*
Singapore	*3.3 (1.7)*	*2.0 (0.1)*	*3.9 (0.9)*	*1.4 (0.3)*
Hong Kong	*2.2 (1.1)*	*4.5 (0.3)*	*3.0 (0.7)*	*1.8 (0.4)*
United States	*1.5 (0.8)*	*3.1 (0.2)*	*5.0 (1.1)*	*1 (0.2)*
Canada	*2.3 (1.2)*	*0.4 (0.0)*	*1.8 (0.4)*	*0.2 (0.0)*
Russia	*0.2 (0.1)*	*0.3 (0.0)*	*2.8 (0.6)*	*3.7 (0.7)*
Turkey	*0.6 (0.3)*	*2.1 (0.1)*	*1.6 (0.4)*	*3.4 (0.7)*
The Netherlands	*0.4 (0.2)*	*0.2 (0.0)*	*0.8 (0.2)*	*4.5 (0.9)*
Italy	*0.1 (0.0)*	*1.5 (0.1)*	*2.7 (0.6)*	*2.2 (0.4)*
United Kingdom	*0.4 (0.2)*	*0.9 (0.1)*	*2.2 (0.5)*	*2 (0.4)*
All others	*13.1 (6.8)*	*11.3 (0.7)*	*21.7 (4.8)*	*23.7 (4.7)*

Source: UNCTAD (2012).

TABLE 9.6 Top Twenty Container Terminals and Their Throughput (TEUs)

Port Name	2000*	2010
Shanghai (China)	*25,002,000*	*29,069,000*
Singapore	*25,866,400*	*28,431,100*
Hong Kong (China)	*21,040,096*	*23,699,242*
Shenzhen (China)	*18,250,100*	*22,509,700*
Busan (South Korea)	*11,954,861*	*14,194,334*
Ningbo (China)	*10,502,800*	*13,144,000*
Guanzhou (China)	*11,190,000*	*12,550,000*
Qingdao (China)	*10,260,000*	*12,012,000*
Dubai	*11,124,082*	*11,600,000*
Rotterdam (Netherlands)	*9,743,290*	*11,145,804*
Tianjin (China)	*8,700,000*	*10,080,000*
Kaohsuing (Taiwan)	*8,581,273*	*9,181,211*
Port Klang (Malaysia)	*7,309,779*	*8,871,745*
Hamburg (Germany)	*7,007,704*	*7,900,000*
Antwerp (Netherlands)	*7,309,639*	*8,468,475*
Los Angeles (United States)	*6,748,994*	*7,831,902*
Tanjung Pelepas (Malaysia)	*6,016,452*	*6,530,000*
Xiamen (China)	*4,680,355*	*5,820,000*
Dallan (China)	*4,552,000*	*5,242,000*
Long Beach (United States)	*5,067,597*	*6,263,399*
Total	***220,907,422***	***254,543,912***

*Data show the number of twenty-footer equivalent units (TEU) moved within a given time.

Source: UNCTAD (2012).

Types of Ocean Carriers

The following are the three major types of ocean carriers. (See also International Perspective 9.2.)

Private fleets. These are large fleets of specialized ships owned and managed by merchants and manufacturers to carry their own goods. Apart from its cost advantages, ownership of a private fleet ensures the availability of carriage that meets the firm's special needs. Such ships can occasionally be leased to other firms at times of limited activity. Some firms in certain industries, such as oil, sugar, or lumber, own their own fleets.

Tramps (chartered or leased vessels): Tramps are vessels usually leased to transport large quantities of bulk cargo (e.g., oil, coal, grain, sugar) that fill the entire ship (vessel). Chartered vessels do not operate on a regular route or schedule. Charter arrangement can be made on the basis of a trip or voyage between origin and destination or for an agreed time period, usually several months to a year. The vessel could be leased with or without a crew (bareboat charter). The major factors behind the continued existence of tramp shipping are that (1) it provides indispensable ocean transportation at the lowest possible cost, and (2) it is

adaptable to changing and/or unanticipated requirements for transportation. When charter rates are low, commodity traders tend to move materials in advance of actual delivery time to take advantage of low transportation costs (Wood et al., 1995). The just-in-time system that delivers products when they are needed is not often feasible in cases in which transport and distribution could be impeded by severe winter weather. A commodity trader's decision to purchase and export a product is influenced by the spread between the export and purchase price, the charter rate, and any warehousing or storage cost. This means that an exporter can purchase and export a product even before delivery time if the charter rate and storage cost are substantially less than the spread and allow for a reasonable profit margin.

Conference lines: A shipping conference line is a voluntary association of ocean carriers operating on a particular trade route between two or more countries. Shipping conferences date back to the nineteenth century when such associations were established for trade between England and its colonies. One of the distinguishing features of a liner service is that sailings are regular and repeated from and to designated ports on a trade route at intervals established in response to the quantity of cargo generated along that route. Even though the sailing schedule is related to the amount of business available, it is general practice to dispatch at least one ship each month (Kendall, 1983). The purpose of a shipping conference is the self-regulation of price competition, primarily through the establishment of uniform freight rates and terms and conditions of service among the member shipping lines. In spite of their cartel-like structure, these conferences are considered a necessary evil to ensure the stability and growth of international trade by setting rate levels that are stable and predictable and by reducing predatory price competition.

Unless rejected, conference agreements become effective between carriers on the forty-fifth day after filing with the Federal Maritime Commission (FMC) or on the thirtieth day after publication of notice of filing in the Federal Register, whichever day is later.

Conferences serving U.S. ports must be "open," that is, they must admit any common carrier willing to serve the particular trade or route under reasonable and equal terms and conditions. This is generally intended to preclude conferences from using membership limitations as a means of discriminating against other U.S. carriers. Conferences are also allowed to form an exclusive patronage contract with a shipper, allowing the latter to obtain lower rates by committing all or a fixed portion of its cargo to conference members. Vessels engaged in liner service may be owned or leased. Conferences compete with independent lines, chartered vessels, and each other, although the same carrier could belong to several conferences.

Example: An exporter in Taiwan intends to arrange for shipment of its textiles by a conference carrier to New York. A case for a lower (tariff) rate for large shipments can be made to a conference rate-making committee that consists of member lines. If the conference elects to reject the application for a lower rate, several options are available to the exporter: (1) the exporter may request a member of the conference to establish the rate independent of the conference; (2) the product could be shipped through nonconference carriers (independent or other conference lines) that offer a reasonably low tariff; (3) the product could be shipped through other ports using other conference carriers; or (4) the shipper could consider nonvessel-operating common carriers (NVOCC) or tramp vessels, depending on the amount of cargo. NVOCCs take possession of smaller shipments from several shippers and consolidate them into full-container loads for shipment by an ocean carrier. NVOCCs charge

their own tariff rates and obtain a bill of lading as the shipper of the consolidated merchandise.

INTERNATIONAL PERSPECTIVE 9.2

Types of Ocean Cargo and Vessels

Types of Ocean Cargo

Containerized: Cargo loaded at a facility away from the pier or at a warehouse into a metal container, usually 20 to 40 feet long, 8 feet high, and 8 feet wide. The container is then delivered to a pier and loaded on to a "containership" for transportation. Some cargo cannot be containerized, including automobiles, live animals, and bulk products.

Bulk: Cargo that is loaded and carried in bulk, without mark or count, in a loose unpackaged form, having homogenous characteristics. To be loaded on a containership, bulk cargo would be put in containers first. It could also be stowed in bulk instead of being loaded into containers. Examples include coal, iron ore, and raw sugar.

Break-bulk: Packaged cargo that is loaded and unloaded on a piece-by-piece basis, that is, by number or count. This can be containerized or prepared in groups of packages covered by shrink wrap for shipment. Examples are coffee, rubber, and steel.

Neo-bulk: Certain types of cargo that are often moved by specialized vessels. Examples include autos and logs.

Types of Ocean Vessels

Tankers: Vessels designed to carry liquid cargo such as oil in large tanks. They can be modified to carry other types of cargo such as grain or coffee.

Bulk carriers: Vessels that carry a variety of bulk cargo.

Neo-bulk carriers: Vessels designed to carry specific types of cargo such as autos or logs.

General cargo vessels: These include (1) Containerships: vessels that carry only containerized cargo; (2) Roll-on and Roll-off (RO/RO) vessels: vessels that allow rolling cargo such as tractors or cars to be driven aboard the vessel; and (3) LASH (Lighter Aboard Ship) vessels: vessels, such as barges, that can carry very large containers. Cargo can be loaded on barges in shallow waters and then loaded on board a vessel.

Barges: Unmanned vessels generally used for oversized cargo and towed by a tugboat.

Combination carriers: Vessels that carry passengers and cargo, such as oil and dry bulk or containers and bulk cargo. Other combinations are also possible.

Carriage of Goods by Sea

International transportation of cargo by sea is governed by various conventions. The Hague Rules of 1924 have won a certain measure of global support. The U.S. law on the carriage of goods by sea is based on the Hague Rules. Subsequent modifications have been made to the Hague Rules (the Hague-Visby Rules, 1968), which are now in force in most of Western Europe, Japan, Singapore, Australia, and Canada. In 1978, the United Nations Commission on International Trade Law (UNCITRAL) was given the task of drafting a new convention

to balance the interests of carriers and shippers. Although the Hague-Visby Rules were intended to rectify the pro-carrier inclination of the Hague Rules, many developing countries felt that the Hague-Visby rules did not go far enough in addressing the legitimate concerns of cargo owners or shippers. The commission's deliberations led to an agreement in 1978 (the Hamburg Rules), which came into effect in 1991 and has limited impact due a small number of ratifications (20 countries by 2013). Unlike the Hague and Hague-Visby Rules, which have been ratified by many developed and developing nations, the Hamburg Rules are mostly followed by developing nations, except Austria (Flint and O'Keefe, 1997). In view of the widespread acceptance of the Hague Rules, it is important to briefly examine some of their central features (see International Perspective 9.3).

Scope of application: The application of the rules depends on the place of issuance of the bill of lading; that is, the rules apply to all bills of lading issued in any of the contracting states. If the parties agree to incorporate any one of the previous rules in their contract, these rules will govern the contract of carriage even when the countries where the parties reside subscribe to different rules. However, this will not be allowed if the parties are required to apply certain rules adopted by their countries. These rules apply only to bill of lading (B/L).

Carrier's duties Under B/L: A carrier transporting goods under a B/L is required to exercise "due diligence" in (1) making the ship seaworthy; (2) properly manning, equipping, and supplying the ship; (3) making the ship (e.g., holds, refrigerating chambers) fit and safe for reception, carriage, and preservation of the goods; and (4) properly and carefully loading, handling, stowing, carrying, and discharging the goods. Whenever loss or damage occurs due to unseaworthiness, the burden of proving the exercise of due diligence falls on the carrier. When different modes of transportation are used, the issuer of the bill of lading undertakes to deliver the cargo to the final destination. In the event of loss or damage to merchandise, liability is determined according to the law relative to the mode of transportation at fault for the loss. If the means of loss is not determinable, it will be assumed to have occurred during the sea voyage (Schaffer et al., 2012).

Carrier's liability and exemptions: The carrier's liability applies to loss of or damage to the goods. It does not extend to delays in the delivery of the merchandise. The rules exempt carriers from liability that arises from actions of the servants of the carrier (e.g., master, pilot) in the management of the shipment, fire and accidents, acts of God, acts of war, civil war, insufficient packing, inherent defects in the goods, and other causes that are not the actual fault of the carrier. That loss or damage to the goods falls within one of these exemptions does not automatically absolve the carrier of liability if the damage or loss could have been prevented by the carrier's exercise of due diligence in carrying out its duties (Carr, 2010; Yancey, 1983).

Period of responsibility: The period of responsibility begins at the time the goods are loaded and extends to the time they are discharged from the ship.

Limitations of action: All claims against the carrier must be brought within one year after the actual or supposed date of delivery of the goods. This means that lapse of time discharges the carrier and the ship from all liability in respect to loss or damage. The Hague Rules also stipulate that notice of claim must be made in writing before or at the time of removal of the goods.

Limits of liability: The maximum limitation of liability is $500 per package. Under the Hague-Visby rules, it is $1,000 per package. In most cases, a container is considered one package, and the carrier's liability is limited to $500. To ensure the application of liability

limits to their agents and employees, carriers add the "Himalaya Clause" to their bills of lading. This clause brings such agents and employees under the protection of the Hague Rules. Exporters can, however, obtain full protection against loss or damage by paying an excess value charge or by taking out an insurance policy from an independent source (Force, 1996; Schaffer et al., 2012).

Proposed Rotterdam Rules

In 2008, a new treaty was adopted (Rotterdam Rules) that replaces the Hague Rules and that is currently awaiting ratification. As of 2013, it had been signed by more than twenty countries, including France, Sweden, Switzerland, and the United States but ratified only by Spain and Togo. Twenty countries have to ratify the treaty before it can enter into force. The Rotterdam Rules build upon the previous conventions and establish a modern and uniform legal regime governing the rights and obligations of shippers, carriers, and consignees under a contract for door-to-door carriage that includes an international maritime transportation. The rules provide a legal framework that takes into account commercial and technological developments such as containerization and electronic transport documents as well as door-to-door carriage under a single contract and carriage that involves multiple modes of transport.

INTERNATIONAL PERSPECTIVE 9.3

The Hague, Hague-Visby, and Hamburg Rules: Overview

All three rules define the rights and duties of parties in a contract covering the carriage of goods by sea, insurance for goods, and transfer of title. The Hague and Hague-Visby Rules are generally identical except for provisions dealing with limitations of liability, third parties, and a few minor areas. The Visby amendments to the Hague Rules increase the limits of the carrier's liability, change the method of expressing the limitation amount (by weight), and protect third parties that act in good faith.

The Hamburg Rules have been criticized by carriers and their insurers as favoring shippers (cargo interests). The prominent differences between the Hamburg Rules and Hague/Hague-Visby are as follows: (1) The Hamburg Rules have higher limits of liability and set higher damages against carriers; (2) under the Hamburg Rules, the carrier is liable for delays in delivery, in addition to loss or damage to goods; (3) any loss or damage to goods in transit imposes a burden of proof on the carrier to show that it was not at fault, whereas such burden is triggered only when the loss or damage resulted from an unseaworthy condition of the ship under the Hague and Hague-Visby Rules; (4) under the Hamburg Rules, the limits of carrier's liability may not extend to acts of independent contractors, unlike under the other two rules.

Container Security

As part of its efforts to target high-risk cargo containers for inspection, U.S. Customs and Border Protection (CBP) uses various sources of information to screen containers in advance of their arrival in the United States (Figure 9.1).

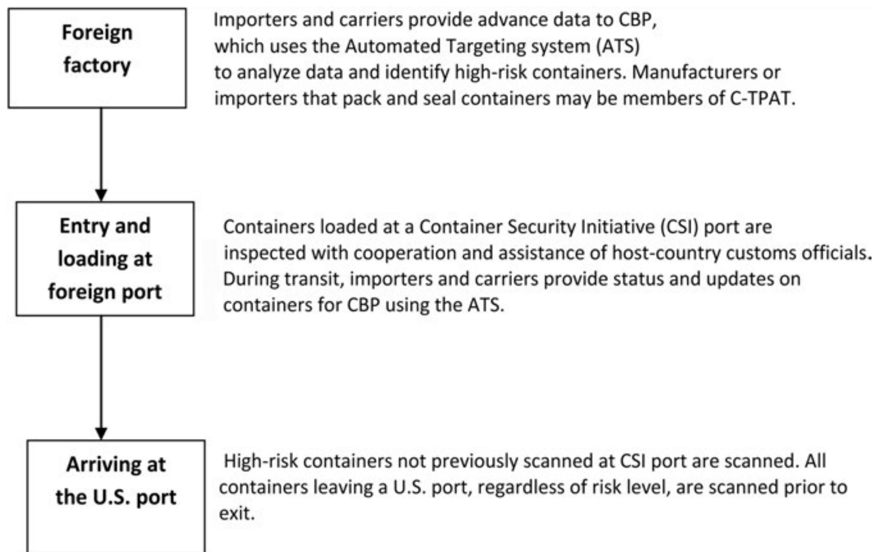

FIGURE 9.1 Global Supply-Chain Process and Cargo Security

- *CBP's twenty-four-hour rule:* CBP's twenty-four-hour rule requires that vessel carriers submit cargo manifest information to CBP twenty-four hours before U.S.-bound cargo is loaded onto a vessel.
- *Automated Targeting System (ATS):* The ATS is a mathematical model that uses weighted rules to assign a risk score to arriving cargo shipments on the basis of shipping information. CBP uses the Automated Targeting System as a decision support tool in targeting cargo containers for inspection.
- *The 10+2 rule:* The cargo information required by the 10+2 rule comprises ten data elements from importers, such as country of origin, and two data elements from vessel carriers, such as the position of each container transported on a vessel. All of this information must be provided to CBP in advance of the ship's arrival at a U.S. port.
- *Cargo Security Initiative (CSI):* CBP temporarily assigns inspectors at foreign ports to inspect containers bound for the United States. In 2007, CBP reached its goal of operating CSI in fifty-eight foreign seaports, and, as of October 2011, these ports collectively accounted for more than 80 percent of the cargo containers shipped to the United States.
- *Customs-Trade Partnership Against Terrorism (C-TPAT):* The C-TPAT program is a government-to-business partnership program that provides benefits to supply-chain companies that comply with predetermined security measures. Under C-TPAT, CBP officials work with private companies to review their supply-chain security plans and improve members' security measures. In return, C-TPAT members may receive benefits, such as reduced scrutiny or expedited processing of their shipments.
- *International collaboration:* CBP also partners with international trade and security groups to develop supply-chain security standards that can be implemented by the

international community. In 2005, the World Customs Organization (WCO) developed the Framework of Standards to Secure and Facilitate Global Trade for which the core concepts are based on components of CBP's CSI and C-TPAT programs.

Freight Calculation

Ocean freight:

Volume: Multiply cargo measurements in centimeters, divide by 35.32 = cubic meters
or
Multiply cargo measurements in inches, divide by 1,728, divide by 35.32 = cubic meters
Weight: Divide the cargo weight, in pounds, by 2.2046 = kilos

Sample shipment:

Medical equipment with dimensions of 45 × 45 × 60 inches/Weight: 1,500 lb.
Actual weight: 1,500 lbs. / 2.2046 = 680 kilos
Volume: 45 × 45 × 60 = 121,500 cu. in. / 1728 = 70.3 cu. ft. / 35.32 = 1.99 cbm.
1,000 kilos is equivalent to one cubic meter
Freight charges would be assessed on the volume (measurement).

Land Transportation

Land transportation carriers (trucks, trains) are used mainly to transport exports to neighboring countries as well as to move goods to and from an airport or seaport. A substantial volume of U.S. exports to Canada and Mexico is moved by rail and/or trucks. Compared to rail transport, trucking has the advantage of flexibility, faster service, lower transportation costs, and less likelihood of damage to merchandise on transit. Rail transport has its own unique advantages: capacity to handle bulk cargo, free storage in transit, and absorption of loading, unloading, wharfage, and lighter charges. With the proliferation of free-trade agreements in various regions, there is likely to be a marked growth in the role of land carriers in transporting exports among countries that are in the same geographical area. For example, in eastern and southern Africa, an agreement that allows movement of land carriers across countries would make trucks and trains the dominant mode of transportation for exports. This is because land transport already accounts for more than 80 percent of the region's freight movements; with a regional arrangement, these transportation services could easily be extended to neighboring countries with limited capital investment.

The use of land transportation is considered economically justifiable for large flows of cargo over distances greater than 500 kilometers (310 miles).

Road Transportation

Trucks transport about 81 percent of the value of trade between the United States and Mexico and 64 percent of that between the United States and Canada each year. This represents $314 billion and $219 billion annually in truck-transported trade with Canada and Mexico,

respectively. In Europe, road transportation accounted for 47 percent of intra-EU transportation in 2009 (European Commission, 2011).

The truck industry subsector provides over-the-road transportation of cargo using motor vehicles, such as trucks and tractor trailers. The subsector is subdivided into general freight trucking and specialized freight trucking. This distinction reflects differences in equipment used, type of load carried, scheduling, terminal, and other networking services. General freight transportation establishments handle a wide variety of general commodities, generally palletized and transported in a container or van trailer. Specialized freight transportation is the transportation of cargo that, because of size, weight, shape, or other inherent characteristics, requires specialized equipment for transportation.

In the United States, the economic slowdown affected the trucking industry far more than the railroad sector. This is mainly due to the fact that, unlike the trucking industry, the railroad sector is used more to transport of noncyclical commodities such as coal and agricultural products, shipments of which stayed relatively stable despite the economic crisis. The trucking industry, which is more dependent on manufacturing and retail demand, experienced a comparatively steep decrease in volume during the economic slowdown. With the crisis compelling production shutdowns in several companies, demand for transportation of goods suffered a considerable decline. Increases in fuel costs also accounted for the downward slide.

The deregulation of the trucking industry has given rise to volatile market conditions for commercial fleets, where intense competition, particularly price based, threatens the existence of several independent carriers. Other factors affecting the performance of the industry include:

- Different domestic rules on weight, temperature, height, and width of merchandise. Switzerland, for example, prohibits trucks weighing more than 28 metric tons from going further than six miles into its territory forcing truckers to piggyback on railroad cars. Poland does not allow trucking when temperatures reach 30 degrees celsius.
- State of infrastructure such as road conditions and speed limits affect the smooth transportation of goods within and across countries.
- Government taxes on diesel fuels, the need to meet different pollution standards, and highway tolls affect the performance and profitability of trucking.

Rail Transportation

The U.S. freight rail network, consisting of 140,000 rail miles (operated by 7 Class I railroads, 21 regional railroads, and 510 local railroads), is widely considered one of the most dynamic freight systems in the world. The U.S. freight railroads are private organizations that are responsible for their own maintenance and improvement projects. Compared with other major industries, they invest one of the highest percentages of revenues to maintain and add capacity to their system (U.S. Department of Transportation, 2012).

The rail network accounts for approximately 40 percent of U.S. freight moves by ton-miles (the length freight travels) and 16 percent by tons (the weight of freight moved). It is estimated that about 91 percent of rail freight consists of bulk commodities, such as agricultural and energy products, automobiles and components, construction materials, chemicals, coal, equipment, food, metals, minerals, and paper and pulp. The remaining 9 percent is intermodal traffic, which generally consists of consumer goods and other miscellaneous products ("intermodal traffic" refers to goods transported on trains before and/or after transfers

from other modes of transportation, such as planes, vessels, or trucks). Freight tends to move from ports, manufacturing hubs, and areas of specific economic activity, such as rural areas for agriculture and energy products, to population centers or outlying regions where power plants and large manufacturing facilities are located. Internationally, the U.S. freight rail network connects with Canada and Mexico through several key gateways along the borders. These gateways allow freight railroads to participate in achieving national export goals and facilitating the safe and efficient importation of goods.

In 2009, about 10 percent of goods in the EU (EU 27) were transported by rail within, compared to 37 percent moved via maritime transportation. EU foreign trade transported by rail accounts only for 3.5 percent of the total tonnage and 1.3 percent of the value. A progressive development of traffic toward road has successfully captured rail movements (Semaine Internationale du Transport et de la Logistique [SITL], 2012).

Rules Governing Inland Carriage

Transportation of merchandise almost always involves the use of an inland carrier (a trucking or rail company) to move merchandise from the exporter's warehouse to the seaport or airport. Inland transportation is governed by domestic legislation unless goods are shipped to a different country or this movement of cargo from warehouse to port is the first part of intermodal transportation to a foreign country. In the United States, different laws, including the Carmack Amendment, govern domestic transportation. Under the Carmack Amendment, rail and motor common carriers are liable for the full value of the goods lost, damaged, or delayed in transit. However, there are certain exceptions to this strict liability: acts of God, acts of shipper, inherent vice (defects in the goods), acts of a public enemy, and intervention of law. Even though there are no universal agreements, a few regional treaties regulate transportation of goods by road and rail (Murray, 2006). Prominent among these is the Convention on the Contract for the International Carriage of Goods by Road (Convention relative au Contract de Transport International de Merchandises par Route, or CMR, 1956) and the Convention Concerning International Carriage by Rail (Convention relative au Transport Internationaux Ferroviares, or COTIF, 1980). Members include most European countries; a few Middle Eastern nations are members of COTIF. The respective conventions cover areas such as scope of application, liability of the carrier, the use of multiple carriers, and time limits:

- The conventions generally apply to contracts for the carriage of goods by road or rail between two countries, of which at least one is a contracting party. The convention also applies to carriage by states or public institutions.
- A carrier is required to issue a consignment note (nonnegotiable) as evidence of contract of carriage and condition of the goods. The consignee has a right to demand delivery of the goods in exchange for a receipt and to sue the carrier in its own name for any loss, damage, or delay for which the carrier is responsible. The shipper can change the place of delivery or order delivery to another consignee at any time before the delivery of the consignment note or cargo to the first consignee.
- In cases involving multiple carriers, each carrier is responsible for the entire transaction.
- Carriers are liable for loss, damage, or delays up to a liability limit insofar as the contract is governed by the CMR or COTIF. There are, however, certain exceptions to liability in

cases such as inherent vice in the goods, circumstances that the carrier could not avoid and the consequences of which he was unable to prevent, or negligence on the part of the shipper.

- There is a limitation period for bringing action (one year) and for notice of reservations (i.e., notice of damage or loss).

Multimodal Transportation

A study on intermodal techniques (rail/truck) in transportation found that improving the competitiveness of intermodal transport for short-distance trips requires the operation of "corridor trains" that make short stops every 100 or 200 kilometers along a route (Anonymous, 1998b). Intermodal transport is used not just to move goods between rail and truck; it is also used for any service that requires more than one means of transportation (e.g., rail and ocean, truck and ocean) under one bill of lading. Such arrangements ideally must seek the fastest and least costly transportation for the shipper. The essence of an intermodal contract is an agreement between different types of carriers (e.g., steamship lines, railroads, trucking firms, airlines) to achieve certain well-defined and carefully described functions. The advantages of such a mode of transport is simplicity for the shipper and consignee (one bill of lading and no other arrangements necessary), reduced damage because of fewer handlings, and reduced pilferage due to limited exposure of cargo. Such services are already offered by the integrators in the airline industry.

Examples of Intermodal Service

A truck moves merchandise from the exporter's warehouse outside New York City to a railroad yard some fifty miles away. The railroad takes the container to a New York port, where it will be placed aboard a ship to Rotterdam, Holland. The whole movement is covered by a single contract of carriage issued by the trucker as the initiating carrier.

Fresh oranges that arrive in Miami, Florida, by sea from Chile are then distributed to a network of inland points by air and then delivered door to door to customers by truck.

The UN convention on multimodal transportation (1980) defines international multimodal transport as the carriage of goods by at least two different modes of transport on the basis of a multimodal transport contract from a place in one country at which the goods are taken in charge by the multimodal transport operator to a place designated for delivery situated in a different country. The term "multimodal transport operator" includes any person who on his or her own behalf (or through another person acting on the operator's behalf) concludes a multimodal transport contract and who acts as a principal, assumes responsibility for the performance of the contract.

Thus, the main features of a multimodal transport are the carriage of goods by two or more modes of transport under one contract, one document, and one responsible party (Multimodal transport operator [MTO]) for the entire carriage. The MTO might subcontract the performance of some or all modes of the carriage to other carriers. The terms "combined transport" and "intermodal transport" are often used interchangeably to describe the carriage of goods by two or more modes of transport.

The development of new transportation techniques, such as containerization and other means of unitization of goods, introduced a significant need for modification of commercial and traditional legal approaches to transport. Goods stowed in a container could be transported by different means of transport, such as ships, railway wagons, road vehicles, or aircrafts, from the point of origin to the final place of destination without being unpacked for sorting or verification when being transferred from one means of transport to another. Gradually, more and more operators took responsibility for the whole transport chain under one single transport contract. Shippers/consignees needed to pursue one single operator in the event of loss of, or damage to the goods involved in multimodal transport, and this single operator would be responsible for the overall transport, rather than several unimodal carriers. There was thus a need for an international legal framework for multimodal transport of goods.

The Multimodal Transport Convention (MTC) addresses the problems raised by multimodal transportation including questions pertaining to documentation and the liability of MTOs. It provides for the issuance of one document to serve the entire transportation period and for liability to cover the whole period during which the MTO is in charge of the goods (i.e., from the time the operator takes control of the goods till delivery).

The MTC failed to attract the thirty ratifications needed for entry into force. A number of reasons are attributed for its lack of popularity:

- It is seen as overly consignor-friendly by the transport industry. Its close association with the Hamburg Rules failed to gain support for it among major maritime nations
- Higher limitations on liability and uniform liability system: The monetary limitation of liability was modeled on the Hamburg Rules. Under the uniform liability scheme, the MTO is responsible for loss, delay, or damage while the goods are in its control. To escape liability, the MTO must show that it took all necessary measures to avoid the occurrence and its consequences.

In view of the absence of a uniform international convention regulating multimodal transport, there has been a proliferation of diverse regional, subregional, and national laws to fill the gap. Significant differences remain among these sets of rules, creating further disunity at the international level (Faghfouri, 2006).

Freight Forwarders in Transportation

A freight forwarder is the party that facilitates the movement of cargo to the overseas destination on behalf of shippers and processes the documentation or performs activities related to those shipments. Freight-forwarding activity dates back to the thirteenth century, when traders employed middlemen, or "frachtors," to cart and forward merchandise throughout Europe. The frachtor's responsibility later extended to provision of long-distance overseas transportation and storage services, issuance of bills of lading, and collection of freight, duties, and payment from consignees (Murr, 1979).

In the United States, the forwarding industry developed in the late nineteenth century. It started in New York, where the bulk of U.S. export trade was handled, to provide various transportation services to shippers. Ullman succinctly points out the changing role of the ocean freight forwarder in the United States:

> Many forwarding concerns originally started as freight brokers, but with the continuing increase in manufactured shipments, the forwarding work took precedence over the broker activity. Today, some forwarders handle ship loads of large parcels either on a common carrier or tramp vessels as brokers, but for the most part, forwarders deal with individual shipments varying in size or containers. (Ullman, 1995, p. 130)

Role and Function of Freight Forwarders

The freight forwarder (1) advises the exporter on the most economical choice of transportation and the best way to pack and ship the cargo to minimize cost and prevent damage, and (2) books air, ocean, or land transportation (or intermodal movement of cargo) and arranges for pickup, transportation, and delivery of the goods. The forwarder also ensures that the goods are properly packed and labeled and that documentation requirements are met so the cargo is cleared at the port of destination. When a letter of credit is used, the forwarder ensures that it is strictly complied with to enable the exporter to receive payment. Thus, the advantage of using a forwarder goes far beyond expediting the movement of freight. Forwarders help shippers and consignees by tracking and tracing cargo. They can also negotiate better rates with carriers because they can purchase space on airlines or ships at wholesale prices. The wide array of services they provide helps shippers save time and money.

Freight forwarders are a significant part of U.S. commerce and facilitate the growth and expansion of international trade. A U.S. Senate report on the industry describes freight forwarding as follows:

> a highly important segment of the economy of the United States in that its functioning makes possible participation in the nation's foreign commerce by many industries and businesses whose lack of familiarity with the complexities and formalities of exporting procedures might hinder or even preclude such participation if forwarding services were not freely available. (Ullman, 1995, p. 133)

Today, it is generally estimated that more than 90 percent of export firms use the services of an international freight forwarder. Most of the forwarding activity is still concentrated in ocean shipping, although some diversification into air and land transportation has occurred.

A forwarder is distinguishable from a nonvessel-operating common carrier (NVOCC). NVOCCs are international ocean carriers that do not operate their own vessels. They fulfill the role of the shipper with respect to carriers and that of a carrier with respect to shippers. Typical NVOCCs guarantee a steamship line a certain amount of freight per week or month and purchase the necessary space on a wholesale basis for shipment of cargo to and from a given port. They publish their own tariffs and receive and consolidate cargo of different shippers for transportation to the same port. They issue bills of lading to acknowledge receipt of cargoes for shipment. Unlike NVOCCs, freight forwarders do not publish their own tariff and consolidate small shipments. Forwarders use the services of NVOCCs and facilitate the movement of cargo without operating as carriers. NVOCCs are often owned by freight forwarders or large transportation companies.

A forwarder also differs from a customs broker in that the latter deals with the clearing of imports through customs, whereas a forwarder facilitates the transportation of exports. The broker is licensed by the U.S. Treasury Department; while the forwarder is licensed by the Federal Maritime Commission (FMC).

Licensing Requirements

To be eligible for an ocean freight forwarder's license, the applicant must demonstrate to the FMC that he or she (1) has a minimum of three years' experience in ocean freight forwarding duties in the United States and the necessary character to render such services, and (2) has obtained and filed a valid surety bond with the FMC. A shipper whose primary business is the sale of merchandise can perform forwarding services without a license to move its own shipments. In such a case, the shipper is not entitled to receive compensation from the carrier for its services. A license is not required for an individual employee or unincorporated branch office of a licensed ocean freight forwarder. A common carrier or agent thereof may also perform forwarding services without a license with respect to cargo carried under such carrier's own bill of lading (Federal Maritime Commission, 1984).

Freight forwarders have these additional obligations and responsibilities:

- A description of the freight forwarder as consignee on an inland transport bill of lading (i.e., truck or rail) may subject the forwarder to liability for freight charges to the airport or seaport. This can be avoided by clearly indicating on the forwarder's delivery instructions that the forwarder is acting merely as an agent and does not have any ownership interest in the merchandise (see International Perspective 9.4).
- The forwarder is liable to the shipper for its own negligence in selecting the carrier, handling documentation, directing cargo, and classifying shipments. The forwarder, for example, must not totally rely on the shipper's instructions with respect to the classification of a shipment. The forwarder must take reasonable measures to ensure that the classification is proper and consistent with the description on the commercial invoice, bill of lading, and other documents.
- In cases in which the forwarder acts as an NVOCC, its liability is that of a common carrier for loss or damage to cargo.
- The forwarder's liability is limited to the lesser of $50 per shipment or the fee charged for its services. Any claims by the exporter against the forwarder must be presented within ninety days of the date of exportation.
- Each freight forwarder is required to maintain current and accurate records for five years. The records should include general financial data, types of services, receipts, and expenses.
- Forwarders are prohibited from providing any rebates to shippers or sharing any compensation or forwarding fees with shippers, consignees, or sellers. NVOCCs can receive compensation from carriers only when they act as mere forwarders, that is, when they do not issue bills of lading or otherwise undertake carriers' responsibilities.

INTERNATIONAL PERSPECTIVE 9.4

Generally Accepted Principles and Practices in Ocean Transportation

A. **Freight forwarders:** The freight forwarder acts as an agent for the shipper in selecting a common carrier and booking cargo space. It does not issue a bill of lading and is not liable for damage to the goods while they are in the possession of the carrier. Liability may, however, arise in cases where the freight forwarder was negligent in selecting the carrier or customs broker.

B. **Removal of limitation to carrier's liability:** The carrier shall become liable for any loss or damage in connection with the transportation of goods in an amount not exceeding $500 per package or, in cases of goods not shipped in packages, per customary freight unit or the equivalent of that sum in other currency unless the nature and value of such goods have been declared by shipper on the bill of lading. The carrier can be held fully responsible for all damages (without the benefit of the liability limitation) in the following cases: (1) material deviation (carrier's geographical departures from course, unauthorized on-deck storage); (2) failure to give shipper fair opportunity to declare a higher value; (3) misdelivery (the carrier that issued the bill of lading is responsible for releasing the cargo only to the party who presents the original bill of lading, unless otherwise agreed with the shipper).

C. **Burden of proof for shipper and carrier:** The initial burden of proof falls on the shipper to prove that the goods delivered to the carrier were in sound condition. This burden can be met by providing a "clean" bill of lading. The provision of a clean bill of lading shifts the burden to the carrier to prove that the damage or loss to the merchandise was not caused by its negligence.

D. **Four parameters to establish seaworthiness of ship:**

1. Is the ship appropriate for the type of cargo?
2. Is the ship properly equipped for the goods (for reception, carriage, preservation of goods)?
3. Is the ship staffed with a competent crew?
4. Did the carrier properly load, handle, stow, and discharge the goods carried? Proper storage varies according to the types of goods transported.

Chapter Summary

Documents frequently used in export-import transactions	1. Air waybill 2. Bill of exchange 3. Bill of lading 4. Through bill of lading 5. Consular invoice 6. Certificate of origin 7. Inspection certificate 8. Insurance certificate 9. Commercial invoice 10. Dock's receipt 11. Destination control statement 12. Shipper's export declaration 13. Pro forma invoice 14. Export packing list 15. Manifest.

Air transportation	*Reasons for the Growth of Airfreight:* Growing demand for imports of heavy equipment and services in many developing countries; the need for timely delivery of imports; technological changes; the role of integrators and forwarders. *Determinants of Air Cargo Rates* Distance, weight and size of cargo, commodity description, special services. *Carriage of Goods by Air* Major international rules: 1. The Warsaw Convention (1929) 2. The Warsaw Convention—Amended (1955) 3. The Montreal Convention (1999).
Ocean freight	Types of ocean carriers: private fleet, tramps, conference lines.
Carriage of goods by sea	*Major international rules:* 1. The Hague Rules (1924) 2. The Hague-Visby Rules (1968) 3. The Hamburg Rules (1978) 4. The proposed Rotterdam Rules (2008) The rules cover rights and duties of parties to a contract of carriage by sea: duty of carrier, carrier's liability, period of responsibility, limitation of action, and limits of carrier's liability.
Land transport	1. *Rail transport:* handles bulk cargo; absorbs loading, unloading, and other charges 2. *Trucking:* has an advantage over rail transport in flexibility, speed of service, and lower transportation costs
Inland carriage	Inland carriage is the use of an inland carrier to move merchandise from the exporter's warehouse to the sea or airport. Major international rules governing inland carriage: 1. Convention on the Contract for the International Carriage of Goods by Road. 2. Convention Concerning International Carriage by Rail. Both conventions cover areas such as liability for loss or damage to shipment, delays in delivery, and time limits for bringing action.
Freight forwarders	A freight forwarder facilitates the movement of cargo to the overseas destination on behalf of shippers and processes the documentation or performs activities related to those developments. *Role and function of a freight forwarder:* 1. Advises shipper on the most economical choice of transportation. 2. Books space and arranges for pickup, transportation, and delivery of goods.

(*Continued*)

	Licensing requirements: To be eligible for a license as a freight forwarder, the applicant must demonstrate to the FMC that he or she has: 1. A minimum of three years' experience in ocean freight forwarding duties in the United States; 2. The necessary character to render such services; and 3. A valid surety bond filed with the FMC.

Review Questions

1. What is the difference between a bill of exchange and a bill of lading? Are straight bills of lading negotiable?
2. What is the significance of these documents for importers: certificate of origin, destination control statement, pro forma invoice?
3. What factors are likely to contribute to the growth in airfreight in future? Is it a major mode of transportation for cargo?
4. What are the three major types of ocean carriers?
5. What is the carrier's duty under a bill of lading? Discuss the "Himalaya Clause."
6. State the major differences between the Hamburg rules and the Hague/Hague-Visby rules on carriage of goods by sea.
7. Discuss the difference between a freight forwarder and an NVOCC.
8. BG, a stevedoring company in the employment of Tatek shipping, negligently dropped several containers of soft drinks as it was loading them on the ship at Port Everglades, Florida. Is the container a package under the Carriage of Goods by Sea Act (COGSA)? The contents of the container were described in the bill of lading as 2,300 cases of soft drinks, with each case containing four six-packs. Can the shippers claim from Tatek and/or BG?

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World Wide Web Resources

Sites on Documentation and Shipping

http://www.ibs-ibp.com/rp01m.htm (information on export documentation and shipping)
http://www.exportproco.com/guide.htm (an interactive guide to export documentation)
http ://wisdairyexport.org/export.htm (export documentation and labeling of agricultural exports).

Case 9.1 What Constitutes a Package Under COGSA?

In 1936, Congress enacted the Carriage of Goods by Sea Act (COGSA) in order to implement the Hague Rules, which the United States signed in 1924. The language in COGSA is almost identical to that in the Hague Rules except with regard to the carrier's limitation of liability. The Hague Rules limit a carrier's liability to £100 per package or unit, whereas COGSA limits such liability to $500 per package or, in the case of goods not shipped in packages, per customary freight unit. They both indicate that the limitation of carrier's liability applies unless the nature and value of the goods in question have been declared by the shipper before shipment and inserted in the bill of lading.

Given the absence of a definition for the term "package," courts and scholars in the field have provided different interpretations of the Rules. This has become a major source of litigation in cargo damage claims.

When a cargo is fully boxed or crated in such a manner that the identity of the cargo is concealed, the cargo is considered a COGSA package regardless of size,

shape, or weight. If, however, the cargo has been partially packaged for facilitating transportation, the parties' description of the cargo in the bill of lading is a determinative factor. In a case where a company sought damages from a carrier for the loss of 1,680 television tuners shipped from New York to Rio de Janeiro, the court rejected the argument that each cardboard carton was a package and held that each pallet constituted a package. The complete shipment consisted of nine pallets, each loaded with six cardboard cartons holding forty tuners. The dock receipt, the bill of lading, and other documents all indicated that the shipment consisted of nine packages.

Another case involves a container load of perfumes and cosmetics shipped from France to Florida that mysteriously disappeared while in a marine terminal at Port Everglades, Florida. The perfumes and cosmetics in the missing container were packaged in a total of 2,270 shoebox-size corrugated cardboard cartons, which were then consolidated into forty-two larger units. They were bound together with plastic wrap and packed onto forty-two pallets with two cartons remaining. The insurance company paid the shipper for the loss under a cargo insurance policy and brought a subrogation action against the carrier. The onboard bill of lading described the cargo as four container units. The pro forma invoice and the revised bill of lading stated that there were forty-two packages plus two cartons. The carrier issued a clean bill of lading with these particulars (forty-four packages). If the bill of lading does not show how many separate packages there are, then, each container is generally considered a package.

Case 9.2 The Container Revolution

Until the 1960s, nearly all international cargo was delivered to the dockside in small packages and shipped on break-bulk ships. They came in boxes, crates, barrels, and drums and loaded on board ship, stowed, and, at the end of the voyage, unloaded individually. This process was complicated and time consuming and exposed cargo to damage and theft.

The container revolution involved the introduction of truck-trailer-size boxes as cargo containers. These standardized containers can be filled with cargo at the farm, factory, or loading depot and then sealed and taken by truck, train, or barge to a port where it is put on board a ship. This change greatly reduced cargo handling time (it costs much less to load and unload containers by crane than it is to load and unload individual packages). Containers also eliminated costs associated with shoreside warehouses to protect conventional cargo from the weather. Export costs relating to crating and packaging as well as potential loss or damage to cargo are substantially reduced.

In typical container transportation, the shipper puts individual packages or cartons in a container, usually at an inland facility, and then the container is moved by rail or truck to a container yard close to a seaport. Once the ship arrives, the container is pulled by a tractor alongside the ship and placed on board the

container ship by cranes. Container ships have specially built vertical cells that are designed to firmly hold the containers in place during the voyage. Today more than 90 percent of world trade is moved in containers. Only a handful of commodities are shipped in break-bulk: steel, paper, plywood. Even rubber and cocoa beans, which were largely shipped in break-bulk, are now moved in containers. The container revolution necessitated the development of port infrastructure such as dockside cranes and standardized containers, including connections to railways and highways, as well as the designation and building of specific areas for containers.

Questions

1. In case 9.1, what is the correct number of COGSA packages?
2. Discuss the major benefits of cargo containers.

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Section IV

Payment Terms and Procedures

ten
Exchange Rates and International Trade

Foreign Exchange Transactions

An exchange rate is the number of units of a given currency that can be purchased for one unit of another currency. It is a common practice in world currency markets to use the indirect quotation, which is quoting all exchange rates (except for the British pound) per U.S. dollar. *The Financial Times* foreign exchange data for May 1, 2013, for example, shows the quotation for the Canadian dollar as being 1.01 per one U.S. dollar. Direct quotation is the expression of the number of U.S. dollars required to buy one unit of foreign currency (Table 10.1). The direct U.S. dollar quotation on May 1, 2013, for the Canadian dollar was U.S. $0.99. Although it is common for foreign currency markets around the world to quote rates in U.S. dollars, some traders state the price of other currencies in terms of the dealer's home currency (cross rates), for example, Swiss francs against Japanese yen, Hong Kong dollar against Colombian pesos, and so on.

TABLE 10.1 Currency Trading, Monday, May 1, 2013

Selected countries	Indirect quotation currency per U.S. $	Cross rates (per yen/per euro)
Canada	1.01	0.0104/1.3301
France	0.76	0.0078/
Germany	0.76	0.0078/
United Kingdom	0.64	0.0066/0.8472
Japan	97.33	128.2750
United States	—	0.0103/1.3186

Source: money.cnn.com/data/currencies, May 1, 2013.

Strictly speaking, it is reasonable to state that the rate of the foreign currency against the dollar is a cross rate to dealers in third countries.

The foreign exchange market is a place where foreign currency is purchased and sold. In the same way that the relationship between goods and money in ordinary business transactions is expressed by the price, so the relationship of one currency to another is expressed by the exchange rate. A large proportion of the foreign exchange transactions undertaken each day are between banks in different countries. These transactions are often a result of the wishes of the banks' customers to consummate commercial transactions, that is, payments for imports or receipts for exports. Other reasons for individual companies or governments to enter into the foreign exchange market as buyers or sellers of foreign currencies include the following:

- Individuals and companies use foreign currencies for foreign travel, purchase of foreign stocks and bonds, and foreign investment; foreign currencies are also used in receipt of income (e.g., interest, dividends, royalties) from abroad and payment of such income in foreign currency.
- Central banks enter the foreign exchange market and buy or sell foreign currency (in exchange for domestic currency) to stabilize the national currency, that is, to reduce violent fluctuations in exchange rates without destroying the viability and freedom of the foreign exchange market.
- Individuals and companies speculate in foreign currency, that is, they purchase foreign currency at a low rate with the hope that they can sell it at a profit.

Foreign exchange trading is not limited to one specific location. It takes place wherever such deals are made, for example, in a private office or even at home, far away from the dealing rooms or facilities of companies. Most of these transactions are carried out between commercial banks and their customers or between commercial banks, which buy and sell foreign currencies in response to the needs of their clients. For example, a Canadian bank sells Canadian dollars to a French bank in exchange for euros. This transaction, in effect, allows the Canadian bank the right to draw a check on the French bank for the amount of the deposit denominated in euros. Similarly, it will enable the French bank to draw a check in Canadian dollars for the amount of the deposit

Foreign exchange rates are based on the supply and demand for various currencies, which, in turn, are derivatives of the fundamental economic factors and technical conditions in the market (Salvatore, 2005). In the United States, for example, the continuous deterioration in the trade deficit in the 1970s, mainly due to increased consumption expenditures on foreign goods, led to an oversupply of dollars in foreign central banks. This, in turn, resulted in a lower dollar in foreign exchange markets. Besides a country's balance of payments position, factors such as interest rates, growth in the money supply, inflation, and confidence in the government are important determinants of supply and demand for foreign currencies and, thus, the exchange rate. The following are some examples:

- The U.S. dollar depreciated substantially against the euro and other major currencies in recent years partly due to interest rate tightening by the European Central Bank and high U.S. trade and budget deficits. Between April 2012 and February 2013, for example, the dollar exchange rate declined from 1 euro = 1.32 USD to 1 euro = 1.36 USD. Currency traders buy currencies of countries with high interest rates in order to maximize their investment returns and sell those currencies with low interest rates.

- The Mexican peso has been appreciating during the past few years due to an increase in the inflow of funds resulting from the rise of international oil prices. The increase of foreign investment in the country has also contributed to the rise in value of the peso, thus causing a reduction in its current account deficit and foreign debt.
- The Japanese yen has depreciated by a substantial margin against other currencies since April 2013 due to the government's aggressive policy of monetary easing.
- The Chinese renminbi has appreciated against major currencies such as the British pound and the U.S. dollar.

Exchange rate fluctuations can have a profound effect on international trade. Export-import firms are vulnerable to foreign exchange risks whenever they enter into an obligation to accept or deliver a specified amount of foreign currency at a future point in time. These firms are then faced with the prospect that future changes in foreign currency values could either reduce the amount of their receipts or increase their payments in foreign currency. U.S. importers of Japanese goods, for example, are likely to incur significant losses when the dollar takes a fall against the yen, often wiping out a significant portion of their profits. In some cases, it may also be that such changes will bring about financial benefits.

The most important types of transactions that contribute to foreign exchange risks in international trade include the following:

- Purchase of goods and services whose prices are stated in foreign currency, that is, payables in foreign currency
- Sales of goods and services whose prices are stated in foreign currency, that is, receivables in foreign currency
- Debt payments to be made or accepted in foreign currency.

Most export-import companies do not have the expertise to handle such unanticipated changes in exchange rates. Banks with international trade capabilities and consultants can help assess currency risks and advise companies to take appropriate measures.

The impact of exchange rate fluctuations on export trade can be illustrated by the following example. Since the dollar began to decline against major currencies, many European and Asian exporters to the U.S. market have been faced with the difficult task of balancing the need to increase prices to preserve profit margins and the importance of keeping prices stable to maintain market shares. Many exporters have been reluctant to increase the prices of their exports to fully offset the decline in the dollar. Some have responded by shifting factories to North America in order to cushion them from currency fluctuations. Prominent examples include the establishment of production facilities by DaimlerChrysler in Alabama and BMW in South Carolina. In April, 2013, General Motors blamed the strength of the Australian dollar, which in April 2013 hit a twenty-eight-year high on trade-weighted basis, for a decision to cut five hundred jobs in Australia. Businesses blame the rising dollar for undermining exports and inward investment. In May 2013, South Korea's government announced $10 billion in new financial support to help the country's exporters, as April data showed a monthly fall in exports amid slowing global demand and a weaker Japanese currency.

The impact of exchange rate risks is felt more by export-import companies than by domestic firms. To the extent that an exporter's inputs are domestic, a strong domestic currency could lead to loss of domestic and foreign markets. Importers also face a loss of domestic markets due to the rise in the price of imports if the domestic currency weakens. In addition, such firms are vulnerable to exchange risks arising from receivables or payables in foreign currency.

INTERNATIONAL PERSPECTIVE 10.1

Exchange Restrictions

There are only a few countries that impose no restrictions on the use of the foreign exchange market. This means that their currency is fully convertible into foreign currency for all uses: trade in goods and services as well as international financial activities. Many Western economies, such as Canada, the United States, Japan, the United Kingdom, and Germany, have convertible currencies.

Currencies of most developing and former Communist nations, however, are either not convertible or legally convertible only at artificial, government-established rates. Such exchange restrictions may be imposed for competitive reasons (keeping a lower value), to promote foreign investment or to discharge debt payments (maintaining a high value). The most extreme form of exchange restrictions (control) is limitation on the availability of foreign currency to purchase imports. Limits can also be placed on the use of foreign currency for certain transactions, such as imports of luxury goods, in order to conserve foreign currency. In terms of exports, exchange control rules could require that exports be properly paid for and that payment be forthcoming within a reasonable time, that is, that proceeds from exports be repatriated to the country's bank within a given period of time after shipment.

Protection Against Exchange Rate Risks

There are several ways in which export-import companies can protect themselves against unanticipated changes in exchange rates. The risk associated with such transactions is that the exchange rate might change between the date the export contract was made and the date of payment (the settlement date), which is often sixty to ninety days after contract or shipment of the merchandise.

Shifting the Risk to Third Parties

Hedging in Financial Markets

Through various hedging instruments, firms can reduce the adverse impact of foreign currency fluctuations. This allows firms to lock in the exchange rate today for receipts or payments in foreign currency that will happen at some time in the future. Current foreign exchange rates are called spot prices; those occurring at some time in the future are referred to as forward prices. If the currency in question is more expensive for forward delivery (for delivery at some future date) than for ordinary spot delivery (i.e., for delivery two business days following the agreed-upon exchange date), it is said to be at a premium. If it is less expensive for forward delivery than for spot delivery, it is said to be at a discount.

In Table 10.2, the forward krone is at a premium since the forward krone is more expensive than the spot. The forward Canadian dollar is at a discount because its forward price is cheaper than spot. When viewed from the point of view of the U.S. dollar, it can also be stated

TABLE 10.2 Hypothetical Exchange Rates, Currency per U.S. Dollar

	Danish krone	Canadian dollar
Spot rate	1.8037	1.4257
Thirty-day forward	1.7948	1.4296
Ninety-day forward	1.7887	1.4273

that the forward dollar is at a discount in relation to the krone or that the forward U.S. dollar is at a premium in relation to the Canadian dollar.

It is pertinent to underscore some salient points about hedging in foreign exchange markets:

- *Hedging is not always the most appropriate technique to limit foreign exchange risks.* There are fees associated with hedging, and such costs reduce the expected value from a given transaction. Export-import firms should seriously consider hedging when a high proportion of their cash flow is vulnerable to exchange rate fluctuations. This means that firms should determine the acceptable level of risk that they are willing to take. In contrast, firms with a small portion of their total cash exposed to foreign exchange rate movements may be better off playing the law of averages—shortfalls could be eventually offset by windfall gains.
- *Hedging does not protect long-term cash flows.* Hedging does not insulate firms from long-term adjustments in currency values. (O'Connor and Bueso, 1990). Thus, it should not be used to cover anticipated changes in currency values. A U.S. importer of German goods would have found it difficult to adequately hedge against the predictable fall of the dollar during the period 2007–2009. The impact of such action is felt in terms of higher dollar prices paid for imports.
- *Forward market hedges are available in a very limited number of currencies.* Most currencies are not traded in the forward market. However, many countries peg their currency to that of a major industrial country whose currency is traded in the forward market. Many Latin American countries, for example, peg their currencies to the U.S. dollar. This insulates U.S. firms from foreign exchange risk in these countries unless the country changes from the designated (pegged) official rate. Foreign firms, that is, non-U.S. firms, in these countries can reduce potential risks by buying or selling dollars (in the event of purchases or sales to these countries) forward as the case may be.

Example 1: Suppose the Colombian peso is pegged to the U.S. dollar at $1 = 1,000 pesos. A British firm that is to make payment in pesos for its imports from Colombia could hedge its position by buying U.S. dollars forward. On the settlement date, pounds will be converted into dollars, which, in turn, could be converted into pesos. This assumes that Colombia does not change the pegged rate during the period.

- *Hedging should not be used for individual transactions.* Since most export-import firms engage in transactions that result in inflows and outflows of foreign currencies, the

most appropriate strategy to reduce transaction costs is to hedge the exported net receivable or payable in foreign currency.

Example 2: Suppose a Canadian firm has receivables from two Japanese buyers amounting to five million yen and payables to four Japanese suppliers worth nine million yen. Instead of hedging all six transactions, the Canadian firm should cover only the net short position (i.e., four million yen) in yen. This reduces the transaction cost of exchanging currencies for the firm.

Spot and Forward Market Hedge

As previously noted, a spot transaction is one in which foreign currencies are purchased and sold for immediate delivery, that is, within two business days following the agreed-upon exchange date. The two-day period is intended to allow the respective commercial banks to make the necessary transfer. A forward transaction is a contract that provides for two parties to exchange currencies on a future date at an agreed-upon exchange rate. The forward rate is usually quoted for one month, three months, four months, six months, or one year. Unlike hedging in the spot market, forward market hedging does not require borrowing or tying up a certain amount of money for a period of time. This is because the firm agrees to buy or sell the agreed amount of currency at a determinable future date, and actual delivery does not take place before the stipulated date.

Example 1: Spot market hedge. On September 1, a U.S. importer contracts to buy German machines for a total cost of 600,000 euros. The payment date is December 1. When the contract is signed on September 1, the spot exchange rate is $0.5000 per euro and the December forward rate is $0.5085 per euro. The U.S. importer believes that the euro is going to appreciate in value in relation to the dollar.

The import firm could buy 600,000 euros on the spot market on September 1 for $300,000 and deposit the euros in an interest-bearing account until the payment date. If the firm does not hedge and the spot exchange rate rises to $0.5128 euro on December 1, the importer will suffer a loss of $7,680, or (0.5128–0.5000) × 600,000.

The import firm could also borrow $300,000 and convert at the spot rate for 600,000 euros. The euros could be lent out or put in certificates of deposit or some other investment vehicle until December 1, when payment is to be made to the exporter. The U.S. dollar loan will be paid from the proceeds of the resale without any foreign exchange exposure. This is often referred to as credit hedge.

Example 2: Forward market hedge. On September 1, a U.S. exporter contracts to sell U.S. goods for SF (Swiss francs) 250,000. The goods are to be delivered and payment received on December 1. When the contract is signed, the spot exchange rate is $0.6098/SF and the December forward rate is $0.6212/SF. The

Swiss franc is expected to depreciate, and the December 1 spot exchange rate is likely to fall to $0.5696/SF.

The U.S. exporter has two options. First, it can sell its franc receivable forward now and receive $0.6212 per franc on the settlement date (December). Second, it can wait until December and then sell francs on spot. Clearly, the forward market hedge is preferable, and the U.S. exporter would gain: (0.6212–0.6098) × 250,000 = $2,850. The decision to use the forward market is based upon an assessment of what the future spot rate is likely to be. It is also important to bear in mind the impact of transaction costs before a firm makes a decision on what action to take. A credit hedge could have been feasible if the spot rate in United States had been higher than the forward rate.

Swaps

A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The central feature of this transaction is that the bank arranges the swap as a single transaction, usually between two partners. Swaps are used to move out of one currency and into another for a limited period of time without the exchange risk of an open position.

Example: A U.S. firm sells semiconductor chips to Nippon, a Japanese firm, for sixty million yen, and payment was made upon receipt of shipment on October 1. The U.S. firm has payables to Nippon and other Japanese firms of about sixty million yen for the purchase of merchandise, with payment due on January 1. The spot exchange rate on October 1 is 120 yen per dollar and the January sixty-day forward rate is 125 yen per dollar.

The U.S. firm sells its sixty-million-yen receipts on the spot market for $500,000 at the price of $1 = 120 yen. Simultaneously, the firm contracts with the same or different bank to purchase sixty million yen in sixty days at the forward price of 125 yen per dollar. In addition to its normal profits on its exports, the U.S. firm has made a profit of 2.5 million yen from its swap transaction. In cases in which the delivery date to the Japanese firms is not certain, the U.S. firm could use a time option that leaves the delivery date open, while locking the exchange rate at a specified rate.

Other Hedging Techniques

Export/import companies can use different techniques in order to avoid foreign exchange risk:

- *Hedging receipts against payables:* An export firm that has receivables in foreign currency (thirty million British pounds) could hedge its receipts against a payable of thirty million pounds to the same or another firm at about the same time. This is achieved with no additional cost and without going through the foreign exchange market. The

same method could be used between export-import firms and their branches or other affiliate companies abroad.

- *Accelerating or delaying payments:* If an importer reasonably believes that its domestic currency is likely to depreciate in terms of the currency of its foreign supplier, it will be motivated to accelerate its payments. This could be achieved by buying the requisite foreign currency before it appreciates in value. However, payments could be delayed if the buyer believes that the foreign currency in which payment is to be made is likely to depreciate in value in terms of the domestic currency.

Guarantees and Insurance Coverage

In certain cases, exporters require a guarantee by the importer, a bank, or another agency against the risk of devaluation or exchange controls. Certain types of insurance coverage are also available against exchange controls. In view of its high cost, hedging is a better alternative than insurance.

Shifting the Risk to the Other Party

Invoicing in One's Own Currency

Risks accompany all transactions involving a future remittance or payment in foreign currency. If the payment or receipt for a transaction is in one's own currency, the risk arising from currency fluctuations is shifted to the other party. Suppose a Korean firm negotiated to make payments (ninety days after the contract date) in its domestic currency (won) for its imports of equipment from a Canadian manufacturer. This shifts the foreign currency risk to the exporter, which will have to convert its won receipts into Canadian dollars. Payment in one's own currency shifts not only the risk of devaluation to the other party but also the risk of imposition of exchange controls by the importing country against convertibility and repatriation of foreign currency.

Invoicing in Foreign Currency

In the event that the agreement stipulates that payment is to be made in foreign currency, it is important for the exporter to require inclusion of a provision that protects the value of its receipts from currency devaluation. In the previous example, the contract could provide for an increase in payment to compensate the Canadian manufacturer/exporter for losses arising from currency fluctuations.

Another method would be to make certain assumptions about possible adverse changes in the exchange rate and add it to the price. If currency changes are likely to result in a 10 percent loss, the price change could be increased by that percentage. An export contract could also provide for the establishment of an escrow account in a third country's currency (a stable currency) from which payments will be made. This protects the exporter from losses due to depreciation of the importer's currency.

INTERNATIONAL PERSPECTIVE 10.2

The Euro: A Brief Overview

What is the euro? The euro is a common currency that replaced all the separate currencies of the participating countries of the European Union (EU). On January 1, 1999, the euro became the legal currency of eleven members of the European Union. The Euro paper currency and coins are the sole legal tender in the seventeen participating members of the EU.

Participating members: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Denmark, Sweden, and the United Kingdom declined to participate at this stage.

The convergence criteria: In order to participate in the single European currency, countries were required to meet certain conditions: inflation rates below 2 to 3 percent, public debt no more than 60 percent GDP, and budget deficits less than or equal to 3 percent GDP.

Benefits and costs: (1) For businesses that are involved in cross-border trade, the euro eliminates the cost of foreign exchange (e.g., hedging expenses) with regard to all intra-zone transactions and also eliminates foreign currency risks in relation to cross-border investments within the euro zone; (2) European businesses have largely benefited from low inflation and interest rates, which is an important policy of the European Central Bank; (3) besides eliminating exchange rate uncertainty, the Euro allows consumers and businesses to compare costs and prices, putting downward pressure on prices and reducing the practice of charging different prices in different markets within Europe; (4) member states hope to achieve rapid economic and financial integration, which will lead to greater economic and budgetary discipline and reduced cost of borrowing in international financial markets; (5) seigniorage will be reduced by the use of the euro as an international currency. The major costs associated with the euro are related to the inability of members to pursue independent policies to address specific macroeconomic problems. In a fully integrated economy like the United States, such problems are overcome by labor mobility or fiscal redistribution.

Chapter Summary

Exchange rates	An exchange rate is the number of units of a given currency that can be purchased for one unit of another currency
Reasons for the existence of the foreign exchange market	1. Foreign travel 2. Purchase of foreign stocks and bonds 3. Foreign investment and other receipts and payments in foreign currency 4. Reduction of currency fluctuations 5. Speculation.

Review Questions

1. Differentiate between the spot and the forward exchange rate. How can a U.S. import firm use the forward market to protect itself from the adverse effect of exchange rate fluctuations?
2. What does it mean when a currency is trading at a discount to the U.S. dollar in the spot market?
3. Why do export-import firms enter the foreign exchange market?
4. Hedging is not always the most appropriate technique to limit foreign exchange risks. Discuss.
5. If a Canadian exporter accepts payments in foreign currency from buyers in the United States, which party bears the currency fluctuation risk? Explain.
6. The euro has now replaced seventeen national currencies. What are the implications of this development to companies exporting to the European Union?
7. Suppose that the spot rate of the British pound today is $1.50 while the six-month forward rate is $1.55. How can a U.S. importer who has to pay 30,000 British pounds in six months hedge its foreign exchange risk?
8. In reference to question 7, what happens if the U.S. importer does not hedge and the spot rate of the pound goes up to $1.60?
9. Suppose the spot rate of the yen today is $0.0100 while the three-month forward rate is $0.0096. How can a U.S. exporter who is to receive 350,000 yen in three months hedge its foreign exchange risk? What happens if the exporter does not hedge and the spot rate of the yen in three months is $0.0098?
10. Do you think the U.S. dollar will continue to maintain its key currency status? Explain.

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World Wide Web Resources

Exchange Rates

Information on currencies, currency derivatives, and foreign exchange rates: http://www.margrabe.com/Currency.html

Information on Federal Reserve data on exchange rates, balance of payments and trade: http://research.stlouisfed.org/fred2/categories/13

Exchange Rates and Trade

Information by the Federal Reserve on inflation and exchange rates: http://www.house.gov/jec/fed.htm
Risk Management

Guide to risk management and information related to this subject: http://www.contingencyanalysis.com/

Case 10.1 Will the U.S. Dollar Maintain Its Key Currency Status?

The global economy has largely depended on the United States, which absorbs about 20 percent of global exports. Many countries lack sufficient domestic demand to sustain economic growth. They consume limited imports and often depend on exports to the U.S. market. For example, exports to the United States accounts for about 18 percent of China's total exports and 75 percent of the combined exports of Canada and Mexico in 2012. In the face of the mounting U.S. merchandise trade deficits ($780 billion in 2012), there is likely to be a shift in the mix of global consumption away from the United States. Other developed and rich developing nations will have to boost private consumption and move the world away from excessive dependence on the U.S. market. This also requires addressing structural impediments to import demand in these countries.

The United States has maintained a strong dollar policy because this keeps U.S. inflation low (due to low price of imports) and makes U.S. assets expensive for foreign investors. Countries exchange their exports for dollars, which are often invested in U.S. Treasuries to shore up the value of their domestic currencies.

Despite rising U.S. trade and budget deficits, the dollar remains the major currency for conducting international trade and investment. For example, 85 percent of foreign exchange trading (in volume) was in dollars in 2012, compared to 40 percent in euros. Critical commodities such as oil are denominated in dollars.

A number of factors lead one to believe that the dollar will continue to maintain its key currency status.

- U.S. economic growth has been and will remain significantly stronger than growth in Japan and major euro zone countries. Inflation has been tamed due to low cost imports.
- The United States has a large, open credit market, diversified financial institutions, and an independent central bank. Japanese and European financial institutions lack the breadth and depth of their U.S. counterparts. Many are beginning to recover after scandals.
- Incentives for investments (rates of return, yields) in the United States are higher than in Japan and Europe.

Questions

1. Why does the U.S. government maintain a strong dollar policy?
2. Do you think the euro will replace the U.S. dollar as a key global currency in the coming decade? Discuss.

Case 10.2 Currency Wars

Many countries (particularly advanced economies such as those in the United States and Europe) are finding economic growth difficult to achieve because of a lack of domestic demand: consumers and businesses are not spending. One way in which governments can try to drive economic growth is by adopting policies that increase their country's exports.

There are various options for doing this, but a favored choice is to depreciate the local currency so that a country's goods and services become relatively cheaper on the global stage. A weak currency also increases the cost of imports, thus making domestic producers more competitive in the national economy, again driving growth.

Since mid-2008, a number of the large exporting countries have adopted policies that have resulted in their currencies remaining weak. The Chinese government is following such policies, and the renminbi remains undervalued (although it has been appreciating against major currencies over the past few years). The United States has been very critical of the Chinese government, but the United States' own bursts of quantitative easing (QE), which were undertaken in an effort to underpin the economy, have affected the U.S. currency, and the Chinese administration in turn argues that the United States is also employing policies to ensure that its own currency remains weak. Similarly, the United Kingdom has implemented QE to support its economy. Meanwhile, the sovereign debt crisis in Europe and politicians' failure to agree to a long-term solution to the problems in Greece in particular has weakened the euro. Japan also recently decided in favor of deliberately weakening the yen.

Currency wars can seriously affect the risks associated with doing cross-border business. Three key risks exist:

1. *Policy uncertainty:* As countries attempt to offset weak currencies, governments can implement policies that affect cross-border business. One example is the pegging of the Swiss franc to the euro, which effectively devalued the Swiss franc overnight by 6 percent, leaving traders with an unexpected potential loss.
2. *Currency uncertainty:* Although currency volatility can be offset through hedging, this adds further costs to businesses, undermining profits amid already-shrinking margins.
3. *Supply chain disruption:* Countries with stronger currencies implement policies to protect their domestic sector. Barriers to trade such as tariffs and import quotas threaten the smooth running of supply chains.

What Usually Happens When Currency Wars Break Out?

The most famous currency wars example is from the 1930s, when countries got into a vicious spiral of currency devaluations in order to try to maintain the competitiveness of their exporters. All that was achieved was that these countries'

trading partners sank deeper into the mire of recession, further curtailing trade and leading to more depreciations. Thus, the global economy shrank and global trade and investment was devastated, a situation that ended only after the outbreak of the Second World War. Although we are not predicting that the current situation will lead to such a severe outcome, there are some parallels between the significant problems in each historical case.

As countries rush to protect the competitiveness of their exports, currency wars will prompt a number of problems, such as asset-price volatility (particularly in the currency markets), increased adoption of trade protection policies, and a rise in antidumping and countervailing duty disputes. These all raise risks for cross-border trade and investment.

Questions

1. Do you think this policy will continue in the long run?
2. What other alternatives are available for countries?

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Methods of Payment

The rapid growth and expansion in global trade cannot be sustained without efficient and timely payment arrangements. Nonpayment or delays in payment for imports could tie up limited credit facilities and create liquidity problems for many exporting companies. Advance payments by overseas customers would similarly tie up a buyers' limited resources and do not necessarily guarantee delivery of agreed merchandise. The ideal payment method is one that protects the contending interests of both sellers and buyers.

Exporters often seek to develop foreign markets by using payment arrangements that are less costly to the buyer, such as consignment sales, open accounts, and documentary drafts, whereby the seller is paid by the foreign wholesaler or retailer only after the goods have been received or sold. It is estimated that about 35 to 50 percent of exports from the United States and the United Kingdom are sold on open account and/or consignment (Cheeseright, 1994; Madura, 2011). This means that the risk of delay in payment or nonpayment could have a crucial effect on cash flow and profits (see Figure 11.1).

FIGURE 11.1 Export Payment Terms Risk/Cost Tradeoff

Export companies need access to credit reports on a global basis. There is a need to increase the existing database on companies in different parts of the world to ensure that formal reviews on credit decisions are based on current and reliable information. It is also important to consider credit insurance and other safeguards.

Consignment Sales

In a consignment sale, the exporter sends the product to an importer on a deferred-payment basis; that is, the importer does not pay for the merchandise until it is sold to a third party. Title to the merchandise passes to the importer only when payment is made to the exporter (Shapiro, 2006). Consignment is rarely used between unrelated parties, for example, independent exporters and importers (Goldsmith, 1989). It is best used in cases involving an increasing demand for a product for which a proportioned stock is required to meet such need (Katzman, 2011; Tuller, 1994). It is also used when a seller wants to test-market new products or to test the market in a new country.

For the exporter, consignment is the least desirable form of selling and receiving payment. The problems associated with this method include the following:

- *Delays in payment:* Consignee bears little or no risk, and payment to seller is delayed until the goods are sold to a third party. This ties up limited credit facilities and often creates liquidity problems for many exporting firms.
- *Risk of nonpayment:* Even though title to the goods does not pass until payment is made, the seller has to acquire possession of merchandise (to sell in importer's country or ship back to home country) in the event of nonpayment. This involves litigation in the importer's country, which often is time consuming and expensive.
- *Cost of returning merchandise:* If there is limited success in selling the product, there is a need to ship it back to the exporter. It is costly to arrange for the return of merchandise that is unsold.
- *Limited sales effort by importers:* Consignees or importers may not be highly motivated to sell merchandise on consignment because their money is not tied up in inventory. They are likely to give priority to products in which they have some financial involvement.

In view of these risks, consignment sales should be used with overseas customers that have extremely good credit ratings and are well known to the exporter. They would also be satisfactory when the sale involves an affiliated firm or the seller's own sales representative or dealer (Onkvisit and Shaw, 2008). This method is frequently used by multinational companies to sell goods to their subsidiaries.

A number of issues should be considered before goods are sold on consignment between independent exporters and importers. First, it is important to verify the creditworthiness of foreign importers, including data on how long particular companies take to settle bills. Exporters can have instant access to information on overseas customers from credit agencies. No exporting company should consider itself too small to take advice on credit matters. Bad and overdue debts erode profit margins and can jeopardize the viability of an otherwise successful company.

Information on creditworthiness should also include analysis of commercial or country risk factors such as economic and political stability as well as availability of foreign currency

to purchase imports. U.S. banks and their overseas correspondents and some government agencies have credit information on foreign customers.

It is also advisable to consider some form of credit insurance to protect against default by overseas customers. Outstanding debt often represents about 30 percent of an export company's assets, and it is important to take credit insurance to protect these assets. Credit insurance also helps exporters obtain access to a wide range of banking services and an improved rate of borrowing (Kelley, 1995; Powell, 2010). Financial institutions tend to look more favorably on businesses that are covered and are often prepared to lend more money at better terms. The parties should also agree on who will be responsible for risk insurance on merchandise until it is sold and payment received by seller and on who pays for freight charges for returned merchandise.

Open Account

An open account is a contractual relationship between an exporter and an importer in which a trade credit is extended by the former to the latter whereby payment is to be made to the exporter within an agreed period of time. The seller ships the merchandise to the buyer and separately mails the relevant shipping documents. Terms of payment range from 30 days to 120 days after date of shipping invoice or receipt of merchandise, depending on the country (Reynolds, 2003).

As in the case of consignment sales, open account is rarely used in international trade between independent exporters and importers. Exporters are often apprehensive about potential defaults by overseas customers. They lack accurate information or may doubt the reliability of available data on foreign buyers to evaluate and determine their creditworthiness to purchase on open account. Unlike consignment sales, importers are expected to remit payment within a certain agreed-upon period regardless of whether they resold the product to third parties.

Open account is often used to increase sales by assisting foreign distributors to start new product lines or to expand existing ones. It could also be used when a seller wants to test-market a new product or try a new market in a different country.

This arrangement gives the buyer/distributor enough time to resell the product to domestic customers and then pay the exporter, while generating business goodwill for future dealings. Many developing nations prohibit purchases on open account and consignment sales because of currency restrictions and lack of control over their balance of payments (Shapiro, 2006).

A major weakness of this method is that the importer could delay payment until merchandise is received, even when the importer is expected to pay within a specified period after shipment. This method also carries a greater risk of default or nonpayment by the buyer. This makes it difficult to sell the account receivable.

Open-account financing is often used for trade between parent and subsidiary companies. It is also used for sales to well-established customers with good credit ratings. When open-account sales to third parties are contemplated, it is important to verify the integrity of the buyers through a credit investigation. This should also take into account the importing country's political and economic conditions. Sources range from commercial credit agencies, such as Equifax and Dunn & Bradstreet, to chambers of commerce, trade associations, commercial banks, and public agencies, such as the Department of Commerce. It is advisable to insure trade debts to protect the seller against default by the importing company. Another safeguard would be to secure collateral to cover a transaction.

Documentary Collection (Documentary Draft)

The documentary collection or documentary draft is one of the most common methods of making payments in international trade. To facilitate the transaction, two banks are usually involved, one in the exporter's country and one in the buyer's country. The banks may be independent banks or branches of the same bank.

A draft can be drawn (documents payable) in the currency of the country of payment or in a foreign currency. This method of payment falls between the open account, which favors the buyer, and the letter of credit, which protects the exporter. Bank fees are less expensive, usually a specific sum for each service, as opposed to a percentage of the transaction amount, which is used for letters of credit.

A typical documentary collection procedure includes the following steps (see also Figure 11.2):

- After the exporter (drawer) and overseas customer (drawee) agree on the terms of sale, the exporter arranges for shipment and prepares the necessary documents such as invoice, bill of lading, certificate of origin, and draft.
- The exporter forwards the documents to its bank (remitting bank) with instructions.
- The remitting bank then forwards the documents to its overseas correspondent bank (collecting bank) in the importer's country, with the exporter's instruction letter that authorizes release of documents against payment (D/P) or acceptance (D/A) or other terms.
- The collecting bank contacts the importer to effect or accept payment. If the instruction is documents against payment (D/P), the importer pays the collecting bank in exchange for the documents. The collecting bank then sends the proceeds to the remitting bank for payment to the seller. If the instructions are documents against acceptance (D/A), the collecting bank releases documents to the overseas customer only upon formal acceptance of the draft. Once the draft is accepted, the collecting bank releases the documents to the buyer. On or before maturity, the collecting bank then presents the accepted draft for payment. When the buyer pays, the collecting bank remits the funds in accordance with instructions.

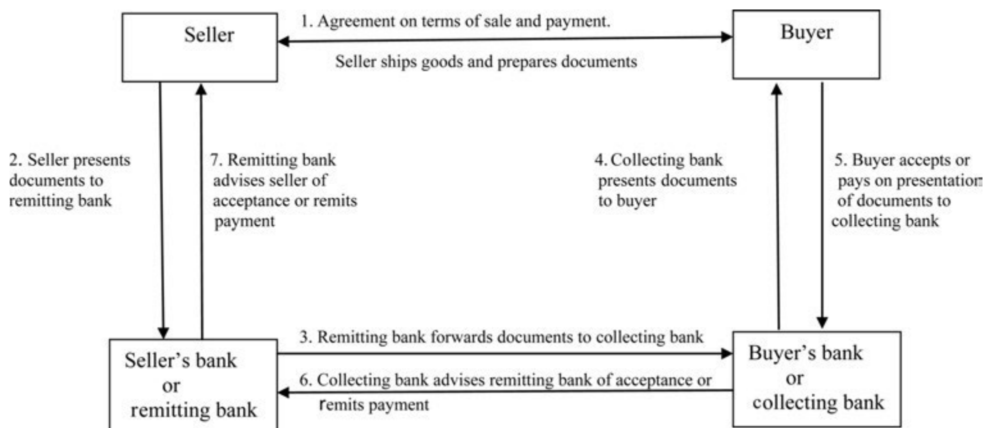

FIGURE 11.2 Documentary Collection

The basic instructions for collection of shipping documents (in addition to those pertaining to release of documents and remittance of funds) include the following:

- Procedures as to how nonpayment or nonacceptance is to be communicated to the remitting bank
- Instructions as to who pays the bank's collection charges
- Listing of documents enclosed
- Name of a party to be contacted in case a problem arises.

The banking practice relating to documentary draft is standardized by the Uniform Rules for Collections (International Chamber of Commerce [ICC], 1995). The uniform rules apply only when the parties to the contract agree to be governed by those standards. The rules set out the rights and duties of banks and users of documentary collections (Reynolds, 2003).

Documents Against Payment

In a typical document against payment (D/P) transaction, the exporter draws a draft on the foreign buyer (drawee) through a foreign bank (collecting bank) that receives the collection documents from the exporter's remitting bank (Johnson and Bade, 2010; Wells and Dullat, 1991). In this instance, a sight draft is presented with other documents specified by the buyer or the buyer's country, and the collecting bank provides these documents to the buyer upon payment. This means that the buyer does not receive the documents and thus does not obtain possession of the goods until payment is made to the collecting bank. This method is widely used in foreign trade and often designated as "sight draft, documents against payment" (S/D, D/P).

The original order bill of lading giving title to the goods is made out to the order of the shipper and is endorsed by the latter either in blank or on the order of the collecting bank (Maggiori, 1992). This ensures that the seller retains title and control of the shipment until it reaches its destination and payment is made to the collecting bank. When the collecting bank is paid, it endorses the bill of lading and other documents to the buyer. The original bill of lading must be properly endorsed by the buyer and surrendered to the carrier before buyer procures possession of the shipment.

Order bills of lading are not available with air shipments. If the importer's name is on the air waybill (not a negotiable document) as consignee, often nothing more is needed to hand over the merchandise to the buyer (importer) than the latter's identification, and the importer can obtain the goods without payment. This problem can be resolved by designating a third party, such as a custom broker or, with prior permission, a collecting bank as consignee on the air waybill. The importer's name should be mentioned as the party to be notified for identification of shipment.

In using S/D, D/P, there remains the potential risk of nonpayment by importer. The buyer's ability or willingness to pay may change between the time the goods are shipped and the time the draft is presented for payment (Johnson and Bade, 2010; McMahon et al., 1994). It could also be that the policy of the importing country may change (e.g., exchange controls), making it difficult for the importer to make payments. In the event of nonpayment by the

buyer, the exporter has the choice of having the merchandise shipped back or selling it to another buyer in the importing country.

Documents Against Acceptance

In this method, the exporter allows the overseas customer a certain period of time to effect payment for the shipment. The buyer receives the documents, and thus the title, to the goods in exchange for acceptance of the draft to pay at some determinable future date. A time draft is used to establish the time of payment; that is, that the payment is due within a certain time after the buyer accepts the draft. A date draft, which specifies the date of payment, is sometimes used. When a time draft is used, the customer can potentially delay payment by delaying acceptance of the draft. An exporter can prevent such delays by either using a date draft or tying the payment date to the date on the bill of lading (e.g., thirty days from the date of the bill of lading) or draft. The collecting bank holds the draft to present for payment on the maturity date.

This method offers less security than an S/D, D/P because documents that certify ownership of merchandise are transferred to an overseas customer prior to payment. Even when the customer is willing and able to pay, payment can be prolonged if the customer delays acceptance of the time draft. This method is quite similar to open-account sales in which the exporter extends a trade credit to an overseas customer in exchange for payment at some determinable future date. One major difference between the two methods is that in the case of documents against acceptance (for which a time or date draft is used), the draft is a negotiable instrument (unlike an account receivable in an open account) that can be sold and easily converted into cash by the exporter before maturity.

A draft drawn on and accepted by a bank is called a banker's acceptance. Once accepted, the draft becomes a primary obligation of the accepting bank to pay at maturity. If the draft is accepted by nonbank entities such as importers, it is known as a trade acceptance. The greater the creditworthiness of the party accepting the draft, the greater the marketability of the banker's or trade acceptance. They are important tools that can be negotiated or discounted to companies engaged in trade finance and which can serve the financing needs of exporters.

Example: A U.S. company, ABC, agreed to sell a ton of oranges to a food company in Singapore (XYZ) for $100,000. A draft drawn by ABC is accepted by XYZ's bank to pay on an agreed-upon future date. ABC has two options:

1. It may hold the acceptance until maturity and then collect. The exporter would receive the face amount less the bank's acceptance commission of 1.2 percent per annum ($ acceptance of $100,000 for three months)

Face amount of the acceptance:	$100,000.00	
Less 1.2% per annum commission for 3 months:	– 300.00	(0.012 × 3/12 × 100,000)
Amount received by exporter in 3 months:	$ 99,700.00	

2. ABC may decide to discount (i.e., sell at a reduced price) and receive the money at once. In this case, ABC will receive the face amount of the acceptance less the acceptance fee and the discount rate.

Face amount of the acceptance:	$100,000.00	
Less 1.2% per annum commission for 3 months:	– 300.00	(0.012 × 3/12 × 100,000)
Less 1.15% per annum discount rate for 3 months:	– 287.50	(0.0115 × 3/12 × 100,000)
Amount received by exporter in 3 months:	$99,412.50	

Direct Collection

Exporters can bypass the remitting bank and send documents directly to the foreign collecting bank for payment or acceptance. This reduces bank charges and speeds the collection process. In this case, the collecting bank acts as the exporter's agent for follow-up and collection without the involvement of the remitting bank.

Liability and Responsibility of the Banks

The Uniform Rules for Collections (ICC, 1995) distinguish two types of collection arrangements: clean collections and documentary collections. In the case of clean collections, a draft is presented to the overseas buyer for the purpose of obtaining payment or acceptance without being accompanied by shipping documents. Documentary collections, which are the subject of this chapter, however, involve the presentation of shipping (commercial) and financial documents (draft or promissory note) by the collecting bank to the buyer. In certain cases in which a collection is payable against shipping documents without a draft (invoice is used in lieu of a draft), it is termed cash against documents.

In documentary collections, banks act as agents for collection and assume no responsibility for the consequences arising out of delay or for loss in transit of any messages, letters, or documents (ICC, 1995). They do not question documents submitted for collection and are not responsible for their form and/or content or for the authenticity of any signatures for acceptance. However, they have to act in good faith and exercise reasonable care in execution of the collection order. The bank's major responsibilities include the following:

- *Verification of documents received:* The banks check whether the documents appear to be as listed in the collection order and advise the party in the event of missing documents.
- *Compliance with instructions in the collection order:* The exporter instructs the remitting bank on payment whether the documents shall be handed to a representative in case of need and what to do in the event of nonpayment or nonacceptance of the draft. These instructions are then sent along with other documents by the remitting bank to the collecting bank. The latter is permitted to act only upon these instructions.

In case the buyer refuses to pay, accept the draft, or pay the accepted draft at maturity, exporters often instruct the collecting bank to (1) protest (i.e., present the dishonored draft again); (2) warehouse the merchandise; or (3) send the merchandise back to the exporter. The collecting bank may be requested to contact the exporter's agent for clearance of the merchandise. All charges for carrying out these instructions are borne by the exporter. If the collecting bank releases the documents to the overseas customer contrary to instructions, the bank is liable to the seller; it has to pay the seller and collect from the buyer (International Perspective 11.1).

The use of documentary collections offers certain advantages. It reduces transaction costs for both parties, helps maintain suitable levels of control for exporters, and speeds up the flow of transactions. The major risk with this method, however, is that the buyer may be unable or unwilling to pay or accept the draft on presentation. It is thus important to check credit references, consider taking out credit insurance, or secure collateral to cover the transaction.

INTERNATIONAL PERSPECTIVE 11.1

Protesting with Delinquent Overseas Customers

When a foreign buyer refuses to pay a sight collection or to accept a term draft, the collecting bank will advise the exporter and either proceed according to the collection instruction or new instruction from the exporter or its bank.

There are a number of reasons why buyers are unwilling to pay or accept a term draft:

- If the price of goods falls after order, buyers often try to find excuses to refuse the goods.
- The amount invoiced may be higher than what was agreed in the contract or the shipment may have been made earlier or later than the agreed date.
- The description of the goods is not consistent with what was agreed between the parties.
- Certain documents are missing to clear goods through customs or an import license was not obtained for the goods.

One course of action available to the exporter is to protest (through its bank) the customer's refusal to honor the sales contract (other available options include negotiating the terms, finding a new buyer, and shipping the goods back to the exporter). Protest entails contacting a notary public or attorney (in the buyer's country) for the purpose of legally presenting a draft to the importer. It enables the exporter to maintain its right of recourse against the overseas buyer. There are a number of limitations to protest actions:

- Protests are not allowed in certain countries. In some countries, such as Peru, a supplier must protest within seven days after the maturity date of the draft. This does not provide sufficient time to the exporter to assess the situation.
- Protests can be quite costly in some countries.
- Such actions may damage future business dealings with customers, especially if the exporter was partly responsible for the problem.

Documentary Letter of Credit

A letter of credit (L/C) is a document in which a bank or other financial institution assumes liability for payment of the purchase price to the seller on behalf of the buyer. The bank could deal directly or through the intervention of a bank in the seller's country. In all types of letters of credit, the buyer arranges with a bank to provide finance for the exporter in exchange for certain documents. The bank makes its credit available to its client, the buyer, in consideration of a security that often includes a pledge of the documents of title to the goods, placement of funds in advance, or a pledge to reimburse with a commission (Reynolds, 2003). The essential feature of this method, and its value to an exporter of goods, is that it superimposes upon the credit of the buyer the credit of a bank, often one carrying on business in the seller's country. The letter of credit is a legally enforceable commitment by a bank to pay money upon the performance of certain conditions stipulated therein to the seller (exporter or beneficiary) for the account of the buyer (importer or applicant).

A letter of credit (L/C) is considered an export or import L/C depending on the party. The same letter of credit is considered an export L/C by the seller and an import L/C by the buyer. The steps involved in Figure 11.3 are as follows:

1. The Canadian buyer in Montreal contracts with the U.S. seller in New York. The agreement provides for the payment to be financed by means of a confirmed, irrevocable documentary credit for goods delivered CIF, port of Montreal.
2. The Canadian buyer applies to its bank (issuing bank), which issues the letter of credit with the U.S. seller as beneficiary.
3. Issuing bank sends the letter of credit to an advising bank in the United States, which also confirms the letter of credit.
4. The advising bank notifies the U.S. seller that a letter of credit has been issued on its behalf (confirmed by the advising bank) and is available on presentation of documents.
5. The U.S. seller scrutinizes the credit. When satisfied that the stipulations in the credit can be met, the U.S. seller arranges for shipment and prepares the necessary documents, that is, commercial invoice, bill of lading, draft, insurance policy, and certificate of origin. Amendments may be necessary in cases in which the credit improperly describes the merchandise.
6. After shipment of merchandise, the U.S. seller submits the relevant documents to the advising/confirming bank for payment. If the documents comply, the advising/confirming bank pays the seller. (If the L/C provides for acceptance, the bank accepts the draft, signifying its commitment to pay the face value at maturity to the seller or bona fide holder of the draft; this is called acceptance L/C. In straight L/C, payment is made by the issuing bank or the bank designated in the credit at a determinable future date. If the credit provides for negotiation at any bank, it is known as negotiable L/C).
7. The advising/confirming bank sends documents plus settlement instructions to the issuing bank.
8. After inspecting the documents for compliance with instructions, the issuing bank reimburses/remits the proceeds to the advising/confirming bank.
9. The issuing bank gives the documents to the buyer and presents the term draft for acceptance. With a sight draft, the issuing bank will be paid by the buyer on presentation of documents.
10. The buyer arranges for clearance of the merchandise, that is, gives up the bill of lading and takes receipt of goods.
11. The buyer pays the issuing bank on or before the draft maturity date.

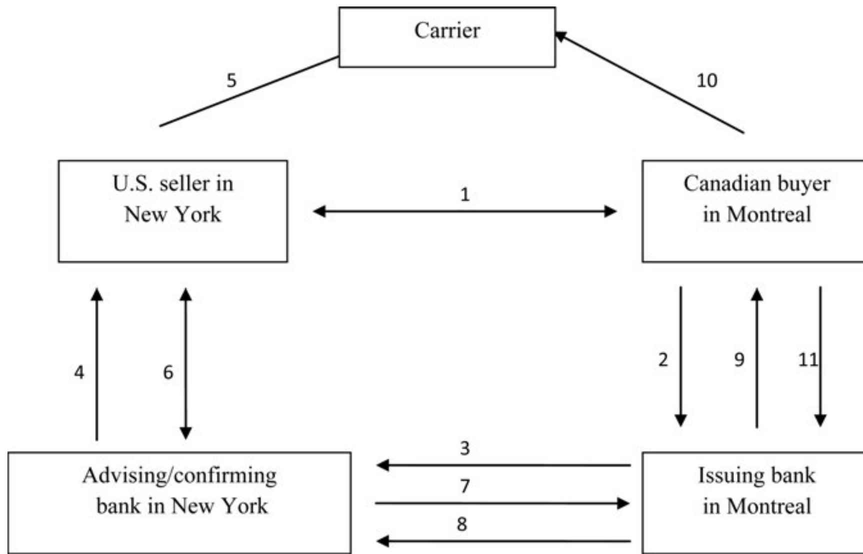

FIGURE 11.3 Documentary Letter of Credit

Issuing banks often verify receipt of full details of the L/C by the advising bank. This is done by using a private test code arrangement between banks. Credits are opened and forwarded to the advising/confirming bank by mail, telex, or cable. Issuing banks can also open credits by using the SWIFT system (Society for Worldwide Interbank Financial Telecommunications), which allows for faster transmission time. It also allows member banks to use automatic authentication (verification) of messages (Ruggiero, 1991).

The letter of credit consists of four separate and distinct bilateral contracts: (1) a sales contract between the buyer and the seller; (2) a credit and reimbursement contract between the buyer and the issuing bank, providing for the issuing bank to establish a letter of credit in favor of the seller and for reimbursement by the buyer; (3) a letter-of-credit contract between the issuing bank and the beneficiary (exporter), attesting that the bank will pay the seller on presentation of specified documents; and (4) the confirmed advice, which also signifies a contract between the advising/confirming bank and the seller, attesting that the bank will pay the seller on presentation of specified documents.

When the letter of credit is revocable, the issuing bank could amend or cancel the credit at any time after issue without consent from or notice to the seller. Revocable L/Cs are seldom used in international trade except in cases of trade between parent and subsidiary companies because they do not provide sufficient protection to the seller. Under the Uniform Customs and Practice for Documentary Credits (UCP), letters of credit are deemed irrevocable even if there is no indication to that effect (ICC, 2007). Irrevocable credits cannot be amended or canceled before their expiry date without the express consent of all parties to the credit. The terms "revocable" and "irrevocable" refer only to the issuing bank.

In cases in which sellers do not know of or have little confidence in the financial strength of the buyer's country or the issuing bank, they often require a bank in their country to guarantee payment (i.e., confirm the L/C).

There are several advantages of using letters of credit. They accommodate the competing desires of the seller and overseas customer. The seller receives payment on presentation of documents to the bank after shipment of goods, unlike open-account sales or documentary collection. In cases in which the advising bank accepts the L/C for payment at a determinable future date, the seller can discount the L/C before maturity. Buyers also avoid the need to make prepayment or to establish an escrow account. Letters of credit also ensure that payment is not made until the goods are placed in possession of a carrier and that specified documents are presented to that effect (Shapiro, 2006).

One major disadvantage with an L/C for the buyer is that issuing banks often require cash or other collateral before they open an L/C, unless the buyer has a satisfactory credit rating. This could tie up the available credit line. In certain countries, buyers are also required to make a prior deposit before establishing an L/C. Letters of credit are complex transactions between different parties, and the smallest discrepancy between documents could require an amendment of the terms or lead to the invalidation of the credit. This may expose the seller to a risk of delay in payment or nonpayment in certain cases.

A letter of credit is a documentary payment obligation, and banks are required to pay or agree to pay on presentation of appropriate documents as specified in the credit. This payment obligation applies even if a seller ships defective or nonexistent goods (empty crates/boxes). The buyer then has to sue for breach of contract. The interests of the buyer can be protected by structuring the L/C to require, as a condition of payment, the following:

- The presentations of a certificate of inspection executed by a third party certifying that the goods shipped conform to the terms of the contract of sale. If the goods are defective or nonconforming to the terms of the contract, the third party will refuse to sign the certificate and the seller will not receive payment. In such cases, it is preferable to use a revocable L/C.
- The presentation of a certificate of inspection executed or countersigned by the buyer. It is preferable to use a revocable L/C to allow the bank to cancel the credit.
- A reciprocal standby L/C issued in favor of the buyer in which the latter could draw on this credit and obtain a return of the purchase price if the seller shipped nonconforming goods (McLaughlin, 1989).

Governing Law

The rights and duties of parties to a letter of credit issued or confirmed in the United States are determined by reference to three different sources:

1. *The Uniform Commercial Code (UCC):* The basic law on letter of credit is codified in article 5–101 to 5–117 of the Uniform Commercial Code. This article has been adopted in all states of the Union. However, some states (New York, Missouri, Alabama) have introduced an amendment providing that article 5 will not apply if the letter of credit is subject, in whole or in part, to the Uniform Customs and Practice for Documentary Credits.
2. *The Uniform Customs and Practice for Documentary Credits (UCP):* Parties to the letter of credit frequently agree to be governed by the rules of the UCP, which is a result of

collaboration among the International Chamber of Commerce, the United Nations, and many international trade banks. The UCP is periodically revised to take into account new developments in international trade and credit (the latest revision was in 2007) (see International Perspective 11.2). The UCC and UCP provisions on letters of credit complement each other in many areas. Under both the UCC and the UCP, the terms of the credit can be altered by agreement of the parties.

3. *General principles of law:* In cases in which the UCC or UCP provisions are not sufficient to resolve a dispute, courts apply general principles of law insofar as they do not conflict with the governing law (UCC or UCP) or agreement of the parties.

INTERNATIONAL PERSPECTIVE 11.2

Understanding the UCP 600

UCP 600 is a revision of the rules of practice for letters of credit prepared under the auspices of the International Chamber of Commerce. It replaces UCP 500, which was released in 1993. UCP 600 became effective on July 1, 2007. The revision was largely triggered by a high frequency of technical rejections of documents under UCP 500. In spite of several comments and suggestions from national committees all over the world, very few substantive changes were made to UCP 500.

Major Changes:

- **Time to examine documents:** UCP 500 gave banks a "reasonable time" to examine the documents and identify discrepancies. UCP 600 replaces "reasonable time" with five banking days.
- **Addresses of applicant and beneficiary:** UCP 500 required that addresses of applicants and beneficiaries in letters of credit match the addresses stated in commercial documents. This was amended to state that the addresses need not match insofar as they are in the same countries.
- **Discrepant documents, waiver and notice:** This relates to cases where the buyer decides to pay against discrepant documents that have been refused by the bank. There is no provision in UCP 500 that allows a bank to rescind its refusal. UCP 600 states that a bank that has refused documents is permitted to later rescind its refusal unless the seller provides contrary instructions (i.e., the issuing bank delivers the documents to the buyer without obtaining the acceptance of the seller or the presenting bank if the seller and presenting bank have not objected).
- **Nomination of a bank obligates it to honor deferred payments:** UCP 500 does not impose an obligation on nominated banks to honor deferred payments (unlike acceptance of time drafts). UCP 600 now states that a letter of credit that is available by deferred payment implicitly authorizes the bank (it is available with) to discount (i.e., to pay immediately with interest deducted from payment, if required to do so by the beneficiary).
- **Banks must follow strict rules for refusing payment:** If documents do not strictly comply (this was modified to state that data in the documents must not conflict), banks may refuse payment but must themselves follow strict rules for refusing payment.

Role of Banks Under Letters of Credit

The buyer's bank issues the letter of credit at the request of the buyer. The details of the credit are normally specified by the buyer. Since the seller wants a local bank available to which the seller can present the letter of credit for payment, an additional bank often becomes involved in the transaction. The second bank usually either "advises" or "confirms" the letter of credit. A bank that advises on the L/C gives notification of the terms and conditions of the credit issued by another bank to the seller. It assumes no liability for paying the letter of credit. Its only obligation is to ensure that the beneficiary (seller) is advised and the credit delivered and to ensure the apparent authenticity of the credit.

An issuing bank may also request a bank to confirm the letter of credit. A confirming bank promises to honor a letter of credit already issued by another bank and becomes directly obligated to the beneficiary (seller), as though it had issued the letter of credit itself. It will pay, accept, or negotiate a letter of credit upon presentation of specific documents that comply with the terms and conditions of the credit. A confirming bank is entitled to reimbursement by the issuing bank, assuming that the latter's instructions have been properly executed. It, however, faces the risk of nonpayment if the issuing bank or the buyer is unable or unwilling to pay the confirming bank, in which case it will be left with title to the goods and obliged to liquidate them to offset its losses.

Both the confirming and the issuing banks have an obligation to the exporter (beneficiary) and the buyer to act in good faith and with reasonable care in examining the documents. The basic rule pertaining to a bank's liability to a beneficiary is that the bank should honor the L/C if the documents presented comply with the terms of the credit. The following circumstances cannot be used by banks as a basis to dishonor (refusal to pay or accept a draft) letters of credit:

- *Dishonor to serve the buyer's interests:* In this case, claims are made by a bank's customer (buyer) that the beneficiary has breached the sales contract or that the underlying agreement has been modified or amended in some way in the face of complying documents. This includes cases of dishonor based on the bank's knowledge or reasonable belief that the goods do not conform to the underlying contract of sale.
- *Dishonor to serve the bank's own interests:* This occurs when the sole reason for dishonor is the bank's belief that it would not obtain reimbursement from its insolvent customer. This involves situations in which the buyer becomes insolvent after the L/C is issued and before the beneficiary's draft is honored.
- *Dishonor after express waiver of a particular discrepancy:* In this case, a bank dishonors an L/C after it has expressly agreed to disregard a particular discrepancy.
- *Dishonor without giving the beneficiary an opportunity to correct the discrepancy:* If the issuing bank decides to refuse the documents, it must give notice to that effect, stating the discrepancy without delay, and must also state whether it is holding the documents at the disposal of and returning them to the remitting bank or beneficiary, as the case may be (Arzt, 1991; Rosenblith, 1991).

Banks may properly dishonor a letter of credit in cases of fraud or forgery, even if the documents presented to the beneficiary appear to comply with the terms of credit. This assumes that there are no innocent parties involved in the presentation of the letter of credit to the bank. Banks are subject to two principles in the conduct of their letter-of-credit transactions: the independent principle and the rule of strict compliance.

The Independent Principle

The letter of credit is separate from and independent of other contracts relating to the transaction. Each of the four contracts in a letter-of-credit transaction is entirely independent. It is irrelevant to the bank whether the seller/buyer has fully carried out its part of the contract with the buyer/seller. The bank's duty is to establish whether the stipulated documents have been presented in order to pay (accept to pay) the exporter. It is not the bank's duty to ascertain whether the goods mentioned in the documents have been shipped or whether they conform to the terms of the contract. Article 4 of the UCP states:

> Credits by their nature are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the credit. (ICC, 2007, p. 5)

The independent principle is subject to a fraud exception. A bank can refuse payment if it has been informed that there has been fraud or forgery in connection with the letter-of-credit transaction and the person presenting the documents is not a holder in due course (as third party who took the draft for value, in good faith, and without knowledge of the fraud). In one case, for example, a buyer notified the issuing bank not to pay the seller under the letter of credit, alleging that the seller had intentionally shipped fifty crates of rubbish in place of fifty crates of bristles. The bank's refusal of payment was accepted by the court as justifiable in view of fraud in the underlying transaction (Ryan, 1990). U.S. courts have held in several cases that banks are justified in dishonoring L/Cs when the documents are forged or fraudulent. Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, or legal effect of any documents. The obligation to honor an irrevocable L/C exists provided the stipulated documents are presented. In credit operations, all parties concerned deal in documents and not in the goods to which the documents relate. Thus, when the L/C is governed by the UCP, it appears that the bank must pay, regardless of any underlying fraud. A bank would, however, be liable for the money paid out if it participated in the fraud.

The Rule of Strict Compliance

The general rule is that an exporter cannot compel payment unless it strictly complies with the conditions specified in the credit (Rosenblith, 1991). When conforming documents are presented, the advising bank must pay, the issuing bank must reimburse, and the buyer is obliged to pay the issuing bank. In certain cases, courts have refused to recognize the substantial-compliance argument by banks to recover their payments from buyers (unless it involves minor spelling errors or insignificant additions or abbreviations in drafts) (Rubenstein, 1994). The reason behind the doctrine of strict compliance is that the advising bank is an agent of the issuing bank and the latter is a special agent of the buyer. This means that banks have limited authority and have to bear the commercial risk of the transaction if they act outside the scope of their mandate (Barnes, 1994; Macintosh, 1992). In addition, in times of falling demand, the buyer may be tempted to reject documents that the bank accepted, alleging that they are not in strict compliance with the terms of the credit.

Two assumptions underlie the doctrine of strict compliance:

1. *Linkage of documents:* The documents (bill of lading, draft, invoice, insurance certificate) are linked by an unambiguous reference to the same merchandise.
2. *Description of goods:* The goods must be fully described in the invoice, but the same details are not necessary in all the other documents. What is important is that the documents, when taken together, contain the particulars required under the L/C. This means that the invoice could include more details than the bill of lading as long as the enlarged descriptions are essentially consistent with those contained in the bill of lading (Murray, 2007).

Discrepancies

Discrepancies occur when documents submitted contain language or terms different from those in the letter of credit or some other apparent irregularity (International Perspectives 11.3 and 11.4). Most discrepancies occur because the exporter does not present all the documents required under the letter of credit or because the documents do not strictly conform to the L/C requirements (Reynolds, 2003).

Example: Dushkin Bank issued an irrevocable L/C on behalf of its customer (buyer), John Textiles, Inc. It promised to honor a draft of KG Company (exporter) for $250,000, covering shipment of "100% Acrylic Yarn." KG Company presented its draft with a commercial invoice describing the merchandise as "Imported Acrylic Yarns."

Discrepancy: The description of the goods in the invoice does not match that stated in the letter of credit. Dushkin Bank could refuse to honor the draft and return the documents to the exporter.

To receive payment under the credit, the exporter must present documents that are in strict accord with the terms of the letter of credit. It is estimated that more than 80 percent of documents presented under L/Cs contain some discrepancy.

There are three types of discrepancies:

- *Accidental discrepancies:* These are discrepancies that can easily be corrected by the exporter (beneficiary) or the issuing bank. Such discrepancies include typographical errors, failure to state the L/C number, errors in arithmetic, and improper endorsement or signature on the draft. Once these discrepancies are corrected (within a reasonable period of time), the bank will accept the documents and pay the exporter.
- *Minor discrepancies:* These are minor errors in documents that contain the essential particulars required in the L/C and can be corrected by obtaining a written waiver from the buyer. Such errors include failure to legalize documents, nonpresentation of all documents required under the L/C, and discrepancies between the wording on the invoice and that in the L/C. Once these discrepancies are waived by the buyer, the transaction will proceed as anticipated.
- *Major discrepancies:* These are discrepancies that fundamentally affect the essential nature of the L/C. Certain discrepancies cannot be corrected under any circumstances: presentation of documents after the expiry date of the L/C, shipment of merchandise

later than the specified date under the L/C, or expiration of the L/C. However, other major discrepancies can be corrected by an amendment of the L/C. Amendments require the approval of the issuing bank, the confirming bank (in the case of a confirmed L/C), and the exporter. Examples of discrepancies that can be amended include an incorrect bill of lading, a draft in excess of the amount specified in the credit, and partial shipments not allowed under the credit.

Discrepancies that can be corrected (accidental, minor, and certain major discrepancies) must be rectified within a reasonable period of time after shipment and before the expiry of the letter of credit. Most letters of credit require that the documents be submitted within a reasonable period of time after the date of the bill of lading. If no time is specified, the UCP requires submission of shipping documents by beneficiary to banks no later than twenty-one days after the date of shipment and, in any event, no later than the expiry date of the credit.

In cases in which the buyer is looking for an excuse to reject the documents (e.g., when the price of the product is falling or the product is destroyed on shipment), the buyer may not accede to a waiver or amendment of the discrepancy or may do so in consideration for a huge discount off the contract price. The buyer could also delay correction, in which case the exporter loses the use of the proceeds for a certain period of time. Besides incurring further bank charges to correct the discrepancy, the seller also faces the risk that the credit will expire before the discrepancies are corrected.

When the discrepancy stands (the discrepancy cannot be corrected or the buyer refuses to waive or amend the terms of the credit), the seller can still attempt to obtain payment by requesting the bank to obtain authority to pay or send the documents for collection (documentary collection) outside the terms of the L/C. If the buyer refuses to accept the documents, the bank will not pay the seller (exporter), and the exporter has to either find a buyer abroad or have the merchandise returned. If the confirming/issuing bank accepts documents that contain a discrepancy, then it cannot seek reimbursement from its respective customers (issuing bank/buyer, respectively) (International Perspective 11.4).

When the issuing bank decides to refuse the document, it must notify the party from which it obtained the document (the remitting bank or the exporter) without delay, stating the reasons for the rejection and whether it holds the documents at the disposal of or is returning them to the presenter.

INTERNATIONAL PERSPECTIVE 11.3

Common Discrepancies in Letters of Credit

More than 80 percent of letter-of-credit documents are rejected by the bank upon presentation. It is thus important to ensure that errors are avoided or detected and that appropriate corrections are made to avoid (nonpayment) delays in payments. Here are some of the common discrepancies:

- Draft is not signed, or it is not consistent with the letter of credit (in terms of the amount, maturity date, etc.) and shows evidence of forgery or alteration.
- Insurance policy is not consistent with the invoice or letter of credit or is dated after the date of bill of lading or not endorsed.

- Commercial invoice does not conform to description of goods (quantity, measurements) in the draft or letter of credit and fails to show terms of shipment.
- Bill of lading/air waybills differ from the letter of credit, show evidence of forgery or alteration, or are not endorsed. It may also be that onboard notations are not dated or signed and that the bill of lading is incomplete (missing originals).
- Incomplete documentation; description of merchandise is not consistent in all documents; letter of credit is overdrawn or expired; or the draft and documents are presented after the time called for in the letter of credit.

INTERNATIONAL PERSPECTIVE 11.4

Unworkable Terms in Letters of Credit

- **Compliance with certain national policies:** Some Middle Eastern countries require a document certifying that the ship carrying the merchandise destined for them will not make stops at Israeli ports. Complying with such requirements, for example, violate the antiboycott provisions of U.S. law.
- **Contradictory/different terms:** Examples of this are the use of the term FOB (free on board) with an additional statement that freight be prepaid to destination or a requirement that the beneficiary submit a certificate providing the origin of each component in an assembled product (Chambers of commerce will certify only local, not foreign, components). Requiring carrier's insurance policy (as opposed to certificate of insurance) will also make it difficult for buyers to comply.
- **Setting unrealistic performance conditions:** Different motivations often lead to the setting of shipping dates, expiration dates or presentation dates for payments that are not realistic and often difficult to comply.

Cash in Advance

This method of payment requires the buyer to pay before shipment is effected. The seller assumes no risk of bad debt and/or delays in payment because advance payment is a precondition of shipment.

Sellers often require advance payment in cases in which the creditworthiness of the overseas customer is poor or unknown and/or the political/economic conditions of the buyer's country are unstable. Cash in advance is sometimes used between related companies. It is also common to require money in advance for samples.

New Payment and Financing Alternatives

Since the 1990s, there has been a rapid expansion of online business-to-business transactions. One of the most significant challenges to this continued growth has been the lack of a payment mechanism for large cross-border transactions. Existing trade payment processes

have not evolved and continue to be labor and document intensive. Any discrepancy in letter-of-credit documents, for example, can delay or even hinder the entire delivery and payment process. Open-account sales also pose a risk of nonpayment by the buyer (Yuan, 2007).

Innovative online payment and financing platforms are beginning to revolutionize the way international trade is conducted. Companies such as TradeCard, TradeBeam, and Bolero now offer a business-to-business e-commerce infrastructure that enables buyers and sellers to initiate, conduct, and settle international trade transactions securely over the Internet.

These online platforms have several advantages over traditional payment methods such as letters of credit:

- *Reduced paperwork and enhanced visibility:* Export-import companies are often faced with complex financing and extensive documentation that can increase the cost of goods shipped by 4 to 6 percent. It is estimated that more than 70 percent of documents are found discrepant, leading to delays in payment or nonpayment. The online platform stores the documents electronically and allows parties to view them and correct any discrepancy online. There is also the benefit of enhanced visibility into the movement of products and payments throughout the transaction lifecycle.
- *Cost savings:* Online platforms require less investment on hardware (they use the Internet) and are less costly than letters of credit. They handle documentation, payments, and other services.
- *Value-added services:* They also provide access to a community of service providers that offer logistics, inspection, export financing, and credit checks of customers.

MS Mode, a Netherlands-based women's-apparel retailer with more than 400 stores throughout Europe recently deployed TradeCard's online platform to increase sourcing from Bangladesh without using letters of credit (Anonymous, 2012). Several other retailers such as Levi Strauss, Columbia Sportswear, Guess, and Rite Aid are also using these platforms to streamline transaction flows ranging from purchase orders to shipment and payments.

Banks are competitors as well as logistic partners to these online platforms, which offer letter-of-credit and open-account services. They also partner with banks for financing services to their customers (see International Perspective 11.5).

In spite of the benefits that the new payment platforms provide, they have yet to achieve universal acceptance within the business community. The benefits of such platforms can be efficiently exploited only when all partners and service providers subscribe to the same platform (David and Stewart, 2010).

INTERNATIONAL PERSPECTIVE 11.5

Tradecard: A Typical Transaction Process

1. Buyer logs into the TradeCard Global e-commerce site by entering username and password.
2. Buyer creates and approves the procurement documents such as the purchase order and cargo insurance, which are stored in its secure proprietary database.

3. Seller is notified by e-mail of the pending order to be reviewed. Seller then logs into the TradeCard Global e-commerce site.
4. Buyer and seller negotiate purchase order terms online and digitally sign the procurement documents. Once the purchase order is complete, seller begins fulfillment.
5. Seller creates and approves commercial invoice and packing list as goods are ready to be shipped. Service providers are notified and facilitate the process, including the creation and submission of the requisite documents into the platform: proof of delivery, inspection certificate.
6. Once all documents are submitted, the patented compliance engine is activated. Buyer approves the payment authorization document and reviews, negotiates, and approves any discrepancies online.
7. Once all compliance requirements are met, TradeCard sends instructions to a bank to debit the buyer's account and credit the seller's account.

The platform allows parties to track the status of their transaction, view document status, contract details, and receive e-mail reminders and other pertinent notices.

Fraud in Documentary Credits

International trade fraud is not a new phenomenon. Ever since trade began, merchants have been victims of fraud and other criminal activity. As early as the 1st century BC, there were pirate states along the Anatolian coast, threatening the commerce of the Roman Empire in the eastern Mediterranean. Roman ships were attacked by pirates who seized their cargoes of grain and olive oil. The Vikings (which means "sea-raider") were renowned for attacking shipping and coastal settlements.

There are different types of trade fraud, ranging from piracy and theft to marine insurance fraud. This section focuses on documentary (letter of credit) fraud.

Common Features of Documentary Fraud

Fraud by Seller

- *Fraudulent seller ships worthless goods or goods of lower quality:* Seller ships worthless goods or goods of lower quality, pays for freight costs, and obtains a genuine bill of lading that enables it to receive payment from the advising or issuing bank for the shipment.
- *Fraudulent seller does not ship any merchandise:* Seller forges an entire set of documents required under the letter of credit and presents them to the bank for payment. Such sellers even furnish the buyer with a performance bond (for 10 percent of the value of the cargo) and obtain full value of the purchase price without sending any merchandise to buyer.

Fraud by Buyer

- *Fraudulent buyer forges original documents for payment:* Seller sends cargo (under documents against payment arrangement) to buyer and submits the original documents to the collecting bank in the buyer's country for presentation against payment. Meanwhile, a copy of the original documents is sent directly to the buyer. The buyer forges the original documents and presents them to the carrier to clear the cargo. The authentic documents are still with the collecting bank.
- *Fraudulent buyer receives merchandise from carrier on the strength of letter of indemnity:* Indemnities are issued to enable the discharge of cargo (or to induce the carrier to discharge at a different destination if sold to another party while on transit) without presentation of the bill of lading. The letter of indemnity substitutes for the bill of lading, allowing the buyer to receive the goods. This occurs when the cargo arrives before the bill of lading. The buyer obtains delivery of the goods and sells the bill of lading to an innocent buyer.

Fraud by Buyer, Seller, and Other Parties

- *Buyer and seller conspire to defraud paying bank:* Seller and buyer conspire to defraud paying bank by using forged documentary credits. Seller may also induce buyer into sending goods on a fraudulent letter of credit.
- *Seller and carrier falsify the actual order and condition of the goods:* Seller and carrier falsify to the buyer the order and condition of the goods by issuing a clean bill of lading. A letter of indemnity taken out by the seller covers the carrier against any liability in connection with the release of the goods. It is fraud on the buyer, who receives a clean bill of lading and assumes the cargo to be in good condition.

Protective Measures Against Documentary Fraud

Proactive Measures by Sellers

- Verify the background and credibility of your partner through your government agency, bank, or professional associations
- Stipulate the required documents and other pertinent conditions in the sales contract
- Check the validity of the letter of credit as well as the credibility of the issuing bank. It is also important to verify that the terms in the letter of credit comply with the sales contract.

Proactive Measures by Buyers

- Verify the background and credibility of your partner through your government agency, bank, or professional associations
- Choose FOB trade term rather the CIF in a sales contract so that you have more control over the shipment. It is also important to verify the availability of the ship, its capacity to carry the agreed merchandise, and its physical location
- Use independent inspectors to verify the quality and quantity of goods and whether they have been loaded on the vessel

- Choose time drafts (instead of sight drafts) to allow you to make payment some days after acceptance of the draft. This allows the buyer to discover fraud after the goods arrive but before the date of payment. It is also possible to condition the passage of title upon buyer's inspection and approval of the goods.
- Verify the authenticity of the documents, especially the bill of lading, before they are presented to the bank for payment. To reduce possible forgery, the buyer can require that original bills of lading be sent directly to banks and not to the seller (shipper) in CIF contracts.
- Sellers can provide performance guarantee to buyer to carry out its obligations. In the event of fraud by seller, issuing bank will be obligated to compensate buyer solely upon demand by buyer. Buyers can also take out export credit insurance.

Proactive Measures by Banks

- Paying bank should offer an additional service for a fee. Banks can undertake an investigation into the validity, genuineness, or accuracy of the documents before payment. The Bank of China, for example, provides a commercial credibility investigation service for its customers. The service includes a report on the foreign partner's background, credit status, and solvency; the name of the loading ship and port; and condition of the goods as well as information on the carrier.
- Make further investigations in cases where fraud is suspected to avoid future occurrences.

Other Letters of Credit

Transferable Letter of Credit

Exporters often use transferable L/C to pay a supplier, while keeping the identity of the supplier and the foreign customer from each other, lest they conduct the next transaction without the exporter. This method is often used when the exporter acts as an agent or intermediary. Under a transferable L/C, the exporter (beneficiary) transfers the rights and certain duties, such as shipment, under the credit to another person, usually its supplier (transferee), who receives payment, provided that the conditions of the original credit are met. The bank requested by the beneficiary to effect the transfer is under no obligation to do so, unless it has expressly consented to it.

It is important to note the following with respect to such letters of credit:

- A credit is transferred only if it is expressly designated as "transferable" by the issuing bank.
- It can be transferred only once. The credit is automatically divisible and can be transferred in fractions, provided that partial shipments are not excluded.
- The name and address of the first beneficiary may be substituted for those of the buyer. This masks the identity of the true suppliers of the merchandise from the buyer.
- The transferee receives rights under this type of L/C. Such a transfer requires the consent of the buyer and of the issuing bank.
- The supplier might demand that the exporter actually transfer the letter of credit in its entirety, without substitution of invoices. The beneficiary (exporter) will receive a commission independent of the L/C transaction.

Example 1: A Canadian bank opens a transferable credit in the amount of $90,000 in favor of a U.S. exporter in Florida for a shipment of tomatoes. The exporter had located a supplier in Texas and had decided to use $85,000 of the credit to pay the supplier. The exporter asks the advising bank in Florida to effect a transfer in favor of the supplier. The supplier is advised of the transfer by the advising bank. The new credit does not mention the amount of the original credit or the name of the foreign buyer but substitutes the name of the exporter (original beneficiary) as the buyer. When the supplier presents conforming documents to the advising bank in Florida, the bank substitutes the exporter's invoice for that of the supplier, pays $85,000 to the supplier, and pays the difference to the exporter. The advising bank forwards the documents to the Canadian bank, which has no knowledge of the transfer for reimbursement.

Transferable L/C is different from assignment of proceeds under the credit. In assignment, the exporter asks the bank holding the L/C to pay either the entire amount or a percentage of the proceeds to a specified third party, usually a supplier. This allows the exporter to make domestic purchases with limited capital by using the overseas buyer's credit. This is done by assigning the proceeds from the buyer's L/C. The beneficiary (exporter) of a letter of credit may assign its rights to the proceeds of the L/C, even if the L/C expressly states that it is nontransferable. Only the beneficiary (not assignee) has rights under the credit, and the overseas buyer as well as the issuing bank often has no knowledge of the assignment.

Example 2: A U.S. exporter has a letter of credit for $40,000 from a buyer in Brazil. The exporter had located a supplier within the United States that will sell the product for $25,000. However, the supplier would not release the product for shipment without some down payment or collateral. The exporter (assignor) could assign part of the proceeds ($25,000) from the L/C to the supplier (assignee). The assignee will then provide the merchandise to the exporter, who will arrange shipment. The exporter (assignor) must submit documents that comply with the credit in order for the advising bank to pay the assignee (supplier). The remainder ($15,000) will be paid to the exporter.

Back-to-Back Letter of Credit

A back-to-back is issued on the strength of another letter of credit. Such credits are issued when suppliers or subcontractors demand payment from the exporter before collections are received from the customer. The back-to-back L/C is separate from the original L/C, and the bank that issued the former is obligated to make payment to suppliers regardless of the outcome of the latter. If there is a default on the original L/C, the bank is left with worthless collateral.

Example: A Japanese manufacturer (exporter) of cars has a letter of credit issued for 1,000 cars by a buyer in New York. Payment is to be made ninety days after shipment. However, subcontractors require payment to be made for spare parts purchased in ten days (earlier than the date of payment provided under the L/C). The Japanese exporter presents the buyer's L/C to the advising bank

in Tokyo and asks the bank to issue a new L/C to the subcontractor, payable in ten days. The first L/C is used as collateral to issue the second L/C in favor of the subcontractor.

Revolving Letter of Credit

Banks make available letters of credit with a set limit for their customers that allow for a free flow of merchandise until the expiry date of the credit. This avoids the need to open credits for each shipment. The value of the credit allowed can be reinstated automatically or by amendment. If credits designated for use during one period can be carried over to the next period, they are termed "cumulative." They are noncumulative if any unused amount is no longer available.

Example 1: Queen's Bank in Fort Lauderdale opens a revolving line of credit for up to $150,000 in favor of Kegan Enterprises, Inc., for the importation of handicrafts. Kegan Enterprises agrees to purchase toys (for $50,000) from South Korea and requests Queen's Bank to open an L/C for $50,000 in favor of the seller in that country. If the credit provides for automatic reinstatement, $100,000 will be readily available for other purchases. In other cases, Kegan Enterprises will have to wait for approval from the bank, reinstating the credit ($100,000) to use for another shipment.

Example 2: Suppose Queen's Bank opens a letter of credit of up to $15,000 a month for six months in favor of Kegan Enterprises. If the credit states that it is cumulative, $30,000 credit not used during the first two months could still be used during the next four months. If it is noncumulative, the credit not used during the two-month period cannot be carried over for use in the next four months.

Red-Clause Credit

Red-clause credits provide for advance payment to an exporter before presentation of shipping documents. It is intended to provide pre-export financing to an agent or distributor for purchase of the merchandise from a supplier. Financing conditional on presentation of negotiable warehouse receipts issued in favor of the advising bank is termed "green-clause credit."

Deferred-Payment Credit

Deferred-payment credit is a letter of credit by which the bank undertakes an obligation to pay at a future date stipulated on the credit, provided that the terms and conditions of the credit are met.

Example: Suppose a U.S. buyer agrees to buy lumber valued at $40 million from a Canadian seller. The parties agree to use a deferred-payment credit. In this case, the U.S. buyer asks its bank to open (issue) a letter of credit obligating itself to pay the seller sixty days after the date of the bill of lading. If the

documents are as stipulated in the credit, the bank undertakes an obligation to pay the Canadian seller sixty days after the date of the bill of lading. No draft, however, need accompany the documents.

What are the major differences between an acceptance letter of credit and a deferred-payment credit?

In the case of acceptance credits, the bank undertakes an obligation to accept drafts drawn on itself provided that stipulated documents are presented. Assume that a Canadian seller and a U.S. buyer agreed to use an acceptance credit payable sixty days after presentation of shipping documents. Once the Canadian seller presents the requisite shipping documents and draft of the advising bank, the bank will stamp the draft "accepted" if it is in strict compliance with the credit. This represents the bank's obligation to pay on the maturity date of the draft. Once accepted by the bank, the draft becomes a negotiable instrument that can be discounted by the accepting bank, enabling the seller to receive payment for the goods in advance of the maturity date of the acceptance. In the case of deferred-payment credits, no draft accompanies the documents. The agreement providing for the Canadian bank to pay the seller sixty days after the date of the bill of lading represents the bank's undertaking of a deferred-payment obligation. In this case, no negotiable draft is generated, and there is no way to discount the bank's deferred payment obligation. Any advance payment by the bank to the seller often requires a collateral or security interest in the proceeds of the deferred credit.

Such credits developed primarily as a way of avoiding charges and fees associated with acceptance credits.

Standby Letter of Credit

The standby letter of credit is generally used to guarantee that a party will fulfill its obligation under a contract. Such credits are opened to cover the account party's business obligations to the beneficiary. A standby letter of credit is thus a bank's guarantee to the beneficiary that a specific sum of the money will be received by the beneficiary in the event of default or nonperformance by the account party under a sales or service contract (Reynolds, 2003). Similar to the documentary letter of credit, a standby credit is payable against presentation of documents that comply with the terms of the standby credit. The documents required to be presented by the beneficiary often include a sight draft and the beneficiary's written statement of default by the account party.

A major problem with such credits is that payments are often required to be made upon the issuing bank's receipt of a signed statement by the beneficiary that the account party did not perform under the contract and that the credit is currently due and payable. There is a possibility of unfair and capricious calling in of the credit, despite the absence of default or nonperformance by the account party. To protect account parties under a standby credit from such unjustified demand by beneficiaries, the following steps are often recommended:

- Include a clause under the credit requiring that the beneficiary present certification by a third party or court that default has occurred.
- Take out an insurance policy that covers commercial and political risk. This would cover exporters against, inter alia, contract repudiation as well as unfair callings by private entities or governments.

- Take out a surety bond issued by an insurance company (instead of a performance bond issued by a bank) to guarantee performance under the contract. Whereas banks honor a drawing under a standby letter of credit based on the face value of the beneficiary's statement of default, insurance companies verify the validity of the claim before payment. If the claim is unfounded, the insurance company will deny payment. However, if the insured's default is proved, payment is made under the credit and thereafter the company will recover from the insured (Kozolchyk, 1996).

The standby letter of credit is commonly used in the case of contractor bids and performance bonds, advance payments, open-account sales, and loan guarantees.

Contractor Bids and Performance Bonds

Bid bonds are issued to a customer to show the seller's real interest and ability to undertake the resulting contract. This is intended to protect buyers from losses incurred in accepting invalid bids. The bid would be legitimately called in if a successful bidder failed to accept the contract.

Example: The Ministry of Defense of the state of Urbania wants to buy 400,000 pairs of winter boots for the military. It invites domestic and foreign manufacturers to submit bids. All bidders are also required to submit a bid bond issued by a reputable surety company or a bank. Nunez Shoes, Ltd., a U.S. footwear company, is awarded the contract. A few days later, Nunez Shoes writes a letter to the Ministry of Urbania, stating that it cannot carry out the contract because the company does not have enough supplies and an adequate labor force. According to the contract, the ministry will be entitled to draw under the credit.

Standby credits are also issued to guarantee performance under a sales and service contract. Using the previous example, suppose Nunez Shoes signs the contract to deliver 400,000 winter boots to Urbania. The ministry could require Nunez Shoes to post a performance bond issued by a reputable bank as guarantee that it will live up to the terms of the sales contract. Performance bond credits are issued for a percentage of the total contract value. Suppose Nunez Shoes manages to deliver only 50 percent of the shoes before the expiry of the sales contract. The ministry will then be entitled to draw under the credit on presentation of the necessary documents.

Performance Guarantees Against Advance Payments

Performance guarantees are bonds issued to guarantee the return of cash advanced by the customer if the seller does not comply with the terms of the contract.

Example: Using the previous example, suppose Nunez Shoes signs the contract with the Ministry of Urbania to supply the winter boots but requires an advance payment of $40,000. The ministry, in turn, could require Nunez Shoes to post an advance payment bond (a standby L/C with a bank to guarantee the return of money advanced by the ministry in the event of default by the seller). In the event that Nunez Shoes does not deliver the product as agreed under the contract,

the ministry would be entitled to call in the credit, that is, to recover its advance payment on presentation of complying documents.

Guarantee Against Payments on Open Account

This type of credit protects the seller in the event that the buyer fails to pay or delays payment. The seller asks the buyer to have a standby letter of credit issued in its favor. Suppose payment is to be made within ninety days to the seller under an open-account transaction and the buyer fails to pay. The seller could then request payment under the credit against presentation of stipulated documents, such as a sight draft, commercial invoice, and the seller's signed written statement.

Loan Guarantees

Standby credits are often issued by banks when an applicant guarantees repayment of a loan taken by another party. Suppose a subsidiary of Nunez Shoes, in England, borrows 200,000 British pounds from a bank in London. If the applicant's financial position is not well known to the bank, the bank could agree to extend the loan provided the parent company (Nunez Shoes in the United States) guarantees payment. Under this arrangement, Nunez Shoes, United States, would have a standby L/C issued in favor of the bank in London. Upon receiving the credit, the London bank would grant the loan to the subsidiary. If Nunez Shoes, England, defaults in repaying the loan, the bank will draw on the credit. In addition to this situation, standby credits are employed to cover rental payments, customs duties, royalties, and tax shelter transactions.

Chapter Summary

Consignment sales	Exporter sends product to importer on a deferred-payment basis. Importer pays seller upon sale of product to a third party. Exporter retains title to goods until payment.
Open-account sales	Exporter ships merchandise to overseas customer on credit. Payment is to be made within an agreed time after receipt of merchandise.
Documentary draft	This is a service offered by banks to sellers to facilitate payment of a sale of merchandise on an international basis. Under this method, the exporter draws a draft on a buyer after shipment of the merchandise, requesting payment on presentation of documents (documents against payment) or acceptance of the draft to pay at some future determinable date (documents against acceptance).
Banker's (trade) acceptance	If a draft is drawn on and accepted by a bank, it is called banker's acceptance. If a draft is accepted by nonbank entities, such as importers, it is trade acceptance.
Role of banks	1. Verify documents to determine whether the documents appear as listed in the collection order and to advise the party in the event of missing documents.

(*Continued*)

	2. Comply with instructions in the collection order. 3. Act as agents for collection and assume no responsibility for damages arising out of delay or for the substance and form of documents, however, must act in good faith.
Clean collections	A documentary draft presented to buyer for payment of acceptance without being accompanied by shipping documents.
Documentary collections	A documentary draft accompanied by shipping documents.
International rules governing documentary collections	Uniform Rules for Collections, 1995, International Chamber of Commerce Publication No. 522.
Documentary letter of credit (L/C)	A document in which a bank or other financial institution assumes liability for payment of the purchase price to exporter on behalf of overseas customer.
Parties to the L/C contract	1. *Sales contract:* Exporter (beneficiary) and importer (account party). 2. *Credit reimbursement contract:* Importer and issuing bank. 3. *L/C contract:* Opening bank and beneficiary. 4. *Confirmation agreement:* Confirming bank and beneficiary.
International rules on L/C	The Uniform Customs Practices for Documentary Credits (UCP), 1993 revision, International Chamber of Commerce Publication No. 500.
Role of banks	1. Banks should act equitably and in good faith. 2. Independent principle: Credits are separate transactions from sales or other contracts, and banks are in no way concerned with or bound by such contracts. The independent principle is subject to a fraud exception. 3. Rule of strict compliance: Exporter cannot compel payment by banks unless the documents presented strictly comply with the terms specified in the credit.
Discrepancies	*Accidental discrepancies:* Discrepancies that can easily be corrected by the beneficiary or the issuing bank. *Minor discrepancies:* Discrepancies that can be corrected by a written waiver from the buyer. *Major discrepancies* Discrepancies that either cannot be corrected or can be corrected only by an amendment to the L/C.
Cash in advance	A method of payment requiring the buyer to pay before shipment is effected.
	Online Payment platforms (Tradecard, Tradebeam): These platforms enable buyers and sellers to initiate, conduct, and settle international trade transactions over the Internet. They have several advantages over traditional payment methods: less paperwork and enhanced visibility, cost savings, and provision of value added services.
	Fraud in documentary credits: Fraud can be perpetrated by sellers, buyers, or other parties. It can be prevented by taking proactive measures such as verifying the background and credibility of the parties, choosing certain trade terms, and verifying the authenticity of documents.

Letters of Credit

1. *Irrevocable:* L/Cs that cannot be amended or canceled without the agreement of all parties to the credit (i.e., the beneficiary, the buyer, and the issuing bank).
2. *Revocable:* L/Cs that may be amended or canceled by issuing bank without prior notice to the exporter (beneficiary). However, issuing banks must honor drafts duly negotiated by other banks prior to revocation.
3. *Confirmed:* A credit in which another bank, usually the advising bank, confirms its obligation to honor drafts and documents presented by the beneficiary, in accordance with the terms of the credit. This applies only to an irrevocable L/C, as the revocable L/C would become irrevocable if another bank added its confirmation.
4. *Transferable:* L/Cs that permit a beneficiary to transfer the credit to a second beneficiary. They are similar to back-to-back L/Cs, but only one credit is issued.
5. *Back-to-Back:* A letter of credit that is issued on the strength of another L/C.
6. *Revolving:* An agreement in which the buyer is allowed to replenish the credit after it is drawn down by a seller.
7. *Red-clause credit:* Advances or pre-export financing provided to an agent or distributor for the purchase of merchandise from a supplier. Such advances are made without presentation of documents.
8. *Green-clause credit:* Allows advances to be made on presentation of warehouse receipts.
9. *Deferred-payment credit.* The seller agrees not to present a sight draft until after a specified period following presentation of documents. No draft need accompany the documents. When it is accompanied by a draft, it becomes an acceptance L/C.
10. *Standby:* A credit used to guarantee that a party will fulfill its obligation under a sales or service contract. Types of standby L/Cs include contractor bids and performance bonds, performance guarantees against advance payments, guarantee against payments on open account, and loan guarantees.
11. *Straight:* An L/C that is payable at the issuing bank or at a designated bank nominated in the letter of credit.
12. *Negotiable:* An L/C that can be negotiated at any bank. This means that the issuing bank will reimburse any bank that pays against the documents stipulated in the credit.

Review Questions

1. Discuss the distribution of risk in the following export payment terms: consignment, time draft.
2. What are the advantages and disadvantages of these payment terms: documentary collections, open-account sales, revocable letters of credit?
3. State the different steps involved in a confirmed documentary letter of credit, with payment terms of ninety days sight.
4. Compare and contrast documentary collections and documentary letter of credit.
5. The manager of the letter of credit division of Citibank in Chicago learns that the ship on which a local exporter shipped goods to Yokohama, Japan, was destroyed by fire. He knows that the buyer in Yokohama will never receive the goods. The manager, however, received all the documents required under the letter of credit. Should the manager pay the exporter or withhold payment and notify the overseas customer in Japan?

6. Compare the role and responsibility of banks in documentary collections and in letters of credit.
7. What is the independent principle?
8. Discuss the rule of strict compliance.
9. Provide an example of a major discrepancy in letters of credit.
10. Briefly describe the following: transferable L/C, back-to-back L/C, deferred L/C, standby L/C.

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World Wide Web Resources

Financing Exports/Trade Payments
http://www.bizhelp24.com/export-import/the-letter-of-credit-2.html
http://www.ruralfinance.org/fileadmin/templates/rflc/documents/1153746522276_Doc_7_1_Trader_Finance_Pay_Methods.pdf
http://export.gov/sbcounselors/eg_main_038170.asp
Institute of International Banking (on financing exports and related topics): http://www.iiblp.org/

Case 11.1 Dishonoring Letters of Credit

In June 2005, JFTC, a Chinese company, agreed to purchase 1,000 metric tons of fertilizers from VA Trading Corporation (VATC), located in Houston, Texas. JFTC obtained a letter of credit from the Bank of China (BC) for the purchase price of $1.2 million. Payment was to be made to VATC after delivery of the merchandise and presentation of the requisite documents to the Bank of China in accordance with UCP 500.

The market price of fertilizers had declined significantly, and the buyer requested a concession. VATC refused to reduce the price. VATC presented the documents specified under the letter of credit (after shipping the goods to JFTC) to Texas Commerce Bank (TCB), which would forward the documents to the BC. Although TCB pointed certain discrepancies between the documents and letter of credit, it did not believe that they would lead to any problems.

The Bank of China notified TCB of the discrepancies and indicated its willingness to contact the buyer (JFTC) about acceptance. JFTC refused to waive the discrepancies, and the Bank of China returned the documents to TCB. VATC was not paid for the shipment.

Questions

1. Discuss the various options available to VATC.
2. Do you think the alleged discrepancies between the documents and letter of credit could be adequate grounds for dishonoring the letter of credit?
3. Do you think JFTC or its bank provided adequate notice to VATC according to UCP 500?

Case 11.2 The Independent Principle in Letters of Credit

A bank in New York issued a letter of credit to a beneficiary (seller) in Spain at the request of the buyer to cover the shipment of building products. When seller presented the documents to the bank for payment, the bank declined to pay on

the ground that it had no opportunity to test the quality of the products. The letter of credit did not require that a testing certificate from an independent laboratory accompany the documents.

Questions

1. Was the bank justified in withholding payment?
2. Does the buyer or the bank have the right to demand inspection of the quality of the merchandise?
3. What is the importance of the independent principle for this case?

Case 11.3 Deferred Payment in Letters of Credit (L/C)

Bank A issued a deferred payment L/C in favor of Martin Co. with a promise to pay sixty days from the bill of lading (BL). It also undertook to cover the confirming bank at maturity. Martin Co. presented complying documents to the confirming bank, after which the latter made a discounted payment. The beneficiary (Martin Co.) then assigned the L/C to the confirming bank. Bank A was not notified of the assignment.

Bank A gave notice to the confirming bank that the L/C was forged and refused payment. It also stated in its response that the confirming bank should have delayed payment till the maturity date, before which the fraud would have been discovered. Bank A claims that it did not ask the confirming bank to discount or give value to the documents before the maturity date. The L/C was subject to UCP 600.

Questions

1. Should Bank A pay the confirming bank? Why/why not?
2. Would the outcome be different if Bank A issued an acceptance L/C?

twelve
Countertrade

Origins of Countertrade

Countertrade is any commercial arrangement in which sellers or exporters are required to accept in partial or total settlement of their deliveries a supply of products from the importing country. In essence, it is a nation's (or firm's) use of its purchasing power as leverage to force a private firm to purchase or market its marginally undesirable goods or exact other concessions in order to finance its imports or obtain needed hard currency or technology. Although the manner in which the transaction is structured may vary, the distinctive feature of such arrangements is the mandatory performance element that is either required by the importer or the importer's government or made necessary by competitive considerations (Verzariu, 1985, 1992).

The origins of countertrade can be traced to ancient times, when international trade was based on the free exchange of goods. Barter flourished in northern Mesopotamia as early as 3000 BC, when inhabitants traded in textiles and metals. The Greeks also profited by the exchange of olive oil and wine for grain and metals sometime before 2000 BC (Anyane-Ntow and Harvey, 1995; Brinton, Christopher, Wolff, and Winks, 1984). Even with the flourishing of a money economy, barter still continued as a medium of exchange. Present-day countertrade involves more than the use of simple barter. It is a complex transaction that includes the exchange of some currency as well as goods between two or more nations. A countertrade transaction may, for example, specify that the seller be paid in foreign currency on the condition that seller agrees to find markets for specified products from the buyer's country.

The resurgence of countertrade has often been associated with East-West trade. At the start of the 1950s, the then-Communist countries of Eastern Europe faced a chronic shortage of hard (convertible) currency to purchase needed imports. In their dealings with Western countries, they insisted that their products be taken in exchange for imports from the latter countries. This practice also proved quite attractive to many developing nations, which also suffer from a shortage of convertible currency. The use of countertrade has steadily increased

and is presently estimated to account for about 20 to 30 percent of world trade (Hennart and Anderson, 1993; Howse, 2010). Although there may be disagreements concerning the current volume of countertrade, the broad consensus is that countertrade constitutes a significant and rapidly growing portion of world commerce (Bost and Yeakel, 1992; McVey, 1984). A large number of U.S. corporations find it difficult to conduct business with many countries without relying on countertrade. For example, about two thirds of foreign purchases of American commercial and military jets are paid for with local products instead of cash (Angelidis, Parsa, and Ibrahim, 2004; Bragg, 1998). Businesses are resorting to countertrade in response to increasing costs and declining availability of trade finance. In response to this growing interest, some U.S. banks have established their own countertrade departments (Welt, 1990).

In the 1980s, countertrade was used mainly as a vehicle for trade finance. It is now used to meet a broad range of business objectives: capital project financing, production sharing, repatriation of profits from countries with hard currency shortages, and competitive bidding on major government procurements (Caves and Marin, 1992; Egan and Shipley, 1996).

Examples of Countertrade

- Malaysia signed a deal swapping palm oil for fertilizer and machinery with North Korea, Cuba, and Russia. Thailand and Iran agreed to barter rice for oil.
- Indonesia negotiated for a power station project with Asea Brown Boveri and for an air traffic control system with Hughes Aircraft. Counterpurchase obligations were to be 100 percent of the FOB values. The firms export, through a trading company, a range of Indonesian products: cocoa to the United States, coal to Japan, fertilizer to Vietnam and Burma.
- Lockheed Martin agreed to sell F-16 military aircraft to Hungary in exchange for large investment and counterpurchase commitments. The firm agreed to buy $250 million (U.S.) worth of Hungarian goods. It established an office in Budapest to participate in tendering and to procure the country's industrial goods for export.
- Taiwan purchased sixty Mirage between 2000 and 2005 from a French aviation company, Dussault. In return, Dussault undertook a joint venture with Taiwan's aerospace company, Chenfeng, for the production of key aircraft parts and components for local aircraft and export (Anonymous, 1997a, 1997b, 1997c).

Benefits of Countertrade

Benefits for Buyers

Transfer of Technology

In exchange for a guaranteed supply of raw materials or other scarce resources, a developed nation will provide the capital, equipment, and technology that are needed to develop such resources. Western firms, for example, assisted Saudi Arabia in the development of its refinery and petrochemical industry in exchange for the right to purchase a certain amount of oil over a given period of time.

Alleviating Balance-of-Payments Difficulties

The financial crisis, coupled with adverse movements in the price of key export commodities, such as coffee or sugar, left many developing countries with severe balance-of-payments difficulties. Countertrade has been used as a way of financing needed imports without depleting limited foreign currency reserves. Some countries have even used it as a way of earning hard currency by promoting the export of their domestic output. Countertrade has thus helped these nations avoid the burden of additional borrowing to finance imports as well as the need to restrict domestic economic activity. Countertrade is also used as a method of entering a new market, particularly in product areas that invite strong competition.

Maintaining Stable Prices for Exports

Countertrade allows commodity exporters to maintain nominal prices for their products even in the face of limited or declining demand. The price of the product that is purchased in exchange could be increased to take into account the inflated price of exports. In this way, an exporter can dispose of its commodities without conceding the real price of the product in a competitive market. In the case of cartels, such as OPEC (Organization of Petroleum Exporting Countries), a member could attract customers through countertrade opportunities without violating price guidelines.

Benefits for Exporters

Increased Sales Opportunities

Countertrade generates additional sales that would not otherwise be possible. It also enables entry into difficult markets.

Access to Sources of Supply

Countertrade provides exporters access to a continuous supply of production components, precious raw materials, or other natural resources in return for sales of manufactured goods or technology.

Flexibility in Prices

Countertrade enables the exporter to adjust the price of a product in exchange for overpriced commodities (International Perspective 12.1).

Theories on Countertrade

A limited number of empirical studies on countertrade have been conducted. The following findings characterize some of the theoretical studies on countertrade practices:

- Countertrade is positively correlated with a country's level of exports. This means that a higher level of international commercial activity is associated with a high level of countertrade (Caves and Marin, 1992; Hennart and Anderson, 1993).
- Countertrade is often used as a substitute for foreign direct investment (FDI). Even though foreign direct investment reduces market transaction costs (by internalizing sources of raw materials and components through vertical integration), multinational companies resort to countertrade as a second-best solution when host countries impose restrictions on inward FDI. Countries engaged in heavy countertrade tend to be those that severely restrict inward FDI. FDI may also be less attracted to politically risky countries, in spite of their positive attitudes toward foreign investment. Such countries are likely to have a high level of countertrade activity (Hennart, 1990).
- The stricter the level of exchange controls, the higher the level of countertrade activity. This appears to be a response to the restrictions imposed on the acquisition of foreign currency. Some studies also show that a significant percentage of countertrade has little to do with foreign exchange shortages but rather is intended to reduce high transaction costs that affect the purchase of technology or intermediate products.
- Countertrade is positively correlated with a country's level of indebtedness. Casson and Chukujama (1990) show that countries with higher debt ratios are more strongly engaged in barter. A country's creditworthiness, as measured by a composite of ratings of international banks, is positively correlated with its barter activities (Hennart and Anderson, 1993).

INTERNATIONAL PERSPECTIVE 12.1

The Mechanics of a Barter Transaction

Suppose a private firm is selling drilling equipment to country A in exchange for ten tons of basmati rice. One method is to use reciprocal performance guarantees such as performance bonds or standby letters of credit. Each party posts a guarantee, and this provides payment to the aggrieved party in the event of failure by the other party to perform its part of the contract (i.e., failure to deliver the goods or delivery of nonconforming goods). However, the fees charged by banks for such guarantees are quite high. Another method is to use an escrow account to secure performance of an obligation by each party. The steps used are as follows:

- The firm opens a documentary letter of credit in favor of country A. In cases where the product is passed to a trading company, the letter of credit is opened by the trading company in favor of the nation.
- Country A delivers the rice to the firm or trading company, and title is transferred.
- When the title passes to the firm, funds equal to the value of the rice shipped are transferred by the firm under the letter of credit into an escrow account.
- The firm makes delivery of the drilling equipment simultaneously or at a later date to country A, and title is transferred to the nation.
- Funds in the escrow account are released to the firm.
- In the event the firm delivers nonconforming goods or fails to deliver the goods, the funds in the escrow account are paid to the nation.

Forms of Countertrade

Countertrade takes a variety of forms (see Figure 12.1). Such transactions can be divided into two broad categories:

- Transactions in which products and/or services are traded in exchange for other products and /or services. These include barter, switch trading, and clearing arrangements.
- Transactions that feature two parallel money-for-goods transactions. These include buy-back, counterpurchase, and offset arrangements.

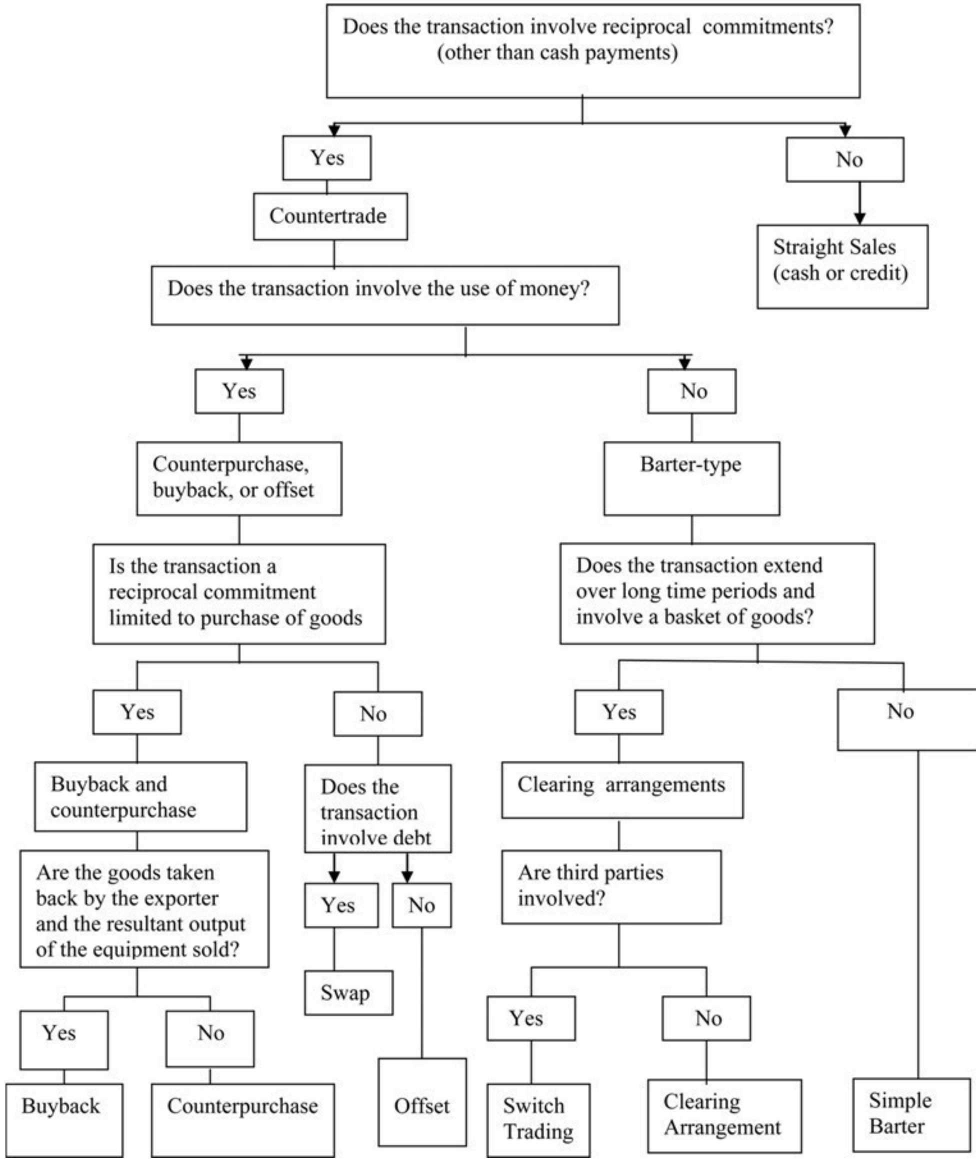

FIGURE 12.1 Classification of Forms of Countertrade

Exchange of Goods (Services) for Goods (Services)

Barter

A classic barter arrangement involves the direct exchange of goods or services between two trading parties (see International Perspective 12.1). An exporter from country A to country B is paid by a reciprocal export from country B to country A, and no money changes hands. The transaction is governed by a single contract. In view of its limited flexibility, barter accounts for about 4 percent of countertrade contracts (Fletcher, 2009). The major problems with barter relate to the determination of the relative value of the goods traded and the reluctance of banks to finance or guarantee such transactions.

> *Example:* In 2009, India agreed to barter its machinery and equipment used for gemstone cutting and polishing for precious and semiprecious stones from the Philippines. Thailand agreed to barter its fruits for Chinese locomotives, passenger buses, and armored cars.

Switch Trading

This is an arrangement in which a switch trader will buy or market countertraded products for hard currency (Figure 12.2). The switch trader will often demand a sizable fee in the form of a discount on the goods delivered.

> *Example:* A U.S. company exports fertilizer to Pakistan. However, the goods to be counterdelivered by Pakistan are of little interest to the U.S. seller. A Romanian company (switch trader) converts the Pakistani goods into cash, pays the U.S. exporter, and retains a commission.

Clearing Arrangements

Under clearing arrangements, two governments agree to purchase a certain volume of each other's goods and/or services over a certain period of time, usually a year. Each country sets up an account in one currency, for example, clearing dollar, pound, or local currency. When a trade imbalance exists, settlement of accounts can be in the form of hard-currency payments for the shortfall, transfer of goods, issuance of a credit against the following

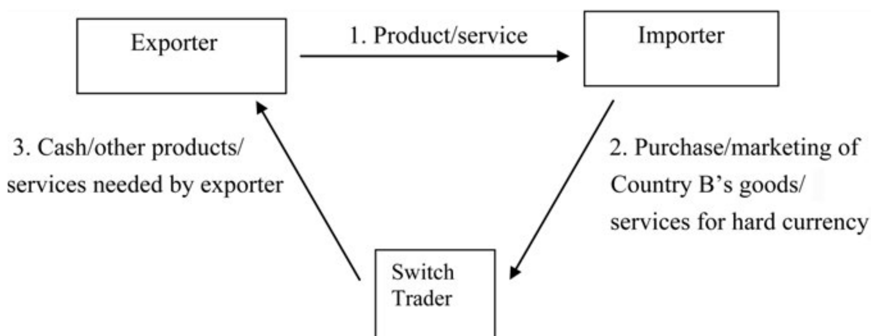

FIGURE 12.2 Switch Trading

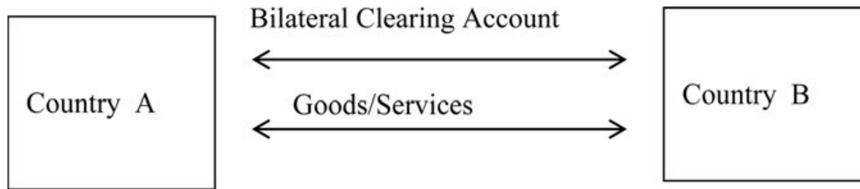

FIGURE 12.3 Clearing Arrangement

year's clearing arrangement, or switch trading. In switch trading, the creditor country can sell its credit to a switch trader for a discount and receive cash payment. The switch trader will subsequently sell the corresponding goods to third parties (see Figure 12.3).

> *Example:* A Swedish company, Sukab, accumulated a large surplus in its clearing account with Pakistan. Sukab sold its credit to Marubeni, a Japanese company, at a discount, and Marubeni in turn liquidated this imbalance by purchasing Pakistani cotton and exporting it to a third country for hard currency (Anonymous, 1996).

Parallel Transactions

Buyback (Compensation Agreement)

In a buyback or compensation transaction, a private firm sells or licenses technology or builds a plant (with payment in hard currency) and agrees to purchase, over a given number of years, a certain proportion of the output of the technology or plant. The output is to be purchased in hard currency. However, since the products are closely related, a codependency exists between the trading parties (see Figure 12.4). The duration of a compensation arrangement could range from a few years to thirty years or longer in cases in which the technology supplier (seller) is dependent upon the buyer's output for itself and its subsidiaries. The arrangement involves two contracts, each paid in hard currency, that is, one for the delivery of technology and equipment and another for the buyback of the resulting output. The two contracts are linked by a protocol that, inter alia, stipulates that the output to be purchased by the technology supplier is to be produced with the technology delivered. Since the agreement entails transfer of proprietary technology, it is quite important to pay special attention to the protection of patents, trademarks, and know-how, as well as to the rights of the technology recipient

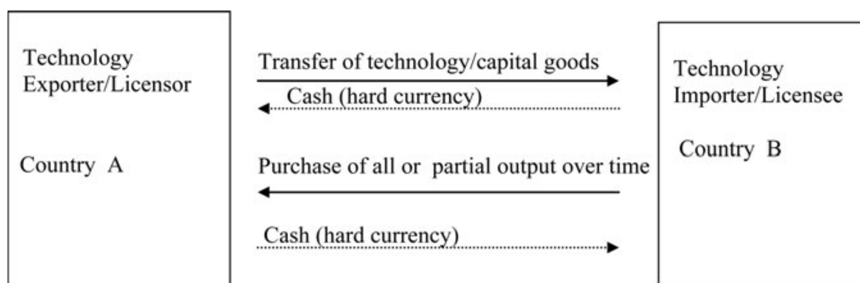

FIGURE 12.4 Buyback

(importer/buyer) with respect to these industrial property rights. Buybacks are estimated to account for 21 percent of countertrade transactions (International Perspective 12.2).

> *Example:* A Japanese company exports computer chip processing and design technology to South Korea, Singapore, and Taiwan, with a promise to purchase a certain percentage of the output over a given period of time. Levi Strauss transfers its know-how and trademark to a Hungarian firm for the production and sale of its products, with an agreement to purchase and market the output in Western Europe.

Counterpurchase

As in a compensation arrangement, counterpurchase consists of two parallel hard currency-for-goods transactions (see Figure 12.5). However, in a counterpurchase, a firm sells goods and/or services to an importer, promising to purchase from the latter or other entities in the importing nation goods that are unrelated to the items sold. The duration of such transactions is often short (three to five years), and the commitment usually requires a reciprocal purchase of less than the full value of the original sale. In cases in which the reciprocal purchase involves goods that are of low quality or in excess supply, the firm usually resells them to trading companies at a discount. Since the arrangement is often governed by two separate contracts, financing can be organized in a way that is similar to any other export transaction. In addition to flexibility in financing, the contractual separation also provides for separate provisions with regard to guarantee coverage, maturity of payments, and deliveries. As in compensation agreements, the two contracts are linked by a third contract that ties the purchase and sales contracts together and includes terms such as the ratio between purchases and sales, starting time of both contracts, import-export verification system, and so forth (Welt, 1990). Counterpurchase accounts for 54 percent of countertrade transactions (Fletcher, 2009). (See International Perspective 12.3).

> *Examples:* Rockwell and the government of Zimbabwe signed a contract in which Rockwell offered to purchase Zimbabwe's ferro chrome and nickel in exchange for its sale of a printing press to Zimbabwe.

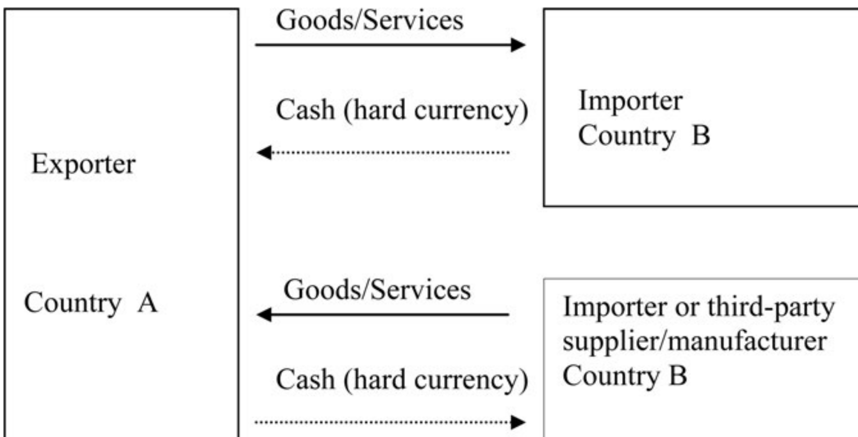

FIGURE 12.5 Counterpurchase

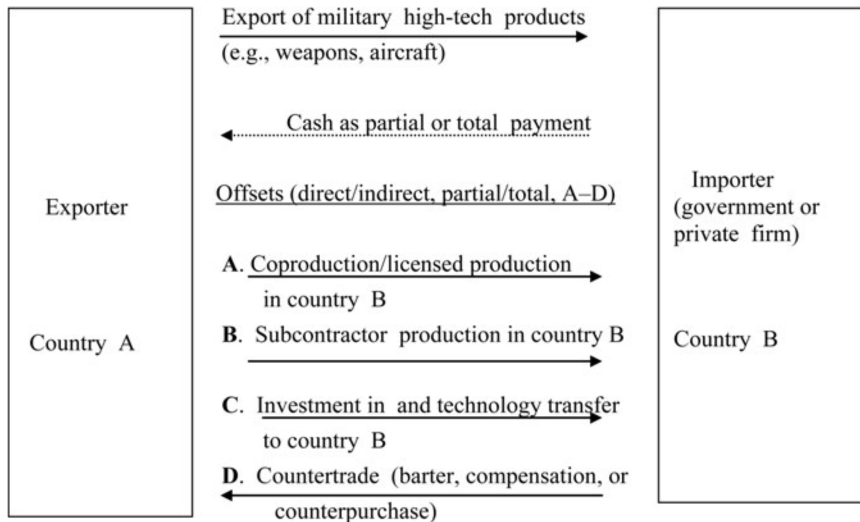

FIGURE 12.6 Offsets

Offsets

An offset is a transaction in which an exporter allows the purchaser, generally a foreign government, to "offset" the cost of purchasing its (the exporter's) product (Cole, 1987) (see Figure 12.6). Such arrangements are mainly used for defense-related sales, sales of commercial aircraft, or sales of other high-technology products. Offsets are used by many countries as a way to compensate for the huge hard-currency payments resulting from the purchase as well as to create investment opportunities and employment. Such arrangements became widespread after 1973 when OPEC sharply increased the price of oil and countries were left with limited hard currency to pay for major expenditures (Egan and Shipley, 1996; Schaffer, 1989).

Direct Offsets

Direct offsets are contractual arrangements, often involving goods or services related to the products exported. Direct offsets include coproduction, subcontractor production, investments, and technology transfer.

Coproduction. Coproduction is an overseas production arrangement, usually based on a government-to-government agreement that permits a foreign government or producer to acquire the technical information to manufacture all or part of an equipment or component originating in the exporting country. It may include a government-to-government production under license. The essential difference between coproduction and licensed production is that the former is normally a joint venture, while the latter does not entail ownership and/or management of the overseas production by the technology supplier. In coproduction, there is usually a government-to-government negotiation, whereas licensed production is based on direct commercial arrangements between the foreign manufacturer and host government or producer. In most cases, coproduction and licensed production are direct offsets because the resulting output directly fulfills part of the sales obligation.

Example: France purchased AWACS (airborne warning and control system) aircraft from Boeing, based on a coproduction arrangement between the U.S. and the French governments. According to the agreement, 80 percent of the contract value was to be offset by the purchase of engines produced through a joint venture between General Electric and a French firm.

Subcontractor production. Subcontractor production is usually a direct commercial arrangement between a manufacturer and an overseas producer (in the host country) for the production of a part or component of the manufacturer's export article. Such an arrangement does not often involve licensing of technological information.

Example: Lockheed Martin and the government of Poland reached a $3.8 billion deal for the latter's purchase of F-16s that included subcontracts with Polish firms to produce "the Pratt & Whitney engine for the F-16" as well as "commercial jet parts for business aircraft," which would then be exported by Poland back to the United States (Peterson, 2011).

Overseas investments. Overseas investments arising from the offset agreement usually take the form of capital investment to establish or expand a company in the purchasing country.

Example: Company A, a U.S. firm, makes an investment in Company B, a foreign firm located in country C, so that Company B can create a new production line to produce a component of a defense article that is subject to an offset agreement between Company A and country C. The transaction would be categorized as investment and would be direct offset because the investment involves an item covered by the offset agreement.

Technology transfer. Even though technology transfer provisions could be included in coproduction or licensed production arrangements, they are often distinct from both categories. A technology transfer arrangement usually involves the provision of technical assistance and R&D capabilities to the joint-venture partner or other firms as part of the offset agreement.

Example: Spain purchases F-18 aircraft from the United States under an offset arrangement that requires the transfer of aerospace and other related technology to Spain.

Indirect Offsets

Indirect offsets are contractual arrangements in which goods and services unrelated to the exports are acquired from or produced in the host (purchasing) country. These include but are not limited to certain forms of foreign investment, technology transfer, and countertrade.

Example 1: As part of the cooperative defense agreement, the Netherlands purchased Patriot fire units from Raytheon Corporation of the United States for $305 million. Raytheon agreed to provide $115 million in direct offsets and $120 million in indirect offsets. The latter obligation was to be discharged through the purchase of goods and services in the Netherlands.

Arms sales account for a substantial part of offset transactions, which, in turn, make up the largest percentage of countertrade deals.

Example 2: Company A, a U.S. firm, makes arrangements for a line of credit at a financial institution for Company B, a foreign firm located in country C, so that Company B can produce an item that is not subject to the offset agreement between Company A and country C. The transaction would be categorized as credit assistance and would be indirect because the credit assistance is unrelated to an item covered by the offset agreement.

Example 3: Company A, a U.S. firm, purchases various off-the-shelf items from Company B, a foreign firm located in country C, but none of these items will be used by Company A to produce the defense article subject to the offset agreement between Company A and country C. The transaction would be categorized as purchases and would, like all purchase transactions, be indirect.

INTERNATIONAL PERSPECTIVE 12.2

Organizing for Countertrade

Once a firm has made a decision to countertrade, it has two organizational options: to use third parties such as consultants and trading houses or to establish a countertrade department within the company. Organizing a countertrade department within the firms has its own benefits and disadvantages.

Advantages	Disadvantages
Direct contact with the customer	Costly and mostly suitable for multinational companies with broad-based product lines
Opportunity for learning and flexibility	Complex and involves corporate planning and coordination of staff
Confidentiality and disposing of control over the operation	Limited expertise; problems with countertraded goods

Countertrade and the WTO

The prevalence of countertrade practices has directed the attention of policymakers to its potentially disruptive effects on international trade. Trade experts claim that countertrade represents a significant departure from the principles of free trade and could possibly undermine the delicate multilateral trading system that was carefully crafted after World War II. This movement toward bilateral trading arrangements deprives countries of the benefits of multilateral trade that GATT/WTO negotiated to confer upon members. Private countertrade transactions, however, fall outside the purview of the GATT, which regulates only governmental actions.

In addition, countertrade tends to undermine trade based on comparative advantage and prolongs inefficiency and misallocation of resources. A country, for example, may have to

purchase from a high-cost/low-quality overseas supplier to fulfill its obligation under the export arrangement. Countertrade also slows down the exchange process and results in higher transaction costs in the form of converting goods into money, warehousing, and discounting to a trader when it cannot use the goods received.

Countertrade is also inconsistent with the national treatment standard, which is embodied in most international and regional trade agreements. The national treatment standard of the GATT/WTO, for example, requires that imported goods be taxed and regulated in the same manner as domestically produced goods. Any commercial transaction that requires the overseas supplier (exporter) to purchase a specified portion of the value of the exports from the purchaser would violate the national treatment standard (Roessler, 1985).

Countertrade constitutes a restriction on imports. The GATT/WTO prohibits restrictions other than duties, taxes, or other charges applied to imports. This means that if import licenses are granted on the condition that the imports are linked to exports, such countertrade practices would constitute a trade restriction prohibited under the general agreement. Without this government restriction, the producer would be able to import any amount of product that efficiency and consumer demand dictated. Such restrictions are in conformity with the agreement if they are imposed to safeguard a country's balance of payments (external financial position), as well as to protect against a sudden surge in imports of particular products. (emergency actions).

Countertrade and the International Monetary Fund

The International Monetary Fund (IMF) imposes a dual regime: on the one hand it attempts to deter members from restricting international payments and transfers for current international transactions, while on the other hand it permits its members to regulate international capital movements as they see fit. Payments for current transactions involve an immediate quid pro quo (i.e., payments in connection with foreign trade, interest, profit, dividend payments), while capital payments are unilateral (e.g., loans, investments). A governmental measure requiring or stimulating countertrade would constitute an exchange restriction on current transactions if it involved a direct limitation on the availability or use of foreign currency.

Governments' Attitudes Toward Countertrade

Consistent with their commitment to a nondiscriminatory trading system, many countries are opposed to government-mandated countertrade because it distorts the free flow of trade and investment. Yet, they do not publicly discourage firms from engaging in countertrade (U.S. ITC, 1985; U.S. Office of Management and Budget, 1986).

The U.S. policy on countertrade was developed in 1983 by an interagency working group. The policy does the following:

- It prohibits federal agencies from promoting countertrade in their business or official contracts.
- It adopts a hands-off approach toward those arrangements that do not involve the U.S. government or that are pursued by private parties. This means that the U.S. government will not oppose participation of U.S. companies in countertrade deals unless such activity has negative implications on national security.
- It provides no special accommodations for cases involving such transactions. The Export-Import Bank (Eximbank) will not provide financing support for the

countertrade component of a transaction or accept countertrade as security, but the U.S. export component is eligible for all types of Eximbank support. Any repayment to Eximbank must be in hard currency and not conditional on the fulfillment of a side contract associated with countertrade.

In view of congressional concern with respect to such practices, the 1998 Trade Act mandated the establishment of an office of barter within the Department of Commerce's International Trade Administration and of an interagency group on countertrade. The Barter and Countertrade Unit established within the Department of Commerce (2005) now provides advisory services to firms interested in such transactions, while the interagency group on countertrade reviews and evaluates U.S. policy on countertrade and makes recommendations to the president and Congress.

Some countries have officially instituted mandatory countertrade requirements for any transaction over a certain value. Australia, for example, mandates local content and other investment requirements for all defense purchases valued at $5 million and above (Liesch, 1991). Certain countries have passed laws providing for counterpurchase operations and the extension of bank guarantees in the form of performance bonds. Indonesia, for example, established a countertrade division within the Ministry of Trade and has mandated countertrade requirements for any transaction exceeding $500,000 (Liesch, 1991; Verdun, 1985). Other countries may not have an official policy on countertrade or may even be opposed to it due to their position on free trade. However, this opposition often yields to the realities of international trade and competition, and a number of these countries are seen providing tacit approval to such transactions (International Perspective 12.4).

INTERNATIONAL PERSPECTIVE 12.3

Negotiating Countertrade Contracts: Pointers

Costs: All costs are included into one price. The price also includes the commission payable to dispose of the countertraded goods.

Contract(s): One or separate contracts can be used. Separate contracts are signified by three legal documents: the original sales contract, which is similar to any standard export contract; the subsequent agreement to purchase from the original buyer a certain amount of goods over a given time period; and some type of protocol that tie the two contracts together.

Barter contract: Barter usually requires one contract. Key provisions include (1) description of goods to be sold and countertraded; (2) guarantee of quality; (3) penalty or other arrangements in the event of late delivery, failure to deliver, or delivery of nonconforming goods (including a bank guarantee or other guarantee in the form of a standby letter of credit in the event of default that provides for full payment); and (4) provisions for settlement of disputes.

Buybacks, counterpurchases, or offsets: Such contracts require the use of one or separate contracts. Key provisions include (1) The compensation ratio, which establishes the counterpurchase commitment by the original exporter; (2) range of products to be countertraded (parties must agree on the list of products to be purchased);

(3) assignment clause, which enables the original seller to transfer its counterpurchase or buyback obligation to a trading house or a barter business club; (4) the penalty clause, which provides for penalties in the event that the original seller fails to fulfill its obligations (i.e., quality specifications and delivery schedules); (5) marketing restrictions (it may be important to secure the right to dispose of the countertraded goods in any market); and (6) provisions on force majeure (delay or default in performance caused by conditions beyond the party's control), applicable law (i.e., the law governing the contract), and dispute settlement.

INTERNATIONAL PERSPECTIVE 12.4

Countertrade with Latin American Countries

A recent study on countertrade with Latin American countries (Angelidis et al., 2004) reports the results of a survey of firms engaged in countertrade transactions. The survey reveals that the following industries account for more than 75 percent of transactions: defense (33.3 percent), manufacturing (30.3 percent) and chemicals (27.3 percent). The participants largely employed counterpurchases and offsets.

The survey also provides a detailed analysis of the major reasons for and challenges of countertrading with these countries.

Reasons for countertrade

- Eliminates problem of inadequate foreign currency reserves
- Offers a way to gain competitive advantage
- Is the only way to do business, demanded by customers
- Increases production capacity and helps achieve growth
- Offers supply of reliable and low-cost inputs
- Circumvents protectionist regulations; reduces adverse impact of foreign currency fluctuations
- Releases blocked funds
- Helps reduce difficulty of obtaining credit for the buyer
- Expertise in countertrade is available to buyer or seller.

Challenges of countertrade

- Often involves complicated and time consuming negotiations
- May result in increase in transaction costs, product mismatch, and the purchase of low-quality goods
- May create problems with disposition of acquired (lack of ready) merchandise and price-setting as well as loss of purchasing flexibility
- Involves third parties and raises the possibility of customers becoming competitors.

Chapter Summary

What is countertrade?	Countertrade is any commercial arrangement in which the exporter is required to accept in partial or total settlement of his/her deliveries, a supply of products from the importing country. Barter could be traced to ancient times. Presently, countertrade is estimated to account for 15–20 % of world trade.
Benefits of countertrade	*Benefits for buyers:* 1. Transfer of technology 2. Alleviation of balance of payments difficulties 3. Market access and maintenance of stable prices. *Benefits for exporters:* 1. Increased sales opportunities 2. Access to sources of supply 3. Flexibility in prices.
Theories on countertrade	1. Countertrade is positively correlated with a country's level of exports. 2. Countertrade is partly motivated in order to substitute for foreign direct investment. 3. The stricter the level of exchange controls, the higher the level of countertrade activity.
Forms of countertrade	Exchange of goods/services for goods/services: 1. *Barter:* Direct exchange of goods and services between two trading parties 2. *Switch trading:* An arrangement in which the switch trader will buy or market countertraded goods for hard currency 3. *Clearing arrangement:* A method in which two governments agree to purchase a certain volume of each other's goods/services over a given period of time. In the event of trade imbalance, settlement could be in hard currency payments, transfer of goods, issuance of a credit or use of switch trading. Parallel transactions: 1. *Buy-back*: An arrangement in which a private firm will sell or license technology to an overseas customer with an agreement to purchase part of the output produced from the use of such technology. The agreement involves two contracts, both of which are discharged by payment of hard currency. 2. *Counterpurchase:* Two parallel transactions in which a firm exports a product to an overseas buyer with a promise to purchase from the latter or other parties in the country goods not related to the items exported. 3. *Offsets:* A transaction in which an exporter allows the purchaser, usually a foreign government, to reduce the cost of purchasing the exporter's product by coproduction, subcontracting, investments and transfers of technology.
Offsets	Direct offsets: 1. *Co-production*: Joint venture or licensing arrangements with overseas customer 2. *Subcontractor production:* Arrangement for production in the importing country of parts or components of the export product destined to the latter 3. *Investments and transfer of technology:* Certain offset agreements provide for investments and technology transfer to the importing country

(*Continued*)

	Indirect offsets: Offset arrangements in which goods and services unrelated to the exports are acquired from or produced in the importing country.
Countertrade and the GATT/WTO	*Concerns of the GATT/WTO with countertrade:* 1. Countertrade represents a significant departure from the principles of free trade based on comparative advantage. 2. Countertrade results in higher transaction costs. 3. Countertrade is inconsistent with the national treatment standard which is embodied in most trade agreements.
Governments' attitude toward countertrade	*U.S. government policy toward countertrade:* 1. U.S. government prohibits federal agencies from promoting countertrade in their business. 2. Adopts a hands-off approach in relation to private transactions. Some countries have a countertrade requirement for certain purchases exceeding a given amount. Such transactions are quite common in defense purchases.

Review Questions

1. What are the major factors accounting for the resurgence of countertrade?
2. What is the benefit of countertrade for exporters?
3. "Countertrade is used as a substitute for foreign direct investment." Discuss.
4. What is the difference between switch trading and a clearing arrangement?
5. Describe the steps involved in a typical barter transaction.
6. Compare and contrast buyback and counterpurchase arrangement.
7. Discuss direct offsets and their components.
8. What are the challenges of countertrade with Latin American countries?
9. What is the U.S. government attitude toward countertrade?
10. Discuss the concerns of WTO with countertrade.

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Verzariu, P. (1985). *Countertrade, Barter and Offsets: New Strategies for Profit in International Trade.* New York: McGraw-Hill.
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World Wide Web Resources

Information on global countertrade, legal and regulatory environment, and conferences pertaining to countertrade, as well as information on the American Countertrade Association: http://www.globaloffset.org/

Information on countertrade and Incoterms, including seminars related to this subject: http://i-b-t.net/anm/templates/trade_article.asp?articleid = 206&zoneid = 3

Articles on countertrade: http://www.investopedia.com/terms/c/countertrade.asp

News and publications on countertrade: http://www.barternews.com/countertrade.htm

Case 12.1 The Bofors-India Countertrade Deal

Bofors AB is a Swedish company that specializes in the manufacturing and sales of weapon systems such as antiaircraft/antitank guns, artillery, and ammunition. The Indian government concluded an agreement with Bofors AB for the purchase of 410 FH77B howitzers ($1.3 billion) in 1986. The FH77B howitzer is a powerful, highly mobile artillery system. It has a gun with a range of 30 km and a capability to fire three rounds in thirteen seconds. It can be integrated with a 6x6 all-terrain vehicle.

The agreement provided for the purchase of goods from India amounting to not less than 50 percent of the value of the contract. Given its lack of experience in countertrade, Bofors AB signed a contract with other Swedish and U.S. trading companies to fulfill its countertrade agreement with India. Among these companies, Sukab took the leading role due to its vast experience in international trade and expertise in countertrade. Sukab is owned by more than eighty Swedish companies and was set up after the Second World War to promote Swedish exports.

Pursuant to the agreement, Sukab promoted the sale of Indian goods in Sweden through various channels, including seminars held by Swedish trade councils and chambers of commerce. It also set up offices in India to provide export training (e.g., on the best ways and means of exporting Indian goods to Sweden).

The Indian government had to approve of all the products being exported. Bofors AB was provided with a list of approved products. Certain products were specifically excluded from the list of exports.

The major factor that motivated India to enter into the countertrade arrangement was its lack of hard currency to pay for the purchase of the howitzers. The countertrade arrangement provided an opportunity to India to generate enough hard currency to fulfill a portion of its commitments. Furthermore, the arrangement allowed India to expand its distribution channels and gain new markets. The countertrade arrangement also allowed Bofors AB to win the contract over other competing firms.

Questions

1. Do you think this was an ideal trading arrangement for Bofors AB?
2. Would this form of trade arrangement be more beneficial to India than to Bofors? Explain.

Case 12.2 Offsets in U.S. Defense Trade

Offsets in defense trade encompass a range of industrial compensation arrangements required by foreign governments as a condition of the purchase of defense articles and services from a nondomestic source. This mandatory compensation can be directly related to the purchased defense article or service, or it can involve activities or goods unrelated to the defense sale. The U.S. government policy on offsets in defense trade states that the government considers offsets to be “economically inefficient and trade distorting,” and it prohibits any agency of

the U.S. government from encouraging, entering directly into, or committing U.S. firms to any offset arrangement in connection with the sale of defense articles or services to foreign governments. U.S. defense contractors generally see offsets as a reality of the marketplace for companies competing for international defense sales (See Tables 12.1 and 12.2). Several U.S. defense contractors acknowledge that offsets are usually necessary in order to make defense sales—sales that can help support the U.S. industrial base. U.S. firms are required to report annually on contracts for the sale of defense articles or defense services to foreign governments or foreign firms that are subject to offset agreements exceeding $5 million in value and on offset transactions completed in performance of existing offset commitments for which offset credit of $250,000 or more has been claimed from the foreign representative (U.S. Department of Commerce, 2012).

During 1993–2010, fifty-two U.S. firms reported entering into 763 offset-related defense export sales contracts worth $111.59 billion with forty-seven countries. The associated offset agreements were valued at $78.08 billion. In 2010, direct offsets (transactions directly related to the defense export sale with an associated offset agreement) accounted for 33.10 percent of the actual value of reported offset transactions. Indirect offsets (transactions not directly related to the defense export sale with an associated offset agreement) accounted for 63.11 percent of the actual value of reported offset transactions. During 1993–2010, direct offsets accounted for 40.22 percent of the actual value of the reported offset transactions, with indirect offsets accounting for 59.04 percent. The top three offset transaction categories reported by industry for 2010 were purchases, subcontracting, and technology transfer (U.S. Department of Commerce, 2012). These three categories represented 81.59 percent of all offset transactions reported for 2010. U.S. prime contractors develop long-term supplier relationships with foreign subcontractors based on short-term offset requirements. These new relationships, combined with the mandatory offset requirements related to offset agreements, can limit future business opportunities for U.S. subcontractors and suppliers, with negative consequences for the domestic industrial base.

TABLE 12.1 Summary of Offset Transactions, 1993–2010

Year	Actual offset transaction **Value** ($ millions)	Credit offset transaction **Value** ($ millions)	**U.S. firms (number)**	**Transactions (number)**	**Countries (number)**
1993	1,897.88	2,213.62	22	444	27
1994	1,934.86	2,206.09	21	566	26
1995	2,890.49	3,592.59	21	711	26
1996	2,875.82	3,098.02	22	634	26
1997	2,720.58	3,272.31	19	578	26
1998	2,312.17	2,623.21	20	582	29
1999	2,059.73	2,808.33	13	513	25
2000	2,208.18	2,846.44	16	627	24

(*Continued*)

TABLE 12.1 (Continued)

Year	Actual offset transaction Value ($ millions)	Credit offset transaction Value ($ millions)	U.S. firms (number)	Transactions (number)	Countries (number)
2001	2,559.08	3,277.70	16	618	25
2002	2,632.53	3,301.01	18	735	26
2003	3,565.51	4,010.65	17	690	31
2004	4,934.53	5,365.74	16	710	33
2005	4,721.98	5,439.03	13	624	30
2006	4,705.84	4,906.42	16	661	28
2007	3,804.53	4,741.70	19	633	28
2008	3,290.73	4,768.23	22	671	30
2009	3,495.37	4,041.25	23	666	28
2010	3,608.13	4,423.52	25	690	28
Total	**$56,217.94**	**$66,935.87**	**61**	**11,353**	**50**

Source: U.S. Department of Commerce (2012)

TABLE 12.2 Number of Offset Transactions by Category and Type and with Multipliers

Transaction category					
Total		**Direct**	**Indirect**	**Unspecified**	**TMG1***
Coproduction	557	557	—	—	27
Credit assistance	165	14	151	—	26
Investment	234	33	196	5	77
Licensed production	133	78	53	2	12
Other	728	161	559	8	189
Purchase	5,372	—	5,372	—	412
Subcontracting	2,517	2,517	—	—	189
Technology Transfer	1,317	570	728	19	313
Training	330	154	171	5	129
Total	**11,353**	**4,084**	**7,230**	**39**	**1,374**

*TMG1: Number of transactions with multipliers greater than 1.

Source: U.S. Department of Commerce (2012).

Questions

1. Does the practice of offsets in defense contracts violate the U.S. official position (as well as its commitment to WTO) on countertrade?
2. Do you think such practices should be extended to commercial products? Discuss.

Section V

Financing Techniques and Vehicles

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thirteen
Capital Requirements and Private Sources of Financing

Many small and medium-size businesses suffer from undercapitalization and/or poor management of financial resources, often during the first few years of operation. The entrepreneur typically either overestimates demand for the product or severely underestimates the need for capital resources and organizational skills. Undercapitalization may also be a result of the entrepreneur's aversion to equity financing (fear of loss of control over the business) or the lender's reluctance to provide capital due to the entrepreneur's lack of credit history and a comprehensive business plan (Gardner, 1994; Hanks, Barnett, Durden, and Woodrum, 2011; Hutchinson, 1995).

Large corporations have an advantage over small businesses in raising capital. They have greater bargaining strength with lenders, they can issue securities, and they have greater access to capital markets around the world. However, major changes are taking place in small and medium-size business financing due to three important factors: technology, globalization, and deregulation. Information technology enables the financial world to operate efficiently and to decentralize while improving control. It also permits businesses seeking capital to choose from a vast range of financial instruments (Farkhanda, 2007; Grimaud, 1995). Globalization allows businesses to turn increasingly to international markets to raise capital. With a touch of a button, businesses have access to individual or corporate sources of finance around the world. With deregulation in many countries, competition in financial products is allowed across all depository institutions. The distinction between investment and commercial banking is quite blurred, and both sectors now compete in the small-business financing market.

It is important to properly evaluate how much capital is needed, in what increments, and over what time period. First are the initial capital needs to start the export-import business. Start-up costs are not large if the exporter-importer begins as an agent (without buying for resale) and uses his or her own home as an office. Initial capital needs are for office supplies and equipment—telephone, fax, computer—and a part-time assistant. The business could also be started on a part-time basis until it provides sufficient revenues to cover expenses, including the owner's salary. However, when the business is commenced with the intention

of establishing an independent company with products purchased for resale (e.g., merchant, distributor), a lot more capital is needed to prepare a business plan, travel, purchase and distribute the product, and exhibit at major trade shows. Capital is also needed to finance growth and expansion of the business. It is thus critical to anticipate capital needs during the time of growth and expansion as well as when there are abnormal increases in accounts receivable or inventory levels or changes in the business cycle.

The capital needs and financing alternatives of an export-import business are determined by its stage of evolution, ownership structure, distribution channel choice, and other pertinent factors. A very small sum of money is often needed to start the business as an agent because no payments are made for merchandise, transportation, or distribution of the product. However, initial capital needs are substantial if a person starts the business as a merchant, distributor, or trading company with products available for resale. This entails payments for transportation, distribution, advertising and promotion, travel, and other expenses.

Capital needs at the start-up stage may be smaller than those needed during the growth and expansion period. However, this depends on the degree of expansion and the capital needed to support additional marketing efforts, inventories, and accounts receivable. The ownership structure of an export-import firm tends to have an important influence on financing alternatives and little or no influence on capital needs. Studies on small-business financing indicate the following salient features:

- Incorporated companies are more likely to receive equity (and other nondebt) financing than debt financing because lenders perceive the incorporated entity as having a greater incentive to take on risky ventures due to its limited liability (Brewer, Genay, Jackson, and Worthington, 1996).
- Younger firms are more likely to obtain equity (nondebt) than debt financing. The probability of receiving debt financing increases with the firm's age. This is consistent with standard theories of capital structure, which state that such businesses have little or no track record on which to base financing decisions and are often perceived by lenders as risky.
- Firms with high growth opportunities, volatile cash flow, and low liquidation value are more likely to finance their business with equity than with debt. In firms with high growth opportunities, conflicts are likely between management and shareholders over the direction and pace of growth options, and this reduces the chances of debt financing. However, businesses with a good track record and high liquidation value (with assets that can be easily liquidated) have a greater chance of financing their business with debt rather than equity (Cheng, 2009; Schleifer and Vishny, 1992; Stulz, 1990; Williamson, 1988).

Capital Sources for Export-Import Businesses

Capital needs to start the business or to finance current operations or expansion can be obtained from different sources. Internal financing should be explored before resorting to external funding sources. This includes using one's own resources for initial capital needs and then retaining more profits in the business or reducing accounts receivables and inventories to meet current obligations and to finance growth and expansion. Such reductions in receivables or inventories should be applied carefully so as not to lead to a loss of customers or goodwill, both of which are critical to the viability of the business.

External financing takes different forms, and businesses use one or a combination of the following:

- *Debt or equity financing:* Debt financing occurs when an export-import firm borrows money from a lender with a promise to repay (principal and interest) at some predetermined future date. Equity financing involves raising money from private investors in exchange for a percentage of ownership (and sometimes participation in management) of the business. The major disadvantage of equity financing is the owner's potential loss of control over the business (Cheng, 2009).
- *Short-term, intermediate, or long-term financing:* Short-term financing involves a credit period of less than one year, while intermediate financing is credit extended for a period of one to five years. In long-term financing, the credit period ranges between five and twenty years.
- *Investment, inventory, or working-capital financing:* Investment financing is money used to start the business (e.g., computer, fax machine, telephone). Inventory capital is money raised to purchase products for resale. Working capital supports current operations such as rent, advertising, supplies, and wages. All three could be financed by debt or equity.

Several sources of funding are available to existing export-import businesses that have established track records. However, financing is quite limited for initial capital needs, and the entrepreneur has to use his or her own resources or borrow from family or friends. It is also important to evaluate funding sources not just in terms of availability (willingness to provide funding) but also with regard to the capital's cost and its effect on business profits, as well as any restrictions imposed by the lenders on the operations of the business. Certain loan agreements, for example, prevent the sale of accounts receivable or equipment or require the representation of lenders in the firm's management. The following is an overview of possible sources of capital for export/import businesses.

Internal Sources

This is the best source of financing for initial capital needs or expansion because there is no interest to be paid back or equity in the business to be surrendered. Start-up businesses have limited chances of obtaining loans, making self-funding the only alternative. Internal sources include the following:

- Money in saving accounts, certificates of deposit, and other personal accounts
- Money in stocks, bonds, and money market funds

External Sources

Family and Friends

This is the second-best option for raising capital for an export-import business. The money should be borrowed with a promissory note indicating the date of payment and the amount of principal and interest to be paid. As long as the business pays a market interest rate, it is entitled to a tax deduction, and the lender gets the interest income. In the event the business fails to repay the loan, the lender may be able to deduct the amount as a short-term capital loss. Such an arrangement protects the lender and also keeps the lender from acquiring equity in the business.

Banks and Other Commercial Lenders

The largest challenge to successful lending is the turnover rate of small businesses. In general, fewer than half of all small businesses survive beyond the third-year mark. However, the survival rate for export-import businesses is generally higher than that for other businesses. Due to the level of risk, banks and other commercial lenders tend to avoid start-up financing without collateral. A 1994 IBM consulting group survey of small businesses revealed that bank credit was the most popular primary source of capital in the United States, followed by internally generated funds. Credit cards were not a significant source of financing. Of the businesses studied, 58 percent maintained a working capital line of credit, and 42 percent had term loans. Only 3 percent of the businesses used Small Business Administration (SBA) loans (Anonymous, 1995).

Banks remain the cheapest source of borrowed capital for export-import firms as well as other small businesses. To persuade a bank to provide a loan, it is essential to prepare a business plan that sets clear financial goals, including how the loan will be repaid. Banks always review the ability of the borrower to service the debt, whether sufficient cash is invested in the business, and the nature of the collateral that is to be provided as a guarantee for the loan. Bankers always investigate the five Cs in making lending decisions: character (trustworthiness, reliability), capacity (ability and track record in meeting financial obligations), capital (significant equity in the business), collateral (security for the loan), and condition (the effect of overall economic conditions) (Hisrich, Peters, and Shepherd, 2009; Lorenz-Fife, 1997). Even though it is often difficult to obtain a commercial loan for start-up capital, a good business plan and a strong, experienced management team may entice lenders to make a decision in favor of providing the loan. The following are different types of financing.

Asset-based financing: Banks and other commercial lenders provide loans secured by fixed assets, such as land, buildings, and machinery. For example, they will lend up to 80 percent of the value of one's home minus the first mortgage. These are often long-term loans payable over a ten-year period. Business assets, such as accounts receivable, inventories, and personal assets (e.g., savings accounts, cars, jewelry) can be used as collateral for business loans. Commercial lenders usually lend up to 50 percent and 80 percent of their value of accounts receivable and inventories, respectively. Use of saving accounts as collateral could reduce interest payment on a loan. Suppose the interest on the savings account is 1 percent and the business loan is financed at 5 percent. The actual interest rate that is to be paid is reduced to 4 percent.

Lines of credit: These are short-term loans (for a period of one year) intended for purchases of inventory and payment of operating costs. They may sometimes be secured by collateral such as accounts receivable and the creditworthiness and reputation of the borrower. A certain amount of money (line of credit) is made available, and interest is often charged on the amount used. Certain lenders do not allow use of such lines of credit until the business's checking account is depleted.

Personal and commercial loans: Owners with good credit standing could obtain personal loans that are backed by the mere signature and guarantee of the borrower. They are short-term loans and subject to relatively high interest rates. Commercial loans are also short-term loans that are often backed by stocks, bonds, and life insurance policies as collateral. The cash value of a life insurance policy can also be borrowed and repaid over a certain period of time (Hisrich et al., 2009).

Credit cards: Credit cards are generally not recommended for capital needs for new or existing export-import businesses because they are one of the costliest forms of business financing. They charge extremely high interest rates, and there is no limit on how much credit card issuers can charge for late fees and other penalties (Fraser, 1996). If financing options are limited, credit

cards could be used if the probability of the business succeeding is very high (e.g., if you have made definite arrangements with foreign buyers). One should shop for the lowest available rates and plan for bank or credit union financing at a later date if the debt cannot be retired within a short time period, possibly with an account receivable or inventory as collateral. A survey of small and medium-size businesses, by Arthur Anderson and Company, in 1994, showed that 29 percent of businesses use credit cards for capital needs (Field, Korn, and Middleton, 1995).

Small Business Administration (SBA)

The SBA has several facilities for lending that can be used by export-import businesses for capital needs at different stages of their growth cycle (see Table 13.1).

TABLE 13.1 SBA Funding for Export-Import and Other Small Businesses

Program	Brief overview
1. The 7(A) Loan Guarantee: Start-up/ expansion/ working capital	SBA can guarantee as much as 85 percent on loans of up to $150,000 and 75 percent on loans of more than $150,000. SBA's maximum exposure is $1.5 million. 7(a) loans have a maximum loan amount of $5 million. Funds could be used to buy land and buildings, to expand facilities, to purchase equipment, or for working capital.
2. Certified Development Company (CDC)/504 Loan	CDCs are nonprofit economic development agencies, certified by the SBA. They work with participating lenders to provide financing. Applicants must have a tangible net worth less than $7.5 million and an average net income less than $2.5 million after taxes for the preceding two years. Loans cannot be made to businesses engaged in speculation or investment in rental real estate. The maximum SBA debenture is $2 million when meeting a public policy goal such as expansion of exports. Loans can be used to purchase land, for improvement or renovation of facilities, and to purchase machinery or equipment. Project assets are often used as collateral. It cannot be used for working capital.
3. Small Business Investment Companies (SBICs)	SBICs are licensed by SBA and lend their own capital as well as funds borrowed through the federal government to small businesses, both new and already established. SBICs make either equity investments or long–term loans to companies with growth potential. Investment is not to exceed 20 percent of the SBIC's private capital in securities or guarantees in any one concern (loans for start-up or expansion).
4. International Trade Loan	Used for businesses preparing to engage in or already engaged in international trade or for those adversely affected by competition from imports. Used to develop and expand export market or for working capital. Loans are guaranteed up to $5 million (loan guarantees to expand market/working capital).
5. Export Express	May be used for revolving lines of credit. Loan enables businesses to enter new or expand existing export market. Maximum loan amount is $500,000. There is a 90 percent guarantee for loans of $350,000 or less. To qualify, the borrower must have been in business for at least a year.

(*Continued*)

TABLE 13.1 (Continued)

Program	Brief overview
6. Export Working Capital (EWC)	EWC loan provides short-term working capital to exporters. May be asset or transaction based. Can also support standby letters of credit. Maximum loan amount is $5 million, with a 90 percent loan guarantee up to $4.5 million.
7. Microloans	The program provides loans up to $50,000. Average loan is about $13,000. Funds available to nonprofit intermediaries, which in turn make loans to small-business borrowers. Collateral and personal guarantee are required. Loan maturity may be as long as six years (loan for start-up/expansion/working capital).
8. Cap lines: working capital; contract; seasonal, and builders cap lines	Finances seasonal and/or short-term working capital needs; advances against existing inventory and receivables; allows consolidatation of short-term debt. Maximum loan is $5 million. Maturity is up to ten years except for builders cap line, which is five years.

Small business investment companies (SBICs): SBICs are private companies funded by the SBA that were established to provide loan (sometimes equity) capital to small businesses. Even though they prefer to finance existing small businesses with a track record, they also consider loans for start-up capital. Members of a minority group could also consider a similar lending agency funded by the SBA that is intended to finance minority start-ups or existing businesses.

The SBA (7(a) Loan Guarantee Program: An SBA guarantee permits a lending institution to provide long-term loans to start-up or existing small businesses. Export-import businesses can use the money for their working capital needs, for example, to purchase inventory and help carry a receivable until it is paid, to purchase real estate to house the business, or for acquisition of furniture and fixtures. The SBA guarantee is available only after the business has failed to obtain financing on reasonable terms from other private sources. It is considered to be a lender of last resort.

The Certified Development Company: The Certified Development Company (CDC 504) program assists in the development and expansion of small firms and the creation of jobs. This program is designed to provide fixed-asset financing and cannot be used for working capital or inventory, consolidating or repaying debt. (For an overview of SBA loans, see International Perspective 13.1)

INTERNATIONAL PERSPECTIVE 13.1

SBA Loans and Their Features

1. **Guaranty loans:** The loans are made and disbursed by private lenders and guaranteed by SBA up to a certain amount. This means that if the borrower defaults on the loan, SBA will purchase an agreed-upon percentage of the unpaid balance. The number of direct and participation loans (loans made jointly by SBA and other lenders) is quite small and has even decreased over the years.

2. **Interest rates:** Maximum allowed interest rates range from highs of prime plus 6.5 percentage points to prime plus 2.75 percentage points, though lenders can and often do charge less. These rates may be higher or lower than rates on nonguaranteed loans. Banks making SBA loans cannot charge "commitment fees" for agreeing to make a loan or prepayment fees on loans under fifteen years (a prepayment penalty kicks in for longer loans), which means the effective rates for SBA loans may be, in some instances, superior to those for conventional loans.
3. **Guarantee fee:** Payment of a guarantee fee is required for all guaranteed loans. Loans are to be secured by a collateral and personal guarantee.
4. **Guarantees of last resort:** SBA loans are provided as a matter of last resort (i.e., when borrowers cannot obtain credit without SBA guarantee). The borrower is expected to have some personal equity and to operate the business on a sound financial basis.

Finance Companies

The following are different ways of raising capital from finance companies to start or expand an export-import business.

Loans from insurance companies and pension funds: Life insurance policies can be used as collateral to borrow money for capital needs. Pension funds also provide loans to businesses with attractive growth prospects. Pension funds and insurance company loans are intermediate- and long-term credits (five to fifteen years). Banks often introduce such lending agencies to their clients when the funds are needed for longer than the banks' maximum maturity period.

Commercial finance companies: These companies grant short-term loans using accounts receivable, inventories, or equipment as collateral. They can also factor (buy) accounts receivable at a discount and provide the export-import firm the necessary capital for growth and expansion. Factoring is a way of turning a firm's accounts receivable into immediate cash without creating new debt. The factoring company will collect the accounts receivable (A/R), assume credit risks associated with the A/R, conduct investigations on the firm's existing and prospective accounts, and do the bookkeeping with respect to the credit. In most cases, a factoring company will advance 50 to 90 percent of the face value of the receivables and later pay the balance less the factor's discount (4 to 7 percent of face value of receivables) once the receivables are collected. An export-import firm could easily factor its receivables so long as it sells to government clients or to major companies that have good credit. The disadvantage with this method is that it is expensive and could absorb a good part of the firm's profits.

Equity Sources

For many export-import businesses, the ability to raise equity finance is quite limited. Although such funding provides the owner with initial capital needs, money for expansion, or

working capital, it means some dilution of ownership and control. Finding compatible business partners and shareholders is always difficult. There are three sources for equity funding:

- *Family and friends*
- *Business angels (invisible venture capitalists):* Business angels provide start-up or expansion capital and are the biggest providers of equity capital for small businesses. They can be found through networking advertisements or newspapers or the World Wide Web. This segment is estimated to represent about 2,000 individuals or businesses investing between $10 billion and $20 billion each year in more than 30,000 businesses (Lorenz-Fife, 1997).
- *Venture capitalists:* Venture capitalists provide equity capital to businesses that are already established and need working or expansion capital. The Small Business Administration (SBA) estimates that 500 venture capital firms are currently investing about $4 billion a year in some 3,000 ventures. They may not be suitable for small export-import firms because:

    1. Their minimum investment is about $50,000 to 100,000.
    2. They seldom provide funding for start-up capital because they are interested in companies with a proven track record and market position.
    3. They expect high returns (10 to 15 percent) on their investments over a relatively short period of time.

Private Sources of Export Financing

In many export transactions, the buyer is unable or unwilling to pay for the goods at the time of delivery. This means that the seller has to agree to payment at some future date or that the buyer should seek financing from third parties. The seller may seek financing from the buyer or third parties for purchasing goods from suppliers, to pay for labor, or to arrange for transportation and insurance (preshipment financing). The exporter may also need post-shipment financing of the resulting account or accounts receivable or both (Hisrich et al., 2009; Silvester, 1995).

Competitive finance is a crucial element in export strategies, especially for small and medium-size companies. Exporters should carefully consider the type of financing required, the length of time for repayment, the loan's effect on price and profit, and the various risks that may be associated with such financing.

In extending credit to overseas customers, it is important to recognize the following:

1. Normal commercial terms range from 30 to 180 days for sales of consumer goods, industrial materials, and agricultural commodities. Custom-made or high-value capital equipment may warrant longer repayment periods.
2. An allowance may have to be made for longer shipment periods than are found in domestic trade because foreign buyers are often unwilling to have the credit period start before they receive the goods.
3. Customers are usually charged interest on credit periods of a year or longer and seldom on short-term credit of up to 180 days. Even though the provision of favorable financing terms makes a product more competitive, the exporter should carefully assess such financing against considerations of cost and risk of default.

Financing by the Exporter

Open Account

Under this arrangement, an exporter will transfer possession or ownership of the merchandise on a deferred-payment basis (payment deferred for an agreed period of time). This can be done in the case of creditworthy customers who have proven track records. In the case of customers who are not well known to the exporter, such arrangements should not be undertaken without taking out export credit insurance.

Consignment Sales

In consignment sales, importers do not pay for the merchandise until it is sold to a third party. Exporters could take out an insurance policy to cover them against risk of nonpayment.

Financing by the Overseas Customer

Advance Payment

The buyer can be required to pay before shipment is effected. The advance payment may comprise the entire price or an agreed-upon percentage of the purchase price. An importer may secure the advance payment through a performance guarantee provided by a third party. Export trading or export management companies, for example, often purchase goods on an advance-payment or cash-on-delivery basis, thus eliminating the need for financing. They can also use their vast international networks to help the exporter obtain credit and credit insurance.

Progress Payment

Payments can be tied to partial performance of the contract, such as production, partial shipment, and so on. This means that a mix of advance and progress payments meets the financing needs of the exporter.

Financing by Third Parties

Short-Term Methods

Loan secured by a foreign account receivable: An exporter can borrow money from a bank or finance company to meet its short-term working capital needs by using its foreign account receivable as collateral. In most cases, the overseas customer is not notified about the loan. As the customer makes payment to the exporter, the exporter, in turn, repays the loan to the lender. It is also possible to notify the overseas customer about the collateral and instruct the latter to pay bills directly to the lender. This may, however, call into question the financial standing of the exporter in the eyes of the overseas buyer.

An exporter can usually borrow 80 to 85 percent of the face value of its accounts receivable if the receivables are insured and the exporter and the overseas customer have good credit ratings.

Most banks are reluctant to lend against receivables that are not insured. The bank's security is effected through assignment of the exporter's foreign accounts receivable. Documentary collections are easier and less expensive to finance than sales on open accounts because the draft in documentary collections is a negotiable instrument (unlike open-account sales, which are accompanied by an invoice and transport documents) that can easily be sold or discounted before maturity. Although most lenders are interested in providing a loan against foreign receivables, it is not uncommon to find some that would prefer to purchase them with full or limited recourse. In both cases, most banks require insurance. (Once the receivables are sold, the exporter will be able to remove the receivables and the loan from its balance sheet.)

Trade/banker's acceptance: In a trade acceptance, a draft drawn by the seller is accepted by the overseas customer to pay a certain sum of money on an agreed-upon date. The exporter could obtain a loan using the acceptance as collateral or discount the acceptance to a financial institution for payment. In cases in which the debt is not acknowledged in the form of a draft, the exporter could sell or discount the invoice (invoice acceptance) before maturity. In both cases, the acceptances are usually sold without recourse to the exporter, and the latter is relieved of the responsibility of collection.

A draft drawn on and accepted by a bank is called a banker's acceptance. Once accepted, the draft becomes a primary obligation of the accepting bank to pay at maturity. This occurs in the case of documents against acceptance (documentary collection or acceptance credit), according to which payment is to be made at a specified date in the future. The bank returns the draft to the seller with an endorsement of its acceptance, guaranteeing payment to the seller (exporter) on the due date. The exporter may then sell the accepted draft at a discount to the bank or any other financial institution. The exporter could also secure a loan using the draft as collateral. The marketability of a banker's or trade acceptance is dependent on the creditworthiness of the party accepting the draft.

Letter of credit: In addition to the acceptance credit discussed previously, the letter of credit could be an important instrument of financing exports:

1. *Transferable letter of credit:* Using this method, the exporter transfers its rights under the credit to another party, usually a supplier, who receives payment. When the supplier presents the necessary documents to the advising bank, the supplier's invoice is replaced by the exporter's invoice for the full value of the original credit. The advising bank pays the supplier the value of the invoice and pays the difference to the exporter.
2. *Assignment of proceeds under the letter of credit:* The beneficiary (exporter) may assign either the entire amount or a percentage of the proceeds of the L/C to a specified third party, usually a supplier. This allows the exporter to make purchases with limited capital by using the overseas buyer's credit. It does not require the assent of the buyer or the buyer's bank.
3. *Back-to-back letters of credit:* A letter of credit is issued on the strength of another letter of credit. Such credits are issued when a supplier or subcontractor demands payment from the exporter before collections are received from the customer. The exporter remains obligated to perform under the original credit, and, if default occurs, the bank is left holding worthless collateral.

Factoring: Factoring is a continuous arrangement between a factoring concern and the exporter, whereby the factor purchases export receivables for a somewhat discounted price (usually 2 to 4 percent less than the full value). The amount of the discount depends on a

number of factors, including the kind of products involved, the customer, the factoring entity, and the importing country. Factoring enables exporters to offer terms of sale on open account without assuming the credit risk. Importers also prefer factoring because by buying on open account, they forgo costly payment arrangements such as letters of credit. It also frees up their working capital. In the case of importers that have not yet established a track record, banks often will not issue letters of credit, so open-account sales may be the only available option (Klapper, 2007).

In export factoring, the exporter receives immediate payment, and the burden of collection is eliminated. Factors have ties to banks and financial institutions in other countries through networks such as Factors Chain International, which enables them to check the creditworthiness of an overseas customer, to authorize credit, and to assume financial risk.

Increases in global trade and competition have resulted in the search for alternative forms of financing to accommodate the diverse needs of customers. In highly competitive markets, concluding a successful export deal often depends on the seller's ability to obtain trade finance at the most favorable terms for the overseas customer.

International factoring achieved another milestone during the past ten years, generating over $2.8 trillion in 2012. In the United States, the factoring industry handled about $10 billion in foreign trade ($93 billion in domestic trade) (Factors Chain International (2013). Annual Review) It is available (2012) in more than forty countries, mostly concentrated in the Americas (9 percent), Western Europe (61 percent), and Asia (27 percent). Even though export factoring has been traditionally associated with the sale of textiles and apparel, footwear, and carpets, it is now used for a host of diversified products.

A typical export factoring procedure includes the following steps. Upon receipt of an order from an overseas customer, the exporter verifies with the factor, through its overseas affiliate, the customer's credit standing and determines whether the factor is willing to authorize credit and to assume financial risk. If the factor's decision is in favor of authorizing credit to the overseas customer, then the parties follow the procedure described in Figure 13.1.

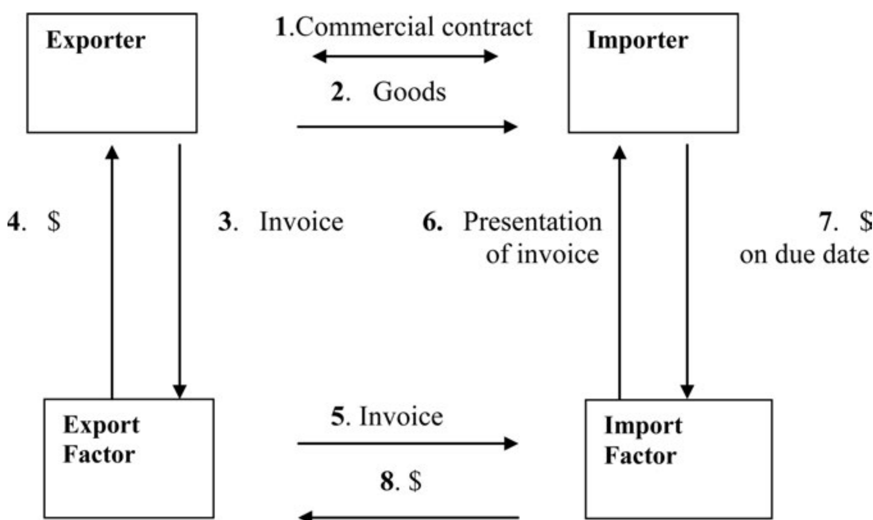

FIGURE 13.1 Export Factoring

TABLE 13.2 Advantages and Disadvantages of Export Factoring

Advantages	Disadvantages
■ Factoring allows immediate payment against receivables and increases working capital.	■ Factoring is not available for shipments with value of less than $100,000. It is appropriate for continuous or repetitive transactions (not for one-shot deals). Factors often require access to a certain volume of the exporter's yearly sales.
■ Factors conduct credit investigations, collect accounts receivable from importer, and provide other bookkeeping services.	■ Factors do not work for receivables with maturities of more than 180 days.
■ Factors assume credit risk in the event of the buyer's default or refusal to pay (nonrecourse).	■ Factors generally do not work with most developing countries because of their inadequate legal and financial framework.
■ Factoring is a good substitute for bank credit when the latter is too restrictive or uneconomical.	■ Exporter could be liable for disputes concerning merchandise (e.g., quality, condition of goods) and contract of sale.

Arrangements with factors are made either with recourse (exporter is liable in the event of default by buyer or other problems) or without recourse, in which case a larger discount may be required since the exporter is free of liability. (For advantages and disadvantages of this financing method, see Table 13.2).

1. The exporter and importer enter into a commercial contract and agree on the terms of sale (i.e., open account).
2. The exporter ships the goods to the importer.
3. The exporter submits the invoice to the export factor.
4. The export factor provides (cash in advance) funds to the exporter against receivables until money is collected from the importer. The exporter often receives up to 30 percent of the value of the receivables ahead of time and pays the factor interest on the money received; alternatively, the factor pays the exporter, less a commission charge, when receivables are due (or shortly thereafter). The commission often ranges between 1 and 3 percent.
5. The export factor passes the invoice to the import factor for assumption of credit risk, administration, and collection of the receivables.
6. The import factor presents the invoice to the importer for payment on the agreed-upon date.
7. The importer pays the import factor.
8. The import factor pays the export factor. In cases where the export factor advanced funds up to a certain percentage (e.g., 30 percent) of the exporter's receivables, the remaining portion (70 percent of receivables less interest or other charges) is paid by the export factor to the exporter.

Intermediate- and Long-Term Methods

Buyer credit: Some export sales, such as those involving capital equipment, require financing terms that extend over several years. The importer may obtain credit from a bank or other financial institution to pay the exporter. The seller often cooperates in structuring the financing arrangements to make them suitable to the needs of the buyer.

Forfaiting: Forfaiting is the practice of purchasing deferred debts arising from international sales contracts without recourse to the exporter. The exporter surrenders possession of export receivables (deferred-debt obligation from the importer), which are usually guaranteed by a bank in the importing country, by selling to a forfaiter at a discount in exchange for cash. The deferred debt may be in the form of a promissory note, bill of exchange, trade acceptance, or documentary credit, which are unconditional and easily transferable debt instruments that can be sold on the secondary market.

The origins of forfaiting date back to the 1940s, when Swiss financiers developed new ways of financing sales of West German capital equipment to Eastern Europe. Since Eastern European countries did not have enough hard currency to finance imports, they sought intermediate-term financing from their suppliers. The leading forfait houses are still located in Europe.

In a typical forfaiting transaction, the overseas customer does not have hard currency to finance the sale and wishes to purchase on credit, usually payable within one to ten years. The exporter (or exporter's bank) contacts a forfaiter and provides the latter with the details of the proposed transaction with the overseas customer. The forfaiter evaluates the transaction and agrees to finance the deal on the basis of a certain discount rate and other conditions. The exporter then incorporates the discount into the selling price. Discount rates are fixed and based on the London Interbank Offered Rate (LIBOR), on which floating interest rates are based. The forfaiter usually requires a guarantee or aval (letter of assurance) from a bank in the importer's country and often provides the exporter with a list of local banks that are acceptable as guarantors. The guarantee becomes quite important, especially in cases of receivables from developing countries. Once an acceptable guarantor is found, the exporter ships the goods to the buyer and endorses the negotiable instruments in favor of the forfaiter without recourse. The forfaiter then pays the exporter the discounted proceeds.

Although export factoring and forfaiting appear quite similar, there are certain differences in terms of payment terms, products involved, continuity of transaction, and overall use:

1. Factors are often used to finance consumer goods, whereas forfaiters usually work with capital goods, commodities, and projects.
2. Factors are used for continuous transactions, but forfaiters finance one-time deals.
3. Forfaiters work with receivables from developing countries whenever they obtain an acceptable bank guarantor; factors do not finance trade with most developing countries because of the unavailability of credit information, poor credit ratings, or inadequate legal and financial frameworks.
4. Factors generally work with short-term receivables, whereas forfaiters finance receivables with a maturity of more than 180 days. (See Table 13.3 for advantages and disadvantages of this financing method.)

TABLE 13.3 Advantages and Disadvantages of Forfaiting

Advantages

1. Forfaiters purchase receivables as a one-shot deal without requiring an ongoing volume of business, as in the case of factoring.
2. Financing can cover 100 percent of the sale. Forfaiting improves cash flow and reduces transaction cost for the exporter since responsibility for collection is assumed by the forfaiter. Forfaiter also assumes all of the payment risk (i.e., credit risk of the guarantor bank and the interest rate risk, as well as the buyer's country risk).

Disadvantages

1. It is not available for short-term financing (less than 180 days). Terms range from one to ten years.
2. Transaction size is usually limited to $250,000 or more.
3. Interest and commitment fees (if advance payment is required by exporter) may be high.
4. Exporter is responsible for quality, condition of goods, delivery, overshipment, and other potential areas of contract disputes.
5. Exporter is responsible for obtaining a bank guarantee for the buyer.

The following are some examples of forfaiting transactions:

- The Bankers Association for Foreign Trade (BAFT) arranged with a cotton machinery company to sell more than $500,000 worth of cotton-lint-removal machinery payable eleven months from the date on the bill of lading. A Greek commercial bank issued the letter of credit, which called for acceptance drafts. Bankers Trust of New York confirmed the letter of credit, and Midland Bank undertook the forfaiting transaction.
- Morgan Grenfell Trade Finance Limited purchased receivables from U.S. exporters to Peru. The finance company required the guarantee of one of the large Peruvian banks and accepted a repayment period of up to five years.
- Morgan Grenfell also financed the down payment in cash (forfaiting) of the sale of electric turbines to Mexico, which was financed by Eximbank. The Eximbank required a 15 percent down payment.
- The Export Development Corporation (EDC) of Canada purchases accounts receivable from Canadian exporters provided the promissory notes issued by the overseas customer are guaranteed by a bank acceptable to the EDC, the transaction complies with the Canadian content requirement, and the promissory note does not exceed 85 percent of the contract price.

Export leasing: This is a financing scheme in which a third party, be it an international leasing entity or a finance firm, purchases and exports capital equipment with a view to leasing it to the importer in another country on an intermediate- to long-term basis. This arrangement is suitable for the export of capital goods. The lessor could be located in the exporting or importing country. Whether it is an operating or finance lease, the legal ownership of the asset remains with the lessor and only possession passes to the lessee. Under the operating lease, the lease rentals are not intended to amortize the capital outlay incurred by the lessor when the equipment was purchased. Instead, the capital outlay and profit are intended to be recovered through the re-leasing of the equipment and/or through its residual

value on its eventual sale. It is not a method of financing the acquisition of the equipment but a lease for a specified period. The lease is reflected in the balance sheet of the lessor, not the lessee. Under the finance lease, the lease rentals are intended to amortize the capital costs of acquisition as well as to provide profit. Usually, the lessee chooses the equipment to be leased and bears the cost of maintenance and insurance. For businesses that need new equipment but lack the necessary resources or hard currency to purchase, leasing becomes an attractive option. It requires little or no down payment, and the equipment can be bought at the end of the lease agreement for a nominal price. Lease payments are tax deductible in many countries. Since such payments do not appear as liabilities in the financial statements, they preserve the lessee's financial position and do not reduce its ability to borrow for other reasons. Other advantages of leasing are that (1) one can lease up-to-date equipment that may be too expensive to purchase, and (2) the lessee can always trade in the old equipment in the event of obsolescence and obtain new even before the end of the lease. There are, however, certain disadvantages: (1) it may attract adverse tax consequences in certain countries, and (2) the cost of leasing is often higher than other financing methods.

Chapter Summary

Major changes in small business financing	Technology, globalization, and deregulation
Determinants of capital needs and financing alternatives	Stage of evolution, ownership structure, and distribution channels
Internal financing	Using one's own resources, retaining more profits in the business, and reducing accounts receivable and inventories
External financing	*Forms of External Financing* Debt or equity financing; short-term/intermediate/long-term financing; investment, inventory, or working capital financing *Sources of External Financing* Family and friends; banks (asset-based financing, lines of credit, personal and commercial loans, credit cards); Small Business Administration; finance companies; and equity sources
Financing by the exporter	1. *Open account:* Payment is deferred for a specified period of time. 2. *Consignment contract:* Importer pays after merchandise is sold to a third party.
Financing by the importer	1. *Advance payment:* Payment is before shipment is effected. 2. *Progress payment:* Payment is related to performance.
Financing by third parties	Short-term Methods 1. *Loan secured by a foreign accounts receivable:* Account receivable used as collateral to meet short-term financing needs.

(*Continued*)

2. *Trade/banker's acceptance:* A draft accepted by the importer is used as collateral to obtain financing.
3. *Letter of credit:* Transferable letter of credit (L/C), assignment of proceeds under an L/C, and a back-to-back L/C used to secure financing.
4. *Factoring:* An arrangement between a factoring concern and exporter whereby the factor purchases export receivables for a discount.

Intermediate- and Long-Term Methods

1. *Buyer credit:* Credit from a bank or financial institution obtained by the importer to pay the exporter.
2. *Forfaiting:* Purchase of deferred debts arising from international sales contracts without course to the exporter.
3. *Export leasing:* Purchase and export of capital equipment with a view to leasing.

Review Questions

1. What are the major changes taking place in small and medium-size business financing?
2. What factors determine capital needs and financing alternatives in export-import trade?
3. State the common external sources of financing for export-import businesses.
4. Describe the following: SBICs, Certifed Development Company, CDC/504 loan program, international trade loan.
5. Discuss the various methods in which a letter of credit can be used to finance exports.
6. What is export factoring? How does it differ from forfaiting?
7. State the typical steps involved in export factoring.
8. What are the disadvantages of factoring?
9. Is venture capital generally suitable for export firms?
10. What are the various loan facilities provided by the SBA to export businesses?

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World Wide Web Resources

Small-Business Financing
Information on articles and links of interest to current and prospective business owners:
http://www.hrsbdc.org/links/general.html

Other Sites for Small Businesses
http://www.creative-edgeonline.com (tips for entrepreneurs, Web presence)
http://www.owi-com/netvalue/v1I1.htm business sites on the Web)
http://www.isquare.com (small-business adviser)
http://www.fed.org (foundation for enterprise development)
http: www.sbaonline.sba.gov/oit/loans.html (trade finance programs)
http://www.usa.ft.com (information about companies, market and world economies)
http://ucfunding.com (factoring)

Case 13.1 Tadoo's Sales to Belgium

Tadoo Inc. is a chemical company incorporated in the state of Tennessee and engaged in the production and sale of various chemical products used to kill harmful insects or strip leaves from trees. Since the company was established, in 1980, it has generated gross sales of more than $60 million, largely from sales in the United States and in Western Europe. Its sales agents and distributors are located in more than a dozen countries.

In September 2000, the Belgian government advertised for a purchase of $20 million in chemical products. The winner of the bid was required to provide financing for a period of two years. Given Tadoo's inability to secure private or

public financing for the sale, it decided to contact a forfaiter to explore the possibility of financing the deal. Tadoo provided the forfaiter with important details to establish the viability of the transaction, including the delivery date, repayment terms (four semiannual repayments over a two-year period), interest rate (payable by buyer), and a letter of credit instrument to be opened in favor of Tadoo through a Belgian bank.

The forfaiter calculated the expected costs (e.g., discount rate, commitment fees) necessary to sell the receivable and added it to the commercial contract so that Tadoo would be able to receive 100 percent of the required cash value. This helped Tadoo to submit a contract price that included financing expenses. The forfaiter also examined the structure of the transaction to ensure that it had maximum liquidity, including the financing period, country risk, and credit risk. The forfaiter was expected to resell the transaction in the market.

Prior to the submission of the bid, Tadoo entered into a detailed contract with the forfaiter. The contract required Tadoo to sell the receivable to the forfaiter and stated the terms and conditions of the contract. It also provided Tadoo the option to cancel the contract with no liability in the event that Tadoo failed to win the bid. A month after the submission of the bid, the Belgian government informed Tadoo that it had been awarded the contract.

Tadoo began to manufacture the product and supplied the product to the buyer in special shipping containers in accordance with the terms of the contract. Four bills of exchange were accepted by the Belgian Bank and later endorsed by Tadoo to the forfaiter without recourse and provided to the latter with supporting documentation. The forfaiter received and verified the documents and paid $20 million to Tadoo. Tadoo was required to honor all its contractual commitments pertaining to product support and warranty, but the financial risk associated with the bill of exchange maturing over a two-year period had been sold to the forfaiter without recourse.

Questions

1. Would Tadoo encounter problems if it were exporting to a developing country?
2. Is this method more beneficial to Tadoo than other forms of financing?

fourteen
Government Export Financing Programs

Export credits are financing arrangements designed to mitigate the risks to buyers and sellers associated with international transactions. With globalization and increased efforts to win export markets, many nations are providing export finance to their exporters. Government financing could be in the form of supplier credit or buyer credit. Supplier credits are credits extended to the buyer by the exporter; that is, the exporter arranges for government financing. Such credits also include a direct extension of credit by the exporter, as well as the exporter's arrangement of financing from other private sources. Buyer's credits are extended to the buyer by parties other than the exporter. Banks, government agencies, or other private parties (domestic or foreign) could provide buyer credits. Programs are usually categorized as short term (usually less than two years), intermediate term (usually two to five years), and long term (usually more than five years) financing. This chapter is primarily devoted to supplier or buyer credits that are extended by government agencies.

Such government-supported financing is provided when exporters are not able to secure financing from the private sector due to political or other risks or to level the playing field by matching credit support that other nations provide their exporters. Over the past decade, China and other emerging economies have adopted creative financing mechanisms that provide government support while skirting the guidelines put forth by the Organization for Economic Cooperation and Development (OECD). In 2011, for example, China offered a $30 billion (U.S.) credit line to a Brazilian customer of Huawei Technologies at interest rates that were 2 percentage points below the London interbank rate and with a two-year grace period on payments. The customer indicated that the financing package was a decisive factor in choosing Huawei over U.S. and European competitors (Hufbauer, Fickling, and Foong, 2011). During the same period, the U.S. Export-Import Bank (Eximbank) helped GE secure a contract with the Pakistani government for sale of 150 locomotives by matching the financing terms offered by China.

Export Credit Agencies (ECAs) in Various Countries

ECAs differ in their goals, magnitude, and types of services. All offer medium- and long-term credits. They also provide other products and services such as short-term export credits, letter of credit guarantees, and bond unfair calling. (see Table 14.1).

Two areas in which ECAs differ are their mission and their organizational structure. Some emphasize the need to support domestic jobs through exports (U.S. Eximbank), while others underline the importance of promoting exports and other business opportunities (ECAs of Canada, France, Germany, Italy, and the United Kingdom). The mission of Japan's ECA is primarily to secure natural resources, ensure competitiveness, and respond to disruptions in the global economy. Most supplement the private sector by playing a role as a lender or insurer of last resort, taking on transactions that are too risky or undesirable for commercial support. Canada's Export Development Corporation, in contrast, has a commercial market orientation and is not restricted from competing with the private sector. In terms of organization, ECAs range from government agencies such as Eximbank (United States), EDC (Canada), and ECGD (United Kingdom) to private companies contracted by the government (COFACE, in France, and Euler Hermes, in Germany).

ECAs receive specific mandates from government and put in place certain policy guidelines. Certain governments emphasize the need to increase financing for small-business exporters (United States, France, Italy, United Kingdom), while others have developed initiatives to support environmentally beneficial exports (United States, Italy).

The Eximbank has additional mandates and requirements beyond those of other ECAs:

- Promotes exports to sub-Saharan Africa
- Must ship certain exports (financed through its direct-loan and loan-guarantee programs) on U.S.-flagged carriers
- Must adhere to specific policy on carbon emissions (it must comply with the provisions of the National Environmental Policy Act)
- Is required by Congress to perform an economic impact analysis to assess whether a project will negatively impact U.S. industries as well as to submit a statement describing a transaction prior to its final approval by its Board of Directors if the transaction value is equal to or greater than $100 million (U.S.) or relates to nuclear power or heavy-water production facilities (only Germany has a similar notification requirement)
- Is subject to higher domestic-content requirements than other ECAs (See Table 14.2).

The Organization for Economic Cooperation and Development (OECD) has developed guidelines on export credits for its members. These are intended to provide the institutional framework for an orderly export credit market, thus preventing an export credit race in which exporting countries compete on the basis of who provides the most favorable financing terms rather than on the basis of who provides the best product at the lowest price. The arrangement applies to officially supported export credits with repayment terms of two years or more, relating to the export of goods and/or services. It does not apply to exports of military equipment and agricultural commodities. The guidelines provide for the following:

TABLE 14.1 Export Credit Agencies (ECAs) of Selected Countries: Range of Services

Agency/ Country*	Short-term insurance	Medium/ long-term export credit	Fixed-rate financing	Foreign exchange risk cover	Direct loans	Investment insurance	Bond support	Unfair calling insurance	L/C cover	Working capital cover
EFIC-Australia	x	✓	✓	x	✓	✓	✓	✓	✓	✓
EDC Canada	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Sinosure-China	✓	✓	x	x	x	✓	✓	✓	✓	✓
Coface-France	✓	✓	✓	✓	x	✓	✓	✓	✓	✓
Hermes-Germany	✓	✓	✓	x	✓	✓	✓	✓	✓	✓
ECGC-India	✓	✓	x	✓	✓	✓	✓	?	✓	✓
SACE-Italy	✓	✓	✓	x	x	✓	✓	✓	✓	✓
Nexi-Japan	✓	✓	✓	x	✓	✓	x	✓	x	✓
Keic South Korea	✓	✓	✓	✓	✓	✓	✓	✓	x	✓
ECGD United Kingdom	x	✓	✓	x	x	✓	x	✓	✓	x
EXIM United States	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

* All the named countries except China and India are members of the OECD. L/C cover: letter of credit guarantee scheme.
Source: British Exporters Association, April, 2010 (www.bexa.co.uk).

TABLE 14.2 Domestic-Content Policies of Selected ECAs

Country	Domestic content policy
United States	85 percent domestic content required to receive full financing. If less than 85 percent, Eximbank will finance the domestic content portion.
Canada	No minimum domestic-content requirement. National benefits policy first considers the gross domestic product and employment impacts of the transaction and then takes into account other factors such as increased access to global markets.
France	20 percent domestic-content requirement
Germany	Three-tier policy: 70 percent and 51 percent minimum domestic-content requirement for the first two tiers, respectively. For the third tier, transactions with less than 51 percent domestic content can be supported if there is a justification from the exporter and interministerial committee.
Japan	30 percent domestic-content requirement. It can be reduced if the project has strategic benefit.
United Kingdom	20 percent domestic-content requirement. If less than 20 percent, the ECA will support the domestic content portion of the transaction.

Source: U.S. Export-Import Bank (2012).

- *Cash payments:* A minimum of 15 percent of the contract price is to be paid in cash.
- *Maximum repayment term:* The maximum repayment term is five years (or eight and a half years with prior notification) with exceptions for poorer countries.
- *Minimum interest rates:* Promote minimum interest rates to reduce the interest rate subsidy component in ECA support. These rates are adjusted on a monthly basis to reflect commercial lending rates.
- *Minimum premium rates:* Promote minimum premium rates to reflect country credit risk including risk pertaining to that of overseas buyer.
- *Tied aid:* Aid conditioned on the purchase of goods and services from the donor countries is limited in two ways: the minimum grant (concessional) portion of such aid has been raised to 35 percent, and such aid is prohibited to richer developing countries.
- *Special sector understandings:* Special sector arrangements have been reached for civil aircraft, nuclear power plants, renewable energy, and water projects.

While the scope of the OECD arrangement has expanded to cover additional areas, the increasing activities of nonmembers, particularly China, threaten the future ability of the agreement to provide a level playing field for exporters. There is a need to include these countries in future arrangements. Other areas of concern include market windows (ECA loans on market terms) as well as nonexport credit financing activities such as untied lending and investment finance that fall outside the arrangement. Such arrangements can have an indirect linkage to exports.

Export-Import Bank of the United States (Eximbank)

The Eximbank was created in 1934 and established under its present law in 1945, with the aim of assisting in the financing of U.S. export trade. It was originally established to finance

exports to Europe after World War II. Eximbank's role in promoting U.S. exports is likely to be more significant now than in the past few decades because (1) the U.S. economy is more internationalized, and exports constitute a growing share of the GNP, and (2) there has been a substantial increase in the volume of international trade, and competition for export markets is quite intense.

Eximbank is intended to supplement but not compete with private capital. It has historically been active in areas in which the private sector has been reluctant to provide export financing. Eximbank has three main functions: (1) provide guarantees and export credit insurance so that exporters and their bankers give credit to foreign buyers; (2) provide competitive financing to foreign buyers; and (3) negotiate with other countries to reduce the level of subsidy in export credits (U.S. Export-Import Bank, 2012).

Over the past few years, Eximbank has focused on a broad range of critical areas, such as provision of greater support to small businesses, promotion of exports to developing nations, and promotion of exports of environmentally beneficial goods and services. It has also been engaged in expanding project finance capabilities as well as in reducing trade subsidies of other governments through bilateral or multilateral negotiations.

In its more than seventy years of operations, the Bank has supported more than $550 billion of U.S. exports (U.S. Export-Import Bank, 2012a). It has assisted U.S. exporters to win export sales in many countries and undertakes risks the private sector is unwilling or unable to take. The Bank also attempts to neutralize financing provided by foreign governments to their exporters when they are in competition for export sales with U.S. exporters. However, the Bank does require reasonable assurance of repayment for the transactions it authorizes and closely monitors credit and other risks in its portfolio.

Annual authorizations have ranged from $14 billion (2008) to $36 billion in 2012 (see Tables 14.3 and 14.4). The largest share of the Bank portfolio involves financing infrastructure projects such as transportation, power generation, oil and gas production, and mining. The highest geographic exposure is in Asia, with almost 40 percent of the total. Eximbank also has enhanced financing available for certain categories of exports: environmentally beneficial goods and services, medical equipment, and transportation security equipment.

The Bank provides assistance to U.S. exporters of goods and/or services provided the exports include a minimum of 50 percent U.S. (local) content and are not military related. Its financing decision is based, inter alia, upon an assessment of the borrower's capability to

TABLE 14.3 Eximbank Geographic and Industry Exposure, 2012 ($millions U.S.)

Region	2012	% Total	Industry	2012	% Total
Asia	42,345	39.70	Air transportation	49,420	46.30
Latin America & Caribbean	22,105	20.70	Manufacturing	18,091	17.00
Europe	11,304	10.60	Oil and gas	13,939	13.10
North America	10,579	9.90	Power projects	8,649	8.10
Oceana	8,305	7.80	All others	16,548	15.50
Africa	5,771	5.40			
All others	6,238	5.90			

Source: Eximbank Annual Report (2012).

TABLE 14.4 Eximbank's Authorization and Top Beneficiaries by Country, 2012

Loan-term	$ Millions (U.S.)	Country	Authorizations ($ billions U.S.)	% total
Long-term				
Loans	11,752.00	Australia	3.16	8.83
Guarantees	14,879.00	Brazil	1.08	3.02
Subtotal	*26, 631.00*	Canada	0.18	0.50
Medium term		China	1.18	3.30
Loans	12.80	Hong Kong	1.07	2.99
Guarantees	186.80	India	0.21	0.59
Insurance	165.00	Ireland	1.27	3.55
Subtotal	*364.60*	Korea	0.54	1.51
Short term		Mexico	2.85	7.97
Working capital	3254.00	Saudi Arabia	5.50	15.37
Insurance	5534.00	Turkey	0.74	4.81
Subtotal	*8788.00*	United Arab Emirates	3.32	9.28
Total authorization	**35,783.60**		**21.10**	**58.97**

repay the loan. There are four major export financing programs provided by Eximbank (U.S. Export-Import Bank, 2012a; Reynolds, 2003):

- Working capital loan guarantees for U.S. exporters
- Credit insurance
- Guarantees of commercial loans to foreign buyers
- Direct loans to foreign purchasers.

U.S. government support for the Bank has been the subject of criticism from various groups:

- The environmental community contends that the Bank provides loans and loan guarantees for projects that harm the environment. These groups raise concerns about the harmful effects of an Eximbank-assisted oil drilling and pipeline project in Chad and Cameroon, a coal-fired power plant in Indonesia, and the loan guarantees for the sale of nuclear fuel to the Czech Republic.
- It is often stated that the Bank's assistance is largely provided to a small number of large U.S. firms such as Boeing, Bechtel, GE, and Halliburton, as well as to countries that do not need financial support in the form of loans, loan guarantees, or insurance. In view of the fact that Eximbank supports about 1 percent of U.S. exports, critics suggest that it has a marginal impact on overall U.S. exports or its trade balance.
- Some of Eximbank's loans to foreign companies have contributed to harm to domestic industries. It is alleged that the $18 million loan to the Chinese iron and steel industry, for example, adversely affected the competitiveness of local industries (U.S. Export-Import Bank, 2012d)Working Capital Guarantee Program.

Working Capital Guarantee Program

The availability of adequate working capital is critical for the maintenance and expansion of a viable export-import business. Banks are often reluctant to make financing available

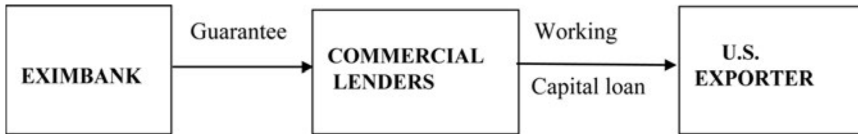

FIGURE 14.1 Working Capital Guarantee Program

because the businesses either have reached the borrowing limits set by their banks or do not have the necessary collateral. The working capital guarantee program is intended to encourage commercial lenders to make loans for various exports-related activities (see Figure 14.1). Such loans may be used for the purchase of raw materials and finished products for export, to pay for overhead, or to cover standby letters of credit, such as bid bonds, performance bonds, or payment guarantees (U.S. Export-Import Bank, 2012c).

Exporters may apply to the Eximbank for a preliminary commitment for a guarantee. The lender also may apply directly for a final authorization. In the case of preliminary commitment, the Eximbank will outline the general terms and conditions under which it will provide the guarantee to the exporter, and this can be used to approach various lenders to secure the most attractive loan package.

INTERNATIONAL PERSPECTIVE 14.1

General Eximbank Criteria for Loans and Loan Guarantees

Foreign Content Policy: To be eligible for support, items must be shipped from the United States and the foreign content (cost of foreign components incorporated in the item in the United States) must be less than 50 percent of the total cost to produce the item. In the case of U.S. items supplied to a foreign project under long-term program support, Eximbank support is available even though the U.S. items aggregate to less than 50 percent of the total project cost (intermediate-term loans and guarantees).

Repayment terms: Repayment usually begins about six months after shipment or project completion, and payments of principal and interest must be made semiannually. Applicable payment term for a transaction can be determined by (a) identifying the country group (I or II) in the list where the product is exported; (b) finding the standard term that applies to the country group and the contract price of your transaction; and (c) reviewing the terms in chart II and the shorter- and longer-than-standard terms.

Scope of coverage: Eximbank's loans, guarantees, and intermediate-term insurance cover 85 percent of the contract price. The foreign buyer is required to make a 15 percent cash payment. Fees charged are based on the risk assessment of the foreign buyer or guarantor and the buyer's country, and the term of the credit.

Interest rates and shipping: Interest rates and maximum maturity terms are subject to OECD guidelines. The lender sets the rate in guarantee programs while loans are often negotiated at fixed rates. Eximbank supported sales of more than $10 million in loans or loan guarantee must be shipped in a vessel of U.S registry unless a waiver has been obtained by the foreign buyer from the U.S. Maritime Administration. This applies in the case of long term financing programs.

The lender must apply for the final commitment. An exporter may also apply through a lender that has been granted a guarantee by the Eximbank. Such lenders have been granted preapproved credit authority (delegated authority) to process working capital loans under established criteria without preapproval from Eximbank. For small-business exporters, the Small Business Administration (SBA) can guarantee a working capital loan up to $1.1 million or up to $2.0 million under a co-guaranty agreement with the Eximbank. Guarantees may be approved for a single loan or for a revolving line of credit.

The major features of the working capital guarantee program are as follows:

Qualified Exports

Eligible exports must be shipped from the United States and have at least 50 percent U.S. content. If the export has less than 50 percent U.S. content, the bank will support only up to the percentage of the U.S. content. Military items as well as sales to military buyers are generally not eligible.

Guarantee Coverage and Term of the Loan

In the event of default by the exporter, Eximbank will cover 90 percent of the principal of the loan and interest, up to the date of claim for payment, provided the lender has met all the terms and conditions of the guarantee agreement. Guaranteed loans generally have maturities of twelve months and are renewable.

Collateral and Borrowing Capacity

Guaranteed loans are to be secured by a collateral. Acceptable collateral may include export-related inventory, export-related accounts receivables, or other assets. Inventory and accounts receivable include goods purchased or sales generated by use of the guaranteed loan. For service companies, costs such as engineering, design, or allocable overhead may be treated as collateral. In the case of letters of credit issued under the guaranteed loan, collateral is required for only 25 percent of the value of the letter of credit.

Exporters can borrow up to 75 percent of their inventory, including work-in-process, and up to 90 percent of their foreign account receivable, thus increasing their borrowing capacity. Table 14.5 illustrates borrowing capacity with and without the working capital facility.

Qualified Exporters and Lenders

Exporters must be domiciled in the United States (regardless of domestic/foreign ownership requirements), show a successful track record of past performance, including an operating history of at least one year, and have a positive net worth. Financial statements must show sufficient strength to accommodate the requested debt.

Any public or private lender may apply under the program. Eligibility is determined on the basis of many factors, including the lender's financial condition, knowledge of trade finance, and ability to manage asset-based loans. Lenders may be approved as priority lenders

TABLE 14.5 Increased Borrowing Capacity under the Eximbank Working Capital Guarantee Program

Collateral	Amount	Working capital without Eximbank		Working capital with Eximbank guarantee	
		Advance rate	Borrowing base	Advance rate	Borrowing base
Export inventory supported by an export order					
Raw materials	300,000	20%	60,000	75%	225,000
Work in process	300,000	0%	0	75%	225,000
Finished goods	600,000	50%	300,000	75%	450,000
Foreign Account receivable (FAC)					
FAC	500,000	0%	0	90%	450,000
L/C backed account receivable	600,000	70%	420,000	90%	540,000
Total Borrowing Base			780,000		1,890,000

or delegated authority lenders. Approved lenders under the priority lender program submit final commitment applications to Eximbank and receive a decision within ten business days. The lender, prior to submission to Eximbank, must approve the loan application. However, approved delegated authority lenders are allowed to approve loans and receive a guarantee from Eximbank without having to submit individual applications for approval.

> *Example:* In 2011, Eximbank approved a request from Geothermal Development Associates (GDA) to support the sale of geothermal equipment to Kenya. GDA needed working capital to fulfill the order, and World Trade Finance provided an Eximbank-guaranteed loan to GDA.

Export Credit Insurance Program (ECIP)

The purpose of the ECIP is to promote U.S. sales abroad by protecting exporters against loss in the event of default by a foreign buyer or debt arising from commercial or political risks. The policy also enables exporters to obtain financing more easily because, with prior Eximbank approval, the proceeds of the policy can be readily assigned to a financial institution as collateral. Eximbank offers a wide range of policies to accommodate many different insurance needs of exporters and financial institutions. For example, insurance policies may apply to shipments to one buyer or many buyers, cover short-term (180 days or less) or intermediate-term (generally one to five years) credit, and provide comprehensive coverage for commercial as well as specific or all political risks. There are also policies specifically geared to small businesses that are beginning to export their goods or services (Small Business Policies). Some export credit insurance policies include the following:

1. *Exporter policies (short-term):* single-buyer/multibuyer policies, small business policies;
2. *Lender policies (short-term):* letter-of-credit policies, financial institution buyer/supplier credit policies;
3. *Policies for exporters and lenders:* documentary and nondocumentary policies;
4. *Other policies:* includes leasing policies for operating and finance leases.

The policies insure both the stream of lease payments and the fair market value of the leased product (Table 14.6 and Figure 14.2).

TABLE 14.6 Export Credit Insurance Policies

Policy	Features
Exporter policies (short term)	
Multi-buyer policy	▪ Provides 90–95 percent commercial, 95–100 percent coverage against buyer default ▪ Exporter's receivables can be assigned to a lender for immediate funding ▪ Premium rates based on tenor, type of buyer, and country of buyer ▪ Available for small-business exporters
Single-buyer policy	▪ Supports single or multiple shipments to a single foreign buyer ▪ Provides 90 percent coverage against buyer default with no first loss deductible ▪ Exporter's receivables can be assigned to lender
Lender policies (short term)	
Bank letter of credit policy	▪ Protects U.S. banks against losses on irrevocable letters of credit opened to finance U.S. exports (failure of a foreign issuing bank to make payments) ▪ Covers 95 percent for private sector, 100 percent for sovereign banks
Financial institution buyer credit policy	▪ Protects lenders that finance purchases by overseas buyers of U.S. exports ▪ Used for one or several shipments from one or several exporters to same buyer ▪ No first loss deductible ▪ Covers 90 percent for private sector, 100 percent for sovereign banks
Exporters/lenders policy (medium term)	▪ Used for financing of capital equipment or services (one or more shipments); no first loss deductible ▪ Insured financial institution disburses funds to exporter once insurance is approved ▪ Insured portion is the lesser of 85 percent of the net U.S. contract value or the U.S. content of the exporter's supply contract

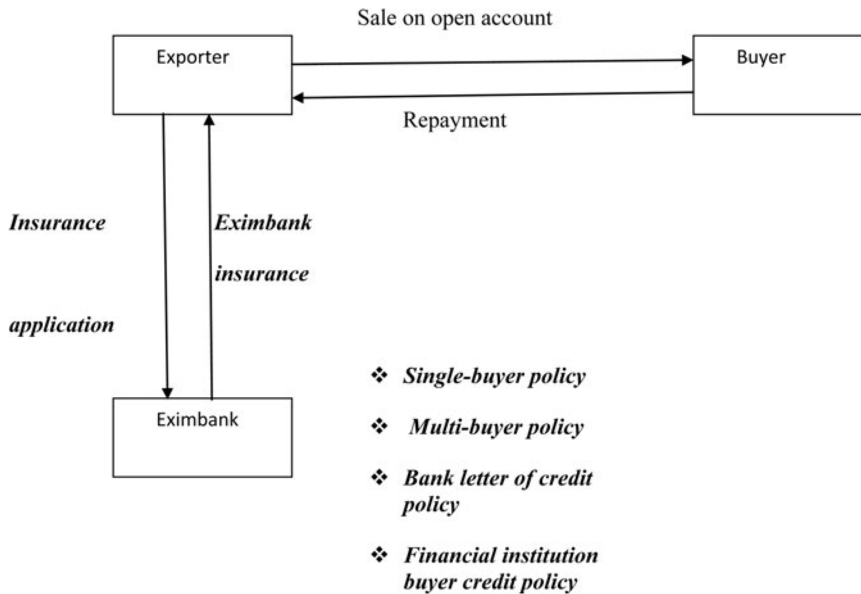

FIGURE 14.2 Export Credit Insurance

Examples: In April 2012, Eximbank announced a three-year renewal of the Bank's Short-Term Africa Initiative (STAI), which provides export-credit insurance for U.S. exporters selling to eighteen countries in sub-Saharan Africa, up to a program limit of $100 million. The initiative is renewed through March 31, 2015. Currently, Eximbank's insurance on all short-term STAI country transactions is available only under the Bank's single-buyer insurance policy, which is a select-risk authorization. Existing Eximbank multi-buyer policyholders with a diverse spread of country and buyer risk are also eligible but must submit separate single-buyer policy applications for each STAI country buyer.

In October 2012, Eximbank renewed a twelve-month export credit insurance policy for Wells Fargo to enable the export of American cotton to a large textile firm in Turkey. The instrument renewed in this transaction was a Financial Institution Buyer Credit (FIBC), allowing Wells Fargo Bank to extend revolving credit to the Turkish textile manufacturer so that it can import American cotton.

Guarantees

Eximbank guarantees provide repayment protection for private-sector loans to creditworthy buyers of U.S. exports (see Figure 14.3). The program covers 100 percent of the commercial and political risks (85 percent of the U.S. contract amount). The foreign buyer is required to make at least a 15 percent cash payment. Exports supported under this program are capital equipment, services, and projects, and the loan guarantees are offered for intermediate- and long-term sales. Guarantees of $20 million or less do not require shipment on U.S.-registered vessels. The credit may be for any amount. The guarantee is unconditional and transferable.

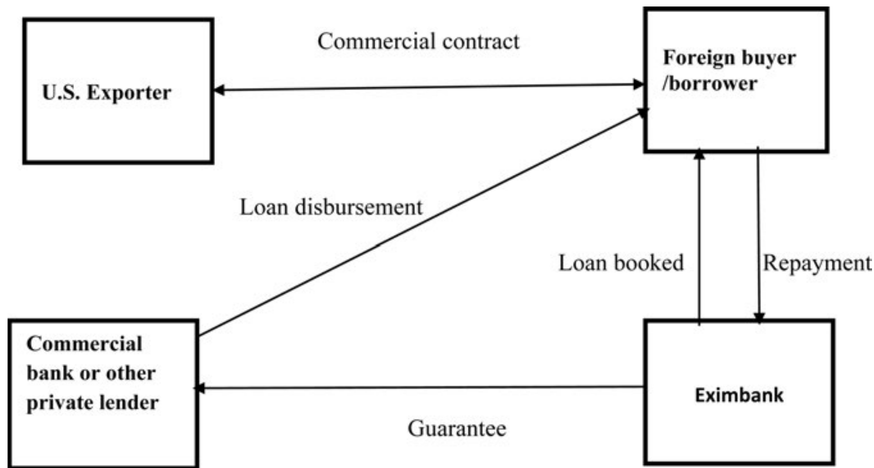

FIGURE 14.3 Guarantee

Example: In May 2012, Eximbank approved a guarantee of a $350 million loan facility to provide the funds to assist Textron Inc. in financing exports by two of its companies, Cessna Aircraft Company and Bell Helicopter Textron. The guaranteed lender is PNC Bank in Pittsburgh, Pennsylvania. The Eximbank-guaranteed loan facility will enable Textron's finance segment to provide financing to international customers that take delivery of new Cessna aircraft and Bell commercial helicopters. The repayment term is twelve years.

Direct Loans Program

Under this program, Eximbank provides fixed-rate loans directly to creditworthy foreign buyers for the purchase of U.S. capital equipment, projects, and related services. The loan covers up to 85 percent of the U.S. export value. The buyer is, however, required to make a cash payment for the difference, that is, 15 percent of the value. The loan is often used by buyers when the financed portion exceeds $10 million (Figure 14.4). A loan agreement as well as shipment on U.S. registered vessels is required. The program supports intermediate- and long-term sales. Transactions normally range from five to ten years, depending on the export value, the product, the importing country, and the terms offered by the competition.

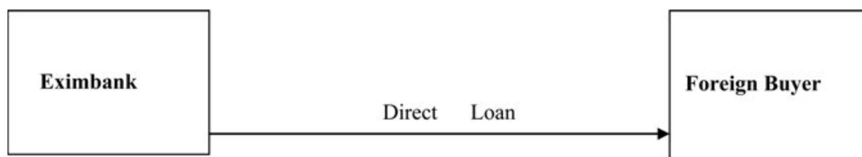

FIGURE 14.4 Direct Loan Program

All direct loans are subject to U.S.-flag shipping requirements. There is no limit on transaction size.

Example: In December 2012, Eximbank approved a $1.03 billion loan to Globalfoundries to finance the export of American-made semiconductor manufacturing equipment to Germany. Eximbank's credit will support the expansion of the Globalfoundries silicon-wafer-fabrication facility in Dresden, Germany.

Small Business Administration

The Small Business Administration (SBA) also provides a few programs for U.S. exporters. The SBA Act defines an eligible small business as one that is independently owned and operated and not dominant in its field of operation. To qualify for the programs, applicants must meet the definition of a small business under SBA's size standards and other eligibility requirements. The following represent general guidelines to determine a small business (Eximbank, 2012b):

Industry	***Maximum size***
Retail and Service	$2.5 to $21.5 million in average annual receipts
Construction	$13.5 to $17.0 million in average annual receipts
Agriculture	$0.50 to $9.0 million in average annual receipts
Wholesale	100 to 500 employees
Manufacturing	500 to 1,500 employees

Some of the SBA programs that are intended to promote exports are described in the following sections.

Export Working Capital Program Loans (EWCP)

The EWCP is a combined effort of the SBA and Eximbank to provide short-term working capital to U.S. exporters. To be processed by the SBA, loan guarantee requests must be equal to or less than $5.00 million. Loan requests greater than $5 million are processed by the Eximbank. The applicant must be in business for one year (not necessarily exporting) at the time of application. The agency can guarantee up to 90 percent of loans and accrued interest up to 120 days.

International Trade Loan Program

This program assists small businesses that are already engaged or preparing to engage in international trade and those that are adversely affected by import competition. The SBA can guarantee up to 90 percent of the loan to a maximum of $4.5 million (the maximum guarantee for the working capital component is $4 million). Maturity on the working capital loan is ten years. Collateral is required and must be located in the United States.

SBA Export Express Loan

SBA Export Express is a flexible financing tool available to assist small businesses in developing and expanding export markets. SBA Export Express offers financing up to $500,000. Export Express can take the form of a term loan or a revolving line of credit. For example, you can use funds to participate in a foreign trade show, support standby letters of credit, or translate product literature for use in foreign markets. You may also use funds to finance specific export orders, expand production facilities, and purchase equipment inventory or real estate.

Overseas Private Investment Corporation (OPIC)

The Overseas Private Investment Corporation (OPIC) is a wholly owned U.S. government corporation that supports American private investment in developing nations and emerging market economies. OPIC programs are presently available for new and expanding businesses in some 150 countries worldwide. The program has generated positive net income for every year of operation since its inception in 1971. Since 1971, OPIC has supported investments worth nearly $200 billion and generated about $75 billion in U.S. exports. Although OPIC is primarily intended to promote U.S. investment abroad, it has played a significant role in expanding American exports. In 2011, OPIC approved a loan of up to $310 million for expanding Kenya's geothermal plant. The funding will enable the plant to double its operating capacity and meet at least 5 percent of Kenya's total power demand. OPIC-backed investments in these countries are also likely to depend on a constant supply of U.S. components, supplies, or raw materials. In short, OPIC helps developing nations expand their economies and become viable markets for U.S. goods and services.

OPIC assists American investors through four principal activities designed to promote overseas investment and reduce associated risks. They are described in the following sections.

Financing Business through Loans and Loan Guarantees

OPIC provides intermediate- and long-term project financing through loans and loan guarantees in countries where conventional financial institutions often are reluctant or unable to provide financing. All projects considered for financing must be commercially and financially sound and must be managed by people with a proven track record of success in the same or a related business. OPIC, for example, carefully reviews whether the project will generate adequate cash flow to pay all operational costs, service all debt, and provide owners with an adequate return on their investments. The proceeds of OPIC financing may be spent for capital goods and services in the United States, the host country, or other, less-developed countries. The following are the major features of the program.

Ownership

Projects wholly owned by governments are not eligible. OPIC finances overseas ventures wholly owned by U.S. companies or joint ventures in which the U.S. investor has at least 25 percent equity. As a rule, at least 51 percent of the voting shares of the overseas venture

must be held by the private sector. Financing is provided in cases in which the government holds majority ownership, provided that management remains in private hands.

OPIC Participation

OPIC assists in designing and coordinating the financial plan with other lenders and investors. OPIC usually participates by providing up to 50 percent of the total cost of a new venture. The percentage is often higher in the case of an expansion of an existing business.

Financing and Loan Terms

For projects sponsored by U.S. small businesses or cooperatives, financing is provided through direct loans ranging from $100,000 to $10 million. Loan guarantees are often used for large-scale projects and range from $10 million to $250 million. The guarantees are issued to U.S financial institutions that are more than 50 percent owned by U.S. citizens, corporations, or partnerships. Foreign corporations that are at least 95 percent U.S. owned are also eligible. Funding sources include commercial banks, pension funds, and insurance companies. OPIC loans typically provide for a final maturity of five to fifteen years, following a certain grace period during which only interest is payable. For loan guarantees, OPIC charges the borrower a guarantee fee that may include an income-sharing provision.

Providing Support to Private Investments

OPIC provides finance to a number of privately owned and managed investment funds so that these funds can extend equity capital to facilitate business formation and expansion. Some funds invest primarily in small companies, whereas others invest in larger projects. Participation in equity ownership ranges from 5 to 40 percent of the company's portfolio. To be eligible for funding, the overseas company must have a significant business connection with the U.S. economy and a positive impact on U.S. employment, the environment, and workers' rights. OPIC-supported investment funds presently operate in Africa, East Asia, South America, and Eastern Europe.

Insuring Investments Against a Broad Range of Political Risks

OPIC offers many programs to insure investments in developing nations against political risk. The following risks are covered:

1. *Currency inconvertibility:* the inability to convert profits, debt services, and other remittances from local currency into U.S. dollars.
2. *Expropriation:* loss of investment due to expropriation, nationalization, or confiscation by the host government.
3. *Losses due to political violence:* loss of assets or income due to war, revolution, civil war, terrorism, and so forth. An investor may purchase a separate policy for loss of business, loss of assets, or both. Coverage is available for new or existing investments. Special insurance

programs are available for the following sectors: financial institutions, leases, oil and gas projects, natural resource projects, contractors, and exporters.

OPIC insurance is available to citizens of the United States, businesses created under U.S. law with majority ownership by U.S. citizens, and foreign companies in which a minimum of 95 percent of the equity is owned by U.S citizens.

Engaging in Outreach Activities

Outreach is mainly designed to inform the U.S. business community of investment opportunities abroad.

Investments by OPIC clients may take many forms, including equity investments, loans, service contracts, leases, joint ventures, franchises, and other arrangements. In the event that the project is foreign owned, OPIC insures the portion of the project (investment) made by the U.S. investor. OPIC does not participate in projects subject to performance requirements that would substantially undercut U.S. trade benefits from the investment (e.g., local content, maximum import, and minimum export requirements imposed by host states).

Private Export Funding Corporation

The Private Export Funding Corporation (PEFCO) is a major source of capital for intermediate- and long-term fixed-rate loans for U.S. exports. It acts as a supplemental lender to traditional sources by making loans available for foreign purchasers of U.S. goods and services.

PEFCO is a private corporation owned by banks and industrial and financial companies. It works closely with Eximbank. Eximbank, for example, unconditionally guarantees all PEFCO loans. It assists in the financing of U.S. exports by providing a direct loan or buying export loans originated by lenders. PEFCO has a program for small-business exporters to provide short-term working capital through private lenders or directly to small business exporters as a lender of last resort.

U.S. Department of Agriculture

The U.S. Department of Agriculture (USDA) provides financial support for U.S. agricultural exports through various programs, including the following:

- The GSM-102 program provides credit guarantees for up to three years and covers 98 percent of the export value and up to 2.8 percentage points of interest on the guaranteed value.
- The GSM-103 program offers credit guarantees with terms of longer than three but not more than ten years. Both guarantees cover commercial and noncommercial risks.
- Public Law 480 authorizes U.S. government financing of sales of U.S. agricultural products to friendly countries on concessional terms.

In addition to government programs, more than a dozen state governments have introduced export financing programs. Some of the programs implemented in California and Illinois have the following essential features: (1) they offer state-funded loan guarantees; (2) preshipment and postshipment assistance is available in the form of loans to lenders and loan guarantees to exporters and their banks; and (3) the state agency acts as a delivery agent for Eximbank programs.

Chapter Summary

Eximbank	Eximbank is an independent agency of the U.S. government, the purpose of which is to aid in financing and to facilitate trade between the United States and other countries. The bank, which is expected to be self-sustaining (except for the initial capital of $1 billion to start operations), makes loans and guarantees with reasonable assurance of repayment. It complements private sources of finance. *Working Capital Guarantee Program* This enables exporters to meet critical pre-export financing needs, such as inventory build up or marketing. Eximbank will guarantee 90 percent of the loan provided by a qualified lender. The guarantee has a maturity of twelve months and is renewable. *Export Credit Insurance Program* Within this program is a wide range of policies to accommodate different insurance needs. Its major features are: U.S. content requirements and restrictions on sales destined for military use and to Communist nations. The program covers (1) exporter policies (short-term): single-buyer/multi-buyer policies, small business policies; (2) lender policies (short-term): letter-of-credit policies, financial institution buyer/supplier credit policies; (3) policies for exporters and lenders: documentary and nondocumentary policies; (4) other policies, including leasing and foreign dealer policies. *Guarantees* The program provides repayment protection for private-sector loans to creditworthy buyers of U.S. goods and services. There is also special coverage for U.S. or foreign lenders on lines of credit extended to foreign banks or foreign buyers. *Direct Loan Program* This program provides intermediate-term and long-term loans to creditworthy foreign buyers for the purchase of U.S. capital goods and services.

(*Continued*)

Small Business Administration (SBA)	The SBA provides certain programs for small-business exporters. *Export Working Capital Program* This program guarantees short-term working capital loans to U.S. small-business exporters. *International Trade Loan Program* The ITLP guarantees loans to small businesses that are already engaged in or that plan to engage in international trade as well as those that are adversely affected by import competition.
Overseas Private Investment Corporation (OPIC)	This self-supporting agency of the U.S. government insures U.S. investors against political and commercial risks and provides financing through loans and loan guarantees.
Private Export Funding Corporation (PEFCO)	This private corporation works in conjunction with Eximbank in the financing of foreign purchases of U.S. goods and services. PEFCO loans are guaranteed by Eximbank.
Department of Agriculture	The USDA provides financial support for export of U.S. agricultural products through GSM-102, GSM-103, and Public Law 480.
State and local export financing programs	States provide different programs to expand exports, including providing loans and loan guarantees. They also act as delivery agents for Eximbank programs.

Review Questions

1. What is the difference between buyer and supplier credit?
2. State the OECD guidelines on export credits.
3. Describe the origins and activities of the Eximbank.
4. What are some of the criticisms of the Eximbank?
5. What is the difference between the working capital guarantee program and the direct loans program?
6. What kinds of exports are eligible under the Export Working Capital Program?
7. Compare and contrast single-buyer and multi-buyer policies.
8. Discuss the role of OPIC in promoting U.S. exports.
9. How does PEFCO promote U.S. exports?
10. State some of the programs available to promote U.S. agricultural exports.

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http://www.exim.gov (U.S. Export-Import Bank: programs, projects fees, and other information)
http://www.export.gov/finance/ (Exporting Finance Program Guide)
http://www.opic.gov/ (OPIC program)
http://www.pefco.com (PEFCO)
U.S. Department of Agriculture (www.usda.gov)

Case 14.1 Trade Finance for Small and Medium-Size Enterprises in Transition Economies

Primary and intermediate commodities continue to dominate the composition of exports from the Commonwealth of Independent States (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Russia, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Such exports may not need elaborate long-term financial arrangements, unlike the high value-added exports from countries of Central and Eastern Europe.

According to the OECD Consensus Risk Classification of 2001, country risks for export credit are subdivided into seven levels, with one signifying minimal risk and category seven indicating the highest risk. Among the transition economies, the Czech Republic, Hungary, Poland, and Slovenia were ranked at level 2, followed by Latvia and Croatia (level 4), Bulgaria and Lithuania (level 5), and Kazakhstan, Romania, and Russia (level 6). All other transition economies were categorized as very high risk countries (level 7). In many of the countries with high risk perceptions, payment terms are largely based on letters of credit and cash in advance. In Russia, for example, three out of five import shipments require advance payments. For small and medium-size imports in these countries, the use of letters of credit and cash in advance represents a significant cost, with adverse effect on their competitiveness.

In many of these countries, the banking system is not well developed to handle foreign trade transactions. In 1999, for example, the sum of loans to the

private sector was estimated at about 20 percent of GDP, compared to more than 100 percent for eurozone countries (International Monetary Fund, 2003).

Adequate trade finance facilities for small and medium-sized enterprises are limited in view of the banks' reluctance to service small companies due to the perception of high risk associated with such financing and the costs of evaluating the creditworthiness of small clients. Trade is often hampered by the limited availability of preshipment working capital financing as well as burdensome collateral requirements. In most of these countries, banks do not provide medium- and long-term trade financing. The average length of commercial credits granted in most countries varies from three to six months. In Russia, for example, commercial loans granted for more than one year accounted for only 18 percent of total commercial loan volume in 2000 (Economic Commission for Europe, 2003; USAID, 2000). The role of leasing in capital investment and trade financing remains quite limited.

In the 1990s, most transition economies introduced export credit insurance and guarantee schemes and established export credit agencies and state-sponsored export-import banks. Besides receiving training and technical advice from the Berne Union (The International Union of Credit and Investment Insurers), many of the more developed members, such as Hungary, Poland, and the Czech Republic, have become full members of the Berne Union (i.e., they have met the benchmarks for membership in terms of trade turnover insured per year and annual premium income). For many of the less developed countries in Central and Eastern Europe, eximbanks and export credit agencies remain undercapitalized, lack reliable credit information, and face difficulties collecting "problem" loans.

Questions

1. Do many transition economies use letters of credit as an important means of payment for international trade? Discuss.
2. Briefly discuss the role of trade financing in transition economies.

Case 14.2 Eximbank Financing: Selected Cases

Omni Helicopters International (OHI) of Brazil (Credit Guarantee)

In December 2012, the U.S. Export-Import Bank (Eximbank) agreed to guarantee financing to support the export of U.S.-made helicopters to Brazil. The Bank approved a final commitment to guarantee support for 85 percent of the U.S. content of the export, a portion amounting to $23.2 million. Omni Helicopters International S.A. (OHI) will buy the aircraft and assign them to its operating subsidiary, OTA. A Philadelphia manufacturer, AgustaWestland Philadelphia Corporation, will supply its twin-engine helicopters in order for OHI to service its transportation contracts with Petrobras, which operates deep-water drilling rigs off the Brazilian coast. Brazil's state-owned Petrobras offshore drilling industry increasingly demands new-technology, medium-lift helicopters to carry passengers to remote offshore operations. The helicopter can carry fifteen passengers.

It features a range of 575 miles and can fly at a cruising speed of 190 miles per hour. The Bank's financing is estimated to support at least 500 American jobs in all phases of aircraft production and delivery, based on the number employed by the company.

BG Energy Holding of Trinidad and Tobago (Direct Loan)

In November 2012, Eximbank approved a $37.6 million direct loan to support exports by McDermott International Inc. and five American suppliers of natural gas compression equipment and technology for a United Kingdom energy project off the coast of Trinidad and Tobago. Under the terms of the direct loan, Eximbank will support exports of U.S.-only goods and services to a $150 million project to construct and install a gas compression system on the existing Hibiscus Platform, situated off the northern coast of Trinidad. The borrower is BG Energy Holding Limited, and the buyer is BG Trinidad and Tobago (BGTT), which is responsible for 46 percent of the larger project.

Houston-based McDermott International Inc. was hired to provide the detail engineering, equipment procurement, unit fabrication, transportation, heavy lift, and installation. The company is responsible also for startup and commissioning. McDermott International is an engineering, procurement, construction, and installation (EPCI) company that executes complex offshore oil and gas projects worldwide. Five U.S. suppliers will manufacture or provide components for the project.

Export of Cotton to Turkey (Credit Insurance)

In October 2012, Eximbank renewed a twelve-month export credit insurance policy for Wells Fargo to enable the export of American cotton to a large textile firm in Turkey, Menderes Tekstil. Farm workers on at least fifteen U.S. farms produced the cotton for export throughout 2013. Depending upon agricultural factors and the precise qualities of cotton needed for various textiles, the cotton will be exported from a combination of farms in North Carolina, South Carolina, Tennessee, Virginia, and other states. Eximbank's support is expected to facilitate $15 million in sales of what these farms produce.

The instrument renewed in this transaction was a Financial Institution Buyer Credit (FIBC), allowing Wells Fargo Bank to extend revolving credit to the Turkish textile manufacturer so that it can import American cotton. The Menderes Tekstil firm is the largest home textiles producer in Turkey and one of the largest in the world. The primary exporters benefiting from this FIBC policy are Cargill Cotton and Carolinas Cotton.

Ethiopian Airlines (Backing Bond Issued by Ethiopian Airlines)

In November 2012, the Eximbank agreed to back bonds issued by Ethiopian Airlines to finance the export of four of ten Boeing 787 Dreamliner aircraft to Ethiopia. Ethiopian Airlines obtained competitive interest rates on its bonds.

Eximbank authorized the final commitment for the purchase of the Dreamliners in May, and Boeing delivered the first aircraft to Ethiopian Airlines in August 2012. Nippon Export and Investment Insurance (NEXI) cofinanced the

transaction. The Boeing 787 aircraft delivered to Ethiopian Airlines are the first of their kind to be delivered to any airline outside Japan and the first one to be financed by Eximbank.

Question

1. Describe how the financing programs mentioned in these examples differ in terms of product and risk coverage.

Section VI

Export Regulations and Tax Incentives

fifteen
Regulations and Policies Affecting Exports

Export Licensing and Administration

Governments use export controls for a variety of reasons. Such controls are often intended to achieve certain desired political and economic objectives. The first U.S. export control was introduced in 1775, when the Continental Congress outlawed the export of goods to Great Britain. Since then, the United States has restricted exports to certain countries through legislation such as the Embargo Act, the Trading with the Enemy Act, the Neutrality Act, and the Export Control Act.

The Export Control Act of 1949 represents the first comprehensive export control program enacted in peacetime. Export controls prior to this time were almost exclusively devoted to the prohibition or curtailment of arms exports (arms embargoes). The 1949 legislation was primarily intended to curtail the export of certain commodities to Communist nations during the Cold War era. Export controls were thus allowed for reasons of national security, foreign policy and short supply. Given America's dominant economic position in the postwar era, it provided leadership in international economic relations and pursued an active foreign policy (Moskowitz, 1996; Stenger, 1984).

In 1969, the often stringent and far-reaching restrictions were curtailed, and a new law (Export Administration Act, 1969) attempted to balance the need for export controls against the adverse effects of an overly comprehensive export control system on the country's economy. This came at a time when the United States was losing ground to other nations in economic performance, such as balance of trade and exports. The overvalued dollar and inflation, for example, had adversely affected U.S. competitiveness in foreign markets and shrank its trade surplus from $6.8 billion in 1964 to a mere $400 million in 1969. The promotion of exports was considered essential to improving the country's declining trade surplus and overall competitiveness as well as to reducing the growing unemployment. The general trend in 1969 and thereafter has been to ease and/or strengthen the position of

exporters and increase the role of Congress in implementing export control policy. Some examples follow:

1. The Equal Export Opportunity Act of 1972 curtailed the use of export controls if the product (that is subject to such restrictions) was available from sources outside the United States in comparable quality and quantity. This was because export controls would be ineffective if certain commodities were available from foreign sources. A 1977 amendment prohibited the president from imposing export controls without providing adequate evidence with regard to the product's importance to U.S. national security interests. In the event that the president decided to prohibit or control exports, the law required that he negotiate with other countries to eliminate foreign availability. The scope of presidential authority to regulate U.S. foreign transactions, including the imposition of export controls, was restricted to wartime only. A statute (the International Emergency Economic Powers Act, 50 U.S. Code 1701 4 seq.) was also passed to regulate presidential powers in the area of export controls during national emergencies. As of 1998, restrictions based on national emergencies have been imposed against Angola, Iraq, Libya, North Korea, Iran, Haiti, and the former Yugoslavia. In short, the president can impose export controls outside emergency and wartime periods only upon extensive review and consultation with Congress.
2. In 1977, Congress introduced limitations on the power of the executive branch to prohibit or curtail agricultural exports. Any prohibition of such exports was considered ineffective without the approval of Congress by concurrent resolution.
3. The 1979 Export Administration Act (EAA) also emphasized the important contribution of exports to the U.S. economy and acknowledged the necessity of balancing the need for trade and exports against national security interests. The law also gave legal effect to the agreement of the Coordinating Committee for Multilateral Export Controls (COCOM), established in 1949 to coordinate controls on exports of technology to Communist countries. It was dissolved in 1994. COCOM was primarily intended to control three categories of goods: conventional arms, nuclear-related items, and dual-use items. The third category was the most controversial since it restricted normal commerce and limited trade in goods and technologies that have both civilian and military applications (Hunt, 1983).
4. A 1985 amendment to the Export Administration Act further restricted the power of the president to impose foreign policy controls that interfere with contracts entered into before the decision to restrict exports, except under very specific circumstances. Congress also established validated licenses for multiple exports, allowing exporters to make successive shipments of the same goods under a single license, waived licensing requirements for certain low-tech goods exports to COCOM nations, and shortened by one third the time period for issuing licenses for exports to non-COCOM members. In view of certain international incidents, such as the downing, in 1983, of a Korean Airlines aircraft by the former Soviet Union, the law, however, tightened export controls on the acquisition of critical military goods and technology by the former Soviet Union and its allies.

Export controls were originally intended to be used against Communist countries. However, with the end of the Cold War, no longer was there a clearly defined single adversary, and it became necessary to adjust the system of export controls to take into account the new reality in international relations. An increasingly global economy also presented new challenges for managing export controls. The growing number of global suppliers of high technology and defense-related items, increased levels of global R&D, dissemination of dual-use technologies,

and the existence of divergent views among Western countries militated in favor of liberalization of export controls. Prior to September 11, 2001, substantial liberalization of controls had taken place in many areas, such as high-performance computers and telecommunications. Export controls were aimed at, inter alia, restricting a narrow range of transactions that could assist in the development of weapons of mass destruction by certain countries. The control system essentially focused on a small group of critical goods and technology and on specific end uses and end users, in addition to certain "reckless" nations that must be stopped from acquiring weapons of mass destruction. The new multilateral arrangement that was developed after COCOM, the Wassenaar arrangement (1990), also focused on transfers of conventional arms and dual-use goods and technology. However, it is not binding, and member countries implement the controls solely at their own discretion. Unlike the situation under COCOM, Wasenaar members do not have veto power over one another's exports and do not have an agreed list of restricted countries. Furthermore, the agreement does not require notification regarding projected exports prior to shipment. Even though Wasenaar member countries agree on the need to avoid destabilizing accumulations of weapons and dual-use items in countries of concern, they disagree about which countries are states of concern (particularly China) and what constitutes a destabilizing transfer (Corr, 2003).

After the events of September 11, 2001, the U.S. government introduced certain restrictions on exports. First, it prohibits the conduct of business with any group whose name appears on the lists of denied persons maintained by the Office of Foreign Assets Control. The list includes the names of terrorists, individuals, and companies associated with terrorists or terrorist organizations. Second, a deemed export license is required before foreign nationals engaged in research in the United States (at a U.S. university campus) receive technology or technical data on the use of export-controlled equipment or materials. For a deemed license to be required, the information being conveyed must both involve controlled equipment (and other materials) and equipment that is not publicly available. The fundamental research exclusion applies to information in the United States that is broadly shared with the scientific community and not restricted for proprietary reasons or specific national security concerns. Third, the U.S. Commerce Department bureau responsible for export controls on dual-use goods and technologies changed its name from the Bureau of Export Administration (BXA) to the Bureau of Industry and Security (BIS), a change that reflected the connection between trade and security. A focus has also been placed on controlling the export of weapons of mass destruction to hostile countries. Since the terrorist attacks of September 11, 2001, many Western governments do not permit risky exports, while approving legitimate ones more efficiently (Walsh, 2002). (See International Perspective 15.3 for multilateral export controls.) In 2011, BIS processed 25,093 export license applications valued at $90 billion (U.S.) and approved 86 percent, returned 13 percent, and denied about 1 percent of the applications. Its average processing time for review of license applications is about thirty days. The largest category of applications concerns the export of crude oil (about $65 billion), followed by chemical manufacturing and equipment ($343 million in 2011).

U.S. Export Administration Regulations

Administration of Export Controls

The Export Administration Regulations (EAR) are designed to implement the Export Administration Act (EAA) of 1979 and subsequent amendments. The EAR is administered by

the U.S. Department of Commerce, Bureau of Industry and Security (BIS). The EAR is not permanent legislation. When it lapsed, presidential executive orders under the Emergency Powers Act directed and authorized the continuation of the EAR. The regulations also implement antiboycott law provisions.

U.S. export controls are primarily imposed for the following reasons (EAR, part 742):

1. *Protect national security:* A major goal of controls is to restrict the export/re-export of items that would make a significant contribution to the military potential of any other country and that would prove detrimental to the national security of the United States. This includes the exports of high-performance computers, software, and technology to particular destinations, end users, and end uses. The list of controlled countries (Country Group D-1) includes Albania, China, Laos, Russia, and Vietnam. The lists of countries and products are periodically reviewed and revised to take into account current developments. The national security–based control list is consistent with the control list of the Wasenaar agreement. National security controls are subject to foreign availability determination; that is, items must be decontrolled if they are available to controlled countries from sources outside the United States in sufficient quantity and comparable quality. In 2009, for example, export controls were lifted on night-vision cameras but tightened on higher-end thermal imaging cameras (Fergusson, 2009).
2. *Further foreign policy goals:* An important goal of controls on the export/re-export of goods and technology is to further the foreign policy objectives of the United States, that is, to support human rights, regional stability, and antiterrorism policies. It is also used to implement unilateral or international sanctions such as those imposed by the United Nations or the Organization of American States. This includes adherence to multilateral nonproliferation agreements in the areas of chemical and biological weapons, nuclear weaponry, and missile technology. Foreign policy controls must be renewed on an annual basis and do not apply to certain items such as medical supplies and donated food and water resource equipment intended to meet basic human needs. The foreign availability of items is supposed to be eliminated through negotiations with other countries.
3. *Preserve scarce natural resources:* Another goal is to restrict the export of goods, wherever necessary, to protect the domestic economy from excessive drain on scarce resources (crude petroleum, certain inorganic chemicals) and to reduce the serious inflationary impact of foreign demand. Domestically produced crude oil and certain unprocessed timber harvested from federal and state lands are controlled because they are in short supply (EAR, part 754).
4. *Control proliferation:* Export controls also aim to prevent the proliferation of weapons of mass destruction, such as nuclear, chemical, and biological weapons, which are often maintained as part of multilateral control arrangements (EAR, part 742.2).

The core of the export control provisions of the EAR concerns exports from the United States. However, the term "exports" has been given broad meaning to include activities other than exports and can apply to transactions outside the United States.

The scope of the EAR covers the following:

- *Exports from the United States:* This includes the release of technology to a foreign national in the United States through such means as demonstration or oral briefing

(deemed export). The return of foreign equipment to its country of origin after repair in the United States, shipments from a U.S. foreign trade zone, and the electronic transmission of nonpublic data that will be received abroad also constitute U.S. exports.

- Re-exports by any party of commodities, software, or technology exported from the United States.
- Foreign products that are direct products of technology exported from the United States.
- *Activities of U.S. persons:* The EAR restricts the involvement of "U.S. persons," that is, U.S. firms or individuals, in the exportation of foreign-origin items or in the provision of services that may contribute to the proliferation of weapons of mass destruction. The regulations also restrict technical assistance by U.S. persons with respect to encryption commodities or software (EAR, part 732).

INTERNATIONAL PERSPECTIVE 15.1

Do You Need a Commerce Export License?

Even though the majority of U.S. export/re-exports do not require a license (EAR 99), it is important to establish whether a license is required for your exports from the United States.

How do you establish whether you need an export license for your product?

A. **Nature of the product intended for export:** It is important to know whether the item you intend to export has a specific Export Control Classification Number (ECCN). You may require a license if your item is listed on the Commerce Control List (CCL) and the country chart in the Regulations states that a license is required to that country. If your item falls under the jurisdiction of the Department of Commerce and is not listed on the CCL, it is designated as EAR 99 (low-tech items that do not require a license unless they are destined to an embargoed country or to an end user of concern in support of a prohibited end use).

B. **Ultimate destination, end user, and end use of the product intended for export:** A license is required for virtually all exports to embargoed destinations (e.g., Cuba, North Korea). You need to consult the list of embargoed countries compiled by three agencies: the Departments of Commerce, State, and Treasury. Certain individuals and organizations are prohibited from receiving U.S. exports, while others may receive such goods only if they have been licensed (including EAR 99 goods). It is important to consult the list of individuals and organizations engaging in activities related to the proliferation of weapons of mass destruction, terrorism, and narcotics trafficking and the list of persons whose export privileges have been revoked by BIS. A license requirement may be based on the end use in a transaction, primarily to control proliferation of weapons.

The Bureau of Industry and Security (BIS) is the primary licensing agency for dual-use exports. The term "dual use" distinguishes items (i.e., commercial items with military applications) covered by EAR from those covered by the regulations of certain other export

licensing agencies, such as the Departments of State and Defense. Although "dual use" is often employed to refer to the entire scope of the EAR, the EAR also applies to some items that have solely civilian uses. It is also important to note that the export of certain goods is subject to the jurisdiction of other agencies, such as the Food and Drug Administration (drugs and medical devices), the Department of State (defense articles), and the Nuclear Regulatory Commission (nuclear materials).

Commerce Export License

Exports and other activities that are subject to the EAR are under the regulatory jurisdiction of the BIS. They may also be controlled under export-related programs of other agencies. Before proceeding to complete any export transaction, it is important to determine whether a license is required. The modalities of transportation are immaterial in the determination whether an export license is required, that is, an item can be sent by regular mail, hand carried on an airplane, or transmitted via e-mail or during a telephone conversation.

The following steps are important in establishing whether a given export item is subject to a license requirement (Figure 15.1).

Step 1: Is the item (intended for export) subject to EAR? Items subject to the EAR regulations include all items in the U.S. or abroad (including those in a U.S. free-trade zone), foreign-made items that are direct products of U.S.-origin technology or software (or that incorporate more than the stipulated minimum amounts of U.S.-origin materials), and certain activities of U.S. persons with regard to encryption commodities or software related to the proliferation of weapons of mass destruction and technical assistance. It also covers activities of U.S. or foreign persons prohibited by any order (denied parties). Publicly available technology and software, phonograph records, magazines, and so on are excluded from the scope of EAR.

If the item is subject to the EAR, it is necessary to classify it under an ECCN (Export Control Classification Number) on the CCL (Commerce Control List). If it is not subject to EAR, there is no need to comply with the EAR. It may be necessary to comply with the regulations of another agency.

Step 2: Is the item classified under the ECCN on the CCL? Any item controlled by the Department of Commerce has an ECCN. Exporters should classify their product according to the Commerce Control List (CCL). They can also send an export classification request to the Department of Commerce. A request can also be made if an item has been incorrectly classified and/or should be transferred to another agency. Given certain changes that are made with regard to product classifications and the EAR, it is important to monitor the CCL for any modifications to your product, including eligibility for a license exception to certain destinations. Some companies may opt to use a computerized product/country license determination matrix. The CCL is composed of ten categories of items ranging from nuclear materials to propulsion systems, space vehicles and equipment. Each of these categories is further divided into five functional groups. Each controlled item has an export classification number (ECCN) based on its category and group.

Step 3: Do the general prohibitions (4–10) apply? Whether a product is listed under an ECCN on the CCL or not (EAR 99), it is important to determine whether general prohibitions on export/re-export to prohibited end uses, users, or embargoed destinations apply. The general prohibitions include engaging in activities prohibited by a denial order or supportive of proliferation activities as well as routing in-transit shipments through certain

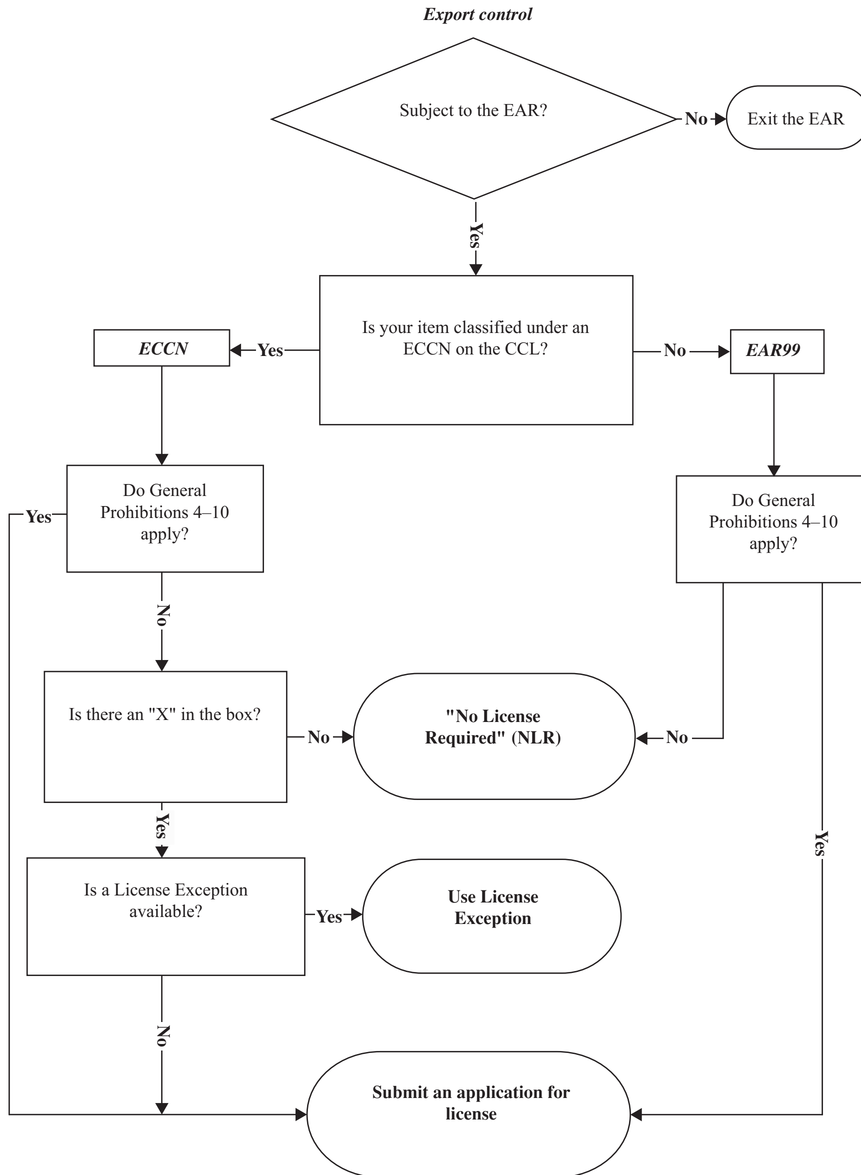

FIGURE 15.1 Steps to Determine Whether a Commerce Export Control License Is Required

destinations. If an item is not listed under the ECCN on the commerce control list (EAR 99) and general prohibitions do not apply, no license is required. However, if the prohibitions apply (for items listed/not listed on ECCN), an application for a license should be submitted.

Step 4: Are there any controls on the country chart? The commerce country chart allows you to determine the export/re-export requirements for most items listed on the CCL. If an "X" appears in a particular cell, transactions subject to that particular reason for control (e.g., national security, antiterrorism)/destination combination require a license unless a license

exception applies. No license is required if the license exception is available provided that general prohibitions 4–10 do not apply to the proposed transaction. No license is required if there is no "X" indicated in the CCL and the country chart sample analysis using the CCL and country chart presented on page 331.

Step 5: Applying for an export license: The BIS provides formal classification for a product or service and issues an advisory opinion or a licensing decision upon review of a completed application submitted in writing or electronically. Even though it is the applicant's responsibility to classify the export, the BIS could be requested to provide information on whether the item is subject to the EAR and, if so, its correct ECCN. In addition to the classification requests, potential applicants could also seek advisory opinions on whether a license is required or is likely to be granted for a particular transaction. Such opinions, however, do not bind the BIS's future actions.

Step 6: Destination Control Statement, shipper's export declaration, and record keeping: A Destination Control Statement (DCS) is intended to prevent items licensed for exports from being diverted while in transit or thereafter. A typical DCS reads as follows:

> These commodities, technology or software were exported from the United States in accordance with the Export Administration Regulations for ultimate destination (name of country). Diversion contrary to U.S. law is prohibited.

A DCS must be entered on all documents covering exports from the United States of items on the CCL and is not required for items classified as EAR 99 (unless it is made under license exception BAG or GFT). DCS requirements do not often apply to re-exports. For holders of a Special Comprehensive License (SCL), use of a DCS does not preclude the consignee from re-exporting to any of the SCL holder's other approved consignees or to other countries for which prior BIS approval has been received. An SCL allows experienced, high-volume exporters to export a broad range of items. It was introduced in lieu of special license and allows exportation of all commodities to all destinations (with some exceptions). Another DCS may be required on a case-by-case basis. The DCS must be shown on all copies of the bill of lading, the air waybill, and the commercial invoice (EAR, part 748). (See International Perspective 15.2 for automated services to facilitate export license applications).

INTERNATIONAL PERSPECTIVE 15.2

Automated Services

AES (Automated Export System): A computerized method for filing shipper's export declarations. AES streamlines the export reporting process by reducing the paperwork burden on the trade community.

ELAIN (Export License Application and Information Network): A system that allows electronic submission of license applications through private vendors.

ERIC (Electronic Request for Item Classification): A supplementary service to ELAIN that allows exporters to submit commodity classification requests electronically to BIS.

SNAP-R (Simplified Network Application Process Redesign): A method for submitting applications over the Internet with a Web browser. To use SNAP-R, one must first apply to BIS for issuance of a company identification number (CIN).

STELA (System for Tracking Export License Applications): An automated voice response system that provides applicants with the status of their license and product classification applications. When the application is approved without conditions, STELA allows exporters to ship their goods without waiting for a formal letter from BIS.

Even though there are few exceptions, submission of a Shipper's Export Declaration (SED) to the U.S. government is generally required under the EAR. Information on the SED, such as value of shipment, quantity, and so on, is also used by the Census Bureau for statistical purposes. The exporter or the authorized forwarding agent submits the SED, which includes information such as criterion under which the item is exported (i.e., license exception, no license required, license number and expiration date), ECCN, and other relevant information.

The exporter is required to keep records for every export transaction for a period of five years from the date of export. The records to be retained include contracts, invitation to bid, books of account, financial records, restrictive trade practices, and boycott documents or reports (EAR, part 762). (See Tables 15.2 and 15.3 for selected cases on export enforcement).

The following example provides an analysis using the CCL and country chart. In order to determine whether a license is required to export/re-export a particular item to a specific destination, it is essential to use the CCL in conjunction with the country chart (EAR, part 774).

This sample entry and related analysis are provided to demonstrate the thought process needed to complete this procedure.

Example: The item destined for export to India is valued at approximately $10,000 and classified under ECCN 2A000.a. On the basis of the item classification, we know that the entire entry is controlled for national security and antiterrorism reasons. The item appears in the country chart column, and the applicable restrictions are NS Column 2 and AT Column 1. An "X" appears in the NS Column 2 cell for India but not in the AT Column 1 cell. This means that a license is required unless it qualifies for a license exception or Special Comprehensive License. It may qualify under a license exception (GBS). (See International Perspective 15.3 for various multilateral arrangements on export controls).

INTERNATIONAL PERSPECTIVE 15.3

Multilateral Export Regimes

- **The Australian Group (AG):** The AG was formed in 1985 to harmonize export controls on chemical and biological weapons. It has thirty-four member countries. Its activities serve to support the objectives of the Biological Weapons Convention (BWC) and the Chemical Weapons Convention (CWC) by enhancing the effectiveness of national export licensing measures. The Group considers export licensing a vital means of ensuring that legitimate trade in chemicals, biological agents, and related equipment is not adversely affected while facilitating transparency to discourage the sale of such products to parties that could develop a biological or chemical weapons program.

- **Nuclear Suppliers Group (NSG):** The NSG was established in 1992 by a group of nuclear supplier countries (forty member countries). It seeks to contribute to the nonproliferation of nuclear weapons through the implementation of guidelines for nuclear and nuclear-related exports.
- **Missile Technology Control Regime (MTCR):** The MTCR was established in 1987 to coordinate national export controls in order to prevent missile proliferation. It has thirty-three member countries. Through a system of export licenses, member countries attempt to control transfers that contribute to delivery systems for weapons of mass destruction.
- **Wassenaar Arrangement (WA):** The WA was founded in 1996 to replace the East-West technology control program under the Coordinating Committee for Multilateral Export Controls (COCOM), which was disbanded in 1994. It is intended to review export controls on conventional arms and sensitive dual goods and technologies. It has thirty-three member countries. The agreement provides for enhanced cooperation among members through information exchange on a regular basis.

Current Developments in Export Controls: In 2009, the U.S. government announced the launch of a comprehensive review of the U.S. export control system. The reform process is driven by the following important principles:

- *Export controls should focus on a small core set of key items that pose a serious threat to U.S. national security* (International Perspective 15.4 on U.S. export controls and China).
- *Unilateral controls must address an existing legal or foreign policy objective.*
- *Export controls must be coordinated with other exporting nations in order to be effective.*
- *Export control lists must be revised on a regular basis (on the basis of technological developments, foreign availability). Licensing processes must be predictable and timely with enhanced enforcement capabilities to address noncompliance.*

The Obama administration has proposed a number of changes to streamline the export control system:

- *A single licensing agency:* The present multiagency structure contributes to institutional squabbling among different agencies, and having one agency could end jurisdictional disputes. Under the present regime, dual-use exports are subject to referral to four departments.
- *A single control list that distinguishes in tiers the sensitivity of items.*
- *A single enforcement structure:* The center would coordinate export control enforcement efforts among various departments and serves as a liaison between law enforcement agencies as well as the intelligence community and export licensing agency.
- *A single information technology system to share information among the relevant agencies* (Fergusson and Kerr, 2012).

INTERNATIONAL PERSPECTIVE 15.4

U.S. Export Controls and the Case of China

In 2010, U.S. exports to controlled countries totaled about $107 billion (U.S.), which represents about 8 percent of total U.S. exports. China is the largest single export market among the controlled country group, with 86 percent of the total, followed by Russia (6 percent) and Vietnam (3 percent). A significant number of U.S. license applications to China involve exports of manufacturing equipment for semiconductors, chemicals, and electronics. U.S. export controls to China arise out of conflicting interests and mutual suspicions on security issues, including, on the U.S. side: (1) China's assertive foreign policy toward its neighbors, such as Japan, Taiwan, and other U.S. allies; (2) China's increasing military capability and growing ability to conduct information warfare, including computer network attacks and cyberespionage; and (3) the growing integration between China's civilian and military-industrial base, which could mean that exports to Chinese civilian firms may benefit the Chinese military. U.S. exports of technical assistance, equipment, and management know-how to the Chinese shipbuilding industry, for example, have assisted in the building of China's own aircraft carriers (Cheng, 2010).

Problems with U.S. Export Controls on China: Few U.S. allies agree on the need to impose export controls on China. Furthermore, many European and Asian countries have acquired technological capabilities in various fields such as semiconductors and satellites, and unilateral U.S. controls will only hurt U.S. exports without curtailing China's access to these technologies. Effective reform of the U.S. export control regime should include identifying key areas of U.S. advantage (i.e., technologies in which the United States is dominant and that, if exported, could enhance China's military industry). Control lists must be revised regularly to take account of new and emerging developments.

Sanctions and Violations

The enforcement of the EAR is the responsibility of the Bureau of Industry and Security, Office of Export Enforcement (located within the Department of Commerce). The Office of Export Enforcement (OEE) works with various government agencies to deter violations and imposes appropriate sanctions. Its major areas of responsibility include preventive enforcement, export enforcement, and prosecution of violators.

Preventive enforcement is intended to stop violations before they occur by conducting prelicense checks to determine diversion risks and the reliability of overseas recipients/end users of U.S. commodities/technology, as well as postshipment verifications. In 2011, BIS's investigations resulted in the criminal convictions of thirty-nine individuals and businesses, with $20.2 million in penalties, $2.1 million in forfeitures, and 572 months of imprisonment. The BIS's Office of Export Enforcement also conducts investigations of potential export control violations. When preventive measures fail, it pursues criminal and administrative sanctions. Violations of the EAR are subject to both criminal and administrative penalties. Fines for export violations can reach up to $1 million (U.S.) per violation in criminal cases, $12,000 per violation in most administrative cases, and $120,000 in cases involving national security issues. In addition, violators may be subject to prison time and denial of export privileges (i.e., they may be placed on the denied-persons list and/or face seizure/forfeiture

of goods). (See International Perspective 15.2, 15.5, and 15.6 for BIS automated services, control agencies, and general prohibitions.)

The EAR also provides certain indicators to help exporters recognize and report possible violations. It reminds exporters to look for the following in export transactions:

- Whether one of the parties to the transaction has a name or address that is similar to an entity on the U.S. Department of Commerce's list of denied persons.
- Whether the transaction has "red flags." Examples include (a) the customer or purchasing agent is reluctant to offer information about the end use of the product; (b) the customer is willing to pay cash for a very expensive item (when the terms provide for financing), has little or no business background, and is unfamiliar with the product, or the customer declines routine training installation or other services; (c) the product ordered is incompatible with the technical level of the country and its packaging is inconsistent with the stated method of shipment or destination; and (d) the shipping routes are abnormal for the producer and destination, delivery dates are vague, and a freight forwarding firm is listed as the product's final destination.

INTERNATIONAL PERSPECTIVE 15.5

U.S. Export Control Agencies

- **Bureau of Industry and Security (BIS):** BIS is part of the U.S. Commerce Department and administers the EAR. It controls dual-use technologies.
- **Office of Defense Trade Controls (DTC):** The State Department's Office of Defense Trade Controls is responsible for the implementation of the International Traffic in Arms (ITAR) regulations. It controls exports of munitions-related merchandise and technology. It consults with the Department of Defense in setting licensing policy and making decisions on license applications. In cases of jurisdictional claims (interdepartmental disputes), it has authority to decide which agency has jurisdiction.
- **Office of Foreign Assets Control (OFAC):** The U.S. Treasury's Department of Foreign Assets Control administers country-specific, politically oriented sanctions programs. Transactions with an embargoed destination that is not covered by OFAC may be covered by BIS or vice versa.
- **Other Agencies:** Nuclear-related export controls are administered by the U.S. Energy Department and by the Nuclear Regulatory Commission. Even in cases where one agency exerts control over a particular type of technology, it will consult with other agencies before making a licensing decision.

INTERNATIONAL PERSPECTIVE 15.6

General Prohibitions and License Exceptions

General Prohibitions:

- Export/re-export and conduct subject to EAR and that are prohibited without a license or a license exception from BIS.

- Engaging in export/re-export of controlled items to listed countries.
- Engaging in re-exports and export from abroad of foreign-made items incorporating more than a de minimis amount of controlled U.S. content. For certain countries and commodities, de minimis is defined as re-exports of foreign-made commodities incorporating controlled U.S.-origin commodities valued at 10 percent or less of the total value of the foreign-made commodity.
- Engaging in re-export and export from abroad of the foreign-produced direct product of U.S. technology and software.
- Engaging in actions prohibited by a denial order, violating any order, and proceeding with transactions with knowledge that a violation has occurred or is about to occur.
- Engaging in export or re-export to prohibited end uses or end users or to embargoed destinations.
- Engaging in actions that support proliferation activities and in export/re-export through or transit through specific countries (e.g., Albania, North Korea, Russia) without a license or license exception (EAR, part 736).

License Exceptions (items that can be exported without a license):

- GBS: Authorizes export/re-exports to country Group B (Western countries).
- LVS: Authorizes limited-value shipments (single shipment) to country Group B.
- CIV: Allows exports/re-exports for civil end uses and users to Group D1 countries (except North Korea).
- TSR: Allows technology/software export/re-exports to country Group B.
- GFT: Allows export/re-exports of gift parcels to an individual or religious or charitable organization located in any country.
- BAG: Authorizes individuals leaving the United States to take to any destination personal baggage, effects, vehicles, and tools of trade.
- TMP: Authorizes various temporary export/re-exports (EAR, part 740).

Antiboycott Regulations

The U.S. antiboycott provisions of the Export Administration Act prohibits U.S. firms from participating in foreign boycotts or embargoes not authorized by the U.S. government. Even though this law was primarily aimed at the Arab boycott against Israel, it prevents U.S. firms from being used to implement foreign policies of other nations that are inconsistent with or contrary to U.S. policy. The law requires companies to report boycott-related requests by other nations and imposes a range of sanctions in the event of violations. In July 2011, for example, Smith International Inc. of Houston, Texas, agreed to pay a $20,500 civil penalty to settle charges that it had violated the antiboycott provisions of the EAR. BIS alleged that during the period 2006–2008, the company violated the EAR in connection with transactions involving the sale of goods and services to Libya and the United Arab Republic. BIS charged that the firm violated the EAR by (a) its failure to report its receipt of nine requests to engage in a restrictive trade practice or boycott; (b) its agreement to refuse to do business with another person pursuant to a request from a boycotting country; (c) its furnishing of prohibited information in a statement certifying that no materials were of Israeli origin nor had Israeli content.

Scope of Coverage

Who Is Covered by the Laws?

The sources of U.S. antiboycott regulations can be found in the Export Administration Act (EAA) and its implementing regulation, the Export Administration Regulations (EAR), and in the Internal Revenue Code. The EAR applies to all "U.S. persons" (individuals and companies located in the United States). It also covers foreign subsidiaries that are controlled by a U.S. company through ownership or management. In such cases, the foreign affiliate is subject to the antiboycott laws and the U.S. parent will be held responsible for any noncompliance. The regulations cover the activities of individuals or companies related to the sale, purchase or transfer of goods or services within the United States or between the United States and a foreign country. This includes U.S. exports, imports, financing, forwarding, and shipping and certain other transactions that may take place outside the United States. To trigger the application of the antiboycott laws, the activity must involve U.S. commerce with foreign countries (EAR, part 760).

What Do the Laws Prohibit?

The laws cover several types of actions:

Refusals to do business: The law prohibits any U.S. person from refusing to do business (expressly or implicitly) with any person pursuant to a request from, agreement with, or requirement of a boycotting country. The use of a designated list of persons also constitutes a refusal to do business prohibited under the act.

Discriminatory Actions: The statute prohibits any U.S. person from discriminating against an individual (who is a U.S. person) on the basis of race, religion, gender, or national origin. It also prohibits similar action against a U.S. corporation on the basis of the race or religion of the owner, officer, director, or employee. Such prohibitions apply when the action is taken in order to comply with or to support an unsanctioned foreign boycott.

Furnishing information to a boycotting country: The statute prohibits the furnishing of information about any business relationship with or in a boycotted country or with blacklisted firms or persons. It also prohibits the actual furnishing of or agreements to furnish information about the race, religion, sex, or national origin of another U.S. person or any U.S. person's association with any charitable organization that supports the boycotted country.

Implementing letters of credit with prohibited conditions or requirements: The statute also prohibits any U.S. person from implementing a letter of credit that contains a condition or requirement from a boycotting country. This includes issuing, honoring, paying, or confirming a letter of credit. The prohibition applies when a beneficiary is a U.S. person and the transaction involves the export of U.S. goods (i.e., shipment of U.S.-origin goods or goods from the United States).

Some exceptions to the prohibitions include the following:

- Compliance with import requirements of a boycotting country
- Compliance with unilateral and specific selections by buyers in a boycotting country
- Compliance with a boycotting country's requirements regarding shipment and transshipment of exports

- Compliance with immigration, passport, visa, employment, and local requirements of a boycotting country.

Reporting Requirements

The regulations require U.S. persons to report quarterly to the U.S. Department of Commerce any requests they have received to take any action to comply with, further, or support an unsanctioned foreign boycott. The U.S. Treasury also requires taxpayers to report activities in or with a boycotting country and any requests to participate in a foreign boycott (see International Perspective 15.7).

INTERNATIONAL PERSPECTIVE 15.7

Requests That Are Not Reportable

- To refrain from shipping on a carrier owned or leased by a particular country or its nationals or a request to certify to that effect.
- To ship goods via a prescribed route or refrain from shipping via a prescribed route or to certify to that effect.
- To supply information regarding the country of origin of goods, the name of the supplier, the provider of services, or the destination of exports.
- To comply with the laws of another country other than one that requires compliance with the country's boycott laws.
- To supply information about the exporter or exporter's family for immigration, passport, or employment purposes.
- To supply a certificate by owner/ master that the vessel, aircraft, or other means of conveyance is eligible to enter a particular port pursuant to its laws.
- To supply a certificate from an insurance company stating that the company has an agent or representative in the boycotting country including the name and address of such agent.

Penalties for Noncompliance

The law provides both criminal and civil penalties for violations of the antiboycott statute. On the criminal side, a person who knowingly violates the regulations is subject to a fine of up to $50,000 or five times the value of the exports involved, whichever is greater. It may also include imprisonment of up to five years. In cases in which the violator has knowledge that the items will be used for the benefit of countries or persons to which exports are restricted for national security or foreign policy purposes, the criminal penalty varies. For individuals, a fine up to $250,000 and/or a prison term of up to ten years may be imposed. For firms, the penalty for each violation can be $1 million or up to five times the value of the exports involved, whichever is greater. Administrative or civil penalties may include any or all of the following: revocation of export licenses, denial of export privileges, exclusion from practice, and imposition of fines of up to $11,000 per violation or $100,000 if the violation involves

items controlled for national security reasons. The Treasury Department may also deny all or part of the foreign tax benefits.

Foreign Corrupt Practices

The Foreign Corrupt Practices Act (FCPA) of 1977 was enacted as a public response to the Watergate scandal of the early 1970s and to revelations of widespread bribery of foreign officials by U.S. companies. In the 1970s, Securities and Exchange Commission (SEC) investigations revealed that more than 400 U.S. companies admitted making illegal payments in excess of $300 million to foreign government officials. Recent FCPA enforcement and compliance actions also show that substantial payments were made by companies such as Siemens AG ($1.6 billion), Halliburton ($579 million), and Wilbros Group ($32 million) to foreign officials to obtain government contracts (Bixby, 2010–2011). The overriding public concern was that this practice could tarnish the reputation of the United States in the world and was not in the best interest of U.S. corporations.

The legislation represents an attempt to enforce morality and ethics in the conduct of international business transactions. It was intended to halt corrupt business practices in order to create a level playing field for honest businesses and to restore public confidence in the integrity of the marketplace. The FCPA was enacted as an amendment to the Securities and Exchange Act of 1934. It was later amended in 1988, as part of the Omnibus Trade and Competitiveness Act. In 1998, the FCPA was again amended to conform to the requirements of the OECD convention on combating bribery of foreign public officials in international business transactions. The OECD Anti-Bribery Convention came into force in February 1999 with the United States as a founding member.

The principal objectives of the legislation are to:

- Prohibit the bribery of foreign officials by U.S. individuals and corporations to obtain or retain a business.
- Establish standards for maintaining corporate records and internal accounting control objectives.

The antibribery provision applies to all publicly held corporations registered with the SEC and all domestic concerns. The 1998 amendments expanded the application of the antibribery provisions to cover "any person" who commits bribery on U.S. territory regardless of whether the accused is a resident or does business in the United States. In addition, individual corporate employees can be prosecuted even if the corporation is found not guilty of violating the FCPA (Gleich and Woodward, 2005). The accounting standards and objectives apply only to SEC registrants or those that are required to file reports with the SEC.

The accounting provisions of the FCPA are intended to prevent companies from escaping detection by maintaining dubious accounts or slush funds. It requires any corporation that has certain classes of shares with the SEC to (1) make and keep accurate books and accounts that fairly reflect the transactions, and (2) maintain a system of internal accounting controls in order to prevent the unauthorized use of corporate assets and transactions and to ensure the accuracy of corporate records.

Scope of Coverage

Who Is Subject to the FCPA?

Antibribery provisions:

- A U.S. issuer, domestic concern or any person including officers, directors, employees, agents or shareholders acting on behalf of the issuer, domestic concern or person.
- Issuers and domestic concerns may also be held liable for any act in furtherance of a corrupt payment taken outside the U.S. A foreign company or person is now subject to the FCPA if causes, directly or through agents any act in furtherance of a corrupt payment to take place within the U.S.
- U.S. parent corporations may be held liable for the acts of foreign subsidiaries

The antibribery provisions apply to all publicly held corporations registered with the Securities and Exchange Commission (issuers of stock in controlling corporations) and other domestic concerns. Domestic concerns are broadly defined to include all U.S. citizens and residents as well as any entity whose principal place of business is in the United States or incorporated under the laws of the United States (Atkinson and Tillen, 2005).

A U.S. parent company may be liable for corrupt payments by its foreign subsidiary if the U.S. parent company knew of or participated in the subsidiary's corrupt action or took no measures to discourage such payments. DPC-Diagnostics Ltd. of Tianjin, China, a wholly owned subsidiary of a California company that produces medical equipment, agreed to pay $4.8 million for violations of the FCPA in 2005. The firm admitted to paying $1.6 million in bribes to physicians and lab personnel in China to obtain business there. The guilty plea was based on the theory that the firm was an agent of the American company (Bixby, 2011).

The FCPA also applies to certain foreign nationals or entities (not issuers or domestic concerns) if they engage directly or through an agent in making or facilitating corrupt payments while in the United States.

The 1998 amendments to the FCPA established jurisdiction on the basis of the nationality principle (U.S. persons are liable even if the actions took place outside U.S. territory) and removed the requirement that there be a use of interstate commerce for acts in furtherance of a corrupt payment to a foreign official by U.S. companies or persons that took place wholly outside the United States.

Accounting provisions:

- Publicly-held entities (issuers) that either have securities registered with the SEC or are required to file reports with the SEC.

The FCPA accounting provisions apply to any issuer whose securities trade on national securities exchange in the United States, including foreign issuers with exchange-traded American depository receipts. They also apply to companies whose stock trades in the over-the-counter market in the United States and that file periodic reports with the SEC. A California company paid more than $2 million in civil and criminal penalty when its two joint-venture partners paid more than $400,000 in bribes to obtain a business in China. The illicit payments were recorded on the books as "business fees" or "travel and

entertainment expenses." The California company failed to provide adequate internal controls. Companies (including subsidiaries of issuers) and individuals may face civil liability for aiding and abetting an issuer's violation of the accounting provisions. This includes managers of subsidiaries who approve certain payments and who should have known that these payments were improperly recorded or otherwise circumvent internal controls.

Criminal liability can be imposed on companies and individuals for knowingly failing to comply with the FCPA's internal control provisions. As with the FCPA's antibribery provisions, individuals are subject to the FCPA's criminal penalties for violations of the accounting provisions only if they acted "willfully." For example, a French company was criminally charged with failure to implement internal controls and failure to keep accurate books and records.

What Is Covered by the FCPA?

The antibribery provision of the FCPA prohibits American businesses from using interstate commerce to pay off foreign officials to obtain or retain a business. The term "interstate commerce" also includes the intrastate use of any interstate means of communication or any other interstate instrumentality. Placing a telephone call or sending e-mail or a fax from, to, or through the United States involves interstate commerce, as does sending a wire transfer from or to a U.S. bank or otherwise using U.S. banks or traveling across state borders (or to or from the United States (U.S. Department of Justice and SEC, 2012).

Payments to any foreign official to obtain the performance of routine governmental action are explicitly exempted. The 1988 amendments to the FCPA changed the knowledge requirement and the definition of grease payments, added certain defenses to charges of bribery under the statute, increased penalties, and authorized the president to negotiate an international agreement prohibiting bribery.

The knowledge requirement: The 1977 act prohibited any payments if the payor knows or has reason to know that the funds will be used to bribe foreign officials. It was believed that a broad application of the "reason to know" standard would put many multinational companies at risk of liability for the actions of their sales agents who engage in bribery without their approval. Such a standard would also invite unwarranted scrutiny of distributors or sales agents in countries that are considered to be corrupt. Given such legitimate business concerns, the "reason to know" standard was removed from the act and objective criteria established with respect to such conduct. This new standard is narrower and holds businesses liable only if they are substantially certain that the illicit payments are to occur or that such a circumstance exists (Hall, 1994). Requisite knowledge requires that a person be aware of a high probability of the existence of such a circumstance (unless the person believes that such a circumstance does not exist). FCPA imposes liability not only on those with actual knowledge of wrongdoing but also on those who purposely avoid actual knowledge (i.e., who exhibit willful blindness or deliberate ignorance to avoid responsibility).

Affirmative defenses against charges of bribery: The FCPA antibribery provisions contain two affirmative defenses (the defendant bears the burden of proving them). Payments are not considered corrupt if:

- *They are lawful under the laws of the foreign country.* To avoid prosecution, the conduct prohibited under the FCPA must be lawful under written local law. An exception under the law of Azerbaijan, for example, relieving bribe payors who voluntarily disclose bribe payments to the authorities of criminal liability does not make the bribes legal.
- *The money was spent as part of demonstrating a product or performing a contractual obligation.* The FCPA allows companies to claim reasonable and bona fide travel and lodging expenses to foreign officials for training and for visits to company facilities as well as for product demonstration and promotional activities.

Exemption of facilitating or expediting payments: A narrow exception is made for "facilitating or expediting payments" made in furtherance of routine governmental action. This includes processing visas or work orders, provision of police protection or mail service, and supplying of utilities such as power or water. Paying a local official a small amount to have the power turned on at a factory may be considered a facilitating payment, while paying an inspector to ignore the necessary permits to operate the factory would be considered a bribe. For example, an Oklahoma-based firm violated the FCPA when its subsidiary paid Argentine customs officials $166,000 to secure clearance for equipment that lacked requisite certifications or could not be imported under local law and to pay a lower-than-applicable duty rate.

Increased penalties: The maximum fine for a corporation was increased from $1 million to $2 million. For individuals, the maximum fine was increased from $10,000 to $250,000. Individuals and corporate employees were made criminally liable even when the corporation is not in contravention of the FCPA.

Authorization to negotiate an international agreement: The act authorizes the U.S. president to negotiate an international agreement with countries that are members of the OECD to prohibit bribery.

Enforcement and Penalties

Enforcement of the FCPA is the joint responsibility of the SEC and the Department of Justice. The Department of Justice has authority for civil enforcement of violations by domestic concerns with respect to the antibribery provisions. It also has exclusive jurisdiction over criminal prosecution in relation to the accounting as well as antibribery provisions of the statute. The SEC has similar authority for civil enforcement of violations of the anti -bribery and accounting provisions.

Criminal penalties may reach up to $2 million for public corporations and domestic concerns and $250,000 and/or a maximum of five years for officers, directors, or employees who commit willful violations of the antibribery provisions. With regard to civil penalties, a maximum of $10,000 may be levied against any company, employee, officer, or director. Injunctive relief is also available to forestall a violation. Enforcement agencies are also increasingly seeking disgorgement of company profits on "tainted contracts" secured through improper payments to foreign officials. Violations of the accounting provisions can result in a fine of $25 million for companies. Culpable individuals can be subject to a criminal fine up to $5 million as well as imprisonment for up to twenty years. Such penalties may also include termination of government licenses and debarment from government contracting programs.

Since the introduction of the FCPA, several U.S. companies have been investigated for bribing foreign officials to obtain contracts. Over the past few years, some companies were

indicted and fined for bribing foreign officials in order to use their influence to secure government contracts. Here are some examples:

- In 2008, Siemens AG (Argentina), producer of power and electrical equipment, was charged with violation of the FCPA. It pleaded guilty to conspiring to violate the FCPA's books and records provisions and paid criminal fines of $450 million on top of $350 million disgorgement of ill-gotten profits. German authorities also collected additional penalties.
- In 2012, Smith & Nephew acknowledged responsibility for the actions of its affiliates, employees, and agents who made various improper payments to publicly employed health care providers in Greece from 1998 until 2008 to secure lucrative business. Smith & Nephew, a Delaware corporation, is headquartered in Memphis, Tennessee, and is a wholly owned subsidiary of Smith & Nephew PLC, an English company traded on the New York Stock Exchange. The company manufactures and sells medical devices worldwide. In total, from 1998 to 2008, Smith & Nephew and its affiliates and employees authorized the payment of approximately $9.4 million to the distributor's shell companies, some or all of which was passed on to physicians to corruptly induce them to purchase medical devices manufactured by Smith & Nephew. As part of the agreement, Smith & Nephew agreed to pay a $16.8 million penalty and is required to implement rigorous internal controls, cooperate fully with the department, and retain a compliance monitor for eighteen months.

FCPA enforcement against foreign firms with no operations or personnel in the United States has raised concerns about the extraterritorial application of U.S. laws and its infringement upon the sovereignty of other nations (McDonald, Yoshino, and Carr, 2010).

U.S. companies could seek an advisory opinion from the Department of Justice on whether a particular transaction would violate the FCPA. Any opinion by the DOJ that sanctions a proposed transaction would create a presumption of legality.

Measures for Compliance with the FCPA

Implementing due diligence procedures: Internal procedures should be developed to evaluate and select foreign partners and agents. Once an appointment has been made consistent with the internal procedures, a written agreement is needed to govern the relationship between the parties. Such an agreement should generally state that the agent/partner has no authority to bind the exporter and that the agreement is valid provided that the foreign agent/partner complies with the FCPA and the foreign country's laws. It should also stipulate that the agent/partner is not an employee, officer, or representative of any government agency. The exporter should be promptly notified of any changes in representation (see International Perspective 15.8).

Seeking an advisory opinion from the government: The U.S. Department of Justice provides advisory opinions on the legitimacy of a proposed transaction. Other federal agencies also provide advisory opinions.

Adopting internal measures and controls: Internal procedures should also be established to guide employees. Such programs include descriptions of policies for employees, agents, or

joint-venture partners for reporting and investigations, procedures for seeking the opinion of counsel, and training programs for officers and employees.

International efforts to control corruption: Among the international efforts to reduce bribery and other corrupt acts are these:

- The OECD Antibribery Recommendation, 1994
- The OECD Convention on Combating Bribery, 1997
- The ICC Rules of Conduct to Combat Extortion and Bribery, 1977 (revised in 1996)
- The United Nations Convention Against Corruption, 2003
- The Inter-American Convention Against Corruption, 1996
- Transparency International (TI), which has as its mission to enhance public transparency and accountability in international business transactions and in the administration of public procurement.

INTERNATIONAL PERSPECTIVE 15.8

FCPA Compliance Challenges: The Case of SOEs in China

The number of state-owned enterprises (SOEs) in China is estimated at more than 12,000, and this poses unique FCPA challenges for U.S. firms that do business with such firms in China. Even though these enterprises are majority owned or controlled by the Chinese government, they have several attributes of private enterprises, such as being publicly traded on a stock exchange. Certain activities of U.S. firms doing business in China can lead to FCPA exposure if:

- They do business or interact with employees of SOEs (employees are considered "foreign officials")
- They use "design institutes" in China to serve as an engineering or consulting firm in connection with certain contracts and projects. Many design institutes in China are state owned, and employees of such firms are likely to be considered "foreign officials" under the FCPA's antbribery provisions.
- Their employees or agents in China provide customers with company-funded gifts, travel, and entertainment to obtain business. Many executives, sales agents, and distributors in China do not view such gifts as improper or illegal. If the U.S. company covers the foreign official's travel, lodging, and other expenses, it has to represent a reasonable and bona fide expenditure that is directly related to the promotion or demonstration of products or services or the execution or performance of a contract with a foreign government or agency.

It is important to note that parent corporations remain indirectly liable for FCPA violations by their foreign subsidiary insofar as they have actual or constructive knowledge that the subsidiary is engaging in improper activity. U.S. companies must also ensure compliance by all other third parties engaged in China, including agents, distributors, or other channel partners, because improper actions by such third parties can also be attributed to a parent corporation.

Antitrust Laws and Trade Regulation

Antitrust laws are intended to enhance efficiency and consumer welfare by proscribing practices that lessen competition or create a monopoly. Such laws also meet the sociopolitical objective of dispersing economic power. Historically, monopolies were often sanctioned in the area of trade and commerce. During the colonial period, for example, private companies such as the East India Company (1600), the Dutch West India Company (1621), and the Hudson Bay Company (1670) received charters from governments that granted them a monopoly on trade. In North America, British merchants were given monopolies over the export and import of goods.

The idea of monopoly rights was soon found unacceptable, as it restricted the rights of individuals to compete freely. In many European countries, monopolies were viewed as incompatible with the competitive integrity of markets and free trade. By 1860, Britain had unilaterally abrogated the rights of commercial monopolies given to particular companies (Johns, 1988). In the United States, there was a call for legislation to control "dangerous conspiracies against the public good" (Shenefield and Stelzer, 1993). The Sherman Act was passed in 1890.

Antitrust laws are often referred to as the Magna Carta of free enterprise because they preserve free competition in domestic and foreign trade and minimize government intervention in business affairs.

U.S. Antitrust Regulations

U.S. antitrust laws can be grouped into three categories:

1. *General prohibitions:* The Sherman Act, the Federal Trade Commission (FTC)
2. *Specific prohibitions:* The Clayton Act and amendments
3. *Exemptions*

General Prohibitions

The Sherman Act outlaws certain concerted activity in restraint of trade between two or more parties. The U.S. Supreme Court has developed certain criteria to determine the lawfulness of a given restraint: the per se rule and the rule of reason. The per se rule applies to those restraints of trade that are prohibited regardless of their effect on competition or economic welfare.

Per se violations include price-fixing, division of markets (market sharing) between competitors, and certain boycotts by sellers or buyers (i.e., agreements between competitors not to deal with a customer or supplier). Restraints that are not categorized as per se violations are subject to the rule of reason; that is, practices are restricted only if they have an adverse effect on competition. This often requires analysis of the competitive structure of the firm, the firm's market share and/or power, and other relevant factors. The Sherman Act also prohibits monopoly abuse and attempts or conspiracies to monopolize trade or commerce with foreign nations. If a firm has a high market share as a result of improved productivity, it is not considered objectionable unless it is obtained through systematic conduct designed to harm competitors.

The Federal Trade Commission proscribes unfair competitive practices even though they do not violate specific provisions of either the Sherman Act or the Clayton Act. It also

prohibits unfair or deceptive practices in or affecting foreign commerce. The commission has authority to issue interpretative rules and general statements of policy, rules, and guidelines that define unfair or deceptive business practices.

Specific Prohibitions

The Clayton Act proscribes any acquisition of the stocks or assets of another entity affecting commerce in any part of the United States that results in the creation of a monopoly or a substantial lessening of competition. The Clayton Act is not limited to the acquisition of a competitor. It also prohibits price discrimination between two purchasers without just cause or exclusive dealing in foreign commerce that tends to create a monopoly or lessen competition in the United States. Exclusive dealing (tying) occurs when the seller sells a product only on the condition that the purchaser will not deal in the goods of the seller's competitor.

Exemptions for Export Cartels

There has been a long-standing practice in many countries to allow export cartel exemptions to antitrust laws. Export cartels exemptions (composed of exporters from a single country) allow firms to fix prices and coordinate conduct that if pursued would lead to antitrust scrutiny. There are three categories of exemptions for export cartels:

1. *Explicit exemptions:* The country's statute explicitly excludes export cartels from the scope of its national competition law. Some countries with explicit exemptions, such as the United States, require notification or authorization, while others, such as Canada, do not have such requirement.
2. *Implicit exemption:* Domestic competition law covers only the conduct of firms operating on the national market (most EU member countries). National antitrust statutes are applied to export cartels only in cases of anticompetitive conduct affecting the domestic market. Ireland's Competition Act of 2002, for example, prohibits export cartels that restrict or distort competition within its domestic market.
3. *No statutory exemption:* There is neither an explicit nor an implicit exemption that allows fixing or similar conduct for export oriented activity (Levenstein and Suslow, 2004). Such a system exists in Luxembourg, Russia, Thailand, and Uruguay.

The rationale behind this exemption is that such activity that is conducted for foreign markets does not necessarily harm competition in the domestic market. It rests on a mercantilist paradigm under which national firms benefit at the expense of other countries' consumers and producers. Advocates of export cartels also believe that such cartels generate efficiency gains by reducing the costs related to selling in foreign markets (i.e., centralization of sales activities avoids costly duplication of services and allows members to enjoy lower rates related to export services, such as insurance and freight). Export cartels are also intended to promote and facilitate small and medium-size firms' exports by reducing overhead costs of exports and thus overcoming the barriers to foreign trade (Desmarais, 2009).

An OECD (2004) study, however, acknowledges the adverse and anticompetitive effects of export cartels. The study indicates that export cartels distort international trade by restricting

the volume of exports and forcing consumers to pay high prices. Export cartels may affect domestic markets indirectly through spillover effects of tacit collusion. Larsen (1970, p. 497) states:

> it is naïve to expect association members to ignore the domestic market while they freely discuss prices and quotas for exports. —the creation of an export association provides an excellent chance for large oligopolists to peacefully coexist both at home and abroad—.

Even though some countries have taken steps to eliminate or limit antitrust exemptions, others are unwilling to relinquish their export cartel exemptions because of the presumed benefits that they may generate to the detriment of other countries.

U.S. Export Cartels

- *The Webb-Pomerene Act (WPA) (1918):* Congress passed the WPA as an export exemption to its antitrust laws in 1918 (exemption from section 1 of the Sherman Act, which prohibits cartels) with a view to encouraging U.S. firms to work together in representing their own interests in the face of powerful foreign cartels. It was also intended to overcome the high fixed costs of exporting, which could be particularly burdensome to small firms. The exemption allows competing firms to set prices, allocate orders, consolidate freight, or arrange shipments. Export associations under the WPA are provided the exemptions provided that they do not reduce competition within the United States (i.e., they do not restrain trade, enhance or depress prices within the United States, or adversely affect the export trade of other U.S. firms that are not members of the association). WPAs are required to register with the Federal Trade Commission (FTC) within thirty days of their creation and also to file annual reports with the FTC. As of 2005, the seven WPAs registered with the FTC accounted for less than 2 percent of U.S. exports. They include export cartels or associations in the areas of cotton, soda ash, dried fruit, paperboard, and phosphate chemicals (U.S. Federal Trade Commission, 2005).
- *The Export Trading Company Act (ETC) of 1982:* In view of the failure of WPAs to increase U.S. exports, Congress enacted the ETC Act to encourage U.S. exports and to create more certainty in the application of antitrust laws to export activities. Under the ETC Act, export associations must apply for an issuance of a certificate exempting them from antitrust liability. Under this procedure, applicants disclose their plans for overseas trade with the government and obtain preclearance, that is, obtain the government's approval for their future export activity. The Commerce and Justice Departments issue the certificate to potential exporters after establishing that their conduct or activity does not substantially lessen competition or unreasonably affect prices in the United States. Applicants are exempt from antitrust laws so long as the minimum standards are met under the act. The ETC Act also provides protection to certificate holders against frivolous lawsuits by competitors that are intended to forestall their export activities. In 2010, there were seventy-three certificate holders accounting for less than 1 percent of U.S. merchandise exports. The limited success of this effort may be attributable to the fear of disclosure of confidential business information to the U.S. government necessary to receive certification as well as the lack of precedent for

interpreting the scope of protection provided under the ETC Act (see International Perspective 15.9).

- *The Foreign Trade Antitrust Improvements Act (FTAIA) (2000):* The FTAIA limits the application of the Sherman Act to trade with foreign nations unless such conduct has a direct, substantial, and reasonably foreseeable effect on domestic trade or commerce. Anticompetitive acts directed at exports without effect on domestic commerce of a U.S. person are treated as foreign transactions and out of reach of U.S. antitrust laws. In the absence of this legislation, the antitrust laws would otherwise have extended to any anticompetitive conduct (e.g., agreements, conspiracy), regardless of its effect on U.S. import, export, or domestic commerce. Although this exemption could be used as an alternative to export certification or preclearance, it does not provide the immunity from prosecution that is available under the latter arrangement.

The following list describes what are generally considered to be practices that businesses should avoid:

1. Discussing prices with competitors
2. Pricing below cost to drive out a competitor or to discourage a new entrant
3. Dividing markets with other competitors
4. Compelling dealers to charge a given price
5. Tying the sale of one product to another
6. Charging customers different prices without reasonable justification
7. Terminating a customer without reasonable justification
8. Abusing market power to the disadvantage of consumers and competitors
9. Joining with a competitor to the disadvantage of other competitors
10. Suggesting that a supplier purchase from another division of the subsidiary.

It is also important for companies to establish an antitrust compliance program.

Extraterritorial Application of U.S. Antitrust Laws

The U.S. antitrust laws are not limited to transactions that take place within U.S. borders. Overseas transactions with a substantial and foreseeable effect on U.S. commerce are subject to U.S. antitrust laws. Efforts by the United States to exercise its jurisdiction outside its borders have often been frustrated by foreign governments that did not want any infringements of their sovereignty. Some countries have enacted legislation to block the enforcement of U.S. laws within their countries, including any cooperation with respect to submission of evidence and documents. In view of such opposition, the U.S. government has resorted to bilateral antitrust agreements with various countries concerning the extraterritorial application of national antitrust laws. The agreements generally provide for the exchange of information, prior notification of enforcement actions, and consultation on policy matters.

Enforcement and Penalties

The Department of Justice and the Federal Trade Commission enforce U.S. antitrust laws. Whereas the Department of Justice can initiate civil or criminal suits against alleged violators, the Federal Trade Commission or states, through the attorney general, are empowered

to bring only civil cases. Private parties that have been adversely affected by a violation of antitrust laws can also sue in federal court for an injunction or damages.

Penalties in criminal cases may involve fines up to $100,000 and imprisonment for up to three years for individuals. Corporations may be fined up to $1 million. Civil penalties could also result in hefty fines.

INTERNATIONAL PERSPECTIVE 15.9

Webb-Pomerene Act versus Export Trading Company Act

Both the Webb-Pomerene Act (WPA) and the Export Trading Company Act (ETC) were intended to increase U.S. exports by exempting export cartels from U.S. antitrust liability. They are similar in the criteria they set for assessing the validity of the application. Neither act holds export cartels liable for ancillary restraints on domestic trade. However, there are major differences between the two acts.

- Unlike the WPA where the FTC does not perform any approving function, the ETC Act empowers the Secretary of Commerce with such a function.
- WPA is limited to the export of goods, whereas the ETC Act covers both goods and services.
- WPA is limited to associations of firms, while the ETC Act expands the exemption to individual firms.
- The WPA does not require antitrust preclearance, while the ETC Act requires written preclearance.

Incentives to Promote Exports

From the 1870s until 1971, U.S. exports typically exceeded U.S. imports, except during World War II. Even during this period, U.S. exports fell below imports because a substantial percentage of the exports was not sold but provided to allies under the Marshall Plan. All this began to change in the 1970s. The United States registered a trade deficit in 1971, when the merchandise trade balance showed a $2.27 billion deficit, in contrast to the previous decades, when exports exceeded imports. Some of the contributing factors to this state of affairs included the overvalued dollar and increased government expenditures at home and abroad that often resulted in purchases of foreign products and services. This situation was further exacerbated in 1973, when oil prices sharply increased and worsened the U.S. trade deficit due to large increases in expenditures for imports for petroleum products (Stein and Foss, 1992) (see International Perspective 15.10).

Domestic International Sales Corporations and the General Agreement on Tariffs and Trades

In an effort to remedy the worsening trade imbalance, the government enacted the Revenue Act of 1972. The act created the Domestic International Sales Corporation (DISC) to

promote U.S. exports by providing tax incentives that would lower the cost of exporting goods in foreign markets. The legislation was also intended to remove the disadvantage faced by U.S. companies engaged in export activities through domestic corporations (Chou, 2005).

The DISC statute was also intended to offset the competitive disadvantage faced by U.S. firms because of the various incentives provided by major trading nations to their export firms. Under the DISC scheme, a U.S. corporation could export its products through a subsidiary (DISC) organized in the United States (a shell corporation) with minimum capital of $2,500. The DISC was required to engage almost exclusively in export sales. The tax implications for a corporation that elected to be treated as a DISC were as follows:

- Approximately half of the DISC's earnings were taxed at the shareholder level regardless of whether they were distributed to shareholders (constructive dividends).
- The remainder of the DISC's earnings was not taxable to the shareholder until actually distributed. This allowed for an indefinite deferral of tax. In effect, this amounted to a de facto tax exemption on about half of the DISC's earnings because deferred taxes may never become due.
- Deferred taxes became due when distributed to shareholders, when a shareholder disposed of its DISC stock, or the corporation ceased to qualify as a DISC.

The DISC came under increasing attack by U.S. trading partners as an unfair and illegal subsidy to U.S. exporters. In a complaint by the European Economic Community and Canada against the United States, the GATT panel issued a report stating that the DISC scheme conferred a tax benefit to exports and resulted in the price of exports being lower than the price of similar goods for domestic consumption. The panel concluded that the scheme was in violation of the General Agreement on Tariffs and Trades (GATT) treaty (GATT, 1977). Even though the United States never conceded the inconsistency of the DISC with the GATT agreement, it nevertheless proceeded to replace the DISC with an alternative scheme that was acceptable to the GATT. (A vestige of the old DISC, the Interest-Charge-DISC, remains in place.)

The Tax Reform Act of 1984 created the Foreign Sales Corporation (FSC) to promote U.S. exports. Once the FSC was incorporated outside the United States and satisfied other requirements in the statute, its earnings were exempt from U.S. taxation. Although the FSC provided a benefit to U.S. exporters comparable to those of the DISC, it was permitted under the GATT because the GATT treaty does not require member countries to tax "economic processes" that take place outside their territory (Levin, 2004).

The European Union filed a complaint with the WTO asserting that the FSC regime was an illegal subsidy inconsistent with the GATT treaty (1998). In 1999, the WTO ruled in favor of the EU and called for the elimination of the FSC regime by 2000. In response to the WTO ruling, the United States repealed the FSC and enacted the Extraterritorial Income Exclusion Act (ETI) (2000), which provides U.S. exporters with the same tax benefit as the FSC. ETI allows U.S. exporters to exclude from federal income tax 15 percent of their net income from the export sale of qualified U.S. origin goods. Alternatively, exporters of low-profit items could exclude 1.2 percent of their gross receipts (not to exceed 30 percent of the net) from the export sale of qualified U.S. origin goods (not more than 50 percent of whose value is attributable to foreign content). The EU again challenged the ETI as an unfair subsidy to U.S. corporations, and the WTO dispute settlement body found that it violated the treaty (2001).

The ETI was phased out in 2004. The IC-DISC appears to be one of the few remaining tax incentives for U.S. exporters (Clausing, 2005; Gravelle, 2005).

Interest-Charge Domestic International Sales Corporations (IC-DISCs)

The IC-DISC is a tax deferral vehicle (on the first $10 million of U.S. export sales) that can be used by small and medium-size exporting companies. It provides a 20 percent tax savings for qualifying U.S. exporters in view of the favorable dividend tax rules under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Loizeau, 2004).

To be eligible for IC-DISC status, a corporation must satisfy certain requirements:

1. It must be a U.S. corporation.
2. At least 95 percent of its foreign trading gross receipts for the tax year must be "qualified exports receipts." Qualified export receipts include receipts from sales, leases, or rental of export property (Section 993 [a]). It also includes gross receipts for services related to warranty, repair, or transportation of export property; engineering or architectural services from overseas projects; and interest on qualified export assets.
3. The adjusted basis of its qualified export assets must be at least 95 percent of its total assets at the end of the tax year. Qualified export assets include accounts receivable, temporary investments, export property, assets used primarily in connection with the production of qualified export receipts, and loans to producers.
4. It must have one class of stock with a minimum value (capital) of $2,500.
5. It must elect in a timely manner to be treated as an IC-DISC for the current tax year.
6. Certain personal holding companies and financial and insurance institutions as well as companies that are members of any controlled group of which an FSC is a member are ineligible to be treated as IC-DISCs.

How Does an IC-DISC Work?

Step 1: A U.S. exporter (or shareholder) forms a tax-exempt IC-DISC corporation.

Step 2: The U.S. exporter pays the IC-DISC commission. The allowable commission rate is the greater of either 50 percent of export net income or 4 percent of gross export income.

Step 3: The U.S. exporter deducts the commission paid to the IC-DISC from its income taxed at 35 percent (the IC-DISC pays no U.S. income tax on the commission income).

Step 4: When the IC-DISC pays dividend to its shareholders, the shareholders pay dividend income tax of 15 percent. (On income at IC-DISC, which is accumulated and untaxed, shareholders are required to pay interest.)

Tax Benefits of IC-DISC

1. *Reduced taxable income:* The U.S. exporter pays an annual tax-deductible commission on its export sales to the IC-DISC. This reduces its taxable base at the corporate level by the commission paid to the IC-DISC.

2. *Increased dividend income to shareholders:* The entire commission paid to the IC-DISC can then be distributed as a dividend at the end of taxable year. This payment could be subject to only a 15 percent individual dividend tax rate rather than the corporate tax rate of 35 percent.
3. *Deferral of IC-DISC income from taxation:* The IC-DISC is not subject to tax. However, its U.S. shareholders are subject to tax on deemed dividend distributions from the IC-DISC, which does not include income derived from the first $10 million of the IC-DISC's qualified export receipts each year. Thus, the IC-DISC allows a U.S. shareholder to defer paying tax on income attributable to $10 million of export sales. The U.S. shareholder must, however, pay an interest charge on its IC-DISC earnings (deferred tax liability) until it is distributed (see Table 15.1).

TABLE 15.1 An Example to Illustrate IC-DISC Tax Savings

	Without IC-DISC	With IC-DISC		
		Combined	Exporter	IC-DISC
Foreign trading gross receipts	*5,000,000*	*5,000,000*		
Cost of goods sold	*3,000,000*	*3,000,000*		
Selling, administrative expenses				
Export net income	*1,000,000*	*1,000,000*		
Tax rate	35%			
Tax paid	350,000			
IC-DISC greater of				
4% export gross receipts			200,000	
50% export net income			*500,000*	
IC-DISC commission			500,000	
IC-DISC commission deduction			500,000	500,000
Tax base after IC-DISC commission			*500,000*	*500,000*
Tax base after			*35%*	*15%*
Tax paid		*250,000*	*175,000*	*75,000*
Tax saving (net)		*350,000*	*–250,000*	*= 100,000*

INTERNATIONAL PERSPECTIVE 15.10

U.S. National Export Initiative

In his State of the Union address in January 2010, President Barack Obama said, "We will double our exports over the next five years." In real terms, that means doubling our exports

from $1.5 trillion at the end of 2009 to $3.1 trillion at the end of 2014. This will support two million domestic jobs through increased intergovernmental cooperation in export promotion. The National Export Initiative (NEI) is a strategy intended to accomplish this objective by 2015. It addresses the following critical issues:

- Increase export assistance to small and medium-sized enterprises (SMEs)
- Promote federal resources and commercial advocacy to assist U.S. companies
- In consultation with state and local government officials, as well as the private sector, lead trade missions to promote American exports
- In partnership with the Export-Import Bank, increase access to financing for SMEs that are looking to export
- Support macroeconomic rebalancing by promoting balanced and strong growth in the world economy through international partnerships
- Reduce barriers to trade and improve market access for domestic producers by opening new markets and enforcing trade agreements
- Create a framework to promote services trade.

U.S. exports have grown 34 percent since President Obama implemented the initiative. In 2011, U.S. goods and services exports reached a record $2.1 trillion and accounted for nearly 14 percent of GDP.

Chapter Summary

Objectives of export controls	These include enhanced national security and foreign policy, nonproliferation of weapons of mass destruction, and prevention of excessive draining of scarce natural resources.
Export controls and major developments	With the end of the cold war, controls have been substantially liberalized and simplified. Present controls focus on a small group of critical goods, technology, and countries. However, after the events of September 2001, certain restrictions have been imposed on exports.
Scope of Export Administration Regulations (EAR)	The EAR covers exports, re-exports, foreign products that are made using U.S. technology, and U.S.-person activities.
Determining license requirements	Step 1: Is the (item subject to export) transaction subject to Export Administration Regulations (EAR)? Step 2: If so, is an export license required on the basis of product characteristics, destination, and use/user and the general prohibitions? Step 3: If yes, is there a license exception? Step 4: If no, apply for a license. If yes, no license required. Step 5: Whether export is made under a license or not, exporters have to comply with SED/DCS and recordkeeping requirements.

Indicators that help identify and report possible violations	One of the parties to the transaction is on the list of denied persons or the transaction has red flags.
The U.S. Antiboycott Law	The law prohibits U.S. firms from participating in foreign boycotts not authorized by the U.S. government.
Who is covered by the laws?	Individuals and companies located in the United States, foreign subsidiaries controlled by a U.S. company, and all activities involving U.S. commerce with foreign nations are covered.
What do the laws prohibit?	Prohibitions include refusing to do business, taking discriminatory actions against a U.S. individual or company in order to support an unsanctioned foreign boycott, furnishing information to a boycotting country, and implementing letters of credit with prohibited conditions.
Exceptions to the prohibitions	These include compliance with import/shipping and documentary requirements of boycotting country, compliance with shipment/transshipment/specific carrier or route selection requirements of boycotting country, and compliance with immigration/passport/employment and other local law requirements of boycotting country.
Enforcement and penalties	Penalties for noncompliance: 1. Criminal penalties: Fines and/or imprisonment 2. Civil penalties: Revocation of export license, denial of export privileges, imposition of a fine, denial of tax benefits.
The Foreign Corrupt Practices Act (FCPA)	Principal objectives behind FCPA: To prohibit bribery of foreign officials by U.S. individuals and corporations to obtain or retain a business; to establish standards for maintaining corporate records and internal accounting control objectives.
Who is subject to the FCPA?	Antibribery provisions A U.S. issuer, domestic concern. or any person, including officers, directors, employees, agents, or shareholders acting on behalf of the issuer, domestic concern, or person. Issuers and domestic concerns may also be held liable for any act in furtherance of a corrupt payment taken outside the United States. A foreign company or person is now subject to the FCPA if it causes, directly or through agents, any act in furtherance of a corrupt payment to take place within the United States.
U.S. parent corporations may be held liable for the acts of foreign subsidiaries	Accounting provisions Publicly held entities (issuers) that either have securities registered with the SEC or are required to file reports with the SEC.
Enforcement and penalties	FCPA is enforced by the Securities Exchange Commission and the U.S. Department of Justice.

(*Continued*)

Measures for compliance with the FCPA	These include implementing due diligence procedures, seeking an advisory opinion from the government, and adopting internal measures and controls.
Antitrust regulation and U.S. trade	There are three categories of antitrust laws: 1. General prohibitions: The Sherman Act, the Federal Trade Commission. 2. Specific prohibitions: The Clayton Act (covers restraints to commerce through mergers, acquisitions, exclusive dealing, and similar arrangements that lessen competition). 3. Exemptions: Exemptions from antitrust laws in the area of export trade include the Webb–Pomerene Act, Export Trade Certificate of Review, and Title IV of the ETC Act.
Extraterritorial application of U.S. antitrust laws	Overseas transactions with a substantial and foreseeable effect on U.S. commerce are subject to U.S. antitrust laws.
Enforcement and penalties	Institutions that enforce U.S. antitrust laws: 1. The Department of Justice initiates civil or criminal suits against alleged violators. 2. The Federal Trade Commission initiates only civil cases. Penalties: 1. Criminal penalties: Fines up to $100,000 and imprisonment for up to three years (individuals); fines of up to $1 million for corporations. 2. Civil penalties: Hefty fines.
Incentives to promote exports	Interest-charge DISCs: Under this arrangement, taxes on export sales can be deferred. However, shareholders must pay interest on their proportionate share of the accumulated taxes deferred. Operational rules are similar to pre-1985 DISCs.

Review Questions

1. State U.S. regulations that have a major impact on exports.
2. Discuss current developments in U.S. export controls.
3. What are the major objectives of U.S. export regulations? How do you establish whether a product needs an export license?
4. What types of actions does the U.S. antiboycott law prohibit? What kinds of requests are not reportable?
5. Discuss the knowledge requirement under the FCPA. Provide examples of U.S. companies indicted for bribing foreign officials.
6. Describe some of the international efforts to control corruption.
7. Discuss the major antitrust exemptions in the area of export trade.
8. Discuss the major incentives to promote exporters since 1972.
9. How does the IC-DISC work?
10. Do you think the IC-DISC will be attacked by U.S. trading partners as an unfair subsidy to U.S. exporters? Why or why not?

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World Wide Web Resources

Bureau of Export Administration: http://www.bis.doc.gov
Export Administration Regulations: http:// www.access.gpo.gov/bis/
The Foreign Corrupt Practices Act (FCPA): http://www.usdoj.gov/criminal/fraud/fcpa/dojdocb.htm, http://www.usdoj.gov/criminal/fraud/fcpa/fcpastat.htm
Convention on Combating Bribery of Foreign Officials: http://www.oecd.org/dataoecd/7/35/35109576.pdf
U.S. antitrust law/policy: http://www.usdoj.gov/
Antitrust Enforcement: http://www.usdoj.gov/atr/public/div_stats/211491.htm
U.S. tax reform and opportunities for exporters:
http://www.taxpolicycenter.org
http://www.swlearning.com/tax/wft/
Wasenaar Arrangement (1990): http://www.wassenaar.org/
Federal Trade Commission (2005): www.ftc.gov/os/statutes/webbpomerene/index.shtm (Webb-Pomerene filings)
ITA-Trade certificate of Review (2010): http://www.trade.gov/mas/ian/etca/index.asp

Case 15.1 Export Trade Certificate of Review

Joint Export Activities to Reduce Costs and Risks

Export Trade Certificates of Reviews (COR) are issued by the Department of Commerce (with the concurrence of the Department of Justice) and provide antitrust protection for certain specified export activities. Companies holding certificates can work together in the appointment of exclusive agents or distributors, the setting of limitations on pricing, or the handling of competitive products. The benefits of COR include a reduction in transportation, warehousing, and marketing costs. It also allows firms to establish joint facilities, set common prices, divide markets and sales territories, bid on large contracts, and share space in overseas trade shows. Small and medium-size companies are able to spread costs and minimize risks in exporting without violating U.S. antitrust legislation. Congress viewed the uncertain application of U.S. laws to export activities as impediments to the growth and expansion of U.S. exports. The certificate provides antitrust preclearance for the specified export activities.

U.S. residents, partnerships, or corporations as well as state and local government entities can apply for COR. Over the past few years, a large number of trade associations have taken advantage of the program for their member firms. If the application meets certification standards, the Commerce Department is required to issue the COR within ninety days of submission of the application. With COR, companies are immune from federal and state antitrust actions. In private antitrust actions, it alters the burden of proof to the advantage of the certificate holder (CH), shortens the statute of limitations covering the CH's conduct, provides for recovery of legal expenses (in cases where the CH prevails), and reduces liability. Since the introduction of the legislation, in 1982, COR was challenged in court only once, in1998, by Horizon International, over the certificate issued to another firm. The U.S. appeals court unanimously upheld the validity of the certificate.

It is important to note that COR will not be granted if the export activity:

(a) Reduces competition in the U.S. or results in the substantial restraint of export trade of any U.S. competitor
(b) Unreasonably affects prices of the covered product or services in the United States
(c) Is carried out with the expectation that the products or services will be re-exported to the United States.

Selected Holders of CORs

- *The Association of Manufacturing Technology (AMT) of McLean, Virginia,* represents the interests of American providers of manufacturing machinery and equipment. Founded in 1902, the organization has two goals: to promote technological advancements in the design, manufacture, and sale of members' products and to act as an industry advocate on trade matters to governments and trade organizations throughout the world. AMT received its COR in 1987 with a view to enhancing the trade competitiveness of its members. Recently, its members were able to cooperate in order to win the contract to supply a large Chinese aircraft plant with the requisite machinery to modernize and win contracts to produce Western aircraft parts. Such cooperation would have been difficult without the COR.
- *American Film Export Association* (AFEA) of Los Angeles, California, is a trade association that provides members with marketing support services, handles government relations, and compiles statistical data. It received a COR in 1987 and has used this opportunity to expand export opportunities for its members. AFEA fosters the exchange of information among its exporting members on foreign market conditions including vital credit data on more than 500 film and television buyers in more than fifty countries. It also assists members in reducing delays in product delivery to overseas distributors, provides international model licensing agreements, and administers an arbitration tribunal, which resolves disputes regarding distribution.

- *Florida Citrus Exports* (FCE) operates as an export joint venture of nine members, including grower-owned cooperatives and packing houses. It received a COR in 1995 and has been able to help members to cut export costs and increase export effectiveness. The COR allows members to share transportation and market development costs, engage in joint promotional activities, speak with one voice in negotiations with export service providers and foreign buyers, prepare joint bids, assist each other in maintaining quality standards, and spread risks. The coordination of transportation is particularly important in exporting perishable commodities.

Questions

1. What are the benefits of certificates of review to U.S. exporters?
2. A certificate of review is not granted in certain cases. Discuss.

TABLE 15.2 BIS Export Enforcement: Selected Cases

Sentencing Date	Defendant	Criminal charges	Case detail
7/27/12	Steven Greenoe	Underlying criminal conviction for knowingly and willfully exporting and causing to be exported from the United States to England firearms designated as defense articles on the United States Munitions List, without having first obtained from the Department of State a license or written authorization for such export.	Export privileges denied until January 10, 2022.
5/12/12	Dennis Nielsen	One count of making false statements in violation of 18 U.S.C. 1001.	Export of computers and parts to Iran via the United Arab Emirates and Germany.
10/11/11	Jeng Shih, aka Jay Shih	Conspired to export U.S.-origin computer equipment, items controlled on antiterrorism grounds and valued at approximately $830,000, to Iran, through the United Arab Emirates, without the required U.S. government authorization and took actions to evade the Regulations (Export Control Classification Number ["ECCN"] 5A992)	Settlement agreement: denial of export privileges for ten years, all of which are suspended provided the respondent complies with the conditions of the ten-year probationary period under the order.

12/06/11	Federal Express Corporation	Aided and abetted the attempted unlicensed export of electronic peripheral equipment (ECCN 5A991) and the attempted unlicensed export of an Intel PC Dialogic Board to Mayrow General Trading in Dubai, U.A.E., in violation of General Order No. 3; aided and abetted the unlicensed export of flight simulation software to Beijing University of Aeronautics and Astronautics (BUAA) a/k/a Beihang University, a PRC entity on BIS's Entity List; and aided and abetted three unlicensed exports of printing equipment to Syria, in violation of General Order No. 2. (ECCN 5A991 and EAR99).	Settlement agreement: civil penalty of $370,000 (litigated case).
2/14/12	3M Attenti, Ltd.	Exported crime control commodities, technology, and software to China without the required licenses; deemed export of crime control technology to an Israeli national without the required license (ECCNs 3A981, 3D980 and 3E980).	Settlement agreement: civil penalty of $230,000.

TABLE 15.3 BIS Export Enforcement: Selected Cases in Antiboycott Compliance

Company name & location	Date order signed	Alleged violations	Settlement amount
Dover Energy	9/12/12	Furnishing information about business relationships with or in a boycotted country; failing to report receipt of a boycott request in a timely manner	$22,000
Parfums de Coeur Ltd.	1/12/12	Furnishing information about business relationships with or in a boycotted country; failing to report receipt of a boycott request in a timely manner	$27,000
W. W. Grainger	9/25/12	Failing to report receipt of a boycott request in a timely manner	$12,000

Case 15.2 Selected Cases in Enforcement of FCPA

- *Eli Lilly:* The SEC charged the Indianapolis-based pharmaceutical company for improper payments its subsidiaries made to foreign government officials to win business in Russia, Brazil, China, and Poland. In December 2012, Lilly agreed to pay more than $29 million to settle the charges.
- *Allianz SE:* The SEC charged the Germany-based insurer with violating the books and records and internal controls provisions of the FCPA by making improper payments to government officials in Indonesia that resulted in $5.3 million in profits. In December, 2012, Allianz agreed to pay more than $12.3 million to settle the SEC's charges.
- *Tyco International:* The SEC charged the Swiss-based global manufacturer with violating the FCPA when its subsidiaries arranged illicit payments to foreign officials in more than a dozen countries. In September 2012, Tyco agreed to pay $26 million to settle the SEC's charges and to resolve a criminal matter with the Justice Department.
- *Oracle:* In 2012, the SEC charged the California-based computer technology company with violating the FCPA by failing to prevent a subsidiary from secretly setting aside money off the company's books to make unauthorized payments to phony vendors in India.
- *Pfizer:* The SEC charged the pharmaceutical company with making illegal payments through its subsidiaries to foreign officials in Bulgaria, China, Croatia, the Czech Republic, Italy, Kazakhstan, Russia, and Serbia to obtain regulatory approvals, sales, and increased prescriptions for its products. Pfizer and a recently acquired subsidiary, Wyeth LLC, which was charged with its own FCPA violations, agreed in August 2012 to pay a combined $45 million in their settlements.
- *Orthofix International:* The SEC charged the Texas-based medical device company with violating the FCPA when a subsidiary paid routine bribes referred to as "chocolates" to Mexican officials in order to obtain lucrative sales contracts with government hospitals.
- *Morgan Stanley:* The SEC charged a former Morgan Stanley executive, Garth R. Peterson, with secretly acquiring millions of dollars' worth of real estate investments for himself and an influential Chinese official who in turn steered business to Morgan Stanley's funds. He agreed to a settlement in which he is permanently barred from the securities industry and must pay more than $250,000 in disgorgement and relinquish his approximately $3.4 million interest in Shanghai real estate acquired through his scheme.
- *Biomet:* The SEC charged the medical device company, based in Warsaw, Indiana, with violating the FCPA when its subsidiaries and agents bribed public doctors in Argentina, Brazil, and China for nearly a decade to win business.
- *Noble Corporation:* The SEC charged three oil services executives of the Noble Corporation with bribing customs officials in Nigeria to obtain illicit permits for oil rigs in order to retain business under lucrative drilling contracts.

- *Smith & Nephew:* The SEC charged this London-based medical devices company with violating the FCPA when its U.S. and German subsidiaries bribed public doctors in Greece for more than a decade to win business. In 2012, the company and its U.S. subsidiary agreed to pay more than $22 million to settle civil and criminal cases.

Questions

1. How does U.S. enforcement of FCPA differ from that of other industrial countries?

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Section VII

Import Procedures and Techniques

sixteen
Import Regulations, Trade Intermediaries, and Services

Import Restrictions in the United States

Tariffs

All goods imported into the United States are subject to duty or duty-free entry, depending on their classification under the applicable tariff schedule and their country of origin. For dutiable products, three different methods are used to levy tariffs:

1. *Ad valorem duty:* The duty levied is a percentage of the value of the imported product. It is the type of duty most often applied. An example would be a 2 percent ad valorem on imports of leather shoes. The duty obligation is proportional to the value of the dutiable cargo and bears no relation to the quantity imported.
2. *Specific duty:* This duty rate is based on the physical unit or weight or other quantity. Such duty applies equally to low- and high-priced goods. To the extent that the same duty rate is applied to similar goods with different import prices, specific duties tend to be more restrictive of low-priced goods. When the price of imports rises, the rate remains unchanged, and the effect of the specific duty declines. Examples would be a $9.00 per ton (wheat) or a $2.50 per dozen (fountain pens) charge.
3. *Compound duty:* Compound duty combines both ad valorem and specific duties. An example would be duties of $2.00 per pound and 4 percent ad valorem (chicken imports).

Most merchandise imported into the United States is dutiable under the most-favored-nation (MFN) rate. The MFN principle is expressed in Article I of the GATT and in a number of bilateral and other treaties. Under this principle, any advantage or favor granted by the United States (a member of the GATT) to any import originating from any other country shall be accorded, unconditionally, to a like product originating from any other GATT/WTO member. If the MFN treatment is provided as a result of a bilateral treaty (MFN treatment for

goods from a country that is not a member of the GATT/WTO), an obligation arises to treat imports from that country as favorably as imports from any other member of the GATT/WTO. Certain Communist countries, such as Cuba and North Korea, are not accorded MFN status and are thus denied the benefit of the low rates of duty resulting from trade agreements entered into by the United States.

Nontariff Barriers

Even though most goods freely enter the United States, there are some restrictions on the importation of certain articles (see International Perspectives 16.1 and 16.2 and Table 16.1). The rules prohibit or limit the entry of some imports; limit entry to certain ports; or restrict routing, storage, or use or require treatment, labeling; or processing as a condition of release from customs. U.S. nontariff barriers fall into the following categories (U.S. Department of Commerce, 2003):

TABLE 16.1 Import Permits, Other Requirements, and Respective Government Agencies

Agricultural commodities	
▪ Cheese, milk and dairy products, fruits and vegetables, meat and meat products (from sources other than cattle, sheep, swine, goats and horses), plant and plant products	U.S. Department of Agriculture (USDA) and the Food and Drug Administration (FDA)
▪ Insects, livestock and animals, meat and meat products (e.g., from cattle, sheep), plant and plant products, poultry and poultry products, seeds	USDA
Arms, ammunition, and radioactive materials	
▪ Arms, ammunition, explosives, and implements of war	Department of State and Department of the Treasury
Consumer and electronic products	
▪ Household appliances such as washers, dryers, air conditioners, refrigerators, and heaters	U.S. Department of Energy
▪ Flammable fabrics	U.S. Consumer safety Commission
▪ Electronic products such as microwave ovens, X-ray equipment, TV receivers	FDA
Foods, drugs, cosmetics, and medical devices	
▪ Foods and cosmetics	FDA
▪ Biological drugs	FDA
▪ Biological drugs for animals	USDA
▪ Narcotic drugs and derivatives	U.S. Department of Justice (USDJ)
▪ Pesticides and toxic substances	U.S. Customs
Textile, wool, and fur products	Federal Trade Commission
Wildlife and pets	U.S. Department of the Interior
Motor vehicles and boats	U.S. Department of Transportation

Alcoholic beverages	FDA
All bottle jackets made of plant materials	USDA
Administering agency for quotas, tariff quotas on imports	U.S. Customs

Prohibited Imports

These imports include certain narcotics and drug paraphernalia (materials used to make or produce drugs); counterfeit articles; products sold in violation of intellectual property rights; obscene, immoral, and seditious matter; and merchandise produced by convicts or forced labor.

Imports Prohibited Without a License

These include arms and ammunition and products from certain countries such as Cuba, Iran, and North Korea.

Imports Requiring a Permit

Such imports include alcoholic beverages, animal and animal products, plant products, and trademarked articles. For example, all commercial shipments of meat and meat food products offered for entry into the United States are subject to the regulations of the Department of Agriculture and must be inspected by the USDA Inspection Service before release by customs.

Imports with Labeling, Marking, and Other Requirements

Certain imports require special labeling. For example, wool and fur products must be tagged, labeled, or otherwise clearly marked to show the importer's name and other required information. All goods imported must be marked individually with the name of the country of origin in English.

Imports Limited by Absolute Quotas

These imports include dairy products, animal feed, chocolate, some beers and wines, textiles and apparel, cotton, peanuts, sugars, syrups, molasses, cheese, and wheat.

Imports Limited by Tariff Quotas

The tariffs rates on these imports are raised after a certain quantity has been imported. Imports covered include cattle, whole milk, motorcycles, certain kinds of fish, and potatoes. Tariff quotas permit a specified quantity of merchandise to be entered or withdrawn for consumption at a reduced rate during a specified period. When imported merchandise exceeds

a tariff quota, the importer is not allowed to commingle the merchandise and classification with non-quota-class goods.

The Buy-American Act of 1933

This act provides for the purchase of goods by the U.S. government (for use within the country) from domestic sources unless they are not of satisfactory quality or are too expensive or unavailable in sufficient quantity. The procurement regulations allow for the purchase of domestic goods even though they are more expensive than competing foreign merchandise, provided that the price differential does not exceed 6 percent (12 percent in high-unemployment areas) in favor of domestic goods.

INTERNATIONAL PERSPECTIVE 16.1

Consumer Products and Import Restrictions in the United States

Products or product categories with no import restrictions

Ceramic tableware, artwork, crafts, gems and gemstones, glass and glass products, household appliances, jewelry and pearls, leather goods that are not made from endangered species, metals, musical instruments, optics and optical instruments, paper and paper products, plastics and plastic products, rubber and rubber products, sporting goods, tools, and other utensils.

Products or product categories subject to certain restrictions or requirements

Aerospace products, live animals and animal products, beverages, chemicals, combustibles, cosmetics, drugs and explosives, foods, radioactive and radio frequency devices, used merchandise, vehicles.

Products or product categories that are generally prohibited

Food products grown or produced in disease-ridden regions, products derived from endangered species, products that infringe intellectual property rights, obscene or pornographic materials, and national treasures.

Source: U.S. Department of Commerce (2009).

INTERNATIONAL PERSPECTIVE 16.2

Import Restrictions in China

Since joining the World Trade Organization (WTO) a decade ago, China has become a fearsome competitor in the field of global trade, increasing exports by almost 600 percent between 2000 and 2008 and growing its economy at annual rates averaging 10 percent. China

has achieved these gains by leveraging its tremendous productive capacity, low labor and capital costs, and strong state support for export-driven growth. They have also employed an increasingly complex set of trade policies and strategies, both fair and unfair, to advance their economic interests—often at the expense of foreign competitors.

It's America's third-largest and fastest-growing export market, accounting for more than $100 billion in U.S. exports of goods and services annually and growing by an average of more than 15 percent each year. China is expected to be the largest source of global demand, as it adds more than 260 million new middle-class consumers to the world economy. An increase in U.S. exports by an additional 10 percent would add some $10 billion new American exports and some 60,000 U.S. jobs. It is important to ensure that China opens its import market and thus complies with its WTO commitments. Here is a list of some trade barriers employed by China.

- **Tariffs and other import charges:** China still maintains high duties on some products that compete with sensitive domestic industries. For example, the tariff on large motorcycles is 30 percent. Likewise, most video, digital video, and audio recorders and players still face duties of approximately 30 percent. Raisin imports face duties of 35 percent.
- **Customs valuation:** Many Chinese customs officials are still improperly using "reference pricing," which usually results in a higher dutiable value (not the transaction value the importer actually paid).
- **Increasing use of antidumping, countervailing, and safeguard measures:** China has emerged as a significant user of antidumping measures. As of 2010, China had a total of 113 antidumping measures in place, affecting imports from seventeen countries and regions, and ten antidumping investigations in progress. China initiated three countervailing duty investigations in 2009. There are issues in the areas of transparency and procedural fairness.
- **Nontariff barriers:** These barriers include, for example, regulations that set high thresholds for entry into service sectors such as banking, insurance, and telecommunications; selective and unwarranted inspection requirements for agricultural imports; and the use of questionable sanitary and phyto-sanitary (SPS) measures to control import volumes.

U.S. Free-Trade Agreements (FTAs)

The United States has fourteen FTAs in force with twenty countries. It is also in the process of negotiating a regional FTA, the Trans-Pacific Partnership, with Australia, Brunei Darussalam, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam, as well as the European Union (EU-US FTA).

One of the prominent exceptions to the MFN principle of nondiscrimination in the treatment of imports is that of free-trade areas and other preferential arrangements. This means that imports from countries with which the United States has free-trade or similar arrangements are accorded low- or duty-free status. It also enables U.S. firms to bid on certain government procurements in the FTA partner country; obtain prompt, adequate, and

effective compensation if its investment in the FTA partner country is taken by the government (expropriated); and supply their services in the FTA partner country and participate in the development of product standards in the FTA partner country. These agreements also provide for the protection and enforcement of American-owned intellectual property rights in the FTA partner country (see International Perspective 16.3).

The U.S./Israel Free-Trade Agreement (1985)

The agreement between the United States and Israel provides for free or low rates of duty for merchandise imports from Israel provided the imports meet the rules-of-origin requirements. To qualify for the preferential tariff rate, the product must be grown, produced, or manufactured in Israel and imported directly into the United States and the cost or value of the materials produced in Israel plus the direct costs of processing operations in Israel must be no less than 35 percent of the import value.

The North American Free Trade Agreement (NAFTA) (1994)

NAFTA eliminated tariffs on most goods originating in Canada, Mexico, and the United States over a maximum transition period of fifteen years (i.e., through 2008). For most Mexico-U.S. trade, NAFTA eliminated existing duties immediately and/or phased them out over a period of five to ten years. On a few sensitive items, the agreement phased out tariffs over fifteen years. NAFTA duty treatment is applicable only to goods wholly produced or obtained in the NAFTA region, that is, goods produced in the NAFTA region wholly from originating materials. Goods processed or assembled from imported merchandise must contain 60 percent regional value content (transaction value method) or 50 percent value content using the net cost method.

U.S./Australia Free Trade Agreement (USAFTA) (2004)

The USAFTA, finalized in 2004 and implemented on January 11, 2005, provides for the elimination of tariffs on more than 97 percent of Australia's nonagricultural exports (as well as two thirds of U.S. tariffs on agricultural products) on the day the agreement took effect. Remaining U.S. tariffs on Australian exports will be phased out over periods between ten and eighteen years. The agreement also provides for annual increases in quotas for Australian exports of beef and dairy products. It outlines rules for determining the origin of goods being traded in order to establish eligibility. The agreement determines "an originating good" as one that is (a) wholly obtained or produced entirely in the country; (b) wholly produced from originating materials; or (c) produced in the country partly from non-originating materials.

The agreement covers other areas such as cross-border trade in services, electronic commerce, investment, protection of intellectual property rights, competition policy, government procurement, and labor and environmental standards, as well as provisions for dispute settlement.

Free Trade with Central America and the Dominican Republic (CAFTA-DR) (2004)

The United States signed CAFTA-DR with five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) and the Dominican Republic in August

2004. These countries make up the second-largest U.S. export market in Latin America, behind Mexico. The agreement provides for the elimination of customs duties on originating goods traded between the parties. Duties on most tariff lines covering industrial and consumer goods were eliminated as the agreement entered into force. Duties on other goods are to be phased out during a ten-year period. Apparel made in these countries will be duty and quota free if U.S. or regional fabric and yarn are used. Additional access is also provided for their sugar exports to the United States from the Latin American countries through modest increases in quotas.

U.S. Trade Preferences

Generalized System of Preferences (GSP)

The GSP is a special arrangement by developed nations, agreed to under the United Nations, to provide special treatment for imports from developing nations to encourage their economic growth. Under the GSP, tariff exemptions and reductions are provided by industrialized countries on a specified range of commodities exported from developing nations. The GSP scheme was first implemented in the United States in 1976 when the government specified some 2,700 articles that were to receive duty-free treatment if imported from 140 designated developing nations. The scheme has been extended since, with certain modifications and limitations.

Imports from eligible countries are subject to tariff exemptions or reductions if:

1. The merchandise is destined for the United States without contingency for diversion at the time of exportation.
2. The cost or value of materials produced in the beneficiary country and/or the direct cost of processing performed is no less than 35 percent of the appraised value of the goods.
3. The United Nations Conference on Trade and Development certificate of origin is prepared and signed by the exporter and filed with the entry of the goods.

There are two important limitations to the application of the GSP. First, the U.S. president is required to suspend GSP eligibility on imports of specific articles from a particular country when that country has supplied more than $155 million in value of the article during the previous calendar year (for 2012) or more than 50 percent of the value of U.S. imports. Since the $155 million limitation was based on the GDP of 2012, appropriate adjustments are made in light of the GDP for the current year. Such limitations do not apply to an eligible least-developed country. Second, the provision of GSP is restricted for the more advanced developing nations. For example, many products from countries such as Israel, Korea, Singapore, and Taiwan were removed from GSP duty-free treatment.

Certain articles are prohibited by law from receiving GSP treatment. These include most textiles and apparel articles, watches, footwear, handbags, luggage, flat goods, work gloves, and leather apparel. In addition, the GSP statute precludes eligibility for import-sensitive steel, glass, and electronic articles. The GSP scheme saved beneficiary countries (128 countries in 2011) import duties of $700 million (2011) on total GSP imports estimated at $18.5 billion (U.S.). Top beneficiaries of the U.S. GSP include India, Thailand, Brazil, Indonesia, South Africa, the Philippines, Turkey, and Russia.

The Caribbean Basin Initiative (CBI)

The CBI is a program intended to provide duty-free entry of goods from designated Caribbean and Central American nations to the United States. The program was implemented in 1984 and has no expiration date. For CBI duty-free treatment, the merchandise must be wholly produced or substantially transformed in the beneficiary country, be destined for the United States without contingency for diversion at the time of exportation, and meet the 35 percent value-added requirement similar to that required in the GSP scheme. Value attributable to Puerto Rico, the U.S. Virgin Islands, and U.S. Customs and Border Protection territory may be counted toward the 35 percent value-added requirement. In the latter case, the attributable value is counted only up to a maximum of 15 percent of the appraised value of the imported article.

The United States-Caribbean Basin Trade Partnership Act (CBTPA, 2000) expands the trade benefits currently available to Caribbean and Central American countries under the CBI. Except for textile and apparel articles, the CBTPA allows tariff treatment similar to that accorded NAFTA signatories for goods excluded from the CBI program (watches, footwear, petroleum products, and so on). Apparel articles assembled in one or more CBTPA beneficiary countries from U.S. or regional fabric or yarn are eligible for duty- and quota-free treatment when they enter the United States.

The trade benefits under CBTPA are expected to continue in effect until September 2020 or the date on which a free-trade agreement is concluded between the U.S. and beneficiary countries.

The Andean Trade Preference (ATP)

This program was enacted in 1991 in order to provide duty-free treatment for imports of merchandise from designated beneficiary countries (Bolivia, Colombia, Ecuador, and Peru) to the United States. The eligibility requirements are similar to those for the CBI. The ATP expired in 2001 and was renewed as part of the Trade Act of 2002. The new program, The Andean Trade Promotion and Drug Eradication Act, provides the same benefits as the ATP. It, however, extends the program by 700 additional products.

A similar arrangement was also made with Marshall Islands and the Federated States of Micronesia in 1989 and has no expiration date.

The African Growth and Opportunity Act (AGOA) (2000)

AGOA was signed into law in May 2000. It is intended to offer beneficiary countries from sub-Saharan Africa duty-free treatment on more than 1,800 items that are exported to the United States. This is in addition to the standard GSP list of approximately 4,600 items. The program also provides duty and quota exemptions to member countries on their exports of textile and apparel products to the U.S. market.

AGOA benefits are extended to countries that are GSP eligible under the existing criteria. Beneficiary countries are also exempted from competitive need limitations, that is, preferential treatment is not suspended if a country is competitive in the production of the item.

As of June 2011, thirty-seven of the forty-eight sub-Saharan countries were designated as AGOA beneficiaries. AGOA was amended in 2002 and 2004. The latest revision (AGOA III of 2004) extends preferential treatment for beneficiary countries until 2015.

In 2011, more than 93 percent of U.S. imports from AGOA-eligible countries entered duty free (under AGOA, GSP, or zero-duty most-favored-nation rates) (Table 16.2).

TABLE 16.2 U.S. Trade with Major Sub-Saharan African (SSA) Countries (2010)*

U.S. exports	% total exports to SSA	U.S. imports	% total exports from SSA
Benin	3.4%	Angola	18.4%
Angola	9.5	Chad	3.1
Ethiopia	5.6	Congo (ROC)	5.1
Ghana	7.3	Equatorial Guinea	3.4
Kenya	2.7	Gabon	3.4
Nigeria	29.8	Nigeria	46.9
South Africa	41.6	South Africa	12.6

*Total U.S. exports to SSA: $16.44 billion; U.S. imports: $64.35 billion (AGOA and GSP: $44.3 billion) (2010)

Source: U.S. Department of Commerce, Bureau of Census (2012).

INTERNATIONAL PERSPECTIVE 16.3

U.S. Free-Trade Agreements (USFTAs)*

Global	Regional	Bilateral
WTO	NAFTA	Australia FTA
	APEC	Bahrain FTA
	CAFTA-DR	Chile FTA
		Colombia FTA
		Israel FTA
		Jordan FTA
		South Korea FTA
		Morocco FTA
		Oman FTA
		Panama FTA
		Peru FTA
		Singapore FTA

*WTO: World Trade Organization; APEC: Asia-Pacific Economic Cooperation; FTA: Free-trade agreement; CAFTA-DR: Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua.

Trade Intermediaries and Services

Customs Brokers

Customs brokers are persons who act as agents for importers for activities involving transactions with the customs service concerning (1) the entry and admissibility of merchandise; (2) its classification and valuation; and (3) the payment of duties and other charges assessed by customs or the refund or drawback thereof. A customs broker could be an individual, partnership, or corporation licensed by the U.S. Department of the Treasury. Finding an honest and knowledgeable broker is crucial to the success of an import firm (see International Perspective 16.4). Dishonest brokers have, for example, been known to make incorrect entries at high rates of duty and to bill the importer and later seek and pocket the refund. Brokers' failure to make timely filings can be costly to the importer (Serko, 1985).

Duties and Responsibilities of Customs Brokers

Customs brokers fulfill a number of functions:

Record of transactions: Customs brokers are required to keep a correct and itemized record of all financial transactions and supporting papers for at least five years after the date of entry. Such books and papers must be available for inspection by officials of the Treasury Department. Brokers are required to make a status report of their continuing activity with customs. A triennial status report and fee must be addressed to the director of the port through which the license was delivered to the licensee.

Responsible supervision: Licensed brokers must exercise responsible supervision and control over the transaction of the customs business. A broker must provide written notification to customs within thirty days after terminating any employee hired for more than thirty consecutive days.

Diligence in correspondence and paying monies: Each licensed broker is required to exercise due diligence in making financial statements, in answering correspondence, and in preparing and filing records of all customs transactions. Payments of duties and other charges to the government are to be made on or before the date that payments are due. Any payment received by a broker from a client after the due date is to be transmitted to the government within five working days from receipt by the broker. A written statement should be made by the broker (to the client) accounting for funds received for the client from the government, as well as those received from the client when no payment has been made or received from a client in excess of charges properly payable within sixty days after receipt.

Improper conduct: The regulations prohibit the filing of false information, the procurement of information from government records to which access is not granted, the acceptance of excessive fees from attorneys, or the misuse of a license or permit. The licensee of a broker that is a corporation or an association can be revoked if it fails for 120 continuous days to have at least one officer who holds a valid broker license.

License Requirements

To obtain a customs broker license, an individual must be (1) a citizen of the United States (but not an officer or employee of the United States); (2) at least twenty-one years of

age; (3) of good moral character; and (4) able to pass an examination to determine that he or she has sufficient knowledge of customs and related laws.

To obtain a broker's license, a partnership or corporation must have one member who is a licensed broker and must establish that the customs transactions are performed by a licensed member or a qualified employee under the supervision and control of the licensed member. Disciplinary action for infractions, such as making false or misleading statements in an application for a license, conviction after filing of a license application, violation of any law enforced by the customs service, and so on, could result in a monetary penalty as well as the revocation or suspension of a license or permit.

A license is not required to transact customs business by the exporter or importer on his or her own account. This also extends to authorized employees or officers of the exporter/importer or customs broker. A license is also not required for a person transacting business in connection with the entry or clearance of vessels or for any carriers bringing merchandise to port. A broker who intends to conduct customs business at a port within another district for which he or she does not have a permit must submit an application for a permit to the director of the relevant port.

INTERNATIONAL PERSPECTIVE 16.4

Criteria for Selecting the Right Customs Broker or Freight Forwarder

- Competitive rate
- Knowledge of the product
- Reputation/integrity
- Service and flexibility
- IT capability
- Account management, financial stability
- Networking capability.

Free-Trade Zones

Free-trade or foreign trade zones (FTZ) are areas usually located in or near customs ports of entry and legally outside the customs territory of the United States. Foreign goods brought into these zones may be stored, broken up, sorted, or otherwise manipulated or manufactured. While these operations are conducted, duty payments are delayed until the products officially enter into the customs territory.

Merchandise may be admitted into an FTZ upon issuance of a permit by the district director, unless the merchandise is brought in solely for manipulation after entry, is transiting the FTZ (for which a permit is granted), or is domestic merchandise.

FTZs are operated as public utilities under the supervision of the Foreign Trade Zones Board, which is authorized to grant the privilege of establishing a zone. Regulations are issued by the board covering the establishment and operation of FTZs. The board, which is composed of the U.S. secretary of commerce (chairperson), the secretary of the Treasury,

and the secretary of the Army, evaluates applications by public and private corporations for a zone on the basis of the following criteria: the need for zone services in the area, suitability of the site and facilities, justification in support of a zone, extent of state and local government support, views of persons or firms to be affected, as well as regulatory policy and other applicable economic criteria. The board also accepts applications for subzones, that is, special-purpose zones established as adjuncts to a zone for a limited purpose. Such zones are single-user facilities, usually accommodating the manufacturing operations of an individual firm at its plant. Every port of entry is entitled to at least one FTZ (Rossides, 1986; U.S. Department of Commerce, 1998, 2003).

Economic Advantages

- Merchandise admitted into the zone is not subject to customs duty until it is admitted into the customs territory. There is no time limit on the storage or handling of the merchandise within the zone.
- Businesses can import a product subject to a high rate of duty and manipulate and manufacture it into a final product that is classified under a lower rate of duty when imported into the customs territory. Importers can also bring in products for display to wholesalers or items restricted under a quota until the next quota period. A quota item may also be transformed in an FTZ into an item that can be freely imported without quota restrictions.
- The importer can establish the duty of foreign merchandise when entered into a zone by applying for a "privileged status." Under this scheme, only the duty previously fixed is payable upon entry of the merchandise into the customs territory at a later date even though its conditions may have changed or resulted in an article subject to a higher rate of duty.
- Duties are paid only on the actual quantity of such foreign goods incorporated in merchandise transferred from a zone of entry into the customs territory. This means that allowances are made for any unrecoverable waste resulting from manufacture or manipulation, thereby limiting the duty to articles actually entered. Savings in duties and taxes may thus result from moisture taken out or dirt removed, and so on. It may also be possible to achieve savings in shipping and taxes by shipping unassembled parts into a zone for assembly.
- Merchandise may be remarked or reconditioned to conform to certain requirements for entry into the customs territory.

The popularity of FTZs has grown not only in the United States but also in different parts of the world. By 1998, the number of such zones in the Unites States exceeded 200. Similar growth in the number of FTZs is observed in Africa, Asia, and Eastern Europe. A substantial part of the merchandise (more than 80 percent) entered under FTZs in the United States is imported into the United States for domestic consumption, while the rest is exported to foreign markets.

Bonded Warehouses

Bonded warehouses are secured, warehouse facilities approved by U.S. Customs and Border Protection in which imported goods are stored or manipulated without paying duty

until the goods are removed and entered for consumption. Duty is not payable when goods under bond are exported, destroyed under customs supervision, or withdrawn as supplies for vessel or aircraft. Merchandise may be kept in the warehouse for up to five years from the date of importation. The advantages of a bonded warehouse are quite similar to those of FTZs.

Any person desiring to establish a bonded warehouse must submit an application to the district director where the facility is located. When the application is approved, a bond is executed to protect the duty liability. Customs regulations provide for different types of bonded warehouses.

The major differences between a bonded warehouse and an FTZ are as follows: (1) costs for the use of bonded warehouses are generally less than for FTZs; (2) bonded warehouses may be established on a user's facilities and with less difficulty than an FTZs; and (3) the permitted types of manipulation are more limited for a bonded warehouse than for an FTZ. For example, goods may be stored or otherwise manipulated in a bonded warehouse as long as the process does not involve manufacturing. The assembly of watch heads by combined domestic and foreign components is a manufacture (not a manipulation) prohibited under customs regulations. However, the repackaging of spare watch parts is a manipulation that is allowable.

Chapter Summary

Tariffs and nontariff barriers	*Methods of levying tariffs:* 1. Ad valorem: Duty based on value of the imported product 2. Specific: Duty based on quantity or volume 3. Compound: Duty that combines both ad valorem and specific *Nontariff Barriers:* Nontariff barriers include quotas, tariff quotas, labeling requirements, licensing requirements, prohibitions on the entry of certain imports, and requirements to purchase domestically produced goods.
Preferential trading arrangements	NAFTA, U.S./Israel FTA, U.S./Australia FTA, the Caribbean Basin Initiative, the Andean Trade Preference, the Generalized System of Preferences, AGOA.
Trade intermediaries and services	Customs brokers, free-trade zones, and bonded warehouses. *Customs brokers:* Customs brokers act as agents for importers with regard to (1) the entry and admissibility of merchandise, (2) its classification and valuation, and (3) the payment of duties and other charges assessed by customs or the refund or drawback thereof.

(*Continued*)

	Free-trade zones:
	Free-trade zones are certain designated areas, usually located in or near a customs port of duty, where merchandise admitted is not subject to a tariff until it is entered into the customs territory. Foreign goods brought into an FTZ may be stored, or otherwise manipulated or manufactured. FTZs are legally considered to be outside the customs territory of a country.
	Bonded warehouses:
	Bonded warehouses are secured, government-approved warehouse facilities in which imported goods are stored or manipulated without payment of duty until they are removed and entered for consumption.

Review Questions

1. What are the different ways in which tariffs are levied in the United States?
2. Discuss the various types of nontariff barriers imposed in the United States.
3. What is the difference between "imports requiring a permit" and "imports prohibited without a license." Provide examples.
4. Does the U.S.-Israeli agreement eliminate all trade barriers between the two countries?
5. Discuss the U.S. GSP and conditions for eligibility.
6. Does AGOA allow free trade in textiles and apparel?
7. What is the difference between a customs broker and a freight forwarder?
8. Discuss the duties and responsibilities of a customs broker.
9. What is a free-trade zone? How does it differ from a bonded warehouse?
10. Discuss some of the economic advantages of free-trade zones?

Minicase 16.1

John Tavis, a licensed broker and owner of Rider Logistics, obtains a power of attorney (POA) from a new client, Heather Mathis, owner of Global Imports (importer) on February 3, 2006. Tavis does not possess a national permit; however, he is permitted to practice in the districts of Laredo and Dallas. (see 19 CFR 127.1, 171 appendix A, HTS: XXII:13).

1. What is the expiration date of the POA? Unless it is revoked earlier, for how long is the broker supposed to retain the POA for recordkeeping purposes?
2. Is a POA required when John Tavis, the broker, is acting as the importer of record?
3. Global Imports requests its supplier in Malaysia to ship directly to its client in New York. Can John Tavis issue a POA on behalf of Global Imports to another broker (which is permitted in the Port of New York) to allow the latter to clear goods on behalf of Global Imports?
4. Global Imports does not have an importer-of-record number. Which CBP form should the broker prepare and file to obtain this number?

CUSTOMS POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS: That Global Imports doing business as a partnership under the laws of the State of Texas residing or having a place of business at 2093 Nova Road, DALLAS, TEXAS hereby constitutes and appoints John Tavis dba RIDER LOGISTICS and it's authorized employees, which may act through any of it's licensed officers or employees duly authorized to sign documents by power of attorney as a true and lawful agent and attorney of the grantor named above for and in the name, place, and stead of said grantor from this date and in ALL Customs Ports and in no other name, to make, endorse, sign, declare, or swear to any entry, withdrawal, declaration, certificate, bill of lading, carnet, or other document required by law or regulation in connection with the importation, transportation, or exportation of any merchandise shipped or consigned by or to said grantor; to perform any act or condition which may be required by law or regulation in connection with such merchandise; to receive any merchandise deliverable to said grantor.

To authorize other Customs Brokers duly licensed within the territory to act as grantor's agent; to receive, endorse and collect checks issued for Customs duty refunds in grantor's name drawn on the Treasurer of the United States; if the grantor is a non-resident of the United States, to accept service of process on behalf of the grantor;

. . .

This power of attorney is to remain in full force and effect until revocation in writing is duly given to and received by grantee (if the donor of this power of attorney is a partnership, the said power shall in no case have any force or effect in the United States after the expiration 2 years from the dates of its execution);

IN WITNESS WHEREOF: the said GLOBAL IMPORTS has caused these presents to be sealed and signed:
(Signature) (Signed) HEATHER MATHIS (Print Name) HEATHER MATHIS

(Capacity) PARTNER Date: FEBRUARY 3, 2006

Witness: (if required) ALAN SCHULMAN (PARTNER) (Signature) (Signed) ALAN SCHULMAN

If you are the importer of record, payment to the broker will not relieve you of liability for Customs Charges (duties, taxes, or other debts owed Customs) in the event the charges are not paid by the broker. Therefore, if you pay by check, Customs charges may be paid with a separate check payable to U.S. Customs which shall be delivered to Customs by the broker. Importers who wish to utilize this procedure must contact our office in advance to arrange timely receipt of duty checks.

Form 16.1

References

Rossides, E. (1986). *U.S. Import Trade Regulation.* Washington, DC : Bureau of National Affairs.
Serko, D. (1985). *Import Practice.* New York: Practicing Law Institute.
U.S. Department of Commerce (1998). *A Basic Guide to Exporting*. Lincolnwood, IL: NTC Books.
U.S. Department of Commerce (2003). *Importing into the United States.* Rocklin, CA: Prima Publishing.

World Wide Web Resources

Information on Foreign Trade Zones
http://www.cbp.gov/xp/cgov/import/cargo_control/ftz/about_ftz.xml
http://ia.ita.doc.gov/ftzpage/tic.html
http://trade.gov/index.asp

Federal Regulations on Customs Tariffs
http://www.lawdog.com/transport/export/custom2.htm
Information on U.S. Customs and Border Protection (importing, exporting, NAFTA, and information on the Harmonized Tariff Schedule):
http://www.customs.ustreas.gov/

Information on the U.S. Generalized System of Preferences
http://www.itds.treas.gov/gsp.html

Importing into EU Countries
http://www.lavellecoleman.ie/cuuploads/editor/file/England%20and%20Wales%20pdfs/Customs,%20Licences%20and%20VAT/2_%20Importing%20into%20the%20EU.pdf

Case 16.1 Tax Deduction for Processing in Maquilas: Mere Assembly or Fabrication

The regulations of U.S. Customs and Border Protection (CBP) provide for deduction of the costs of U.S. components or materials assembled abroad upon importation into the United States. In order to qualify for this exemption from duty assessment, the components must be exported in a condition ready for assembly without fabrication and have retained their physical identity without change in form or shape. CBP also requires that the components not be advanced in value abroad except by mere assembly or operations incidental to the assembly process such as cleaning, lubricating, and painting. This has largely facilitated the establishment of maquilas (manufacturing operations in a free trade zone area overseas and often re-export to the raw material's country of origin) (in bond plants) along the U.S.-Mexico border in order to assemble U.S. components for re-export to the United States.

ABC Corporation of Phoenix, Arizona, attempted to take advantage of this opportunity by shipping U.S. components to Mexico for assembly and re-export. The company shipped straight steel strips from Tucson, Arizona, to neighboring Nogales, Mexico, for use in luggage, which was later imported into the United States. CBP denied a deduction from the value of the luggage for the cost of the steel strips, stating that shaping the steel strips before placing them within the luggage constituted a further fabrication and not mere assembly; that is, the bending process was not incidental to the assembly of a component exported from the United States. ABC Corporation does not believe that the denial by CBP was justified.

Questions

1. Do you agree with CBP?
2. What is your advice to ABC Corporation?

Case 16. 2 Import Penetration Rates in U.S. High-Value Industries: Focus on China

The U.S. trade deficit in goods and services declined from $560 billion in 2011 to $540 billion in 2012. This reflected a $16.8 billion improvement in the services trade surplus and a $2.7 billion improvement in the goods trade deficit. While the U.S. trade deficit in petroleum products declined, the deficit in nonpetroleum goods increased by about 9 percent. The growing deficit in nonpetroleum products, especially manufactured products (which increased by $44.7 billion in 2012), represents a substantial threat to the recovery of U.S. manufacturing employment.

Much of the deficit on manufactured goods is with China, Japan, and South Korea. China alone is responsible for about 72 percent of the U.S. trade deficit in manufactured goods (2012). In spite of increasing wages and transportation costs, Chinese-made high-value products are taking an increasing share of the U.S. market. In 2011, for example, products made in China captured 5.28 percent of total U.S. purchases of capital-intensive products. In many advanced manufacturing sectors, China's import penetration rates have substantially increased over the past ten to fifteen years.

Many factors have contributed to the growing U.S. market share of Chinese high-technology industries:

- *Rising productivity in China's export sector:* This enables producers to absorb higher labor costs without passing them to consumers.
- *Export subsidies to producers:* The Chinese government provides support to its industries through lower costs for land, energy, water, and other inputs.
- *Intervention in the foreign exchange markets to reduce renminbi appreciation:* China's recent intervention is estimated at $250 million a day to either halt or limit currency appreciation (see Tables 16.3 and 16.4).

TABLE 16.3 Import Penetration Rates of Selected Chinese Products in the U.S. Market

Product	% Increase in U.S. market share (1997–2011)	Product	% Increase in U.S. market share (1997–2011)
Tire cords and fabrics	71,500	Enameled iron and sanitary ware	3,066
Commercial and service-industry machinery	36,100	Electronic components	2,488
Coated fabrics	4,312	Semiconductors and related devices	2,142
Broadcast/wireless communications equipment	3,547	Speed changers, high-speed drives, and gears	2,131

TABLE 16.4 Fastest-Growing U.S. High-Value Exports to China (2011–2012)

Product	% Increase in U.S. exports to China (2011–2012)	Product	% Increase in U.S. exports to China (2011–2012)
Heavy duty trucks and chassis	115	Textile/fabric finishing mill products	41
Magnetic and optical media	109	Commercial and service industry machinery	41
Industrial machinery	66	Industrial gases	32
Farm machinery and equipment	46	Vehicle transmission and power train parts	29

Source: Comtrade

Question

1. Compare U.S. import penetration rates for products from Germany and China using currently available data.

seventeen
Selecting Import Products and Suppliers

Selecting Products for Importation

One of the most important import decisions an exporter-importer must make is the selection of the proper product that serves the market need. In the absence of such a product, one is left with a warehouse full of merchandise that no one is interested in buying. Nevertheless, importing can become a successful and profitable venture so long as sufficient effort and time are invested in selecting the right product for the target market.

How does one find the right product to import? There are two ways to selecting a product for importation: the reactive approach and the proactive approach.

The Reactive Approach

This is a way of selecting a product without a proper assessment of market needs. Some people, for example, travel to an exotic location, stumble on a fascinating product, and decide to import for resale. The decision may be based on the uniqueness of the product or its quality, availability, or cost. It is also common to select a product based on government import data (i.e., to identify what is hot and trendy or to exploit trade leads that are often posted on the Internet).

Products that are unique and unusual can be appealing to customers because they are a welcome change from the standardized and identical products sold in the domestic market. The fact that a product is imported and unusual is in itself sufficient reason for many people to purchase the item. The provision of quality products at lower prices also provides importing firms a competitive advantage (Shippen, 1999). In the apparel sector, for example, imports presently account for more than half of total U.S. market share in 2010, mainly due to their cost advantage.

In cases where there is a continuous increase in demand for the product, imports become a major source of domestic supply because the product is either not produced in the country

or not produced in sufficient quantities to satisfy the growing demand. The major reason for global sourcing in the chemical industry, for example, is the unavailability of needed products in the U.S. market. Many products manufactured abroad are of better quality than those produced domestically. German machine tools, Japanese cars, and French perfumes have proven market demand because of their high quality. In some cases, certain designs could best be manufactured overseas. Identifying a quality product has the potential to increase profits.

Where and How Do You Find the Right Product to Import?

Any one or a combination of the following can be used in order to find, assess, and select the right product for importation

Domestic Market Research

Primary market research can be conducted by a consulting firm to identify the best line of products for the domestic market. A variety of statistical sources provide data on projected total demand for certain products. Trade flows can also be examined to gather information on domestic demand and growth trends for various products. Some secondary sources also provide important market information, such as domestic market overviews, market share data, and opinions of industry experts. Such secondary market research studies and surveys can be purchased for a fraction of the cost of primary research. Online data can also provide industry and product information.

Trade Publications

Trade publications such as *Trade Channel, Asian Sources,* and *General Merchandise* provide business and trade opportunities in various countries. They include various advertisements of products and services available for import from all parts of the world (Nelson, 2008; Weiss, 2007). Certain banks with international departments often publish newsletters with offers to buy and sell. The prospective importer can also use electronic bulletin boards of the World Trade Centers to find out what products are available for import.

Foreign Travel

Whenever one visits a foreign country, it is important to look for products that may have a market at home. If a good product is obtained, it would create a profitable business opportunity. One could find new and exciting products that are not currently imported in the public markets, bazaars, or gift stores. Once a good product is identified, a few samples can be purchased. The manufacturer's address can be obtained from the country's trade department or from local vendors, usually for a small referral fee. If one does not travel overseas, it is always possible to ask friends or agents abroad for product information.

Trade Fairs and Shows

One way of finding a product is to attend trade fairs and trade shows. Many exporters find such shows to be an effective means of promoting their products. It is estimated that almost 2,000 trade shows take place in more than seventy countries every year. Trade shows represent an entry point into export markets worldwide. Importers have an opportunity

to consider a variety of potential products to buy, establish personal contacts, identify new prospects, or gather competitive information. Many exporters introduce their products to the foreign market with the hope of writing orders at the show or of finding suitable distributors or manufacturers' agents who will handle their products in overseas markets. Major shows in the United States are published in the *Exhibits Guide.* The Department of Commerce publishes information on upcoming trade fairs and trade shows in the United States and abroad. There are also online sources on various shows and exhibitions in certain product areas to be held in various parts of the world. A recent online announcement, for example, invites buyers and sellers of furniture to the international furniture fair in Copenhagen, Denmark, where major dealers from around the globe are expected to exhibit their furniture.

Foreign Countries' Trade Offices

Most countries have export promotion offices abroad. A trade promotion office provides important information on a country's major export products or services, suppliers, and other helpful information. In the absence of a trade promotion office for a nearby country, the embassy could be a good source of information on potential products to import.

The Proactive Approach

The proactive approach to selecting import products involves developing a product that solves problems encountered by consumers. Financial success largely reflects the value that is provided in the marketplace. It grows out of one's passion to improve a product's quality or functionality: Haagen Dazs ice cream (to put seasonal fruits in the ice cream), Marcel Schurman greetings cards (to allow buyers to write their own sentiments), or edible supermarket labels (to provide harmless labels in case they are inadvertently consumed by adults or children).The ability to provide such value is often influenced by one's experience, education, and enthusiasm for the product.

When selecting the product, one is guided by the following considerations:

- *Products with entry barriers:* Products with high entry barriers tend to earn above-average rates of profit. Entry barriers could be created by product differentiation (designing the product for the market), which gives the owner an exclusive right to make or trade the product. Entry barriers also include high capital requirements (for example, large industrial equipment that is expensive and subject to special shipping and handling requirements) and special access to channels of distribution (Grant, 2010).
- *Absence of close substitutes:* The absence of close substitutes for a product makes it difficult for consumers to choose another product in response to price increases (demand is inelastic with respect to price). For example, switching from Apple to Intel equipment involves buying new software and hardware. If an importer redesigns a product for a given market along with other complementary assets, the cost of switching by users to another product can be quite expensive.
- *Limited bargaining power of buyers:* The less differentiated the product, the more likely it is that the buyer will switch suppliers on the basis of price. It may not be profitable to start with big buyers such as Walmart since they use their strong bargaining power to pressure suppliers accept to lower prices.

Even though some imported products can be sold without any modification, most products imported into the United States are designed for the U.S. market. For example, all cars, watches, clothing, and furniture produced and sold in Asian countries are different from those imported and sold in the United States and Europe. They are redesigned to suit the market in terms of functionality, pattern, color, and so on. Baskets used in Asian countries for collecting clams on the seashore have to be redesigned as a single-serving bread basket for U.S. homes and restaurants. Clothing made in Central American countries has to be redesigned or tailored for American sizes. The popular Mazda Miata was designed in California for the U.S. market (Spiers, 2001). Designers can be located at universities (engineering schools) or technical institutes and are often remunerated on a royalty basis.

The process of assessing the viability of your product with potential buyers or retailers begins with the first stage of product identification and continues throughout the process of redesigning and test-marketing the new product (product samples). It may be necessary to redesign the product if test sales (product samples) indicate the need for further improvements.

Regardless of the method used to find the potential product to import, it is advisable to buy a sample or a small order to determine whether there are any prohibitions or restrictions to entry and whether the product can be sold at a competitive price. The sample can be inspected by a customs broker to establish whether the product can be freely entered and, if it is allowed entry, the applicable duty rate. The sample could also be shown to a freight forwarder to obtain an estimate of the shipping and insurance cost in order to calculate the price at which the merchandise will be sold. It is important to realistically evaluate the price in terms of competing products in the market. When calculating the total cost plus a decent profit margin, if the price is much higher than that for a competing product in the market, it may be necessary to go back to the drawing board.

Suppose the product is not subject to prohibitions or restrictions and can be sold at a competitive price. The next step is to pre-sell the product to likely buyers. This will determine whether people will buy the product and how much they are willing to pay for it. This can be done by the potential importer or salespeople. The process of supplier selection and negotiation to purchase the first shipment should be done only after making an assessment of how much one can realistically sell.

Reactive versus Proactive Approach to Product Importation

The reactive approach to product importation is largely based on short-term market needs. Financial success is a product of long-term relationships and repeat sales. Importing umbrellas one year and moving on to furniture the next year is similar to building a business and abandoning it before it could pay off (Spiers, 2001). The proactive approach has several advantages:

- It seeks to identify and solve customer problems by selecting and designing the right product for the market (on the basis of your background and experience). Importing unfamiliar products solely on the basis of trade leads or market trends can be risky. Numerous products made overseas are unsafe for consumption. Choosing the right product based on your knowledge and experience is thus critical to long-term success.

- Importing the appropriate product for the market requires the development of the requisite infrastructure (product design, registration of patents, selection of the best suppliers, and access to distribution channels). Such an investment of financial resources, time, and effort is inconceivable using the reactive approach because efforts invested to start one product are wasted when one begins to quickly replace it with another product (Table 17.1).

Factors to Consider When Importing:

- *Long lead times*: Once you place an order and pay a small down payment, overseas suppliers will begin to manufacture your product. It may take the supplier one to four months to make the product.
- *A hefty minimum order:* It is not unusual for suppliers to request for large minimum orders.
- *Payment terms:* Most suppliers expect to be paid by wire transfer until they establish a certain level of trust.
- *Quality control:* It takes a few shipments to get the product that meets all your specifications (International Perspective 17.1).
- *Language barriers:* Most vendors are able to read English much better than they can understand the spoken language.

TABLE 17.1 Comparing Two Approaches to Selecting Products for Importation

	Reactive approach	Proactive approach
Where and how do you find the right product?	Trade publications, trade leads, market research, foreign travel, trade fairs, foreign embassies or consulates	Identify and solve problems faced by customers with regard to a given product.
How do you select the right product?	Product uniqueness, quality, price, shortages, popularity in home market	Select the product largely on the basis of one's education, experience, and enthusiasm.
Major steps	Once the product is selected, a sample or small order is purchased to receive feedback from buyers or retailers and to determine any import restrictions. If there are no restrictions and the feedback from retailers is positive, test-market the product. You can then select the best supplier and negotiate a purchase agreement for your first shipment.	Identify a problem faced by customers on the basis of your background and experience. Develop a product to solve the problem, and contact suppliers for developing or designing the product. Check for any import restrictions, test-market the product (samples), and make further improvements on the basis of the feedback from test-marketing. You can then select the best supplier and negotiate a purchase agreement for your first shipment.

INTERNATIONAL PERSPECTIVE 17.1

Quality Control for Imports

Ensuring quality is the best means of winning consumer confidence and sales. Many manufacturing firms find that they must meet new and different standards criteria (national, corporate, regional, or international) to compete in the global marketplace. Even though the majority of industrial standards are voluntary, there are mandatory government imposed standards in the fields of health and safety, food and drugs, and the environment. In many European countries, consumers often base their purchasing decision on proof of certification for the product or service. European Community directives also mandate that companies meet certain product certification standards in order to sell in the European Union.

In the area of imports, quality standards provide a basis for assessing quality of products and services. Suppliers are provided a guide as to the quality of product to be manufactured, while buyers are provided with the confidence that the goods are safe and meet high quality standards. It is important to establish quality testing and inspection procedures. In the case of large orders, the importer could appoint a quality inspector at the supplier's location to assess and advise the supplier on quality. Acceptance and payment on a letter of credit can be made conditional on receipt of a satisfactory inspection certificate.

An example of a quality control program for imports is the one jointly created by the International Automotive Task Force for the auto industry (ISO/TS 16949). TS16949 is based on ISO-9001 and aims at developing a quality-management system that emphasizes continual improvement, defect prevention, and reduction of variation and waste in the supply chain. The requirements are to be applied throughout the supply chain. It also encourages firms to be responsible stewards of the environment (ISO-14001).This is intended to ensure that products or services satisfy the customer's quality requirements and comply with any regulations applicable to those products or services.

Determining Import Volume

Much of the literature on imports underlines the importance of high per capita incomes and population size in determining import levels. All other things being equal, countries with higher per capita incomes will be able to import more per person than countries with lower levels (Lutz, 1994). Larger countries (in terms of population) import fewer manufactured goods on a per capita basis because they tend to have a diversified industrial base, as investment will be attracted to these countries to take advantage of their big markets. This view can be exemplified by the case of the United States and Japan, both of which have low import propensities compared to countries such as Belgium or the Netherlands. Economic theory also suggests that import levels are affected by other factors, such as the price of imports denominated in foreign currency and the exchange rate, as well as the price of domestic goods relative to imports (Deyak, Sawyer, and Sprinkle, 1993; Warner and Kreinin, 1983). While relative prices have a predictable and systematic impact on imports, price elasticities tend to be low, in most instances well below unity. This suggests that large relative price swings are required to have an appreciable impact on trade patterns (Reinhart, 1995). For developing countries, however, determinants of import demand include government restrictions on

imports, and availability of foreign exchange (Sarmad, 1989). The study by Sarmad examining the factors that influenced import demand in Pakistan from 1959 to 1986 found that the policy of devaluation or raising tariffs was not significant in reducing imports except in the case of imports of machinery and transport equipment. In countries with successful import-substitution strategies, the impact of relative prices and tariffs tends to decline in terms of their influence on import demand. Import substitution is a policy that taxes and restricts imports to protect and subsidize domestic industries. This policy, which paradoxically led to more import dependence (e.g., for purchases of raw materials, components), was a popular economic strategy among some developing nations (Lindert and Pugel, 1999).

INTERNATIONAL PERSPECTIVE 17.2

Major Factors in International Supplier Selection

- **Quality assurance:** Certification of potential suppliers for strict quality assurance, technical capability to prevent quality failures, and overall commitment to quality assurance
- **Financial conditions:** Low-cost supplier (e.g., purchase price, transportation cost, documentation), provision of favorable payment terms (open account sales), freight terms such as FOB, CIF
- **Service performance:** Supplier's commitment to and capability for timely delivery of services, and technical assistance
- **Perceived risks:** Presence or absence of political and economic risks such as political instability, currency inconvertibility, and unstable exchange rates
- **Buyer-supplier relationships:** Financial stability, negotiation flexibility of supplier
- **Trade restrictions:** Tariff and nontariff barriers, countertrade requirements by supplier or country
- **Cultural and communication barriers:** Language, business customs, ethical standards, communication barriers, electronic data exchange capability.

Selecting the Supplier

The product selected for importation may be manufactured by several firms in different countries or within the same country. The next important step is to assess and select the right supplier on the basis of a number of critical factors, such as quality, delivery time and supplier reliability, transportation cost, import duty implications, protection of intellectual property rights, and suppliers' ability to meet standard requirements.

A study conducted in 1983 on the decision process of U.S. purchasing agents suggests timely delivery, product brand name, and style as important factors that determine purchasing decisions (Ghymn, 1983). A major concern in the minds of many U.S. importers is the quality of the imported product. In today's marketplace, where many firms are competing for the buyer's attention, it is the customer who defines quality in terms of his or her needs. To be successful, an importer should select a supplier who can deliver a

product that satisfies consumer needs, has minimum defects, and is priced competitively. Also adding to the importance of quality and the local market appeal of the product is the availability of core supplier benefits, such as warranties, timely delivery, favorable transportation terms, as well as after-sales service and reliability. Low-cost suppliers can also be identified on the basis of their proximity to raw materials, labor costs, current exchange rates, or transportation costs.

Import duties could be eliminated or substantially reduced by selecting suppliers located in countries that participate in a preferential trade arrangement. In the United States, for example, most products imported from Canada, Mexico (NAFTA), Caribbean countries (CBI), Israel (FTA), and countries eligible for GSP benefits are subject to duty-free treatment. For example, ceramic tile imported from Italy is subject to a 13.5 percent duty, whereas an identical tile coming from Israel would cost the importer only 4.3 percent duty. To qualify for such favorable treatment, it is necessary to mark the country of origin of the import.

Selection of the supplier should also be based on the integrity of the product. Integrity of the product includes the assumption that the import does not violate any intellectual property rights registered in the country, such as patent, trademark, design, or copyright, and that it meets certain regulatory requirements, such as product compliance with the various import laws relating to marking, labeling, inspections, and safety. There has been a rise in the production and sale of counterfeit and pirated goods in many parts of the world. Industry experts, for example, estimate lost sales from unauthorized use of U.S. intellectual property rights at $60 billion annually. It is also important to select suppliers that meet certain product safety standards. For example, food service ceramics must be tested for lead, and toys must meet labeling and safety standards. A potential importer should be aware of any foreign laws that might affect purchase, such as export restrictions or quotas. The importer also needs to ascertain whether the supplier has already appointed other distributors or sales agents in the territory and whether the distribution channels available are acceptable in terms of overall profitability and risk. For example, an agent is likely to realize limited profits if the supplier has a distributor in the market (see International Perspective 17.3 for a typical import transaction).

Once a small number of potential suppliers are identified, a personal visit can be made to perform the necessary evaluation and to select the right supplier. Final selection will be made based on factors such as (1) the supplier's international knowledge and experience; (2) the supplier's willingness to devote sufficient time to develop the market; (3) the supplier's willingness to provide necessary training; and (4) the supplier's agreement to provide certain market exclusivity and an acceptable payment arrangement. It is also important to obtain a credit report for the supplier. Such evaluation is critical regardless of the marketing channels adopted by the importer.

Helpful Tips to Limit Choice of Countries/Suppliers

Once you have selected the product for importation, your next step is to link up with overseas suppliers. It is important to limit your choice of countries or suppliers from which you will import the selected product. Here are some helpful steps.

Step 1: Let us assume that you have chosen to import *fertilizers* in view of your background and previous work experience as an organic chemist in a fertilizer company.

TABLE 17.2 U.S. Imports of Fertilizers 2008–2012 ($ thousands U.S.)

Exporters	Imported value 2008–2012					Increase	% world
	2008	2009	2010	2011	2012	since 2008	total 2012
World	892,503	4,385,484	7,070,067	9,621,736	9,286,668	4.05	100
Canada	4,445,271	2,900,024	3,917,550	4,829,403	4,492,821	1.07	48.38
Oman	15,000	18,947	167,788	161,485	51,7579	3,350.53	5.57
Trinidad and Tobago	233,001	118,246	252,184	449,134	418,558	79.64	4.51
Egypt	226,998	52,464	219,490	279,086	306,089	34.84	3.3
Kuwait	393,311	67,753	159,416	176,167	225,230	–42.73	2.43
Qatar	233,210	141,090	142,071	169,189	216,724	–7.07	2.33
Saudi Arabia	249,056	158,399	186,961	284,440	205,398	–17.53	2.21
China	394,842	105,373	279,102	204,580	195,060	–50.6	2.1
Israel	68,544	34,908	98,327	257,895	190,819	178.39	2.05
Bahrain	128,140	87,691	90,475	161,314	175,238	36.76	1.89
Morocco	67,977	6,974	74,150	118,395	157,877	132.25	1.7
Indonesia	337	260	13,642	31,251	144,476	42,771	1.56
Lithuania	140,012	19,222	35,250	169,602	143,115	2.22	1.54
Romania	94,709	15,848	104,551	202,202	135,742	43.33	1.46
Norway	104,017	48,449	98,015	112,098	135,624	30.39	1.46
The Netherlands	59,009	33,521	44,788	90,395	124,823	111.53	1.34

Source: Comtrade.

Step 2: You can access a trade database (Comtrade.org or tradedataweb.gov) to get the HTS number as well as establish the volume of imports and supplying countries during the past few years (see Table 17.2).

Step 3: You see that U.S. imports in fertilizers are growing by about 4 percent a year. Note that imports do not always determine market potential. A product can always be adapted to suit the market. The data shows that Indonesia, Oman, and Israel have been gaining market share over suppliers from other countries. You can also inquire about prices and quality.

Step 4: You can contact the embassies or commercial attachés of Indonesia, Oman, and Israel in the United States to obtain a list of suitable manufacturers or suppliers. You can also consult the following trade publications on the Internet: *Asianproducts.com; tradechannel.com; eximinfo.org; compass.com; made-in.com; alibaba.com; sourcing.tdc.trade.com; wand.com; worldchambers.com; Foreign-trade.com/exhibit.htm.*

Step 5: Contact potential suppliers and request client references, licensing information (license to do business), and information on their manufacturing: experience, cost, quality, production capacity delivery schedule, and intellectual property protection.

Step 6: Request product samples (prototype), and evaluate whether the product has sufficiently incorporated your design specifications and its overall quality. This can lead to a purchase agreement (Table 17.3).

TABLE 17.3 Imports: Purchase Documentation and Agreement

Common forms for purchase agreements	1. *Price lists:* Price lists can be sent by seller as a result of buyer's request for quotation or recent communication with buyer (price lists are not considered offers). 2. *Quotation:* Seller forwards price quotation (pro forma invoice) in response to buyer's offer to purchase a specific quantity. It contains all the terms and conditions. Buyer should review before placing any orders (offer to buyer). 3. *Purchase order (PO):* Buyer issues purchase order. If buyer wants to further negotiate certain terms such as price, he or she makes a counteroffer before sending the PO. 4. *Acknowledgment and acceptance of PO:* Once seller communicates acceptance of PO, it is considered confirmation of sales contract. Seller proceeds with manufacture and shipment of the product. 5. *Invoice:* Seller prepares commercial invoice when product is ready for shipment to facilitate payment.
Important provisions in international purchase contracts	1. Quantity, price including rebates or discounts, issues relating to parallel imports 2. Currency: Denomination of currency and responsibility in the event of currency fluctuations 3. Payment method: open account, documentary collection, letter of credit, or other form 4. Import financing: Terms of financing and duration 5. Security interest in the event of open account sales 6. Passage of title, delivery, and risk of loss 7. Warranties and product defects 8. Preshipment inspections 9. Export licenses 10. Governing law

INTERNATIONAL PERSPECTIVE 17.3

A Typical Import Transaction

Step 1: Once a product is selected (see section on selecting products), the importer writes to overseas suppliers to send price lists and product catalogues.

Step 2: Upon receipt of the price lists and catalogues, the importer then shows the catalogues to potential customers without disclosing the supplier's name and address.

Step 3: If there is a favorable response from potential customers, the importer contacts the overseas supplier to request for product samples and pays for its shipment by air. In the meantime, importer checks with customs to determine the applicable duty and other import requirements for the product.

Step 4: If the product sample received is found acceptable by importer, the importer then orders a trial shipment by air and makes an advance payment to the supplier. The importer should communicate domestic marking, labeling, and other requirements to the overseas supplier. The supplier's credit references can be obtained

from the supplier, banks, and the U.S. Department of Commerce. Potential customers are approached to place orders for the product.

Step 5: As the goods arrive at the airport, importer arranges with a customs broker to clear customs. The importer sets the selling price.

Step 6: If the trial shipment sells easily, the importer orders large shipments by sea freight and prepares a formal price list and product catalogue.

Pricing the Imported Product

Knowledge of the price structure for imported goods makes it possible to determine the appropriate price to be charged for the merchandise. The price structure in Table 17.4 could be used as a general guide.

Import Marketing Channels

One of the fundamental decisions for foreign suppliers is whether to sell their products directly or through intermediaries. Relying on an intermediary relieves the producer of international marketing activities. However, the producer forgoes part of the export profit and does not obtain firsthand information on the market, and this, in turn, may reduce the firm's product adaptation capacity (International Perspective 17.4).

Two of the important developments in marketing channels have been the involvement of large retail groups in direct importation and the subcontracting abroad of production by major manufacturing companies. In this age of intense competition, firms that manufacture standardized products can no longer rely on firm-specific advantages arising solely from technology. They should focus on ways of minimizing costs by manufacturing certain components (or subcontracting such production) in low-cost countries.

There are three major markets for imported goods in the United States.

1. *Mass markets:* Mass market retailers such as Walmart or ToysRus account for about 55 percent of the U.S. retail market. There are a number of limitations to accessing these markets for new importers. First, they focus on popular and proven items for sale at the lowest possible price. Second, their orders contain a number of conditions that are quite difficult for new importers to meet. These conditions, if unmet lead to penalties and fees. Such conditions include but are not limited to requiring sellers to put the purchase order on all bills of lading, requiring short delivery windows, or imposing other shipping and delivery instructions.
2. *The fashion "trendy" market:* Fashion markets represent less than 10 percent of the U.S. retail market. They focus on exclusive, expensive products for a narrow segment of the market. In view of the unpredictable nature of the market as well as the small orders involved, there is limited competition.
3. *The regular retailers:* These include mainline retail stores (department stores), neighborhood stores, and stores in shopping malls and account for about 35 percent of the market. They are ideal markets for new importers.

TABLE 17.4 Landed-Cost Survey, DM Import Company, Davie, Florida

Supplier: V. Maundo, Nairobi, Kenya	
Quantity: 150 Makonde carvings	
Gross sales price	3,500.00
Less cash discount (15%)	525.00
Net sales price	2,975.00
Landed cost	
Purchase price	2,975.00
Packing	—
Inland freight	—
Duty (2,975 – insurance ($50) + freight (800)) = 7% (2125.70)	48.75
Brokerage and banking charges	160.00
Custom bond fee	50.00
Merchandise processing	8.00
Harbor maintenance fee	2.00
Total landed cost (CIF, Miami)	3,343.75
Expenses	
Advertising	—
Repacking	15.00
Interest	10.00
ABI (Automatic broker interface fee)	10.00
Total landed costs and expense	**3,378.75**
Unit cost	$22.52 per item
Suggested selling price	$45.00
Net Profit	6,750 ($45 x 150) – 3,378.75 (22.52 x 150) = $3,371.25

Note: Markup is generally 60–100 percent for consumer items; 20–30 percent for industrial goods; 250–300 percent for mail-order items.

Independent sales representatives (ISRs) are crucial in helping importers navigate the unchartered territory of import marketing. ISRs help with pricing, distribution, credit checks of buyers, packaging, and other pertinent issues. It is important to sign a formal contract with ISRs covering items such as sales territory, commissions, and incentives.

Financing Imports

Imports can be financed by using methods such as documentary collection, letters of credit, transferable letters of credit, or back-to-back letter of credit. Readers can refer to the section in Chapter 11 on the various types of letters of credit.

INTERNATIONAL PERSPECTIVE 17.4

The Ten Most Common Mistakes of Potential Importers

1. Failure to develop sufficient knowledge of the import process before starting the business including import regulations.
2. Insufficient knowledge of the product to be imported.
3. Insufficient knowledge of the costs involved in obtaining, importing, and marketing a product.
4. Neglecting to seek quality products at lowest possible price.
5. Failure to maintain a good working relationship with suppliers, banks, customs brokers, and other intermediaries.
6. Inability to develop an appropriate price structure.
7. Insufficient knowledge of the market.
8. Insufficient working capital.
9. Unwillingness to modify products to meet regulations or consumer preferences.
10. Failure to invest sufficient time and effort to develop the business.

International Sourcing

The outsourcing of products and services to external suppliers continues to expand, as firms search for ways to lower costs while improving their products to remain competitive. By the end of 1998, it is estimated that U.S. companies had spent more than $100 billion on outsourcing. Outsourcing is commonly used by firms in the areas of communications, computers, and semiconductors. Firms that outsource often realize cost savings and an increase in capacity and quality. In spite of its fast growth, outsourcing is frequently perceived to be poorly controlled, high in cost, and a drain on quality and service performance (for advantages and disadvantages, see International Perspective 17.5). A firm can undertake outsourcing under various arrangements.

INTERNATIONAL PERSPECTIVE 17.5

Advantages and Disadvantages of Outsourcing

Advantages	Disadvantages
1. Lower price	1. Difficulty of evaluating and selecting qualified suppliers
2. Higher-quality products (qualified suppliers)	2. Potential problems with quality and delivery time
3. Supply of products not available domestically	3. Political and labor problems

4. Advanced technology available from foreign sources	4. Paperwork and extra documentation as well as added costs such as freight, insurance import duties, cost of letter of credit, travel, and marking
5. Ability to satisfy countertrade obligations	5. Currency fluctuations and payment problems
6. Improved international competitiveness	6. Difficulty of responding quickly to market

Wholly Owned Subsidiary

A firm may move production of parts or components to an affiliate established in a low-cost location abroad. The firm will then import the output as it is needed. For example, Sony outsources production of parts to its manufacturing plants located in China and other low-cost locations around the world.

Overseas Joint Ventures

A firm can import supplies made under a joint-venture arrangement. For example, Fujitsu imports parts for its DRAMs production from its joint-venture partner in Taiwan. Mitsubishi Electric and Toshiba have also contracted DRAM manufacturing to Taiwanese partners.

In-Bond Plant Contractor

A firm sends raw materials and components to be processed or assembled in a low-cost location by an independent contractor. No customs duty is imposed by the country where the goods are assembled (temporarily imported under bond), and when the products are re-exported to the home country, import duties are imposed only on the value added abroad. The most popular is the maquiladora (manufacturing operations in a free trade zone (FTZ), where factories import material and equipment on a duty-free basis for assembly, processing, or manufacturing and then export the assembled, processed and/or manufactured products, sometimes back to the raw materials' country of origin), which allows U.S. or other foreign companies to combine their technology with low-cost labor in Mexico. The raw materials or components imported in bond and duty free are processed or assembled for eventual re-export. The maquiladora can also be established as a wholly owned operation of the foreign firm.

Contract Manufacturing

A company enters into a contract with a foreign supplier to import a given quantity of products according to specifications. The supplier manages the day-to-day operation of the production process and allows the importer to focus on other core activities. The contract will provide for assurance of quality and quality control. Nortel, a Canadian-based manufacturer of communications equipment, outsources nearly $1 billion worth of components to contract manufacturers abroad. Cisco uses contract manufacturers to reduce production cost

and to focus on research and development. Its products are mostly made by global manufacturers such as Flextronics and Jabil.

Chapter Summary

Selecting products for importation	A. *Reactive approach:* Selecting products without a proper assessment of long-term market needs. Products are found on the basis of market research, trade leads, foreign travel, or trade fairs and selected in terms of certain appealing characteristics such as quality, price, uniqueness, or popularity in the home market. B. *Proactive approach:* Products are developed or designed for the market and intended to solve a given problem faced by consumers.
Steps taken before selecting the product and supplier	1. Purchase a sample of the promising item. 2. Request inspection by customs to determine if there are any restrictions to entry of the product and establish the applicable duty. 3. Check with a freight forwarder about shipping and insurance cost. 4. Estimate the price and determine whether the product can be sold at a competitive price.
Determinants of import volume	1. High per capita income 2. Population size 3. Price of imports denominated in foreign currency 4. Exchange rates 5. Price of domestic goods relative to imports 6. Price elasticity 7. Government restrictions, availability of foreign exchange.
Selecting the supplier: important considerations	1. Product quality, brand name 2. Market appeal, minimum defects 3. Other supplier benefits: timely delivery, warranties, after-sales service, reliability 4. Protection of intellectual property rights.
Import marketing channels	1. Mass markets 2. Trendy markets 3. Regular retail markets
Financing imports	1. Open account 2. Consignment 3. Documentary collection 4. Letter of credit

Review Questions

1. How are products considered for importation?
2. What is contract manufacturing?
3. State some of the factors that determine import volume.
4. Explain the major steps involved in a typical import transaction.
5. What are some of the advantages of outsourcing?

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World Wide Web Resources

Finding Your Partners

Information on trade opportunities and partnerships:
http://www.sba.gov/content/state-trade-and-export-promotion-step-fact-sheet
http://www.agoa.gov/tradelinks/tradelinks.html
http://www.dmoz.org/Business/International_Business_and_Trade/Import_and_Export/Portals/Trade_Boards/

Learn How to Trade

U.S. Customs and Border Protection guide to importation and planning for growth:
http://www.unzco.com/basicguide/c2.html
http://www.cbp.gov/xp/cgov/trade/

Trade Shows

Information on international trade shows and conferences:
http://www.biztradeshows.com/
http://www.globalsources.com/TRADESHW/TRDSHFRM.HTM

Case 17.1 The ATA Carnet: Unlocking Customs for Temporary Entry of Goods

The ATA Carnet is an international customs document used by travelers to temporarily import certain goods without paying tariffs or going through customs formalities. The term "ATA" stands for the French words "Admission Temporaire." It is created by an international convention to promote world trade and can be used in more than ninety countries. Major trading nations such as EU member countries, Australia, Canada, China, Hong Kong, India, Israel, Japan, Malaysia, New Zealand, South Africa, Thailand, and the United States all accept ATA carnets. The United States acceded to the ATA carnet convention in 1986.

In the United States, carnets are issued and guaranteed by the U.S. Council for International Business (USCIB). The USCIB is liable for the payment of liquidated damages to customs in the event that the carnet holder fails to comply with customs regulations. The carnet is valid for one year from the date of issuance.

There are a number of benefits that can be derived by importers from using the ATA carnet. First, it enables them to avoid complicated customs procedures. The ATA carnet allows the importer to use a single document for clearing goods through customs in several different countries. It also allows for unlimited exits from and entries into the United States and participating foreign countries during the one-year period of validity. Second, the importer will not be required to pay customs duty or to post a temporary import bond.

ATA carnets cover virtually all goods except food and agricultural products (consumables), disposable products, and hazardous items. Merchandise intended for sale or resale must be entered as a regular customs entry. The ATA guaranteeing association (USCIB in the case of the United States) requires a security deposit (about 40 percent of the value of goods) to cover any customs claim that might arise from a misused carnet. The deposit is returned upon the cancellation of the carnet. Application for a carnet is made online at www.merchandisepassport.org.

In the case of certain countries that do not accept ATA carnets, companies can apply for a temporary import bond (TIB), a document that can be purchased from a customs broker at the time of entry. TIB deposits and payments are made in the importing country each time a product is imported.

Harley-Davidson moved its classic bikes, motorcycle parts, and artifacts to ten cities around the world, including Barcelona, Hamburg, Toronto, Sydney, and Tokyo and back to its headquarters in Milwaukee, Wisconsin, in 2002–2003 using the ATA carnet. The tour, intended to celebrate the company's one hundredth anniversary, was made easier by the carnet, which eliminated the need to pay duties and taxes and reduced the delays and costs of physically crossing international borders.

Questions

1. Identify a company in a specific sector and determine how it can take advantage of the ATA carnet system.
2. Are there any disadvantages in using the ATA carnet?

Case 17.2 Maytag's Triad Strategy

Firm strategy plays an important part in determining the competitiveness of an industry in a global market. As governments embrace trade liberalization, local industries have become increasingly exposed to fierce competition from a growing array of international suppliers. Domestic producers of bulk appliances like dishwashers and refrigerators were largely insulated from foreign competition because of their size, which makes them expensive to ship across the ocean. However, low labor and production costs added to declining transportation costs have enabled many Asian appliance makers such as China's Haier Group and South Korea's LG Electronics to increase their U.S. market share. They are also opening plants in Mexico and neighboring countries to save on shipping.

Maytag had to adjust to the new competition through global sourcing and collaborative supply chain networks. In the case of dishwashers, its triad strategy entails sourcing the motors from suppliers in China, producing wire harnesses in Mexico, and assembling the parts in Jackson, Tennessee.

Dispensing certain activities across the transnational value chain to lower costs and gain competitive advantage is considered a successful global business strategy. This approach allows U.S. companies to share the risk with suppliers and to choose foreign companies with the best product lines or services.

Maytag selected certain suppliers (of motors for dishwashers) from China largely due to their low prices. However, it decided to make the wire harness in Mexico because they tend to be different in each model, and sudden shifts in demand require proximity to the market.

Questions

1. Would you advise Maytag to produce motors for the dishwashers in Mexico in view of the latter's proximity to the U.S. market?
2. Would you advise Maytag to lobby the government for higher tariffs on imports of motors and /or wire harnesses so that it could produce them in the United States for the domestic and export market?

eighteen
The Entry Process for Imports

All goods entering the United States are subject to certain customs procedures regardless of their value or dutiable status. Duties accrue upon the imported merchandise on arrival of the vessel within the customs port (or on arrival of the merchandise within the territory of U.S. Customs and Border Protection [CBP] for other means of transport). The making of an entry is generally required within five working days after arrival of the importing vessel or aircraft. "Entry" is the act of filing the necessary documentation with the customs officer to secure the release of imported merchandise. If entry is not made within fifteen calendar days after arrival of the goods, the goods are placed in a warehouse at the risk and expense of the importer. They may be sold at public auction if entry is not made within six months from the date of importation. Goods subject to depreciation (perishables) and explosive substances may be sold earlier (International Perspective 18.1).

Goods may be entered by the owner, purchaser, an authorized regular employee, or a licensed customs broker. When the goods are consigned to "order," the bill of lading, properly endorsed by the consignee, may serve as evidence of a right to make entry. An air waybill may be used for merchandise arriving by air. A nonresident consignee has the right to make entry, but any bond taken in connection with the entry shall have a resident corporate surety (in the case of a carnet, a resident guaranteeing association). A foreign corporation in whose name a product is entered must have a resident agent at the place where the port of entry is located. In most cases, entry is made by a person (firm) certified by the carrier bringing the goods to the port of entry. The person (firm) entering the goods is considered the "owner" for customs purposes. The carrier issues a "carrier's certificate" stating that the consignee named in the document is the owner or consignee of the goods. In certain cases, entry may be made by means of a duplicate bill of lading or a shipping receipt (in the latter case, entry must be made by the actual consignee or duly authorized agent). Where the goods are not imported by a common carrier, entry is made by the importer who possesses the goods at the time of arrival.

The importer or agent pays the estimated duty at the time of making entry even though customs has not yet liquidated the entry (i.e., final assessment of duty has not been made). Imported goods are not legally entered until after the shipment has arrived within the port of entry, delivery of merchandise has been authorized by customs, and estimated duties have been paid. It is the responsibility of the importer to arrange for examination and release of the goods. The required documentation can now be transmitted electronically to customs. CBP is in the process of moving toward a new paperless system in which importers can file their entries from a single location and clear shipments in hours instead of days (see International Perspective 18.4 for automated services).

CBP processed 29 million trade entries and collected about $31.4 billion in tariffs, taxes, and user fees in 2005. Additional revenues accrue from confiscations of cash allegedly involved in money laundering, penalties for violations of import quotas, and so forth (Bovard, 1998). In addition to CBP, importers should contact other agencies when questions regarding particular commodities arise. Questions with respect to imports of products regulated by the Food and Drug Administration (FDA), for example, should be forwarded to the nearest FDA district office. Similarly, the respective federal agencies should be consulted whenever an imported product is subject to their regulatory regimes.

The Entry Process

Filing Entry Papers

The entry process requires filing the necessary documents to enable customs to determine whether the merchandise may be released from its custody, as well as for duty assessment and statistical purposes. Both of these processes can be accomplished electronically via the Automatic Broker Interface Program. What are entry documents? Entry documents generally consist of (1) an entry manifest (Form 7533) or application and special permit for immediate delivery (Form 3461); (2) a commercial invoice (or pro forma invoice when the commercial invoice cannot be produced); (3) a bill of lading, air waybill, or other evidence of right to make entry; (4) a packing list, if appropriate; and (5) other documents necessary to determine the admissibility of the merchandise. This may include information to determine whether the imported merchandise bears an infringing trademark. If the goods are to be released from customs on entry documents, an entry summary for consumption must be filed. An entry summary includes the entry package returned that allows for release of merchandise and other forms (Form 7501) (see International Perspective 18.2 for different types of entries).

Release of Merchandise and Deposit of Estimated Duty

Once the complete entry is made by filing with customs (i.e., the declared value, classification, and rate of duty applicable to the merchandise, as well as an entry summary for consumption), the product is released by customs and the estimated duty deposited. A bond must be posted before filing the entry summary to guarantee payment of duties or taxes upon the final assessment of duties or other fees by customs (liquidation of entry). Bonds are required for almost all formal entries and may be required for some informal entries and

temporary importation under bond entries. There are also bonds covering the activities of warehouse proprietors, carriers, and so on.

If goods are to be released upon entry, an entry summary for consumption must be filed and estimated duties deposited at the port of entry within ten working days of the goods' entry. Immediate release of a shipment can be obtained through a special permit (Form 3461) prior to arrival of the goods. Carriers participating in the Automated Manifest System can receive conditional release authorizations after leaving the foreign country and up to five days before landing in the United States. Upon approval by CBP, shipments are released expeditiously after arrival of the merchandise. However, entry summary must be filed and estimated duties deposited within ten working days after release. Immediate delivery release is allowed for certain types of goods: articles for a trade fair, shipment consigned to an agency of the U.S. government, tariff quota merchandise (in some cases, merchandise under absolute quota), or merchandise arriving from Canada or Mexico (when approved by bond director and bond is on file). In cases where articles subject to different rates of duty are packed together, the commingled articles shall be subject to the highest rate of duty applicable to any part of the commingled lot. However, the consignee or agent can segregate the merchandise to allow customs agents to ascertain the appropriate duty (within thirty days after notice by customs of such commingling).

A bond is different from a carnet because the latter serves as a customs entry document and as a customs bond. Carnets are ordinarily acceptable without the need for additional security. Institutions that issue carnets or guarantee the payment obligation under carnets must be approved by CBP. In cases where a carnet is not used, a bond is usually required to secure a customs transaction. A single-entry bond application is made by the importer or designated person to secure the entry of a single customs transaction, while a continuous-bond application is made for multiple transactions. Such application is made to the port director. A single-entry bond is generally for the value of the merchandise plus duties, taxes, and fees. Customs bonds (usually 10 percent of the duties, taxes, and fees paid by the importer during the previous thirteen months) are valid until canceled either by the importer or surety. In lieu of a bond, an importer may pledge cash, savings bonds, or Treasury notes. Bonds and /or cash are held until one year after an importation is liquidated (in the case of transportation under bond, the importer demonstrates that the merchandise was either exported or destroyed properly). Customs bonds can be terminated by sending a letter to the port where the bond was originally registered, and the cancellation takes effect ten days after the request is received (sureties are required to send a request to customs and principal, and this takes effect thirty days after receipt).

Bonds may be secured through a resident U.S. surety company, through a resident and citizen of the United States, or in the form of cash or other government obligations. The list of corporations authorized to act as sureties on bonds and the limits of their bonds is published by the Treasury Department. If individuals sign as sureties, customs often requires two sureties on a bond to protect the revenue and to ensure compliance with the regulations. There are also other requirements that individuals have to meet to act as sureties: U.S. residency and citizenship, evidence of solvency and financial responsibility, and ownership of property that could be used as security within the limits of the port where the contract of suretyship is approved. The current market value of the property less any debts must be equal to or greater than the amount of the bond. In the event of default by the importer, the surety and importer are liable to pay liquidated damages to customs (Serko, 1985) (Table 18.1).

TABLE 18.1 Bond Requirements by U.S. Customs and Border Protection (CBP)

Type of bond	Bond requirements
Single transaction bond	
A. Basic single entry (for general goods)	Value + duty
B. Quota or visa entries	3 x value
C. Temporary importation	2 x estimated duty
D. Entries requiring compliance with other federal agencies	3 x value
E. Goods unconditionally free of duties	10 percent of value
F. Autos	3 x value
G. Antidumping/countervailing duties	Established by CBP
Continuous bond	
A. Basic entries	10 percent of annual estimated duties for the next calendar year and rounded up to the next $10,000 but not less than $50,000
B. Goods conditionally free of duties	10 percent of duty applicable if the merchandise were dutiable
C. Goods unconditionally free of duties	0.5 percent x annual estimated import value

INTERNATIONAL PERSPECTIVE 18.1

Avoiding Errors in Invoicing

Any inaccurate or misleading representation or omission of required information in an invoice presented to customs pertaining to an entry may result in delays in the release of merchandise or claims against the importer (unless the importer can establish due diligence). The invoice should reflect the real nature of the transaction. All invoices must include the following information:

- Description of port of entry and detailed description of merchandise, including grade, quality, quantity, and marks and numbers (for product and/or packages as the case may be) under which the product is sold.
- Description of the name of the actual seller, the importer, and the place and date of sale. It should also include the purchase price in the currency of sale. In the event that the product is shipped other than in pursuance of a purchase agreement, the invoice must state the value that the owner or shipper would have received in the ordinary course of trade.
- All charges included in the invoice price, including commissions and insurance, as well as any rebates or drawbacks allowed upon exportation of the merchandise. It should also state the value of any materials supplied by the importer.
- Any discounts as well as charges incurred by seller or consignee to deliver the merchandise to buyer and not just the FOB price.

INTERNATIONAL PERSPECTIVE 18.2

Types of Entry

Entry for consumption: This is the most common type of entry. Merchandise that is not held for examination is released under bond. Even in cases where examination is required (e.g., to determine value, dutiable status, and proper markings or whether shipment contains prohibited articles), certain packages are designated for examination while the rest of the shipment is released under bond.

Entry for warehouse: Imported goods may be placed in a customs bonded warehouse and payment of duties deferred until the goods are removed for consumption. No duty is payable if they are re-exported or destroyed under customs supervision. Goods may be manipulated, sorted, or repackaged in the bonded warehouse for eventual consumption or export. In this case, the duty payable is for the manipulated or new product at the time of withdrawal. Goods may remain in a bonded warehouse up to five years from the date of importation.

Entry for transportation in bond: Merchandise may be entered for transportation in bond without appraisement to any other port of entry designated by the importer. Only an entry for consumption is accepted if more than a year has elapsed since the date of original importation (Customs Form 7512).

Informal entry: Under this category are commercial entries valued at under $2,000, household and personal effects, and tools of trade. This does not require the same formalities as consumption entry and is also liquidated at entry.

Mail entry: Merchandise that is imported by mail. No entry is required on duty-free merchandise not exceeding $2,000 in value. There is also no need to clear shipments for imports of under $2,000 in value (e.g., parcel delivered by letter carrier). For merchandise whose value exceeds $2,000, formal entry (consumption entry) is required. For mail entry of certain products such as furs, leather, and footwear, the limit is $250.

Temporary importation under bond: Certain types of goods that are not imported for sale (or sale on approval) are admitted without payment of duty, under bond, for exportation within one year (can be extended up to three years upon application to the port director) from the date of importation. This generally includes merchandise imported for repair, articles used as models, samples, and animals and poultry imported for breeding. The ATA carnet can be used for this purpose.

Drawback entry: A refund of 99 percent of all customs duties is allowed under certain conditions: (1) if the imported material is exported in the same condition as when imported or when destroyed under customs supervision within three years of the date of importation, or (2) if the imported merchandise is used in the manufacturing process and exported within five years from the date of importation.

Liquidation, Protests, and Petitions

Liquidation is the final ascertainment of the duties and drawback accruing on an entry by customs. Liquidation is required for all entries of imported merchandise except the following: temporary importation bond entry, transportation in bond, and imports that are subject to immediate exportation. The liquidation procedure involves determination of the value of

imports, ascertainment of their classification and applicable rate of duty, and the computation of the final amount of duty to be paid. Customs will then establish whether any additional (excess) duty has to be paid (refunded) to the importer as the case may be and notify the importer, consignee, or agent of the liquidation by posting a public notice. A formal entry is liquidated when an entry appears on the bulletin notice of liquidation posted in customs.

It is also important to note the following:

- *Limitation on liquidation:* If imported merchandise is not liquidated within one year from the date of entry, it is considered liquidated at the rate and amount of duty stated at the time of entry.
- *Voluntary reliquidation by customs:* Customs could reliquidate any entry within ninety days from the date of notice of the original liquidation.
- *Liquidation for informal, mail, and baggage entries:* The effective date of liquidation for such entries is the date of payment of estimated duties upon entry of merchandise or the date of release by customs under free duty or permit for immediate delivery (Rossides, 1986).

Conversion of Currency

The date of exportation of the goods is the date used to determine the applicable rate of exchange for customs purposes.

Liquidation is not final until any protest that has been filed against it has been decided. An importer who disagrees with the liquidation of an entry may file a protest in writing within ninety days after the date of notice of liquidation. The protest could be with respect to any one or more of the following: the appraised value of the merchandise, classification, duties and other charges, the exclusion of a product from entry, or the refusal to reliquidate an entry. If a protest is denied by the district director, the importer can appeal to the Court of International Trade. The parties have a right to further appeal to the Court of Appeals for the Federal Circuit and from there to the highest court in the country, the Supreme Court of the United States. An importer can also request a further review of the protest beyond than that provided by the district director. If the protest is denied by the latter, the matter is forwarded for review by the regional commissioner.

Any interested party could file a petition with the secretary of the Treasury if the individual or group believes that the appraised value, classification, or rate of duty for an imported merchandise is not correct. The term interested party includes manufacturers, producers, wholesalers, or trade unions in the United States.

The Harmonized Code (HS Code)

The HS code is a harmonized commodity description and coding system that is used for classifying traded products. The Harmonized System was developed under the auspices of the World Customs Organization (WCO), with the active participation of governments and private organizations. Since entering into force on January 1, 1988, the HS has been partially amended every four to six years to bring the HS nomenclature in line with the current international trade patterns, technological progress, and customs practices. It is used by more than 200 countries and customs or economic unions representing about 98 per cent of world trade.

The major benefits of adopting the harmonized system are as follows:

- The HS Code will be in line with the tariff determination procedures of most countries of the world (in the United States, it is called the Harmonized Tariff Schedule of the United States or HTSUS).
- It facilitates the shipment and documentation of merchandise and creates a uniform and familiar system for exporters shipping to other countries.
- Such uniformity in classification and coding across countries simplifies the conduct of international trade negotiations and increases the accuracy of international trade statistics.

The HS Code classifies goods according to their "essential character" or, in the case of apparel, on the basis of the fiber of chief weight. It is a detailed classification system containing approximately 5,300 headings and subheadings organized into ninety-nine chapters and twenty-one sections (Tables 18.2 and 18.3). The six digits can be broken down into three parts. The first two digits (HS-2) identify the chapter the goods are classified in (e.g. 09 = Coffee, Tea, Maté, and Spices). The next two digits (HS-4) identify headings within that chapter (e.g. 09.02 = Tea, whether or not flavored). The next two digits (HS-6) are even more specific (subheadings) (e.g. 09.02.10 = green tea [not fermented]). HS Code up to the six-digit level is followed internationally and is common to all countries.

In the example in Table 18.2, lentil is coded as 071340 in Turkey, the United States, and Canada. However, some countries add more digits (the United States, South Korea, the European Union, and Canada add four additional digits (total of ten digits); Turkey adds six more digits; India adds two more digits; and Japan adds three more digits) to suit their national statistical and trading needs.

Goods imported are subject to duty or duty-free status in accordance with their classification under the U.S. code (HTSUS). Duty-free status, for example, is available under certain conditional exemptions provided in column 1 of the tariff schedule. Column 2 is intended for countries that do not qualify for the most-favored-nation (MFN) duty rate, and imports under this category are subject to the highest rate (Table 18.3). In cases in which the correct classification is not certain or the product falls under more than one classification, it is important to resort to the body of interpretative rules provided under the HTSUS or to seek a binding tariff classification ruling from customs, which can be relied on before placing or accepting orders. Although the average tariff rate in the United States is now around 5 percent, some imports are subject to high tariffs: watch parts (151.2 percent), some shoe imports (67 percent). In certain cases, it is also possible for customs to reverse its classification even

TABLE 18.2 Classification of Lentil Under the HS Codes of Turkey, the United States, and Canada

Country	Turkey	United States	Canada
HS Code	0713.40	0713.40	0713.40
Seeds for sowing	0713.40.00.00.11	0713.40.10.00	0713.40.00.10
Green	0713.40.00.00.12	0713.40.10.10	0713.40.00.91
Red	0713.40.00.00.13	0713.40.10.30	0713.40.00.92
Other	0713.40.00.00.19	0713.40.10.80	0713.40.00.99

TABLE 18.3 Harmonized Tariff Schedule of the United States

Heading/ subheading	stat. suffix	Article description	Units of quantity	Rates of duty/general	Special	2
4902		Newspapers, journals and periodicals, whether or not illustrated or containing advertised material: appearing at least four times a week				
4902.10.00	00		Kg	Free	Free	Free
4902.90		Other:				
4902.90.10	00	Newspaper supplements printed by a granure process	No	1.6 percent	Free (A,CA,E, IL, MX)	25 percent
4902.90.20			Free	Free		
	20	Other: Newspapers appearing less than four times a week	Kg			
	40	Other business and professional journals and periodicals	No			
	60	Other (including single issues tied together for shipping purposes	No			

Note: CA = Canada (import from Canada), A = GSP countries, MX = Mexico, E = Caribbean Basin countries, IL = Israel, J = Andean Preference Pact.

Rates of Duty—General: GATT members and others obtaining such status by a bilateral agreement; Special: Imports from countries accorded special duty treatment (i.e., Canada, Mexico, GSP countries); 2: Countries not friendly to the United States (e.g., Libya, North Korea).

after the product has been imported and used. The U.S. Customs Service reversed its decision on imports of muffin mix toppings in 1996 and required the importer to pay a $750,000 penalty for violating the U.S. sugar quota (the decision was, however, reversed for the second time). In another case, imports of large antique red telephone booths were blocked on the grounds that the product was actually a steel product restricted by import quotas (Bovard,

1998). Thus, one cannot overemphasize the importance of obtaining expert opinion, seeking an advance ruling by customs, or establishing reliable procedures on the correct description and classification of a given product before importation.

It is also important to note that the term "HTSUS" is used for imports and that the classification is managed by the Office of Tariff Affairs and Trade Agreements within the International Trade Commission (ITC). When one is exporting from the United States, the system of classification is called Schedule B and is managed by a different agency, the U.S. Census Bureau. HTSUS and Schedule B are identical up to the six-digit level but may vary at the level of the commodity code.

Customs Valuation

In 1979, the United States adopted the customs valuation system that was the result of the Tokyo Round negotiations of the GATT. Valuation of a product is important because most imported products are subject to tariffs based on the percentage of the value of the import (ad valorem rate). It also helps countries to maintain accurate and comparable records of their international trade transactions (International Perspective 18.3).

Imported merchandise is appraised on the basis and in the order of the following:

1. Transaction value
2. Deductive value
3. Computed value

The Transaction Value

Transaction value is the invoice price of the goods as they enter the United States. In determining transaction value, the price actually paid or payable will be considered without regard to its method of derivation. The value includes various costs that enhance the good's value to the importer (i.e. packing costs, sales commissions, and royalties). It also includes any direct or indirect items provided by the buyer free of charge or at a reduced cost for use in the production or sale of merchandise for export to the United States. In short, the transaction value is the price actually paid or payable for imported merchandise, excluding international freight, insurance and other CIF charges. Transaction value cannot be used in the following situations:

- In cases in which the transaction value cannot be determined (e.g., proceeds of subsequent sales) or is not acceptable (related-party transactions)
- In cases involving restrictions on the sale or use of the product.

Example 1: A foreign shipper sold merchandise at $1,500 to a U.S. buyer. The seller subsequently increased the price to $1,650. The invoice price is $1,500 because that was the price agreed to and actually paid by the importer. The merchandise should be appraised at $1,500 because that was the price actually paid by the buyer—the transaction value.

Example 2: DM, Inc., a firm located in Miami, Florida, purchased 10,000 barrels of crude oil from a Venezuelan oil company, Soto, Inc., for $250,000. The

price consists of $200,000 for the oil and $50,000 for ocean freight and insurance. Soto would have charged $210,000 for the oil. However, since it owes DM $10,000, Soto charged DM only $200,000 for the oil. The transaction value is $210,000, that is, the sum of ($200,000 + $10,000), excluding CIF charges of $50,000 for ocean freight and insurance.

If the transaction value cannot be determined, the transaction value of an identical product or, in the absence of the latter, the transaction value of a similar product (commercially interchangeable) will be used. The transaction value of identical and similar merchandise (ISM) will be used under the following circumstances:

- The products (ISM) must have been sold for export to the United States at or about the same time as the merchandise being appraised.
- Value must be based on sales of ISM at the same commercial level and in substantially the same quantity as the sale of the merchandise being appraised.
- The ISM must be produced in the same country and by the same person (if not available, by a different person) as the merchandise being appraised.
- In cases involving two or more transaction values for ISM, the lowest value will be used as the appraised value of the imported merchandise.

Deductive Value

This method is used when the transaction value cannot be determined, such as sales between related parties. However, if the importer designates computed value as the preferred method of appraisement, the latter can be used as the next basis of determining value. Deductive value is essentially the resale price of an imported product, with deductions for commissions, profit, and general expenses; transportation and insurance costs (from the country of export to the United States); import duties and taxes; and any cost of further processing after importation. The deductive value is generally calculated by starting with the unit price and making additions to (such as packing costs) and deductions from that price (see International Perspective 18.3).

Example 1: Merchandise is sold to an unrelated person from a price list that provides favorable unit prices for purchases in larger quantities:

Total Quantity Sold	***Unit Price***
65	$90.00
50	95.00
60	100.00
25	105.00

In this example, the unit price used in determining deductive value is $90, since the greatest quantity is sold at that price.

Example 2: A foreign parent company sells parts to its U.S. subsidiary in Texas. The product is not sold to unrelated parties, and there is no similar or identical merchandise from the country of production. The U.S. subsidiary further

processes the product and sells it to an unrelated buyer in Florida within 180 days after importation.

In this example, the merchandise should be appraised under deductive value, with allowances for profit and general expenses, freight and insurance, duties and taxes, and the cost of processing.

Computed Value

The computed value starts with the costs of the materials, labor, and overhead in producing the imported goods. Customs then adds profits and general expenses incurred by the producer (based on average estimates for similar goods in the same country), as well as the prorated value of any materials supplied by the buyer free of charge or at reduced price and packing costs (U.S. Department of Commerce, 2003).

Example: Suppose that under Example 2 the U.S. importer requested that the shipment be appraised under computed value. The merchandise is appraised using the company's profit and general expenses if not inconsistent with sales of merchandise of the same class or kind.

If none of the previous methods can be used to appraise the imported merchandise, the customs value is based on a value derived from one of these methods, reasonably adjusted or administered flexibly. If an identical or similar product, for example, is not available in the exporting country, customs could appraise an identical or similar product from a third country to determine value.

INTERNATIONAL PERSPECTIVE 18.3

Unit Price in Deductive Value

One of three prices is used based on time and condition of sale:

- If the merchandise is sold in the condition as imported at or about the date of importation of the merchandise being appraised, the unit price used is the one at which the greatest quantity of the product is sold.
- If the merchandise is sold in the condition as imported but not sold at or about the date of importation of the merchandise being appraised, the unit price used is the one at which the greatest quantity of the merchandise is sold before the ninetieth day after the date of importation.
- If the merchandise is not sold in the condition as imported and is not sold before the close of the ninetieth day after the date of importation of the merchandise being appraised, the unit price used is the one at which the greatest quantity (after processing) is sold before the eightieth day after the date of importation. An amount equal to the value of the further processing is deducted from the unit price in arriving at the deductive value. This method cannot be used if the further processing destroys the identity of the merchandise.

Rules of Origin and Other Marking Requirements

Imported articles are to be marked with the name of the country of origin to indicate to the ultimate purchaser the name of the country in which the product was manufactured. The ultimate purchaser is generally the last person in the United States who will receive the article in the form in which it was imported.

Country-of-origin determination is important because imports are subject to selective tariffs and nontariff barriers depending on the origin of the merchandise. Country-of-origin is the country of manufacture, production, or growth of an article. Most imports, for example those from Canada and Mexico, enter duty free, whereas those from other nations are subject to a higher tariff, a quota, or even an import ban (e.g., on imports from Cuba and North Korea). Customs uses the "substantial transformation test" to determine the country of origin of a product that is made up of components or materials from several different countries. The country of origin is determined to be the one where the product was substantially transformed in its current state (Buonafina and Haar, 1989).

Markings must be legible and located in a conspicuous place, where they can be seen by someone who is handling the merchandise casually. They should be capable of remaining (permanently) on the article during transportation or handling. In the case of certain articles for which marking is not required, such as artworks, lumber, and sugar, their containers must be marked to indicate the English name of the country of origin. There are also special marking requirements for certain articles, for example, watches, surgical instruments, knives, razors, steel, pipes, and vacuum containers. However, marking is not required for imports not intended for sale (personal use items), products used for further processing, crude substances, or items that are incapable of being marked or cannot be marked without injury or prohibitive expense. Other articles not required to be marked with the country of origin include articles valued at no more than $200 that are passed without the filing of a customs entry, articles brought into a foreign trade zone or a bonded warehouse for immediate exportation, and certain coffee, tea, and spice products. Notwithstanding the exemption, the containers must be marked to show the country of origin of such articles, according to the Code of Federal Regulations (19 CFR 1304).

INTERNATIONAL PERSPECTIVE 18.4

Automated Services in the United States to Facilitate International Trade

- **Automated Broker Interface (ABI):** The Automated Broker Interface is a component of the U.S. CBP's Automated Commercial System that permits participants to electronically file required import data with Customs. ABI participants include brokers, importers, carriers, port authorities, and independent service centers. Presently, more than 96 percent of all entries are filed through ABI. ABI speeds up the release of merchandise. Entry summaries are electronically transmitted, validated, confirmed, corrected, and paid. Participants are also informed of current information. Participants can request quota status, visa requirements, and entry or entry summary status. ABI allows filers to pay for multiple entries with one payment transaction.

- **Automated Clearing House (ACH):** The Customs Automated Clearing House is an electronic payment option that allows participants to pay customs fees, duties, and taxes electronically. Participants' banks must belong to the National Clearinghouse Association. The accuracy and speed of ACH result in a higher volume of transactions.
- **Automated Export System (AES):** The Automated Export System is a joint undertaking of the Bureau of Export Administration, CBP, and other federal agencies intended to assure compliance with U.S. export regulations and improve trade statistics. Its objective also includes introduction of a paperless reporting system for export information by 2002, which was partially accomplished.
- **Automated Information Systems Security Policy (AIS):** This policy provides guidance for the protection of AIS resources by establishing uniform policies and procedures for the Customs AIS Security program. It provides security for information that is collected, processed, stored, or transmitted.
- **Automated Manifest System (AMS):** This is a cargo inventory control and release notification system. AMS interfaces with other systems such as ABI to allow for faster identification and release of low-risk shipments. It speeds the flow of cargo and entry processing and provides participants with electronic authorization of cargo release prior to arrival. It also facilitates the intermodal movement and delivery of cargo.
- **AMS paperless master in-bond participants:** This program is designed to take advantage of the detailed information available within the AMS to control the movement and disposition of master in-bond shipments from the custody of the ocean carrier at the port of unlading to the same carrier's custody at the port of destination. AMS tracks and records such merchandise.
- **Cargo Selectivity:** This system is used to sort high-risk cargo from low risk cargo and to determine the type of examination required. It accepts data transmitted through ABI and compares it against established criteria.

Chapter Summary

<table>
<tr><td>Entry of imports</td><td>Entry is the act of filing the necessary documentation with customs to secure release of imported merchandise.
Accrual of duties on imports
1. On arrival of the vessel: Upon arrival of vessel within the U.S. customs territory
2. Arrival of merchandise: Upon arrival of merchandise within the U.S. customs territory (for other means of transport)
Who May Enter the Goods
Owner, purchaser, authorized regular employee, or a licensed customs broker
Documentation Required to Enter Merchandise
Entry manifest, commercial invoice, pro forma invoice, packing list, and other necessary documents</td></tr>
</table>

(*Continued*)

	Release of Merchandise After complete entry is made, product is released by customs and estimated duty paid. A bond must be posted to guarantee payment of duty upon final assessment of duty. A bond may be secured through a resident surety company, resident, citizen, or posted in the form of cash or other government obligations. Liquidation and Protests 1. *Liquidation:* This involves the final ascertainment of the duties and drawback accruing on an entry by customs. 2. *Protests:* If an importer disagrees with the liquidation of an entry, it is possible to file a protest in writing with the district director within ninety days after notice of liquidation. The decision can be appealed to the Court of International Trade, the Court of Appeals for the federal circuit, and the Supreme Court of the United States.
Harmonized Tariff Schedule of the United States (HTSUS)	HTSUS is a commodity description and coding system that is used by many countries. It classifies goods according to their essential character.
Customs valuation	Imported merchandise is appraised on the basis and in order of the following: 1. *The transaction value:* Invoice value of the goods as they enter customs. 2. *The deductive value:* Resale price of imported merchandise with deductions for profit and general expenses. 3. *The computed value:* Cost of materials, labor, and overhead in producing the imported product plus profits and general expenses incurred by the producer and value of any items supplied by buyer.
Rules of origin and other marketing requirements	*Marking requirements:* Every imported article must be legibly marked with the English name of the country of origin unless otherwise indicated.

Review Questions

1. When do duties accrue upon imported merchandise?
2. What is entry of goods? Who may enter the goods?
3. Explain the difference between a single-entry bond and a continuous-entry bond.
4. What happens to merchandise that is not liquidated within one year from the date of entry?
5. Discuss the advantages of HTSUS.
6. Briefly describe computed value.
7. Why do importing countries require certificates of origin?
8. Describe some of the automated services at CBP.
9. What is liquidation of entry?
10. Transaction value cannot be used in certain circumstances. Discuss.

Minicase 18.1

A U.S. makeup retailer imports lipstick from an unrelated Mexican company that uses the materials identified in the table and faces costs identified for materials used in the assembly of one tube of lipstick. In Mexico, the company assembles the materials into a finished product (a tube of lipstick packaged for retail sale). Upon importation of the product, the retailer, who is also the importer of record, intends to sell the lipstick for "cost + 20%."

Part no (PN)	Description	Cost	Country of origin
1.	Plastic tube base	$0.05	Mexico
2.	Plastic tube cover	$0.05	Mexico
3.	Plastic swivel base	$0.05	Canada
4.	Metal shell	$0.05	China
5.	Metal collar	$0.05	China
6.	Small round mirror that attaches to bottom of PN 1	$0.05	United States
7.	Lipstick mass	$0.55	France
8.	Packaging material	$0.10	United States

1. What is the per unit entered value?
2. What is the country of origin for the retail package?

Minicase 18.2

TABLE 18.5

COMMERCIAL INVOICE

DONGA MICHAEL, INC.

Shipper/Exporter		**No. and Date of Invoice**
Donga Michael, Inc. 570, Freedom Road, Taeu Seoul, Korea		US0001E Wednesday, November 12, 2014
For Account and Risk of Messers		**No. and Date of L/C**
Tom Salves Stores 23 Furn Rd. Ft. Lauderdale, Fl. 45682		**L/C Issuing Bank**
Notify Party		
		Remarks
Port of Lading	**Final Destination**	P/O No.: IWUVU1
Kimpo, Korea	Seattle, WA	
Carrier	**Departure on or about**	Marks and Numbers of Pkgs.
Aircraft United Parcel Service	November 18, 2006	

Description of Goods	**Quantity**	**Unit Price**	**Amount**
1. Country of Origin: Korea Men's 100% Cotton Knit Polo Shirt Stitch count of 12 stitches per 2 cm in each direction PN: POKNSHRT	1,000pcs	1.50 USD	$1,500
2. Country of Origin: Japan Women's Cotton Knit Black Bras Containing Lace PN: AB40ZYI	1,200pcs	2.00 USD	$2,400
(2%, Net 15 Days) **TOTAL**	**2,200pcs**		**$3,900**

Master Bill: 001-63324833
House Bill: UPS56676406
Estimated Entry Date 11/19/06

1. What is the entered value at customs in Seattle? What is the port code?
2. In June 2006, the Department of Commerce published a countervailing duty order for a 20 percent duty on women's undergarments from Japan. It was effective as of June 1, 2006. What amount is due for this shipment?

Minicase 18.3

1. What is the transaction value of a shipment invoiced at $100,000 if the terms of sale are Delivered Duty Paid (DDP), the ocean freight paid is $6,000, the insurance paid is $850, the duty rate is 6.5 percent, and a harbor maintenance fee and a merchandise processing fee are paid at .125 percent and .21 percent, respectively?
2. Calculate the appraised value for a shipment of 10,000 computer monitors with a unit value of $75 CIF, Los Angeles.

   a. The seller received the cathode ray tubes used in the manufacture of these computer monitors free of charge from a third party that was satisfying a debt owed to the seller of the finished computer monitors.
   b. The cathode ray tubes, including transportation and insurance, would have cost $25.00 each.
   c. There is no through bill of lading associated with this entry.
   d. Foreign inland freight is $1.00 each.
   e. Ocean freight is $2.50 each.
   f. Marine insurance is $0.50 each.

3. What is the dutiable value for the following transaction? The terms of sale are delivered, duty and fees paid, Chicago. The commercial invoice appears as follows:

12,000 dozen baseball caps, @ $30 per dozen	$360,000
International freight charges	2,500
International insurance	800
Brokerage charges	150
Total DDP Price	$363,450

   The caps are classified 6505.90.8090 @ $0.187 per kg. + 6.8%. The net weight of the shipment is 8,000 kgs. The actual ocean freight charges were $2,800. Transaction value is the appropriate basis of appraisement.
4. ____ is the price actually paid or payable for imported merchandise when sold for exportation to the U.S.

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U.S. Department of Commerce (2003). *Importing into the United States.* Rocklin, CA: Prima.

World Wide Web Resources

Import Regulations

Information on the importation of goods to the United States/CBP rules and regulations: http://www.cbp.gov/xp/cgov/import/infrequent_importer_info/internet_purchases.xml; http://cbp.customs.gov/linkhandler/cgov/toolbox/publications/trade/iius.ctt/iius.pdf

Information on tariffs and related matters, including the U.S. Harmonized Tariff Schedule: http://www.usitc.gov/

Publications of U.S. Customs and Border Protection (entry of goods, classification, and valuation of merchandise): http://www.customs.ustreas.gov/xp/cgov/toolbox/publications/

Case 18.1 Deemed Liquidation by Customs

Koyo Corporation of USA (Koyo) imported roller and ball bearings for resale in the United States. At the time of entry, antidumping duty orders issued by the Department of Commerce were in effect. The orders required duty deposits to cover estimated antidumping duties between 48 and 74 percent ad valorem. Liquidation of the entries was suspended due to the ensuing litigation brought by Koyo to roll back the order. The importers (Koyo) were successful, and the rates were substantially lowered.

In view of the successful outcome for Koyo in the litigation, Commerce issued instructions to U.S. Customs and Border Protection to liquidate the entries at lower rates. CBP did not comply with Commerce's instructions. When Koyo contacted customs one year later about the liquidation of its entries, CBP found these entries to have been "deemed liquidated" at the original higher antidumping duty rate.

Koyo took the case to the U.S. Court of International Trade (CIT), protesting the liquidations (after its initial protest was denied by CBP). The issue is whether the deemed liquidations claimed by Customs were justified under existing rules. The requirements for deemed liquidation following antidumping proceedings are that: (1) the suspension of liquidation that was in place must have been removed; (2) Customs must have received notice of the removal of the suspension; and (3) Customs must not liquidate the entry at issue within six months of receiving such notice.

The "deemed liquidation" provision was added to the customs law in 1978 to place a limit on the period within which importers would be subject to the prospect of liability for a customs entry and to terminate the government's cause of action for the entry in question.

The court stated that Congress intended to encourage prompt liquidation and did not intend Customs not to obey its instructions and thereby retain funds to which it no longer had valid claim. It ordered Customs to reliquidate the entries at the appropriate duty rates, as instructed by Commerce, and refund the duties owed with interest to Koyo (2004 U.S. App; Fed. Circ, 2004).

Questions

1. Do you agree with the decision on prompt liquidation?
2. Conduct Internet research to examine the reasons why Congress introduced the provision on "deemed liquidation."

Case 18.2 Product Classification

Better Home Plastics Corp. (BHP) imported shower curtain sets that consisted of an outer textile curtain, an inner plastic magnetic liner, and plastic hooks. While the textile curtain is semitransparent and decorative, the inner liner also matches the curtain and adds to the set's decorative appearance. The sets are sold to retailers at prices ranging from $5.00 to $6.00.

U.S. Customs and Border Protection classified the merchandise under HTSUS 6303.92.0000 at a rate of duty of 12.8 percent ad valorem. BHP protested that classification, stating that the merchandise should have been classified under HTSUS 3924.90.1010 (by the set's inner plastic liner) with a prescribed duty of 3.36 percent ad valorem. According to the General Rules of Interpretation, when goods are classifiable under two or more headings such as textile curtain and inner plastic liner, customs must classify the merchandise based on the heading which provides the most specific description (rule of relative specificity). This rule may not apply in cases where both headings are regarded as equally specific and each refers to only part of the items within the set.

In cases where the rule of relative specificity does not apply, merchandise can be classified by the component that gives their essential character (the essential character test).

BHP contends that the essential-character test must be applied to classify the merchandise on the basis of its inner plastic liner, while Customs believes that the essential character of the product is embodied in the textile curtain because (a) the liner is used for a short time when someone uses the shower while the curtain is employed throughout the day; (b) consumers buy the product because of the decorative function of the outer curtain (not the inner plastic liner); and (c) the plastic liner is usually replaceable at one-third to one-quarter the price of the set.

Questions

1. Do you agree with the position of BHP? Why or why not?
2. What is the essential-character test?

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Import Relief to Domestic Industry

The acceleration in globalization witnessed over the past two decades and the corresponding increased exposure to competition from low-price producers in China and other developing nations have created a new economic environment. Since production costs—especially those that are wage related—cannot be infinitely reduced, the main way for manufacturing firms in those economies to position themselves in domestic and international markets is to focus on offering upgraded and differentiated rather than "mundane" labor-intensive products. However, in an effort to increase market share, many producers and their governments are resorting to unfair trade practices. For example, in October 1999, the World Trade Organization (WTO) dispute resolution panel, responding to a complaint brought by the EU, concluded that the foreign sales corporation program relating to the U.S. tax treatment of its foreign sales corporations constituted an illegal export subsidy and requested its removal. Similarly in 2010, the WTO panel found that U.S. antidumping measures taken against Thailand's exports of merchandise bags were inconsistent with the WTO agreement. The United States has prevailed in several cases pertaining to unfair trade practices affecting its domestic industries.

Import Relief Under the WTO

The WTO's most-favored-nation principle provides for equal treatment of goods and services from all member countries. This principle of nondiscrimination, however, is subject to certain exceptions:

A. Unfair imports
- Actions taken against dumping (selling at an unfairly low price)
- Subsidies and special "countervailing" duties to offset the subsidies

B. Fairly traded imports
- Emergency measures to limit imports temporarily, designed to "safeguard" domestic industries.

Unfairly Traded Imports

Antidumping Actions

The WTO's Antidumping Agreement governs the application of antidumping (AD) measures by WTO member countries. A product is considered to be "dumped" if it is exported to another country at a price below the normal price for a like product in the exporting country. Antidumping measures (the imposition of antidumping duties on the product in question) are unilateral remedies that the government of the importing country may apply after a thorough investigation has determined that the product is, in fact, being dumped and that sales of the dumped product are causing material injury to a domestic industry that produces a like product. Its substantive requirements provide for the calculation of the export price and normal value as a basis for establishing dumping margins (the difference between export price and normal value). Export price is considered to be the price of the product when it is sold to unrelated buyers in the importing country without including shipping charges. If the product is exported from a nonmarket economy country, the agreement provides for the use of "constructed price."

The WTO agreement also sets forth rules for determining whether dumped imports are causing injury to a domestic industry that produces a like product. Injury is defined to mean material injury itself, the threat of material injury, or material retardation in the establishment of a domestic industry. It is important to establish that the dumped imports are a cause of injury to domestic industry. The WTO provides rules and procedures for initiating an antidumping investigation. Dumping disputes may be submitted to the WTO dispute settlement body (DSB) for resolution. It may also review the final antidumping order of administrative agencies for consistency with the agreement. Antidumping duties are applied on all imports of the subject merchandise as long as necessary to counteract dumping that is causing the injury.

Countervailing Duty Actions

The WTO's Subsidies Agreement provides rules for the use of government subsidies and for the application of remedies to address subsidized trade that has harmful commercial effects. These remedies can be pursued through the WTO's dispute settlement procedures or through a countervailing duty (CVD) investigation, which can be undertaken unilaterally by any WTO member government. A subsidy is a benefit by a government to a domestic firm in the form of direct transfer of funds (potential transfer such as a loan guarantee), foregone government revenue such as a tax credit, or the purchase or provision of goods. The WTO allows certain types of government subsidies such as domestic subsidies used to fund social programs, finance R&D, and support firms in meeting one-time costs of environmental requirements. A subsidy granted by a WTO member government is prohibited by the Subsidies Agreement if it is contingent on export performance or on the use of domestic over imported

goods. These prohibited subsidies are commonly referred to as export subsidies and import substitution subsidies (Czako, Human, and Miranda, 2003).

A subsidy granted by a WTO member government is "actionable" under the agreement (again, certain exceptions are made for agricultural subsidies) if it "injures" the domestic industry of another country or if it causes "serious prejudice" to the interests of another country. Serious prejudice can arise in cases where a subsidy impedes or displaces another's country's exports or increases the market share of the subsidizing country. Every WTO member is required to notify the WTO Subsidies Committee each year of any subsidy (as defined by the Subsidies Agreement) that it is granting or maintaining within its territory.

Fairly Traded Imports

The WTO's safeguards agreement establishes rules for the application of safeguard measures by WTO member countries. A safeguard is a temporary import restriction (e.g., a quota or tariff increase) that a country is allowed to impose on a product if imports of that product are increasing to an extent that causes or threaten to cause serious injury to a domestic industry that produces a similar or directly competitive product. Under the WTO rules, member countries must conduct an investigation before they can apply a safeguard measure, and they must make a formal determination that imports of the product are significantly impairing or threatening to impair a domestic industry. They are only temporary (applied up to four years, with the possibility of an extension for another four) and must be applied on a nondiscriminatory basis and removed as conditions warrant. The WTO encourages countries imposing safeguards to compensate exporting nations by reducing tariffs on other products (Trebilcock and Howse, 2005).

U.S. Import Relief to Domestic Industries

The U.S. trade policy is based on combating unfairly traded imports. There are regulations in place to provide relief to domestic producers that are adversely affected by imports that benefit from government subsidies in home countries or are dumped at low prices in the U.S. market. The U.S. rules are largely consistent with the WTO's terms.

Antidumping and Countervailing Duties

U.S. antidumping and countervailing duty laws have been subject to several changes over the years; the most recent amendments were to implement the Uruguay Round Agreements of the GATT. An important effect of the agreement is that it has reduced the discretion previously available to the administering authorities by imposing strict statutory time limits. In the case of an antidumping or countervailing duty petition, for example, domestic authorities are required to make an initial determination within twenty days after the petition is filed. Similar time limits are imposed on the determination of injury. The U.S. Court of International Trade has taken the position that the WTO panel rulings do not have a binding effect (that they are merely persuasive) on U.S. court decisions on such matters (Folsom, Gordon, and Spanogle, 2005).

Antidumping or countervailing duties are a statutory remedy that cannot be vetoed by the president except by negotiation of an international trade agreement. Such an agreement may,

for example, take the form of voluntary export restraints to restrain the flow of the offending goods to the U.S. market.

It is important to describe the terms that are often used in the analysis of unfair trade practices, that is, dumping, subsidies, and material injury.

Dumping is defined as selling a product in the United States at a price that is lower than the price for which it is sold in the home market in the ordinary course of trade (certain adjustments are made for differences in the merchandise, quantity purchased, or circumstances of sale). In the absence of sales or sufficient sales of the like product in the domestic market of the exporting country, dumping may be measured by comparison (1) with a comparable price of a like product sold in a third country, or (2) with the cost of production in the country of origin plus a reasonable amount for administrative, selling, and other costs and for profits (constructed value). Selection of the third country is often based on the similarity of merchandise sold there to the merchandise exported to the United States, the volume of sales (country with largest volume of sales), and similarity of market in the third country, in terms of organization and development, to that of the United States. In calculating constructed value, transactions with related parties that do not fairly reflect the usual market price, as well as sales that are made at less than the cost of production, are disregarded. In cases in which the economy of the home market is state controlled and does not reflect the market value of the product, foreign market value can be determined on the basis of, in order of preference, (1) the price at which such or similar merchandise produced in a non-state-controlled economy is sold for consumption in that country or in another country, including the United States, or (2) the constructed value of such and similar merchandise in a country where the economy is not state controlled. Where the price comparison requires a conversion of currencies, such conversion is made using the rate of exchange on the date of sale.

A major problem with the application of such methods is that the surrogate market economy country selected for comparison may be inappropriate (in terms of its level of economic development) or that its producers may not be willing to furnish the information necessary to determine constructed value (Czako et al., 2003).

There is no agreed-upon definition of subsidies anywhere in the GATT or domestic law. However, it is reasonable to infer from the list of practices that are considered subsidies that a subsidy is a preferential benefit given by the government to domestic producers. The benefit could be in the form of income or price support of any direct or indirect financial contributions (e.g., grants, loans, tax credits, loan guarantees) (International Perspective 19.1).

Export subsidies are benefits intended to increase exports; domestic subsidies are granted for a product regardless of whether it is exported or consumed at home. Governments provide domestic subsidies to achieve certain socioeconomic goals, such as optimum employment or location of industries in depressed regions, that could not be attained through the efforts of the private sector alone. Although domestic subsidies may increase the subsidizing country's trade flow, they do not attract international condemnation as export subsidies.

It is important to review the rules with respect to permitted or actionable subsidies. If an actionable subsidy is found in a country that is a signatory to the GATT Subsidies Code and that subsidy causes injury to a domestic industry, a countervailing duty is imposed on the subsidized imported product. Proof of injury is not required if the subsidized import comes from a country that is not party to the Subsidies Code or similar agreement. A countervailing duty is imposed to offset the subsidy, that is, equal to the net amount of the subsidy (Trebilcock and Howse, 2005).

The rules and practices on actionable subsidies, nonactionable subsidies (e.g., nonspecific subsidies, subsidies for R&D) are consistent with the WTO rules.

Proof of Injury and Remedies

In both antidumping and countervailing duty investigations, it is important to establish causation: material injury or threat of material injury to or retardation of a U.S. industry producing similar products caused by the importation of subsidized and dumped products. Imports do not have to be the sole or even the major cause of the injury. "Like products" are defined as products that are the same or, in the absence of such, "most similar in characteristics and uses" to the foreign product under investigation. In one case, for example, the U.S. International Trade Commission (ITC) defined one U.S. industry as canned mushrooms (and thus not similar to fresh mushrooms). This narrow definition gives the exporter a much larger U.S. market share, thus supporting a preliminary injury determination (USITC, 2008).

Typically, the ITC considers the collective impact of all imports of a product from a given country in arriving at its injury determination. However, in countervailing duty investigations, there is no injury determination for imports from countries that are not signatories of the Subsidies Code or an equivalent arrangement with the United States unless the goods are entered duty free.

In determining whether there is injury to a U.S. industry, the ITC considers import volumes, price effects, and the impact on domestic producers of like products, as well as all other relevant economic factors that have a bearing on the domestic industry. Domestic industry impact analysis considers the effect of allegedly dumped imports on the development and production of the domestic industry, employment, and utilization of plant capacity in the relevant industry. Threat of material injury can be found, for example, if lost sales indicate a threat to future sales, production, and profit. Price undercutting is not a per se basis for a finding of injury if the demand for the product is not price sensitive. Lost sales to the domestic industry have traditionally served as an important element of injury (Czako et al., 2003). Injury may be shown even in cases that involve an improvement in the condition of the industry or a decrease in import volume. The ITC's determination of threat of material injury is made on the basis of evidence that the threat is real and the actual injury imminent and not based on "mere conjectures and suppositions" (19 U.S. Code 1677).

Once it is established that foreign merchandise is being sold in the United States at less than fair market value and injury to domestic industry is established, an antidumping duty is imposed on the product (i.e., an amount by which the foreign market value exceeds the United States price of the merchandise). The causation factor can be satisfied if the dumped or subsidized imports contribute even minimally to an injury to the domestic industry. A correlation between dumped or subsidized imports and alleged injury is not required for an affirmative injury determination.

The cumulation doctrine is also allowed in determining material injury in dumping or subsidy cases. This means that the effect of dumped and/or subsidized imports from two or more countries of like products (that compete with each other and with domestic products) can be assessed to determine injury to domestic industry. This encourages petitioners to name as many countries as possible. Similarly, if a subsidy is shown to exist and to cause material injury or threat to U.S. industry, then a duty equal to the subsidy (countervailing duty) is imposed. In the case of agricultural products, injury could still be established even though

the prevailing market price is at or above the minimum support price. This is intended to ensure that injury analysis is not distorted by the beneficial effects of government assistance programs (Trebilcock and Howse, 2005)

Antidumping and Countervailing Duty Proceedings

Antidumping (AD) and countervailing duty (CVD) investigations are conducted either on the basis of a petition filed with the Department of Commerce (Commerce) through the International Trade Administration (ITA) and the International Trade Commission on behalf of a domestic industry or by Commerce upon its own initiative. In the latter case, Commerce must notify the ITC. In a countervailing duty investigation, the ITC plays an active role only when the foreign government conferring the subsidies has entered a trade agreement such as the Subsidies Code or a similar arrangement with the United States (USITC, 2008). The procedural steps of a typical investigation are described in Table 19.1.

Initiation of Investigation by Commerce

Once a petition is filed or an investigation started at the initiative of Commerce (ITA), the ITC begins to investigate the material injury or the threat of material injury to the domestic industry. In the case of a petition, Commerce determines within twenty days whether to initiate or terminate the investigation on the basis of whether the petition adequately alleges material injury or threat thereof with sufficient information supporting the allegations and whether the petition has been filed by or on behalf of the industry (domestic producers or workers supporting the petition must account for at least 25 percent of total production and more than 50 percent of production of those supporting or opposing the petition). If the 50 percent requirement is not met, Commerce must poll the industry or rely on other information to determine if the

TABLE 19.1 Antidumping and Countervailing Duty Investigations

Day	Event
0	Petition filed
20	Decision on initiation
45	Preliminary injury determination by ITC*
AD:160	Preliminary determination by ITA
CVD: 85	Preliminary determination by ITA
AD:235	Final determination by ITA*
CVD:160	Final determination by ITA*
AD: 280	Final injury determination by ITC
CVD:205	Final injury determination by ITC*
AD:287	Publication of order
CVD:211	Publication of order

Note: AD = Antidumping duty; CVD = Countervailing duty; *If the determination is negative, the investigation is terminated.

required level of support for the petition exists. In order to establish a standing to file a petition on behalf of an industry, it is common practice for various producers to file as co-petitioners or as co-petitioners with unions or trade associations; petitioners can also secure letters or support from nonpetitioning members of the domestic industry, unions, or trade associations.

If Commerce (ITA) decides to initiate an investigation, it will begin to establish whether there is a subsidy or dumping in the U.S market, and the commission will continue its investigation on injury to domestic industry.

Preliminary Phase of the ITC's Investigation

Within forty-five days after a petition is filed or an investigation is begun by Commerce, the ITC makes its preliminary determination, that is, whether there is a reasonable indication of injury to domestic industry. If the determination is negative or the imports subject to the investigation are negligible, the proceedings terminate.

Preliminary Phase of Commerce's Investigation

If the ITC's determination is affirmative, Commerce makes its preliminary determination on the basis of the information available at the time as to whether there is a reasonable basis to believe or suspect that a countervailable subsidy or sales at less than fair market value exists.

If commerce finds a reasonable basis, it estimates the dumping or subsidy margin within 140 and 65 days, respectively, of initiating an investigation. However, such deadlines can be extended at the petitioner's request or if the case is extraordinarily complicated.

If Commerce's preliminary determination is affirmative, Commerce (1) suspends liquidation of the investigated merchandise subsequently entered into the United States or withdrawn from warehouse; (2) requires that bonds or cash deposits be posted for each entry of the merchandise in an amount equal to the estimated net subsidy or dumping margin; and (3) continues the investigation. In addition, the ITC institutes a final investigation concerning injury, threat, or retardation. If Commerce's preliminary determination is negative, Commerce's investigation simply continues (USITC, 2006).

Final Phase of Commerce's Investigation

Within seventy-five days after its preliminary determination, Commerce makes a final determination as to whether a subsidy is being provided or sales at less than fair value are being made. If the final determination is negative, the proceedings end, and any suspension of liquidation is terminated, bonds or other security released, and deposits refunded. Any party to the proceedings can request a hearing before final determination by Commerce. If the final determination by Commerce is affirmative, the ITC then makes its determination on injury.

Final Phase of the ITC's Investigation

The ITC makes its final determination with respect to material injury, threat of material injury, or retardation of domestic industry as a result of sales at less than market value or subsidies. The investigations must be completed within 120 days after Commerce's affirmative

preliminary determination (if Commerce's preliminary determination is affirmative) or within seventy-five days after Commerce's affirmative final determination (if Commerce's preliminary determination is negative).

Issuance of an Order

If the final determination of the ITC is affirmative, Commerce issues an antidumping or countervailing duty order, usually within a week of the ITC's determination. The order requires the deposit of estimated antidumping or countervailing duties at the same time as other estimated customs duties pending calculation of the final AD or CV duties. If the final determination by the ITC is negative, no AD or CVD duties are imposed, and any suspension of liquidation is terminated, bonds released, and deposits refunded (USITC, 2006). If the petitioner alleges in an investigation the existence of a critical circumstance, that is, massive entry of subsidized imports or imports sold at less than fair value in a relatively short period, Commerce's final determination, if affirmative, will include a retroactive suspension of liquidation for all unliquidated entries of merchandise entered into the United States, including those withdrawn from the warehouse.

Suspension of Investigation

An investigation can be suspended prior to a final determination by Commerce if the parties (exporting or subsidizing government) involved agree to cease exports or eliminate the dumping margin or subsidy within a few months after suspension of the investigation. At the same time that it suspends a proceeding, Commerce must issue an affirmative preliminary determination. Suspensions are reviewed by the ITC to ensure that the injurious effect of imports is eliminated by the agreement. If the ITC determines that the injurious effect is not eliminated, the investigation, if not yet completed, will resume.

Appeal of Determinations

Any interested party adversely affected by a determination by Commerce or the ITC may appeal to the U.S. Court of International Trade. In the case of NAFTA members, an interested party may appeal for a review by a binational panel set up under the agreement (Tables 19.2 and 19.3).

TABLE 19.2 Disposition of U.S. AD and CVD Investigations, 1980–2008

	Antidumping duty (%)	Countervailing duty (%)*
Terminated before preliminary Commission (ITC) determination	63 (5)	54 (11)
Preliminary ITC determinations		
Affirmative	876 (82)	272 (75)

(*Continued*)

TABLE 19.2 (Continued)

	Antidumping duty (%)	Countervailing duty (%)*
Negative	193 (18)	89 (25)
Terminated after affirmative preliminary determination by ITC (before final determination)	156 (13)	88 (19)
Final ITC determinations		
Affirmative	505 (68)	132 (54)
Negative	241 (32)	111 (46)

*AD/CVD investigations covered imports valued at $66 billion (U.S.) or 0.3% of U.S. total imports.

Source: International Trade Commission (2012)

TABLE 19.3 Top Six Countries Cited, 1980–2004

Antidumping Cases (%)		Countervailing Duty Cases (%)	
United Kingdom	(3.4)	India	(3.8)
France	(3.7)	Belgium	(4.6)
Italy	(4.3)	United Kingdom	(4.9)
Brazil	(4.5)	Spain	(5.1)
Canada	(4.6)	Korea	(5.8)
Taiwan	(5.6)	Germany	(6.0)

INTERNATIONAL PERSPECTIVE 19.1

Antidumping Duties and Fair Trade

Antidumping duties are generally intended to prevent predatory pricing by foreign firms. By setting low prices in export markets, such firms drive domestic producers out of business. Once these firms have gained a controlling interest of the export market, they increase their price to recover their losses. Such economic theory behind antidumping rules is questionable because:

- Such actions are unlikely to escape the attention of governments in importing countries.
- Any subsequent increases in prices are likely to invite other exporters to enter the market, thus nullifying the firm's potential gains from market power. Thus, if firms are not certain about future gains from market power, they are not likely to take losses on their export sales.
- Setting different prices in different markets is not inconsistent with normal business practice, especially in imperfect competitive markets.

Existing regulations to establish dumping often lead to unfair and arbitrary outcomes since the standard set to evaluate import prices and injury are difficult to meet due to

variations in accounting methods, difficulty in collecting price information, lack of transparency in decision making process, and so forth. Furthermore, the low burden of proof to establish material harm to domestic producers often leads to acceptance of bogus claims. In the United States, for example, only 17 percent of dumping claims were rejected by the authorities between 1980 and 1997.

For domestic industries that have the support of unions and politicians, even a threat by Commerce to bring a case often leads foreign exporters to agree to a settlement rather than risk broader trade tension. Many exporters agree to voluntary export restraints. Such agreements, if conducted in consultation with domestic industry, would amount to antitrust violation in many countries.

A study by the ITC indicates that the removal of outstanding antidumping (AD) and countervailing duty (CVD) orders results in a welfare gain. While domestic companies and their workers receiving AD/CVD protection earned $658 million more profits and wages, terminating this protection would have increased overall American business profits and wages by $1.85 billion in industries that were not receiving such protection (USITC, 1995). The economic effects of AD/CVD orders are ranked third behind the Multifiber Arrangement restrictions and the Jones Act maritime restrictions in their net costs to the economy.

Other Trade Remedies

Unfair Trade Practices in Import Trade

The ITC is authorized, upon the filing of a complaint or on its own initiative, to investigate alleged violations of section 337 and to determine whether such violations exist. Section 337 of the Tariff Act of 1930 prohibits (1) the importation of articles that violate a valid and enforceable U.S. patent, trademark, copyright, and so on, for which an industry exists or is in the process of being established in the United States, and (2) unfair methods of competition by the importer or consignee that could adversely affect a U.S. industry (19 U.S. Code S.1337). The ITC's investigations also include gray-market imports (i.e., products manufactured abroad by the owner or under license that are imported by unauthorized sources into the United States). The strict meaning of gray-market goods is products that are authorized by the owner of production rights to be made and sold in one market are diverted and sold in another, often unauthorized market. The problem with such goods in import trade is that they are often purchased at discounted prices abroad and imported into the United States, taking away the market from authorized dealers.

A large percentage of Section 337 cases involve patent infringement; others pertain to violation of other forms of intellectual property. Such actions can also be raised with the U.S. Patent and Trademark Office. The remedies for such violations include the following:

1. A general or limited exclusion order that directs customs to deny entry of certain goods
2. A cease and desist order that enjoins a person from further violation of Section 337.

These remedies may be ordered by the ITC in the case of imports that infringe upon U.S. intellectual property rights without finding injury. ITC determinations may be appealed to the U.S. Court of Appeal for the Federal Circuit (International Perspective 19.2).

Unjustified Foreign Trade Practices

Section 301 of the Trade Act of 1974 was introduced as part of an effort to seek open access to U.S. exports in foreign markets. It is directed at foreign government practices that restrict U.S. exports or artificially direct goods or services to the United States. It is applicable to the export of goods and services, investment practices, and intellectual property rights.

Special 301 is another version of Super 301 that is applicable to intellectual property rights. Priority countries (countries that do not provide adequate protection for intellectual property rights) are identified for bilateral negotiations. A Special 301 investigation is similar to an investigation initiated in response to an industry Section 301 petition. Trade sanctions for noncompliance could be imposed in the event that the country declines bilateral consultations or fails to implement an agreement to open its market or provide adequate protection for U.S. intellectual property rights.

Import Interference with Agricultural Programs

The ITC conducts investigations at the direction of the president to determine whether imports interfere with or render ineffective any program of the Department of Agriculture. The ITC makes its findings and recommendations to the president, who may take appropriate remedial action, including the imposition of a fee or quota on the imports in question. However, fees or quotas may not be imposed on imports from nations that are members of the WTO (USITC, 2006).

Trade Adjustment Assistance

For companies and workers adversely affected by fairly traded imports, trade adjustment assistance is provided in the form of retraining or relocation assistance for workers or certain forms of technical and financial assistance to companies. The Department of Labor (adjustment assistance for workers) or Commerce (adjustment assistance for firms) makes an affirmative determination that imports constitute an important contributing factor to declines in production and sales as well as loss of jobs in the affected industries. The available assistance can be pursued before or in tandem with escape-clause proceedings.

The Escape Clause

Under Section 201 of the U.S. Trade Act (1974), the ITC assesses whether U.S. industries are being seriously injured by fairly traded imports and can recommend to the president that relief be provided to those industries to facilitate their adjustment to import competition. Relief could take the form of increased tariffs or quotas on imports and/or adjustment assistance for the domestic industry. Such relief is temporary and may be provided for up to five years, with one possible extension of not more than three years. Such actions can be appealed to the U.S. Court of International Trade and then to the Court of Appeals for the Federal Circuit and from there to the U.S. Supreme Court.

From 1975 through 2008, the ITC conducted seventy-three escape-clause (safeguard) investigations accounting for $60 billion of U.S. imports. About 47 percent of such investigations were decided in the affirmative, and the ITC recommended remedial action.

Import Relief Based on National Security

The Tariff Act (19 U.S. Code S.1862) gives the president discretion to restrict imports that threaten national security. The Department of Commerce makes findings and recommendations to the president, who may order the imposition of a quota, fee, tariff, or other remedies. Although such remedies are rarely invoked, they could conceivably be used by companies in some strategic sectors. Such remedies are available only if it is established that a strategically important industry is adversely affected by imports and that supplies may not be available during a crisis from either domestic or foreign sources.

INTERNATIONAL PERSPECTIVE 19.2

The Semiconductor Industry

The semiconductor industry has been a target of industrial policy in many countries. In the United States, the government has paid a large share of R&D expenditures since the 1950s. In Japan, the industry was protected by high tariffs, restrictive quotas, and the need for approval of licensing arrangements. Even after the abolition of formal barriers in the 1970s, the Japanese government provided R&D support, preferential procurement policies, and so on. In Europe, stiff tariff rates on imports were used to protect domestic firms.

The Semiconductor Accord: The first agreement (1986) between the United States and Japan focused on improving market share, acquiring access to the Japanese market, and terminating unfair trade practices such as dumping by Japanese companies. The Reagan administration applied some $165 million in retaliatory duties on Japanese imports in 1987. The Japanese were compelled to raise prices for their semiconductors sold in the United States in order to avoid the imposition of special tariffs and duties resulting from U.S. antidumping investigations.

The agreement resulted in a rise in U.S. foreign market share (U.S. market share in Japan had grown from 9 percent in 1987 to 14 percent in 1991). The price of Japanese chips sold in the United States increased by more than 30 percent. The agreement was extended in 1991, endorsing the desirability of increasing the foreign market share in Japan by more than 20 percent by the end of 1992. It also paved the way for U.S. and Japanese firms to enter into joint ventures.

As the 1991 agreement expired in 1996, the two governments announced new industry and government agreements on semiconductors. The key provisions of the new agreement included the continuation of existing cooperative activities between users and suppliers as well as new cooperative activities among suppliers from the two countries. These activities included the creation of international standards, designs, and environmental data (e.g., imports, exports, market size, market growth, openness of market). U.S. and Japanese industries collect and submit data to their respective governments for review in bilateral consultations. The semiconductor industry in Japan has reached the same profit level as that of the United States, as both are focused on capital expenditures.

Problems with Managed Trade: The major shortcomings with such arrangements are that it is arbitrary and once established, becomes institutionalized and perpetuated. It may also distort competition in the semiconductor industry with adverse effects on users such as the computer industry.

Chapter Summary

Dumping and subsidies	Dumping is the selling of a product in a foreign market at a price that is lower than the price for which it is sold in the home market. Subsidies are any benefit given by the government to domestic producers. Domestic subsidies are provided to achieve certain socioeconomic goals, such as optimum employment. Export subsidies are intended to promote exports. *Proof of Injury and Remedies* In both cases, remedies are subject to proof of injury of subsidized or dumped imports. Injury is generally established by considering import volumes, lost sales, and impact on domestic producers of similar products. *Antidumping and countervailing duty proceedings* 1. Initiation of investigation by commerce 2. Preliminary phase of ITC investigation 3. Preliminary phase of Commerce investigation 4. Final phase of investigation by commerce 5. Final phase of investigation by the ITC.
Other categories of trade remedies	1. Unfair trade practices, S.337 2. Unjustified foreign trade practice, S. 301 3. Import interference with agricultural programs 4. Trade adjustment assistance 5. The escape clause.

Review Questions

1. What is the difference between dumping and subsidies?
2. State the types of nonactionable subsidies.
3. What is to be established in every subsidy and dumping investigation?
4. Briefly describe the preliminary phase of an ITC investigation.
5. Describe the procedural steps in a typical antidumping or countervailing duty investigation.
6. What is the role of the U.S. ITC in import relief?
7. Explain the escape clause. Can it be applied at any time to protect domestic industry?
8. Describe Special 301.

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World Wide Web Resources

U.S. International Trade Commission on antidumping and countervailing duties: http://www.usitc.gov/trade_remedy/731_ad_701_cvd/index.htm

Abstract of judicial review of International Trade Commission determinations: http://www.questia.com/PM.qst?a = o&d = 5000248716

The Heritage Foundation on antidumping laws: http://www.heritage.org/Research/TradeandForeignAid/BG906.cfm

Special 301 Report: http://www.ustr.gov/about-us/press-office/reports-and-publications/2012–2

Case 19.1 Similar Products and Dumping

A Chilean salmon exporter was accused of dumping salmon in the U.S. market at less than fair value. An antidumping petition was filed in 1997 by the Coalition for Fair Atlantic Salmon Trade. The U.S. Department of Commerce (ITA) initiated an antidumping duty investigation to determine whether Chilean exporters of Atlantic fresh farmed salmon were selling the fish in the United States at less than fair market value, to the detriment of U.S. industry. The purpose of the investigation was to determine whether dumping duties should be imposed on the subject merchandise when imported into the United States.

The ITA conducted an investigation in order to compare the price of the salmon sold in the United States with its "normal value" in Chile (home market). Since the product is not sold in the home market, the ITA based the normal value on the price of the salmon sold in Japan. The exporter sold "premium"-grade salmon in the United States while it sold "premium" and "superpremium" grades in Japan. The ITA found that (a) salmon industries do not recognize any grade higher than premium grade, and all salmon in this range are graded equally; (b) salmon graded "superpremium" are in fact premium grade and comparable in the market place. The ITA recognized that the exporter reported higher prices for sales of superpremium-grade salmon to Japan (sales of premium salmon to Japan

covered a few months and involved relatively small quantities and thus were insufficient to help in evaluating price differences). The practical consequences of the ITA's decision to classify the two grades of salmon (superpremium and premium) as identical in physical characteristics was to impose a dumping margin of 2.23 percent on the Chilean exports of premium salmon in the United States.

Questions

1. Are the products sold in Japan and the United States identical for duty analysis?
2. Based on the information, do you think dumping has occurred in the United States?

Case 19.2 Dominican Republic: Safeguard Measures on Imports of Polypropylene Bags and Tubular Fabric

On October 15, 2010, Costa Rica requested consultations (under the WTO) with the Dominican Republic concerning provisional and definitive safeguard measures imposed by the Dominican Republic on imports of polypropylene bags and tubular fabric and the investigation that led to the imposition of those measures. Costa Rica was concerned about certain aspects of the safeguard measures and the underlying investigation. In particular, Costa Rica alleged that these measures appeared to be inconsistent with the Agreement on Safeguards and Article XIX:1(a) of the GATT (1994). The dispute settlement panel concluded its work and submitted its report in January 2012. The panel concluded that the provisional and definitive duties were safeguards, since they suspended the Dominican Republic's obligations under GATT Articles I:1 (the most-favored-nation obligation, because certain countries of origin—Colombia, Indonesia, Mexico, and Panama—were excluded from its application) and II:1(b) (since they imposed a tariff surcharge, different from an ordinary customs duty, which was not set forth in the Dominican Republic's GATT Schedule). After concluding that GATT Article XIX and the Safeguards Agreement were applicable to this dispute, the panel addressed the substantive claims raised by the complainants.

The panel found that the Dominican Republic acted inconsistently with its obligations under the GATT 1994 and the Safeguards Agreement because the report published by the competent authorities failed to provide an explanation for the existence of unforeseen developments and for the effect of the obligations of the GATT (1994).

The panel found that the Dominican Republic acted inconsistently with its obligations under the Safeguards Agreement and the GATT by excluding certain products from the definition of the domestic directly competitive product and certain producers of like or directly competitive products for the purpose of defining the domestic industry. It also failed (1) to provide reasoned and adequate explanations with respect to the existence of serious injury, and (2) to take all

reasonable steps to exclude Thailand, as a developing country, from the application of the provisional and definitive safeguard measures.

Soon after the issuance of the report, the Dominican Republic lifted the safeguard measure that was the subject of this dispute and established the MFN tariff at the level that was in place before the application of the safeguard.

Question

1. Is the Dominican Republic required to notify exporting nations subject to the measures under the safeguards agreement of the definitive safeguard measure?

twenty
Intellectual Property Rights

Intellectual property rights (IPRs) are associated with patents, trademarks, copyrights, trade secrets, and other protective devices granted by the state to facilitate industrial innovation and artistic creation (Keupp, Beckenbauer, and Gassman, 2010; Wolfhard, 1991). The grant of exclusive property rights provides owners with personal incentives to make the most productive use of their assets and facilitates transfers by making possible a high degree of exchange. Intellectual property rights are one form of exclusive rights conferred by the state to promote science and technology. The issue of intellectual property has received wider attention than other property rights for the following reasons:

- The volume of trade in goods protected by intellectual property rights is becoming increasingly significant as more countries produce and consume products that result from creative activity and innovation (Denton, 2011; Gadbaw and Richards, 1988).
- The globalization of markets has created opportunities for the production and/or sale of unauthorized copies to supply the newly generated demand. In the first quarter of 2005, more than $1.1 billion (U.S.) of counterfeit goods were seized worldwide. More than $500 billion (U.S.) in such goods are seized every year. Copyright piracy amounted to about $500 million (U.S.) in India and $2.5 billion (U.S.) in China in 2004. In China alone, it is estimated that there are about eighty-three manufacturing plants with 765 production lines that specialize in the production of pirated goods (Bird, 2006; Linek and Iwanicki, 2006).

What Are Intellectual Property Rights?

Intellectual property rights are exclusive rights given to persons over the use of their creation for a given period of time. Such rights are customarily divided into various areas, as detailed in the following material.

Patents

A patent is a proprietary right granted by the government to inventors (and other persons deriving their rights from the inventor) for a fixed period of years to exclude other persons from manufacturing, using, or selling a patented product or from utilizing a patented method or process. At the expiration of the time for which the privilege is granted, the patented invention is available to the general public or falls into public domain.

Patents may be granted for new and useful products as well as for processes for the manufacture (or methods of use) of new or existing products. The basis for patent protection is promotion of innovative activity, dissemination of technical knowledge, and facilitation of transfer of technology. Even though patents are granted as a recognition of the concept of a natural right in inventions, they provide an incentive for the encouragement of inventions and the promotion of economic development. With the monopoly grant, the patent owner can divulge the invention to the public and still retain exclusive use of it for the period of the patent. At the end of the monopoly period, the patent becomes available for the unrestricted use of the public. Patent protection also encourages transfer of technology through direct investment or licensing. In the United States, patents are valid for a period of twenty years from the filing date. Patent violations are generally referred to as patent infringement or piracy.

Trademarks

A trademark is a word, name, symbol, or device or any combination of these used by a manufacturer or seller of goods to identify and distinguish the particular manufacturer's/seller's goods from goods made or sold by others (Ladas, 1975). In general, trademarks perform three functions:

1. Identify one seller's goods and distinguish them from goods sold by others
2. Signify that all goods bearing the trademark come from a single source and are of equal quality
3. Serve as a primary instrument in advertising and selling the goods.

An important part of the advertising effort is to develop goodwill. Trademark rights can be acquired by registration or use (reputation). Registered marks are renewable. Once a trader acquires a reputation in respect of a mark, that is, an unregistered mark, it becomes part of that trader's goodwill and is protectable as a registered mark. Violation of trademarks consists of counterfeiting and other forms of infringement, such as advertising, sales, or distribution of goods bearing a mark similar to that of the owner that results in deception or confusion. Counterfeiting is the unauthorized use of a mark. In the United States, trademarks are valid for ten years from the date of registration.

Trade Secrets

A trade secret involves a formula, method, or technique that derives independent economic value from not being generally known or available to other persons who can obtain economic value from its disclosure or use (Kinter and Lahr, 1983). The historical roots of trade secrets protection can be traced to ancient China, where death by torture was prescribed for

revealing the secret of silkmaking to outsiders, and to ancient Rome, where enticing a competitor's servant to disclose business secrets was a punishable offense. In England, the movement of artisans to other countries was prohibited by a series of statutes aimed at preventing knowledge of British processes from reaching possible competitors in Europe and America, and employers sued would-be emigrants and those who tried to seduce them (Ashton, 1988). Violation of trade secrets includes acquisition of a trade secret by improper means or disclosure without the consent of the owner.

In most developed nations, however, protection is afforded through laws pertaining to contracts, criminal law, or torts, such as breach of confidence (Hannah, 2006; Seyoum, 1993). Protection of trade secrets does not expire after a set period of time, as do other intellectual property rights. The owner, in effect, has perpetual monopoly on the innovation. A large part of the technology being developed now, perhaps with the exceptions of pharmaceuticals and specialty chemicals, does not get patented. Many high-technology innovations, such as aircraft and automobiles, and most low-technology innovations, such as detergents or food products, are not patented (Williams, 1983). In some countries, a formula might be patentable, while methods of production based on personal skills might not be. Patent protection also ends at some point, even if one is able to obtain and keep the patent. Thus, companies prefer to maintain new innovations as trade secrets and protect their technology by contract rather than by patent.

Copyrights

A copyright is a form of protection granted to authors of original works, including literary, dramatic, musical, artistic, and certain other intellectual works. The owner of the copyright has the exclusive right to reproduce, distribute, sell, or transfer the copyrighted work to other persons. In the United States, copyrights are protected for a minimum period of fifty years after the death of the author. The core copyright industries (i.e., business and entertainment software) are second only to motor vehicles and automotive parts in terms of estimated sales and exports ($134 billion of exports in 2010) and also have grown twice as fast as the rest of the U.S. economy.

Intellectual Property Rights and International Trade

An important feature of intellectual property rights is their exclusiveness and territorial dimension. This means that a patent holder or licensee is the person solely entitled to manufacture and market the patented product within a given territory of the state in which the patent is granted. The exclusive and territorial character of such rights is capable of creating obstacles to both the free movement of goods and competition. For example, a patent or trademark owner in country A may be entitled to block the importation of a product legally manufactured in country B by its own licensee or subsidiary. Although such restrictive use of intellectual property rights interferes with free trade, the grant of monopoly rights is considered an acceptable trade-off to encourage research and the diffusion of new knowledge and technology. In short, free trade between countries as a result of an agreement such as NAFTA, EEC, or WTO does not preclude prohibitions or restrictions on imports, exports, or goods in transit, justified on the grounds of the protection of intellectual property rights.

A number of issues pertaining to intellectual property rights have important implications to the conduct and growth of international trade. They are described in the following sections.

The Growth of Trade in Counterfeit Goods

The globalization of markets, the increased demand for new products, and the nearly prohibitive R&D costs of developing such products have created incentives for the unauthorized use of intellectual property rights. For example, counterfeiting (false labeling for sale in export markets) has spread from the faking of strong brand-name consumer goods to a variety of consumer and industrial goods. Related violations include copyright and patent infringement and unfair competition. The International Intellectual Property Alliance estimates that more than half of all compact disks and about 70 percent of all video games sold in Brazil are pirated (International Perspective 20.1).

Lack of Adequate Protection for IPRs in Many Countries

An important contributing factor to trade in counterfeit/pirated goods is the lack of adequate protection and effective enforcement of intellectual property rights in many countries. Furthermore, some new technologies do not fit within any of the existing types of intellectual property. For example, in many developing countries, the protection of computer software, biotechnology, and semiconductor chips remains unclear. For example, copyright piracy exceeded $1.7 billion (U.S.) in Russia alone in 2004. Even though Russia has laws on IPRs, there is limited enforcement by local authorities. Jail sentences for piracy are rare, and authorities do not conduct surprise inspections or seize or confiscate equipment (Bird, 2006).

Piracy of IPRs as a Trade Barrier

Given the fact that counterfeit/pirated goods displace those of legitimate producers, such action distorts international trade and has the long–term effect of reducing trade in technology–intensive goods. Piracy leads to the misallocation of resources by diverting trade from legitimate producers to pirates. Trade experts believe that elimination of piracy abroad of U.S. intellectual property could easily wipe out a majority of the U.S. trade deficit.

Protection of Intellectual Property Rights

Protection Under Domestic Laws

Most countries have domestic laws to protect intellectual property rights. In the United States, Section 337 of the Tariff Act of 1930 authorizes the International Trade Commission (ITC) to institute an investigation into the importation of articles that may infringe on U.S patents, trademarks, or copyrights. If the ITC determines that a violation exists, U.S. Customs and Border Protection (CBP) is then charged to enforce an exclusive order, that is, to stop the article from entering the United States; upon a subsequent violation, the property may be seized and forfeited to the U.S government. Since 1972, 505 individual cases of

alleged IPR violations have been filed against non-U.S. firms in forty countries. More than 70 percent of these section 337 cases were decided in favor of the complainant (Chiang, 2004). Unlike in antidumping and countervailing duties cases, in which domestic injury must be proved, the U.S. Department of Commerce does not play a role in IPR cases.

Section 301 of the 1974 U.S. Trade Act contains significant measures to ensure trade compliance. It allows the United States to apply trade sanctions to countries that impose an unjustifiable burden on or restrict U.S. commerce. Such burdens include but are not limited to denial of fair and equitable market opportunities such as denial of most-favored-nation treatment (MFN) to U.S. goods and services, lack of adequate and effective protection of IPRs (including those in countries that are part of the Uruguay Round Agreement on Trade-Related Aspects of Intellectual Property [TRIPs], signed in 1994), export targeting, and denial of workers' rights. A section 301 investigation may be commenced by the U.S. Trade Representative's Office (USTR) or any interested party that files a petition with the USTR. The USTR must conclude its investigation within a certain period after initiation of an investigation. It may authorize retaliatory action against the foreign country.

Special 301 focuses on unfair IPR practices. The Special 301 Provision of the 1988 Omnibus Trade and Competitiveness Act requires the U.S. Trade Representative to identify by April 30 of each year countries that fail to provide adequate protection and enforcement for intellectual property rights or deny fair and equitable market access to persons that rely on IPR protection. The USTR classifies countries that fail to provide adequate protection or enforcement into the following three categories:

- Countries under Priority Watch List: Countries whose policies or practices have the greatest adverse impact (actual or potential) on the relevant U.S. products, and which are not engaged in good-faith negotiations to address these problems
- Countries under Watch List: Countries with serious IPR deficiencies but which are not yet placed on the priority watch list.
- Countries under Section 301 Monitoring: Countries that are monitored for implementation of certain agreements or memorandum of understanding on IPR.
- The USTR classifies countries that fail to provide adequate protection or enforcement into one of three categories: priority foreign country, priority watch list, or watch list (International Perspective 20.2).

Countries Under Priority Watch List

A country may be designated as a priority foreign country if:

- Its policies or practices have the greatest adverse impact (actual or potential) on the relevant U.S. products
- It is not engaged in good faith negotiations to address these problems.

U.S. Customs and Border Protection has the authority to prohibit the importation of imports that violate intellectual property rights. IPRs subject to protection have to be registered with the U.S. Patent and Trademark Office. CBP monitors imports to prevent the importation of violating articles in response to the IPR owner's request or on its own

initiative. Customs regulations establish the authority for CBP to record trademarks, trade names, and copyright; to seize counterfeit articles that violate IPRs; and to restrict the importation of gray-market imports. The port director has the authority to demand the redelivery of violating articles and to claim liquidated damages in the event of failure to redeliver the goods. CBP also monitors importations of articles (for a fee) on a nationwide basis and reports to the patent holder the names and addresses of importers of infringing goods.

The USTR is required to initiate a Section 301 investigation within thirty days after identification of a priority foreign country. If negotiations are not successful within six to nine months, the USTR may retaliate against the exports of the country by withdrawing trade agreement concessions and imposing duties or other restrictions on imports. In this category are countries whose protection and enforcement of IPRs warrant close monitoring and resolution. The 2012 list of countries under this category included Argentina, Chile, China, Egypt, India, Indonesia, and Russia.

INTERNATIONAL PERSPECTIVE 20.1

Some Red Flags for IPRs

- Importer is known to buy infringing goods and has a history of enforcement actions for IPR violations.
- Merchandise is shipped in small quantities on informal entries.
- Merchandise is imported from sources (countries and/or vendors) with IPR problems.
- Company documents show IPR identifier but the company does not have a license agreement with the owner of IPR.
- Provides invoices with no model or catalogue numbers and merchandise without lot numbers, factory codes, expiration dates, or dates of manufacture.
- Payment term is C.O.D. rather than by letter of credit.
- Shipment is underinsured.
- There are vague or unusual shipment terms and an unusually high or low value for the merchandise.

INTERNATIONAL PERSPECTIVE 20.2

Protection and Enforcement of Intellectual Property Rights

Canada: Canada remained on the priority watch list in 2012, subject to review if Canada enacts long-awaited copyright legislation. It has not fully implemented the World Intellectual Property Organization (WIPO) Internet treaties and has yet to address the challenges of piracy over the Internet. Canada needs to strengthen its border enforcement efforts, including providing customs officials with ex officio authority to take action against the importation, exportation, and transshipment of pirated or counterfeit goods. The United

States remains concerned about the availability of rights of appeal in Canada's administrative process for reviewing the regulatory approval of pharmaceutical products, as well as limitations in Canada's trademark regime.

Algeria: Algeria remained on the priority watch list in 2012. The United States remains concerned about an Algerian law that bans an increasing number of imported pharmaceutical products and medical devices in favor of local products. The United States also remains concerned about the lack of protection against the unfair commercial use, as well as unauthorized disclosure, of test and other data generated to obtain marketing approval for pharmaceutical products. Algeria should strengthen patent protection and enforcement efforts to address widespread piracy and counterfeiting.

Bolivia: Bolivia remained on the watch list in 2012. Bolivia's Intellectual Property Office recently undertook efforts to improve public awareness about IPR protection and enforcement. However, high levels of piracy and counterfeiting persist, and there is a continued need to improve criminal and civil IPR enforcement. Bolivia should provide for more efficient prosecution of IPR violations, for better coordination among Bolivian enforcement authorities, and for additional resources to be allocated to enforcement officials.

Finland: Finland remained on the watch list in 2012. Major concerns include the lack of product patent protection for certain pharmaceutical products, inadequate regulatory framework regarding process patents filed before 1995 and pending in 1996, and denial of adequate protection to many of the top-selling U.S. pharmaceutical products currently on the Finnish market.

Source: U.S. Trade Representative (2012).

Watch List

This category includes a list of countries that warrant special attention because they maintain certain practices or barriers to market access for intellectual property products that are of particular concern. The 2012 list included Belarus, Bolivia, Colombia, Turkey and Vietnam.

It is important to note that a Special 301 investigation is similar to an investigation initiated in response to an industry Section 301 petition (unfair foreign trade practices), except that the maximum time allowed for the latter is shorter (in cases involving violation of TRIPs) than for other Section 301 investigations. Special 301 is potentially an effective tool to protect U.S. IPRs abroad because it allows the administration to use a variety of trade sanctions (e.g., removal of GSP or MFN status) against a priority foreign country. However, its implementation has been sporadic and inconsistent over the years. For example, certain countries with gross violations of IPRs are not included on the priority country list, and in some cases, when they are identified, they do not face sanctions. Russia was classified as a watch list country for many years in spite of its rampant black markets in DVDs, films, music, and so forth. India was classified under the priority foreign country category several times, but no sanctions were imposed even though there was no resolution of the problem through bilateral negotiations.

International and Regional Protection

The Paris Convention

The Paris Convention is used in connection with two separate treaties: (1) international protection of industrial property, and (2) international copyright protection (the Universal Copyright Convention). The Paris Convention for the protection of industrial property was concluded in 1883 and has gone through various revisions. It applies to industrial property in the widest sense, including patents, trademarks, trade names, and so on. The treaty sets forth three fundamental rules:

1. *National treatment:* The principle of national treatment provides that nationals of any signatory nation shall enjoy in all other countries of the Union the advantages that each nation's laws grant to its own nationals.
2. *Right of priority:* The right of priority enables any resident or national of a member country to apply for protection in any other member state of the convention within a certain period of time (twelve months for patents and six months for trademarks and industrial designs) after filing the first application in one of the member states to the treaty. These later applications will then be regarded as if they had been filed on the same day as the first application. A major advantage of this is that applicants wishing protection in multiple countries need not file all applications at the same time but have six to twelve months from the first application to decide in which countries to apply for protection.
3. *Minimum standards:* The convention lays down minimum standards common to all member countries.

The Universal Copyright Convention

The convention (1952, revised in 1971) establishes the national treatment standard and minimum rules common to all member countries. It also allows countries to set formalities or conditions for the acquisition or enjoyment of copyright in respect to works first published in its country or works of its nationals wherever published.

The Paris Convention is administered by the World Intellectual Property Organization (WIPO). WIPO's mission is to promote the protection of intellectual property throughout the world. WIPO membership includes more than 130 countries.

The Patent Cooperation Treaty

Under the terms of the Patent Cooperation Treaty (PCT), a single application suffices to launch a worldwide search for novelty in all member countries; filing an application in one of the designated offices eliminates the need to file applications in the patent offices of all other member states. The application with the search report will be forwarded to the countries where the applicant seeks patent protection. Although such a system eliminates duplication of filing and patent examination in each patent office of a member country, each country retains full jurisdiction to grant or refuse a patent in accordance with its own domestic legislation. The PCT has been signed by 133 countries and regional patent systems such as the European Patent Office (EPO) and the African Regional Industrial Property Organization (ARIPO).

Trade-Related Aspects of IPRs (TRIPs)

The developed countries criticize the intellectual property conventions administered by WIPO because its minimum standards are considered insufficient and it offers no provisions for dispute settlement. Member states retain broad discretion in granting intellectual property rights. Existing multilateral treaties fail to protect the most basic rights: Certain fields of patentable technologies such as pharmaceuticals, biotechnology, agricultural chemicals, and copyrightable documents such as education materials have been excluded from protection in many countries. Some countries limit patentability to the process (not the product), and /or limit the duration of patent protection.

They contend that the deficiencies in the protection of intellectual property rights distort international trade and reduce the value of concessions negotiated in various rounds of trade negotiations. The Intellectual Property Committee (IPC), a cross-industry organization of large multinational corporations, notes that:

> Inadequate international protection of intellectual property has become a major cause of distortions in the international trading system—and that it is both appropriate and necessary for intellectual property issues to be dealt with under international trade rules. (Gad, 2003, p. 676)

Subsequent negotiations led to the adoption of the Uruguay Round Agreement on Trade-Related Aspects of Intellectual Property (TRIPs) in 1994. The agreement established multilateral obligations for the protection and enforcement of the IPRs and provided a dispute settlement mechanism under the World Trade Organization (WTO).

The TRIPs agreement covers almost all forms of intellectual property including patents, trade and service marks, industrial designs, trade secrets, and layout designs of integrated circuits.

The three fundamental features of the agreement are:

1. *Standards:* The agreement sets out minimum standards of protection to be provided by each member country. It provides broader protections for intellectual property rights by granting the most-favored-nation (MFN) treatment for all signatories. It also requires members to comply with existing agreements such as the Paris Convention and the Berne Convention for the protection literary and artistic works. It further supplements additional obligations on matters where the preexisting conventions are silent or inadequate.
2. *Enforcement:* The TRIPs agreement lays down domestic procedures and remedies for the enforcement of IPRs.
3. *Dispute settlement:* The agreement makes disputes between WTO members subject to the WTO's dispute settlement procedures. It also authorizes trade sanctions against noncompliant nations.

Regional Conventions

The major regional agreement in the area of IPRs is the European Patent Convention (1973), under which a single application may result in the grant of a European patent valid in all member countries. It is a centralized patent-granting system administered by the European

Patent Office (EPO) in Munich, Germany, on behalf of member countries. A similar regional organization is the African Regional Intellectual Property Organization (ARIPO), located in Harare, Zimbabwe. ARIPO was established in 1976 to grant regional patents valid in all designated member countries.

Global E-Commerce: Selling in a Networked Economy

Information and communication technologies (ICT) are leading to a hyperconnected world where people and businesses can communicate with each other instantly. It is introducing new business opportunities by improving efficiency and productivity and generating new products and services (World Economic Forum, 2012). Much like the advent of railways and electricity, it is also profoundly changing the dynamics of economic growth.

The global online population is increasing at a rapid pace: The number of global Internet users increased from 361 million in 2000 to 2.4 billion in 2012 (Internetworldstats.com). Asia has the largest number of Internet users, accounting for 45 percent of the global online population, followed by Europe (22 percent) and North America (11 percent). In 2012, Africa evidenced the largest increase in Internet usage since 2000 (3,600 percent), followed by the Middle East (2,640 percent) and Latin America and Caribbean (1,311 percent) (Table 20.1).

Global E-Commerce

The size of global e-commerce (comprising business-to-business and business-to-consumer transactions) was estimated at $16 to 20 trillion in 2013, accounting for about 14 percent of global sales. There are already a number of stories about business successes with global online sales. A producer of draperies and other goods in New York, for example, sells her products in faraway places as South Africa, Turkey, and Saudi Arabia. Women entrepreneurs in Guyana are selling hand-woven hammocks to consumers in different parts of the world via the Internet. Global business-to-business e-commerce has also been quite successful in a number of industries. Websites such as E-steel, COVISINT, and Commercx are linking buyers and sellers of steel, car parts, and plastics, respectively, and facilitating greater volumes of cross-border trade (Freund and Weinhold, 2004).

The Internet and International Trade

Many studies show the positive effects of the Internet on international trade. The Internet reduces search costs (the cost of matching buyers and sellers) as well as the costs of finding agents, distributors, or retailers. Local distribution costs, including wholesale and retail margins, are estimated to be about 55 percent ad valorem tariff for the United States and 40 percent for other countries (Anderson and Van Wincoop, 2004). The Internet enables direct links in the supply chain. It also allows direct sales to the consumer without using intermediaries. Brynolfsson, Hu, and Michael (2003) show that increased product variety through electronic markets can be a significant source of consumer surplus gain. This happens because online retailers are able to provide a large number of products for sale without regard to warehouse space. For example, the number of book titles available at Amazon.com

TABLE 20.1 World Internet Usage

Regions	Population 2012	Internet users, December 2000	Internet users, December 2012	Internet penetration Population	% Growth internet use 2000–2012	Internet users
Africa	1,073,380,925	4,514,400	167,335,676	*15.6*	*3607*	*7*
Asia	3,922,066,987	114,304,000	1,076,681,059	*27.5*	*842*	*45*
Europe	820,918,446	105,096,093	518,512,109	*63*	*393*	*22*
Middle East	223,608,203	3,284,800	90,000,455	*40.2*	*2640*	*3.7*
North America	348,280,154	108,096,800	273,785,413	*78.6*	*153*	*11.4*
Latin America & Caribbean	593,688,638	18,068,919	254,915,745	*42.9*	*1311*	*10.6*
Oceana/ Australia	35,903,569	7,620,480	24,287,919	*67.6*	*218.7*	*1.0*
World	**7,017, 846,922**	**360,985,492**	**2,405,518,376**	***34.3%***	***566.4%***	***100%***

Source: Internetworldstats.com.

is fifty-seven times greater than the stock of books in any large bookstore. Internet retailers have unlimited "virtual inventory" and can offer a greater range of products and services to consumers than brick-and-mortar retailers. The Internet platform also allows firms to learn far more information about consumer preferences (e.g., through search engines, website visits, terms used to search for information) and thus tailor advertisements that are targeted to specific market segments at a relatively low cost.

Freund and Weinhold (2004) show that the reduced transaction costs arising from the Internet help increase the volume of international trade. The positive effects of the Internet are larger for developing countries than for advanced nations, partly because advanced countries have developed the requisite infrastructure and networks to access world markets. The new platform thus reduces the importance of past linkages for current trade. The Internet is likely to have a greater effect on the volume of trade in services (than on goods) because of the intrinsic nature of services.

In spite of the rapid increase in global e-commerce, there are still a number of challenges to overcome:

- *Logistics and payment issues:* Even though the Internet provides easy access to global goods and services, shipping and distribution to different corners of the world can be difficult. The Internet does not eliminate challenges related to transportation, distribution, and tariff and nontariff barriers, as well as payment and financing. Some businesses may not have acquired the core capabilities for exploiting electronic banking: technical and business dynamic capabilities such as managing customer relationships and integrating physical and virtual channels.
- *High return rates:* Consumers cannot touch and see the physical product and may have a different impression when they actually see the product. Furthermore, the cost of shipping and tariffs may make the product less competitive. Some estimate that international return rates for goods ordered online can be as high as 80 percent.
- *Customer trust:* The biggest challenge to online commerce is ensuring customer trust. The threat of online scams, credit card fraud, and similar problems may make customers reluctant to use online stores.
- *Limited ICT readiness in many developing countries:* In many developing countries, the level of ICT readiness is still quite low because of an insufficient development of ICT infrastructure. This makes it difficult to access a good part of this market online.

Trading Online

The website is the main tool of communication in the online market, and it is thus important to invest sufficient resources in building an attractive website with good content (some importers also use eBay, Amazon, and Craigslist to market their products). It has to be fully functional (can upload images, accept payments), have updated information, load quickly, and be customer-friendly. If you are not familiar with Web designs, you can always hire a Web designer. Besides interactivity (interaction between the site and user), other attractive features of a website include personalization (advice, product selection), notification of product availability, a newsletter, and search capability (from the home page), as well as clear notification of shipping, taxes, and other charges.

You can market your website through Google, Facebook, Twitter, Pinterest, blogs, or YouTube. It is also important to note the following pertinent issues:

- *Registering your domain name:* It is good to pick and register a domain name that people can easily remember.
- *Hosting the website:* There are a number of companies that will host your site for a modest annual fee. Make sure they offer technical support.
- *Promoting your website:* You can promote the site by enhancing its ranking through website optimization. You can also use social media such as Facebook and YouTube as well as search engines such as Google and Yahoo.

International Regulation of Electronic Commerce

The emergence of new technologies raises issues about the extent to which a balance has to be maintained between government regulation to protect the consumer and self-regulation. In 1997 the Clinton administration outlined a framework for global e-commerce and underlined the need for regulation and negotiation of international agreements on electronic commerce. It states:

> In some areas, government agreements may prove necessary to facilitate electronic commerce and protect consumers—Where government intervention is necessary to facilitate electronic commerce, its goal should be to ensure competition, protect intellectual property and privacy, prevent fraud, foster transparency, support commercial transactions and facilitate dispute resolution (principle 3). (White House, 1997)

The framework also emphasizes the need to avoid undue restrictions, recognize the unique qualities of the Internet, and support and enforce a predictable, minimalist, consistent, and simple legal environment for commerce on a global basis. The United Nations Commission on International Trade Law (UNCITRAL) adopted a model law on electronic commerce in 1996 that is acceptable to states with different economic and social systems. The model has been adopted by several countries and influenced the development of uniform e-commerce laws in the United States and Canada.

The UNCITRAL model law is based on the following basic principles:

- *Functional equivalence:* The model law attempts to extend the same level of recognition to electronic documents as to corresponding paper documents with respect to concepts such as "writing," "signature," or "originals." In cases where the law requires information to be in writing, that requirement is satisfied by an electronic message if the information is accessible to be used for subsequent reference.

  In order to ensure that a message that is required to be authenticated is not denied legal recognition because it was not done in a manner peculiar to paper documents, the model law establishes general conditions under which electronic documents will be considered authentic, credible, and enforceable if they require a signature. To be valid, electronic documents must identify the originator and confirm that the originator approved the content of the message.

Certain international trade documents such as insurance certificates and quality or inspection certificates are usually accepted only if they are "original" in order to reduce instances of alteration that would be difficult to detect. The model law sets minimum requirements for acceptance of electronic documents if (a) there exists a reliable assurance as to the integrity of the information from the time when it was first generated in its final form and (b) information is being capable of being displayed to the person to whom it is to be presented.

- *Technology neutrality:* The rules should provide equal treatment to paper-based and electronic transactions. They should neither require nor assume a particular technology. It also extends similar treatment to different electronic transactions such as telex, e-mail, or Electronic Data Interchange.
- *Party autonomy:* The model law recognizes the primacy of party agreement on whether and how to use e-commerce techniques. It also allows the parties to determine the security level appropriate for their transactions.

Part 2 of the model law deals with specific uses of e-commerce such as EDI messages as substitutes for transport documents. The transfer of any right or obligation that is to be conveyed by paper documents can be equally conveyed by electronic means, provided a reliable method is used to transfer them.

Other international initiatives on e-commerce include:

- *UNCITRAL Model Law on Electronic Signatures (2001*): This model law establishes criteria for technical reliability to establish an equivalence between electronic and handwritten signatures as well as basic rules of conduct that may serve as guidelines for assessing duties and liabilities for the signatory, the relying party, and trusted third parties intervening in the signature process.
- *United Nations Convention on the Use of Electronic Communications in International Contracts (2005):* The Electronic Communications Convention aims at facilitating the use of electronic communications in international trade by ensuring that contracts concluded and other communications exchanged electronically are as valid and enforceable as their traditional paper-based equivalents. The convention applies to all electronic communications exchanged between parties whose places of business are in different states when at least one party has its place of business in a contracting state (Art. 1). It may also apply by virtue of the parties' choice. Contracts concluded for personal, family, or household purposes, such as those relating to family law and the law of succession, as well as certain financial transactions, negotiable instruments, and documents of title, are excluded from the convention's scope of application (Carr, 2010).
- *International Chamber of Commerce (ICC) Guidelines on E-Commerce (1997 and 2001):* The ICC sets out best practices for adoption by businesses in order to promote trust in e-commerce by focusing on issues such as authentication, certification, public key certificates, and record keeping (Carr, 2010).

Regional initiatives on e-commerce include:

- *EU directive on e-commerce (2000*): The directive sets up an internal market framework for electronic commerce, which provides legal certainty for business and consumers alike. It establishes harmonized rules on issues such as transparency and information

requirements for online service providers, commercial communications, electronic contracts, and limitations of liability of intermediary service providers (Carr, 2010).

- *EU directive on e-signatures (1999):* This directive establishes the legal framework at the European level for electronic signatures and certification services. The aim is to make electronic signatures easier to use and help them become legally recognized among the member states.

Chapter Summary

Intellectual property rights (IPRs)	Intellectual property rights are associated with patents, trademarks, copyrights, trade secrets, and other protective devices granted by the state to facilitate industrial innovation and artistic creation.
Major issues related to IPRs and international trade	1. The growth of trade in counterfeit goods 2. Lack of adequate protection and enforcement of IPRs in many countries 3. The long-term effect of piracy on trade in technology-intensive goods.
U.S. classification of countries that do not provide adequate protection of IPRs	1. Priority foreign countries: Countries that do not provide adequate protection to IPRs and whose policies have the greatest adverse impact on U.S. commerce 2. Priority watch list: Countries that warrant close monitoring and resolution 3. Watch list: Countries that warrant special attention.
Regional and international protection	*International protection:* The Paris Convention, the Universal Copyright Convention, the Patent Cooperation Treaty, trade-related aspects of IPRs (the TRIP) agreement. *Regional protection:* The European Patent Convention, the African Regional Industrial Property Organization
Global e-commerce	The volume of global e-commerce was estimated at $1620 trillion in 2013. The global online population was estimated at 2.41 billion. The Internet reduces search costs (the cost of matching buyers and sellers), as well as the costs of finding agents, distributors, or retailers. The reduced transaction costs arising from the Internet help increase the volume of international trade. The positive effects of the Internet are larger for developing countries than for advanced nations. Some of the challenges of online trade include logistics and payment issues, customer trust, and limited ICT readiness in many developing countries. The website is the main tool of communication in the online market.

International regulation of e-commerce	■ The UNCITRAL Model Law on Electronic Commerce (1996) ■ UNCITRAL Model Law on Electronic Signatures (2001) ■ United Nations Convention on the Use of Electronic Communications in International Contracts (2005) ■ International Chamber of Commerce (ICC) Guidelines on E-Commerce (1997 and 2001)

Review Questions

1. What is the importance of IPRs to international trade?
2. What are patents? What are the advantages of providing an exclusive (monopoly) right to patent holders?
3. What is the importance of trademarks?
4. Discuss some of the reasons why some inventions are not patented.
5. Explain why piracy of IPRs is a trade barrier.
6. Discuss the level of protection and enforcement of IPRs in Japan and China.
7. What is the right of priority under the Paris Convention?
8. What are the three fundamental principles of the TRIPs agreement?
9. What are some of the challenges of online trade?
10. How can someone promote a website?

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World Wide Web Resources

Patents and intellectual property: http://members.tripod.com/~patents2/

Intellectual property mall: www.ipmall.info/

Intellectual property (copyrights, trademarks, and patents): http://www.brint.com/IntellP.htm

A Free Trade Area for the Americas (intellectual property): http://www.cptech.org/pharm/belopaper.htm

U.S. intellectual property for nonlawyers: http://www.fplc.edu/tfield/ipbasics.htm

Global Internet usage data: http://www.internetworldstats.com/stats.htm

UNCITRAL model law on e-commerce: http://www.uncitral.org/uncitral/uncitral_texts/electronic_commerce/1996Model.html

UNCITRAL model law on electronic signatures: http://www.uncitral.org/pdf/english/texts/electcom/ml-elecsig-e.pdf

Case 20.1 Patents and Access to Lifesaving Drugs

Under the Uruguay Round Agreement (1995), the jurisdiction of the World Trade Organization was expanded to include the protection of intellectual property rights. The agreement covers a wide range of subjects, including patents, copyrights, and trade secrets. It allows trade sanctions against countries that fail to abide by the agreement. With regard to the protection of pharmaceutical products, the agreement, Trade Related Aspects of Intellectual Property Rights, or TRIPs, attempts to strike a balance between the short-term benefits of proven lifesaving drugs and the long term objective of encouraging technological innovation. TRIPs imposes the following obligations on member countries: (1) protects product or process patents for at least twenty years from the date the patent application was filed; (2) prohibits discrimination between different fields of technology or places of invention and between imported and locally produced products; (3) allows governments to license someone to produce the patent product or process without the consent of the patent owner (a number of conditions must be met: the licensee must have tried unsuccessfully to get a license from the owner under

reasonable terms unless there is a national emergency; the patent owner must be adequately remunerated; and the license must be nonexclusive).

Many developing countries were concerned with the potential implications of TRIPs for protecting public health. This issue gained worldwide attention when a number of South African drug companies challenged the legality of the newly enacted legislation, which allowed for compulsory licensing of patented pharmaceuticals. The U.S. government also threatened to issue a compulsory license order against Bayer AG unless the company made significant quantities of capsules available at a reduced price to victims of anthrax. Member countries agreed to interpret the TRIPs agreement in a way that supports public health by promoting access to existing drugs and the creation of new medicines. They also agreed to extend exemptions on pharmaceutical patent protection for the least-developed countries until 2016.

The TRIPs agreement states that compulsory licensing can be used only to supply the domestic market. This means that (a) countries that produce under compulsory license would be unable to export the drug, and b) countries that do not have the manufacturing capability could not import it for domestic consumption. In August 2003, WTO members agreed to make it possible for countries to import cheaper generics made under compulsory licenses if they are unable to manufacture the medicines themselves.

Questions

1. Does TRIPs balance the interests of drugs companies with that of consumers in developing countries?
2. What suggestions do you have that might be acceptable to both parties?

Case 20.2 Intellectual Property Rights and International Trade

Intellectual property rights are exclusive rights given by the government to creators of new products, services, and processes. They include patents, trademarks, know-how, and copyrights. With the globalization of national economies, IPRs are playing an important role in global trade as many products incorporate technology-intensive components. Industries that depend on patent protection include the chemical, pharmaceutical, aerospace, electronics, and semiconductor industries. Copyright-based industries include movie, book, data processing, and recording industries. Businesses in retail, transportation, and other sectors also depend on IPRs such as know-how and trademarks.

In the United States, IPR-related activities account for about 75 percent of the GDP growth during the post–World War II period and 60 percent of total U.S. exports between 2000 and 2007. IPR-intensive industries also contribute positively to the U.S. economy through productivity gains and other spillover effects.

In 2009, domestic sales by research-based pharmaceutical companies that are members of Pharmaceutical Researchers and Manufacturers of America (PhRMA)

reached an estimated $183 billion, while sales abroad by PhRMA member companies totaled about $103 billion. The intellectual property industries contribute positively to the overall U.S. trade balance through royalties and licensing fees. Rights-holders may authorize the use of technologies, trademarks, and entertainment products that they own to entities in foreign countries, resulting in revenues through royalties and license fees. In 2009, U.S. receipts from cross-border trade in royalties and license fees (relating to patent, trademark, copyright, and other intangible rights) totaled $89.8 billion, down from $93.9 billion in the previous year. Also in 2009, U.S. payments of royalties and license fees to foreign countries amounted to $25.2 billion. Industrial processes, computer software, and trademarks accounted for the bulk of U.S. international trade in intangible assets.

Advances in information and technology and declining costs of transportation and communications, spurred by globalization, have fundamentally changed information and trade flows. Such changes have created new markets for U.S. exporters but at the same time have been associated with the proliferation of counterfeiting and piracy on a global scale.

Several factors contribute to the growing problem of IPR infringement:

- While the costs and time for research and development are high, IPR infringement is associated with relatively low costs and risks and a high profit margin. It takes a drug company about ten to fifteen years of research and development to create a new drug. PhRMA member companies, for example, collectively spent an estimated $46 billion for research and development (domestic and abroad) in 2009. In contrast, drug counterfeiters can lower production costs by using inexpensive and perhaps dangerous or ineffective ingredient substitutes.
- The development of technologies and products that can be easily duplicated, such as recorded or digital media, also has led to an increase in counterfeiting and piracy. Increasing Internet usage has contributed to the distribution of counterfeit and pirated products.
- Civil and criminal penalties often are not sufficient deterrents against piracy and counterfeiting. The United States is especially concerned with foreign IPR infringement of U.S. intellectual property. IPR infringements levels in the United States are estimated to be relatively low compared to those in other countries.

According to the Organization for Economic Cooperation and Development (OECD), world trade in counterfeit and pirated goods was estimated at about $200 billion in 2005. In the United States, the domestic value of IPR-related seizures grew by more than 25 percent each year during 2005–2008. It peaked at $272 million in 2008 and then dropped by 4 percent to about $261 million in 2009. Of all U.S. trading partners, China continues to account for the majority of counterfeits intercepted at the U.S. border. Other top trading partners from which IPR-infringing goods were seized include Hong Kong, India, Taiwan, and Korea.

Question

1. Do you think counterfeiting improves the welfare of poor countries?

Appendices

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Appendix A
Trading Opportunities in Selected Countries

A.1 Trading Opportunities in Africa and the Middle East

Egypt

Country Profile

Population: 85,295,388 (2013)
Exports: $28.37 billion
Major Exports: Crude oil and petroleum products, cotton yarn, raw cotton, textiles, metal products
Export Partners: Italy, India, Saudi Arabia, United States, Turkey
Imports: $58.76 billion
Major Imports: Machinery and equipment, foods, fertilizers, wood products, durable consumer goods, capital goods.
Import Partners: United States, China, Germany, Italy, Kuwait
Trade as % GDP: Exports: 23.31%; Imports: 30.16%
Major Trading Partners: United States, Germany, Italy
Currency and Exchange Rate: Egyptian pounds per U.S. dollar—6.05
GDP: $537.8 billion
GDP per capita: $6,600
External Debt: $34.88 billion

Import Policies

- *Entry of goods:* Most commodities can be imported without a license except those that require import licenses. Importers must apply for a license for dietary products and renew the license every one to five years depending on the product, at a cost of approximately $1,000 per renewal. The government requires registration and approval of all imports

of nutritional supplements, specialty foods, and dietary foods. It must also approve the importation of new, used, and refurbished medical equipment and supplies to Egypt.

- *Tariffs and taxes:* The liberalizing reforms undertaken by the government of Egypt in the past seven years have reduced the overall weighted tariff average from 14.6 percent to 10.1 percent. Tariffs on the vast majority of goods entering Egypt are below 15 percent. Vehicles, alcohol, tobacco, and selected cereals are the only items on which tariffs are still 40 percent or higher. All clothing faces a relatively high tariff of 30 percent.
- *Nontariff barriers:* NTBs include (a) lack of transparency in government procurement, (b) inspection for quality control, arbitrary testing procedures that discriminate against foreign products, (c) barriers in banking, telecommunications, and express delivery services.
- *Intellectual property rights protection:* There is inadequate protection and enforcement of IPRs in Egypt. Allegations of trademark infringement, copyright piracy, inadequate patent term, and broad compulsory licensing provisions are major trade barriers in trade in technology-intensive products.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, consular/customs invoice, sanitary certificate, radiation certificate (agricultural imports).
- *Marketing and distribution:* Agents and distributors generally handle imports. Large retailers import directly from foreign manufacturers.

Best Export Prospects

- *Commercial sectors:* Telecommunications equipment and services, electricity and power generation (ELP), port development, medical equipment and supplies, safety and security, franchise.
- *Agricultural sectors:* Cold-storage facilities, slaughterhouses (beef processing), edible oil, fruit, and vegetables processing, meat processing, dairy processing (live dairy and beef farms), confectionery, snacks, packaging equipment, silos and storage facilities.

Promising imports from Egypt: Cotton, beans, onions, rice, textiles and clothing, manufactured goods, petroleum and petroleum products, metal products

Major impediments to exporting from Egypt (in order of importance): Access to inputs at competitive prices, inadequate technology and skills, inefficient market research to identify overseas markets, technical standards, access to trade finance, meeting quality requirements for overseas buyers, inadequate infrastructure, rules-of-origin requirements, and burdensome customs procedures and corruption at foreign borders

Major impediments to importation to Egypt (in order of importance): Tariffs and nontariff barriers including burdensome import procedures, cost and delays due to domestic and foreign transportation, technical standards, corruption, crime and theft

Ghana

Country Profile

Population: 25,199,609 (2013)

Exports: $13.58 billion

Major Exports: Oil, gold, cocoa, timber, tuna, bauxite, aluminum, manganese ore, diamonds, horticultural products

Export Partners: France, Netherlands, United States, Italy, United Kingdom, India
Imports: $17.52 billion
Major Imports: Capital equipment, petroleum, foodstuffs
Import Partners: China, Nigeria, United States, India, Netherlands, United Kingdom
Trade as % GDP: Exports: 38%; Imports: 51%
Currency and Exchange Rate: 1.82 cedis per U.S. dollar
GDP: $83.18 billion
GDP per capita: $3,300
External Debt: $11.23 billion

Import Policies

- *Entry of goods:* Ghana is a member of the World Trade Organization (WTO) and the Economic Community of West African States (ECOWAS). Ghana has bound all agricultural tariffs in the WTO at an average of 97.2 percent, more than five times the average level of its MFN applied rates on agricultural goods. On industrial goods, almost all of Ghana's tariffs are unbound at the WTO, allowing Ghana to raise tariffs to any rate at any time without violating WTO commitments and contributing to uncertainty for traders.
- *Tariff and taxes:* Ghana's average most-favored-nation (MFN) applied tariff rate in 2010 was 12.8 percent. For agricultural goods, the average applied tariff is 17.4 percent, and for nonagricultural products it is 12.3 percent. Along with other ECOWAS countries, Ghana adopted a common external tariff (CET) with five bands. The five tariff bands are: no duty on social goods *(e.g.,* medicine, publications); 5 percent duty on imported raw materials; 10 percent duty on intermediate goods; 20 percent duty on finished goods; and 35 percent duty on goods in certain sectors that the government seeks to protect, such as poultry and rice. Ghana currently maintains 190 exceptions to the CET, and the highest applied tariff is 20 percent.
- *Nontariff barriers:* Importers are confronted by a variety of fees and charges in addition to tariffs. Ghana levies a 12.5 percent value-added tax (VAT) plus a 2.5 percent National Health Insurance levy on the duty-inclusive value of all imports as well as on locally produced goods, with a few selected exemptions. In addition, Ghana imposes a 0.5 percent ECOWAS surcharge on all goods originating in non-ECOWAS countries and charges 0.4 percent of the free on board (FOB) value of goods (including VAT) for the use of the automated clearing system, the Ghana Community Network. Under the Export Development and Agricultural Investment Fund (EDAIF) Act, Ghana imposes a 0.5 percent duty on all nonpetroleum products imported in commercial quantities. Ghana also applies a 1 percent processing fee on all duty-free imports. Imports are subject to an inspection fee of 1 percent of cost, insurance, and freight (CIF) of the goods. Importers have reported that the flat fee is not based on the cost of the services rendered. Destination inspection companies (DICs) are licensed by the Ghanaian government, and inspection by the DICs accounts for the longest delays in import clearance.
- *Intellectual property rights protection:* Companies that do initiate cases report prolonged waits for resolution, a possible factor in discouraging other companies from filing cases. There is virtually no government-initiated enforcement.
- *Documentation requirements:* Original bill of lading/air waybill, invoice, packing list, final classification and valuation report (FCVR), import declaration form (IDF) from the Ministry of Trade and Industry, tax clearance certificate from the Domestic Tax

Revenue Division issued in the name of the importer or 1 percent of CIF payment fee, tax identification number (TIN) from the Ghana Revenue Authority, permit or license from the appropriate ministry, agency, or department as applicable for restricted goods, appropriate letter of exemption from payment of duty and/or taxes as applicable.

- *Marketing and distribution:* Most exports to Ghana are handled through local representatives and distributors.

Best Export Prospects

Agricultural products/commercial sectors: Capital equipment, petroleum, foodstuffs

Promising imports from Ghana: Minerals, sugar beets, light industry products
Major impediments to exporting from Ghana (in order of importance): Access to trade finance, burdensome procedures and corruption at foreign borders, identification of potential market opportunities, access to imported inputs at competitive prices, high cost or delays caused by domestic/international transportation
Major impediments to importing to Ghana (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, corruption at the border, high cost or delays caused by domestic and international transportation, domestic technical standards and requirements, crime and theft

Israel

Country Profile

Population: 7,707,042 (2013)
Exports: $64.74 billion
Major Exports: Machinery, cut diamonds, software, chemicals, textiles and clothing, agricultural products
Export Partners: United States, Hong Kong, Belgium, United Kingdom, India, China
Imports: $77.59 billion
Major Imports: raw materials, military equipment, investment goods, rough diamonds and oil
Import Partners: United States, China, Germany, Belgium, Switzerland, Italy
Trade as % GDP: Exports: 37.00%; Imports: 38%
Major Trading Partners: United States, Belgium, Hong Kong, Germany, Switzerland, United Kingdom
Currency and Exchange Rate: new Israeli shekels per U.S. dollar—3.90
GDP: $247.9 billion
GDP per capita: $32,200
External Debt: $104.2 billion

Import Policies

- *Entry of goods:* Israel has import licensing requirements on many food and agricultural products. Under the U.S.-Israel Free Trade Agreement, all duties on U.S. exports to

Israel were eliminated in 1995. Israel has strict marking and labeling requirements, and thus it is important for exporters to consult with the Israeli importer prior to shipment of merchandise.
- *Tariff and taxes:* For countries with which Israel does not have a free-trade agreement, tariffs range from 0.5 to more than 95 percent of CIF value. Purchase taxes are also imposed on certain luxury and consumer items such as alcohol, cigarettes, automobiles, and color televisions, and tariff rate quotas are imposed on imported wines.
- *Nontariff barriers:* Certain imports such as certain agricultural products or other substances are prohibited on grounds of national security or human, animal, or plant health. Textile products such as used clothing are restricted, and those with second fabrics are banned. Many products are subject to mandatory standards designed to favor domestic products over imports. There are strict regulations on imported meat and meat products. There are also strict certification, packaging, and labeling requirement for certain products.
- *Intellectual property rights protection:* Israel has made the necessary changes to comply with its commitments to the GATT/WTO TRIPs obligations. Cable TV, video, and software piracy remains widespread in Israel, as well as trademark infringements in textiles. Other issues include the need to improve data protection, the terms of patents for pharmaceutical products, and provisions on the publication of patent applications in Israel.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, sanitary certificate, health certificate (cattle), photo-sanitary certificate (plants and plant products), special certificate (liquors), registration requirements (drugs), kosher certificate (food products).
- *Marketing and distribution:* Most exports to Israel are handled through local representatives and distributors.

Best Export Prospects

- *Agricultural products:* Wheat, feed grains, dried fruits, tree nuts, beef.
- *Commercial sectors:* Travel and tourism, medical equipment, automotive aftermarket parts and equipment, intelligent transportation system, educational services, electricity, homeland security, offshore gas, telecommunications, electronic components.

Promising imports from Israel: Dairy products, fruits and vegetables, machinery and equipment, metals, polished diamonds, textiles and clothing, high-tech equipment, chemical and oil products

Major impediments to exporting from Israel (in order of importance): Access to inputs at competitive prices, inefficient market research to identify overseas markets, technical standards abroad, high cost or delays caused by domestic or international transportation, rules-of-origin requirements, and burdensome customs procedures and corruption at foreign borders

Major impediments to importation to Israel (in order of importance): Burdensome import procedures, cost and cost/delays due to domestic and foreign transportation, technical standards, corruption, crime and theft

Kenya

Country Profile

Population: 44,037,656 (2013)
Exports: $5.942 billion
Major Exports: Tea, horticultural products, coffee, petroleum products, fish, cement
Export Partners: Uganda, Tanzania, Netherlands, United Kingdom, United States, Egypt, Democratic Republic of the Congo
Imports: $14.39 billion
Major Imports: machinery and transportation equipment, petroleum products, motor vehicles, iron and steel, resins and plastics
Import Partners: China, India, United Arab Emirates, Saudi Arabia, South Africa, Japan
Trade as % GDP: Exports: 29%; Imports: 46%
Currency and Exchange Rate: Kenyan shillings (KES) per U.S. dollar—85.82
GDP: $76.07 billion
GDP per capita: $1,800
External Debt: $9.526 billion

Import Policies

- *Entry of goods:* Kenya is a member of the World Trade Organization (WTO), the Common Market for Eastern and Southern Africa (COMESA), and the East African Community (EAC). As a result, the country has undertaken substantial trade liberalization initiatives, including reduction of its most-favored-nation (MFN) tariffs, removal of quantitative restrictions, improvement of the business environment, and trade facilitation.
- *Tariff and taxes:* Kenya's average applied tariff rate for all products was 12.5 percent in 2011. High ad valorem import tariffs and a value-added tax (VAT) inhibit trade, especially in the agricultural sector. Kenya applies the EAC Customs Union's Common External Tariff (CET), which includes three tariff bands: no duty for raw materials and inputs; 10 percent for processed or manufactured inputs; and 25 percent for finished products. "Sensitive" products and commodities, comprising fifty-eight tariff lines, have applied ad valorem rates above 25 percent. This includes a 60 percent rate for most milk products, 50 percent for corn and corn flour, 75 percent for rice, 35 percent for wheat, and 60 percent for wheat flour. For some products and commodities, the tariffs vary across the five EAC member states.
- *Nontariff barriers:* Kenya justifies its existing import controls as necessary to address health, environmental, and security concerns. All importers pay an import declaration fee set at 2.25 percent of the customs value of imports and are required to furnish several documents. Importers must provide a Certificate of Conformity (CoC) after export certification by preshipment inspection companies (SGS or Intertek International) contracted by the GOK. After a CoC is issued, the Kenya Bureau of Standards issues the import standardization mark, a stick-on label to be affixed to each imported item. Numerous bureaucratic procedures at the Port of Mombasa increase the cost of imported goods significantly. Multiple agencies (i.e., customs, police, port authority, and standards inspection agencies) subject importers to excessive and inefficient

inspection and clearance procedures. These procedures can create opportunities for graft and unnecessary delays.

- *Intellectual property rights protection:* Imported pharmaceutical drugs, shoes, textiles, office supplies, tubes and tires, batteries, shoe polish, soaps, and detergents are the most commonly counterfeited items. IPR enforcement against pirated Kenyan and foreign works, however, remains weak.
- *Documentation requirements:* Import declaration form, certificate of conformity from agent for regulated products, import standards mark (where applicable), pro forma invoice, bill of lading, packing list.
- *Marketing and distribution:* Kenya has no laws or policies requiring the retention of a local agent or distributor by a U.S. or other foreign company exporting to Kenya. However, generally speaking, it is highly advisable for a foreign company to retain an agent or distributor who is resident in Kenya. If the product to be exported requires servicing, qualified service personnel and a reasonable supply of spare parts must be provided. Failure to address the issue of aftersales support and service is a major impediment to success in Kenya.

Best Export Prospects

- *Agricultural products:* Corn maize, wheat, rice rough, animal genetic, sugar.
- *Commercial sectors:* Construction/medical/telecommunications equipment, electrical power supplies, aircraft and parts.

Promising imports from Kenya: Tea, coffee, wheat, fruits and vegetables, light-scale consumer goods

Major impediments to exporting from Kenya (in order of importance): Identification of potential market opportunities, access to trade finance, burdensome procedures and corruption at foreign borders, access to imported inputs at competitive prices, high cost or delays caused by domestic transportation, difficulty in meeting buyer's quality and quantity requirements

Major impediments to importation to Kenya (in order of importance): Corruption at the border, burdensome import procedures, tariff and nontariff barriers, crime and theft, domestic technical standards and technical requirements

Nigeria

Country Profile

Population: 174,507,539
Exports: 97.46 billion
Major Exports: Petroleum, cocoa, rubber
Export Partners: United States, India, Brazil, Spain, France, Netherlands
Imports: $70.58 billion
Major Imports: Machinery and transport, chemicals, food and live animals
Import Partners: China, United States, India, Netherlands, S. Korea
Trade as % GDP: Exports: 39.62%; Imports: 36%

Major Trading Partners: United States, Brazil, Spain, China, Netherlands, France, Germany, Italy
Currency and Exchange Rate: nairas per U.S. dollar—157.3
GDP: $450.5 billion
GDP per capita: $2,700
External Debt: $10.1 billion

Import Policies

- *Entry of goods:* Importers are required to open an irrevocable letter of credit after receipt of an approved revised "Form M" processed through their banks. All items entering the country must be labeled in metric terms exclusively. Entries of goods through Nigerian ports are faced with time-consuming inspections and high costs.
- *Tariffs and taxes:* Nigeria's most recent tariff review occurred in September 2008. The 2008–2012 CET has five tariff bands. The five tariff bands include no duty on capital goods, machinery, and essential drugs not produced locally; 5 percent duty on imported raw materials; 10 percent duty on intermediate goods; 20 percent duty on finished goods; and 35 percent duty on goods in certain sectors that the government seeks to protect. It has introduced a number of levies on selected agricultural products.
- *Nontariff barriers:* Nontariff barriers to trade include (a) export subsidies and various incentive programs, and (b) nontransparent tendering procedures that are often claimed to use the patronage system. In December 2010, the government announced the removal of textiles, furniture, and toothpicks from the list of prohibited imports. It also increased the age limit on imported cars from ten years to fifteen years.
- *Intellectual property rights protection:* Even though there are laws to protect intellectual property rights in Nigeria, enforcement remains quite weak. Nigeria is considered Africa's largest market for pirated goods from third countries. Trademark infringement and piracy of patents (especially pharmaceuticals), sound recordings, and tapes is claimed to be a major problem.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, sanitary certificate, disinfection certificate, certificate of analysis.
- *Marketing and sales:* Products are generally exported to Nigeria through local agents and distributors. Machinery and equipment are sometimes purchased directly from overseas manufacturers mainly to avoid delays of the distribution system.

Best Export Prospects

- *Agricultural sectors:* Wheat, rice, wines and spirits, dairy products.
- *Industrial sectors:* Aerospace/aviation/avionics, agriculture machinery, automobiles, computers/software/peripherals, construction equipment, education/training, electrical power equipment, general security, marine vessels/equipment/accessories, medical equipment, oil and gas field machinery, telecommunications equipment, trucks.

Promising imports from Nigeria: Cocoa, oil, rubber

Major impediments to exporting from Nigeria (in order of importance): Access to trade finance, identification of potential market opportunities, burdensome procedures and corruption at foreign borders, meeting the requisite quality or quantity requirements, inadequate production and technical skills, and high cost or delays caused by domestic/international transportation

Major impediments to importation to Nigeria (in order of importance): Tariff and nontariff barriers, burdensome import procedures, corruption, cost/delays due to international transportation, crime and theft

South Africa

Country Profile (2012)

Population: 48,601,098 (2013)
Exports: $101.2 billion
Major Exports: Gold, minerals and metals, machinery and equipment
Export Partners: China, United States, Japan, Germany, and United Kingdom
Total Imports: $106.8 billion
Major Imports: Machinery, transport equipment, chemicals, petroleum products, scientific instruments, foodstuffs
Import Partners: China, Germany, United States, Japan, Saudi Arabia, India, United Kingdom
Trade as % GDP: Exports: 28.82%; Imports: 29.43%
Currency and Exchange Rate: rand per U.S. dollar—8.10
GDP: $578.6 billion
GDP per capita: $11,300
External Debt: 47.56 billion

Import Policies

- *Entry of goods:* Import permits are required only for certain products, such as agricultural and fishery products. South Africa is part of a customs union (SACU) where products by non-SACU countries are able to move within the four countries (Botswana, Namibia, Lesotho, and Swaziland) with a lower tariff rate.
- *Tariff and taxes:* South Africa has a three-column tariff based on the Harmonized System: general rates, EU preferential rate, and SADC preferential rate. Many goods, especially industrial inputs, are duty-free. Where duties apply, the rates generally fall between 5 percent and 25 percent, although protection can be quite high, with automobile tariffs at 50 percent. Goods not less than R400 are not liable for customs duty and do not have to be entered on a bill of entry.
- *Nontariff barriers:* ITAC requires importers to apply for permits on used goods, certain consumer products, wood and paper products, and chemicals. Other categories of controlled imports include waste, scrap, ashes, residues, and goods subject to quality specifications. Other often cited nontariff barriers to trade include customs valuation above invoice prices, import quotas on many products, antidumping measures, excessive

regulation, standards, and sanitary and phytosanitary as well as labeling and packaging requirements.

- *Intellectual property rights protection:* Even though there are laws to protect intellectual property rights in South Africa, enforcement remains quite weak. DVDs, video, and software piracy remains widespread in South Africa. There is also illegal commercial photocopying, especially at universities, libraries, and other on-campus venues.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, health certificate, photo-sanitary certificate, permits for agricultural products.
- *Marketing and distribution:* Import distribution and sale are usually handled by an agent or distributor, selling through established wholesales or dealers. Certain exports are also distributed through branches or subsidiaries.

Best Export Prospects

- *Commercial sectors:* Green technologies, electrical power systems, information technology (IT), telecommunications, mining equipment, pollution control equipment, aerospace, green building technologies, automotive aftermarket: specialty equipment, transportation infrastructure, agricultural equipment.
- *Agricultural sectors:* Grains, vegetable oils, oilseed meals, alcoholic beverages, poultry.

Promising imports from South Africa: Agricultural products, coal, gold, minerals and metals

Major impediments to exporting from South Africa (in order of importance): High cost or delays caused by domestic transportation, access to imported inputs at competitive prices, burdensome procedures and corruption at foreign borders, high cost or delays caused by international transportation

Major impediments to importation to South Africa (in order of importance): High cost or delays caused by domestic transportation, burdensome import procedures, tariffs and nontariff barriers, high cost or delays caused by international transportation

Zimbabwe

Country Profile

Population: 13,182,908 (2013)
Exports: $3.314 billion
Major Exports: tobacco, gold, ferroalloys and cotton, platinum, textile/clothing
Export Partners: South Africa, China, Congo (DR), Botswana, Italy
Imports: $4.675 billion
Major Imports: Transport equipment and machinery, chemicals, manufactures, petroleum products
Import Partners: South Africa, China
Trade as % GDP: Exports: 49.41%; Imports: 88%
Currency and Exchange Rate: Zimbabwean dollars per U.S. dollar—234.25
GDP: $6.909 billion
GDP per capita: $500
External Debt: $6.98 billion

Import Policies

- *Entry of goods:* It is difficult to import products into Zimbabwe since the country places exceptionally high tariffs, quotas, or bans on certain products.
- *Tariff and taxes:* Since the advent of the coalition government in 2009, import tariffs have been reduced to align them with regional and international practice. There are three different types of payments upon importation of goods into Zimbabwe: import duty, surtax, and value-added tax (VAT). These are described in the Harmonized System Tariffs Handbook and other relevant subsequent legislation. Most imported goods are subject to surtax and VAT. The government uses the General Agreement on Trade and Tariffs (GATT) method of customs valuation.
- *Nontariff barriers:* Until recently, there was no widespread use of nontariff barriers to control trade in Zimbabwe. In 2010 and again in 2011, Zimbabwe imposed temporary or partial bans on various meat products. Officially, these restrictions were motivated by consumer-protection or disease-prevention considerations, but they also have the effect of protecting local producers from foreign competition.
- *Intellectual property rights protection:* IPRs exist in Zimbabwe, but there is a lack of adequate enforcement. Videocassette, audio, and software piracy is widespread.
- *Documentation requirements:* Bill of entry plus relevant invoices, shipping documents such as a bill of lading, freight statements, and certificates of origin, especially for products entering from member states of SADC and PTA.
- *Marketing and Distribution:* Marketing and distribution is handled by local agents and distributors.

Best Export Prospects

- *Agricultural products:* Cotton, tobacco.
- *Commercial sectors:* Tourism, mining, and manufacturing.

Promising imports from Zimbabwe: Gold, tobacco, tea, cotton, and certain manufactures
Major impediments to exporting from Zimbabwe (in order of importance): Access to trade finance, inappropriate production technology and skills, access to imported inputs at competitive prices, identification of potential market opportunities, high cost or delays caused by domestic /international transportation.
Major impediments to importing to Zimbabwe (in order of importance): Tariffs and nontariff barriers, burdensome import procedures, corruption at the border, high cost or delays caused by international/domestic transportation

A.2 Trading Opportunities in the Americas

Argentina

Country Profile

Population: 42,610,981 (2013)
Exports: $85.36 billion
Major Exports: Edible oils, feeds, motor vehicles
Imports: $67.33 billion

Major Imports: Machinery, vehicles and transport products, chemicals, plastic
Trade as % GDP: Exports: 21.82%; Imports: 19.53%
Major Trading Partners: United States, Brazil, Germany, China, Chile, Spain
Currency and Exchange Rate: Argentine pesos per U.S. dollar—4.569
GDP: $764.9 billion
GDP per capita: $18,200
External Debt: $130.2 billion

Import Policies

- *Entry of goods:* The government of Argentina requires the presentation of an import license for the purpose of customs clearance. Certificate of origin and consularization requirements are also placed on a broad range of imports.
- *Tariff and taxes:* MERCOSUR maintains a Common External Tariff (CET) schedule with a limited number of country-specific exceptions, with most-favored-nation (MFN) applied rates ranging from 0 percent to 35 percent ad valorem. In July 2012, Argentina partially eliminated its exemptions to the CET on capital goods and currently imposes the 14 percent CET rate on imports of capital goods that are produced domestically; imports of certain other capital goods that are not produced domestically are subject to a reduced ad valorem tariff of 2 percent. In early 2012, the Argentine government announced a tax increase on "high-end" imported cars and motorcycles. Argentine consumers are now required to pay an additional 10 percent tax on such vehicles imported from outside MERCOSUR.
- *Nontariff barriers:* Since 2011, Argentina increased its use of nonautomatic import licenses and imposed other nontariff barriers. Since April 2010, Argentina has required importers to obtain a "certificate of free circulation" from the National Food Institute prior to importing food products. Argentina prohibits the import of many used capital goods. The Resolution 3373 issued in August 2012 increased the tax burden for importers. In May 2012, the Argentine National Mining Agency issued resolutions requiring mining companies registered in Argentina to use Argentine-flagged vessels to transport minerals and their derivatives for export from Argentina and to purchase domestic capital goods, spare parts, inputs and services, in accordance with the government's import substitution policies.
- *Documentation requirements:* Maritime shipments: commercial invoice (original and three copies), bill of lading, packing, insurance, certificate of origin; air cargo shipments: commercial invoice (original and three copies), air waybill, packing list, certificate of origin.
- *Marketing and distribution:* Imports can be handled through branches, import houses (import merchants) or local representatives. Government agencies and local manufacturing firms make direct imports.

Best Export Prospects:

- Industrial sector: Agricultural machinery, irrigation equipment, parts and components, electronic security equipment, food processing equipment, information and communications technology, medical equipment, instruments, and supplies, mining machinery and equipment, renewable energy technology and equipment.

- Agricultural sector: Animal genetics (bovine semen), food ingredients (natural origin), planting seeds.
- Services: Travel and tourism.

Promising imports from Argentina: Soybeans and derivatives, petroleum and gas, vehicles, corn, wheat

Major impediments to exporting from Argentina (in order of importance): Access to imported inputs at competitive prices, access to trade finance, inappropriate production technology and skills, identification of potential markets and buyers, burdensome procedures and corruption at foreign borders, high cost or delays caused by domestic transportation

Major impediments to importation to Argentina (in order of importance): Tariffs and nontariff barriers, burdensome import procedures, domestic technical requirements and standards, corruption at the border, high cost or delays caused by international/ domestic transportation

Brazil

Country Profile

Population: 201,009,622
Exports: $242 billion
Major Exports: iron ore, soybean bran, orange juice, footwear
Imports: $238.8 billion
Major Imports: capital goods, chemical products, oil, electricity
Trade as % GDP: Exports: 11.89%; Imports: 12.62%
Major Trading Partners: European Union, Latin America, United States
Currency and Exchange Rate: reals per U.S. dollar—2.1
GDP: $2.36 trillion
GDP per capita: $12,000
External Debt: $405.3 billion

Import Policies

- *Entry of goods:* Exporters and Brazilian importers must register with the Foreign Trade Secretariat (SECEX). Brazil has both automatic and nonautomatic import license requirements. Ministry of Health's regulatory agency, ANVISA, must approve product registrations for imported pharmaceuticals, medical devices, health and fitness equipment, cosmetics, and processed food products. The product labeling should provide the consumer with precise and easily readable information about the product's quality, quantity, composition, price, guarantee, shelf life, origin, and risks to the consumer's health and safety. Imported products should bear a Portuguese translation of this information. Products should be labeled in metric units or show a metric equivalent.
- *Tariff and taxes:* Brazil is a member of the MERCOSUR customs union, which maintains a Common External Tariff (CET) schedule with a limited number of country-specific exceptions, with most-favored-nation (MFN) applied rates ranging from zero to 35 percent ad valorem. Brazil's MFN applied tariff rate averaged 11.6 percent in

2012. Brazil's average bound tariff rate in the WTO is significantly higher at 31.4 percent. Brazil's maximum bound tariff rate for industrial products is 35 percent, while its maximum bound tariff rate for agricultural products is 55 percent.
- *Nontariff barriers:* Brazil applies to imports federal and state taxes and charges that can effectively double the actual cost of imported products in Brazil. Brazil also prohibits a number of imports, including some blood products and all used consumer goods. Brazil also restricts the entry of certain types of remanufactured goods (e.g., earth-moving equipment, automotive parts, and medical equipment). In general, Brazil allows the importation of such goods only if an importer can provide evidence that the goods are not or cannot be produced domestically.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, sanitary certificate, health certificate, inspection certificate.
- *Marketing and distribution:* Marketing and distribution is often handled through agents and distributions.

Best Export Prospects

- *Industrial sectors:* Aerospace /aviation, construction and engineering industry, cosmetics, defense, drugs and pharmaceuticals, education and training, electrical power and renewable energy industries, environmental technologies, IT hardware and software, medical equipment, mining, oil and gas industry, safety/security, telecommunications, transportation.
- *Agriculture sectors:* Food, equipment and services.
- *Services:* Travel and tourism.

Promising imports from Brazil: Transport equipment, iron ore, soybeans, footwear, coffee, autos

Major impediments to exporting from Brazil (in order of importance): High cost or delays caused by domestic transportation, access to trade finance, high cost or delays caused by international transportation, access to imported inputs at competitive prices, rules-of-origin requirements abroad, inappropriate production technology and skills, technical requirements and standards abroad, identification of potential markets and buyers, difficulties in meeting quality/quantity requirements of buyers, burdensome procedures and corruption at foreign borders

Major impediments to importation to Brazil (**in order of importance**)**:** Tariffs and nontariff barriers, burdensome import procedures, high cost or delays caused by domestic transportation, high cost or delays caused by international transportation, domestic technical requirements and standards, corruption at the border, inappropriate telecommunications infrastructure, crime and theft

Canada

Country Profile

Population: 34,568,211
Exports: $481.7 billion

Major Exports: Timber, automobile products, machinery, petroleum
Imports: $480.9 billion
Major Imports: Machinery and equipment, petroleum, chemicals, and automobiles
Trade as % GDP: Exports: 31.17%; Imports: 32.39%
Major Trading Partners: United States, Japan, United Kingdom, Germany, Mexico, China
Currency and Exchange Rate: Canadian dollars per U.S. dollar—1.001
GDP: $1.446 trillion
GDP per capita: $41,500
External Debt: $1.181 trillion

Import Policies

- *Entry of goods:* The United States and Canada maintain different regulations regarding product labeling. Most goods can be imported into Canada subject to certain conditions. The conditions are: (1) *Is entry of the article prohibited into Canada?* Examples are hate literature, pornography, and other goods that the Canadian Department of Foreign Affairs and International Trade keep out pursuant to international sanctions; (2) *Is the article allowed in only under the authority of an import permit?* Canada controls imports of textiles and clothing, steel, wheat, barley and their products, supply-managed farm products (dairy, chicken, eggs, turkey), firearms and similar items, and some miscellaneous items (details of these can be found on the Import Control List); (3) *Is the article subject to some privately certified standard?* Examples are all electrical appliances and equipment, which must be certified by the Canadian Standards Association before they can be sold in Canada; (4) *Is there a provincial rule to comply with?* Examples are imports of liquor, wine, and beer, which require prior authorization from the appropriate liquor commission before Customs Canada will clear them.
- *Tariff and taxes:* Pursuant to the NAFTA, Canada eliminated tariffs on January 1, 1988, on all industrial and most agricultural products imported from the United States. In 2010 Canada announced the unilateral elimination of import tariffs on manufacturing inputs. Most tariffs were eliminated immediately, and the remainder will be eliminated by 2015. For non-NAFTA exporters, duty rates in Canada range between 0 percent and 35 percent, and the average duty rate is 8.56 percent. Some goods are not subject to duty (e.g., certain electronic products, antiques, toys). The Good and Services Tax (GST) is 7 percent on most imported goods.
- *Nontariff barriers:* The requirement that Canadian label information be provided in English and French creates extra costs for U.S. exporters. Exporters of food products face additional challenges because of different rules regarding the types of health claims that can be made on labels and different nutrition standards, such as recommended daily allowances of vitamins. Certification might be required for certain products. Prohibited imports include (1) meat for human consumption not subjected to antemortem inspection; (2) secondhand automobiles manufactured prior to the year in which importation is sought; (3) specified classes of second-hand aircraft; (4) certain types of weapons.

The Canadian market for imported wine and spirits operates in a highly regulated environment and is characterized by government monopolies. Provincial liquor boards have sole authority to import wine into Canada. The exception is the Alberta Liquor Control Board, which has privatized its entire retail network. The other provincial liquor boards import, warehouse, and distribute imported wines to their various retail outlets. However, private

individuals and restaurateurs, hoteliers, and so on may obtain approval to import unlisted products through the Liquor Control Boards.

Electrical equipment for connection to mains power must receive the prior approval of either the Canadian Standards Association (CSA) or the relevant provincial electricity authority.

There are basically six categories of goods that require import permits: (1) Animal and animal products—turkeys, eggs, chicks, and chickens; (2) dairy products—animal feeds, butter, butterfat, cheese, dry casein and caseinates, dry whey and all milk and milk products such as buttermilk, skimmed milk, dry whole milk, evaporated milk, and condensed milk, blends, ice cream and ice milk/products/mixes, and yoghurt; (3) other agricultural items—beef and veal, wheat, barley; (4) textile and textile products—fabric or yarn, cotton terry towels and washcloths, sheets and pillowcases of cotton or artificial fibers, cotton broad woven fabrics, and cellulose acetate woven fabric; (5) clothing and accessories—work gloves, outerwear garments, hosiery, pants, blouses and ladies shirts, sleepwear, bathrobes, rainwear, sportswear, foundation garments, swimwear, underwear, jackets, top coats, overcoats, men and boys suits, sports coats, blazers, men's and boys' shirts, sweaters, pullovers, cardigans, handbags or fabric, apparel goods; (6) miscellaneous—endangered species, racoon dogs, arms of war, carbon steel, speciality steel products, prohibited weapons, softwood lumber.

- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading, packing list, certificate of origin, insurance certificate, sanitary certificate, photosanitary certificate.
- *Marketing and distribution:* Imports are marketed and sold through wholesalers, distributors, manufacturers' sales subsidiaries, or agents. Department stores and other large Canadian buyers purchase through agents located abroad.

Best Export Prospects

- *Industrial sectors:* Automotive, aerospace, oil and gas, defense products and services, safety and security equipment, renewable energy, information and communications technology, pollution control, wastewater treatment, mining.
- *Agricultural sectors:* Food service, snack food, fresh vegetables, fresh fruit, organic food, red meats, processed fruit and vegetables.
- *Service sector:* Travel and tourism.

Promising imports from Canada: Motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment, chemicals, plastics, fertilizers; wood pulp, timber, crude petroleum, natural gas, electricity, aluminum

Major impediments to exporting from Canada (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, burdensome procedures and corruption at foreign borders, rules-of-origin requirements abroad, access to trade finance, inappropriate production technology and skills, high cost or delays caused by international transportation, access to imported inputs at competitive prices, high cost or delays caused by domestic transportation, difficulties in meeting quality/quantity requirements of buyers

Major impediments to importation to Canada (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, domestic technical requirements and

standards, high cost or delays caused by international and domestic transportation, inappropriate telecommunications infrastructure, corruption at the border, crime and theft

Chile

Country Profile

Population: 17,216,945
Exports: $8.66 billion
Major Exports: Copper, other metals and minerals, wood products, fish and fishmeal, fruits
Imports: $70.2 billion
Major Imports: Consumer goods, chemicals, motor vehicles and fuels
Trade as % GDP: Exports: 38.07%; Imports: 34.72%
Major Trading Partners: Asia, European Union, Latin America, United States
Currency and Exchange Rate: Chilean pesos per U.S. dollar—488.9
GDP: $319.4 billion
GDP per capita: $18,400
External Debt: $102.1 billion

Import Policies

- *Entry of goods:* There are virtually no restrictions on the types or amounts of goods that can be imported into Chile, nor any requirements to use the official foreign exchange market. However, Chilean customs authorities must approve and issue a report for all imports valued at more than $3,000. Importers and exporters must also report their import and export transactions to the Central Bank. Chile prohibits the importation of used vehicles, used motorcycles, and used retreaded tires (with the exception of wheel-mounted tires).
- *Tariff and taxes:* Chile has a uniform applied tariff rate of 6 percent for nearly all goods. However, there are several exceptions to the uniform tariff. The United States-Chile Free Trade Agreement (FTA) entered into force on January 1, 2004. Under the FTA, Chile immediately eliminated tariffs on 87 percent of bilateral trade. All trade in consumer and industrial goods is duty-free beginning in 2013, while remaining tariffs on most agricultural goods will be eliminated by 2015.
- *Nontariff barriers:* Chile maintains a complex price band system for wheat, wheat flour, and sugar that, under the FTA, will be phased out by 2015 for imports from the United States. A price band system was created in 1985 and is intended to guarantee a minimum and maximum import price for the covered commodities. Chile was listed on the Priority Watch List in the 2012 Special 301 Report for intellectual property rights (IPR) issues under the FTA.
- *Documentation requirements:* Commercial invoices, certificates of origin, bills of lading, freight insurance, and packing lists. Special permission, certificates, and approval documents, such as sanitary and phytosanitary certificates, are required for most agricultural products and in special cases for industrial products.
- *Marketing and distribution:* Imports are sold through local agents, distributors, or wholesalers.

Best Export Prospects

- *Industrial sector:* Agricultural machinery and equipment, construction, electric power equipment, healthcare, mining equipment, safety and security, telecommunications, water resources equipment.
- *Agricultural sector:* Food processing, red meat and poultry, edible fish and seafood, prepared fruit, vegetables, oilseed products, confectionary products, baked products, snack food, beverages.
- *Services:* Travel and tourism.

Promising imports from Chile: Copper, fruit, fish products, paper and pulp, chemicals, wine

Major impediments to exporting from Chile (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, high cost or delays caused by international transportation, access to imported inputs at competitive prices, inappropriate production technology and skills, rules-of-origin requirements abroad, difficulties in meeting quality/quantity requirements of buyers, burdensome procedures and corruption at foreign borders, access to trade finance, high cost or delays caused by domestic transportation

Major impediments to importation to Chile (in order of importance): High cost or delays caused by domestic transportation, burdensome import procedures, domestic technical requirements and standards, high cost or delays caused by international transportation, tariffs and nontariff barriers, inappropriate telecommunications infrastructure, crime and theft, corruption at the border

Colombia

Country Profile

Population: 45,745,783
Exports: $59.96 billion
Major Exports: Petroleum, coffee, coal, bananas, flowers
Imports: $55.49 billion
Major Imports: Industrial equipment, transportation equipment, consumer goods, chemicals
Trade as % GDP: Exports: 18.95%; Imports: 20.13%
Major Trading Partners: United States, Mexico, Venezuela
Currency and Exchange Rate: 1,800.4 pesos per U.S. dollar
GDP: $500 billion
GDP per capita: $10,700
External Debt: $73.41 billion

Import Policies

- *Entry of goods:* Importers must follow the basic steps to complete an import transaction into Colombia: when required, obtain import permits from pertinent government

agencies; buy and fill out the Import Registration form; file the Import Registration form and obtain approval from the Ministry of Commerce, Industry, and Tourism; make arrangements with a financial entity to pay for the imported goods; ask the exporter to ship goods to a Colombian port; request the Cargo Manifest from the transportation firm.

- *Tariff and taxes:* The United States-Colombia Trade Promotion Agreement (CTPA) entered into force on May 15, 2012. About 80 percent of U.S. exports of consumer and industrial products to Colombia became duty-free immediately upon entry into force of the CTPA. Colombia is a member of CET, with an average duty level ranging between 11 and 13.5 percent. For non-CET nations, duty rates in Colombia vary from 0 to 35 percent, with the average duty rate at 11.31 percent. Some products can be imported free of duty (e.g., books, laptops and other electronic products). VAT is levied on imports at a standard rate of 16 percent or at a reduced rate in some cases, calculated on the sum of the CIF value, duty, and excise if applicable.
- *Nontariff barriers:* The Colombian government had required that importers purchase local production of certain agricultural products in order to import under duty tariff rate quotas (TRQs). There remains a need for further IPR improvements in Colombia, and actions are still needed to reduce optical media piracy and combat piracy over the Internet, which is a growing problem in Colombia.
- *Documentation requirements:* Import declaration (when the import value is equal or more than $1,000 [U.S.]), Andean custom value declaration (when the import value is equal to or more than $5,000 [U.S.] FOB), commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, import registration, import declaration, sanitary certificate, photo-sanitary certificate, certificate of purity.
- *Marketing and distribution:* Imports are usually handled through a local agent or distributor. Large Colombian firms also deal directly with overseas supplies.

Best Export Prospects

- *Agricultural sector:* Consumer-oriented products, cotton, wheat, soybean meal, soybeans.
- *Industrial sector:* Automotive parts and accessories, construction and mining equipment, electrical power systems, food and beverage processing/packaging equipment, information technology (IT), medical equipment, military equipment, oil and gas machinery and services, telecommunications equipment and services, transportation and infrastructure.
- *Services:* Traveling and tourism.

Promising imports from Colombia: Petroleum, coal, emeralds, coffee, nickel, cut flowers, bananas, apparel

Major impediments to exporting from Colombia (in order of importance): Identification of potential markets and buyers, high cost or delays caused by domestic transportation, inappropriate production technology and skills, technical requirements and standards abroad, access to imported inputs at competitive prices, high cost or delays caused by international transportation, access to trade finance, difficulties in meeting quality/quantity requirements of buyers, rules-of-origin requirements abroad, burdensome procedures and corruption at foreign borders

Major impediments to importation to Colombia (in order of importance): Tariffs and nontariff barriers, burdensome import procedures, high cost or delays caused by international and domestic transportation, domestic technical requirements and standards, corruption at the border, crime and theft, inappropriate telecommunications infrastructure

Mexico

Country Profile

Population: 116,220,947
Exports: $370.9 billion
Major Exports: Crude oil, oil products, coffee, silver, engines, cotton
Imports: $379.4 billion
Major Imports: metal manufactures, agricultural machinery, electrical equipment
Trade as % GDP: Exports: 31.67%; Imports: 33.00%
Major Trading Partners: United States, Canada, Japan
Currency and Exchange Rate: Mexican pesos per U.S. dollar—13.25
GDP: $1.761 trillion
GDP per capita: $15,300
External Debt: $125.7 billion

Import Policies

- *Entry of goods:* Most duties are ad valorem, assessed on the FOB or CIF value or at specific rates, whichever is greater. The General Import Tax Law of Mexico sets out specific, general and mixed tariff rates. The general rates (ad valorem) are mainly 3 percent, 8 percent, 13 percent, 18 percent, 23 percent, and 35 percent, while the specific rates are established according to unit of merchandise. Mixed rates are part ad valorem and part specific rates and are applied to some products from sensitive sectors, such as sugar.
- *Tariff and taxes:* Under NAFTA, Mexico has eliminated tariffs on all industrial and most agricultural products from Canada and the United States. Pursuant to the terms of the NAFTA, on January 1, 2003, Mexico eliminated tariffs on all remaining industrial products and most agricultural products imported from the United States. On January 1, 2008, Mexico eliminated its remaining tariffs and tariff-rate quotas on all U.S. agricultural exports. A special tax on production and services (IEPS) is assessed on the importation of alcoholic beverages, cigarettes, and cigars, among others. This tax may vary from 25 to 160 percent depending on the product. The value-added tax (IVA) on most sales transactions is 11 percent for products staying in the Mexican border region, within twenty miles of the border, and 16 percent for products that enter the interior of Mexico. Basic products such as food and drugs (but not processed foods) are exempt from the IVA.
- *Nontariff barriers:* Very few items are subject to specific import licensing. The importer will, however, need to be appropriately registered as an importer in the National Importers Registry that is kept and updated by the Treasury Ministry. Products such as toys, wine and liquor, chemicals, and textiles also require registration in a special Sector Registry. Both registrations can be carried out through the Ministry or through a

customs broker. Some imports that require specific licensing include health and food articles, machinery, chemicals, and pharmaceuticals. Under NAFTA, Mexico has abolished licensing requirements for goods from member countries, except for certain items: import licenses for weapons and ammunition; import authorization for some leather and fur products, fresh/chilled and frozen meat, and agricultural machinery; "advance sanitary import authorization" or "notification of sanitary import" for medical products and equipment, pharmaceuticals, diagnostic products, toiletries, processed food, and certain chemicals, used goods, and refurbished equipment; import authorizations for products made from endangered species; import authorization for toxic and hazardous products. All Mexican importers must apply and be listed on the "Padrón de Importadores" maintained by the Secretariat of Finance and Public Credit (Hacienda).

- *Intellectual property rights protection:* Despite strengthened enforcement efforts by Mexico's federal authorities over the past several years, weak penalties and other obstacles to effective IPR protection have failed to deter the rampant piracy and counterfeiting found throughout the country.
- *Documentation requirements:* The basic Mexican import document is the "pedimento de importación." This document must be accompanied by a commercial invoice (in Spanish) and the other necessary documents like pro forma invoice, bill of lading/air waybill, packing list, shipping documents, certificate of origin, sanitary certificate, photo-sanitary certificate, health certificate. Products qualifying as North American must use the NAFTA Certificate of Origin in order to receive preferential treatment.
- *Marketing and distribution:* Main channels for imports in Mexico are local manufacturers and other large buyers, distributors, sales agents, and branches or subsidiaries of foreign manufacturers.

Best Export Prospects

- *Agricultural products:* Coarse grains, red meats, soybeans, dairy products, wheat, poultry meat, cotton, sugar and sweeteners, feeds and fodder, soybean meal, processed fruits and vegetables, and feeds and animal fats.
- *Industrial sector:* Auto parts and maintenance equipment, energy sector, environmental sector, franchising sector, housing and construction, Internet and IT services, IT health care, medical devices, packaging equipment, plastic materials/resins, renewable energy, security and safety equipment and services, smart grid, telecommunications equipment, transportation infrastructure equipment and services.
- *Services:* Travel and tourism, education and training services.

Promising imports from Mexico: Manufactured goods, oil and oil products, silver, fruits, vegetables, coffee, cotton

Major impediments to exporting from Mexico (in order of importance): Identification of potential markets and buyers, access to trade finance, access to imported inputs at competitive prices, technical requirements and standards abroad, high cost or delays caused by domestic transportation, inappropriate production technology and skills, burdensome procedures and corruption at foreign borders, rules-of-origin requirements abroad, difficulties in meeting quality/quantity requirements of buyers, high cost or delays caused by international transportation

Major impediments to importation to Mexico (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, corruption at the border, crime and theft, high cost or delays caused by international transportation, domestic technical requirements and standards, high cost or delays caused by domestic transportation inappropriate telecommunications infrastructure

Venezuela

Country Profile

Population: 28,459,085
Exports: $96.9 billion
Major Exports: Petroleum, bauxite, aluminum, steel, chemicals, agricultural products, basic manufactures
Imports: $56.69 billion
Major Imports: Raw materials, construction materials, machinery and transport equipment
Trade as % GDP: Exports: 29.94%; Imports: 19.70%
Major Trading Partners: Brazil, Netherlands, United States, Colombia, Argentina
Currency and Exchange Rate: bolivares per U.S. dollar—4,289
GDP: $402.1 billion
GDP per capita: $13,200
External Debt: $63.74 billion

Import Policies

- *Entry of goods:* Special permits must be obtained in order to import certain goods for which the government has claimed exclusive import rights. These products include certain types of apparel and certain consumer durables. Some types of exports to Venezuela—such as medical devices—require approval in advance by the Venezuelan Ministry of Health (MINSALUD). An executive resolution published in Venezuela's Official Gazette on March 13, 2012, provides favorable treatment to public-sector entities and state-owned enterprises, exempting them from presenting or maintaining import licenses, paying tariffs, or presenting documents or certificates related to the regulation of customs and duties.
- *Tariff and taxes:* According to the WTO, in 2012 Venezuela applied a simple average tariff of 15 percent on agricultural goods and 12.1 percent on nonagricultural goods. At a July 2012 MERCOSUR summit in Rio de Janeiro, Venezuela became the fifth full member of MERCOSUR. Under the terms of its accession, Venezuela has four years from its date of accession to adopt the MERCOSUR Common External Tariff (CET) and to provide duty-free treatment to its four MERCOSUR partners on all goods. Venezuela is permitted by MERCOSUR to maintain 260 exceptions to the CET until December 31, 2016, and 160 exceptions to the CET until December 31, 2017.
- *Nontariff barriers:* The Law of Fair Costs and Prices was enacted on July 14, 2011, and entered into effect on November 22, 2011. The law gives a newly created Venezuelan government entity, the Superintendent of Fair Costs and Prices (SUNDECOP), broad authority to regulate the prices of almost all goods and services sold to the public.

Currency controls introduced in 2003 continue to pose as a significant trade barrier in Venezuela. Importers must have prior authorization to obtain foreign currency before purchasing imports. Venezuela maintains the authority to impose tariff-rate quotas (TRQs) for up to 62 Harmonized Tariff System code eight-digit headings. Currently, the government applies TRQs to oilseeds, corn, wheat, milk and dairy, and sugar. The issuance of import licenses for such TRQs has negatively affected trade in basic agricultural commodities as well as processed products.

- *Intellectual property rights protection:* Copyright piracy and trademark counterfeiting remain widespread, including piracy over the Internet. Other concerns include the lack of effective protection against unfair commercial use of undisclosed test data and other data generated to obtain marketing approval for pharmaceutical products.
- *Documentation requirements:* Special permits if necessary, commercial invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, import license, sanitary certificate, health certificate, photo-sanitary certificate.
- *Marketing and distribution:* Imports are generally handled through local agents, wholesalers, or distributors.

Best Export Prospects

- *Agricultural products:* Corn, soybeans, wheat.
- *Industrial products:* Livestock, raw materials, machinery and equipment, transport equipment, construction materials, medical equipment, pharmaceuticals, chemicals, iron and steel products.
- *Services:* Franchising, telecommunications services, computer services.

Promising imports from Venezuela: Petroleum, bauxite and aluminum, minerals, chemicals, agricultural products, basic manufactures

Major impediments to exporting from Venezuela (in order of importance): Access to imported inputs at competitive prices, access to trade finance, inappropriate production technology and skills, difficulties in meeting quality/quantity requirements of buyers, burdensome procedures and corruption at foreign borders, high cost or delays caused by domestic transportation, identification of potential markets and buyers, technical requirements and standards abroad, high cost or delays caused by international transportation, rules-of-origin requirements abroad

Major impediments to importation to Venezuela (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, corruption at the border, domestic technical requirements and standards, crime and theft, high cost or delays caused by domestic and international transportation, inappropriate telecommunications infrastructure

A.3 Trading Opportunities in Asia

Australia

Country Profile

Population: 22,262,501
Exports: Goods (FOB): $263.9 billion

Major Exports: Coal, gold, meat, wool
Imports: Goods (FOB): $239.7 billion
Major Imports: Machinery and transportation equipment, computers and office machines, telecommunication equipment and parts
Trade as % GDP: Exports: 21.29%; Imports: 19.78%
Major Trading Partners: ASEAN, United States, Japan, China
Currency and Exchange Rate: Australian dollars per U.S. dollar—0.963
GDP: $960.7 billion
GDP per capita: $42,400
External Debt: $1.466 trillion

Import Policies

- *Entry of goods***:** Exporters should be aware of Australia's rules and procedures regulating the packaging, labeling, ingredients, marketing, and sale of specific products. Australia has stringent prohibitions and quarantines against a number of products, particularly those considered to be of potential public danger and agricultural products that are considered to have the potential to introduce pests or disease. There are also very strict sanitary and phytosanitary restrictions affecting imports of fresh fruit and vegetables and imports of meat and poultry products.
- *Tariffs and taxes:* Duty rates in Australia vary from 0 to 10 percent, with an average duty rate of 4.6 percent. Some goods are not subject to duty (e.g., laptops and other electronic products). The Free Trade Agreement between the United States and Australia (AUSFTA) came into effect on January 1, 2005. AUSFTA eliminated import tariffs on 99 percent of U.S. manufactured industrial and consumer goods, and 100 percent of U.S. agricultural products.
- *Nontariff barriers:* Some exporters may find it difficult to comply with Australia's import quarantine requirements. Aside from issues relating to the importation of food and animals, quarantine measures cover a number of other imported products such as farm, mining and construction machinery, some packaging goods, and other products that may pose a contamination risk to Australia's agricultural industry or natural environment. Exporters of chemicals need to ensure that products comply with the Australian Dangerous Goods Code requirements.
- *Intellectual property rights protection:* A strong rule of law protects property rights in Australia and operates against corruption. Both foreign and domestically owned businesses enjoy considerable flexibility in their licensing, regulation, and employment practices.
- *Documentation requirements:* Customs does not require companies or individuals to hold import licenses, but importers may need to obtain permits to clear the goods. The minimum amount of documentation required for customs clearance comprises a completed Customs Entry or Informal Clearance Document (ICD), an air waybill (AWB) or bill of lading (BLAD), and invoices and other documents relating to the importation.
- *Marketing and distribution:* Imports are generally sold through local sales agents, distributors, and licensees.

Best Export Prospects

- *Agricultural products:* Nutritious snacks, rice crackers, rice and grain cakes, beverages, spices.
- *Industrial sector:* Aircraft and parts, automotive parts and accessories, biotechnology, construction machinery, cosmetics, medical equipment, mining equipment, oil and gas field machinery, renewable energy, software.
- *Services:* Travel and tourism, information technology services, franchising.

Promising imports from Australia: Coal, iron ore, gold, meat, wool, alumina, wheat, machinery and transport equipment

Major impediments to exporting from Australia (in order of importance): Identification of potential markets and buyers, high cost or delays caused by international transportation, access to imported inputs at competitive prices, technical requirements and standards abroad, high cost or delays caused by domestic transportation, rules-of-origin requirements abroad, burdensome procedures and corruption at foreign borders, inappropriate production technology and skills, access to trade finance, difficulties in meeting quality/quantity requirements of buyers

Major impediments to importation to Australia (in order of importance): High cost or delays caused by international transportation, tariffs and nontariff barriers, domestic technical requirements and standards, burdensome import procedures, high cost or delays caused by domestic transportation, inappropriate telecommunications infrastructure crime and theft, corruption at the border

China

Country Profile

Population: 1,349,585,838
Exports: Goods (FOB): $2.05 trillion
Major Exports: machinery and equipment, textiles, clothing
Imports: $1.817 trillion
Major Imports: machinery and equipment, textiles, plastics, iron and steel
Trade as % GDP: Exports: 31.37%; Imports: 27.30%
Major Trading Partners: United States, Hong Kong, Japan, South Korea, Taiwan, Germany
Currency and Exchange Rate: yuan per U.S. dollar—6.311
GDP: $12.38 trillion
GDP per capita: $9,100
External Debt: $770.8 billion

Import Policies

- *Entry of goods:* Some items are prohibited from entering China: arms, ammunition, and explosives of all kinds; printed matter, magnetic media, films, or photographs that are deemed to be detrimental to the political, economic, cultural, and moral interests of China; disease-carrying animals and plants; foods, medicines, and other articles coming from disease-stricken areas; old or used garments; Food items containing certain

food colorings and additives deemed harmful to human health by the Ministry of Health are also barred. Labeling and marking requirements are mostly made by different industry authorities. However, all products sold in China must be marked in the Chinese language. The State Administration for Quality Supervision, Inspection, and Quarantine (AQSIQ) requires imported and exported (but not domestic) food items such as candy, wine, nuts, canned food, and cheese to have labels verified and products tested for quality before a good can be imported or exported.

- *Tariffs and taxes:* Beginning in 2002, its first year in the WTO, China significantly reduced tariff rates on many products, decreased the number of goods subject to import quotas, expanded the number of Chinese enterprises with trading rights and the products they could import, and increased the transparency of its licensing procedures. China maintains high duties on some products that compete with sensitive domestic industries. For example, the tariff on automobiles is 25 percent. Likewise, most video, digital video, and audio recorders and players still face duties of approximately 30 percent. Some agricultural items continue to face high tariffs and taxes; for instance, certain tree nut imports face duties of up to 25 percent.
- *Nontariff barriers:* Significant nontariff barriers still exist in China, which include, for example, regulations that set high thresholds for entry into services sectors such as banking, insurance, and telecommunications; selective and unwarranted inspection requirements for agricultural imports; and the use of questionable sanitary and phytosanitary (SPS) and technical barriers to trade (TBT) measures.
- *Intellectual property rights protection:* Key concerns include unacceptable levels of retail and wholesale counterfeiting; persistently high levels of book and journal piracy; end-user piracy of business software; lack of effective trade-secret protection and enforcement; and copyright piracy over the Internet. The lack of deterrent penalties and other policies, such as barriers to the market for legitimate products, contribute to the poor record on reducing IPR crime in China. There are legitimate industry concerns that laws or policies in a variety of fields might be used to unfairly favor domestic intellectual property (IP) over foreign IP, including procurement preferences for products with domestically developed IP and the treatment of IPR in setting standards.
- *Documentation requirements:* Necessary documents vary by product but may include standard documents such as a bill of lading, invoice, shipping list, customs declaration, insurance policy, and sales contract, as well as more specialized documents such as an import quota certificate for general commodities (where applicable), import license (where applicable), inspection certificate issued by the General Administration of the PRC for Quality Supervision, Inspection, and Quarantine (AQSIQ) or its local bureau (where applicable), and other safety and/or quality licenses.
- *Marketing and distribution:* Companies that handle export/import trade must be approved by the central government. Importation is generally made through local sales agents, international trading companies, or Chinese firms with regional or national networks. Various sales techniques are used such as advertisement, direct mass mailing to end users, trade fairs and exhibitions.

Best Export Prospects

- *Agricultural products:* Animal feed, cotton, fish and fish products, hides and skins, processed food products, soybeans, tree nuts, wood and wood products.

- *Industrial sector:* Aviation market, railway and metro industry, medical device and healthcare service market, safety security market, marine industries, air pollution, ICT equipment and software, green building.
- *Services:* Education and training, travel and tourism, franchising.

Promising imports from China: Electrical and other machinery, including data-processing equipment, apparel, radio telephone handsets, textiles, integrated circuits

Major impediments to exporting from China (in order of importance): Potential markets and buyers, technical requirements and standards abroad, access to imported inputs at competitive prices, inappropriate production technology and skills, access to trade finance, high cost or delays caused by international transportation, difficulties in meeting quality/quantity requirements of buyers, high cost or delays caused by domestic transportation, burdensome procedures and corruption at foreign borders, rules-of-origin requirements abroad

Major impediments to importation to China (in order of importance): Tariffs and nontariff barriers, burdensome import procedures, domestic technical requirements and standards, high cost or delays caused by international and domestic transportation, corruption at the border, inappropriate telecommunications infrastructure, crime and theft

India

Country Profile

Population: 1,220,800,359
Exports: $309.1 billion
Major Exports: Clothing, gems, jewelry, engineering goods, chemicals
Imports: $500.3 billion
Major Imports: Petroleum, machinery, gems, fertilizer
Trade as % GDP: Exports: 23.88%; Imports: 30.33%
Major Trading Partners: United States, Germany, China, United Arab Emirates, United Kingdom
Currency and Exchange Rate: Indian rupees per U.S. dollar—53.17
GDP: $4.784 trillion
GDP per capita: $3,900
External Debt: $299.2 billion

Import Policies

- *Entry of goods:* In the past decade, India has steadily replaced licensing and discretionary controls over imports with deregulation and simpler import procedures. The majority of import items fall within the scope of India's EXIM policy regulation of Open General License (OGL). This means that they are deemed to be freely importable without restrictions and without a license. Imports of items not covered by OGL are regulated and fall into three categories: banned or prohibited items, restricted items requiring an import license, and "canalized" items importable only by government trading monopolies and subject to Cabinet approval regarding timing and quantity.

- *Tariff and taxes:* India has progressively cut duties and taxes since 1991. These reforms are complemented by a consistent decline in import tariff rates over the past fifteen years—from peak rates of 350 percent in June 1991 to an average of 10 percent in 2012. In February 2007, the Government of India (GOI) further reduced the peak applied customs duty on nonagricultural goods from 12.5 percent to 10 percent. However, India's tariffs are still relatively high by international standards.
- *Nontariff barriers:* Import licensing, standards, testing, labeling and certification, antidumping and countervailing measures, export subsidies and domestic support, procurement, service barriers.
- *Intellectual property rights protection:* India remained on the Priority Watch List in the 2012 Special 301 Report because of concerns regarding weak protection and enforcement of intellectual property rights. Recent patent-related actions have only heightened these concerns.
- *Documentation requirements:* Import license, commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, insurance certificate, health certificate, sanitary certificate, plant certificate.
- *Marketing and sales:* Foreign firms are not allowed to set up Indian branches or subsidiaries. Foreign exchange regulations require that an Indian firm be employed as an agent. Products can also be imported and marketed through a distributor.

Best Export Prospects

- *Agricultural sector:* Corn, vegetable oil, cotton, nuts, cashew nuts, wood products, intermediate food products.
- *Industrial sector:* Precious stones, machinery, mineral fuel (oil), electrical machinery, fertilizers, nuclear reactors, organic chemicals, iron and steel, plastic.
- *Services:* Telecommunications, aviation, and services.

Promising imports from India: Petroleum products, precious stones, machinery, iron and steel, chemicals, vehicles, apparel

Major impediments to exporting from India (in order of importance): Identification of potential markets and buyers, high cost or delays caused by domestic transportation, access to imported inputs at competitive prices, technical requirements and standards abroad, high cost or delays caused by international transportation, inappropriate production technology and skills, difficulties in meeting quality/quantity requirements of buyers, access to trade finance, rules-of-origin requirements abroad, burdensome procedures, and corruption at foreign borders

Major impediments to importation to India (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, high cost or delays caused by international and domestic transportation, corruption at the border, domestic technical requirements and standards, inappropriate telecommunications infrastructure, crime and theft

Indonesia

Country Profile

Population: 251,160,124

Exports: $188.7 billion

Major Exports: Textiles, garments, gas, plywood, rubber
Imports: $179 billion
Major Imports: Manufactures, chemicals, foodstuffs, fuels
Trade as % GDP: Exports: 26.33%; Imports: 24.92%
Major Trading Partners: Japan, United States, Singapore, South Korea
Currency and Exchange Rate: Indonesian rupiahs per U.S. dollar—9,670
GDP: $1.212 trillion
GDP per capita: $5,000
External Debt: $187.1 billion

Import Policies

- *Entry of goods:* The Government of Indonesia (GOI) requires extensive documentation prior to allowing import of goods. The Indonesian National Agency of Drug and Food Control (BPOM) announced on September 1, 2010, that it would modify enforcement of its labeling policies and require that all processed food products entering Indonesia be fully labeled in the Bahasa language.
- *Tariff and taxes:* In 2012, Indonesia's average most-favored-nation (MFN) applied tariff was 7.7 percent. Indonesia periodically changes its applied rates. In December 2011, the Ministry of Finance increased applied import duties for designated grain and oilseed products from 0 percent to 5 percent. In August 2012, the Ministry of Finance temporarily reduced import duties on soybeans from 5 percent to 0 percent through the end of 2012 to counter rising international soybean prices.
- *Nontariff barriers:* Exporters to Indonesia must comply with numerous and overlapping import licensing requirements that impede access to Indonesia's market. In 2009, the Indonesian government implemented a sweeping regulation imposing nonautomatic import licensing procedures on a broad range of products, including electronics, household appliances, textiles and footwear, toys, and food and beverage products.
- *Documentation requirements:* At minimum, the exporter or his agent must provide a pro forma invoice, commercial invoice, certificate of origin, bill of lading, packing list, and insurance certificate. In addition to those documents additional certificates are often required by technical agencies.
- *Intellectual property rights protection:* Indonesia is currently on the Special 301 priority watch list for intellectual property rights (IPR) protection. Indonesia's failure to effectively protect intellectual property and enforce IPR laws has resulted in high levels of physical and online piracy. The International Intellectual Property Alliance estimates that 87 percent of business software is unlicensed, while retail and mall piracy rates are likely even higher.
- *Marketing and distribution:* Distribution must be handled through a company owned by a local representative or distributor.

Best Export Prospects

- *Agricultural products:* Cotton, soybeans, consumer-ready food products, wheat.
- *Industrial products:* Aircraft and parts, computers and peripherals, electrical power systems, medical equipment and suppliers, mining equipment, oil and gas equipment, telecommunications, water and wastewater equipment.
- *Services:* Franchising, tourism, education and training.

Promising imports from Indonesia: Oil and gas, electrical appliances, plywood, textiles, rubber

Major impediments to exporting from Indonesia (in order of importance): Identification of potential markets and buyers, high cost or delays caused by domestic transportation, access to trade finance, high cost or delays caused by international transportation, access to imported inputs at competitive prices, difficulties in meeting quality/quantity requirements of buyers, technical requirements and standards abroad, rules-of-origin requirements abroad, inappropriate production technology and skills, burdensome procedures and corruption at foreign borders

Major impediments to importation to Indonesia (in order of importance): Tariffs and nontariff barriers, corruption at the border, burdensome import procedures, high cost or delays caused by domestic transportation, domestic technical requirements and standards, high cost or delays caused by international transportation, crime and theft, inappropriate telecommunications infrastructure

Japan

Country Profile

Population: 127,253,075
Exports: $792.9 billion
Major Exports: Semiconductors, office machinery, chemicals, motor vehicles
Imports: $856.9 billion
Major Imports: Fuels, foodstuffs, chemicals, textiles, office machinery
Trade as % GDP: Exports: 15.22%; Imports: 16.14%
Major Trading Partners: Southeast Asia, United States, Australia
Currency and Exchange Rate: yen per U.S. dollar—79.42
GDP: $4.525 trillion
GDP per capita: $36,200
External Debt: $3.024 trillion

Import Policies

- *Entry of goods:* Any person wishing to import goods must declare them to the Director-General of Customs and obtain an import permit after necessary examination of the goods concerned. Certain items may require a Japanese import license. These include hazardous materials, animals, plants, perishables, and, in some cases, articles of high value. Import quota items also require an import license. Correct packing, marking, and labeling are critical to smooth customs clearance in Japan.
- *Tariff and taxes:* On average, the applied tariff rate in Japan is one of the lowest in the world. In fiscal year (April–March) 2010, the simple average applied MFN (most-favored-nation) tariff rate was 5.8 percent, down from 6.1 percent in FY2008. In addition, import duties on many agricultural items continue to decrease, and there are no tariffs on many major sectors, such as autos and auto parts, aircraft, marine vessels, software, computers, industrial machinery and works of fine art. However, certain products, including leather, rubber, footwear and travel goods, textiles and clothing, certain processed foods, and some manufactured goods, have relatively high tariff rates.

- *Nontariff barriers:* While tariffs are generally low, Japan does have nontariff barriers that impede or delay the importation of foreign products into Japan, such as: standards unique to Japan (formal, informal, de facto, or otherwise); the effective shutting out of new entrants in the market; official regulations that favor domestically produced products and discriminate against foreign products; the concentration of licensing powers in the hands of industry associations with limited membership; the existence of cartels (both formal and informal).
- *Intellectual property rights protection:* In general, Japan maintains a strong intellectual property rights (IPR) regime, but there are costs and procedures of which prospective investors should be aware.
- *Documentation requirements:* Documents required for customs clearance in Japan include standard shipping documents such as a commercial invoice, a packing list, and an original and signed bill of lading or, if the goods are shipped by air, an air waybill.
- *Marketing and distribution:* Most imports and exports are handled by large trading companies with strong ties to Japanese manufacturers. Local agents can be appointed to handle marketing and sales.

Best Export Prospects

- *Agricultural products:* Red meats, feeds and fodders, cotton, consumer food and beverages.
- *Industrial products:* Aerospace, computer software, cosmetics/toiletries, electronic components, medical equipment, pharmaceuticals, renewable energy, safety and security, soil remediation/engineering services, telecommunications equipment.
- *Services:* Travel and tourism, education and corporate training.

Promising imports from Japan: Motor vehicles and parts; semiconductors; iron and steel products; plastic materials; power-generating machinery

Major impediments to exporting from Japan (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, difficulties in meeting quality/quantity requirements of buyers, high cost or delays caused by international transportation, access to imported inputs at competitive prices, burdensome procedures and corruption at foreign borders, rules-of-origin requirements abroad, high cost or delays caused by domestic transportation, inappropriate production technology and skills, access to trade finance

Major impediments to importation to Japan (in order of importance): Tariffs and nontariff barriers, domestic technical requirements and standards, burdensome import procedures, high cost or delays caused by international and domestic transportation, inappropriate telecommunications infrastructure, crime and theft, corruption at the border

A.4 Trading Opportunities in Eastern Europe

The Czech Republic

Country Profile

Population: 10,162,921
Exports: $134.1 billion

Major Exports: Manufactured goods, machinery and equipment, chemicals
Imports: $129 billion
Major Imports: Machinery transport equipment, manufactured goods, chemicals
Trade as % GDP: Exports: 72.55%; Imports: 68.53%
Major Trading Partners: Germany, Slovakia, Austria
Currency and Exchange Rate: koruny per U.S. dollar—19.59
GDP: $286.7 billion
GDP per capita: $27,200
External Debt: $90.18 billion

Import Policies

- *Entry of goods:* While most products and services are exempt from the licensing process, oil, natural gas, pyrotechnical products, sporting guns, and ammunition and military equipment require a license. Under EU rules, imports of clothing, shoes, porcelain, and steel from certain Asian and Eastern European countries may require licenses. Electrical and electronic equipment may be subject to additional requirements under the EU Waste Electric and Electronic Equipment Directive (WEEE) and Restriction of Hazardous Substances Directive(RoHS) regulations. Czech labeling requirements were harmonized with EU norms in 2002. In general, labels must be in the Czech language and can be affixed to the product or on a leaflet attached to the product.
- *Tariff structure:* The Integrated Tariff of the European Community, referred to as TARIC (Tarif Intégré de la Communauté), is designed to show various rules that apply to specific products being imported into the customs territory of the EU. The value-added tax (VAT) applies to all goods, both domestic and foreign, sold within the Czech Republic. The VAT rate is generally 20 percent, although a lower VAT of 14 percent is charged for selected goods, such as food and services.
- *Nontariff barriers:* The Czech Republic is committed to a free market and maintains a generally open economy, with few barriers to trade and investment.
- *Intellectual property rights protection:* IPRs are generally adequately protected in the Czech Republic. Existing legislation guarantees protection of all forms of property rights, both intellectual and physical.
- *Documentation requirements:* Commercial invoice, bill of lading, declaration of conformity (issued by importer), import licenses for selected goods.
- *Marketing and distribution channels:* Foreign products are generally sold through agents and distributors. Selling techniques include advertisement through various media, door-to-door sales, and trade fairs and shows.

Best Export Prospects

- *Agricultural products:* Dried nuts and fruits, fish and crustaceans, soybean meal, wine and spirits, wood.
- *Industrial products:* Automotive parts and equipment, energy, information technology, medical equipment, scientific equipment and EU-funded projects.
- *Services:* Franchising, education, information services.

Promising imports from the Czech Republic: Machinery and transport equipment, raw materials and fuel, chemicals

Major impediments to exporting from the Czech Republic (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, access to trade finance, difficulties in meeting quality/quantity requirements of buyers, high cost or delays caused by international transportation, inappropriate production technology and skills, access to imported inputs at competitive prices, burdensome procedures and corruption at foreign borders, rules-of-origin requirements abroad, high cost or delays caused by domestic transportation

Major impediments to importation to Czech Republic (in order of importance): High cost or delays caused by international transportation, burdensome import procedures, tariffs and nontariff barriers, domestic technical requirements and standards, high cost or delays caused by domestic transportation, corruption at the border, crime and theft, inappropriate telecommunications infrastructure

Hungary

Country Profile

Population: 9,939,470
Exports: $105.1 billion
Major Exports: Machinery and equipment, agricultural and food products, and other manufactures
Trade as % GDP: Exports: 92.27%; Imports: 84.91%
Imports: $98.2 billion
Major Imports: Fuels and electricity, food and agriculture, machinery and equipment, raw materials
Major Trading Partners: Germany, Austria, France, Russia, Italy
Currency and Exchange Rate: forints per U.S. dollar—225.4
GDP: $195.4 billion
GDP per capita: $19,800
External Debt: $170 billion

Import Policies

- *Entry of goods:* The Integrated Tariff of the Community, referred to as TARIC (Tarif Intégré de la Communauté), applies to specific products being imported into the customs territory of the EU. Many EU member states maintain their own list of goods subject to import licensing. Hungary's restricted "Import List" includes goods like arms/military equipment, explosives and pyrotechnic products, security paper, uranium, and radioactive isotopes.
- *Tariff and taxes:* With Hungary's accession to the European Union on May 1, 2004, Hungary adopted the EU's common external tariff (CXT) rates, resulting in an average tariff level of 3 percent. However, Hungary still collects the value-added tax (VAT) on all goods with Hungary as a final destination. As of July 1, 2009, the VAT increased from 20 to 25 percent. In addition to the 25 percent VAT, a new 18 percent VAT category was introduced for certain products such as dairy products, goods produced from grain, starch, flour, and milk. The new 18 percent VAT is also levied on central heating services.

- *Nontariff barriers:* There are some products still subject to quotas and hence retaining additional protection. These include new and used automobiles, textiles, clothing, and footwear. Agricultural products are protected under different nontariff measures.
- *Intellectual property rights protection:* On January 1, 2003, Hungary acceded to the European Patent Convention and has accordingly amended the Hungarian Patent Act. It is a party to the WTO Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement and other major international IPR agreements.
- *Documentation requirements:* Single administrative document (SAD) for nonagricultural products, commercial invoice, bill of lading, air waybill, packing list, certificate of origin, insurance certificate, phytosanitary certificate (plant and plant products), veterinary certificate, registration and approval (pharmaceuticals).
- *Marketing and distribution:* Imports are generally sold through branches, sales agents, or distributors. Exhibitions, printed advertising, and trade fairs are popular selling techniques in Hungary.

Best Export Prospects

- *Agricultural products:* Soybean meal, bovine semen, poultry breeding stock, dried fruits and nuts.
- *Industrial products:* Computers and computer products, logistics, medical equipment, pollution control, renewable energy, safety and security.
- *Services:* Travel and tourism, franchising, investment.

Promising imports from Hungary: Machinery and equipment, food products, raw materials, fuels and electricity

Major impediments to exporting from Hungary (in order of importance): Identification of potential markets and buyers, difficulties in meeting quality/quantity requirements of buyers, high cost or delays caused by international transportation, technical requirements and standards abroad, inappropriate production technology and skills, high cost or delays caused by domestic transportation, access to imported inputs at competitive prices, rules-of-origin requirements abroad, burdensome procedures and corruption at foreign borders, access to trade finance

Major impediments to importation to Hungary (in order of importance): High cost or delays caused by international transportation, tariffs and nontariff barriers, burdensome import procedures, high cost or delays caused by domestic transportation, domestic technical requirements and standards, inappropriate telecommunications infrastructure, corruption at the border, crime and theft

Poland

Country Profile

Population: 38,383,809

Exports: $192.3 billion

Major Exports: manufactured goods, chemicals, machinery and equipments, food and live animals

Imports: $206.5 billion
Major Imports: manufactured goods, chemicals, machinery and equipment, and mineral fuels.
Trade as % GDP: Exports: 42.25%; Imports: 43.45%
Major Trading Partners: Germany, Russia, Italy
Currency and Exchange Rate: zlotych per U.S. dollar—3.27
GDP: $799.2 billion
GDP per capita: $21,000
External Debt: $310.2 billion

Import Policies

- *Entry of goods:* Many EU member states maintain their own list of goods subject to import licensing. Poland's "Import List" includes goods for which licenses are required, their code numbers, any applicable restrictions, and the agency that will issue the relevant license. The Import List also indicates whether the license is required under Polish or EU law.
- *Tariff and taxes:* Upon its accession to the European Union on May 1, 2004, Poland became part of the EU customs union. This means that the same import duty rates are applicable in all member states. Tariff rates are contained in the European Union's Common External Tariff.
- *Nontariff barriers:* All business entities operating in Poland (including foreign companies) have equal access to international trade. However, this access is subject to trade policy measures introduced by the EU, which Poland as a member is obliged to observe. There are certain licensing requirements not related to commercial policy for trading in dual-use (i.e., both civil and military use) goods and technologies; in certain chemicals, particularly narcotic drugs and psychotropics; or in cultural goods.
- *Intellectual property rights protection:* The Polish government views protecting intellectual property (IP) rights as a core element of Poland's economic development. Its efforts have led to a significant reduction in the availability of pirated goods at border and open-air markets.
- *Documentation requirements:* The Single Administrative Document (SAD) is required for nonagricultural products. Other required documents include: commercial invoice, pro forma invoice, bill of lading, air waybill, packing list, insurance certificate, sanitary certificate, animal and animal products, phytosanitary certificate (plants), safety certificate (for certain products).
- *Marketing and distribution:* There are state agencies that accept foreign representation. Imports are also handled through branch offices or distributors. Selling techniques include advertising through newspapers, direct mail publicity, trade fairs, and shows.

Best Export Prospects

- *Agricultural products:* Feed and fodder, processed fruit and vegetables, tree nuts, wine, salmon whole, hardwood lumber.
- *Industrial products:* Energy, aviation, cosmetics, defense, green building products, information technology, machine tools, medical equipment, plastic production and equipment, waste management.
- *Services:* Computer services.

Promising imports from Poland: Machinery and transport equipment, intermediate manufactured goods, miscellaneous manufactured goods, food and live animals

Major impediments to exporting from Poland (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, access to trade finance, difficulties in meeting quality/quantity requirements of buyers, access to imported inputs at competitive prices, inappropriate production technology and skills, high cost or delays caused by international transportation, rules-of-origin requirements abroad, burdensome procedures and corruption at foreign borders, high cost or delays caused by domestic transportation

Major impediments to importation to Poland (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, high cost or delays caused by international transportation, domestic technical requirements and standards, high cost or delays caused by domestic transportation, inappropriate telecommunications infrastructure, corruption at the border, crime and theft

The Russian Republic

Country Profile

Population: 142,500,482

Exports: $530.7 billion

Major Exports: Petroleum, petroleum products, natural gas, wood and wood products, coal, metals, chemicals

Imports: $335.4 billion

Trade as % GDP: Exports: 31.05%; Imports: 22.29%

Major Imports: Machinery and equipment, consumer goods, medicines, meat, grain, sugar, semifinished metal products.

Major Trading Partners: Germany, Netherlands, Ukraine

Currency and Exchange Rate: Russian rubles per U.S. dollar—31.32

GDP: $2.504 trillion

GDP per capita: $17,700

External Debt: $565.9 billion

Import Policies

- *Entry of goods:* Russia continues to maintain a number of barriers with respect to imports, including tariffs and tariff-rate quotas, discriminatory and prohibitive charges and fees, and discriminatory licensing, registration, and certification regimes. As a result, exporters have been facing additional delays, valuation questions, and other issues. Labels on food and nonfood items must have certain featured information in the Russian language. It is advisable to place the Rostest mark on the label for products that have appropriate Rostest and sanitary-epidemiological certificates. This rule is applicable to both food and nonfood items. On January 1, 2010, the Russia-Kazakhstan-Belarus Customs Union (the Customs Union or CU) adopted a common external tariff (CET) with the majority of the tariff rates established at the level applied by Russia at that time.

- *Tariffs and taxes:* In 2011, the CU increased import tariffs on 124 types of products, roughly 40 percent of which apply to U.S. producers. Products subject to tariff increases include continuous-action elevators and conveyors specially designed for underground use, liquid-filled radiators, and various industrial products. Import duties are very high on finished vehicles, as much as 30 percent for new cars and at a prohibitive level for used cars older than five years. As part of its WTO accession commitments, Russia agreed to end the WTO-inconsistent elements of the program (the domestic-content provisions applying to goods) by July 1, 2018, and to reduce the average bound tariff rate on imported vehicles to 12.3 percent by 2019.
- *Nontariff barriers:* In general, exporters face a number of nontariff trade barriers when exporting to Russia. Russia's regime remains extremely complex due to its lack of clarity and transparency and its overall redundancy. Discrimination against foreign providers of nonfinancial services is, in most cases, not the result of federal law but stems from abuse of power and from subnational regulations and practices that may violate Russian law.
- *Documentation requirements:* Importers are required to complete a Russian customs freight declaration for every item imported. In addition, currency control regulations require issuance of a "transaction passport" for both exports and imports. Other documents include: commercial invoice, bill of lading, air waybill, packing list, certificate of origin, veterinary certificate, safety certificate.
- *Intellectual property rights protection:* In 2010, Russia made significant progress in improving the legislative environment and legal framework for IPR protection, but copyright violations (films, videos, sound recordings, computer software) remain a serious problem.
- *Marketing and distribution:* Import products are marketed through distributors, sales agents, or branch offices. Various media such as television, radio, print, and billboards are used for advertising consumer goods. Exporters to Russia use exhibitions to introduce and market their product.

Best Export Prospects

- *Agricultural and food products:* Beef, livestock genetics, soybeans, prepared foodstuffs, hatching eggs, nuts, spirits.
- *Industrial products:* Agricultural equipment, apparel, auto parts and service equipment, aviation, chemicals/plastics, construction, consumer electronics, electrical power generation and transmission equipment, energy efficiency/green build, medical equipment, refinery equipment, safety and security equipment.
- *Services:* Travel and tourism, franchising.

Promising imports from Russia: Petroleum and petroleum products, natural gas, metals, wood and wood products, chemicals, and a wide variety of civilian and military manufactures

Major impediments to exporting from Russia (in order of importance): Inappropriate production technology and skills, technical requirements and standards abroad, difficulties in meeting quality/quantity requirements of buyers, identification of potential markets and buyers, burdensome procedures and corruption at foreign borders, access to imported inputs at competitive prices, high cost or delays caused by domestic transportation, access to trade finance, high cost or delays caused by international transportation, rules-of-origin requirements abroad

Major impediments to importation to Russia (in order of importance): Corruption at the border, tariffs and nontariff barriers, burdensome import procedures, crime and theft, high cost or delays caused by domestic transportation, domestic technical requirements and standards, inappropriate telecommunications infrastructure, high cost or delays caused by international transportation

A.5 Trading Opportunities in the European Union (EU)

Denmark

Country Profile

Population: 5,556,452
Total Export: $110.8 billion
Major Export: Machinery and instruments, meat and meat products, fuels, dairy products, pharmaceuticals, furniture, windmills
Export Partners: Germany, Sweden, United Kingdom, Norway, United States, Netherlands, France
Imports: $97.91 billion
Major Imports: Machinery and equipment, petroleum, chemicals, grain and foodstuffs
Import Partners: Germany, Sweden, Netherlands, United Kingdom, China, Norway
Trade as % GDP: Exports: 53.1%; Imports: 47.0%
Currency and Exchange Rate: Danish kroner per U.S. dollar—5.84
GDP: $208.5 billion
GDP per capita: $37,700
External Debt: $626.9 billion

Import Policies

- *Entry of goods*: Denmark relies on several of the EU's policies and regulations on imported goods. Duty rates are applied on a cost, insurance, and freight (CIF) basis to all dutiable products imported from non-EU countries with certain exceptions. Imports on farm products must follow regulations in accordance with Common Agricultural Policy (CAP).
- *Tariff structure*: Non-EU imports of manufactured goods are subject to rates between 5 percent and 14 percent. The standard VAT rate for importing items into Denmark is 25 percent.
- *Nontariff barriers (NTBs)*: Most goods may enter Denmark free from restrictions. Import licenses issued by the Ministries of Industry, Agriculture, or Fisheries are required for only a limited range of items, including agricultural products and textiles and products originating in specified countries. Exporters should stay attentive to three areas where barriers to intra-EU trade remain most prevalent. These areas include product specifications, product approval, and documentation and labeling.
- *Intellectual property rights protection:* There is adequate protection for IPRs in Denmark.

- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, sanitary certificate for certain food products.
- *Marketing and distribution channels:* Methods of distribution vary from product to product. Capital goods, commodities, and industrial raw materials are handled by non-stock sales agents. High-tech and specialized products are handled by stocking distributors, and consumer goods are handled by importing agents and distributors.

Best Export Prospects

- *Agricultural products:* Nuts, cereals, turkey meat, sweet corn, wines, dog and cat food, and forest products.
- *Industrial products:* Computers and peripherals, computer software, electrical power systems, medical equipment, oil and gas, pollution control and telecommunication equipment, automotive and aircraft parts, apparel, building products, sporting goods equipment.
- *Services:* Architectural, construction and engineering services, travel and tourism services.

Promising imports from Denmark: Meat and dairy products, chemicals, fish, industrial machinery and equipment

Major impediments to exporting from Denmark (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, access to imported inputs at competitive prices, burdensome procedures and corruption at foreign borders, access to trade finance

Major impediments to importation to Denmark (in order of importance): Tariffs and nontariff barriers, domestic technical requirements and standards, burdensome import procedures, high cost or delays caused by international transportation

France

Country Profile

Population: 65,951,611
Exports: $567.5 billion
Major Exports: Machinery and transport equipment, chemicals, foodstuffs, agricultural products, iron and steel products
Export Partners: Germany, Italy, Spain, Belgium, United Kingdom, United States, Netherlands
Imports: $658.9 billion
Import Partners: Germany, Belgium, Italy, Netherlands, Spain, United Kingdom, China
Trade as % GDP: Exports: 25.2%; Imports: 29.2%
Major Imports: Machinery and equipment, vehicles, crude oil, aircraft, plastics, chemicals
Currency and Exchange Rate: euros per U.S. dollar—0.7838
GDP: $2.253 trillion
GDP per capita: $35,500
External Debt: $5.633 trillion

Import Policies

- *Entry of goods:* No import licenses are required except for certain agricultural products and commodities subject to state trading. Goods that originate from countries not eligible for such liberalized treatment require individual licenses, normally valid for six months. Exporters to France must comply with EU and French labeling laws. Labels must be written in French and generally state the product, brand name/trademark, composition and usage instructions, name of manufacturer, and price. Mark of origin is also required on all imports.
- *Tariff structure:* The duty rates applied to imports into France typically range between 0 percent (e.g., for books) and 17 percent (e.g., for Wellington boots). The standard VAT rate for importing items into France is 19.6 percent, with certain products, such as books, subject to the VAT at the reduced rate of 5.5 percent.
- *Nontariff barriers (NTBs):* Non-EU imports of manufactured goods are subject to rates between 4.2 percent and 17.3 percent ad valorem, while raw materials enter with higher tariff rates. Most agricultural imports from non-EU countries are covered by the CAP (i.e., subject to variable levies).
- *Intellectual property rights protection:* Intellectual property protection is generally adequate.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/ air waybill, packing list, certificate of origin. For certain imports, a sanitary and health certificate, a phytosanitary certificate (certain plants), and a certificate of compliance (machinery) are required.
- *Marketing and distribution channels:* Sales agents, branches, and subsidiaries are often used to import into France. Distributors also import foreign goods for resale.

Best Export Prospects

- *Agricultural products:* Beverages, including mineral water, beer, wine, and spirits; fresh and dried fruits; nuts; fresh and dried vegetables; meat and offal, organics.
- *Industrial products:* Computers and software, aircraft and parts, travel and tourism, safety and security equipment, telecommunications equipment, computers and peripherals, medical equipment, automotive parts and equipment, plastics, textile, cosmetics, educational services.
- *Services:* Travel and tourism, insurance, employment services.

Promising imports from France: Machinery and equipment, agricultural products, chemicals, and foodstuffs

Major impediments to exporting from France (in order of importance): Burdensome procedures and corruption at foreign borders, identification of potential markets and buyers, access to imported inputs at competitive prices, technical requirements and standards abroad, rules-of-origin requirements, access to trade finance

Major impediments to importation to France (in order of importance): Burdensome import procedures, high cost or delays caused by international transportation, domestic technical requirements and standards, tariffs and nontariff barriers

Germany

Country Profile

Population: 81,147,265
Exports: $1.492 trillion
Major Exports: Motor vehicles, machinery, chemicals, computer and electronic products, electrical equipment, pharmaceuticals, metals, transport equipment, foodstuffs, textiles, rubber and plastic products
Imports: $1.276 trillion
Major Imports: Machinery, data processing equipment, vehicles, chemicals, oil and gas, metals, electric equipment, pharmaceuticals, foodstuffs, agricultural products
Trade as % GDP: Exports: 47.8%; Imports: 40.9%
Major Trading Partners: France, Netherlands, United States, United Kingdom
Currency and Exchange Rate: euros per U.S. dollar—0.7838
GDP: 3.123 trillion
GDP Per Capita: $39,100
External Debt: $5.624 trillion

Import Policies

- *Entry of goods*: Germany relies on several of the EU's policies and regulations on imported goods. Germany is a member of the European Union (EU). Preferences are given to EU associate members, developing countries, and EFTA members. The European customs tariff applies for goods originating outside the single European market, since customs tariffs have been harmonized within the Union. Imports on farm products must follow regulations in accordance with Common Agricultural Policy (CAP).
- *Tariff structure*: The duty rates applied to imports into Germany typically range between 0 percent (e.g., for books) and 17 percent (e.g., for Wellington boots). The standard VAT rate for importing items into Germany is 19 percent, with certain products, such as books, newspapers, and magazines, subject to the VAT at the reduced rate of 7 percent.
- *Nontariff barriers*: Prohibitions and restrictions are applicable in certain areas such as firearms and ammunition (weapons of riflemen, hunting weapons, prohibited items), fireworks, literature with unconstitutional content, pornography, food, and narcotics. Imports of certain agricultural products such as foodstuffs and textiles require specific import licenses. Some imports are subject to quantitative restrictions (e.g., meat) and/or the requirement for specific import licenses or confirmation that the manufacturer is licensed to export from the country of origin (e.g., apparel manufactured in developing countries). Specific import regulations may also apply to products under monopoly control (e.g., medicines).
- *Intellectual property rights protection:* IPRs are generally well protected in Germany. However, the level of software piracy continues to be a source of concern.
- *Documentation requirements*: Pro forma invoice, commercial invoice, bill of lading/air waybill, packing list, certificate of origin, sanitary certificate, packing list.
- *Marketing and distribution channels*: Trade fairs are important tools for introducing new products and/or companies to the German market. Most imports to Germany

move through import regional houses, wholesalers, and distributors. Direct sales are also common for machinery and equipment. Multinationals use branch offices (subsidiaries) to sell their products.

Best Export Prospects

- *Agricultural products:* Catfish, citrus, fats and oils, lumber products, pet food and supplies, red beef, wine and beer.
- *Industrial products:* Auto parts, computers, peripherals and software, electronic components, drugs and chemicals, medical equipment, telecommunications and scientific instruments.
- *Services:* Computer services, franchising, information services, travel and tourism.

Promising imports from Germany: Machine, machine tools, chemicals, iron and steel products

Major impediments to exporting from Germany (in order of importance): Burdensome procedures and corruption at foreign borders, identification of potential markets and buyers, access to trade finance, technical requirements and standards abroad, rules-of-origin requirements abroad, high cost or delays caused by international transportation, access to imported inputs at competitive prices

Major impediments to importation to Germany (in order of importance): Tariffs and nontariff barriers, domestic technical requirements and standards, high cost or delays caused by international transportation, burdensome import procedures

Ireland

Country Profile

Population: 4,775,982
Exports: $113.6 billion
Major Exports: Machinery and equipment, computers, chemicals, medical devices, pharmaceuticals; food products, animal products
Export Partners: United States, United Kingdom, Belgium, Germany, France, Switzerland
Imports: $63.1 billion
Major Imports: Data-processing equipment, other machinery and equipment, chemicals, petroleum and petroleum products, textiles, clothing
Import Partners: United Kingdom, United States, Germany, Netherlands
Trade as % GDP: Exports: 59.3%; Imports: 33.0%
Major Trading Partners: United Kingdom, Germany, France, United States
Currency and Exchange Rate: euros per U.S. dollar—0.7838
GDP: $191.5 billion
GDP per capita: $41,700
External Debt: $2.352 trillion

Import Policies

- *Entry of goods:* Ireland relies on several of the EU's policies and regulations on imported goods. Imports on farm products must follow regulations in accordance with Common

Agricultural Policy (CAP). All importers must fill in an intrastate declaration form before entering goods into Ireland (used whether the country of origin of products is an EU state or a non-EU state). Most duties are ad valorem, based on the GATT Valuation Code (CIF value).

- *Tariff structure:* The duty rates applied to imports into Ireland typically range between 0 percent (e.g., for books) and 17 percent (e.g., for Wellington boots). The standard VAT rate for importing items into Ireland is 23 percent, with certain products, for example newspapers and periodicals, subject to the VAT at the reduced rate of 13.5 percent.
- *Nontariff barriers:* Import licenses are required for a limited number of items, including agricultural products. Phytosanitary certificates are also required for plants, some cut flowers, rooted plants and plant material, and trees and shrubs. Imports of certain goods (including textiles, steel, footwear, ceramic products, toys, and porcelain and glass products) originating in certain non-European Union (EU) countries are subject to either quantitative restrictions or surveillance measures. Imports from non-EU countries of products covered by the Common Agricultural Policy may be subject to various charges.
- *Intellectual property rights protection:* Generally, adequate protection exists for protection of IPRs.
- *Documentation requirements:* Commercial invoice, bills of lading/air waybill, packing list, certificate of origin, phytosanitary certification, insurance.
- *Marketing and distribution channels:* Agents, distributors, and representatives are used to import products into Ireland. Retail channels also import a variety of food products.

Best Export Prospects

- *Agricultural products:* Pears, wine, corn gluten feed.
- *Industrial products:* Air conditioning and refrigeration equipment, building products, computers, peripherals and software, construction equipment, drugs and pharmaceuticals, electrical power systems, electronic components, industrial chemicals, medical and telecommunications equipment.
- *Services:* Travels and tourism, computer services.

Promising imports from Ireland: Data-processing equipment, chemicals, animal and animal products

Major impediments to exporting from Ireland (in order of importance): Access to trade finance, identification of potential markets and buyers, access to imported inputs at competitive prices, high cost or delays caused by international transportation, technical requirements and standards abroad, rules-of-origin requirements abroad

Major impediments to importation to Ireland (in order of importance): High cost or delays caused by international transportation, burdensome import procedures, tariffs and nontariff barriers, high cost or delays caused by domestic transportation, inappropriate telecommunications infrastructure, domestic technical requirements and standards

Italy

Country Profile

Population: 61,482,297
Exports: $483.3 billion

Major Exports: Engineering products, textiles and clothing, production machinery, motor vehicles, transport equipment, chemicals, food, beverages and tobacco, minerals, nonferrous metals
Export Partners: Germany, France, United States, Spain, Switzerland, United Kingdom
Imports: $469.7 billion
Import Partners: Germany, France, China, Netherlands, Spain
Major Imports: Engineering products, chemicals, transport equipment, energy products, minerals and nonferrous metals, textiles and clothing, food, beverages, and tobacco
Trade as % of GDP: Exports: 26.4%; Imports: 25.6%
Major Trading Partners: EU members, United States
Currency and Exchange Rate: euros per U.S. dollar—0.7838
GDP: $1.834 trillion
GDP per capita: $30,100
External Debt: $2.46 trillion

Import Policies

- *Entry of goods*: Italy relies on several of the EU's policies and regulations on imported goods. Most duties are ad valorem, based on the GATT Valuation Code (CIF value). Imports on farm products must follow regulations in accordance with Common Agricultural Policy (CAP).
- *Tariff Structure*: The duty rates applied to imports into Italy typically range between 0 percent (e.g., for books) and 17 percent (e.g., for Wellington boots). The standard VAT rate for importing items into Italy is 20 percent, with certain products, such as books, newspapers, and magazines, subject to the VAT at the superreduced rate of 4 percent.
- *Nontariff barriers:* Quotas are established on an EU basis for a range of goods (e.g., textiles, agri-foods and steel and iron industry products). A particular certificate, Titolo all'Importazione, must be requested from the Italian Ministry of Foreign Trade. Import licenses are required for a limited list of items and are issued by the Ministry of Foreign Trade. There are a number of Italian regulations and European Union (EU) directives that prohibit certain foodstuffs, food colorings, drugs and narcotics, and plant and animal products.
- *Intellectual property rights protection:* There are problems with respect to piracy of computer software, film video, and musical recording, and adequate penalties to deter such activity do not exist.
- *Documentation requirements:* Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, health certificate (cattle, horses and other animals, fish and fish products) and phytosanitary certificate (plants).
- *Marketing and distribution channels:* Distributors transport consumer goods, the largest distributor being Coop Italia. Local agents who know the market generally handle promotion.

Best Export Prospects

- *Agricultural products*: Logs and wood products, oilseeds, cattle and swine, nuts, grain and feed.

- *Industrial products:* Aircraft and parts, computers, parts and software, electric power systems, chemicals, pollution control and telecommunication equipment.
- *Services:* Computer services, franchising, insurance.

Promising imports from Italy: Textiles and apparel, leather, glassware, food and agricultural products, chemical products, olive oil, precious metals, ceramic goods

Major impediments to exporting from Italy (in order of importance): identification of potential markets and buyers, access to imported inputs at competitive prices, access to trade finance, high cost or delays caused by international/domestic transportation, difficulties in meeting quality and quantity requirements of buyers

Major impediments to importation to Italy (in order of importance): Burdensome import procedures, high cost or delays caused by international/domestic transportation, tariffs and nontariff barriers, domestic technical requirements and standards

The Netherlands

Country Profile

Population: 16,805,037
Exports: $556.5 billion
Major Exports: Machinery and equipment, chemicals, fuels, food and tobacco
Export Partners: Germany, Belgium, France, United Kingdom, Italy
Imports: $490.1 billion
Major Imports: Machinery and transport equipment, chemicals, foodstuffs, fuels, clothing
Import Partners: Germany, China, Belgium, United Kingdom, Russia, United States
Trade as % GDP: Exports: 78.4%; Imports: 69.0%
Major Trading Partners: Germany, Belgium, Luxembourg, United Kingdom, United States
Currency and Exchange Rate: euros per U.S. dollar—0.7838
GDP: $709.5 billion
GDP per capita: $42,300
External Debt: $2.655 trillion

Import Policies

- *Entry of goods:* The Netherlands relies on several of the EU's policies and regulations on imported goods. Imports on farm products must follow regulations in accordance with Common Agricultural Policy (CAP).
- *Tariff structure:* Import tariffs on manufactured goods from non-EU countries range from 0 percent (e.g, for books) and 17 percent (e.g., for Wellington boots). The standard VAT rate for importing items into the Netherlands is 21 percent (raised in October 2012 from 19 percent), with certain products, such as books, newspapers, and magazines, subject to the VAT at the reduced rate of 6 percent.
- *Nontariff barriers:* EU imports restrictions apply on certain imports. Quotas are established across the EU for a range of goods, such as textiles, agri-foods, and steel- and iron-industry products.
- *Intellectual property rights protection:* Protection of IPRs is generally adequate.

- *Documentation requirements*: Commercial invoice, pro forma invoice, bill of lading/air waybill, packing list, certificate of origin, health certificate, and phytosanitary certificate.
- *Marketing and distribution channels:* Products can be exported through a variety of experienced importers, agents, and distributors. Certain consumer goods are imported directly by wholesalers and retailers.

Best Export Prospects

- *Agricultural products:* Grapefruits, tobacco, wines, honey, pecans.
- *Industrial Products:* Apparel, auto parts, building products, computer parts and software, electronic components, laboratory and scientific instruments, medical products, pollution control, security and telecommunications equipment.
- *Services:* Telecommunications services, franchising.

Promising imports from the Netherlands: Agricultural products, beer, chemicals, petroleum products, office machines

Major impediments to exporting from the Netherlands (in order of importance): Identification of potential markets and buyers, rules-of-origin requirements abroad, technical requirements and standards abroad, access to trade finance, high cost or delays caused by international/domestic transportation, access to imported inputs at competitive prices

Major impediments to importation to the Netherlands (in order of importance): Tariffs and nontariff barriers, domestic technical requirements and standards, burdensome import procedures, high cost or delays caused by international/domestic transportation, inappropriate telecommunications infrastructure

The United Kingdom

Country Profile

Population: 63,395,574
Exports: $481 billion
Major Exports: Manufactured goods, fuels, chemicals, food, beverages
Export Partners: Germany, United States, Netherlands, France, Switzerland, Ireland, Belgium
Imports: $646 billion
Major Imports: Manufactured goods, machinery, fuels, foodstuff
Import Partners: Germany, China, Netherlands, United States, France, Belgium, Norway
Trade as % GDP: Exports: 20.7%; Imports: 27.8%
Major Trading Partners: EU, China, United States
Currency and Exchange Rate: British pounds per U.S. dollar—0.6324
GDP: $2.323 trillion
GDP per capita: $36,700
External Debt: $9.836 trillion

Import Policies

- *Entry of goods:* The United Kingdom relies on several of the EU's policies and regulations on imported goods. Imports on farm products must follow regulations in

accordance with Common Agricultural Policy (CAP). All importers must fill in an intrastate declaration form before entering goods into the United Kingdom (used to determine whether the country of origin of the products is an EU state or a non-EU state).

- *Tariff structure*: Import tariffs on manufactured goods from non-EU countries range from 0 to 17 percent of CIF value. The standard VAT rate for importing items into the United Kingdom is 20 percent, with certain products, such as children's car seats, subject to the VAT at the reduced rate of 5 percent. Most duties are ad valorem (%), based on the GATT Valuation Code (CIF value).
- *Nontariff barriers:* Import licenses are required for a limited number of items, including agricultural products. All agricultural products are subject to quotas and import licenses under the Common Agricultural Policy (CAP). Minimum import prices are enforced through variable import levies. Importation of specified products such as cereals and rice, beef and veal, sugar, and wine without a quota license is prohibited. Products including textiles, steel, footwear, ceramic products, toys, porcelain, and glass products originating in certain non-EU countries are subject to quota restrictions and also require an import license.
- *Intellectual property rights protection:* Protection of IPRs is generally adequate.
- *Documentation requirements:* Commercial invoice, bill of lading/air waybill, packing list, certificate of origin, sanitary certificate.
- *Marketing and distribution:* The distribution of foods is carried out by specialized branches, departmental stores, and cooperatives. Large retail outlets purchase products directly from the foreign manufacturer.

Best Export Prospects

- *Agricultural products:* Forest products, seafood, beer, wine, nuts, pet food.
- *Industrial products:* Aircraft and parts, apparel, building products, computers, parts and software, drugs and pharmaceuticals, medical equipment, defense equipment.
- *Services:* Tourism, franchising.

Promising imports from the United Kingdom: Textile and apparel, beverages, medical equipment, cereals, machinery

Major impediments to exporting from the United Kingdom (in order of importance): Identification of potential markets and buyers, technical requirements and standards abroad, rules-of-origin requirements abroad, access to trade finance, burdensome procedures and corruption at foreign borders, high cost or delays caused by international or domestic transportation

Major impediments to importation to the United Kingdom (in order of importance): Burdensome import procedures, tariffs and nontariff barriers, domestic technical requirements and standards, high cost or delays caused by international/domestic transportation, inappropriate telecommunications infrastructure

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TABLE A.1 Country Profile Data Sources

Data	Year	Source(s)
Population	2013	CIA, *The World Factbook:* https://www.cia.gov/library/publications/the-world-factbook/geos/uk.html
Exports, major exports, export partners, major imports, import partners, currency rate, GDP, GDP per capita, external debt	2012	CIA, *The World Factbook:* https://www.cia.gov/library/publications/the-world-factbook/geos/uk.html
Trade as % GDP	2011	Worldbank (export of goods and services; import of goods and services as % of GDP): http://search.worldbank.org/
Import policies	2013	Office of the US Trade Representative, 2013 National Trade Estimate Report on Foreign Trade Barriers: http://www.ustr.gov/sites/default/files/2013%20NTE.pdf
Best export prospects, promising imports	2012	US commercial service, country commercial guide: http://www.buyusainfo.net/Export market info provided by the Australian government: http://www.austrade.gov.au/
Major impediments to exporting	2012	*The Global Enabling Trade Report 2012:* http://www3.weforum.org/docs/GETR/2012/GlobalEnablingTrade_Report.
Major impediments to importation	2012	*The Global Enabling Trade Report 2012:* http://www3.weforum.org/docs/GETR/2012/GlobalEnablingTrade_Report.

Appendix B
Importing into the United States

Important Questions

Section 1: Entry of Goods

1. Do I need a license to import goods into the United States?
2. What products are prohibited from importation?
3. What factor should be considered before importation?
4. What do you consider before importing goods by mail?
5. What are the specific requirements of a commercial invoice when clearing goods from customs?
6. What is consumption entry?
7. What is a formal entry, and how do I file it?
8. What is general-order merchandise?
9. Is Puerto Rico considered part of the customs territory of the United States?
10. Do the following items require an entry during importation?
    a. Articles exported from space within the purview of the Tariff Act of 1930
    b. Domestic animals driven across a neighboring country by owner for temporary pasturage and brought back within thirty days
    c. Exported articles that are undeliverable (within forty-five days) and that are within the custody of the carrier or foreign customs service
    d. Personal goods purchased while overseas.
11. What are some of the eligibility requirements for participation in the ABI program?
12. What is required of importers who are habitually late in paying bills to U.S. Customs and Border Protection?
13. Are there taxes or fees required to import goods into the United States other than customs duties?

14. Can a foreign company export to the United States without an importer of record in the United States?
15. If goods arrive to the port of Miami, can they be cleared at the port of Dallas (if the importer requires it)?

Section 2: Customs Bonds

1. When is a customs bond required?
2. How do you obtain a customs bond?
3. What are the two major types of customs bonds?
4. What are some of the ways in which a bond to ensure the exportation of merchandise may be canceled?
5. Can a bond rider be used to terminate the bond?
6. What charges are supposed to be paid first on merchandise remaining in a bonded warehouse beyond the specified time?
7. What type of bond is used to indemnify the United States for detention of copyrighted material?

Section 3: Quota, Marking Requirements, and Trade Agreements

1. What is the difference between an absolute and a tariff quota?
2. Do most goods from NAFTA countries enter duty-free into the United States?
3. What countries are not eligible for normal trade relations (NTR) or most-favored-nation (MFN) duty rates?
4. What is a nonqualifying operation under NAFTA?
5. What happens to imports that are not properly marked?
6. A shipment of beef valued at $5,000 is subject to a tariff quota. At the time of importation, a high tariff rate is in effect, but a lower rate is soon expected. How can an importer take advantage of the lower rate?
7. When imported merchandise exceeds a tariff quota, the importer may not commingle the merchandise and classification with nonquota class goods. True or false?
8. What is the rate of duty on imports from GSP eligible countries?
9. A claim for preferential treatment under NAFTA may be filed within one year from the date of importation of the goods. True or false?
10. What are the origin criteria for textiles and apparel products under NAFTA?

Section 4: Value

1. What is value, and what value is used for customs purposes?
2. What are the secondary bases of value if the transaction value cannot be used?
3. In establishing transaction value, what is to be included in the price?
4. What is an assist?
5. What should be excluded from transaction value?
6. What is the basis of appraisal for the following merchandise: A U.S. produce wholesaler imports avocados from Mexico on consignment. A few days after importation, the

wholesaler sells the avocados (for $ 0.25 per avocado) to retailers and receives a 2 percent commission from Mexican sellers. CBP has sufficient information to appraise the merchandise.

7. What is the transaction value of the shipment of 5,000 imported computer monitors with a per-unit price of $50 FOB? The manufacturer received from the importer, free of charge, design work produced in the United States and 5,000 U.S.-originating modules to be incorporated in the production of the monitors. The costs are as follows: cost of acquiring design work: $10,000; cost of transportation to place of production: $100; cost of acquiring modules: $75 each; cost of transportation of modules: $5,250.
8. What is "identical merchandise"?

Section 5: Broker Compliance and Other Areas

1. Is a power of attorney required when a broker is acting as the importer of record?
2. When is a multiple-country declaration required?
3. What rate of currency exchange should be used when foreign currency is converted?
4. What are the penalties for conducting customs business without a license? What are the penalties against any broker who (a) continuously makes the same errors on a particular type of entry, and (b) does not have a working knowledge of customs operation sufficient to render valuable service?
5. What information should be on a bill of lading?
6. Is the commercial invoice required at the time of shipment?
7. How does the duty drawback claim work?
8. Are there laws governing labeling requirements for certain products?
9. Does an importer who sells merchandise to another company that exports it qualify for a duty drawback?
10. Does the firm qualify for a rejected merchandise drawback claim under the following conditions:

    a. A Miami firm imports 200 pounds of shrimp for its national network of seafood restaurants. When it opens the boxes, it finds that it received 200 pounds of pork.
    b. An importer of oranges finds thirty crates of unordered vegetables.
    c. A company in New York imports twenty cases of Argentine wine. There is a strike at the port, and the wine is not unloaded for a few days. When the importer picks up the wines, they are frozen.

Answers

Section 1: Entry of Goods

1. *Do I need a license to import goods into the United States?* No. However, for certain items such as food products, plant, animal and dairy products, prescription medications, you may require a license or permit from various government agencies.
2. *What products that are prohibited from importation?* Certain narcotics, drug paraphernalia, counterfeit articles, obscene and immoral articles as well as merchandise produced by convicts or through forced labor.

3. *What factor should be considered before importation?* It is important to verify whether an item is subject to quotas and other restrictions or permits, reduced rates of duty, marking of country of origin as well as exclusive rights due to ownership of intellectual property rights by certain companies.
4. *What do you consider before importing goods by mail?* Can the item be legally sent through the U.S. Postal Service; is the value less than $2,000 (since items valued at over $2,000 require a formal entry); is the item subject to restrictions?
5. *What are the specific requirements of a commercial invoice when clearing goods from customs?* Description of the item, quantity, value (in foreign currency and U.S. dollars), country of origin, place of purchase, name and address of seller, and consignee.
6. *What is consumption entry?* This is the most common type of entry. Imported goods are intended for use in the United States or directly go into the commerce of the United States without any time or use restrictions. It may be formal or informal.
7. *What is a formal entry, and how do I file it?* A formal entry is used for merchandise valued at more than $2,000 and is supported by a surety bond to ensure payment of duties and compliance with Customs regulations. The major differences between formal and informal entries are the bond requirement and the liquidation process. When filing a formal entry, (a) identify the port of entry, relevant product classification, and tariff rate; (b) find out if the product is subject to any special requirements (or if there are any special forms that apply) such as quota, visa, FDA, NAFTA, or GSP; (c) ask the limit of liability for a customs bond. No more than a week before the expected arrival of the merchandise at the port or no later than ten days after arrival, fill out the appropriate forms (e.g., Form 5106,7501), purchase a customs bond, and submit to U.S. Customs and Border Protection, along with invoice, packing list, shipping documents, and a check. After processing, the merchandise may be subject for release or examination before release. The entry will be liquidated one year after release of merchandise. Until then, the bond or cash will be held as surety.
8. *What is general-order merchandise?* Merchandise shall be considered general-order merchandise when it is taken into the custody of the port director and deposited in the public stores or a general-order warehouse at the risk and expense of the consignee for any of the following reasons: entry is not made within the time provided by customs regulations; entry is incomplete due to failure to pay the estimated duties; entry cannot be made for want of proper documents or other reasons, or the merchandise is not correctly invoiced. The general order expires six months from the date of importation. Such merchandise may be exported without examination or appraisement if the merchandise is delivered to the exporting carrier within six months from the date of importation. This merchandise may be entered within six months from date of importation for immediate transportation to any port of entry designated by the consignee. After six months from the date of importation, entry for immediate transportation is allowed.
9. *Is Puerto Rico considered part of the customs territory of the United States?* Yes.
10. *Do the following items require an entry during importation:*

    a. *Articles exported from space within the purview of the Tariff Act of 1930.* No
    b. *Domestic animals driven across a neighboring country by owner for temporary pasturage and brought back after thirty days.* Yes.
    c. *Exported articles that are undeliverable (within forty-five days) and that are within the custody of the carrier or foreign customs service.* No.

d. *Personal goods purchased while overseas.* Yes. Entries must be filed on a timely basis to avoid paying fees to the carrier and the bonded warehouse. Personal importations are generally cleared informally, that is, no bond is required. No duty is assessed if the goods are valued at less than $200. If the goods are valued at more than $200, a duty as well as a processing fee will be assessed. Imports that require a permit from other government agencies are subject to a formal entry and the posting of a customs bond.

11. *What are some of the eligibility requirements for participation in the ABI program?* The basic eligibility requirements for participation are the ability to demonstrate a reputable background and the basic skills for performing entry services; the ability to make a commitment for sending not less than 90 percent of entry/entry summary volume electronically; the ability to satisfactorily complete all of the qualification testing phases as outlined in the program; the ability to maintain operational standards for data quantity and quality; the ability to maintain timely updates.
12. *What is required of importers who are habitually late in paying bills to U.S. Customs and Border Protection?* The port director notifies the importer to file the entry summary with duties attached before release of merchandise.
13. *Are there taxes or fees required to import goods into the United States other than customs duties.* Yes. Here are some of the them.

a. *Federal excise tax:* Importation of alcoholic beverages and tobacco
b. *Merchandise processing fee (MPF):* Ad valorem fee of 0.21 percent for formal entries (minimum of $25 and maximum of $485). It is based on value of merchandise being imported, not including duty, freight, and insurance. For informal entries, it ranges from $5 to $9 per shipment.
c. *Harbor maintenance fee (HMF):* This is for merchandise transported by ship and is 0.125 percent of the value of the cargo. Goods arriving by ship are subject to both MPF and HMF.

14. *Can a foreign company export to the United States without an importer of record in the United States?* Yes. A resident agent, such as a broker in the state where the port of entry is located, can enter goods on behalf of the corporation.
15. *If goods arrive to the port of Miami, can they be cleared at the port of Dallas (if the importer requires it)?* In general, entry must be filed at the first port of arrival. To clear goods in Dallas, however, an immediate transportation entry (IT) must be filed by a broker, carrier, or importer (that is bonded with CBP). In Dallas, a consumption or warehouse entry must be filed for clearance from CBP.

Section 2: Customs Bonds

1. *When is a customs bond required?* A customs bond is required for imported merchandise valued at more than $2,000; goods subject to quota or visa restrictions or other government requirements; transportation of cargo or passengers to the United States or domestic transportation of imported cargo from one state to another; bonded warehouse facilities for imported or exported goods.
2. *How do you obtain a customs bond?* Customs bonds are obtained through a surety licensed by the Treasury Department. The list of licensed sureties is available online.

3. *What are the two major types of customs bonds?* Continuous-entry bonds applications are made for multiple transactions, while single-entry bonds are used to secure the entry of a single customs transaction. Continuous bonds are 10 percent of duties paid for the past year. Single-entry bonds (SEB) are generally in an amount not less than the total entered value plus any taxes and duties. The minimum amount for SEBs is $100.
4. *What are some of the ways in which a bond to ensure the exportation of merchandise may be canceled?* Listing of the merchandise on the outward manifest, inspector's certificate of lading, record of clearance of the vessel, production of a foreign landing certificate (when required by the port director).
5. *Can a bond rider be used to terminate the bond?* No. To be valid, a bond rider must be signed, sealed, witnessed, executed, and filed at the port of approval.
6. *What charges are supposed to be paid first on merchandise remaining in a bonded warehouse beyond the specified time?* Internal revenue taxes.
7. *What type of bond is used to indemnify the United States for detention of copyrighted material.* A single-entry bond.

Section 3: Quotas, Marking Requirements, and Trade Agreements

1. *What is the difference between an absolute and a tariff quota?* When absolute quotas are filled, further entries are prohibited during the remainder of the quota period. While some quotas are allocated to specific foreign countries, others are global. If the quota is exceeded by quota entries, the commodity is released on a pro rata basis. Tariff quotas allow a certain amount of a commodity to be entered at a reduced tariff during the quota period. Quantities entered in excess of the quota for the period are subject to higher duty rates.
2. *Do most goods from NAFTA countries enter duty-free into the United States?* Yes. However, proof of certificate of origin and/or country of origin marking on the goods is required. The manufacturer or seller of the goods should provide the importer with such a document.
3. *What countries are not eligible for normal trade relations (NTR) or most-favored-nation (MFN) duty rates?* Cuba and North Korea.
4. *What is a nonqualifying operation under NAFTA?* Dismantling.
5. *What happens to imports that are not properly marked?* The goods are seized or a penalty issued.
6. *A shipment of beef valued at $5,000 is subject to a tariff quota. At the time of importation, a high tariff rate is in effect, but a lower rate is soon expected. How can an importer take advantage of the lower rate.* A warehouse entry (type 21) can be filed, and when the lower rate is effective, the merchandise can be withdrawn (type 32) and the lower duty paid.
7. *When imported merchandise exceeds a tariff quota, the importer may not commingle the merchandise and classification with nonquota class goods.* True.
8. *What is the rate of duty on imports from GSP-eligible countries?* Zero.
9. *A claim for preferential treatment under NAFTA may be filed within one year from the date of importation of the goods.* True.
10. *What are the origin criteria for textiles and apparel products under NAFTA?* To be eligible for duty-free treatment, the yard-forward-rule states that the yarn used to form the fabric must originate in a NAFTA country.

Section 4: Value

1. *What is value, and what value is used for customs purposes?* Value is the price paid or payable for goods. It includes selling commissions, assists, royalties, packing and proceeds. Duty is assessed on the price paid and does not include freight and insurance charges.
2. *What are the secondary bases of value if the transaction value cannot be used?* The secondary bases of value, in order of precedence, are transaction value of identical merchandise, transaction value of similar merchandise, deductive value, computed value.
3. *In establishing transaction value, what is to be included in the price?* The packing costs incurred by the buyer; any selling commission incurred by the buyer; the value of any assist; any royalty or license fee that the buyer is required to pay as a condition of the sale; and the proceeds accruing to the seller of any subsequent resale, disposal, or use of the imported merchandise.
4. *What is an assist?* Items that the buyer of imported merchandise provides directly or indirectly, free of charge or a reduced cost, for use in the production or sale of merchandise for export to the United States (e.g., tools, dies, molds, engineering, development, artwork, design work).
5. *What should be excluded from transaction value?* The cost and charges for transportation or insurance relating to the shipment of the goods to the United States; costs incurred for constructing, assembling, or transporting the goods after importation; and tariffs and taxes for which the seller is ordinarily liable.
6. *What is the basis of appraisement for the following merchandise: A U.S. produce wholesaler imports avocados from Mexico on consignment. A few days after importation, the wholesaler sells the avocados (for $ 0.25 per avocado) to retailers and receives a 2 percent commission from Mexican sellers. Customs has sufficient information to appraise the merchandise.* Deductive value.
7. *What is the transaction value of the shipment of 5,000 imported computer monitors with a per-unit price of $50 FOB? The manufacturer received from the importer, free of charge, design work produced in the United States and 5,000 U.S.-originating modules to be incorporated in the production of the monitors. The costs are as follows: cost of acquiring design work: $10,000; cost of transportation to place of production: $100; cost of acquiring modules: $75 each; cost of transportation of modules: $5,250.* Answer: 630,250.
8. *What is "identical merchandise"?* Merchandise identical in all respects to the merchandise being appraised; produced in the same country as the merchandise being appraised; or produced by the same person as the merchandise being appraised.

Section 5: Broker Compliance and Other Areas

1. *Is a power of attorney required when a broker is acting as the importer of record?* No. A CBP power of attorney executed by a partnership is valid for two years.
2. *When is a multiple-country declaration required?* A multiple-country declaration is required for merchandise that has been subject to manufacturing processes in more than one country.
3. *What rate of currency exchange should be used when foreign currency is converted?* The rate of exchange in effect on the date of exportation.
4. (a) *What are the penalties for conducting customs business without a license? $10,000 for any one incident.*

(b) *What are the penalties against any broker who continuously makes the same errors on a particular type of entry?* $1,000

(c) *What are the penalties against a broker who does not have a working knowledge of customs operation sufficient to render valuable service?* $5,000

5. *What information should be on a bill of lading?* Receipt of the goods, contract of carriage and commitment to deliver the goods at the designated port of destination to the holder of the bill of lading.
6. *Is the commercial invoice required at the time of shipment?* No. It is required at the time of entry.
7. *How does the duty drawback claim work?* Importers can get a refund of duty paid on imports when they are exported or destroyed. Proof of duty payment, export (bill of sale or air waybill), or destruction (witnessed by customs officer) is required. A drawback claim must be made within three years after the date of exportation. A postimportation NAFTA duty refund claim may be filed within one year after the date of importation of the goods.
8. *Are there laws governing labeling requirements for certain products?* Yes. Most textile, wool, and fur products, for example, must have a label or tag disclosing the fiber or fur content, importer, distributor, seller, country of origin, and so forth.
9. *Does an importer who sells merchandise to another company that exports it qualify for a duty drawback?* No.
10. *Does the firm qualify for a rejected merchandise drawback claim under the following conditions:*

    a. *A Miami firm imports 200 pounds of shrimp for its national network of seafood restaurants. When it opens the boxes, it finds that it received 200 pounds of pork.* Yes.
    b. *An importer of oranges finds thirty crates of unordered vegetables.* Yes.
    c. *A company in New York imports twenty cases of Argentine wine. There is a strike at the port, and the wine is not unloaded for a few days. When the importer picks up the wines, they are frozen.* No.

Appendix C
Trade Profiles of Selected Countries

TABLE C.1 Trade Profiles of Selected Nations (2010) ($ Millions U.S.)

	Merchandise Trade		Services Trade		Trade (% of GDP)	
	Exports	**Imports**	**Exports**	**Imports**	**Exports**	**Imports**
Developed Countries						
Australia	212,554	201,640	48,490	51,470	23	22
Austria	152,313	158,752	54,161	36,926	54	52
Belgium	412,223	390,443	85,339	78,377	106	100
Canada	388,019	402,280	67,432	89,963	29	31
Denmark	97,681	84,848	60,405	51,894	51	44
Finland	69,630	68,510	27,729	27,650	41	40
France	520,881	605,706	143,896	131,391	26	29
Germany	1,268,874	1,066,839	233,338	262,245	46	41
Greece	21,409	63,173	37,338	19,892	20	28
Ireland	116,801	60,032	97,833	107,270	104	81
Italy	447,535	483,814	97,368	108,616	26	29
Japan	769,839	694,052	138,875	155,800	17	16
Netherlands	573,360	516,927	83,361	84,384	84	77
New Zealand	81,396	30,617	8,908	9,227	71	31
Norway	131,395	77,252	39,506	42,358	41	29
Spain	245,637	314,320	122,773	86,752	26	28
Sweden	158,314	148,710	64,835	47,316	49	43

(*Continued*)

TABLE C.1 (Continued)

	Merchandise Trade		Services Trade		Trade (% of GDP)	
	Exports	Imports	Exports	Imports	Exports	Imports
Switzerland	195,392	175,933	81,649	39,435	52	41
United Kingdom	405,666	560,097	253,287	162,086	29	32
United States	1,278,263	1,969,184	522,510	367,016	12	16
High-Income Countries						
Chile	71,028	58,958	10,685	11,568	38	33
Korea	466,384	425,212	81,556	92,936	54	51
Kuwait	67,024	22,446	7,137	12,260	68	32
Malaysia	198,801	164,733	32,760	32,216	97	83
Mauritius	2,239	4,402	2,656	1,956	50	66
Saudi Arabia	249,700	97,077	10,346	50,996	60	34
Singapore	351,867	310,791	112,061	96,255	222	195
Trinidad and Tobago	10,590	6,575	758	335	55	34
Middle-Income Countries						
Argentina	430	56,503	12,931	13,769	4	19
Botswana	4,693	5,657	385	867	34	44
Brazil	201,915	191,491	30,294	59,746	11	12
China	1,978,846	1,837,134	276,681	243,043	37	34
Colombia	39,820	40,683	4,357	7,893	15	17
Costa Rica	9,385	13,570	4,149	1,769	38	43
Egypt	26,438	52,923	23,618	12,991	23	30
Indonesia	157,818	131,737	16,211	25,601	25	22
Jamaica	1,337	5,195	2,600	1,767	28	49
Mexico	298,305	310,618	14,935	21,818	30	32
Peru	35,565	30,126	3,816	2,165	25	21
Philippines	51,496	58,229	14,358	11,188	33	35
Thailand	195,319	182,400	34,058	44,592	72	71
Turkey	113,981	185,542	34,247	18,343	20	28
Uruguay	6,733	8,622	2,458	1,365	24	26
Venezuela	65,786	40,800	1,626	10,548	17	13
Low-Income Countries						
Bangladesh	19,191	27,819	1,209	4,128	20	32
Ethiopia	2,238	8,582	1,991	2,534	14	37
Ghana	7,896	10,703	1,344	2,444	30	42
India	219,959	327,230	123,277	116,140	20	26

Kenya	5,151	12,090	2,920	1,816	26	44
Nigeria	82,000	44,235	2,613	3,144	44	24
Pakistan	21,420	39,044	2,949	6,481	14	26
Tanzania	3,687	7,830	2,047	1,840	25	42
Uganda	1,612	4,550	984	1,809	15	37
Vietnam	72,192	84,801	7,460	9,921	75	89
Zambia	7,200	5,321	312	901	46	38
Zimbabwe	2,500	3,800	0	0	33	51

Source: Adapted from the World Bank (2012). *World Development Indicators.* Washington, DC: The International Bank for Reconstruction and Development/The World Bank. Available at: http://data.worldbank.org/sites/default/files/wdi-2012-ebook.pdf

Appendix D
Average Tariff Rates of Selected Countries

TABLE D.1 Average Tariff Rates of Selected Countries (2009–2010)

Country	Year	Primary Products (%)	Manufacturer Products (%)
Algeria	2009	7.8	8.9
Argentina	2010	1.6	7.0
Australia	2010	0.4	2.5
Brazil	2010	1.5	9.8
Cameroon	2009	12.9	15.9
Canada	2010	0.3	1.1
Chile	2010	2.7	4.8
China	2010	1.8	5.6
Colombia	2010	8.8	8.9
Egypt	2009	6.4	9.5
European Union	2010	0.5	2.3
Ghana	2009	8.9	8.4
India	2009	7.5	8.3
Indonesia	2010	1.8	2.9
Israel	2009	3.3	3.7
Korea (South)	2010	12.7	5.1
Malaysia	2009	5.0	3.7
Mexico	2010	1.5	2.4
New Zealand	2010	0.4	2.1
Nigeria	2010	9.1	10.8
Norway	2010	1.2	0.2

Peru	2010	1.3	3.0
Philippines	2010	5.1	4.7
Saudi Arabia	2009	2.8	4.2
Singapore	2010	0.0	0.0
Thailand	2009	2.9	6.1
Uganda	2010	8.8	7.9
United States	2010	1.2	2.0
Zambia	2009	3.1	4.2

Source: Adapted from the World Bank (2012). *World Development Indicators.* Washington, DC: The International Bank for Reconstruction and Development/The World Bank. Retrieved from http://data.worldbank.org/sites/default/files/wdi-2012-ebook.pdf

Appendix E
Doing Business with China

In order to maintain long-term sustainable development, China is actively trying to shift away from an export-led economy toward a growth model driven by domestic demand and consumption. Currently, private consumption in China accounts for only 35 percent of the country's overall GDP, the lowest among major Asian economies. To help remedy this and increase domestic spending, the country aims to double the 2010 per capita incomes of its urban and rural residents by 2020. This goal, if realized, will release $10 trillion (U.S.) of purchasing capacity into the China market. This will create immense opportunities for foreign investors and exporters looking to sell to the Chinese market.

Any entity or individual wishing to be involved in the import and export of goods in China must first register with the Ministry of Commerce (MOFCOM).

Importing Goods into China

I. Importing into China

Imports to China are classified into three categories:

- Permitted
- Restricted
- Prohibited

A. Permitted Goods

This category covers most imported goods. MOFCOM has implemented an automatic licensing system to monitor the importation of such goods. Every year, the government issues a catalog of goods subject to automatic licensing. Importers must apply for an automatic license, and the goods import contract is one of the required application documents.

Each automatic import license is valid for six calendar months, and each license should be used for only one batch of goods. However, multiple licenses can be obtained under one import contract, and one license can be used for as many as six batches of certain goods.

B. Restricted Goods

Restricted goods are monitored through quotas or licenses. Goods may be restricted for reasons ranging from protecting national security to public welfare considerations.

B.1 Goods requiring licenses: The government issues a catalog of import goods requiring licenses on an annual basis. Imported goods requiring licenses fall into two categories: used mechanical and electronic products and substances that deplete the ozone layer. Such licenses are valid for one year.

B.2 Goods subject to tariff rate quota: Imports such as wheat, corn, rice, sugar, cotton, and wool and wool tops are subject to tariff rate quota (TRQ). Under TRQ administration, goods imported within the quota are subject to a lower tariff rate. Companies seeking to import at the lower TRQ tariff rate must apply to MOFCOM for quota allocation between October 15 and October 30 each year.

C. Prohibited Goods

Goods such as certain wastes and toxins are banned from import into China. The government publishes a catalog of goods that are prohibited from importation into China.

II. Import Inspection and Certification

China has complex inspection and certification requirements. Certain goods need to be inspected upon arrival or else must be accompanied by formal certification recognized by the Chinese government.

The GAQSIQ is the administrative department in charge of quality supervision, inspection, animal and plant quarantine, and food safety for all goods transported across the Chinese border.

The China Compulsory Certificate (CCC) is a certificate or mark required by the Chinese government. The government releases the product catalog subject to CCC requirement. Goods are not allowed to be imported, sold, or used at any business or service sites in China without the CCC mark if they are listed in the CCC catalog.

III. Import Taxes and Duties

Importing to and exporting from China generally involve three types of taxes: (1) value-added tax; (2) consumption tax; and (3) customs duties.

- *Value-added tax:* Imports are subject to the value-added tax (VAT), and the applicable tax rates are the same as those applied to goods sold within the domestic market. VAT is payable on the day of customs clearance. It is 17 percent for most goods, although some goods may be subject to a 13 percent VAT. The input VAT imposed on importing

goods can be used to deduct the output VAT paid when the imported goods are sold in the domestic market.

- *Consumption tax:* Items subject to the consumption tax (CT) include luxury goods such as high-end watches, nonrenewable petroleum products such as diesel oil, and high-energy consumption products such as passenger cars and motorcycles. It is collected on either an ad valorem basis or a quantity basis, with tax rates and amounts varying greatly. CT should be paid within fifteen days from the day that customs issues the bill of payment.
- *Import duties:* Import duties consist of the following:

  (a) *Most-favored-nation duty rate (MFN):* Applies to goods imported from WTO member nations, countries with which China agreed to extend such treatment (under a bilateral arrangement), or goods that originated from China.
  (b) *Conventional duty rate:* Applies to imports that originate from countries that have entered into regional trade agreements containing preferential duty rates. This includes imports from countries that are members of ASEAN or countries that have free-trade deals such as Pakistan, Singapore, Chile, and Peru.
  (c) *Special preferential duty rate:* Applies to less-developed countries to which China extends preferential duty rates. Such duties are lower than MFN and conventional duty rates.
  (d) *General duty rate:* Applies to countries that are neither members of the WTO nor signatories to a trade agreement with China. It also applies to products of unknown origin.
  (e) *Tariff quota rate:* Applies to products subject to tariff quotas. For example, wheat imported within the quota faces a tariff of 1 percent. while the MFN and conventional rates are 65 and 80 percent, respectively.
  (f) *Temporary duty rate:* To increase imports and increase domestic consumption, the government issues temporary duty rates that are lower than the MFN rate. In 2013, it implemented such duty rates for more than 780 commodities such as pacemakers, infant milk powder, and alfalfa.

IV. Place of Origin of Imports

Where the goods are produced in two or more countries or territories, the country or territory where the goods undergo a final substantial change and completion is the place of origin of the goods. The basic standard for determining "substantial change" is a change in tariff classification.

V. Duty Relief

Duty relief includes statutory duty relief, policy-based duty relief (or special tariff relief), and temporary duty relief. Items exempt from duties under statutory duty relief are (1) single consignments of goods if the value is below RMB50, or (2) advertising materials and trade samples of no commercial value.

Some goods are exempt from duties if they are re-exported or re-imported within six months after the import or export. This includes (1) goods to be exhibited or used at exhibitions, trade fairs, conferences, and other similar events; (2) instruments, equipment, and items to be used for scientific research and for educational and medical activities; (3) other goods to be used for noncommercial purposes.

Goods eligible for policy-based duty relief include (1) scientific educational supplies; (2) special products for the disabled; (3) poverty-alleviation supplies and charitable donations; (4) processing trade products; and (5) goods traded in free-trade zones and export-processing zones.

Under special circumstances, the State Council may provide temporary duty relief for certain categories or batches of goods.

VI. Calculating Import Taxes and Duties Payable

Import taxes and customs duties payable are calculated on the basis of the price or value of the imported goods. This value is called the duty paying value (DPV). DPV is determined on the basis of the transacted price of the goods.

DPV includes transportation-related expenses and insurance premiums on the goods prior to unloading at the place of arrival in China. Import duties and taxes collected by customs are excluded from DPV.

Import taxes and duties can be calculated after determining the DPV and the tax and tariff rates of the goods. The formulae are:

(a) *Value-added tax*

VAT payable = Composite assessable price × VAT rate
Composite assessable price can be calculated as follows:

- Composite assessable price = DPV + Import duty + CT; or
- Composite assessable price = (DPV + Import duty)/ (1 − CT rate)

(b) *Consumption tax*

Ad valorem basis:

- **CT Payable = Composite assessable price × CT rate**
- Composite assessable price = (DPV + Import duty)/ (1 − CT rate)

Quantity-based:

- **CT Payable = Quantity of taxable goods × Tax amount per unit**

Compound formula:

- **CT payable = Composite assessable price × CT rate + Quantity of taxable goods × Tax amount per unit**
- Composite assessable price = (DPV + Import duty + Quantity of taxable goods × Tax amount per unit) / (1 − CT rate)

TABLE E.1 China's Merchandise Trade with Selected Countries ($ thousands U.S.)

	2010		2011		2012	
Country	**China's Export**	**China's Import**	**China's Export**	**China's Import**	**China's Export**	**China's Import**
Brazil	24,460,652	38,099,447	31,836,677	52,386,750	33,291,955	52,067,130
Canada	22,216,134	14,921,961	25,266,590	22,167,123	28,057,385	22,768,135
France	27,858,709	17,116,565	30,245,913	22,078,793	27,096,843	24,234,467
Germany	68,047,133	74,251,272	76,399,999	92,726,220	68,953,652	92,026,190
India	40,913,958	20,846,313	50,536,416	23,372,279	47,671,119	18,817,457
Japan	121,043,965	176,736,084	148,268,708	194,567,856	151,175,807	177,700,978
Mexico	17,872,653	6,875,188	23,975,906	9,377,587	27,472,214	9,171,453
Russia	29,612,074	25,913,994	38,903,018	40,362,600	43,995,679	43,993,375
South Africa	10,799,862	14,896,422	13,362,300	32,095,190	15,272,669	15,675,229
South Korea	68,766,311	138,339,223	82,920,308	162,716,843	87,534,145	166,573,569
United Kingdom	38,767,054	11,305,193	44,122,055	14,556,661	46,170,943	16,804,264
United States	283,780,323	102,734,185	325,010,988	123,124,010	351,791,801	128,613,682

Source: Comtrade, International Trade Statistics (www.trademap.org)

(c) *Import duty*

Ad valorem basis:

- **Duty payable = DPV × Tariff rate**

Quantity-based:

- **Duty payable = Quantity of imported goods × Amount of duty per unit**

Compound formula:

- **Duty payable = DPV × Tariff rate + Quantity of imported goods × Amount of duty per unit**

Import taxes and duty payable should be calculated in RMB. The benchmark exchange rate published by the People's Bank of China is applied in such case.

Exporting Goods from China

For goods subject to export restrictions, an export licensing administration system is imposed in China. There are three types of export licensing in China: (1) export quota license (e.g., wheat, corn, cotton, crude oil); (2) export quota tender (e.g., magnesia); and (3) export license (e.g., beef, pork, chicken).

The government publishes a catalog of export goods requiring licenses on an annual basis. Each export license can be used for only one batch of goods. However, the license can be used for up to twelve batches under certain circumstances, including for goods of foreign invested enterprises (FIEs) that are subject to export license administration. An export license is valid for six months and must be used within the same year as the issuance date.

Export Duties

Export duties are imposed on only a few resource products and semimanufactured goods. In 2013, China continued to levy temporary tariffs on exports including coal, crude oil, chemical fertilizers, and iron alloy to conserve resources.

The tax base for export duties are the same as import duties—the DPV. The DPV for export duties is based on transacted price (i.e., the lump sum price receivable by the domestic seller exporting the goods to the buyer). Export duties, freight-related expenses and insurance fees after loading at the export spot, and commissions borne by the seller are excluded.

TABLE E.2 China Trade Indicators: Top Ten Exports (2012) ($ thousands U.S.)

Product Categories	Exported Value	Trade Balance	Share in World Exports (%)
Electrical, electronic equipment	487,462,307	105,864,888	22.4
Machinery, nuclear reactors, boilers, etc.	376,002,094	194,089,642	18.2
Articles of apparel, accessories, knit or crochet	87,059,741	85,715,062	41.1

(*Continued*)

TABLE E.2 (Continued)

Product Categories	Exported Value	Trade Balance	Share in World Exports (%)
Furniture, lighting, signs, prefabricated buildings	77,904,042	75,021,052	37.2
Optical, photo, technical, medical, etc. apparatus	72,816,793	–33,553,001	13.2
Articles of apparel, accessories, not knit or crochet	61,237,963	58,572,738	31.4
Articles of iron or steel	56,202,059	46,154,333	18.7
Plastics and articles thereof	55,218,364	–14,268,072	10
Vehicles other than railway, tramway	55,174,251	–15,438,482	4.3
Footwear, gaiters and the like, parts thereof	46,817,564	45,031,509	39.5

Source: Comtrade, International Trade Statistics (www.trademap.org)

TABLE E.3 China Trade Indicators: Top Ten Imports (2012) ($ thousands U.S.)

Product Categories	Imported Value	Trade Balance	Share in World Imports (%)
Electrical, electronic equipment	381,597,419	105,864,888	16.2
Mineral fuels, oils, distillation products, etc.	311,857,463	–280,808,402	9.2
Machinery, nuclear reactors, boilers, etc.	181,912,452	194,089,642	8.6
Ores, slag, and ash	133,685,768	–133,262,333	49.7
Optical, photo, technical, medical, etc. apparatus	106,369,794	–33,553,001	19.8
Vehicles other than railway, tramway	70,612,733	–15,438,482	5.7
Plastics and articles thereof	69,486,436	–14,268,072	12.4
Organic chemicals	60,921,639	–20,494,507	13.1
Copper and articles thereof	54,607,290	–47,414,047	31.2
Oil seed, oleagic fruits, grain, seed, fruit, etc. (NES)	38,550,840	–35,923,110	39.7

NES = not elsewhere specified
Source: Comtrade, International Trade Statistics (www.trademap.org)

TABLE E.4 China Top Ten Trading Partners (2012) ($ thousands U.S.)

China's Export Destination	Export Value ($ Thousands U.S.)	Share in China's Exports (%)	China's Source of Imports	Import Value ($ Thousands U.S.)	Share in China's Imports (%)
United States	351,791,801	17.2	Japan	*177,700,978*	*10.2*
Japan	151,175,807	7.4	South Korea	*166,573,569*	*9.5*
South Korea	87,534,145	4.3	Taiwan	*132,183,692*	*7.6*
Germany	68,953,652	3.4	United States	*128,613,682*	*7.4*
Netherlands	58,829,087	2.9	Germany	*92,026,190*	*5.3*
India	47,671,119	2.3	Australia	*78,669,668*	*4.5*
United Kingdom	46,170,943	2.3	Malaysia	*58,262,012*	*3.3*
Russia	43,995,679	2.2	Saudi Arabia	*54,902,945*	*3.1*
Singapore	40,302,689	2.0	Brazil	*52,067,130*	*3.0*
Australia	37,694,580	1.8	Russia	*43,993,375*	*2.5*

Source: Comtrade. International Trade Statistics (www.trademap.org)

Appendix F
U.S. Trade Profile

TABLE F.1 U.S. International Trade in Goods and Services, 2005–2010

	2005	2006	2007	2008	2009	2010
TRADE BALANCE						
Total	–708,624	–753,288	–696,728	–698,338	–381,272	–500,027
Goods	–780,730	–835,689	–818,886	–830,109	–505,910	–645,857
Services	72,106	82,401	122,158	131,770	124,637	145,830
Travel	12,230	13,228	20,228	29,929	20,073	27,998
Passenger fares	–4,580	–5,008	–2,494	–884	966	3,652
Other transportation	–22,199	–19,496	–15,135	–12,680	–7,058	–11,266
Royalties and license fees	48,871	58,511	71,324	72,502	67,334	72,133
Other private services	55,945		61,793	59,476	–13,863	–163,115
Other[1]	–15,594	–11,743	–10,826	–13,600	–3,346	–29,270
U.S. Government miscellaneous services	–2,567	–2,581	–2,731	–2,972	–3,346	–3,500
EXPORTS						
Exports, total	1,287,441	1,459,823	1,654,561	1,842,682	1,575,037	1,837,577
Goods	911,686	1,039,406	1,163,957	1,307,499	1069,491	1,288,699
Services	375,755	420,417	490,604	535,183	505,547	548,878
Travel		86,187	97,355	110,423	94,191	103,505

Passenger fares	20,609	21,638	25,187	30,957	26,103	30,931
Other transportation	32,013	35,824	40,638	44,016	35,533	39,936
Royalties and license fees	74,448	83,549	97,803	102,125	97,183	105,583
Other private services	153,665	176,798	211,641	232,019	234,858	250,320
Other[1]	12,082	15,587	17,091	14,711	16,611	17,483
U.S. Government miscellaneous services	778	834	890	933	1,069	1,121
IMPORTS						
Imports, total	1,996,065	2,213,111	2,351,289	2,541,020	1,956,310	2,337,604
Goods	1,692,416	1,875,095	1,982,843	2,137,608	1,575,400	1,934,555
Services	303,649	338,016	368,446	403,413	380,909	403,048
Travel	69,930	72,959	77,127	80,494	74,118	75,507
Passenger fares	25,189	26,646	27,681	31,841	25,137	27,279
Other transportation	54,212	55,320	55,773	56,696	42,591	51,202
Royalties and license fees	25,577	25,038	26,479	29,623	29,849	33,450
Other private services	97,720	127,308	149,848	172,543	174,325	180,598
Other[1]	27,676	27,330	27,917	28,311	30,474	30,391
U.S. Government miscellaneous services	3,345	3,415	3,621	3,905	4,415	4,621

[1]Represents transfers under U.S. military sales contracts for exports and direct defense expenditures for imports

Source: U.S. Census Bureau 2011.

TABLE F.2 U.S. Exports, Imports with Selected Countries, 2008–2010 ($ millions of dollars)

Country	U.S. Exports			U.S. General Imports		
	2008	**2009**	**2010**	**2008**	**2009**	**2010**
Unit indicator						
Total	1,287,442	1,056,043	1,278,263	2,103,641	1,559,625	1,913,160
Argentina	7,536	5,569	7,395	5,822	3,890	3,803
Australia	22,219	19,599	21,798	10,589	8,012	8,583
Austria	2,649	2,537	2,428	8,457	6,379	6,835
Belgium	28,903	21,608	25,456	17,308	13,826	15,552

(*Continued*)

TABLE F.2 (Continued)

Country	U.S. Exports			U.S. General Imports		
	2008	2009	2010	2008	2009	2010
Brazil	32,299	26,095	35,425	30,453	20,070	23,958
Canada	261,150	204,658	249,105	339,491	226,248	277,647
Chile	11,857	9,346	10,905	8,196	5,949	7,009
China	69,733	69,497	91,881	337,773	296,374	364,944
Colombia	11,437	9,451	12,069	13,093	11,323	15,659
Costa Rica	5,680	4,700	5,180	3,938	5,612	8,697
Côte d'Ivoire	254	206	163	1,092	745	1,177
Czech Rep.	1,378	970	1,411	2,569	1,933	2,450
Denmark	2,711	2,056	2,133	6,446	5,511	6,011
Ecuador	3,450	3,938	5,410	9,048	5,273	7,451
Egypt	6,002	5,253	6,835	2,370	2,058	2,238
El Salvador	2,462	2,019	2,433	2,228	1,822	2,206
Ethiopia	302	267	773	152	113	128
Germany	54,505	43,306	48,161	97,497	71,498	82,429
Finland	3,761	1,662	2,181	5,903	3,985	3,884
France	28,840	26,493	26,969	44,049	34,236	38,355
Georgia	586	364	301	208	70	198
Ghana	608	716	989	222	135	273
Greece	1,932	2,487	1,108	999	841	798
Honduras	4,846	3,368	4,606	4,041	3,319	3,932
Hong Kong	21,499	21,051	26,570	6,483	3,571	4,296
Hungary	1,431	1,233	1,290	3,103	2,223	2,489
Iceland	470	350	325	241	179	201
India	17,682	16,441	19,250	25,704	21,166	29,533
Indonesia	5,644	5,107	6,946	15,799	12,939	16,478
Iran	683	280	208	104	65	95
Iraq	2,070	1,772	1,642	22,080	9,263	12,143
Ireland	7,611	7,465	7,276	31,346	28,101	33,848
Israel	14,487	9,559	11,294	22,336	18,744	20,982
Italy	15,461	12,268	14,219	36,135	26,430	28,505
Japan	65,142	51,134	60,486	139,262	95,804	120,545
Jordan	940	1,192	1,174	1,137	924	974
Kenya	442	654	375	344	281	311
Korea, South	34,669	28,612	38,846	48,069	39,216	48,875
Kuwait	2,719	1,951	2,774	7,093	3,783	5,382
Morocco	1,436	1,630	1,947	879	468	685

Netherlands	39,719	32,242	34,939	21,123	16,098	19,055
New Zealand	2,534	2,159	2,819	3,171	2,558	2,762
Nicaragua	1,094	715	981	1,704	1,612	2,007
Nigeria	4,102	3,687	4,068	38,068	19,128	30,516
Norway	3,292	2,790	3,099	7,315	5,688	6,950
Panama	4,887	4,293	6,063	379	302	381
Paraguay	1,610	1,355	1,810	78	56	62
Peru	6,183	4,919	6,754	5,812	4,223	5,057
Philippines	8,295	5,766	7,376	8,713	6,794	7,982
Poland	4,131	2,302	2,982	2,587	2,038	2,964
Portugal	2,646	1,085	1,058	2,451	1,577	2,141
Qatar	2,716	2,713	3,160	484	506	466
Russia	9,335	5,332	6,006	26,783	18,200	25,691
Saudi Arabia	12,484	10,792	11,556	54,747	22,053	31,413
Senegal	137	176	218	18	7	5
Singapore	27,854	22,232	29,017	15,885	15,705	17,427
Slovakia	548	210	256	1,301	628	1,073
Slovenia	310	244	328	467	388	465
South Africa	6,490	4,453	5,631	9,948	5,879	8,220
Spain	12,190	8,717	10,178	11,094	7,857	8,553
Sri Lanka	283	230	179	1,962	1,593	1,748
Sweden	5,018	4,561	4,706	12,498	8,186	10,495
Switzerland	22,024	17,504	20,687	17,782	16,053	19,136
Taiwan	24,926	18,486	26,043	36,326	28,362	35,846
Tanzania	169	158	164	56	49	43
Thailand	9,067	6,918	8,977	23,538	19,082	22,693
Trinidad & Tobago	2,250	1,988	1,926	9,030	5,180	6,613
Tunisia	502	501	571	644	326	405
Turkey	9,959	7,095	10,546	4,642	3,662	4,207
Uganda	89	119	94	53	31	58
Ukraine	1,868	887	1,359	2,340	495	1,078
United Arab Republic	14,417	12,211	11,673	1,286	1,498	1,145
United Kingdom	53,599	45,704	48,414	58,587	47,480	49,775
Uruguay	893	745	975	244	239	235
Venezuela	12,610	9,315	10,649	51,424	28,059	32,707
Vietnam	2,789	3,097	3,709	12,901	12,288	14,868
Zambia	79	57	56	51	9	30
Zimbabwe	93	85	68	112	22	59

Source: U.S. Census Bureau (2011).

TABLE F.3 U.S. Exports and General Imports by Selected SITC Commodity Groups, 2008–2010 ($ millions)

Selected Commodity	2008	2009	2010	2008	2009	2010	2008	2009	2010
Unit indicator	U.S. Exports			U.S. General Imports			U.S. Trade Balance		
Total	1,287,442	1,056,043	1,278,263	2,103,641	1,559,625	1,913,160	–816,199	–503,582	–634,897
			115,786						
Agricultural commodities \3	115,248	98,423	115,786	80,662	71,849	82,015	34,586	26,574	33,771
			115,786				0	0	115,786
Animal feeds	7,610	7,763	8,996	1,258	1,162	1,349	6,352	6,601	7,647
Cereal flour	2,870	2,957	3,037	4,268	4,161	4,519	–1,398	–1,204	–1,482
Coffee		9,146	6		283	4,055	0	8,863	–4,049
Corn	13,931	9,146	10,181	350	283	300	13,581	8,863	9,881
Cotton, raw and linters	4,812	3,365	5,896	12	1	8	4,800	3,364	5,888
Hides and skins		11,618	2,039		4,598	56	0	7,020	1,983
Live animals		16,443	797		210	2,355	0	16,233	–1,558
Meat and preparations	12,584	11,618	13,216	5,046	4,598	5,071	7,538	7,020	8,145
Oils/fats, vegetable		16,443	2,650		210	3,940	0	16,233	–1,290
Rice		14,014	2,328		18,571	574	0	–4,557	1,754
Soybeans	15,455	16,443	18,589	182	210	220	15,273	16,233	18,369
Sugar		743,321	65			1,236	0	743,321	–1,171
Tobacco, unmanufactured			1,167			701	0	0	466

Vegetables and fruit	14,040	14,014	15,712	19,145	18,571	20,915	–5,105	–4,557	–5,203
Wheat	11,294	5,380	6,769	1,080	698	563	10,214	4,682	6,206
Other agricultural		743,321	24,318			36,153	0	743,321	–11,835
Manufactured goods \3	912,382	743,321	873,246	1,490,383	1,185,889	1,438,617	–578,001	–442,568	–565,371
Automatic data processing Equipment	28,639	21,282	22,238	96,526	91,098	113,476	–67,887	–69,816	–91,238
Airplane parts	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Airplanes	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Alcoholic beverage, distilled	1,049	1,007	1,126	5,478	5,011	5,608	–4,429	–4,004	–4,482
Aluminum	6,204	4,291	5,171	13,429	8,679	10,815	–7,225	–4,388	–5,644
Artwork/antiques	5,409	4,605	3,034	7,513	5,031	6,268	–2,104	–426	–3,234
Basketware, etc.	7,692	8,068	8,360	12,196	11,530	13,316	–4,504	–3,462	–4,956
Chemicals (cosmetics)	11,534	11,120	12,488	9,577	8,396	9,564	1,957	2,724	2,924
Chemicals (dyeing)	6,238	5,546	7,407	3,073	2,424	3,105	3,165	3,122	4,302
Chemicals (fertilizers)	6,540	3,475	3,731	8,377	4,156	6,647	–1,837	–681	–2,916
Chemicals (inorganic)	12,846	10,203	11,806	16,826	10,790	13,833	–3,980	–587	–2,027
Chemicals (medicinal)	37,379	41,809	41,960	59,212	60,002	65,170	–21,833	–18,193	–23,210
Chemicals (NES)	25,287	20,428	24,136	12,713	9,582	11,379	12,574	10,846	12,757
Chemicals (organic)	34,256	27,779	37,494	47,802	42,183	45,792	–13,546	–14,404	–8,298

(*Continued*)

TABLE F.3 (Continued)

Selected Commodity	2008	2009	2010	2008	2009	2010	2008	2009	2010
Unit indicator	U.S. Exports			U.S. General Imports			U.S. Trade Balance		
Chemicals (plastics)	40,281	33,078	42,019	18,912	13,694	17,825	21,369	19,384	24,194
Cigarettes		2,919	371		69,326	182	0	–66,407	189
Clothing	3,169	2,919	3,197	78,893	69,326	78,518	–75,724	–66,407	–75,321
Copper	3,439	2,375	3,496	10,358	5,596	7,821	–6,919	–3,221	–4,325
Cork, wood, lumber	4,241	3,495	4,732	5,704	3,574	4,479	–1,463	–79	253
Crude fertilizers	2,428	1,765	2,367	2,966	1,682	2,257	–538	83	110
Electrical machinery	82,049	63,964	77,019	112,623	91,683	119,634	–30,574	–27,719	–42,615
Fish and preparations	4,017	3,763	4,223	13,994	12,982	14,576	–9,977	–9,219	–10,353
Footwear	673	620	728	19,545	17,523	20,902	–18,872	–16,903	–20,174
Furniture and parts	5,170	4,023	4,821	31,371	24,588	31,124	–26,201	–20,565	–26,303
Gem diamonds	5,943	2,156	2,862	19,744	12,736	18,599	–13,801	–10,580	–15,737
General industrial machinery	55,192	45,034	51,793	66,910	50,181	60,426	–11,718	–5,147	–8,633
Glassware		864	1,015		2,117	2,588	0	–1,253	–1,573
Glass	3,317	2,828	3,380	2,653	2,117	2,588	664	711	792
Gold, nonmonetary	18,714	13,898	17,458	6,120	8,810	12,491	12,594	5,088	4,967
Iron and steel mill products	18,493	12,022	15,720	38,910	18,230	24,440	–20,417	–6,208	–8,720

Jewelry	4,834	4,322	4,848	9,615	8,676	10,085	–4,781	–4,354	–5,237
Lighting, plumbing	2,516	2,141	2,509	7,767	6,120	7,397	–5,251	–3,979	–4,888
Metal manufactures (NES)	18,743	14,669	17,491	30,403	21,414	25,913	–11,660	–6,745	–8,422
Metal ores; scrap	29,431	20,058	28,366	9,309	5,460	7,293	20,122	14,598	21,073
Metalworking machinery	6,074	4,294	5,330	8,548	4,961	5,565	–2,474	–667	–235
Nickel	1,567	931	1,130	3,430	1,665	2,976	–1,863	–734	–1,846
Optical goods	2,860	2,773	3,278	5,090	4,513	5,507	–2,230	–1,740	–2,229
Paper and paperboard	14,668	12,891	14,920	18,073	14,463	15,285	–3,405	–1,572	–365
Photographic equipment	3,595	3,211	3,345	2,489	1,776	2,048	1,106	1,435	1,297
Plastic articles (NES)	9,511	8,224	9,710	15,793	13,743	16,042	–6,282	–5,519	–6,332
Platinum	1,161	844	1,370	7,115	2,982	4,146	–5,954	–2,138	–2,776
Pottery		28,056	98		36,181	1,501	0	–8,125	–1,403
Power generating machinery	33,658	28,056	33,013	48,187	36,181	42,465	–14,529	–8,125	–9,452
Printed materials	6,355	5,601	5,879	5,372	4,231	4,585	983	1,370	1,294
Pulp and waste paper	7,744	6,694	8,640	4,004	2,441	3,887	3,740	4,253	4,753
Records/ magnetic media	5,250	4,413	4,424	6,735	5,183	5,296	–1,485	–770	–872
Rubber articles (NES)	1,915	1,625	2,049	3,169	2,481	3,310	–1,254	–856	–1,261

(*Continued*)

TABLE F.3 (Continued)

Selected Commodity	2008	2009	2010	2008	2009	2010	2008	2009	2010
Unit indicator	**U.S. Exports**			**U.S. General Imports**			**U.S. Trade Balance**		
Rubber tires and tubes	3,981	3,641	4,159	9,705	8,136	10,673	–5,724	–4,495	–6,514
Scientific instruments	42,588	38,105	44,276	37,275	31,975	37,795	5,313	6,130	6,481
Ships, boats	3,114	1,917	2,498	1,675	1,267	1,588	1,439	650	910
Silver and bullion		36,956	1,672		24,235	4,383	0	12,721	–2,711
Spacecraft		19,992	(–)		119,392	(–)	0	–99,400	0
Specialized industrial machinery	51,928	36,956	46,754	35,574	24,235	30,912	16,354	12,721	15,842
Televisions, VCRs, etc.	24,379	19,992	21,511	133,187	119,392	137,305	–108,808	–99,400	–115,794
Textile yarn, fabric	11,860	9,288	11,384	21,854	18,232	22,120	–9,994	–8,944	–10,736
Toys/games/ sporting goods	4,697	4,170	4,245	32,617	27,918	30,630	–27,920	–23,748	–26,385
Travel goods	463	449	463	7,986	6,444	8,012	–7,523	–5,995	–7,549
Vehicles	98,871	65,288	88,119	190,799	127,863	178,946	–91,928	–62,575	–90,827
Watches/clocks/ parts	416	356	379	4,340	3,065	3,747	–3,924	–2,709	–3,368
Wood manufactures	2,270	1,725	2,053	8,446	6,230	6,920	–6,176	–4,505	–4,867
							0	0	0

Mineral fuel \3	76,075	54,536	80,460	491,885	271,739	354,968	–415,810	–217,203	–274,508
Coal	8,196	6,162	10,100	3,958	1,766	2,018	4,238	4,396	8,082
Crude oil	2,270	1,618	1,368	353,537	194,603	260,105	–351,267	–192,985	–258,737
Petroleum preparations	51,384	36,351	53,528	87,103	52,584	67,409	–35,719	–16,233	–13,881
Liquefied propane/butane	1,011	1,409	2,448	4,755	2,202	2,541	–3,744	–793	–93
Natural gas	4,879	3,271	4,921	34,423	16,056	17,402	–29,544	–12,785	–12,481
Mineral fuels, other mineral	7,030	5,131	7,434	4,452	2,444	3,410	2,578	2,687	4,024
Reexports	131,066	120,345	155,847	(X)	(X)	(X)	(X)	(X)	(X)

NES = not elsewhere specified; \1 F.a.s. basis; \2 Customs value basis; \3 Includes other commodities not shown separately; X = not applicable.

Source: U.S. Census Bureau, 2011.

TABLE F.4 U.S. Exports of Goods by State of Origin, 2010 ($ millions)

State and other areas	2010	
	Total	Rank
Unit indicator		
Total	**1,278,263**	(X)
United States	**1,207,883**	(X)
Alabama	15,502	25
Alaska	4,155	42
Arizona	15,636	24
Arkansas	5,219	37
California	143,192	2
Colorado	6,727	32
Connecticut	16,056	23
Delaware	4,966	39
District of Columbia	1,501	47
Florida	55,365	4
Georgia	28,950	12
Hawaii	684	51
Idaho	5,157	38
Illinois	50,058	6
Indiana	28,745	13
Iowa	10,880	28
Kansas	9,905	30
Kentucky	19,343	19
Louisiana	41,356	9
Maine	3,164	43
Maryland	10,163	29
Massachusetts	26,304	14
Michigan	44,768	7
Minnesota	18,904	20
Mississippi	8,229	31
Missouri	12,926	27
Montana	1,389	48
Nebraska	5,820	35
Nevada	5,912	34
New Hampshire	4,367	40
New Jersey	32,154	11
New Mexico	1,541	46
New York	69,696	3
North Carolina	24,905	16
North Dakota	2,536	44

Ohio	41,494	8
Oklahoma	5,353	36
Oregon	17,671	21
Pennsylvania	34,928	10
Rhode Island	1,949	45
South Carolina	20,329	17
South Dakota	1,259	49
Tennessee	25,943	15
Texas	206,961	1
Utah	13,809	26
Vermont	4,277	41
Virginia	17,163	22
Washington	53,353	5
West Virginia	6,449	33
Wisconsin	19,790	18
Wyoming	983	50
Puerto Rico	22,784	(X)
Virgin Islands	1,899	(X)
Other[1]	45,698	(X)
Estimated shipments	(X)	(X)
Unreported	(X)	(X)
Timing adjustments	(X)	(X)
Foreign Trade Zone[2]	26,209	(X)

X = Not applicable.

[1]Includes unreported, not specified, special category, estimated shipments, re-exports;

[2]Foreign Trade Zone shipments are included in U.S. total and distributed among individual states.

Source: U.S. Census Bureau, U.S. International Trades in Goods and Services.

TABLE F.5 U.S. Agricultural Exports by State 2007–2009 ($ millions)

State	2007	2008	2009
Unit indicator			
United States	82,217	115,305	96,632
Alabama	626	994	867
Alaska	4	5	5
Arizona	496	746	626

(*Continued*)

TABLE F.5 (Continued)

State	2007	2008	2009
Unit indicator			
Arkansas	2,123	3,200	2,616
California	11,313	13,353	12,499
Colorado	1,018	1,235	1,113
Connecticut	257	377	339
Delaware	162	247	236
Florida	1,925	2,188	2,060
Georgia	1,438	2,057	1,841
Hawaii	88	100	102
Idaho	1,203	1,815	1,484
Illinois	4,723	7,560	5,538
Indiana	2,436	3,805	3,140
Iowa	5,259	7,870	6,486
Kansas	3,883	5,930	4,705
Kentucky	1,237	1,662	1,485
Louisiana	733	953	838
Maine	105	122	112
Maryland	362	487	439
Massachusetts	105	121	119
Michigan	1,372	1,924	1,552
Minnesota	3,619	5,469	4,284
Mississippi	1,176	1,707	1,275
Missouri	2,024	3,195	2,706
Montana	739	1,257	929
Nebraska	4,063	5,930	4,826
Nevada	45	60	72
New Hampshire	20	24	23
New Jersey	244	334	311
New Mexico	271	383	262
New York	836	1,163	928
North Carolina	2,068	3,107	2,879
North Dakota	2,545	3,949	3,186
Ohio	2,202	2,840	2,671
Oklahoma	890	1,632	982
Oregon	1,194	1,551	1,340
Pennsylvania	1,516	1,941	1,732
Rhode Island	13	15	16

South Carolina	390	663	550
South Dakota	1,864	3,054	2,327
Tennessee	785	1,365	1,202
Texas	5,210	6,042	4,747
Utah	334	462	374
Vermont	119	155	130
Virginia	548	825	718
Washington	2,665	3,174	2,968
West Virginia	49	70	67
Wisconsin	2,090	3,014	2,238
Wyoming	62	114	104
Unallocated	3,825	5,171	4,689

* Data are for year ending September 30.

Sources: U.S. Department of Agriculture, Economic Research Service, "State Export Data"; TechAmerica Foundation Trade in the Cyberstates 2010, annual (copyright). See also <http://www.techamericafoundation.org>.

TABLE F.6 U.S. High-Technology Exports by Industry and Major Country, 2007–2008 ($ billions)

Selected Industry	2007	2008	2009
Total exports	**214.3**	**218.8**	**187.7**
Computers and office equipment	47.1	47.0	38.3
Consumer electronics	8.8	8.6	7.6
Communications equipment	29.7	32.6	29.6
Electronic components	17.7	17.5	16.3
Semiconductors	50.0	50.2	43.6
Industrial electronics	38.5	38.7	28.3
Electromedical equipment	16.6	18.3	20.2
Photonics	5.9	5.9	3.9
Canada	29.4	29.1	37.3
China	14.5	15.0	28.1
Japan	11.9	10.9	28.0
Korea, South	8.9	7.5	14.0
Malaysia	7.4	8.3	9.0
Mexico	26.0	27.7	7.2
Taiwan	8.4	8.0	7.0
European Union	46.6	46.9	7.0

Sources: http://aeanet.org; TechAmerica Foundation Trade in the Cyberstates 2010, annual (copyright). See also <http://www.techamericafoundation.org>.

TABLE F.7 U.S. Exporting Companies by Employment-Size Class, 2008–2009 ($ millions)

Employment size-class	Number of Exporters		Export Value (mill)[1]	
	2008	2009	2008	2009
All companies, total	289,711	275,843	1,150,903	938,794
No. employees unknown	102,521	99,305	95,111	83,161
1–19 employees	112,327	107,482	81,889	68,360
20–49 employees	32,801	30,582	46,596	37,633
50–99 employees	16,975	15,603	35,212	32,572
100–249 employees	13,048	11,910	62,274	51,186
250–499 employees	4,931	4,387	40,885	35,111
500 or more employees	7,108	6,574	788,935	630,770

[1] Known value is defined as the value of exports by known exporters, (fas)basis.

Source: U.S. Census Bureau. For more information: http://www.census.gov/foreign-trade/www/

Appendix G
Export Credit Agencies in Selected Countries

Canada: Export Development Corporation

The *Export Development Corporation* (EDC) is Canada's official credit agency. It is a Crown corporation wholly owned by the government of Canada and provides financing and risk management services to Canadian exporters and investors in up to 200 markets worldwide. It has seventeen offices spread across the country and permanent representations in fourteen foreign markets.

As a Crown corporation, EDC operates at arm's length from the federal government and according to commercial principles. EDC's mandate is spelled out in the *Export Development Act.* The corporation is financially self-sustaining. Its treasury and risk-management strategies enable it to assist Canadian exporters without relying on tax dollars. EDC raises funds by charging fees for its services and interest on its loans, as well as by issuing debt in capital markets.

EDC is governed by a board of directors appointed by the government (primarily from the private sector) that is responsible for the supervision of the direction and management of the corporation. The board reports to Parliament through the minister for international trade.

EDC products and services include insurance, financing for Canadian companies and for their foreign customers, and bonding solutions, as well as information on opportunities in international markets.

In 2012, EDC facilitated $87.4 billion in exports and investment in eighty-seven markets. Approximately 80 percent of EDC's customers are small and medium-size businesses.

In response to the global credit crunch in 2009, the government of Canada broadened EDC's mandate and scope of activity for a two-year period to include support for domestic trade and business opportunities. During the first year of this expanded mandate, EDC provided $2.5 billion in domestic support for 208 Canadian companies.

Mission

The mission of the EDC is to support and develop, directly or indirectly, Canada's export trade and Canada's capacity to engage in that trade, and to respond to international business opportunities. In March 2009, EDC's mandate was extended through Canada's Economic Action Plan to enable it to engage in trade-related domestic activity for two years. In March 2011, these temporary powers were extended until March 2012.

Products

EDC's financial services include:

- Loans to foreign companies looking to buy goods and services from Canada
- Working capital loans to Canadian companies with export contracts
- Loans and insurance to help Canadian companies invest abroad
- Guarantees to banks, making it easier for them to lend to Canadian companies
- Insurance to protect Canadian companies against a variety of risks, including nonpayment
- Bonding services to help Canadian companies guarantee their performance
- Equity solutions

Domestic-Content Policy

There is no minimum domestic-content requirement. National Benefits policy first considers the gross domestic product and employment impacts of the transaction and then takes into account other factors, such as increased access to global markets (U.S. General Accounting Office, 2012).

Financing Methods

Export guarantee program: Provides guarantees to financial institutions to encourage them to extend financing to businesses.

Foreign buyer financing: This provides Canadian firms all the benefits of a cash sale because EDC disburses the funds directly to the firms and collects from the firms' customer.

Foreign investment financing: In collaboration with Canadian firms' financial institution, EDC can offer investment financing to support expansion plans, including investments in equipment and facilities, as well as acquisition of a foreign company.

Supplier Financing: EDC provides supplier financing by purchasing promissory notes under the terms of the commercial contract, giving firms the equivalent of a cash sale (for investment-grade buyers—those rated BBB or higher).

Project finance: When firms want to participate in a large-scale global project or joint venture, EDC can provide advice, underwriting expertise, and project finance support across a variety of industry sectors.

Domestic financing: Domestic financing is available to qualified Canadian companies involved in trade-related sectors of the economy in the form of direct loans, co-lending or guarantees (EDC, 2013).

China: China's Exim Bank and Sinosure

There are two major state-owned institutions that provide export credit in China: the Export-Import Bank of China and the China Export and Credit Insurance Corporation (Sinosure).

China Export Import Bank (China Exim Bank) is China's official export credit agency. The bank was founded in 1994 and has already become the world's largest export credit agency. Its services include export credits, guarantees, and concessional loans, which are an important part of China's foreign aid.

Even though the institution does not publish lending figures, U.S. officials estimate that it finances more exports than the ECAs of the Group of Seven industrialized nations combined. The *Financial Times* estimates that in 2009 and 2010, China Exim Bank (along with China Development Bank) lent more than $110 billion (U.S.) to other developing countries, which is more than what was lent by the World Bank during the same period. China's Exim Bank is not bound by OECD guidelines.

China Exim Bank finances the construction of dams, particularly in Africa and Southeast Asia. It finances hydropower projects in Kamchay (Cambodia), Mphanda Nkuwa (Mozambique), Merowe (Sudan), and Yeywa (Burma), as well as other dams in Albania, Cambodia, Guinea, Laos, Malaysia, Mozambique, Nepal, the Republic of Congo, Zambia, and elsewhere.

In August 2007 China Export and Import Bank issued *Guidelines for Environmental and Social Impact Assessments of the China Export and Import Bank's (China EXIM Bank) Loan Projects.* These guidelines are an improvement over the bank's 2004 environmental policy, which was released to the public in April 2007 (International Rivers, 2013).

Sinosure is China's sole provider of export insurance. It was established in 2001, the year China joined the WTO. Along with China's Exim Bank, Sinosure is at the forefront of China's export boom, providing competitive financing to exporters and buyers of Chinese goods and services. In 2009, for example, the institution insured $116 billion (U.S.) worth of exports worldwide. Recently, more than $1 billion (U.S.) in claims were paid by Sinosure in the aftermath of the Libyan uprisings. In 2001, the Chinese government injected an additional $3.1 billion (U.S.) to its capital stock.

Sinosure provides a great number of commercial and political-risk insurance products to exporters and buyers of Chinese goods and services, such as short-, medium-, and long-term export credit insurance. In such cases, there is 95 percent cover for commercial and political risk, with maximum repayment of ten years for 85 percent of the value of exported goods and services. The institution also provides investment insurance products and has started selling bonds and guarantees (CC Solutions, 2012).

China's official system of export financing is supplemented by lending from commercial banks controlled or owned by the government as well as quasi-government agencies. The China Development Bank, for example, extends loans for special projects that are included in China's official economic plans. The ultimate goal is to produce national champions able to compete on a global scale (Tucker, 2012).

From 2005 to 2008, China supported more than 3 percent of its merchandise exports with financing assistance, while the United States supported only 1 percent of its merchandise with export credit assistance during the same period. It issued more than $203 billion in new medium- and long-term export credit financing between 2006 and 2010, an amount four times that invested by the United States in absolute dollars and ten times more as a share of GDP.

China is not a member of OECD, but it is blamed for providing aggressive export credit financing (Ezell, 2011; Tucker, 2012). Its export financing program in Africa in particular has drawn much criticism from the Western world (Bosshard, 2010; Brautigam, 2009). The United States and China agreed to negotiate export credit deals, with a goal of concluding an agreement by 2014 (Palmer, 2012).

France: Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE)

The *Compagnie Française d'Assurance pour le Commerce Extérieur* (COFACE) was founded in 1946 as France's official export credit agency. It was subsequently privatized by the government and continued as a commercial enterprise. Currently, COFACE is owned by the bank group Natexis. The company is headquartered at Puteaux, France, and employs about 4,883 people. It facilitates state guarantees for exports by French corporations and provides other international support for exporters. It also manages public export guarantees for the government.

As a worldwide leader in credit insurance, COFACE offers companies protection against the risk of financial default of their domestic and foreign clients. In 2011, the Group posted a consolidated turnover of €1.6 billion. Each quarter, COFACE publishes its assessments of country risk for 157 countries, based on its unique knowledge of companies' payment behavior and on the expertise of its 250 underwriters.

In addition to its private-sector activities, COFACE manages a separate account for state export credits and reports to the Ministry of Finance, which takes decisions on the largest and most important transactions. There is a 20 percent domestic-content requirement for a transaction to be considered for the export credits (U.S. General Accounting Office, 2012; International Business Review, 2013).

Domestic Content Policies, Including Minimum Domestic Content to Receive Full Medium- and Long-Term Support

To be eligible for full support, merchandise must have at least 20 percent domestic content.

Functions

1. *Export finance*

The state participates in the financing of export credits with maturities of more than two years through NATEXIS Banques Populaires in order to stabilize credits granted in euros or foreign currency.

In France, export credit financing involves close cooperation between the commercial banks and two public institutions: NATEXIS Banques Populaires and COFACE. Like COFACE, NATEXIS acts for its own account (and thus is subject to general banking rules) and for the account of the state (as the manager of the stabilization mechanism).

NATEXIS also manages for the account of the state foreign aid loans and grants provided through financial agreements and the Fonds d'études et d'aide au secteur privé (FASEP—Fund for Assistance to the Private Sector).

2. *Aid finance*

A reform of the French aid and cooperation system was implemented in February 1998. Two areas of intervention were established and are updated yearly: a "priority zone of solidarity" (*zone de solidarité prioritaire,* ZSP) encompassing many developing countries without access to the international capital market, in which French Overseas Development Agency (ODA) is essentially provided by the French Development Agency (AFD) and the Ministry of Foreign Affairs; and a "partnership zone" consisting of the emerging economies, in which ODA is essentially provided by the Ministry of Economic Affairs, Finance, and Industry through the Reserve for Emerging Economies (*Réserve pays émergents,* RPE), managed by the Direction des Relations Economiques Exterieures or Department of foreign economic relations (DREE) (OECD, 2013).

Insurance and Guarantee Programs for Exporters

COFACE offers a wide range of insurance schemes covering commercial and political risks, during both the period of manufacture and the period of the credit. COFACE insurance policies are always conditional (compensation is paid only if damage occurs as a result of one of the risks covered) and the proportion covered is always less than 100 percent.

For *supplier credit,* regardless of the type of policy, the percentages covered are usually as follows:

- For commercial risks, 85 percent, but where the contract is secured by a bank approved by COFACE, cover may be increased to 90 percent.
- For political risks, coverage is 90 percent.

For buyer credits, the percentage covered is 95 percent for all risks.

- For heavy capital goods and major projects, the insurance provided by COFACE takes the form of individual policies covering commercial and political risks.
- For mass-produced or light manufactured goods, there are two possibilities:
  1. A comprehensive policy whereby the exporter agrees to cover commercial risks for all operations of this type but is free to select the countries for which the exporter wants political risk cover.
  2. An open policy whereby the exporter is free to select the risks to be covered (political and/or commercial) and the transactions to be guaranteed.
- For exports of consumer goods, raw materials, and equipment, credit guarantees in the form of comprehensive policies normally cover only a period of six months. These cover total export sales for various risks: private or government buyer, commercial or political risk. The policyholder is still free to exclude certain risks for certain countries (political risk or government buyer risk).

In accordance with the Arrangement and the Berne Union Understandings, the maximum terms for private credits guaranteed by COFACE are in principle the following:

Repayment period (unless otherwise specified):

- For heavy capital goods and major projects, five to ten years, depending on the contract price and the country of destination

- For light capital goods, three years or more, depending on the contract price
- For consumer goods, six months.

Repayment of principal is in equal half-yearly installments with no grace period.

Generally, minimum cash payments of 15 percent are required. This may be increased up to 20 percent or 25 percent, depending on the country and the buyer.

Local costs are covered and financed up to the amount of the cash payments and on the same terms as the export credit for the portion that may be repatriated. Assistance with local costs is provided only in exceptional cases and in accordance with the arrangement.

Eligibility

The main eligibility criteria are:

- The creditworthiness of the buyer's country
- The ceiling, if any, for the country concerned
- The total transaction value and terms of payment requested.

Transactions insured by COFACE may in principle include a foreign-content equivalent to up to 40 percent of the contract value, providing the foreign component originates from another EC country. Foreign content originating from a non-EC country may not exceed 30 percent of the total contract price for cash transactions or pure credit cover or 20 percent for stabilized credit.

Germany: HERMES

The German Federal Government has entrusted the management of the Official Export Guarantee Scheme to a consortium of two private companies. This mandatory consortium, which consists of Euler Hermes Kreditversicherungs-AG ("Euler Hermes"), the leading partner in the consortium, and PricewaterhouseCoopers AG ("PwC AG") is authorized to provide and manage the insurance business in the name and for the account of the state (OECD, 2013).

Applications for cover are first checked and processed by the consortium. Euler Hermes normally evaluates and takes decisions on applications covering a value of up to five million euros, on the basis of guidelines set by an Interministerial Committee for Export Guarantees. On larger contracts, decisions are taken by the Federal Ministry of Economics and Technology after discussion with the Interministerial Committee.

Mission

The mission of the consortium is to promote German exports; insure against political and commercial risk; open new markets, especially in emerging countries; and support foreign countries, particularly those in difficult phases of development and restructuring (U.S. Government Accounting Office, 2012).

Domestic-Content Policies, Including Minimum Domestic Content to Receive Full Medium- and Long-Term Support

There is a three-tier policy, with 70 percent and 51 percent minimum domestic content for the first two tiers. For the third tier, transactions with less than 51 percent domestic content can be supported if there is a justification from the exporter and the Interministerial Committee gives its approval.

Functions:

1. *Export finance*

KfW was established in 1948. Its initial task was to administer Marshall Plan aid made available under the European Recovery Programme (ERP) for financing the most urgent reconstruction projects after World War II. Today, it is a bank with responsibilities for economic policy. It promotes the German economy by granting investment loans and facilitates international project and export credits ("KfW IPEX-Bank"). Since 2004, international project and export finance activities are carried out under the label KfW IPEX-Bank, a member of KfW-Bankengruppe.

KfW IPEX-Bank is a legally independent but is a 100 percent subsidiary of KfW. KfW also extends loans and grants on behalf of the federal government within the framework of German financial cooperation with developing countries. In the field of international project and export financing, the bank concentrates on medium- and long-term loans in certain industries but also offers short-term trade finance instruments.

Eighty percent of KfW's capital is provided by the Federal Republic and 20 percent comes from the Länder (federal states). Its executive bodies are the Board of Managing Directors (Vorstand) and the Board of Supervisory Directors. The Board of Managing Directors is responsible for conducting business and administering assets.

2. *Aid finance*

KfW implements the part of the aid program that concerns bilateral financial cooperation.

Insurance and Guarantee Programs for Exporters

The *Wholeturnover Policy* offers exporters supplying goods and services to several buyers in various countries an easily manageable tool for safeguarding trade receivables with a credit period of up to twelve months.

Cover includes protection against payment default, particularly due to buyer insolvency or nonpayment of receivables within six months after the due date (protracted default), adverse measures taken by foreign governments or warlike events, nonconversion or transfer of local currency amounts, confiscation of the goods due to political circumstances, and contract frustration due to political circumstances.

The *Wholeturnover Policy Light* offers small and medium-size export companies supplying goods and services to several buyers in various countries an easily manageable tool for safeguarding trade receivables with a credit period of up to four months.

It offers protection against payment default if the foreign buyer fails to make payment within six months after due date (protracted default).

Manufacturing Risk Cover safeguards the production costs invested in the performance of an export transaction. It offers protection against a discontinuation of production, particularly due to the insolvency of the foreign buyer, the cancellation of the contract or the occurrence of other fundamental contract violations, adverse measures taken by foreign governments or warlike events, embargo measures taken by the Federal Republic of Germany or third countries participating in the export transaction, and nonpayment of cancellation fees or nonfulfillment of the claim to partial repayment after legitimate cancellation of the contract by the buyer.

Supplier Credit Cover safeguards amounts receivable due to a German exporter under a single export transaction with short, medium, or long repayment terms.

It offers protection against payment default due to the insolvency of the foreign buyer, adverse measures taken by foreign governments or warlike events, nonconversion or transfer of local currency amounts, and confiscation of the goods due to political circumstances or contract frustration due to political circumstances, as well as nonpayment within six months after due date (protracted default).

The *Revolving Specific Policy* safeguards trade receivables with repayment terms of up to twenty-four months due to an exporter supplying one specific foreign buyer with goods or services on a continuous basis.

It offers protection against payment default, particularly due to the insolvency of the foreign buyer, nonpayment of the amounts owing within six months after due date (protracted default), adverse measures taken by foreign governments or warlike events, nonconversion or transfer of local currency amounts, confiscation of the goods due to political circumstances, and contract frustration due to political circumstances.

Eligibility

Insurance cover may be provided to a German exporter or to a bank financing a German export transaction. In principle, all types of goods and services are eligible for cover. The limits to eligibility arise at the point where a transaction may contravene the vital interests of the Federal Republic of Germany. Such restrictions on eligibility may be based on the type of goods concerned, the country of destination, a combination of the two, the parties of the contract, the payment terms agreed, or other issues connected with environmental aspects, human rights, or corruption.

The transaction must be justifiable in terms of the commercial and political risk involved. In this context, the creditworthiness of the foreign buyer is scrutinized and the country risk is examined to determine the risk on the basis of payment record in the past and the future ability of the country to service its debts.

Export business is eligible for support only if the conditions agreed in the contract are in line with those generally accepted in export trade. This is particularly true for payment conditions in accordance with the terms of the Berne Union. The other conditions are regulated by the OECD Arrangement and relevant EU legislation.

Cover is normally made available only to German exporters and for goods manufactured in (and services rendered from within) the Federal Republic of Germany. However, some foreign content of an export contract may be included, depending on where the foreign content originates and its share of the total contract value.

Japan: JBIC and NEXI

Trade and investment insurance is administered by Nippon Export and Investment Insurance (NEXI), an independent administrative institution, in order to provide efficient administrative services for Japanese companies (OECD, 2013).

NEXI's capital amounts to JPY 104.4 million. The entire capital comes from the Ministry of Economy, Trade, and Industry, which also reinsures agreements underwritten by NEXI.

NEXI insures repayment of export credits. This insurance enables commercial banks, which normally would be unwilling to assume the risk of foreign long-term financing, to fund overseas projects. Close cooperation among the Japan Bank for International Cooperation (JBIC), commercial banks, the business community, and NEXI ensures the availability of funds for export financing.

Japan Bank for International Cooperation (JBIC) runs a program of guarantees for bank-to-bank loans and buyer credits that cannot be covered by NEXI.

Mission

The mission of JBIC is to secure natural resources, ensure competitiveness of Japanese companies, respond to disruptions in the international economy, and improve the environment. The mission of NEXI is to contribute to Japan's economy by anticipating changes in the market, respond to customer needs, and conduct insurance business in covering risks that arise in international transactions but are not covered by regular commercial insurance (U.S. Government Accounting Office, 2012).

Domestic-Content Policies for Medium- and Long-Term Support

To qualify for support, merchandise must have at least 30 percent domestic content. The ECA can make exceptions to support projects with less than 30 percent domestic content if the project has strategic interests.

Functions

1. *Export finance*

JBIC is a government financial institution established by the merger of the Export-Import Bank of Japan (EXIM) and the Overseas Economic Cooperation Fund, Japan (OECF) in 1999. In carrying out Japan's external economic policy and supporting economic cooperation, JBIC operates on two fronts: international financial operations (as the successor to EXIM) and overseas economic cooperation (as the successor to OECF). International financial operations provide financial assistance, including export loans.

2. *Aid finance*

JBIC's Overseas Economic Cooperation Operations Department provides financial assistance, including ODA loans.

Insurance Programs for Exporters and Banks

Insurance Covering Exports

Export credit insurance covers losses suffered by a Japanese company that exports goods and services to a foreign country if the company is unable to ship its goods owing to (a) war, revolution, import restriction/prohibition, or force majeure such as natural disaster, or (b) bankruptcy of the importer. The insurance also covers the company's losses if it is unable to collect payment for the exports or service after goods have been shipped for the reasons mentioned.

The types of insurance offered include export credit insurance, which covers export and intermediary trade on a case-by-case basis; short-term comprehensive insurance, which covers the export and intermediary trade of a company as a whole; and short-term trade insurance for manufacturers, which covers their transactions with a specified buyer.

Insurance Covering Loans (Buyer Credit)

Export credit insurance also covers losses suffered by a Japanese commercial bank that provides loans to a foreign importer to purchase goods and services from a Japanese company if the loan cannot be repaid owing to (a) war, revolution, prohibition of foreign currency conversion into currency such as yen or dollar, suspension of remittance, or force majeure such as natural disaster, or (b) bankruptcy or default of the importer. War, revolution, prohibition of foreign currency conversion into currency such as yen or dollar, suspension of remittance or force majeure such as natural disaster, and so on are considered political risk, while bankruptcy or default of an importer are regarded as commercial risk.

Coverage

For indemnification:

1. Maximum percentage of cover (for percentage of cover, customer's option).
2. Maximum percentage of cover for consumer goods.
3. Consumer goods are not covered.
4. Contracts (export contracts, loan agreements) with foreign governments.

(See Table G.1)

TABLE G.1 Political and Commercial Risk Coverage

		Specific insurance (short-term)	Specific insurance (mid-/long term)	Comprehensive insurance (short-term)	Comprehensive insurance (mid-/long-term)
Prior to shipment	Political risk	95% (1)	95% (1)	80% 40% (2)	80%
Prior to shipment	Commercial risk	80% (1)	80% (1)	80% 40% (2)	80%

(*Continued*)

TABLE G.1 (Continued)

		Specific insurance (short-term)	Specific insurance (mid-/long term)	Comprehensive insurance (short-term)	Comprehensive insurance (mid-/long-term)
After shipment	Political risk	97.5%	97.5% 100% (4)	97.5% 40% (2)	97.5% 100% (4)
After shipment	Commercial risk	90%	95% 100% (4)	90% 0% (3)	95% 100% (4)

(1) Maximum percentage of cover (for percentage of cover, customer's option).
(2) Maximum percentage of cover for consumer goods.
(3) Consumer goods are not covered.
(4) Contracts (export contracts, loan agreements) with foreign governments.

Eligibility

In principle, no export credit can be provided for transactions with "high-risk" countries or countries where a default has already occurred. NEXI has a classification for various buyer countries based on their creditworthiness.

Export Finance Programs

Direct Credit

Buyer credits and bank-to-bank loans are extended to foreign governments, foreign banks, foreign corporations, and international or regional agencies. In the case of buyer credits and bank-to-bank loans, JBIC carries the risk itself for its portion of the financing. For the bank-financed part, however, NEXI insurance is in principle required.

Eligibility of Direct Credit

When extending buyer credits or bank-to-bank loans, JBIC takes account of the requests of borrowers, types of project, and so forth on a case-by-case basis.

Terms of financing are determined in the same way as for supplier credits.

Refinancing

Export credits with a repayment term not exceeding six months are provided entirely by commercial banks. Most medium- and long-term supplier credits are refinanced by JBIC at the relevant rate in combination with commercial bank participation at market rates. All supplier credits are eligible for refinancing, provided that the minimum duration exceeds six months and sales of capital goods are involved.

Eligibility of Refinancing

Refinancing is not automatic. Each transaction is separately screened by JBIC, which makes the decision whether to refinance on a case-by-case basis.

Aid Finance Programs

Associated Financing

JBIC (Overseas Economic Co-operation Department) cooperates with commercial banks to extend concessional aid credits to developing countries.

United Kingdom: Export Credits Guarantee Department (ECGD)

The mission of the Export Credits Guarantee Department (ECGD) is "to benefit the UK economy by helping exporters of UK goods and services win business and UK firms to invest overseas, by providing guarantees, insurance and re-insurance against loss, taking into account the Government's international policies" (OECD, 2013).

ECGD's main functions are to facilitate UK exports by providing insurance to UK exporters against the risks of nonpayment by overseas buyers and guarantees to banks against nonrepayment of loans they make to overseas borrowers to finance the purchase of goods and services from UK suppliers.

ECGD derives its statutory powers from the Export and Investment Guarantees Act of 1991. Guarantees are given to banks that provide finance to overseas buyers of services performed by UK contractors of major projects outside the United Kingdom and the supply by UK exporters of capital goods. Its activities cover investment insurance and reinsurance given to private-sector insurers to whom ECGD's term credit insurance activities were transferred for short-term export credits.

ECGD is expected to run its credit insurance operations so as to generate sufficient reserves to break even, which is required by the UK government. ECGD publishes trading accounts and carries out all the administrative work necessary to meet these objectives. This includes processing applications for cover from initial receipt to issuing guarantee documents and the supporting tasks of obtaining relevant commercial and economic information about buyers, borrowers, and countries; determining premium rates and methods of risk control; collecting premiums; handling and paying claims; keeping records of income, expenditures, and reserves; and maintaining relations with similar institutions in other countries.

Export Finance

There is no official institution in the United Kingdom for export credit financing or refinancing.

Aid Finance

The Department for International Development (DfID) is the government department responsible for managing Britain's program of development assistance to poorer countries, including trade, investment, and agricultural policies.

Insurance and Guarantee Programs for Exporters

ECGD offers direct insurance to exporters for individual export contracts under its Export Insurance Policy (EXIP). The risks covered include purchaser's insolvency or failure to make payment and other contractual nonperformance, together with a range of political risks, from delays in the transfer of funds to the occurrence of hostilities that affect the performance of the insured contract.

Cover can be provided both for the cost incurred during the period when goods are being manufactured or works and services are being performed and for amounts owed by the purchaser under the contract for delivered goods and services. The maximum percentage of loss covered is 95 percent, but exporters are free to select a lower percentage.

Eligibility

EXIPs are provided to exporters carrying on business in the United Kingdom. For credits in excess of two years, the normal OECD arrangement rules on credit terms and down payments apply, with a 5 percent down payment usually required on signature of the insured contract. UK content must be at least 20 percent of the eligible contract value.

ECGD reviews the economic and financial standing and prospects of all overseas markets on a continuous basis. For some countries, it sets limits on the total amount it will insure and may introduce other market restrictions, such as stipulations about methods and timing of payment. Additionally, ECGD operates controls at the portfolio level, which apply to business in markets where exposure is already significant or the risk is deemed to be high. The review process that forms the basis of these market and portfolio controls is based upon the use of an econometric model, which assesses the risk of default in each market via the use of economic forecasts and expert judgments of political risk.

An assessment of all the risks is made before each guarantee or policy of insurance is issued, and additional security may be required. The assessment includes all the factors relevant to the case and the market and how they may affect ECGD's whole portfolio of risks. There are therefore controls at portfolio, market, and case level. Subject to these controls, the availability of cover is normally regulated on a "first come, first served" basis.

Guarantees for Banks

1. *Supplier credit*

The supplier credit financing facility provides an unconditional guarantee to banks for 100 percent of the amount financed. This is a multitransaction facility in the form of a master guarantee issued to a financing bank that agrees to purchase the full principal value of bills of exchange or promissory notes accepted or issued by buyers. ECGD may require bills or notes given by a buyer to be unconditionally guaranteed by a third party. It is also possible under this facility for banks to arrange loans to buyers or establish lines of credit; bills or notes need not be required for these transactions. Contracts to be financed are approved individually by ECGD. In most cases, there is no recourse to the exporter in the event of a claim.

Exporters may take out an EXIP to cover the commercial and political risks of nonpayment during the period between the signing of the contract and the sale of the bills or notes issued under it to the bank. This cover is not available separately.

2. *Buyer credit*

ECGD guarantees lending banks the repayment of loans made to overseas borrowers for the purchase of major UK capital goods with a contract value of at least GBP five million. Guarantees are usually for 100 percent of the principal and interest due under the loan provided in support up to 85 percent of the amounts due under the relevant export contract. In rare instances, risk sharing may result in a lower percentage of guaranteed principal or interest. ECGD retains a right of recourse to an exporter for amounts it may have paid under a guarantee to a bank at a time when the exporter is in default under the terms of its contract.

For project loans of at least GBP twenty million (UK export credit loan value) where cover is given on a project finance basis (i.e., where repayment is not secured by guarantees from project sponsors or third parties but will depend on the revenue-earning capacity of the project), ECGD provides cover for defined political risks only or, alternatively, cover for all risks up to 100 percent of principal and interest. The guaranteed percentage for all risks cover is decided on a case-by-case basis, depending on the quality of the project, the strength of the participants, and the degree of risk sharing among all parties, including the lenders. The basic structure of this facility is the same as for the standard buyer credit.

Eligibility

The basic eligibility criteria are the same as those for exporters (including the system of controls at portfolio, market, and case level). In addition, the minimum credit period for financing facilities is two years, and there are minimum contract values as follows:

Supplier credit financing facility: GBP 25,000
General-purpose lines of credit: GBP 25,000
Buyer credit: GBP 5,000,000

ECGD has also entered into a number of bilateral reinsurance agreements with other export credit agencies to provide a single facility to borrowers who order goods or services from suppliers in the United Kingdom and other countries (instead of individual facilities supported by each export credit agency).

Domestic-Content Policies for Medium- and Long-Term Support

Twenty percent domestic content is required to receive full support. If domestic content is less than 20 percent, the ECA will support the domestic content portion of the transaction (U.S. Government Accounting Office, 2012).

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Appendix H
A Brief Comparison of Cargo Conventions

TABLE H.1

	Hague Rules	Hague-Visby Rules	Hamburg Rules	Rotterdam Rules*
Contract of carriage	Contract of carriage applies only to contracts of carriage covered by a bill of lading (BL) or any similar document of title, in so far as such document relates to the carriage of goods by sea.	Same as Hague rules	Contract of carriage by sea includes carriage by some other means.	The contract shall provide for carriage by sea and may provide for carriage by other modes of transport in addition to the sea carriage.
Which voyages are covered	No provision	Rules apply to every bill of lading relating to the carriage of goods between ports in two different states if (1) BL issued in a contracting state (CS); (2) carriage from a CS; or (3) contract of carriage expressly applies rules.	Rules apply if (1) BL issued in a CS; (2) carriage from or to CS; (3) BL expressly provides for its application.	Rules apply if any one of the following places is located in a contracting state: (a) the place of receipt; (b) the port of loading; (c) the place of delivery; or (d) the port of discharge. Receipt and delivery must be in different states.
Carrier's period of responsibility	"Carriage of goods" covers the period from the time when the goods are loaded on to the time they are discharged from the ship.	Same as Hague rules	Covers the period during which the carrier is in charge of the goods at the port of loading, during the carriage and at the port of discharge.	The period of responsibility of the carrier begins when the carrier or a performing party receives the goods for carriage and ends when the goods are delivered.

Carrier's duty of care	The carrier shall be bound before and at the beginning of the voyage to exercise due diligence to (a) make the ship seaworthy; (b) properly man, equip, and supply the ship; (c) make the holds, refrigerating and cool chambers, and all other parts of the ship in which goods are carried, fit and safe for their reception, carriage, and preservation. Also carrier must properly and carefully load, handle, stow, carry, keep, care for, and discharge goods.	Same as Hague rules	Carrier and his servants or agents must take all measures that could reasonably be required to avoid the event causing loss and its consequences.	To carry the goods to the place of destination and deliver them to the consignee; to properly and carefully receive, load, handle, stow, carry, keep, care for, unload, and deliver the goods. Before, at the beginning of, and during the voyage by sea, carrier is to exercise due diligence to (a) make and keep the ship seaworthy; (b) properly crew, equip, and supply the ship and keep the ship so crewed, equipped, and supplied throughout the voyage; (c) make and keep the holds and all other parts of the ship fit and safe for their reception, carriage, and preservation.

(*Continued*)

TABLE H.1 (Continued)

	Hague Rules	Hague-Visby Rules	Hamburg Rules	Rotterdam Rules*
Liability of carrier	"Goods" does not include live animals and deck cargo. Carrier's defenses include act, neglect, or default of the master, mariner, pilot, or the servants of the carrier; fire unless caused by carrier, accidents of the sea, act of God, war, riots, strikes, saving or attempts to save life or property at sea, waste from inherent defect, insufficient packing, or latent defects. Any other cause arising without the actual fault or privity of the carrier or without the fault or neglect of the agents or servants of the carrier, but the burden of proof shall be on the person claiming the benefit of this exception.	Same as Hague rules	Carrier must prove that he and his servants or agents took all measures that could reasonably be required to avoid the occurrence and its consequences.	Must either show absence of fault on the part of the carrier or its crew. Carrier's defenses include act of God, accidents, war, terrorism, civil war, quarantine restrictions, strikes, fire on the ship, latent defects not discoverable by due diligence, act or omission by shipper, inherent defect, quality or vice of the goods, insufficiency of packing or marking, saving or attempting to save life or property at sea.
Burden of proof	Rules not specific on this issue	Rules not specific on this issue	Carrier must prove that reasonable steps to avoid loss were taken unless damage is caused by fire,	Claimant to prove that loss damage or delay took place during carrier's period of responsibility. Carrier to prove that cause or one of the causes of the loss, damage, or delay is not attributable to its fault or the fault of any performing party, master or crew of ship, or employees.

Limits of liability for goods lost or damaged	£100 ($500) per package or unit unless value declared and inserted in the B/L.	2 SDRs per kg or 666.67 SDRs per package	2.5 SDRs per kg or 835 SDRs per package	875 SDR per package or other shipping unit or 3 SDR per kg of gross weight subject of claim, whichever is higher, unless value declared.
Limits of liability for goods delayed	No provision	No provision	2.5 x freight payable on goods delayed, subject to upper limit of total freight on all goods or amount of limitation if goods have been lost or destroyed.	2.5 times freight payable for goods delayed, not to exceed limit for total loss.
Upper or lower limit by agreement	Upper limit allowed if recorded in BL. Lower limit allowed in special circumstances.	Upper limit allowed if recorded in BL. Lower limit allowed in special circumstances.	Upper limit allowed if recorded in BL. No specific right to agree lower limits.	Upper limit allowed if agreed between carrier and shipper. Except in "volume contracts," terms that limit liability of carrier will be void.
Statement in BL	Prima facie evidence of accuracy.	Prima facie evidence in hands of shipper, conclusive in hands of third party such as consignee to whom the B/L is transferred in good faith.	Prima facie evidence of statement in hands of shipper (whether shipped or received B/L). Conclusive in hands of third party who relies on statements. If freight is payable by holder of the B/L failure to state this is evidence that no freight is payable.	Prima facie evidence of the carrier's receipt of the goods as stated. Proof to contrary not admissible where contract is negotiable or nonnegotiable but requires it be surrendered for delivery and the document is in the hands of a consignee/third party acting in good faith.

(*Continued*)

TABLE H.1 (Continued)

Duties of shipper with regard to info supplied to carrier	Shipper is deemed to guarantee accuracy of statement as to weight and quantity of cargo. Shipper to indemnify carrier for loss resulting from errors.	Same as Hague rules	Same as Hague rules	Shipper is deemed to have guaranteed the accuracy of the information provided.
Notification	Notice of loss or damage must be given in writing to the carrier or his agent on day of delivery or within three days where damage is latent.	Same as Hague rules	Notice of loss or damage to be given in writing to carrier by the working day following delivery to consignee or within fifteen days of delivery where damage is latent. Notice of delay must be given within sixty days of delivery. Carrier must give notice of complaint to shipper within ninety days of delivery.	Notice of loss of or damage to goods to be given at time of delivery or within seven working days after delivery if damage not apparent. Notice of loss or damage due to delay to be given within twenty-one consecutive days of delivery. Need not give notice if joint inspection by receiver and carrier.
Consequences of failure to notify carrier of damage etc.	Failure to notify is prima facie evidence of delivery of goods in condition described in BL.		Failure to notify is prima facie evidence of delivery of goods in condition described in BL. If complaint not made in the case of delay within sixty days, carrier is exempted from liability.	Failure to give notice raises presumption that goods delivered in same condition as described in the contract particulars. It does not affect the right to claim compensation for loss or damage nor does it affect the allocation of the burden of proof.

Limitation of action	Suit must be brought within one year of delivery or date delivery should have taken place.	Same as Hague Rules. Indemnity actions may be brought after one year; the period for commencing suit to be determined by local law but not to be less than three months after claim settled or suit served.	Litigation or arbitration to be commenced within two years from date of delivery of goods or the last day upon which the goods should have been delivered. Indemnity proceedings may be commenced after this period (at least ninety days from date of commencement of action against carrier must be allowed).	Two years after delivery or when goods should have been delivered. An action for an indemnity can be brought within the later of time allowed under local law or ninety days after claimant settled with primary claimant or was served with process, whichever is earlier.
Place to commence proceedings	No specific provision	No specific provision	Shipper may sue in court of (a) principal place of business of carrier; (b) place contract was made; (c) port of loading or discharge; (d) place of arrest of vessel. This may be challenged by the carrier if he submits to one of the other jurisdictions and provides security for the claim.	Domicile of carrier, the place of receipt or delivery under the contract, port of loading or port of discharge or agreed jurisdiction between shipper and carrier. Agreed jurisdiction will be “exclusive” under certain circumstances, including volume contracts.

* Proposed Rotterdam Rules. The agreement has not yet entered into force.

Appendix I
Countries That Are Members of Cargo Conventions

Hague Rules	Hague-Visby Rules	Hamburg Rules	Rotterdam Rules*
Algeria, Angola, Aruba, Argentina, Australia, Bahamas, Bangladesh, Belize, Bolivia, Brazil, Brunei, Bulgaria, Colombia, Congo (DR), Cuba, Dominica, Estonia, Fiji, Ghana, Grenada, Guinea Bissau, Guyana, India, Iran, Israel, Ivory Coast, Jamaica, Madagascar, Malaysia, Malta, Mauritius, Monaco, Mozambique, Pakistan, Panama, Papua New Guinea, Philippines, Portugal, St. Kitts and Nevis, Sao Tome, Seychelles, Slovenia, Solomon Islands, Somalia, Timor, Trinidad and Tobago, Turkey, Tuvalu, United States	*Argentina, Australia, Bahrain, Belgium, Bermuda, Canada, China, Croatia, Denmark, Ecuador, Finland, France, Germany, Greece, Hong Kong, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, S. Korea, Kuwait, Latvia, Lithuania, Mexico, Montserrat, Netherlands, New Zealand, Norway, Oman, Poland, Portugal, Qatar, Russia, Singapore, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Taiwan, Thailand, Tonga, Turks and Caicos, Ukraine, United Arab Emirates, United Kingdom, Venezuela, Vietnam*	*Albania, Australia, Austria, Barbados, Bolivia, Botswana, Burkina Faso, Burundi, Cameroon, Canada, Chile, China, Colombia, Czech Republic, Dominican Republic, Egypt, Gambia, Georgia, Guinea, Hungary, Iraq, Jordan, Kazakhstan, Kenya, Lebanon, Lesotho, Liberia, Malawi, Morocco, Nigeria, Paraguay, Romania, Senegal, Sierra Leone, Slovakia, Syria, Tanzania, Tunisia, Uganda, Ukraine, Venezuela, Zambia*	

Appendix J
Rotterdam Rules

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Chapter 6

LEGAL ISSUES AND REGULATORY DEVELOPMENTS

This chapter provides information on some important legal issues and recent regulatory developments in the fields of transport and trade facilitation, together with information on the status of the main maritime conventions.

A. IMPORTANT DEVELOPMENTS IN TRANSPORT LAW

Adoption of a new United Nations Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea: the Rotterdam Rules

In 2008, after years of deliberation, work on the text of a draft Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea was completed, and a final draft text, as approved by the United Nations Commission on International Trade Law (UNCITRAL) was adopted by the United Nations General Assembly on 11 December 2008. This new United Nations convention, to be known as the "Rotterdam Rules"[1] (hereinafter referred to as "the Convention" or "the Rotterdam Rules") was open for signing at a special conference held in Rotterdam in September 2009. Thereafter, states will consider whether to become parties to the new Convention; 20 ratifications are required for the Convention to enter into force.[2] In this context it is important to note that ratification of the Convention is conditional upon denunciation of any other international convention in the field of carriage of goods by sea. That is to say, for Contracting States to any other international sea-carriage convention, ratification of the Rotterdam Rules becomes effective only if and when denunciation of the Hague Rules,[3] the Hague-Visby Rules[4] or the Hamburg Rules,[5] as the case may be, has become effective.[6] Thus, adherence to the Rotterdam Rules requires an unequivocal decision that, on balance, national interests are better served by the new Convention, rather than by any of the established international maritime cargo-liability regimes.[7]

This new United Nations convention, to be known as the "Rotterdam Rules"was open for signing at a special conference held in Rotterdam in September 2009. Thereafter, States will consider whether to become parties to the new Convention; 20 ratifications are required for the Convention to enter into force.

Background

By way of background, it should be noted that the regulation of liability arising in connection with the international carriage of goods

by sea has, over the past decades, become increasingly diverse. Many states are Contracting States to the Hague Rules or the Hague-Visby Rules. The 1978 United Nations Convention on the Carriage of Goods by Sea (the Hamburg Rules), which entered into force in 1992, was designed to provide a modern successor to the Hague-Visby Rules, but failed to attract widespread acceptance; although the Hamburg Rules are now in force in 34 states, none of the major shipping nations has ratified the Convention. As a result, three mandatory liability regimes, namely the Hague Rules, the Hague-Visby Rules and the Hamburg Rules, have come to coexist internationally. At the same time, the exponential growth of containerization and the consequent change of international transport patterns and requirements have increased the need for appropriate modern regulation. In relation to multimodal transportation, no uniform international liability regime is in force, and the international legal framework is particularly complex, as liability continues to be governed by existing unimodal conventions, and by increasingly diverse national, regional and subregional laws and contractual agreements.[8]

It is against this background that the new Rotterdam Rules were prepared, with the aim of establishing a modern set of internationally uniform rules that provide commercial parties with much-needed legal certainty. States will now have to carefully consider the merits of the new Convention and decide whether the Rotterdam Rules comply with their expectations, both in terms of its substantive provisions and in terms of its potential to provide international uniformity of laws in the field.

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The substantive work was carried out by an UNCITRAL working group, established by the UNCITRAL Commission.[9] Together with a number of other interested intergovernmental and non-governmental organizations, the UNCTAD secretariat has been participating in the relevant UNCITRAL working group meetings as an observer and has provided substantive analytical comments for consideration by the working group throughout the drafting process.[10] While proper consideration of the Convention's individual provisions or a comprehensive summary of its content is not possible here,[11] an analytical overview of some of its central features is provided, with a view to assisting policymakers in their assessment of the potential merits of ratification of the new Convention. As will be seen, many aspects of the new Convention appear potentially problematic, in particular from the perspective of small- and medium-scale shippers in developing countries.[12]

Substantive scope of coverage

The Rotterdam Rules consist of 96 articles which are contained in 18 chapters. Many of the provisions are lengthy and highly complex, which, unfortunately, makes national differences in their interpretation and application likely and may give rise to significant litigation.[13] To a large extent, the Convention covers matters that are dealt with in the existing maritime liability regimes, namely the Hague-Visby Rules and the Hamburg Rules, albeit with significant changes in terms of structure, wording and substance. In addition, several chapters are devoted to matters currently not subject to international uniform law such as delivery of the goods[14] and the transfer of the right of control and of rights of suit.[15] The new Convention also provides for electronic communication and the issue of electronic substitutes for traditional paper documents, largely by recognizing contractual agreements in this respect and by according electronic records a similar status to paper-based documents.[16] Two separate chapters provide complex rules on jurisdiction and arbitration.[17] These chapters are, however, optional, and will only be binding on Contracting States that have declared their intention to be bound – a state of affairs which may give rise to parallel legal proceedings in different Contracting States, and ultimately, conflicting judgments.

Scope of application[18]

The Rotterdam Rules apply to contracts of carriage[19] in which the places of receipt and delivery are in different States, provided the contract involves an international sea leg and the contractual place of receipt, loading, discharge or delivery is located in a Contracting State (article 5). The Rules do not apply to charter parties or to "other contracts for the use of a ship or for any space thereon" and to contracts of carriage in non-liner transportation, except where "there is no charter party or other contract for the use of a ship or of any space thereon and a transport document or an electronic

transport record is issued" (article 6). However, in these cases, the Rotterdam Rules would apply as between the carrier and consignee, controlling party or holder that is not an original party to a contract excluded under article 6 (article 7).

Multimodal transport[20]

Importantly, and in contrast to the existing international maritime regimes, the Rotterdam Rules have a broad scope of application and also cover contracts for multimodal transportation that involve an international sea leg, irrespective of which mode of transport is dominant.[21] While at present there is no international convention in force to govern multimodal transportation, the extension of the Convention's scope of coverage to multimodal transport involving a maritime leg was subject to considerable controversy throughout the negotiations, as was the text of the relevant provisions in the Rotterdam Rules.[22] This was due, in particular, to: (a) concerns about the potential for conflict with unimodal conventions in the field of road, rail, air and inland waterway carriage, which in many instances also apply to loss arising during a particular stage of a multimodal transport; (b) the desire by some states to ensure the continued application of existing national law on multimodal transportation; (c) concerns about further fragmentation of the law applicable to international multimodal transportation; and (d) the fact that the substantive content of the liability regime is based exclusively on considerations and principles applicable to sea carriage, rather than multimodal transportation.[23]

Importantly, and in contrast to the existing international maritime regimes, the Rotterdam Rules have a broad scope of application and also cover contracts for multimodal transportation that involve an international sea-leg, irrespective of which mode of transport is dominant.

The issue of potential overlap/conflict with existing international conventions applicable to road, rail, air and inland waterway carriage[24] has, to some extent, been addressed in a separate provision (article 82), which gives precedence to these conventions to the extent that they apply beyond pure unimodal transportation by road, rail, air and inland waterway, respectively.[25] However, otherwise, substantive rules pertaining to other modes of transport come into play only in relation to losses "arising solely before or after sea carriage", and only in the form of "mandatory provisions on the carrier's liability, limitation of liability and time for suit" contained in any "international convention that would have applied mandatorily" to the stage of carriage where the loss occurs, had a separate unimodal transport contract been made (article 26). Such mandatory provisions would, in a cargo claim, need to be applied in context with the remainder of the provisions of the Rotterdam Rules – a difficult task for courts in different jurisdictions, which may be expected to result in internationally diverging judgments. In all other cases, that is to say where no international unimodal convention would have been applicable to the claim in question, or where a loss could not be (sufficiently) attributed to any particular modal stage of a multimodal transport, the provisions of the Rotterdam Rules, i.e. of a substantively maritime liability regime, would apply to determine the parties' rights and the extent of any liability. Existing national laws on multimodal transportation will play no role in relation to contracts falling within the scope of the new Convention.

Existing national laws on multimodal transportation will play no role in relation to contracts falling within the scope of the new Convention

Liability of the carrier[26]

The carrier (as well as any maritime performing party, such as a terminal operator)[27] is under a number of obligations, breach of which gives rise to liability for damage to, loss of or delay in delivery[28] of the goods. The liability of the carrier under the Rotterdam Rules is subject to financial limitation (article 59),[29] with limitation amounts higher than in the Hague-Visby Rules or Hamburg Rules[30] and subject to a two-year time bar (article 62), which may be extended by declaration (article 63). The carrier may lose the right to financial limitation of liability in case of recklessness or intention (article 61).

The carrier's main obligations include the duty to carry the cargo and deliver the goods to the consignee (article 11), a duty of care during the carrier's period of responsibility, i.e. from receipt to delivery of the goods (articles 13 (1) and 12), and a duty to exercise due diligence to make and maintain the vessel seaworthy (article 14);[31] this includes (a) the physical seaworthiness of the vessel; as well as (b) manning, supply and equipment; and (c) the cargoworthiness of the vessel. In contrast to the Hague-Visby Rules, the seaworthiness

obligation is a continuous one, applying throughout the carriage, and there is no general reversal of the burden of proof regarding the exercise of due diligence (cf. article IV, r.1 of the Hague-Visby Rules). Instead, the central provision dealing with liability of the carrier for loss, damage or delay in the context of a cargo claim, article 17, which sets out a list of exceptions to liability, including some that differ from the list in article r. 2 of the Hague-Visby Rules,[32] also contains detailed and complex rules on burden of proof.

The shipper's obligations and liability are more extensive than in the Hague-Visby Rules and are set out in some detail in a separate chapter (chapter 7).

Worth noting in this respect are a number of points which are of particular relevance in the context of contracts conducted on the carrier's standard terms, i.e. contracts of adhesion. First, the carrier's period of responsibility (from receipt to delivery) may be contractually defined (i.e. restricted), to cover only the period from initial loading to final unloading under the contract (article 12 (3)). Secondly, the carrier's responsibility for certain functions, such as loading, handling, stowing and unloading may be contractually transferred to the shipper, documentary shipper[33] or consignee (article 13 (2)). Thirdly, the carrier's liability for special cargo and for live animals may be contractually limited or excluded (article 81). Therefore, a carrier may only be liable from loading to discharge and for only some of a carrier's functions set out in the Convention.

Moreover, the rules on burden of proof[34] within the scheme of the Convention appear to differ significantly from those in the established maritime liability conventions, favouring the carrier, in particular in cases where unseaworthiness of the vessel has contributed to a loss.[35] The Rotterdam Rules envisage proportional allocation of liability in these cases, whereas under the Hague-Visby Rules a carrier would be liable in full, unless it could prove the proportion of loss not due to breach of its seaworthiness obligation. This reflects an important shift in commercial risk allocation to the detriment of shippers.

Liability of the shipper[36]

The shipper's obligations and liability are more extensive than in the Hague-Visby Rules and are set out in some detail in a separate chapter (chapter 7). They include fault-based liability relating to the preparation and delivery for carriage of the goods (article 27) and in respect of wide-ranging information and documentation requirements (article 29), which may become particularly relevant in the context of new maritime security requirements.[37] They also include strict liability (see article 30 (2)) for loss arising from the shipment of dangerous cargo (article 32) and the failure to provide timely and accurate contract particulars (article 31 (2)).

Importantly, the relevant rules on burden of proof[38] are more onerous than under existing maritime liability regimes, which could have important practical implications for the outcome of claims by the carrier against the shipper, in particular in cases where unseaworthiness of the vessel may have contributed to a loss arising from the carriage of dangerous cargo. Thus, whereas under the Hague-Visby Rules, in cases where unseaworthiness can be identified as a contributory cause, a shipper would in most instances be free from liability. Under the Rotterdam Rules, a shipper could become liable in full for any of the potentially extensive losses sustained by the carrier (e.g. loss of a vessel, third-party liability). In this context, it is worth highlighting that the potentially very extensive liability of the shipper is not subject to any monetary limitation.[39]

A final consignee who makes a claim under the contract may also become liable for breach of any of the shipper's obligations.[40] Moreover, a so-called "documentary shipper", i.e. a party who is not the contracting shipper but who "accepts to be named as "shipper" in the transport document"(article 1(9)), such as an FOB seller, is also liable for any breach of a shipper's obligations, in addition to the shipper himself (article 33).

Delivery of the goods

It should also be noted that there is a separate chapter dealing with delivery of the goods (chapter 10), providing for a new obligation on the part of the consignee to accept delivery of the goods from the carrier (article 43) and including detailed rules on delivery of the goods under different types of transport documents/electronic records. Importantly, the chapter also includes complex new rules to effectively shift the risk of delayed bills of lading from carrier to consignee: in cases where the final consignee/endorsee of goods shipped under a negotiable transport document (i.e. a bill of

There is a separate chapter dealing with delivery of the goods (chapter 10).

lading), typically a CIF[41] buyer in a chain of contracts, is notified of the arrival of the goods at destination, but (a) is late in requesting delivery of the goods from the carrier, for whatever reason, or (b) is not yet in possession of the bill of lading, the carrier may, in certain circumstances, deliver the goods without the need for surrender of the bill of lading (article 47), or invoke wide-ranging rights to dispose of the goods (article 48). Thus, a final consignee/endorsee, having paid his seller, under a CIF contract, against tender of a negotiable transport document, may be left empty-handed and unable to sue the carrier for misdelivery. The provisions, apparently intended to provide a solution to the practical problem of negotiable bills of lading being delayed in a chain of international transactions involving different buyers and banks, may seriously undermine the document of title function of the negotiable bill of lading, which is key to its use in international trade.[42]

Mandatory nature of liability

Article 79 sets out the general rule on mandatory application of the liability regime. Accordingly, unless otherwise provided in the Convention, a contractual term is void (a) if it excludes or limits the obligations or liability of the carrier or maritime performing party; and (b) if it excludes, limits or increases the obligations or liability of shipper, consignee, controlling party, holder or documentary shipper (e.g. FOB seller). Thus, in contrast to the Hague-Visby Rules, it is not only the carrier who is subject to mandatory minimum liability standards under the Convention, but also the shipper (and potentially anyone liable for breach of the shipper's obligations, such as the consignee and documentary shipper). While the carrier's liability, which is subject to a financial cap, may be increased contractually, the shipper's liability may not. However, it should again be noted that the shipper's mandatory liability under the Rotterdam Rules is, in any event, not subject to any monetary limitation.

By establishing minimum levels of carrier liability, which apply mandatorily and may not be contractually modified, existing liability regimes seek to ensure the protection of cargo interests with little bargaining power, i.e. small shippers and third-party consignees, against unfair contract terms unilaterally introduced by the carrier in his standard terms of contract.

Volume contracts[43]

So-called "volume contracts", which for the first time are regulated in an international convention, are subject to special rules providing for extensive freedom of contract. This represents an important novel feature, distinguishing the new Rotterdam Rules from existing conventions in the field and, therefore is of particular interest.

Although in general minimum standards of liability apply to contracts covered by the Rotterdam, this is subject to an important exception. So-called "volume contracts", which for the first time are regulated in an international convention, are subject to special rules providing for extensive freedom of contract. This represents an important novel feature, distinguishing the new Rotterdam Rules from existing conventions in the field, and therefore it is of particular interest. By way of background, it seems appropriate to briefly recall the rationale for mandatory regulation of liability in a field where commercial parties contract with one another, and therefore, normally freedom of contract reigns.

All international liability regimes for the carriage of goods by sea currently in force (i.e. the Hague, Hague-Visby and Hamburg Rules) establish minimum levels of carrier liability, which apply mandatorily, that is to say the relevant substantive rules on liability of the carrier may not be contractually modified to the detriment of the shipper or consignee.[44] Contractual increase of the carrier's liability is, however, permitted.[45] The mandatory scope of application of the relevant regimes extends to contracts of carriage which are not individually negotiated between the parties, but are conducted on the carrier's standard terms, as typically contained in or evidenced by a bill of lading or other transport document issued by the carrier.[46]

The main purpose of this approach, common to all established international liability regimes, is to reduce the potential for abuse in the context of contracts of adhesion, used where parties with unequal bargaining power contract with one another. In liner carriage, where few large liner companies dominate the global market[47] and goods are typically shipped under bills of lading or other standard form documents – issued and signed by the carrier and usually drafted in terms favourable to the carrier, with no scope for negotiation

– the potential for abuse arising from the unequal bargaining power of the parties is particularly obvious. By establishing minimum levels of carrier liability, which apply mandatorily and may not be contractually modified, existing liability regimes seek to ensure the protection of cargo interests with little bargaining power, i.e. small shippers and third-party consignees, against unfair contract terms unilaterally introduced by the carrier in his standard terms of contract. Thus, a central feature of the established international legal framework is a restriction of freedom of contract with the legislative intent of ensuring the protection of small shippers and consignees against unfair standard contract terms.

Against this background, the regulation on volume contracts in the Rotterdam Rules, providing contracting parties with extensive freedom of contract, proved to be highly controversial throughout the drafting process.[48]

A volume contract is very broadly defined as "a contract of carriage that provides for the carriage of a specified quantity of goods in a series of shipments during an agreed period of time. The specification of quantity may include a minimum, a maximum or a certain range" (article 1(2)). Parties to a volume contract may derogate from the provisions of the Convention (article 80), subject to certain conditions[49] and subject to some relevant statutory limits on the right to derogate.[50]

These include – on the carrier side – the loss of the right to financial limitation of liability in case of recklessness or intention (article 61); and the obligation, under articles 14(a) and (b) to make and keep the ship seaworthy and to properly crew, equip and supply the ship. Not mentioned in this context is the third aspect of the carrier's seaworthiness obligation, i.e. the obligation to make and keep the vessel cargoworthy (see article 14(c)); therefore, contractual derogation in this respect would, quite surprisingly, be permitted. As far as the shipper's obligations and liabilities are concerned, no derogations are permitted regarding (a) the duty to provide documentation, instructions and information under article 29; and (b) the obligations and (strict) liability arising in the context of dangerous goods, under article 32.

It is important to note that a shipper's liability arising from breach of articles 29 and 32 – which may be extensive, such as in the case of loss of or delay of a vessel, and is not subject to monetary limitation – may not be contractually excluded, limited or modified. This means that a shipper would always be exposed to potentially extensive (and unlimited) liability under the Rotterdam Rules for losses arising from the carriage of dangerous cargo or breach of the obligation to provide certain documentation, information and instruction.[51]

Volume contracts are exempt from the mandatory scope of application of the liability regime, based on the proposition that these types of contract are concluded between parties of potentially equal bargaining power.[52] However, the definition of "volume contract" is extremely wide and no minimum quantity of cargo is prescribed. As a result, almost any type of contract in the liner trade might be devised as a volume contract, subject to almost complete freedom of contract. Given that liner carriage is dominated by a small number of global liner-carriage operators, concerns arise about the position of small shippers, who might face contractual terms unilaterally set by the carrier. Against this background, a central question is whether the statutory safeguards included in the Rotterdam Rules are effective to protect small parties against the use of volume contracts as contractual devices to circumvent the mandatory liability regime.

Parties to a volume contract may derogate from the provisions of the Convention (Art. 80), subject to certain conditions and subject to some relevant statutory limits on the right to derogate.

As between carrier and shipper, derogations from the Convention set out in a volume contract[53] are binding, even if the contract has not been individually negotiated.[54] Although the shipper must be given the opportunity to contract on terms of the Convention, without derogation,[55] in practice, a shipper may find itself under commercial pressure to agree to a volume contract, such as a much higher freight rate that would apply unless consent was given. Similarly, while third parties are only bound by volume contracts if they expressly consent to be bound,[56] it is not clear whether this will ensure the effective protection of small third-party consignees, who in practice may find that their only commercially viable choice is to give their consent. Thus, depending on the approach taken by courts in the application of the relevant provisions, it remains to be seen whether the statutory safeguards are adequate to ensure that notional agreement of a volume contract may not be used as a contractual device to circumvent otherwise applicable mandatory liability rules to the detriment of a small shipper or consignee.

The provisions on volume contracts may, if and when the Convention enters into force, have important repercussions, both for commercial contracting practice and, more generally, for the prospects of international legal uniformity in the field of carriage of goods. If, in future practice, the use of volume contracts with contractual modification of the provisions of the Convention becomes the norm, the potential benefits associated with a predictable internationally uniform liability regime may, in the longer run, fail to materialize.

The provisions on volume contracts may, if and when the Convention enters into force, have important repercussions, both for commercial contracting practice and, more generally, for the prospects of international legal uniformity in the field of carriage of goods.

Concluding remarks

As is true in respect of any new international convention, much will depend on what courts in different jurisdictions make of the complex provisions of the new Convention and how they interpret and apply them in practice. However, as the above analysis shows, there are a number of areas of potential concern, in particular from the perspective of small and medium-sized shippers and consignees in developing countries.

Overall, it appears that the Rotterdam Rules are in substance more favourable to carriers than any of the existing international conventions in the field. Thus, the rules on burden of proof, for instance, seem to be more advantageous to carriers than those in the Hague-Visby or Hamburg Rules, with potentially important consequences for the outcome of legal disputes between carrier and cargo interests. Moreover, the obligations and liability of the shipper, which are much more extensive and detailed than under existing maritime liability regimes, are mandatory, and the shipper's liability is – in contrast to the liability of the carrier – not subject to any monetary limitation. As a matter of policy, this important shift in commercial risk allocation to the detriment of shippers may be of concern to those representing the interests of transport users.[57]

The provisions in chapter 10 which, under certain circumstances, permit the carrier to deliver the goods without surrender of a negotiable transport document are new and potentially problematic, as they may undermine the document of title function of the negotiable bill of lading, which is key to its use in international trade.

The regulation of volume contracts in the Rotterdam Rules, also new and untested, may lead to a state of affairs in which freedom of contract becomes the norm and in which strength of bargaining power matters more than it has since the advent of the Hague Rules in 1924. This would be of particular concern from the perspective of small shippers and consignees, who as a result of commercial pressure might find themselves bound by contractual terms effectively set unilaterally by one of a small number of large global liner-carrying companies. Larger shippers too should be aware that their potentially extensive liability under the Rotterdam Rules for loss arising (at least in part) from the carriage of dangerous goods would be non-negotiable, even in the context of a volume contract. More generally, extensive use of volume contracts in future commercial contracting practice could mean effectively less rather than more uniformity of liability rules at the international level.

In relation to regulation of liability arising from multimodal transport involving an international sea leg, the new Convention adopts an approach which is complex and may give rise to difficulties in its practical application. Substantive liability rules vary, depending on whether a loss may be attributed to a particular non-sea leg of the multimodal transport and on whether existing international conventions governing carriage of goods by land or air would have applied had a separate contract been made for that particular leg of the transport. In summary, the position appears to be as follows:

(a) in cases where a loss was not clearly attributable to a particular modal stage of transport, as will often be the case in containerized transport, the substantively maritime liability regime set out in the Rotterdam Rules would determine the rights and liabilities of the contracting parties, even if the transport was carried out mainly by land;

(b) the position would be the same in cases where a loss arose during land transport, but none of the existing unimodal international conventions would have been applicable, had a separate contract been made for the relevant land leg of transportation;

(c) in cases where a loss could be attributed to a mode of transport other than sea carriage and one of the existing unimodal transport conventions would have applied (had a separate contract

been made), the mandatory provisions on carrier liability, limitation of liability and time for suit contained in the relevant unimodal convention would apply, together with the remainder of the Rotterdam Rules. The mixture of substantive rules from different international conventions which courts in different jurisdictions would, in these cases, need to apply in context is highly complex and clearly likely to lead to nationally differing results.

More generally, the complexity and considerable scope for interpretation inherent in the Convention means that extensive litigation may be required to gain a clear understanding of the new rules, with courts in different jurisdictions adopting potentially differing approaches to interpretation and application of the provisions.[58] The likelihood of conflicting legal proceedings, and ultimately, conflicting judgments at the international level is further compounded by the fact that, as already noted,[59] chapters in the Convention setting out rules on jurisdiction and arbitration are optional for Contracting States, and as a result, contractual jurisdiction and arbitration clauses may be valid under the same conditions in only some but not all Contracting States. Thus, much costly litigation may be required, before a desirable degree of legal certainty may be achieved. This prospect appears to be particularly unfortunate in respect of a new international Convention which aims to establish internationally uniform rules in a variety of jurisdictions; it may also be of concern to commercial parties whose rights and liabilities may in future be regulated by the Rotterdam Rules.

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B. NEGOTIATIONS ON TRADE FACILITATION AT WTO

1. Facilitating trade and transport: How can WTO disciplines help?

Negotiations on trade facilitation have been ongoing since 2004 as part of the World Trade Organization (WTO) Doha Development Round of trade negotiations. With these negotiations, members aim at expediting the release, clearance and movement of goods. Other objectives of the negotiations are to enhance technical assistance and support for capacity-building, and to draft provisions for effective cooperation between customs or any other appropriate authorities on trade facilitation. Trade-supporting service providers and importers and exporters alike stand to gain from these negotiations, mainly through the simplification and harmonization of procedures and formalities in the cross-border movement of goods and enhanced transparency.

The WTO system is based on legal disciplines which ensure trade openness and liberalization. Since 1947, the General Agreement on Tariffs and Trade (GATT) (originally drafted in 1947 and incorporated without any changes in the WTO agreement in 1994) in its articles X, VIII, and V contains disciplines pertaining to the administration and publication of trade regulations (article X), the fees and formalities connected with importation and exportation (article VIII), and the freedom of transit (article V). Against the background of the wide-ranging tariff reductions achieved in the Uruguay Round, efforts to address non-tariff barriers to trade have become more pressing in recent years. The increased use of information technologies and electronic information transmission, together with globalized production networks with reduced inventories, have led countries to seek the review, clarification, and improvement of the relevant GATT disciplines so as to include trade facilitation disciplines as another cornerstone of the multilateral trading system.

2. 2009: Trade facilitation negotiations pick up momentum

The negotiations on trade facilitation are an integral part of the Doha trade negotiations. This means that negotiations on trade facilitation are dependent on progress made in the other areas of the Doha Round. The failure to reach an agreement on the main areas of the Doha Round in July 2008 also affected the meetings of the WTO Negotiating Group on Trade Facilitation (NGTF). In particular at the end of 2008 and the beginning of 2009 the overall pace of negotiations in the NGTF slowed down, with less time being devoted to the review of the textual proposals, and comments made by delegations limited to oral interventions. This

1 The United Nations General Assembly adopted the United Nations Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea on 11 December 2008. The General Assembly authorized the opening for signature of the Convention at a signing ceremony to be held on 23 September 2009 in Rotterdam, the Netherlands, and recommended that the rules embodied in the Convention be known as the "Rotterdam Rules". The text of the Convention, as adopted, is set out in the annex to the General Assembly Resolution A/RES/62/122. It is also contained in annex I of UNCITRAL's report on its forty-first session, document A/63/17, which is available at http://www.uncitral.org. The report itself provides a useful overview of the final discussions, prior to the finalization of the text. All other working documents of Working Group III (Transport) are also available on the UNCITRAL website. Unless otherwise provided, references hereinafter to "articles" relate to provisions in the new Rotterdam Rules.

2 Article 94. The Convention enters into force on the first day of the month following the expiration of one year after the date of deposit of the twentieth instrument of ratification, acceptance, approval or accession.

3 International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, 1924.

4 International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading, 1924 (Hague Rules), as amended by the Visby and SDR protocols of 1968 and 1979.

5 United Nations Convention on Contracts for the Carriage of Goods by Sea, 1978.

6 See article 89(3).

7 Once the Rotterdam Rules have attracted the required number of 20 Contracting States and enter into force, carriage of goods by sea from or to any of the Contracting States may be governed by the Rotterdam Rules or by national law, depending on whether a contract falls within the scope of application of the Rotterdam Rules and on the substantive law which, according to the conflict of law rules of the forum, is held to apply to the dispute. In general, it may be expected that courts in Contracting States to the Hague-Visby Rules would apply neither the Rotterdam Rules nor the Hague-Visby Rules to outward shipments from a Contracting State to the Rotterdam Rules.

8 The United Nations Convention on International Multimodal Transport 1980 has not attracted the required number of 30 ratifications to enter into force. Several states have, however, adopted national laws on multimodal transportation which are based on the 1980 Convention. See: UNCTAD, "Implementation of multimodal transport rules", UNCTAD/SDTE/TLB/2 and Add.1. See also: UNCTAD, "Multimodal transport: the feasibility of an international legal instrument", UNCTAD/SDTE/TLB/2003/1 (available at http://www.unctad.org/ttl/legal).

9 The UNCITRAL Commission, at its thirty-fourth session, created a working group to consider possible uniform regulation in the field of maritime transport. In view of UNCTAD's involvement with the subject, the Commission specifically provided that the work should be carried out in close cooperation with interested intergovernmental organizations, such as UNCTAD. See also the São Paulo Consensus at paras. 93 and 107 for an express mandate of the UNCTAD secretariat to assist developing countries in the ongoing negotiations.

10 Relevant documentation highlighting potential areas of concern, in particular from the perspective of developing countries, is available on the UNCTAD website at http://www.

unctad.org/ttl/legal. For an article-by-article commentary on the original draft legal instrument published in 2002, see UNCTAD/SDTE/TLB/4. Much of the analysis remains relevant, even in respect of the final draft text of the Convention. See also: UNCTAD, Carrier liability and freedom of contract under the UNCITRAL draft instrument on the carriage of goods [wholly or partly] [by sea], UNCTAD/SDTE/TLB/2004/2. The documentation is also available on the UNCITRAL website as working documents A/CN.9/WG.III/WP.21/Add.1, A/CN.9/WG.III/WP.41 and A/CN.9/WG.III/WP.46.

11 A bibliography of academic writing on the Rotterdam Rules is available on the UNCITRAL website (http://www.uncitral.org). For an analytical overview of the Convention, see, for instance: Diamond A (2008), The Next Sea Carriage Convention? Lloyd's Maritime and Commercial Law Quarterly (LMCLQ) 135; and Thomas D R (2008), An appraisal of the liability regime established under the new UN Convention, 14, Journal of International Maritime Law (JIML) 496. See also: Sturley M (2008), Transport law for the twenty-first century: an introduction to the preparation, philosophy, and potential impact of the Rotterdam Rules, 14, JIML 461. For earlier analysis of different aspects of the draft legal instrument, see the papers of a colloquium held in 2002 in Romsey, published in LMCLQ (2004) 304–417; and papers of an international symposium held in 2004 in Hamburg, published in Transportrecht (2004) 274–308.

12 On the industry side, strong opposition against ratification of the new Convention has been voiced by the European Shippers' Council (ESC), which represents the interests of 12 national transport user organizations/shippers' councils from 12 countries (see the ESC position paper of 24 March 2009 and press release of 29 June 2009, available at http://www.europeanshippers.com), and by CLECAT (the European Association for Forwarding, Transport, Logistic and Customs Services), which represents European freight forwarders, logistics service providers and customs agents (see the CLECAT position paper of 29 May 2009, available at http://www.clecat.org). According to information in the ESC press release (above), the European Commission too has serious reservations about ratification and intends to release proposals for the development of a EU equivalent later in 2009. The press release refers to a statement made by the head of the European Commission's Directorate-General for Transport and Energy at an ESC seminar on 22 June 2009 in Antwerp, in which he is quoted as noting, inter alia, that the new Convention "was not conforming to the European multimodal expectations".

13 Note, for instance, the conclusions of Thomas D R (2008), An appraisal of the liability regime established under the new UN Convention, 14, JIML 496, at 511: "The Rules are a formidably comprehensive and complex code, as the survey of the liability regime undertaken in this article amply confirms. Their vulnerability ultimately is not necessarily to be attributed to the legal principles and framework that is propounded but to their suffocating wordiness, careless use of language and persistent refusal to abide by the basic rules of elegant and effective drafting. When the time comes to put the drafting to the test [. . .] it is suspected that the Rules may be found to be wanting and productive of more disputes than might be considered healthy for the shipping industry." See also: Tetley W (2008), Some general criticisms of the Rotterdam Rules, 14, JIML 625, at 626.

14 On this aspect, see Diamond A (2008), The next sea carriage Convention? LMCLQ 135; van der Ziel G (2008), Delivery of the goods, rights of the controlling party and transfer of rights, 14, JIML 597; Asariotis R (2008), What future for the bill of lading as a document of title? 14, JIML 75. See also: Asariotis R (2004), Main obligations and liabilities of the shipper, Transportrecht 284.

15 On this aspect, see Williams R (2008), Transport documentation under the new Convention, 14, JIML 566. For some analysis of earlier drafts of the text, see also: Clarke M (2002), Transport documents: their transferability as documents of title; electronic documents. LMCLQ 356; and Schelin J (2004), Documents, Transportrecht 294.

16 On this aspect, see Goldby M (2008), Electronic alternatives to transport documents and the new Convention: a framework for future development? 14, JIML 586. For some comments regarding earlier drafts of the text, see also: van der Ziel G (2003), The legal underpinning of e-commerce in maritime transport by the UNCITRAL Draft Instrument on the Carriage of Goods by Sea, 9, JIML 461.

17 See articles 74 and 78. In general, the rules on jurisdiction and arbitration that are set out in chapters 14 and 15 only apply if a Contracting State declares that it will be bound by them. In the absence of such a declaration, national rules would apply to determine whether contractual choice of a forum is admissible. Both chapters envisage a list of places, at the claimant's choice, for the institution of legal/arbitral proceedings against the carrier. Contractual choice of forum is only permitted in the context of volume contracts, and under certain conditions, but the position of third parties is specially regulated. Whether third parties are bound by a contractual choice of forum depends on the "law of the court seized" (in the case of jurisdiction clauses) or the "applicable law" (in the case of arbitration clauses) and on whether the selected forum is situated in one of the listed places. There is considerable uncertainty associated with the practical application of these provisions in different jurisdictions, which may or may not have opted into the jurisdiction and arbitration chapters. For detailed analysis, see Baatz YM (2008), Jurisdiction and arbitration under the Rotterdam Rules, 14, JIML 608. On this issue, at an earlier stage of the negotiation process, see also: Berlingieri F (2004), Freedom of contract under the Rules, Forum and Arbitration Clauses, Transportrecht 303.

18 For some discussion of earlier drafts of the text, see, for instance: Sturley MF (2005), Solving the scope-of-application puzzle: contracts, trades and documents in the UNCITRAL transport law project, 11, JIML 22; and Rosaeg E (2002), The applicability of conventions for the carriage of goods and for multimodal transport, LMCLQ 316.

19 Contract of carriage is defined in article 1(1) as a "contract in which the carrier, against the payment of freight, undertakes to carry goods from one place to another. The contract shall provide for carriage of goods by sea and may provide for carriage by other modes of transport in addition to sea carriage."

20 For an analysis of relevant provisions, see Hancock C (2008), Multimodal transport and the new UN Convention on the carriage of goods, 14, JIML 484. In relation to earlier versions of the draft conventions, see Hoeks M (2008), Multimodal carriage with a pinch of sea salt: door-to-door under the UNCITRAL draft instrument, European Transport Law 257; Faghfouri M (2006), International regulation of liability for multimodal transport—in search of uniformity, World Maritime University (WMU) Journal of Maritime Affairs 61; Haak KF and Hoeks M (2004), Arrangements of intermodal transport in the field of conflicting conventions, 10, JIML 422; Clarke M (2003), A conflict of conventions: The UNCITRAL/CMI draft transport instrument on your doorstep, 9, JIML 28; Czerwenka B (2004), Scope of application and rules on multimodal transport contracts, Transportrecht 297; and Alcantara JM (2002), The new regime and multimodal transport, LMCLQ 399.

21 See the definition of contract of carriage set out in article 1(1): "Contract of carriage" means a contract in which a carrier, against the payment of freight, undertakes to carry

goods from one place to another. The contract shall provide for carriage by sea and may provide for carriage by other modes of transport in addition to sea carriage". The definition has been criticized as lacking in precision, as different approaches to the interpretation of the second sentence of the provision appear possible. For some discussion of different approaches to interpretation, see Diamond A (2008), The next sea carriage Convention? LMCLQ 135 at 140.

22 The substantive scope of application and the provisions regulating the application of the Convention to multimodal transport remained controversial, even at the UNCITRAL Commission meeting at which the final text was agreed, with some States proposing to make the multimodal application of the new international regime optional, or proposing to provide for continued applicability of existing national law. Others expressed concern about the suitability of the substantive liability regime in the context of international multimodal transportation. See A/63/17 at paras. 23, 93–98 and 270–278.

23 Ibid.

24 In particular the Convention on the Contract for the International Carriage of Goods by Road (1956), as amended by the 1978 Protocol (the "CMR"), the Uniform Rules concerning the Contract for International Carriage of Goods by Rail (appendix B to the Convention concerning International Carriage by Rail, as amended by the Protocol of Modification of 1999 (the "CIM-COTIF"), the Convention for the Unification of Certain Rules for International Carriage by Air 1999 (the "Montreal Convention"), and the Budapest Convention on the Contract for the Carriage of Goods by Inland Waterways, 2000 (the "CMNI").

25 Only the application of existing international conventions (and any relevant future amendments thereto on carrier liability) has been preserved; see article 82. For relevant discussions at the 2008 UNCITRAL Commission session, see A/63/17 at paras. 249–254.

26 The term "carrier" is defined in article 1(5), as "a person that enters into a contract of carriage with a shipper". On carrier liability, see, for instance: Nikaki T (2008), The fundamental duties of the carrier under the Rotterdam Rules, 14, JIML 512; Honka H (2004), Main obligations and liabilities of the carrier, Transportrecht 278; and Berlingieri F (2002), Basis of liability and exclusions from liability, LMCLQ 336.

27 Defined in articles 1(7) and (6). Accordingly, a maritime performing party is a party that performs or undertakes to perform any of the carrier's obligations, at the carrier's request or under his supervision, "during the period between arrival of the goods at the port of loading and their departure from the port of discharge. An inland carrier is a maritime performing party only if it performs or undertakes to perform its services exclusively within a port area."

28 Liability for delay in delivery only arises in cases where a time for delivery has been agreed in the contract. Delay is defined in article 21: "Delay in delivery occurs when the goods are not delivered at the place of destination provided for in the contract of carriage within the time agreed."

29 See article 59, according to which "the carrier's liability for breaches of its obligations under this Convention is limited to 875 [SDR] per package or other shipping unit or 3 [SDR] per kg of the gross weight of the goods that are subject to the claim or dispute, whichever amount is higher," except where a higher value of the goods has been declared or a higher limit of liability has been agreed. Note that for potential liability from delay in delivery, a separate limit of 2.5 times the agreed freight applies (article 60). This is similar to the corresponding limit in the Hamburg Rules.

30 The relevant limitation amounts under the Hague-Visby Rules and Hamburg Rules are 666.7 SDR/pkg or 2 SDR/kg, and 825 SDR/pkg or 2.5 SDR/kg, respectively.

31 Note that while there is an express seaworthiness obligation, there is no corresponding obligation in respect of vehicles other than ships that may be used in the performance of the contract.

32 Note in particular articles 17(3) (f), (h), (i), (n) and (o). The so-called "nautical fault" exemption has been omitted (cf. article IV r. 2(a) HVR), as has the so-called "catch-all" exemption (article IV, r. 2(q) HVR). The fire exemption (cf. article IV r. 2(b) HVR) has been retained, but it no longer protects the carrier in cases of proven negligence (cf. article 17(4)). Exempting events/circumstances without express parallel in the Hague-Visby Rules include "loading, handling, stowage or unloading of the goods" performed pursuant to a "free in and out stowage" (FIOS)-type agreement which is now expressly permitted under article 13(2), as well as "reasonable measures to avoid or attempt to avoid damage to the environment." Moreover, the list of events or circumstances includes "acts of the carrier in pursuance of the powers conferred by articles 15 and 16". Article 15 deals with potentially dangerous cargo and gives the carrier broad rights, "notwithstanding" its obligations regarding delivery of the goods and care of cargo (articles 11 and 13), to dispose of goods. Article 16 gives the carrier a broad right to "sacrifice goods at sea", "notwithstanding" articles 11, 13 and 14, i.e. irrespective of the carrier's seaworthiness obligation.

33 A "documentary shipper" is defined in article 1(9) as "a person, other than the [contracting] shipper, that accepts to be named as "shipper" in the transport document or electronic transport record."

34 For detailed analysis, see Asariotis R (2008), Burden of proof and allocation of liability for loss due to a combination of causes under the Rotterdam Rules, 14, JIML 537. For earlier analysis, see also: UNCTAD (2004), Carrier liability and freedom of contract under the UNCITRAL draft instrument on the carriage of goods [wholly or partly] [by sea], UNCTAD/SDTE/TLB/2004/2; and Asariotis R (2002), Allocation of liability and burden of proof in the draft instrument on transport law, LMCLQ 382.

35 Ibid. See also: Sturley M (2009) Modernizing and Reforming US Maritime Law: The Impact of the Rotterdam Rules in the United States, 44, Texas International Law Journal 427 at 447–448 and Hooper C (a former president of the United States Maritime Law Association and member of the United States delegation to the UNCITRAL Working Group), The Rotterdam Rules – simpler than they appear, The Arbitrator 40 (2009) 5, available at http://www.smany.org/sma/pdf/Vol40_No3_Apr2009.pdf.

36 The term "shipper" is defined in article 1(8) as "a person that enters into a contract of carriage with a carrier". On the liability of the shipper, see Baughen S (2008), Obligations of the shipper to the carrier, 14, JIML 555 at 564. For analysis of the relevant provisions, as contained in an earlier text of the draft convention, see Asariotis R (2004), Main obligations and liabilities of the shipper, Transportrecht 284. See also: Zunarelli S (2002), The liability of the shipper, LMCLQ 350.

37 Information duties and any potential liability for failure to comply may, in future, become more relevant as a result of international and national regulation to enhance maritime and supply-chain security. Potential losses could arise, for instance, as a result of the delay of a vessel, or due to a failure on the part of the shipper to provide required documentation or information. For some information, see an UNCTAD report published in 2004 entitled "Container security: major initiatives and related international developments" (UNCTAD/SDTE/TLB/2004/1), which is available at http://www.unctad.org/ttl/legal.

38 See notes 34 and 35, above.
39 However, note that a two-year time bar applies to all claims under the Convention, article 62.
40 See article 58(2), which states that a "holder" who "exercises any rights under the contract of carriage" also "assumes any liabilities imposed on it under the contract of carriage". However, it has been argued, with reference to the wording of articles 58(2) and 79(2)(b) that the statutory obligations set out in chapter 7 may be personal to the shipper, and cannot be contractually transferred to a third-party consignee. See Baughen S (2008), Obligations of the shipper to the carrier, 14, JIML 555 at 564; and the discussion by Williams R (2008), Transport documentation under the new Convention, 14, JIML 566 at 583.
41 CIF stands for Cost, insurance and freight. See INCOTERMS 2000, published by the International Chamber of Commerce.
42 For an overview of the role and function of different types of transport documents, see UNCTAD: The use of transport documents in international trade, UNCTAD/SDTE/TLB/2003/3, paras. 9–42, available at http://www.unctad.org/ttl/legal. For a critical assessment of the approach adopted in the Rotterdam Rules, see the references in note 14, above.
43 For analysis of the regulation of volume contract under the Convention, see Asariotis R, UNCITRAL draft convention on contracts for the carriage of goods wholly or partly by sea: Mandatory rules and freedom of contract, in: Antapassis, Athanassiou and Rosaeg eds. (2009), Competition and regulation in shipping and shipping-related industries, Martinus Nijhoff 349. On this issue, at an earlier stage of the negotiation process, see also: Berlingieri F (2004), Freedom of contract under the Rules; Forum and Arbitration Clauses, Transportrecht 303.
44 See article III, r.8 of the Hague Rules and the Hague-Visby Rules and article 23 of the Hamburg Rules.
45 Article V of the Hague-Visby Rules and article 23(2) of the Hamburg Rules.
46 The mandatory application of the Hague Rules and the Hague-Visby Rules extends to "bills of lading or similar documents of title" (see article I(b) of the Hague-Visby Rules). Non-negotiable seawaybills are not expressly covered. However, as they are also standard form documents, issued by a carrier and operating as a receipt and as evidence of a contract of carriage, the national legislation of some States extends the protection of the Hague Rules and the Hague-Visby Rules to non-negotiable seawaybills. The Hamburg Rules apply to all contracts for the carriage of goods by sea, other than charter parties (articles 1(6), 2(1) and (3) of the Hamburg Rules) and thus include contracts covered by negotiable as well as non-negotiable transport documents. See the UNCTAD report entitled "The use of transport documents in international trade", UNCTAD/SDTE/TLB/2003/3.
47 See chapter 4, table 32.
48 For an overview of the genesis of the set of provisions dealing with volume contracts and the relevant debate within the UNCITRAL Working Group, see the final report of the Working Group, A/CN.9/645 at paras. 235–253. Relevant proposals submitted by delegations in the course of the UNCITRAL Working Group deliberations concerning volume contracts are contained in documents A/CN.9/WG.III/WP.34 and 42 (United States), and in document A/CN.9/WG.III/WP.88 (Australia and France). Relevant submissions by Governments to the UNCITRAL Commission at which the text was finalized are available on the UNCITRAL website (under Commission documents for the forty-first session). It should be noted that a number of delegations, including Australia, New Zealand and China, had expressed particular concerns in relation to the treatment of volume contracts. These, however, did not lead to a change in the final text as adopted by the Commission.

49 Article 80(2).
50 Article 80(4).
51 It should again be noted that information duties and any potential liability for failure to comply may, in future, become more relevant as a result of international and national regulation to enhance maritime and supply-chain security—see note 37, above.
52 See only the report of the UNCITRAL Working Group on the work of its final session in January 2008, A/CN.9/645, at para. 36.
53 While derogations must be set out in the volume contract, incorporation of (standard) terms by reference is permitted; see article 80(2) and (3).
54 Article 80(2)(b).
55 Article 80(2)(c).
56 Article 80(5).
57 It should be noted that at the time of writing, ratification of the Convention appears to enjoy the support of carrier representatives such as the European Community's Shop-owners Associations (ECSA), the International Chamber of Shipping (ICS) and the World Shipping Council (WSC), whereas strong opposition has been expressed by the European Shippers' Council (ESC) and freight forwarders' organization CLECAT as well as the International Association of Freight Forwarders Associations (FIATA). Position papers by these and some other industry representatives are available on the UNCITRAL website at http://www.uncitral.org.
58 See also note 13, above.
59 See note 17, above, and the accompanying text.
60 The 1988 SUA Convention came into force on 1 March 1992. As at 2 October 2009, it had 154 parties, representing 93.45 per cent of world tonnage. Its text can be found at http://www.admiraltylawguide.com. For its latest updated status, check the IMO website at http://www.imo.org.
61 For a description of amendments to the 1988 SUA and its 1988 Protocol adopted in 2005 under the auspices of IMO, see the *Review of Maritime Transport 2006.* As at 2 October 2009, the 2005 amendment to the SUA Convention had not yet entered into force. Only nine Contracting States had become parties, representing 6.01 per cent of world tonnage.
62 Reports are issued under the MSC.4/Circ series. Their texts can be found at http://docs.imo.org.
63 http://www.icc-ccs.org
64 IMO, in its "Code of practice for the investigation of crimes of piracy and armed robbery against ships" distinguishes "piracy" from "armed robbery against ships", with "piracy" being restricted to unlawful acts as defined in article 101 of the 1982 United Nations Convention on the Law of the Sea. The code of practice was adopted in November 2001 during the twenty-second session of the IMO Assembly, by resolution A/922(22). For the text of the code, see MSC 74/24/Add.1—Report of the MSC at its seventy-fourth session, annexes 1–22, annex 18, article 2.2; or MSC/Circ.984; available at http://www.docs.imo.org. The ICC International Maritime Bureau (IMB) defines "piracy and armed robbery" as: "an act of boarding or attempting to board any ship with the apparent intent to commit theft or any other crime and with the apparent intent or capability to use force in the furtherance of that act." This updated definition covers actual or attempted attacks whether the ship is berthed, at anchor or at sea (http://www.icc-ccs.org).
65 ICC-IMB Piracy and Armed Robbery Against Ships Report—Annual Report 2008.

Appendix K
Freight Calculations

Air Freight: Conversion Table

Physical Weight and Linear Measure

- Conversion from pounds to kilos: multiply by 0.4536
- Conversion from kilos to pounds: multiply by 2.2046
- Conversion from metric ton to kilos: multiply by 1,000
- Conversion from inches to centimeters: multiply by 2.54
- Conversion from centimeters to inches: multiply by 0.453592

Dimensional Weight (Volume Weight)

For every shipment, physical weight is compared to dimensional weight and the *higher of the two* is used to determine the shipment cost. IATA standard is based on 6,000 cubic centimeters per kilogram:

Example: length (centimeters, cm) x width (cm) x height (cm)/6,000 = volume kilos
length (inches) x width (inches) x height (inches)/366 = volume kilos
length (inches) x width (inches) x height (inches)/166 = volume pounds

One pallet with the following dimensions: 150 kgms and 122 x 102 x 127 cms
Weight: 150 kgms or 122 × 102 × 127/6,000 = 263.40 volume kilos

One pallet with the following dimensions: 150 kgms and 48 x 40 x 50 inches
Weight: 150 kgms or 48 × 40 × 50/366 = 262.30 volume kilos

One pallet with the following dimensions: 150 kgms and 48 x 40 x 50 inches
Weight: 150 kgs or 48 × 40 × 50/166 = 578.31 volume pounds

Sea Freight: Conversion Table

Physical Weight and Linear Measure

- Conversion from pounds to kilos: multiply by 0.4536
- Conversion from kilos to pounds: multiply by 2.2046
- Conversion from metric ton to kilos: multiply by 1,000
- Conversion from long ton to pounds: multiply by 2,240
- Conversion from short ton to pounds: multiply by 2,000
- Conversion from inches to centimeters: multiply by 2.54
- Conversion from centimeters to inches: multiply by 0.453592
- Meters to feet: multiply by 3.281

Dimensional weight (volume weight)

1,000 kilos or 1 cubic meter

- Conversion from cubic meters to cubic feet: multiply by 35.3145
- Conversion from cubic feet to cubic inches: multiply by 1,728
- Conversion from cubic meters to cubic centimeters: multiply by 1,000,000
- Conversion from volume kilos to cubic meters: multiply by .006

One pallet with the following dimensions: 150 pounds and 45 x 45 x 60 inches
Actual weight: 1,500 lbs or 1,500/2.2046 = 680 kilos

Volume: 45 x 45 x 60 /1,728 = 70.30 cubic feet; 70.30/ 35.32 = 1.99 cubic meter. One cubic meter is equivalent to 1,000 kilos. Thus, freight will be based on volume.

Appendix L
Sample Export Business Plan: Donga Michael Export Company

Executive Summary

Donga Michael is a newly created export company located in Fort Lauderdale, Florida. The company started its operation in September 2010. It exports computers and parts to the Republic of South Africa. Trade in computers between the United States and South Africa has been growing at a faster rate since the end of apartheid. The company intends to supply high-quality computers to the business sector and, later, to schools and universities.

South Africa is the largest computer market for the United States in sub-Saharan Africa. Every year, it imports computer peripherals and accessories worth more than $60 million. With the end of apartheid and the lifting of sanctions, South Africa is open for trade and investment. The development of a black professional and business class and the building of infrastructure facilities to enable all South Africans to participate in the economic life of the country provide enormous business opportunities for U.S. exporters of information technology. Even though there is strong price competition in the computer sector, Donga Michael will focus on the upper end of the consumer market. Donga Michael's competitive advantages over existing companies include a coordinated marketing program, prompt delivery and services, and a professional image and expertise in the North American market.

President and founder George Hunat brings a wealth of experience to the firm. Vice President Alice Munroe also has extensive marketing experience. The estimated required investment is $200,000. Mr. Hunat will invest $40,000 of his own personal funds in the business. Ms. Munroe will invest $35,000, while $80,000 will be borrowed from a local bank. The balance of $45,000 is solicited from a venture capitalist, who will acquire 37.5 percent of the corporation stock.

The company intends to become a major player in the South African market in the coming years, capturing about 20 percent of the computer market. After this objective is realized, the company intends to explore export opportunities in Zimbabwe, Zambia, and Kenya.

General Industry and Company

The South African computer market is valued at more than $1 billion and is changing its focus from mainframes to personal computers (PCs) and PC-based networks. The increasing processing power coupled with decreasing prices for personal computers is also boosting demand for laptop computers and peripheral equipment, including printers and storage devices. Opportunities exist for sales of computers, peripherals, and accessories, as South African manufacturing and service companies seek to become more competitive in the domestic and global marketplaces. Presently, about four U.S. companies sell computer hardware to the South African market. Local manufacture of PCs remains negligible, and there is an increasing demand for established computer brand-name products. Donga Michael intends to bring such products into the market at competitive prices to help regain the market share lost during the sanctions period. With closer economic relations between South Africa and other African countries, the South African market will become the beachhead from which exports could be made to neighboring states, such as Zimbabwe, Zambia, Kenya, Tanzania, and Uganda. An encouraging development pertaining to the industry is the revision of U.S. controls on computer exports in 2006. The new regulations eliminate or significantly ease controls on computer exports to most countries of the world, except those designated as terrorist states. There are no U.S. restrictions on computer products and accessories that Donga Michael plans to export to South Africa. A problem that plagues the industry in the short term, however, is the shortage of trained manpower to manage the complex and interconnected networks proliferating everywhere.

Donga Michael is a newly created export firm that is incorporated as a Chapter S corporation in the state of Florida. The company will market digital ABD machines with central processing input-output units, parts and accessories, laptop and notebook computers, networking software, and software for computer-aided design and electronic design automation. The products need not be adapted for the South African market except for the different voltages (i.e., 100v). George Hunat and Alice Munroe are the two partners of the firm and also manage the company as president and vice president, respectively.

Target Market

South Africa has a gross domestic output of $364 billion and a per capita income of $11,300 (as of 2012) and remains the largest economy in sub-Saharan Africa. It possesses a modern infrastructure, supporting an efficient distribution of goods to major urban centers throughout the region, and well-developed financial, legal, and communications sectors. Its economic growth has been in the range of 3 to 3.5 percent over the past five years. However, with favorable economic conditions and a stable political climate, it is likely to register higher rates of growth, estimated at 5 to 10 percent, in the next few years and beyond. This is critical to offset high unemployment rates. Present efforts to revamp the educational system, boost economic productivity, and provide access to basic services to all South Africans present opportunities for U.S. companies to export computers and other information technology.

Total U.S. merchandise exports to South Africa in 2012 amounted to $7.6 billion. The South African information technology market is the twentieth largest in the world and constitutes one of the top ten emerging markets being targeted by international computer companies. The base of installed personal computers is slightly more than 950,000, and indications are

that 84 percent of the top information technology users are investing in client-server systems. Information and communications technology spending is likely to grow from $13 to $18 billion in the next few years. The U.S. market share for computer peripherals was estimated at about 30 percent in 2005, amounting to about $45 million. A couple of reasons account for the continual expansion of the market for computer peripherals and accessories:

1. Because the country ended its isolation and instituted a democratic political system for all South Africans, there is a significant inflow of foreign investment. For example, between 2005 and 2007, more than 200 companies set up factories or offices in South Africa. This creates business opportunities for exports of computers and information technology.
2. The black middle class has experienced faster growth since the end of the apartheid system. This emerging professional and business class will soon be a big consumer market.

In terms of market access, there are no restrictions or quotas on computer peripheral imports to South Africa. These imports are, however, subject to a 10 percent ad valorem tariff and a 14 percent value-added tax. There are no nontariff barriers such as requirements for prior deposits or foreign exchange restrictions.

There is fierce competition in the South African market. Acer Africa is the top PC assembler and distributor, followed by Mustek electronics and IBM. Third-country suppliers from the Far East, Britain, France, Germany, and Italy are also present. Donga Michael should focus on the upper end of the consumer market for use by the business sector. In spite of the relatively high prices charged for its products compared to those of the competition, discerning firms know the value of quality products and would be favorably disposed to buying U.S.-made computers and parts. U.S.-branded peripherals have high status in South Africa.

Marketing Plan and Sales Strategy

Donga Michael Inc. intends to target the middle- to upper-level business firms that are in the process of using computers for various office functions, such as finance and accounting, word processing, electronic communication, and presentation. It should later begin to focus on high schools, universities, and research centers by entering into a supply agreement with the government. The company can establish retail outlets in major cities, and, since it represents a well-known brand, it can have a marketing advantage.

Donga Michael can also promote sales by participating in computer trade exhibitions, advertising, and carefully managed public relations programs, such as sponsorship of special events, charitable donations to social causes, and so on.

TABLE L.1 U.S. Exports/Imports to South Africa (Exports/imports of electronic products ($ thousands)

Year	2010	2011	2012
U.S. Exports	360,532	436,821	488,332
U.S. Imports	64,800	79,800	76,843

Source: Comtrade. International Trade Statistics. United Nations

Management and Organization

The company is managed by George Hunat, founder and president, and Alice Munroe, vice president and director of sales and marketing. George Hunat has an MSc in computer engineering from Emory University in Atlanta, Georgia. Since graduating in 1985, he has worked as director of logistics for a multinational firm in San Diego, California (1985–1989), and later joined a successful computer export firm in Silicon Valley, California, as export manager (1989–1997). He has extensive experience in computer sales, marketing, and logistics operations. Alice Munroe received a BA in computer systems from Texas A&M in 1987 and has since worked as a marketing manager for a communications firm in New York.

Donga Michael will employ six people and a clerk. The employees will be trained to handle distribution, storage, transportation, and marketing of Donga Michael's computer products. Two of the trainees will be sent to South Africa to handle marketing and distribution. They will also recruit and train South African employees who will handle the retail outlets in major urban centers. For the first few years, the retail outlets will be located in Johannesburg, Pretoria, and Cape Town.

The employees and clerk will be paid hourly at $8.00 and $6.00 per hour, respectively. The capital structure and salary levels are as follows:

Long-Term Development Plan

Donga Michael plans to show steady progress over the next five years, becoming one of the largest retailers of computers and parts in South Africa. It plans to capture 20 percent of the market by 2020.

The marketing staff will be increased as more sales are generated. Additional sales distribution outlets will be established in other urban areas. After five years, the company plans to expand to Zimbabwe, Zambia, and Kenya. Additional bank financing will be secured to finance the expansion.

TABLE L.2 Ownership Structure

Partners	Capital	Ownership Share	Salary/month
George Hunat	$40,000 (20%)	33.33%	$3,500
Alice Munroe	$35,000 (18%)	29.16%	$3,000
Bank Loan	$80,000 (40%)	——	
Venture capital	$45,000 (23%)	37.50%	

Future increases in salary will be based on sales performance.

TABLE L.3 Financial Plan: Donga Michael Export Company Forecasted Income Statements for the Ending Year

	2010	2011	2012	2013
Sales	$120,000	$1,120,000	$3,980,000	$5,200,000
Less cost of goods sold	30,000	350,000	600,000	1,350,000
Commission	10,000	120,000	200,000	420,000
Delivery	32,000	60,000	98,000	150,000
Total variable expenses	**72,000**	**530,000**	**898,000**	**1,920,000**
Less fixed expenses				
Rent	10,000	10,000	10,000	10,000
Advertising	15,000	22,000	25,000	60,000
Travel	20,000	25,000	27,000	20,000
Utilities	7,000	7,500	7,700	8,000
Wages	25,000	38,000	45,000	45,000
Misc.	15,000	18,000	22,000	25,000
Total fixed expenses	**92,000**	**120,500**	**136,700**	**168,000**
Net Income	**(44,000)**	**469,500**	**2,945,300**	**3,112,000**

TABLE L.4 Forecasted Balance Sheet for the Ending Year

Assets	**2010 ($)**	**2011($)**	**2012 ($)**	**2013 ($)**
Cash	$40,000	$165,000	$600,000	$750,000
Accounts receivable	420,000	500,000	700,000	850,000
Inventory	100,000	150,000	160,000	220,000
Other	320,000	400,000	500,000	650,000
Less depreciation	15,000	25,000	30,000	45,000
Total assets	**865,000**	**1,190,000**	**1,930,000**	**2,425,000**

Liabilities	**2010 ($)**	**2011 ($)**	**2012 ($)**	**2013 ($)**
Accounts payable	150,000	220,000	230,000	150,000
Long-term debt	80,000	50,000	40,000	22,000
Retailed earnings	——	220,000	200,000	400,000
Total liabilities and capital	**230,000**	**490,000**	**470,000**	**572,000**

Appendix M
Sample Import Business Plan: Otoro Import Company

Executive Summary

Otoro Imports is a spice importing and marketing corporation established in June 2011. It is located in Los Angeles, California, and specializes in the importation and marketing of high-quality spices at competitive prices. The company also provides certain programs to educate and inform distributors, retailers, and consumers about the use and health benefits of spices.

The United States is the world's largest spice importer and consumer. With the increased ethnic diversity of the population, the strong U.S. dollar, and limited domestic production, there is greater demand for and affordability of such foods. The industry is dominated by a small number of companies. Otoro intends to import three types of spices: black and white pepper, paprika, and cinnamon, products showing fast growth in domestic demand.

The management team includes David Lee, president, and Howard Tzu, vice president. They both have extensive experience in the spice industry. The company has hired four full-time employees and a clerk. It will hire additional employees as the need arises. The company will market the imports through its retail outlets in California, Florida, and New York and through outside distributors in other states. Its future plan includes expansion to Canada and Mexico and a substantial presence in the U.S. market by 2015, probably controlling about 25 percent of the market.

General Description of Industry and Company

Otoro Imports intends to import spices from various countries for sale and distribution in the United States. Besides the importation and marketing of high-quality spices, Otoro intends to provide education programs to its distributors and retailers about the various types of spices, their uses, and their health benefits. As sales volume increases, the company also plans to hold free public seminars to inform and educate the North American consumer about the benefits and usage of various spices. The company aims to be known as the premier

spice importing and marketing firm in North America. Its development goals are for steady expansion, with profitability by the second year.

The United States is the world's largest spice importer and consumer. Per capita consumption totaled 3.5 pounds in 2008 and was expected to grow in the next few years. A number of factors contribute to the growing demand for spices in the United States. First, the growth of ethnic populations has caused a surge in the use of the spices common to their different cultures. According to the U.S. census, the Asian and Hispanic populations grew by 4.0 and 8.5 million, respectively, between 1995 and 2005. Second, ethnic foods have become increasingly popular in the United States. Nowadays, it is rare to see a typical shopping center without an ethnic restaurant. There is also a trend toward the use of spices to compensate for reduced salt and fat levels in foods.

The industry is dominated by a small number of companies that process and market imported or domestically produced spices. For example, McCormick/Schilling accounts for about 37 percent of the U.S. retail market. Given the trend toward mergers in most sectors, there is a possibility of mergers and acquisitions in the spice industry, resulting in fewer, larger firms.

Otoro intends to import high-quality spices at competitive prices. It ensures importation of top-quality spices by maintaining constant communication with foreign producers and stationing a quality control specialist at most export locations to determine and advise on quality before importation into the United States. Importation from Indonesia, India, and China of seven of the most popular spices in the United States (vanilla beans, black and white pepper, capsicum, sesame seed, cinnamon, mustard, and oregano) is planned over the next five years because of these countries' comparative advantages in climate, soil, and labor costs.

The seven products to be imported make up about 75 percent of U.S. spice imports (see Table M.1). The import of spices increased from 292,074 tons in 2004 to 510,874 tons in

TABLE M.1 U.S. Spice Imports

Product	Profile
Vanilla beans	Imports average more than $62 million a year. Major suppliers include Comoros, Madagascar, and the Pacific Islands. Mainly used for ice cream.
Black and white pepper	Imports average more than $55 million a year for black pepper and about $12 million for white pepper. Major suppliers are Brazil, India, and Indonesia. Used as seasonings for food.
Capsicum and paprika peppers	Capsicum peppers are mainly imported from China, India, Mexico, and Palestine. Paprika is imported from Hungary, Morocco, and Spain. Total imports amount to more than $62 million a year.
Mustard seed	Import value averages $138 million a year. There is some domestic production. Most imports come from Canada.
Cassia and cinnamon	Widely used for doughnuts. Most imports come from Indonesia. Import value averages about $30 million a year.
Oregano	Mostly used for pizza. Imported from Mexico and Turkey. Annual imports average about $14 million a year.
Sesame seed	Used in the fast-food sector. Imported from Guatemala, El Salvador, and Mexico. Import value averages about $45 million a year.

2009. There has been a marked increase in spice imports since 2000. Otoro will import three products during the first two years: black and white pepper, paprika, and cinnamon.

Presently, there are no restrictions on the importation of spices into the United States. However, food safety regulations require that spices be treated to kill insects and microorganisms that thrive under tropical conditions.

Otoro will market the imported spices through its retail outlets in California, New York, and Florida. In other states, the product will be marketed through distributors.

Target Market

Otoro intends to operate retail outlets in major metropolitan centers of California (Los Angeles, San Diego, and San Jose), Florida (Jacksonville, Miami, and Tampa), and New York (New York City, Buffalo, and Rochester). In other states, the products will be marketed through distributors. The major customers include restaurants, fast-food chains, and individual consumers.

Imports have played an important role in the American diet by providing needed spices throughout the year and by moderating retail prices during times of shortages or other disruptions in domestic production. The United States produces a limited supply of spices—garlic, onions, mustard, ginger, and capsicum pepper—and its average annual exports are estimated at $89 million. However, the United States imported about 92 percent of the spices consumed domestically as of 2008, and thus there is heavy reliance on foreign suppliers. The volume of spice imports has grown substantially in the past decade. The major suppliers include Canada, China, India, Indonesia, and Mexico. India has supplied the largest share during the past few years.

A number of factors contribute to steady growth and expansion of spice imports in the United States:

- Given the current per capita consumption, total domestic use of spices is likely to increase by more than $300 million over the next few years.
- The increased ethnic diversity of the U.S. population will lead to more consumption of spices.
- Because domestic production of spices is limited in volume and variety, the United States will continue to import more than 90 percent of its domestic spice needs.
- The increased value of the U.S. dollar in relation to the currencies of our major exporters, such as Indonesia, as well as low U.S. tariffs for spice imports, is likely to increase the availability and affordability of such foods.
- Foreign producers have increasingly adapted new production technologies to meet the necessary safety and quality standards of U.S. consumers and have also enhanced the popularity of imported spices.

There is strong competition from established companies in the industry that sell natural as well as artificial substitutes. However, Otoro's competitive advantage will be in the supply of high-quality spices at competitive prices. Furthermore, current and future needs cannot be met by the existing competition, and Otoro wants to position itself as an important supplier of black and white pepper, paprika, and cinnamon. Industry sources also indicate that these three products will constitute the fastest-growing spice import groups in the U.S. market.

Marketing Plan and Sales Strategy

Otoro will invest sufficient resources to achieve improvements in quality and reliability. It is important to find a suitable manner of presentation (e.g., bags, baskets, tins) that saves time and is attractive to customers. The product will be marketed at a low price to be competitive in the market. Promotion includes participation in food shows and advertising.

Management and Organization

The company is managed by its founder, David Lee (president), and Howard Tzu (vice president). They both worked as managers for a reputable spice trading firm in Las Vegas, Nevada. Four people will be hired during the first phase of operation to clear imports from customs, transport the goods, and warehouse the shipment. The employees and a clerk will be paid $10.00 and $7.00 per hour, respectively. The capital structure and salary levels are as follows:

Long-Term Development Plan

Otoro intends to be a major retailer and distributor of natural spices, capturing about 25 percent of the U.S. market by 2015. In the next five years, expansion plans will be focused on Canada and Mexico. Additional borrowing may be required to finance expansion.

TABLE M.2 Ownership Structure

Partners	Capital ($)	Ownership Share (%)	Salary/month ($)
David Lee	350,000	58.33	4,000/month
Howard Tzu	250,000	41.67	3,000/month
Bank Loan	150,000	——	———

TABLE M.3 Otoro Imports: Projected Income Statement

	Year 1	Year 2	Year 3
Total net sales	$450,000	$800,000	$1,500,000
Cost of goods sold	150,000	350,000	650,000
Gross profit	**300,000**	**450,000**	**850,000**
Expenses			
Utilities	35,000	40,000	60,000
Postage	2,000	3,000	4,500
Warehouse	86,000	100,000	250,000

(*Continued*)

TABLE M.3 (Continued)

	Year 1	Year 2	Year 3
Transportation	$40,000	$55,000	$100,000
Rent	85,000	85,000	85,000
Miscellaneous	60,000	75,000	100,000
Total Expenses	**308,000**	**358,000**	**599,500**
Net profit (loss) before taxes	**(8,000)**	**92,000**	**250,500**

TABLE M.4 Start-Up Expenses for the First Six Months

Items	Range ($)
Supplies	1,000–2,000
Insurance	400–600
Rent	2,000–2,500
Utilities	400–600
Insurance	500–700
Furniture, etc.	3,000–5,000
Licenses/taxes	200–500
Advertising	3,000–4,000
Professional services	5,000–8,000
Salaries	200,000–240,000
Inventory	350,000–500,000
Operating capital	5,000–8,000
Total start-up expenses	**570,800–771,600**

Appendix N
Export Sales Contract (Basic Clauses)

1. Prices

A. Prices include the following costs:

(i) Seller's usual inspection and factory tests
(ii) Seller's usual packing (or containerizing if applicable) for export
(iii) Freight by Seller's usual means to alongside vessel at the point of export designated by Seller (but not the cost of insurance or charges for pier handling, marshaling, lighterage, and heavy lifts). Insurance to cover the inland shipment shall be arranged by Seller at Buyer's expense if Seller is arranging for the export shipment pursuant to Article 3. . . .

B. Unless otherwise stated, prices are quoted in Canadian funds.

2. Taxes, Duties, and Exchange Rates

A. Prices quoted include all applicable Canadian taxes except for sales, use, excise, value-added, and similar taxes. If sales, use, excise, value-added, or similar taxes are levied against the Seller, the Buyer shall reimburse the Seller upon presentation of invoices therefor. However, where a refund of such taxes may be applied for, the Seller, if promptly furnished by the Buyer with evidence of exportation, will apply for a refund. If the Buyer has reimbursed the Seller, the Buyer shall be credited with the refund.
B. Prices quoted do not include Canadian import duties. All rights in drawback of customs duties paid by the Seller belong to and shall remain in the Seller. At the Seller's request, the Buyer shall provide documents and assistance necessary to process the Seller's drawback claims, failing which the Buyer shall reimburse the Seller for such import duties. Such reimbursement shall be payable upon presentation of Seller's invoice therefor.
C. Prices quoted herein are based upon the prevailing rates for taxes and freight at the date of the Proposal and, with respect to the purchase price of goods to be bought by the Seller

in foreign countries, on duty and exchange rates current at the date of the Proposal. Any increase or decrease in these rates or the imposition of any new duties or taxes between the date of the Proposal and the date of payment by the Seller will be paid by the Buyer, upon presentation of Seller's invoices therefor, or will be credited to the Buyer.

D. Any taxes, duties, fees, charges, or assessments of any nature levied by any governmental authority other than of Canada in connection with this contract, whether levied against the Buyer, against the Seller or its employees, or against any of the Seller's subcontractors or their employees, shall be for the Buyer's account and shall be paid directly by the Buyer to the governmental authority concerned. If the Seller, its subcontractors, or the employees of either are required to pay any such taxes, duties, fees, charges, or assessments in the first instance or as a result of the Buyer's failure to comply with any applicable laws or regulations governing the payment of such levies by the Buyer, the amount of any such payment so made shall be reimbursed by Buyer, payable upon presentation of Seller's invoice therefor.

3. Payment

A. Payment shall be made in Canadian dollars at Toronto, Canada, as follows:

(i) On all orders of ten thousand dollars ($10,000) or less, payment in full shall be made simultaneously with the giving of the order.

(ii) On orders of more than ten thousand dollars ($10,000), payment shall be made through a Letter of Credit to be established by the Buyer at its expense (including any bank confirmation charges). All Letters of Credit shall be in favor of and acceptable to the Seller, shall be maintained in sufficient amounts and for the period necessary to meet all payment obligations, shall be irrevocable and issued or confirmed by a Canadian chartered bank in Toronto within fifteen days after the date of this contract, shall permit partial deliveries, and shall provide for pro rata payments, payable upon presentation of Seller's invoices and Seller's certificate of delivery FOB factory or of delivery into storage with cause therefor.

B. If the Buyer fails to fulfill any payment obligation, the Seller may suspend performance (and any costs incurred by the Seller as a result thereof shall be paid by the Buyer, payable upon presentation of invoices therefor) or may complete performance if Seller deems it reasonable to do so. Seller shall be entitled to an extension of time for performance of its obligations equaling the period of Buyer's nonfulfillment, whether or not the Seller elects to suspend performance. If such nonfulfillment is not rectified by the Buyer promptly upon notice thereof, the Seller may, in addition to its other rights, terminate this contract, and the Buyer shall pay to the Seller its charges for termination, payable upon presentation of Seller's invoice therefor and determined according to the TERMINATION CHARGES clause.

4. Delivery, Title, and Risk of Loss

A. Except as stated in paragraph C below, Seller shall deliver the goods FOB factory. Partial delivery shall be allowed. Any delivery dates given are approximate and are based upon prompt receipt by Seller of all information necessary to permit Seller to proceed with work without interruption.

B. Title and risk of loss and damage shall pass to the Buyer on delivery.
C. If the goods or any part thereof cannot be delivered when ready due to any cause referred to in the EXCUSABLE DELAY clause, the Seller may place such goods into storage (which may be at the place of manufacture). In such event:
   (i) Seller's delivery obligations shall be deemed fulfilled, and title and risk of loss and damage shall pass to Buyer,
   (ii) Any amounts payable to the Seller on delivery shall be payable upon presentation of Seller's invoices and its certification as to such cause, and
   (iii) All expenses incurred by the Seller, including but not limited to all expenses of preparation and shipment into storage, handling, storage, inspection, preservation, and insurance, shall be for Buyer's account and shall be payable upon Seller's presentation of invoices therefor.

5. Excusable Delay

A. The Seller shall not be in breach of any of its obligations under this contract where failure to perform or delay in performing any obligation is due, wholly or in part, to:
   (i) a cause beyond its reasonable control;
   (ii) an act of God, an act or omission of the Buyer or of any governmental authority (de jure or de facto), wars (declared or undeclared), governmental priorities, port congestion, riots, revolutions, strikes or other labor disputes, fire, flood, sabotage, nuclear incidents, earthquake, storm, epidemic; or
   (iii) inability due to a cause beyond the Seller's reasonable control to obtain necessary or proper labor, materials, components, facilities, energy, fuel, transportation, governmental authorizations or instructions, or material or information required from the Buyer. The foregoing shall apply even though any such cause exists at the time of the order or occurs after the Seller's performance of its obligations is delayed by another cause.
B. The Seller will notify the Buyer of any failure to perform or delay in performing due to a cause set out in paragraph A and shall specify, as soon as practicable, when the obligation will be performed. Subject to paragraph C, the time for performing the obligation shall be extended for the period lost due to such a cause.
C. Where the period lost is at least sixty days and the parties have not agreed upon a revised basis for performing the obligation, including the adjustment of the prices, then, either party may, upon thirty days' written notice, terminate this contract, whereupon the Buyer shall pay to the Seller termination charges determined in accordance with the TERMINATION CHARGES clause.

6. Termination Charges

A. In the event that this contract is terminated by the Seller pursuant to any of its terms, the termination charges payable by the Buyer shall be calculated as follows:
   (i) material, labor, and indirect expenses committed or incurred to date of termination;
   (ii) all costs incurred in the execution of the termination;
   (iii) reasonable profit on (i) and (ii) herein above cited;

(iv) the greater of 10 percent of the unbilled portion of the contract price or the unrecoverable, ongoing, fixed costs and expenses due to discontinuities in operation plus loss of reasonable anticipated profit; and

(v) interest at the rate of 1.5 percent per month on the amount of the claim as cited in (i) to (iv) inclusive, if the termination charges are not paid as invoiced.

B. The termination charges shall be payable upon presentation of Seller's invoice therefor.

7. Export Shipment

If the Seller agrees to make export shipment, all fees and expenses, including but not limited to those covering preparation of consular documents, consular fees, storage, marine insurance (including war risk, if available) and other insurance, ocean freight, and Seller's then current fees for such services shall be payable by the Buyer upon presentation of invoices therefor. Unless otherwise instructed by the Buyer, the Seller shall prepare consular documents according to its best judgment but without liability for fines or other charges due to error or incorrect declarations.

8. Government Authorizations

The Seller shall, without any assumption of liability therefor, apply for an export permit on behalf of the Buyer where a permit is required by law. In the event that an export permit is denied or revoked, the Buyer shall have the right to elect to terminate the contract subject to the payment to the Seller of termination charges determined according to the TERMINATION CHARGES clause. The Buyer shall be responsible for obtaining any import permit, exchange permit, or other governmental authorization required by the law of the country of importation.

9. Nuclear Use

The goods sold are not intended for nor shall they be used for or as any part of any activity or process involving any use or handling of any radioactive material, including any nuclear material (as that term is defined in the Nuclear Liability Act of Canada). If the goods or any part thereof are used by the Buyer contrary to the aforesaid, the Buyer shall provide, at its own expense, insurance and indemnity satisfactory to the Seller protecting the Seller and all of its subcontractors and suppliers from all loss, expense, damages, costs, or liability of every kind, whether in contract or in tort (including negligence), and the Seller may terminate this contract. Upon such termination, the Buyer shall pay to the Seller termination charges determined according to the TERMINATION CHARGES clause.

10. Patents

A. The Seller shall, if notified promptly in writing and given authority, information, and assistance, defend, at its own expense, any suit or proceeding brought against the Buyer

so far as based on a claim that the goods, or any part thereof, sold under this contract infringe any patent of Canada, and the Seller shall pay all damages and costs awarded therein against the Buyer. In the event that the goods, or part thereof, are in such a suit held to constitute an infringement and use of the goods, or part thereof, is enjoined for the intended use, the Seller shall, at its expense and option:

(i) procure for the Buyer the right to continue using the same;
(ii) replace the same with noninfringing goods or part thereof;
(iii) modify the same so as to eliminate infringement; or
(iv) remove the same and refund the purchase price (less reasonable depreciation for any period of use) and any transportation costs and installation costs paid by the Buyer.

B. The preceding paragraph shall not apply to any goods, or any part thereof, manufactured to the Buyer's design. As to such goods, or part, the Seller assumes no liability whatsoever for infringement.
C. The rights and obligations of the parties with respect to patents or any other industrial property rights are solely and exclusively as stated herein, and the foregoing states the entire liability of the Seller for patent infringement.

11. Warranties

A. The Seller warrants to the Buyer that the goods manufactured by the Seller will be free from defects in material, workmanship, and title and will be of the kind and quality described in the contract.
B. If a failure to meet any of the foregoing warranties, except as to title, appears within one year from the date of shipment or within one year after completion of installation, if the latter is supervised by or performed by the Seller, and provided that completion of installation is not unreasonably delayed by the Buyer, then the Buyer shall not be entitled to terminate or rescind this contract, but the Seller shall correct any such failure by either, at its option, repairing any defective or damaged part or parts of the goods or by making available, FOB Seller's plant or other points of shipment, any necessary repaired or replacement part or parts. Where a failure cannot be corrected by the Seller's reasonable efforts, the parties shall negotiate an equitable adjustment in price. In the event of a failure to meet the warranty as to title, the Buyer shall not be entitled to elect to terminate or rescind this contract but the Seller shall correct such failure. The foregoing sets out the Seller's sole obligation for failure to comply with the foregoing warranties. The Seller shall have no obligation whatsoever and the Buyer shall have no right to make a claim against the Seller in respect of the failure to meet any of the foregoing warranties, except as to title, which appears after the one–year period set out in this clause.
C. The obligations set forth in this clause are conditional upon:

(i) proper storage, installation (except where installation is supervised by or performed by the Seller), use, maintenance, and compliance with any applicable recommendations of the Seller; and
(ii) the Buyer promptly notifying the Seller of any defect and, if required, promptly making the goods available for correction.

D. There is no warranty whatsoever with respect to goods normally consumed in operation or that have a normal life shorter than the warranty period set out in this clause.
E. With respect to goods not manufactured by the Seller (except for integral parts of the goods sold, to which the warranties given in this clause shall apply), the Seller gives no warranty whatsoever, and only the warranty, if any, given by the manufacturer shall apply.
F. The foregoing is exclusive and in lieu of all other warranties and conditions, regardless of whether they be oral, written, express, or implied by statute, including the implied conditions of reasonable fitness for purpose, merchantability, and correspondence with description.

12. Limitation of Liability

A. In no event, whether as a result of a breach of contract or a tort (including negligence), shall the Seller be liable to the Buyer for:

   (i) loss of profit or revenue, loss of use, cost of capital, downtime costs, cost of substitute goods, facilities, services or replacement power;
   (ii) property damage external to the product and loss arising out of such damage;
   (iii) special or consequential damages; and
   (iv) any of the foregoing suffered by a customer of the Buyer.

B. Except as may be provided in the PATENTS clause, in no event, whether as a result of a breach of contract or a tort (including negligence), shall the liability of the Seller to the Buyer exceed the price of the goods or part thereof or to the service which gives rise to the claim.
C. If the Buyer transfers title to or leases the goods sold hereunder to or otherwise permits or suffers use by any third party, Buyer shall obtain from such third party a provision affording Seller and its suppliers the protection of paragraph A.
D. If the Seller furnishes Buyer with advice or other assistance that concerns the goods supplied hereunder or any system or equipment in which any such goods may be installed and which is not required pursuant to an express term of this contract, the furnishing of such advice or assistance is done without any assumption of responsibility or liability therefore, and the Buyer shall not institute a claim in contract or in tort (including negligence) arising out of or in any way connected therewith.

13. General

A. Unless otherwise stated in this contract, the goods shall be installed by and at the expense of the Buyer.
B. The delegation or assignment by the Buyer of any or all of its duties or rights without the Seller's prior written consent shall be void.
C. No waiver, alteration, or modification of any of the provisions of this contract shall be binding on the Seller unless it is in writing and signed by a duly authorized representative of the Seller.
D. Any goods sold shall comply with federal and provincial laws and regulations applicable to the manufacture, packing, and shipment of such goods as of the date of the Seller's

Proposal and shall comply with any amendments thereto that may have come into effect prior to the time such goods are shipped, provided that the price and, if necessary, delivery shall be equitably adjusted to compensate the Seller for having to comply with such amendments.

E. The invalidity, in whole or in part, of any of the foregoing clauses will not affect the remainder of such clauses or any other clauses in this contract.

F. Any reference to "goods" in this contract shall, where the context requires, be a reference to a single chattel personal or to a part of such single chattel personal.

G. No trade usage or course of dealing will be binding on the Seller unless specifically referred to in the contract.

H. This contract and any amendments thereto shall be governed in all respects including, but not limited to, validity, interpretation, and effect, by the laws of the Province of Ontario and of Canada.

Exhibit A: Price Adjustment Clause (Manufacturing Only)

All prices stated herein are subject to adjustments, upon completion of this agreement, for changes in labor and material costs. Such adjustments involving increases or decreases in the prices stated herein are to be determined in accordance with the following:

1. Labor

A. For the purpose of adjustment, the proportion of the price representing labor is accepted as 50 percent thereof.

B. The above amount accepted as representing labor will be adjusted for changes in labor cost. Such adjustment will be based upon the Index Numbers of the *Average Hourly Earnings in the Electrical Industrial Equipment Manufacturing Industry,* published monthly by Statistics Canada.

2. Material

A. For the purpose of adjustment, the proportion of the price representing material is accepted as 40 percent hereof.

B. The above amount accepted as representing material will be adjusted for changes in material costs. Such adjustment will be based upon the *Combined Index of Wholesale Prices for Iron and Non-Ferrous Metals Groups* (excluding gold), or any similar mutually agreed-upon index published monthly by Statistics Canada.

The averages of the monthly indices for labor and material referred to above for the period from a date six months preceding shipment to date of shipment of order under this agreement will be computed separately, and percentage increases or decreases will be established for labor and material by comparison with corresponding indices in effect at the time this proposal was made in the month of ______________________.

The adjustments for changes in labor and material will be obtained by applying the respective percentages of increase or decrease to the amounts covering labor and material as

specified above, and the results will be accepted as an increase or decrease in the aforementioned price.

If Field Construction is involved, refer for Price Adjustment Clause for Field Labor to ________ on page ________________.

Exhibit B: Price Adjustment Provisions

Upon completion of the work, the total contract price for the apparatus to be supplied under this contract shall be subject to an increase or decrease due to fluctuation in the cost of material and/or labor. Adjustments shall be determined in accordance with the following, and the results shall be accepted as an increase or decrease in the contract price.

1. Labor

A. For the purpose of adjustment, the proportion of the contract price representing labor is accepted as 50 percent.

B. The amount so accepted as representing labor will be adjusted for changes in labor costs. Such adjustment will be based upon Table 18 "Average Hourly Earnings, Machinery—Except Electrical, Canada" as shown in *Employment Earnings and Hours,* published monthly by Statistics Canada. An average of those published monthly/hourly earnings for the period from a date six months before complete shipment to the date complete shipment of the apparatus is made from the Company's works will be calculated, and the percentage increase or decrease will be calculated by a comparison with such published hourly earnings for the month during which the Company's tender was submitted. The adjustment for changes in labor costs will be obtained by applying such percentage of increase or decrease to the amount representing labor above mentioned.

2. Material

A. For the purpose of adjustment, the proportion of the contract price representing material is accepted as __________ percent hereof.

B. The amount so accepted as representing material will be adjusted for changes in material costs. Such adjustment will be based upon Table 2 "General Wholesale Index—Iron Products (1,935 2 39 5 100)" as shown in *Industry Price Indexes,* published monthly by Statistics Canada. An average of those published indexes for the period from the date six months before complete shipment to the date complete shipment of the apparatus is made from the Company's works will be computed, and the percentage increase or decrease will be calculated by a comparison with such published index for the month during which the Company's tender was submitted. The adjustment for changes in material costs will be obtained by applying such percentage of increase or decrease to the amount representing material above mentioned.

3. Subcontract

To carry out this contract, the Company will purchase the components or material listed below, which may increase or decrease in price due to increases or decreases in the cost of labor

or material. The Purchaser shall reimburse the Company the amount of any increase, and the Company shall credit the Purchaser the amount of any decrease due to such adjustment from date of submission of the Company's tender.

Exhibit C: Price Adjustment Clause (Field Labor Only)

Prices stated herein applicable to construction or assembly of the equipment provided, at the Purchaser's site, are subject to adjustments upon completion of this agreement for changes in labor costs. Such adjustments, involving increases or decreases in the prices stated herein, are to be determined in accordance with the following:

1. Field Labor

A. For the purpose of adjustment, the proportion of the price representing labor is accepted as _____________ percent thereof.

B. The above amount accepted as representing labor will be adjusted for changes in labor cost. Such adjustment will be based upon the *Average Hourly Earnings in the Construction Industry, Other Engineering Group* published monthly by Statistics Canada, for the area of ___________________________.

The monthly average hourly earnings for labor referred to above for the period of construction under this agreement will be computed separately, and percentage increases or decreases will be established for labor by comparison with corresponding average hourly earnings in effect at the time this proposal was made in the month of ______________________.

The adjustments for changes in labor will be obtained by applying the respective percentage of increase or decrease to the amounts covering labor as specified above, and the result will be accepted as an increase or decrease in the aforementioned price.

Appendix O

Sample Distributorship Agreement

This Distributorship Agreement is entered into this day of ___________ between ABC 2 Company, hereinafter referred to as “Company,” having its principal place of business at Naples, Florida, and XYZ Company of Mexico City, Mexico, hereinafter referred to as “Distributor.”

1. Definitions

A. Product(s): Product or products refers to products manufactured or marketed by the Company, including spare parts, which are listed in Exhibit A. Exhibit A is subject to change by mutual agreement of the parties.
B. Territory: Territory shall mean the geographical area designated under Exhibit B. Exhibit B may be revised from time to time by mutual agreement of the parties.
C. Contract year: Contract year shall mean the period commencing January 1 and ending on December 31. The first contract year shall commence as of the date of this contract, and subsequent years shall commence on January 1 thereafter.
D. Trade terms: Trade terms such as FOB, CIF, etc., shall be interpreted according to the latest version of International Chamber of Commerce (ICC) Rules.
E. Purchaser: Purchaser shall mean a purchaser of goods for consumption and not for resale as a distributor.

2. Appointment and Acceptance

A. Company hereby appoints Distributor as the sole importer-distributor of products in the territory, and Distributor accepts such appointment.
B. Company shall not appoint any third person to import, sell, or otherwise deal with products in the territory during the time the agreement is in effect.

3. Term of the Agreement

The term of this agreement shall be from _________ to _____________ unless sooner terminated or further extended as hereinafter provided.

4. Minimum Annual Purchases

Distributor shall purchase from Company during the contract year such minimum dollar or unit amount of products as specified in Exhibit C attached thereto. Minimum sales for subsequent periods shall be specified in an addendum to this agreement. Should no agreement be reached between the parties, the minimum annual sales for the new contract year shall be deemed to be ___ percent of the minimum annual sales for the preceding contract year.

5. Prices for the Products

A. Company reserves the right to establish or revise at its sole discretion, from time to time, upon thirty days, prices and terms of its sales of products to Distributor, including the right at any time to issue new price lists and to change the prices, terms, and provisions therein contained. The price to be paid by the Distributor, excluding spare parts, shall be the price quoted on the Company's current international price list, less a discount of 12 percent.
B. Company shall provide an additional discount of 3 percent when Distributor takes responsibility at the Company's request to service products during the guarantee period. Company shall provide replacement parts free of charge to Distributor during the guarantee period.
C. Distributor shall bear the cost of freight, insurance, and duties for such parts. Distributor shall make no charge for the replacement parts to customer.
D. After the end of the guarantee period, spare parts shall be sold to Distributor at the Company's current international price, less a discount of 20 percent.

6. Payments to Distributor for Direct Sales

A. Where the Company sells products direct to a customer, the Company shall pay Distributor such commission as is agreed between the parties. In the event that no specific commission is agreed, Company shall pay Distributor 8 percent of the net selling price for the products.
B. Any sums earned by Distributor shall be paid by Company thirty days after receipt by the Company of payment for any such order, provided that no such sums shall be payable by the Company to Distributor in respect of any orders received by the Company after termination of this agreement, except where orders are accepted from potential customers within six months after termination of this agreement and at the time of termination the Distributor has provided the Company with a written list of such potential customers, including evidence to show potential customer's communication and intent to buy the products.

7. Government Licenses and Permits

The Company shall secure the necessary licenses and permits for the sale and export of the products. It is also incumbent on the Distributor to obtain the necessary licenses and permits required for purchase and importation of the products.

8. Intellectual Property Rights

A. The Distributor shall not remove or obliterate any marks or symbols affixed on the goods without the written permission of the Company. A small label bearing the words "supplied by," together with the name and address of the Distributor, shall be applied to the goods.
B. The Distributor shall advertise the goods solely under the trademarks of the Company. However, it shall not act in any manner, whether by advertising or other means, that might adversely affect the validity of any intellectual property rights belonging to the Company.
C. The Distributor shall at all times do all in its power to protect the Company's intellectual property rights and shall ensure that the same remain connected only with the products as defined in this agreement and as the Company may indicate from time to time.
D. The Distributor shall notify the Company in writing as soon as it becomes aware of any infringements of the latter's intellectual property rights in the territory. The Distributor shall bring an action to prevent infringement of such rights at the Company's expense. However, the Company shall not be liable for any infringement caused by the actions of the Distributor.

9. Warranty and Liability

A. The Company guarantees that products sold to Distributor are free from defects in material and workmanship and agrees to reimburse all costs of repairs, including reasonably necessary related labor charges, or, at Company's option, to replace any or all defective products within the period of such warranty.
B. The period of the warranty shall extend for one year after the date of sale to the customer for products and ninety days from the date of sale to customer for parts. The Company shall not be liable for the acts or defaults of the Distributor, its employees, or its representatives.

10. Undertakings by the Distributor

A. Distributor agrees to be responsible for supplying or making arrangements for supplying all necessary service to products in the territory, and this includes using its best efforts to provide the best possible service for all owners of products. The Distributor shall hire an adequate number of technicians in order to provide such services promptly.
B. Distributor shall purchase and maintain such volume and assortment of parts as may be necessary to satisfy the service needs of customers.

C. Distributor shall use its best efforts to promote the sales of the goods in its territory as well as maintain adequate staff of salespeople to carry out such responsibility.
D. If at any time during the continuance of this agreement the Distributor shall become entitled to any development, improvement, or invention relating to any of the products, the Distributor shall give notice in writing to Company and grant to the Company a first option to acquire rights with respect to such invention.
E. The Distributor shall spend a reasonable sum each year on promoting the product in the territory. The Company may make a contribution toward such costs.
F. The Distributor shall assist the Company to produce sales literature in the language of the territory and also provide the Company any sales literature prepared by it relating to the products.
G. The Distributor shall provide Company detailed reports of sales every ninety days, general market information in the territory, and suggestions for any improvements in December of each year.
H. The Distributor shall refrain from purporting to act as an agent of the Company unless otherwise specified in the agreement. In addition, Distributor shall not make any contracts binding the Company or warehouse or advertise the goods outside its territory as well as get involved in the manufacture, production, sale, or advertising of competing goods in the territory.
I. The Distributor shall not transfer or assign the benefit of this agreement to any third party without the prior written consent of the Company.

11. Undertakings by the Company

The Company agrees to undertake the following responsibilities:

A. Assist the Distributor in advertising the goods by providing the necessary advice and literature as it considers reasonably sufficient to promote the goods in the territory.
B. Support the Distributor in its sales and technical efforts by paying regular visits to the territory of experienced personnel. In the event that a technician is sent to assist the Distributor, the Distributor shall be responsible for traveling expenses to and from the territory, all local traveling expenses, accommodation, and reasonable subsistence costs in the territory.
C. Provide the Distributor with maintenance and servicing instructions and other documentation as well as information on technical changes that are necessary and relevant in connection with the products. The Company may provide appropriate training to suitable qualified technicians of the Distributor that is necessary to install, maintain, or service the products. The parties will determine in due course where the training will take place as well as matters pertaining to expenses.

12. Termination

This agreement may be terminated by a written instrument duly executed by the parties if any of the following situations arise:

A. Either party commits any breach of contract and, in the case of a breach capable of being remedied, the party does not remedy the same within sixty days after receipt of notice in writing of such breach.
B. Either party becomes insolvent or goes into liquidation or has a receiver appointed in respect of all or a substantial part of its business.
C. Payment of any sum remains unpaid to either party for a period of thirty days after the due date.

The innocent party may forthwith, by notice in writing, terminate this agreement. Any such termination shall be without prejudice to the rights of the parties accrued up to the date of termination. Neither party will be responsible, by reason of termination of this agreement, to the other for compensation or damages on account of any loss of prospective profits on anticipated sales or on account of expenditures, investments, leases, or other commitments relating to the business or goodwill of either party.

Within thirty days after the termination or expiration of this agreement, Company may, at its option, repurchase from Distributor, at the latter's net warehouse cost, any or all products and/or parts that are commercially usable or salable as well as any usable advertising or promotional materials. Distributor shall return any packaging or promotional materials that were provided by Company free of charge. Distributor shall cease all use of the name and trademark of Company.

13. Force Majeure

The occurrence of certain events that make the continuance of this agreement impossible, such as riots, government restrictions, or other events outside the reasonable control of the party, shall not constitute a breach of this agreement.

14. Agreement and Interpretation

A. This agreement and its annexes constitute the whole of the agreement between the Company and Distributor with respect to the products. No variation, alteration, or abandonment of any of its terms shall have effect unless made in writing by the Distributor or its duly authorized representative and by the Company or its duly authorized representative.
B. This agreement shall be construed in accordance with U.S. law.
C. The illegality or invalidity of any part of this agreement shall not affect the legality or validity of the remainder thereof.
D. The headings are for reference purposes only and shall not affect the interpretation of this agreement.

List of Exhibits

A. Products
B. Territory

C. Minimum annual purchases
D. Price list
E. Initial order
F. Intellectual property rights

Signed for ABC Company	Signed for XYZ distributor
by	by
In the presence of	In the presence of

Appendix P
Sample Sales Representative Agreement

MEMORANDUM OF AGREEMENT entered into in duplicate, this ________ day of __________.

> BETWEEN: __________ duly incorporated under the laws of Canada, having its head office and principal place of business at Toronto, Province of Ontario (hereinafter referred to as party of the first part [PFP].
> AND: a body politic and corporate, having its head office and place of business in _________ (herein after called the Sales Representative).

WITNESSETH THAT in consideration of the premises and of the mutual covenant and agreements hereinafter contained, the parties hereto agree each with the other as follows:

> PFP hereby engages the Sales Representative to provide services in accordance with the terms and conditions of this Agreement for the sale of proprietary products (hereinafter called Equipment) listed in Schedule attached hereto and made an integral part hereof to markets in (hereinafter called Served Market).

1. Territory

The geographical area (hereinafter called Territory) in which the Sales Representative shall undertake the responsibilities specified in this Agreement is __________.

2. Terms and Scope

The term of this Agreement shall be from _________ to _________ unless sooner terminated as hereinafter provided. The provisions of this Agreement shall govern all transactions

between PFP and the Sales Representative unless otherwise agreed to in writing by the duly authorized representatives of both parties.

3. Company Responsibilities

PFP agrees that during the term of this Agreement, it will, subject to and in accordance with the terms and conditions herein expressed:

A. keep the Sales Representative advised of new products, sales plans, and objectives with respect to Equipment for Served Market Customers in the Territory;
B. support the sales efforts of the Sales Representative by furnishing printed commercial and technical data and information and other publications that PFP may have available from time to time for export distribution; and
C. pay a commission as provided in Article 5 hereof on orders for Equipment received and accepted by PFP from Served Market Customers in the Territory as a result of the effort of the Sales Representative. As used in this Agreement, the terms "order" or "orders" include contracts for Equipment with Served Market Customers in the Territory executed by PFP.

4. Sales Representative Responsibilities

The Sales Representative agrees that during the term of this Agreement, it will, subject to the terms and conditions herein expressed:

A. maintain an adequate sales organization and use its best efforts to assist PFP in the sale of Equipment to Served Market Customers in the Territory;
B. maintain active contacts with Served Market Customers in the Territory;
C. keep PFP fully informed of all governmental, commercial, and industrial activities and plans that do or could affect the sale of Equipment to Served Market Customers in the Territory;
D. provide market information to PFP on Served Market Customers' and competitors' activities;
E. recommend improvements to sales plans, assist in developing strategy, and clarify the Equipment requirements of Served Market Customers in the Territory;
F. as requested, transmit proposals and technical data to Served Market Customers in the Territory, interpret customer inquiries, requirements, and attitudes, and assist in contract negotiations. (All proposals so transmitted will contain terms and conditions of sale substantially in accordance with PFP's Standard Terms and Conditions of Sale, a copy of which is attached hereto and is subject to change by PFP from time to time. No proposal shall be transmitted to a Served Market Customer unless terms and conditions of sale are approved by PFP or the Standard Terms and Conditions of Sale are incorporated in such proposal.); and
G. perform such liaison services with Served Market Customers in the Territory as PFP may from time to time direct relative to any order(s) awarded to PFP from the supply of Equipment, including assistance in the resolution of any claims or complaints of such Customers arising out of PFP's performance of said order(s).

5. Compensation

A. As compensation to the Sales Representative for services rendered hereunder, PFP agrees to pay the Sales Representative a commission on the following orders for PFP's proprietary equipment from Served Market Customers in the Territory during the term of this Agreement:

(i) Orders that are forwarded by the Sales Representative.
(ii) Orders that the Sales Representative has specifically identified to PFP being forthcoming directly from a Served Market Customer in the Territory when, in the absolute judgment of PFP such commission may be warranted by the effort used by the Sales Representative resulting in said orders.

B. The commission, based on the net sale price (FOB factory), will be paid in accordance with the Schedule(s) attached hereto and made an integral part of this Agreement.
C. Said commission shall be disbursed in Canadian dollars to the Sales Representative within thirty days subsequent to the payment for the Equipment delivered to the Served Market Customer in accordance with the terms of payment established and accepted in the contract between PFP and the Served Market Customer.
D. No commissions will be paid on the value of technical, construction, installation, or similar services, nor on the value of insurance, bonds, interest, ocean freight, or other charges that may be included in the PFP's invoice to a Served Market Customer.
E. It is understood that if an order should be rescinded, revoked, or repudiated by a Served Market Customer for reasons beyond PFP's control or by PFP for breach of contract or by either party for force majeure causes, or it becomes invalid or inoperative due to any governmental regulation, the Sales Representative shall not be entitled to a commission with respect to such order, except pro rata to the extent of any amounts PFP may have received and retained as payment for Equipment delivered to a Served Market Customer.
F. It is further understood that no compensation, by way of commission or otherwise, shall be due the Sales Representative in connection with an order on which a commission would otherwise be payable, if as to such an order:

(i) any applicable governmental law, rule, or regulation prohibits or makes improper the payment of any commission, fee, or other payment to a Sales Representative;
(ii) any Served Market Customer makes it a condition that no commission, fee, or payment be made to a Sales Representative; or
(iii) any action has been taken by the Sales Representative in violation of its commitments set forth in Article 6, paragraphs C and D.

6. Relationship of Parties and Controlling Laws

A. PFP may assign the installation and commissioning portion of its contract to the Sales Representative, but, except as aforesaid, this Agreement and any rights hereunder are nonexclusive and nonassignable, and any assignment by one party without the prior written consent of the other party shall be void. The Sales Representative is an independent contractor to PFP. It is understood that the Sales Representative or its agents, subsidiaries, affiliates, and

employees are in no way the legal representatives or agents of PFP for any purpose whatsoever and have no right or authority to assume or create, in writing or otherwise, any obligation of any kind, expressed or implied, in the name of or on behalf of PFP. PFP reserves the right to determine in its sole discretion the acceptability of any order, any provisions thereof, or any condition proposed by the customer and shall in no way be obligated to bid, quote to, or negotiate with any Served Market Customer.

B. This Agreement and any services hereunder are subject to and shall be governed by all the applicable laws and regulations of Canada; the rights and obligations of the Sales Representative as well as those of PFP under or in connection with this Agreement shall be governed by such laws and regulations and by the law of the Province of Ontario, Canada.

C. The Sales Representative agrees to comply with the law applicable to the performance of its obligations under the terms of this Agreement. Without limitation to the foregoing, the Sales Representative will comply fully with the export control laws and regulations of the Canadian Government with respect to the disposition of products and the printed commercial and technical data and information and other publications supplied by PFP. Further, the Sales Representative agrees that it will not pay, nor will it make any offer or commitment to pay, anything of value (either in the form of compensation, gift, contribution, or otherwise) to any employee, representative, person or organization in any way connected with any Customer, private or governmental, where such payment is contrary to applicable law, including the laws of Canada and the laws of the country in which the Sales Representative provides services under this Agreement.

D. With respect to any transaction arising under this Agreement, it is specifically understood and agreed that neither the Sales Representative nor its employees or representatives shall receive any payments in the nature of a rebate or similar benefit paid directly or indirectly by the Customer, nor shall any employee or representative of PFP receive any such payment paid directly or indirectly by the Sales Representative or by the Customer.

7. Expiration, Renewal, Termination

A. This Agreement shall automatically expire at the end of the term specified in Article 2 hereof unless specifically renewed prior thereto by mutual consent given in writing by the parties hereto.

B. This Agreement may be terminated prior to the completion of the term specified in Article 2 hereof:

   (i) by mutual consent given in writing by the parties hereto;
   (ii) by either party at will, with or without cause, upon no less than sixty days notice in writing by registered mail, cable, or personal delivery to the other party; or
   (iii) by PFP upon one day's similar notice in the event the Sales Representative attempts to assign this Agreement or any right hereunder without PFP's prior written consent; there is a change in the control or management of the Sales Representative that is unacceptable to PFP; the Sales Representative ceases to conduct its operations in the normal course of business; a receiver for the Sales Representative is appointed or applied for or it otherwise takes advantage of an insolvency law; the Sales Representative represents other parties whose representation, in PFP's opinion, involves a conflict with the Sales Representative's

obligations hereunder; or the Sales Representative breaches this Agreement or acts in any manner deemed by PFP to be detrimental to the best interest of PFP. The foregoing events shall without limitation be deemed to be cause for termination by PFP.

8. Obligations Upon Expiration or Termination

In the event that an order from any Served Market Customer in the Territory for the supply of Equipment is accepted by PFP prior to the date of expiration or termination of this Agreement, the obligations assumed by both parties hereunder with respect to any such order shall continue in force until fully performed. In the event this Agreement expires or is terminated, and within from the date of such expiration or termination an order from a Served Market Customer in the Territory for the supply of Equipment is accepted by PFP and is implemented within said period by financial arrangements acceptable to PFP, the Sales Representative's rights to commission payments will be fully protected, provided such purchase order is awarded in the sole opinion of PFP as a result of services performed by the Sales Representative prior to the effective date of expiration or termination. Such acceptance of an order from, or the sale of any Equipment to, a Served Market Customer after the expiration or termination of this Agreement shall not be construed as a renewal or extension hereof, but the obligations undertaken in this Article 8 shall survive such expiration or termination.

9. Private Information

A. The Sales Representative shall maintain in confidence and safeguard all business and technical information that becomes available to it in connection with this Agreement, the information being either of proprietary nature or not intended for disclosure to others. This obligation shall continue for five years after expiration or termination of this Agreement.
B. Knowledge or information of any kind disclosed by the Sales Representative to PFP shall be deemed to have been disclosed without obligation on the part of PFP to hold the same in confidence, and PFP shall have full right to use and disclose such information, subject to the approval of the Sales Representative, whose approval shall not be withheld without proper cause and without any compensation to the Sales Representative beyond that specifically provided by this Agreement.

10. Company Trademarks and Trade Names

The Sales Representative agrees that it will comply at all times with the rules and regulations furnished to the Sales Representative by PFP with respect to the use of and trademarks and trade names; it will express and identify properly the "Authorized Sales Representative" relationship with PFP for Equipment; it will not publish or cause to be published any statement, nor encourage or approve any advertising or practice, that might mislead or deceive any parties or might be detrimental to the good name, trademark, goodwill, or reputation of PFP or its products. The Sales Representative further agrees upon request to withdraw any statement and discontinue any advertising or practice deemed by PFP to have such effect.

11. Limitation of Liability

Neither party to this agreement shall have liability to the other with respect to the claims arising out of, in connection with, or resulting from this agreement, whether in contract, tort (including negligence of any degree), or otherwise except as provided under the terms of this agreement.

12. Release of Claims

In consideration of the execution of this Agreement by PFP, the Sales Representative hereby releases PFP from all claims, demands, contracts, and liabilities, if any thereby, as of the date of execution of this Agreement by the Sales Representative, except indebtedness that may be owing founded upon a written contract.

13. Failure to Enforce

The failure of either party to enforce at any time or for any period of time the provisions hereof in accordance with its terms shall not be construed to be a waiver of such provisions or of the right of such party thereafter to enforce each and every provision.

14. Notices

Any notice, request, demand, direction, or other communication required or permitted to be given or made under this agreement or in connection therewith shall be deemed to have been properly given or made if delivered to the party to whom it is addressed, or by registered mail, cable, or telex addressed as follows: ______________________________________.

15. Execution and Modification

A. This Agreement constitutes the entire and only agreement between the parties respecting the sales representation to the Served Market of Equipment specified herein.
B. This Agreement wholly cancels, terminates, and supersedes any and all previous negotiations, commitments, and writing between the parties with respect to Equipment. No change, modification, extension, renewal, ratification, rescission, termination, notice of termination, discharge, abandonment, or waiver of this Agreement or any of the provisions hereof; nor any representation, promise, or condition relating to this Agreement shall be binding upon PFP unless made in writing and signed by duly authorized personnel of PFP,

IN WITNESS WHEREOF, this agreement has been executed by both parties.

Appendix Q
North American Free Trade Agreement

Between the Government of the United States of America, the Government of Canada and the Government of the United Mexican States (Selected Provisions) Effective January 1, 1994

Part One: General Part

Article 101: Establishment of the Free Trade Area

The Parties to this Agreement, consistent with Article XXIV of the *General Agreement on Tariffs and Trade,* hereby establish a free trade area.

Article 103: Relation to Other Agreements

1. The Parties affirm their existing rights and obligations with respect to each other under the *General Agreement on Tariffs and Trade* and other agreements to which such Parties are party.
2. In the event of any inconsistency between this Agreement and such other agreements, this Agreement shall prevail to the extent of the inconsistency, except as otherwise provided in this Agreement.

Part Two: Trade in Goods

Article 301: National Treatment

1. Each Party shall accord national treatment to the goods of another Party in accordance with Article III of the *General Agreement on Tariffs and Trade* (GATT), including its interpretative

notes, and to this end Article III of the GATT and its interpretative notes, or any equivalent provision of a successor agreement to which all Parties are party, are incorporated into and made part of this Agreement.

2. The provisions of paragraph 1 regarding national treatment shall mean, with respect to a state or province, treatment no less favorable than the most favorable treatment accorded by such state or province to any like, directly competitive or substitutable goods, as the case may be, of the Party of which it forms a part.

3. Paragraphs 1 and 2 do not apply to the measures set out in Annex 301.3.

Article 302: Tariff Elimination

1. Except as otherwise provided in this Agreement, no Party may increase any existing customs duty, or adopt any customs duty, on an originating good.

2. Except as otherwise provided in this Agreement, each Party shall progressively eliminate its customs duties on originating goods in accordance with its Schedule to Annex 302.2.

3. On the request of any Party, the Parties shall consult to consider accelerating the elimination of customs duties set out in their Schedules. An agreement between two or more Parties to accelerate the elimination of a customs duty on a good shall supersede any duty rate or staging category determined pursuant to their Schedules for such good when approved by each such Party in accordance with its applicable legal procedures.

4. Each Party may adopt or maintain import measures to allocate in-quota imports made pursuant to a tariff rate quota set out in Annex 302.2, provided that such measures do not have trade restrictive effects on imports additional to those caused by the imposition of the tariff rate quota.

5. On written request of any Party, a Party applying or intending to apply measures pursuant to paragraph 4 shall consult to review the administration of those measures.

Article 305: Temporary Admission of Goods

1. Each Party shall grant duty-free temporary admission for:

a. professional equipment necessary for carrying out the business activity, trade, or profession of a business person who qualifies for temporary entry pursuant to Chapter Sixteen (Temporary Entry for Business Persons),
b. equipment for the press or for sound or television broadcasting and cinematographic equipment,
c. goods imported for sports purposes and goods intended for display or demonstration, and
d. commercial samples and advertising films, imported from the territory of another Party, regardless of their origin and regardless of whether like, directly competitive, or substitutable goods are available in the territory of the Party.

2. Except as otherwise provided in this Agreement, no Party may condition the duty-free temporary admission of a good referred to in paragraph 1(a), (b), or (c), other than to require that such good:

a. be imported by a national or resident of another Party who seeks temporary entry;
b. be used solely by or under the personal supervision of such person in the exercise of the business activity, trade, or profession of that person;
c. not be sold or leased while in its territory;
d. be accompanied by a bond in an amount no greater than 110 percent of the charges that would otherwise be owed on entry or final importation, or by another form of security, releasable on exportation of the good, except that a bond for customs duties shall not be required for an originating good;
e. be capable of identification when exported;
f. be exported on the departure of that person or within such other period of time as is reasonably related to the purpose of the temporary admission; and
g. be imported in no greater quantity than is reasonable for its intended use.

3. Except as otherwise provided in this Agreement, no Party may condition the duty-free temporary admission of a good referred to in paragraph 1(d), other than to require that such good:

a. be imported solely for the solicitation of orders for goods, or services provided from the territory, of another Party or non-Party;
b. not be sold, leased or put to any use other than exhibition or demonstration while in its territory;
c. be capable of identification when exported;
d. be exported within such period as is reasonably related to the purpose of the temporary admission; and
e. be imported in no greater quantity than is reasonable for its intended use.

4. A Party may impose the customs duty and any other charge on a good temporarily admitted duty-free under paragraph 1 that would be owed on entry or final importation of such good if any condition that the Party imposes under paragraph 2 or 3 has not been fulfilled.

5. Subject to Chapters Eleven (Investment) and Twelve (Cross-Border Trade in Services):

a. each Party shall allow a vehicle or container used in international traffic that enters its territory from the territory of another Party to exit its territory on any route that is reasonably related to the economic and prompt departure of such vehicle or container;
b. no Party may require any bond or impose any penalty or charge solely by reason of any difference between the port of entry and the port of departure of a vehicle or container;
c. no Party may condition the release of any obligation, including any bond, that it imposes in respect of the entry of a vehicle or container into its territory on its exit through any particular port of departure; and
d. no Party may require that the vehicle or carrier bringing a container from the territory of another Party into its territory be the same vehicle or carrier that takes such container to the territory of another Party.

6. For purposes of paragraph 5, "vehicle" means a truck, a truck tractor, tractor, trailer unit or trailer, a locomotive, or a railway car or other railroad equipment.

Article 306: Duty-Free Entry of Certain Commercial Samples and Printed Advertising Materials

Each Party shall grant duty-free entry to commercial samples of negligible value, and to printed advertising materials, imported from the territory of another Party, regardless of their origin, but may require that:

a. such samples be imported solely for the solicitation of orders for goods, or services provided from the territory, of another Party or non-Party; or
b. such advertising materials be imported in packets that each contain no more than one copy of each such material and that neither such materials nor packets form part of a larger consignment.

Article 307: Goods Re-Entered After Repair or Alteration

1. Except as set out in Annex 307.1, no Party may apply a customs duty to a good, regardless of its origin, that re-enters its territory after that good has been exported from its territory to the territory of another Party for repair or alteration, regardless of whether such repair or alteration could be performed in its territory.

2. Notwithstanding Article 303, no Party may apply a customs duty to a good, regardless of its origin, imported temporarily from the territory of another Party for repair or alteration.

3. Annex 307.3 applies to the Parties specified in that Annex respecting the repair and rebuilding of vessels.

Article 309: Import and Export Restrictions

1. Except as otherwise provided in this Agreement, no Party may adopt or maintain any prohibition or restriction on the importation of any good of another Party or on the exportation or sale for export of any good destined for the territory of another Party, except in accordance with Article XI of the GATT, including its interpretative notes, and to this end Article XI of the GATT and its interpretative notes, or any equivalent provision of a successor agreement to which all Parties are party, are incorporated into and made a part of this Agreement.

2. The Parties understand that the GATT rights and obligations incorporated by paragraph 1 prohibit, in any circumstances in which any other form of restriction is prohibited, export price requirements and, except as permitted in enforcement of countervailing and antidumping orders and undertakings, import price requirements.

3. In the event that a Party adopts or maintains a prohibition or restriction on the importation from or exportation to a non-Party of a good, nothing in this Agreement shall be construed to prevent the Party from:

a. limiting or prohibiting the importation from the territory of another Party of such good of that non-Party; or
b. requiring as a condition of export of such good of the Party to the territory of another Party, that the good not be re-exported to the non-Party, directly or indirectly, without being consumed in the territory of the other Party.

4. In the event that a Party adopts or maintains a prohibition or restriction on the importation of a good from a non-Party, the Parties, on request of any Party, shall consult with a view to avoiding undue interference with or distortion of pricing, marketing and distribution arrangements in another Party.

5. Paragraphs 1 through 4 shall not apply to the measures set out in Annex 301.3.

Article 316: Consultations and Committee on Trade in Goods

1. The Parties hereby establish a Committee on Trade in Goods, comprising representatives of each Party.

2. The Committee shall meet on the request of any Party or the Commission to consider any matter arising under this Chapter.

3. The Parties shall convene at least once each year a meeting of their officials responsible for customs, immigration, inspection of food and agricultural products, border inspection facilities, and regulation of transportation for the purpose of addressing issues related to movement of goods through the Parties' ports of entry.

Chapter 4. Rules of Origin

Article 401: Originating Goods

Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:

(a) the good is wholly obtained or produced entirely in the territory of one or more of the Parties, as defined in Article 415;
(b) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the Parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this Chapter;
(c) the good is produced entirely in the territory of one or more of the Parties exclusively from originating materials; or
(d) except for a good provided for in Chapters 61 through 63 of the Harmonized System, the good is produced entirely in the territory of one or more of the Parties but one or more of the non-originating materials provided for as parts under the Harmonized System that are used in the production of the good does not undergo a change in tariff classification because

  (i) the good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or
  (ii) the heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts, provided that the regional value content of the good, determined in accordance with

Article 402, is not less than 60 percent where the transaction value method is used, or is not less than 50 percent where the net cost method is used, and that the good satisfies all other applicable requirements of this Chapter.

Chapter 8. Emergency Action

Article 801: Bilateral Actions

1. Subject to paragraphs 2 through 4 and Annex 801.1, and during the transition period only, if a good originating in the territory of a Party, as a result of the reduction or elimination of a duty provided for in this Agreement, is being imported into the territory of another Party in such increased quantities, in absolute terms, and under such conditions that the imports of the good from that Party alone constitute a substantial cause of serious injury, or threat thereof, to a domestic industry producing a like or directly competitive good, the Party into whose territory the good is being imported may, to the minimum extent necessary to remedy or prevent the injury:

(a) suspend the further reduction of any rate of duty provided for under this Agreement on the good;
(b) increase the rate of duty on the good to a level not to exceed the lesser of

 (i) the most-favored-nation (MFN) applied rate of duty in effect at the time the action is taken, and
 (ii) the MFN applied rate of duty in effect on the day immediately preceding the date of entry into force of this Agreement; or

(c) in the case of a duty applied to a good on a seasonal basis, increase the rate of duty to a level not to exceed the MFN applied rate of duty that was in effect on the good for the corresponding season immediately preceding the date of entry into force of this Agreement.

2. The following conditions and limitations shall apply to a proceeding that may result in emergency action under paragraph 1:

(a) a Party shall, without delay, deliver to any Party that may be affected written notice of, and a request for consultations regarding, the institution of a proceeding that could result in emergency action against a good originating in the territory of a Party;
(b) any such action shall be initiated no later than one year after the date of institution of the proceeding;
(c) no action may be maintained

 (i) for a period exceeding three years, except where the good against which the action is taken is provided for in the items in staging category C+ of the Schedule to Annex 302.2 of the Party taking the action and that Party determines that the affected industry has undertaken adjustment and requires an extension of the period of relief, in which case the period of relief may be extended for one year provided that the duty applied during the initial period of relief is substantially reduced at the beginning of the extension period, or

(ii) beyond the expiration of the transition period, except with the consent of the Party against whose good the action is taken;

(d) no action may be taken by a Party against any particular good originating in the territory of another Party more than once during the transition period; and
(e) on the termination of the action, the rate of duty shall be the rate that, according to the Party's Schedule to Annex 302.2 for the staged elimination of the tariff, would have been in effect one year after the initiation of the action, and beginning January 1 of the year following the termination of the action, at the option of the Party that has taken the action

(i) the rate of duty shall conform to the applicable rate set out in its Schedule to Annex 302.2, or
(ii) the tariff shall be eliminated in equal annual stages ending on the date set out in its Schedule to Annex 302.2 for the elimination of the tariff. 3. A Party may take a bilateral emergency action after the expiration of the transition period to deal with cases of serious injury, or threat thereof, to a domestic industry arising from the operation of this Agreement only with the consent of the Party against whose good the action would be taken.

3. A Party may take bilateral emergency action after the expiration of the transition period to deal with cases of serious injury, or threat thereof, to a domestic industry arising from the operation of this Agreement only with the consent of the Party against whose good the action would be taken.

4. The Party taking an action under this Article shall provide to the Party against whose good the action is taken mutually agreed trade liberalizing compensation in the form of concessions having substantially equivalent trade effects or equivalent to the value of the additional duties expected to result from the action. If the Parties concerned are unable to agree on compensation, the Party against whose good the action is taken may take tariff action having trade effects substantially equivalent to the action taken under this Article. The Party taking the tariff action shall apply the action only for the minimum period necessary to achieve the substantially equivalent effects.

Article 802: Global Actions

1. Each Party retains its rights and obligations under Article XIX of the GATT or any safeguard agreement pursuant thereto except those regarding compensation or retaliation and exclusion from an action to the extent that such rights or obligations are inconsistent with this Article. Any Party taking an emergency action under Article XIX or any such agreement shall exclude imports of a good from each other Party from the action unless:

(a) imports from a Party, considered individually, account for a substantial share of total imports; and
(b) imports from a Party, considered individually, or in exceptional circumstances imports from Parties considered collectively, contribute importantly to the serious injury, or threat thereof, caused by imports.

Part Three: Technical Barriers to Trade

Article 904: Basic Rights and Obligations

Right to Take Standards-Related Measures

1. Each Party may, in accordance with this Agreement, adopt, maintain or apply any standards-related measure, including any such measure relating to safety, the protection of human, animal, or plant life or health, the environment or consumers, and any measure to ensure its enforcement or implementation. Such measures include those to prohibit the importation of a good of another Party or the provision of a service by a service provider of another Party that fails to comply with the applicable requirements of those measures or to complete the Party's approval procedures.

Right to Establish Level of Protection

2. Notwithstanding any other provision of this Chapter, each Party may, in pursuing its legitimate objectives of safety or the protection of human, animal, or plant life or health, the environment or consumers, establish the levels of protection that it considers appropriate in accordance with Article 907(2).

Non-Discriminatory Treatment

3. Each Party shall, in respect of its standards-related measures, accord to goods and service providers of another Party:

(a) national treatment in accordance with Article 301 (Market Access) or Article 1202 (Cross-Border Trade in Services); and
(b) treatment no less favorable than that it accords to like goods, or in like circumstances to service providers, of any other country.

Unnecessary Obstacles

4. No Party may prepare, adopt, maintain or apply any standards-related measure with a view to or with the effect of creating an unnecessary obstacle to trade between the Parties. An unnecessary obstacle to trade shall not be deemed to be created where:

(a) the demonstrable purpose of the measure is to achieve a legitimate objective; and
(b) the measure does not operate to exclude goods of another Party that meet that legitimate objective.

Article 905: Use of International Standards

1. Each Party shall use, as a basis for its standards-related measures, relevant international standards or international standards whose completion is imminent, except where such

standards would be an ineffective or inappropriate means to fulfill its legitimate objectives, for example because of fundamental climatic, geographical, technological, or infrastructural factors, scientific justification or the level of protection that the Party considers appropriate.

2. A Party's standards-related measure that conforms to an international standard shall be presumed to be consistent with Article 904(3) and (4).

Part Five: Investment, Services and Related Matters

Article 1102: National Treatment

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

3. The treatment accorded by a Party under paragraphs 1 and 2 means, with respect to a state or province, treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that state or province to investors, and to investments of investors, of the Party of which it forms a part.

Article 1103: Most-Favored-Nation Treatment

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

Article 1106: Performance Requirements

1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory:

(a) to export a given level or percentage of goods or services;
(b) to achieve a given level or percentage of domestic content;
(c) to purchase, use, or accord a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory;

(d) to relate in any way the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with such investment;
(e) to restrict sales of goods or services in its territory that such investment produces or provides by relating such sales in any way to the volume or value of its exports or foreign exchange earnings;
(f) to transfer technology, a production process or other proprietary knowledge to a person in its territory, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal, or competition authority to remedy an alleged violation of competition laws or to act in a manner not inconsistent with other provisions of this Agreement; or
(g) to act as the exclusive supplier of the goods it produces or services it provides to a specific region or world market.

Article 1107: Senior Management and Boards of Directors

1. No Party may require that an enterprise of that Party that is an investment of an investor of another Party appoint to senior management positions individuals of any particular nationality.

2. A Party may require that a majority of the board of directors, or any committee thereof, of an enterprise of that Party that is an investment of an investor of another Party, be of a particular nationality, or resident in the territory of the Party, provided that the requirement does not materially impair the ability of the investor to exercise control over its investment.

Article 1110: Expropriation and Compensation

1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:

(a) for a public purpose;
(b) on a nondiscriminatory basis;
(c) in accordance with due process of law and Article 1105(1); and
(d) on payment of compensation in accordance with paragraphs 2 through 6.

2. Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("date of expropriation"), and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.

3. Compensation shall be paid without delay and be fully realizable.

Article 1114: Environmental Measures

1. Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining, or enforcing any measure otherwise consistent with this Chapter that it considers appropriate

to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

2. The Parties recognize that it is inappropriate to encourage investment by relaxing domestic health, safety, or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion, or retention in its territory of an investment of an investor. If a Party considers that another Party has offered such an encouragement, it may request consultations with the other Party and the two Parties shall consult with a view to avoiding any such encouragement.

Chapter 12. Cross-border Trade in Services

Article 1201: Scope and Coverage

1. This Chapter applies to measures adopted or maintained by a Party relating to cross-border trade in services by service providers of another Party, including measures respecting:

(a) the production, distribution, marketing, sale, and delivery of a service;
(b) the purchase or use of, or payment for, a service;
(c) the access to and use of distribution and transportation systems in connection with the provision of a service;
(d) the presence in its territory of a service provider of another Party; and
(e) the provision of a bond or other form of financial security as a condition for the provision of a service.

2. This Chapter does not apply to:

(a) financial services, as defined in Chapter Fourteen (Financial Services);
(b) air services, including domestic and international air transportation services, whether scheduled or non-scheduled, and related services in support of air services, other than

   (i) aircraft repair and maintenance services during which an aircraft is withdrawn from service, and
   (ii) specialty air services;

(c) procurement by a Party or a state enterprise; or
(d) subsidies or grants provided by a Party or a state enterprise, including government-supported loans, guarantees and insurance.

3. Nothing in this Chapter shall be construed to:

(a) impose any obligation on a Party with respect to a national of another Party seeking access to its employment market, or employed on a permanent basis in its territory, or to confer any right on that national with respect to that access or employment; or
(b) prevent a Party from providing a service or performing a function such as law enforcement, correctional services, income security or insurance, social security or insurance,

social welfare, public education, public training, health, and child care, in a manner that is not inconsistent with this Chapter.

Article 1202: National Treatment

1. Each Party shall accord to service providers of another Party treatment no less favorable than that it accords, in like circumstances, to its own service providers.

2. The treatment accorded by a Party under paragraph 1 means, with respect to a state or province, treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that state or province to service providers of the Party of which it forms a part.

Article 1205: Local Presence

No Party may require a service provider of another Party to establish or maintain a representative office or any form of enterprise, or to be resident, in its territory as a condition for the cross-border provision of a service.

Chapter 14. Financial Services

Article 1403: Establishment of Financial Institutions

1. The Parties recognize the principle that an investor of another Party should be permitted to establish a financial institution in the territory of a Party in the juridical form chosen by such investor.

2. The Parties also recognize the principle that an investor of another Party should be permitted to participate widely in a Party's market through the ability of such investor to:

(a) provide in that Party's territory a range of financial services through separate financial institutions as may be required by that Party;
(b) expand geographically in that Party's territory; and
(c) own financial institutions in that Party's territory without being subject to ownership requirements specific to foreign financial institutions.

Article 1404: Cross-Border Trade

1. No Party may adopt any measure restricting any type of cross-border trade in financial services by cross-border financial service providers of another Party that the Party permits on the date of entry into force of this Agreement, except to the extent set out in Section B of the Party's Schedule to Annex VII.

Article 1405: National Treatment

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords to its own investors, in like circumstances, with respect to the establishment,

acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory.

2. Each Party shall accord to financial institutions of another Party and to investments of investors of another Party in financial institutions treatment no less favorable than that it accords to its own financial institutions and to investments of its own investors in financial institutions, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments.

Chapter 15. Competition Policy, Monopolies, and State Enterprises

Article 1501: Competition Law

1. Each Party shall adopt or maintain measures to proscribe anticompetitive business conduct and take appropriate action with respect thereto, recognizing that such measures will enhance the fulfillment of the objectives of this Agreement. To this end the Parties shall consult from time to time about the effectiveness of measures undertaken by each Party.

2. Each Party recognizes the importance of cooperation and coordination among their authorities to further effective competition law enforcement in the free trade area. The Parties shall cooperate on issues of competition law enforcement policy, including mutual legal assistance, notification, consultation, and exchange of information relating to the enforcement of competition laws and policies in the free trade area.

3. No Party may have recourse to dispute settlement under this Agreement for any matter arising under this Article.

Chapter 16. Temporary Entry for Business Persons

Article 1603: Grant of Temporary Entry

1. Each Party shall grant temporary entry to business persons who are otherwise qualified for entry under applicable measures relating to public health and safety and national security, in accordance with this Chapter, including the provisions of Annex 1603.

2. A Party may refuse to issue an immigration document authorizing employment to a business person where the temporary entry of that person might affect adversely:

(a) the settlement of any labor dispute that is in progress at the place or intended place of employment; or
(b) the employment of any person who is involved in such dispute.

Part Six: Intellectual Property

Article 1701: Nature and Scope of Obligations

1. Each Party shall provide in its territory to the nationals of another Party adequate and effective protection and enforcement of intellectual property rights, while ensuring that measures to enforce intellectual property rights do not themselves become barriers to legitimate trade.

Article 1705: Copyright

1. Each Party shall protect the works covered by Article 2 of the Berne Convention, including any other works that embody original expression within the meaning of that Convention. In particular:

(a) all types of computer programs are literary works within the meaning of the Berne Convention and each Party shall protect them as such; and
(b) compilations of data or other material, whether in machine readable or other form, which by reason of the selection or arrangement of their contents constitute intellectual creations, shall be protected as such.

The protection a Party provides under subparagraph (b) shall not extend to the data or material itself, or prejudice any copyright subsisting in that data or material.

Article 1711: Trade Secrets

1. Each Party shall provide the legal means for any person to prevent trade secrets from being disclosed to, acquired by, or used by others without the consent of the person lawfully in control of the information in a manner contrary to honest commercial practices, in so far as:

(a) the information is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons that normally deal with the kind of information in question;
(b) the information has actual or potential commercial value because it is secret; and
(c) the person lawfully in control of the information has taken reasonable steps under the circumstances to keep it secret.

2. A Party may require that to qualify for protection a trade secret must be evidenced in documents, electronic or magnetic means, optical discs, microfilms, films or other similar instruments.

3. No Party may limit the duration of protection for trade secrets, so long as the conditions in paragraph 1 exist.

Article 1712: Geographical Indications

1. Each Party shall provide, in respect of geographical indications, the legal means for interested persons to prevent:

(a) the use of any means in the designation or presentation of a good that indicates or suggests that the good in question originates in a territory, region, or locality other than the true place of origin, in a manner that misleads the public as to the geographical origin of the good;
(b) any use that constitutes an act of unfair competition within the meaning of Article 10*bis* of the Paris Convention.

2. Each Party shall, on its own initiative if its domestic law so permits or at the request of an interested person, refuse to register, or invalidate the registration of, a trademark containing or consisting of a geographical indication with respect to goods that do not originate in the indicated territory, region, or locality, if use of the indication in the trademark for such goods is of such a nature as to mislead the public as to the geographical origin of the good.

Chapter 22. Institutional Arrangements and Dispute Settlement Procedures

Article 2001: The Free Trade Commission

1. The Parties hereby establish the Free Trade Commission, comprising cabinet-level representatives of the Parties or their designees.

2. The Commission shall:

(a) supervise the implementation of this Agreement;
(b) oversee its further elaboration;
(c) resolve disputes that may arise regarding its interpretation or application;
(d) supervise the work of all committees and working groups established under this Agreement, referred to in Annex 2001.2; and
(e) consider any other matter that may affect the operation of this Agreement.

Article 2005: GATT Dispute Settlement

Disputes regarding any matter arising under both this Agreement and the General Agreement on Tariffs and Trade, any agreement negotiated there under, or any successor agreement (GATT), may be settled in either forum at the discretion of the complaining Party.

Article 2021: Private Rights

No Party may provide for a right of action under its domestic law against any other Party on the ground that a measure of another Party is inconsistent with this Agreement.

Appendix R
Trade Documents

TABLE R.1 Pro Forma Invoice

PROFORMA INVOICE

Export References:		*Expiration Date:*
Exporter Name and Address:	*Ultimate Consignee Name and Address:*	*Sold To Name and Address:*
Intermediate Consignee/Consigned to:	*Notify Party Name and Address:*	*Date of Shipment:* *AWB/BL Number:* *Currency:* *Letter of Credit Number:*
Conditions of Sale and Terms of Payment: *Freight (please mark): Pre-paid ___ Collect___* *Title Transfer Occurs At:* *Payment Terms:*	*Transportation method:* *Via:* *From:*	*Total Number of Packages:* *Total Net Weight (kgs):* *Total Gross Weight (kgs):*

Item Number, Product Description, Tariff Classification Number, Country of Origin	*Quantity*	*Unit Price*	*Total Price*

Please Note: *These commodities, technology, or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law prohibited.*

Authorized Signature:		*Company:*
Name:		*Title:*
Date:	*E-mail:*	*Telephone Number(s)* *Voice:* *Facsimile:*

This invoice is for export/import purposes only and not intended for payment purposes

Sample Documents

TABLE R.2 Air Waybill (Air Consignment Note)

Shipper's Name and Address

Shipper's Account Number

Not Negotiable

Air Waybill

Issued by

Copies 1, 2 and 3 of this Air Waybill are originals and have the same validity

Consignee's Name and Address

Consignee's Account Number

It is agreed that the goods described herein are accepted in apparent good order and condition (except as noted) for carriage SUBJECT TO THE CONDITIONS OF CONTRACT ON THE REVERSE HEREOF. ALL GOODS MAY BE CARRIED BY ANY OTHER MEANS INCLUDING ROAD OR ANY OTHER CARRIER UNLESS SPECIFIC CONTRARY INSTRUCTIONS ARE GIVEN HEREON BY THE SHIPPER, AND SHIPPER AGREES THAT THE SHIPMENT MAY BE CARRIED VIA INTERMEDIATE STOPPING PLACES WHICH THE CARRIER DEEMS APPROPRIATE. THE SHIPPER'S ATTENTION IS DRAWN TO THE NOTICE CONCERNING CARRIERS' LIMITATION OF LIABILITY. Shipper may increase such limitation of liability by declaring a higher value for carriage and paying a supplemental charge if required.

Issuing Carrier's Agent Name and City

Accounting Information

Agent's IATA Code | Account No.

Airport of Departure (Addr. of First Carrier) and Requested Routing

To	By first Carrier	Routing and Destination	to	by	to	by	Currency	CHGS Code	WT/VAL PPD	WT/VAL COLL	Other PPD	Other COLL	Declared Value for Carriage	Declared Value for Customs

Airport of Destination | Flight/Date | **For Carrier Use only** | Flight/Date | Amount of Insurance | INSURANCE: If Carrier offers insurance and such insurance is requested in accordance with conditions thereof, indicate amount to be insured in figures in box marked "amount of insurance".

Handling Information - These commodities, technology or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law prohibited.

SCI

No. of Pieces RCP	Gross Weight	kg lb	Rate Class / Commodity Item No.	Chargeable Weight	Rate / Charge	Total	Nature and Quantity of Goods (incl. Dimensions or Volume)

Prepaid	**Collect**
Weight Charge	
Valuation Charge	
Tax	
Total Other Charges Due Agent	
Total Other Charges Due Carrier	
Total Prepaid	**Total Collect**
Currency Conversion Rates	CC Charges in Dest. Currency
For Carriers Use only at Destination	Charges at Destination

Other Charges

I hereby certify that the particulars on the face hereof are correct and that insofar as any part of the consignment contains dangerous goods, I hereby certify that the contents of the consignment are fully and accurately described above by proper shipping names and are classified, packaged, marked and labeled, and in proper condition for carriage by air according to the applicable national governmental regulations.

Signature of Shipper or his Agent

Executed on (Date) at (Place) Signature of Issuing Carrier or its Agent

Total Collect Charges

Page 1 of 1

TABLE R.3 Commercial Invoice

COMMERCIAL INVOICE

Export References:		
Exporter Name and Address:	*Ultimate Consignee Name and Address:*	*Sold To Name and Address:*
Intermediate Consignee/Consigned to:	*Notify Party Name and Address:*	*Date of Shipment:* *AWB/BL Number:* *Currency:* *Letter of Credit Number:*
Conditions of Sale and Terms of Payment: *Freight:* *Title Transfer Occurs At:* *Payment Terms:*	*Transportation:* *Via:* *From:*	*Total Number of Packages:* *Total Net Weight (kgs):* *Total Gross Weight (kgs):*

Line No.	*Item Number, Harmonized Number, Product Description*	*Country of Origin*	*Quantity*	*Unit Price*	*Total Price*

***Please Note**: These commodities, technology, or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law prohibited.*

Authorized Signature:	*Company:*
Name:	*Title:*
Date:	*Telephone Number(s)* *Voice:* *Facsimile:*

This invoice is for export/import purposes only and not intended for payment purposes.

TABLE R.4 Dock Receipt

Dock Receipt

Page 1 of 1

Exporter				Booking Number	Document Number
				Export References	
Ultimate Consignee				Forwarding Agent	
Notify Party				Also Notify	
Pre-Carriage By		Place of Receipt		Domestic Routing	
Exporting Carrier		Port of Loading		Loading/Pier Terminal	
Port of Discharge		Place of Receipt on Carrier		Type of Move	

Marks and Numbers	No. of Pkgs	HM	Description	Weight (lbs.)	Measurements

Delivered By:

Truck ____________

Arrived Date ______ Time ______

Unloaded Date ______ Time ______

Checked by ____________

Placed in ship on

Received the above described goods or pkgs subject to all the terms of the undersigned's regular form of dock receipt and bill of lading which shall constitute the contract under which the goods are received, copies of which are available from the carrier on request and may be inspected at any of its offices.

For the Master:

By ____________

Date

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TABLE R.5 Ocean Bill of Lading

Ocean Bill of Lading

Exporter			Booking Number	Document Number
			Export References	
Ultimate Consignee			Forwarding Agent	
Notify Party			Also Notify	
Pre-Carriage By	Place of Receipt		Domestic Routing	
Exporting Carrier	Port of Loading		Loading Pier/Terminal	
Port of Discharge	Place of Receipt on Carrier		Type of Move	

Marks and Numbers	No. of Pkgs	HM	Description	Weight	Measurements

Ship Ref No. ______ ______ There are: ___ pages, including attachments to this Ocean Bill of Lading

These commodities, technology or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law prohibited.
Carrier has a policy against payment solicitation, or receipt of any rebate, directly or indirectly, which would be unlawful under the United States Shipping Act, 1984 as amended.

FREIGHT RATES, CHARGES, WEIGHTS AND/OR MEASUREMENTS

Received by Carrier for shipment by ocean vessel between port of loading and port of discharge, and for arrangement or procurement of pre-carriage from place of receipt and on-carriage to place of delivery, where stated above, the goods as specified above in apparent good order and condition unless otherwise stated. The goods to be delivered at the above mentioned port of discharge or place of delivery, whichever is applicable.

IN WITNESS WHEREOF ___ original Bills of Lading have been signed, not otherwise stated above, one of which being accomplished the others shall be void.

DATED AT ______

BY ______

Agent

Mo. Day Year

B/L No.

This document created using Shipping Solutions Professional export software, www.shipsolutions.com.

TABLE R.6 Packing List

Packing List													
Shipper/ Exporter:		*Ultimate Consignee:*		*Bill To:*						*Intermediate Consignee*			
Commercial Invoice No.: **Order No.:** **AWB/BL Number:** **Date Of Shipment:** **Currency:** **Freight:**		**Total number of Packages:** **Total Gross Weight (Lbs):** **Total Gross Weight (Kgs):** **Total Net Weight (Lbs):** **Total net Weight (Kgs):** **Total Cubic Feet:** **Total Cubic Meters:**		**Transportation:** **Conditions of Sale and Terms of Payment:**									
Shipment Line No.	**Item Number**	**Item Description, Sales Order No., Customer PO No.**	**Shipped Quantity**	**Packaging Type**	**Dimensions**							**Per package gross weight**	
					Inches			**centimeters**					
					L	**W**	**H**	**L**	**W**	**H**		**LBS.**	**KGS.**
Country of Origin: Marks:													

Note: These commodities, Technology or software were exported from the United States in accordance with the Export Administration Regulations. Diversion contrary to U.S. law is prohibited.

Signature: ______________________________ Date:

TABLE R.7 Shipper's Letter of Instruction

1a. U.S. PRINCIPAL PARTY IN INTEREST (USPPI) *(Complete name and address)* ZIP CODE			2. DATE OF EXPORTATION	3. TRANSPORTATION REFERENCE NO.
1b. USPPI'S EIN (IRS) or ID NO.	1c. PARTIES TO TRANSACTION ☐ Related ☐ Non-Related			
4a. ULTIMATE CONSIGNEE *(Complete name and address)*				
4b. INTERMEDIATE CONSIGNEE *(Complete name and address)*				
5a. FORWARDING AGENT *(Complete name and address)*			6. POINT (STATE) OF ORIGIN OR FTZ NO.	7. COUNTRY OF ULTIMATE DESTINATION
5b. FORWARDING AGENT'S EIN (IRS) or ID NO.				
8. LOADING PIER *(vessel only)*	9. METHOD OF TRANSPORTATION *(specify)*		14. CARRIER IDENTIFICATION CODE	15. SHIPMENT REFERENCE NO.
10. EXPORTING CARRIER	11. PORT OF EXPORT		16. ENTRY NUMBER	17. HAZARDOUS MATERIALS ☐ Yes ☐ No
12. PORT OF UNLOADING *(vessel and air only)*	13. CONTAINERIZED *(vessel only)* ☐ Yes ☐ No		18. IN BOND CODE	19. ROUTED EXPORT TRANSACTION ☐ Yes ☐ No

20. SCHEDULE B DESCRIPTION OF COMMODITIES *(Use Columns 22-24)*

D/F or M (21)	SCHEDULE B NUMBER (22)	QUANTITY-SCHEDULE B UNITS (23)	SHIPPING WEIGHT (Kilograms) (24)	VIN/PRODUCT NUMBER/ VEHICLE TITLE NUMBER (25)	VALUE (U.S. Dollars, omit cents) (Selling price or cost if not sold) (26)
					$0

27. LICENSE NO./LICENSE EXCEPTION SYMBOL/AUTHORIZATION	28. ECCN *(When Required)*
29. Duly authorized officer or employee	The USPPI authorizes the forwarder named above to act as forwarding agent for export control and customs purposes.
Signature	
Title	
Date	31. Authentification *(When Required)*
Telephone No. (Include Area Code)	E-mail Address

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