Global Finance

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Trade Theory

The basic economics of international trade

- Trade theory focuses on the basis for international trade and the microeconomic implications of expanding markets and trade.
- Trade theory dates back to arguments in the early 19th century about the value and virtues of free trade.
- Then, as now, trade was seen by some as a powerful social good, and by others as a pernicious attack on the common man.
  - In todays vernacular one might say that there is a suspicion that free trade is good for the 1% but bad for the working person.

- In the United States, the authority to negotiate trade agreements was give to the president under the Trade Promotion Authority (TPA) passed in 1974.

Expanding Markets and Economic Efficiency

- International trade and globalization are not only the results of increasing economic efficiency, they are causative forces as well.
  - Competition drives efficiency.
- There is no assurance that expanding markets, increasing competition and a greater productive efficiency will lead to a more equitable distribution of wealth.
- Therefore carefully crafted government policies are necessary to correct some of the injurious effects of the impersonal marketplace.
- This describes much of the evolution of capitalism from the unfettered capitalism of more than a hundred years ago to the regulated social capitalism that most developed countries now espouse.

Microeconomic Impact of Expanding Markets

Producer/Seller Impact of trade:

- Producers and sellers in expanding markets are pressured into becoming more efficient.
- Less innovative firms vanish, while more innovative, efficient firms prosper and expand.
- There are factors, either microeconomic or macroeconomic, that are completely out of the control of a firm that may make it inefficient.
- Government mandated legislation is another way a firm can lose it's competitive advantage.
- Producer/sellers are also consumers. They must acquire resources to produce goods.
  - Ex. President Bush imposed tariffs on imported steel in 2002. He won favor with steel producing states like PA and WV, but was criticized in steel consuming states like TN, where there is a large amount of auto production.

Resource suppliers: Labor

- As transportation and communications improve, labor markets also broaden and become more competitive.
- Ex. High skilled, technical workers, are allowed to work in the US under the H1-B program. Initially capped at 65,000 workers, demand increased the cap to 195,000 by 2003. it is now back at 65,000 with an exception of 20,000 more with STEM advanced degrees. University employees are exempt form the cap.
- Historically, the physical location of a worker was critical. Today, because of advances in computers and information technology, it is inconsequential.
- There are significant short-run costs associated with increased specialization and/or increasing productivity stemming from globalizing labor markets.
- Ex. The US government created a special program (NAFTA-Trade Adjustment Assistance) for workers who were laid off because of NAFTA. In 1994, 17,000 workers qualified for this program.
  - NAFTA is a great example of the controversy over whether trade helps or hurts an economy. Many unions are skeptical of the positive arguments and worked for this kind of assistance to workers who might have been harmed.
  - As we saw earlier, TAA was too little and too late.
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Resource Suppliers: Capital

- Because funds are much more mobile than is labor, money and capital markets exhibit a higher degree of efficiency than do labor markets and consequently will globalize much more rapidly.
  - Money moves quickly, but people move slowly.
  - Today we see migration patterns in the EU because of labor imbalances –primarily from the less developed to the more developed economies.
- **Law of one price** – Bryan and Farrell in 1994 noted in 1994 that in the new global markets, participants are increasingly able to price financial instruments more precisely across markets in multiple currencies.
- They further argue that the global capital market will play an ever greater role in determining the rate of return on capital investments, while the actions of the central banks will matter even less.
- Most importantly, the global capital market is integrating to the point where the price of government debt is market determined.
  - Greece has found it essentially impossible to sell its debt at reasonable prices because the markets perceive far too much risk. This has made governments and quasi-government organizations like the European Central Bank and the International Monetary Fund the lenders of last resort. As of the summer of 2015, Greece is seeking a bailout from the rest of the EU. It is otherwise unable to pay its debts.

Consumers

- Consumers are the one group that almost universally benefits from the added competition associated with expanding markets.
- They reap the benefits of new and improved products, new and better choices, and lower prices.
- Free trade agreements have brought price competition and extensive product selection to American consumers, but it has also meant that certain US businesses could not compete with producers in other countries. In many cases, the US has stopped producing many goods because they can be imported more cheaply.
  - The economists like Adam Smith and David Ricardo would have said this is exactly the way things should be –and it is a good thing for everyone.
  - Displaced workers in industries like steel, manufacturing, clothing, and other areas are not so enthusiastic –for good reason.
  - Consumers love it since they are getting products that they could not afford otherwise.

Issues to Consider

- Exchange Rates are variable and can change and disrupt your business.
- Country Risk –as we have seen there is much diversity in the way countries approach business
- Economic Risk
- Sovereign Risk
- Political Risk-How politically stable is the country?
- Transfer risk –can you move goods and money in and out of a country?
- Neighborhood Risk – what happens around a country can affect what happens to the country.

Exchange Rate Determination

- The rate at which the currency of one county can be converted into that of another country, specifically a **price**.
- In a given country, supplies of foreign currencies come into the market from the export of goods and services, from unilateral transfers into the country, and from capital movements into the country.
- Demands for foreign currencies arise from import activities, from unilateral transfers out of the country, and from capital movements out of the country.
- **Derived demand** is the desire to acquire foreign produced goods. Thus, the demanders should be thought of as those who want to make payments to parties in the other country.

Control of Exchange Rates

- All major trading nations have a flexible system of exchange in which relative currency values are determined by private demand and supply forces in the market.
- Until around 1971, international exchange rates were controlled by governments. Rates were not permitted to move in response to changes in demand and supply.
- Two of the major benefits of a fixed exchange rate regime are that it eliminates most exchange rate risk and reduces transactions costs associated with trading in different currencies. The development and spread of the Euro, as well as attempts by various countries to peg their national currencies to some anchor currency through the use of **currency boards** are reflections of the benefits of adoption of a common currency and/or elimination of exchange rate instability.
  - But when Greece gave up its own currency, it also gave up the possibility of printing more money to pay debts it could not otherwise pay. This is the way countries would deal with problems in the past. They could devalue their currency making it harder for their citizens to buy abroad and reducing demand, and at the same time make their products cheaper. This could help rebalance the inflow and outflow of money –the balance of payments problem.

Country Risk

- While all business transactions involve some degree of risk, those involving trade across international borders carry additional risks not present in domestic transactions.
- When doing business across international boundaries, and especially when investing in foreign countries, it is critical that one understand the nature and extent of such risks, and develop strategies and techniques to mitigate against potential losses stemming from such factors.

- The World Bank maintains an index of the ease of doing business in various countries:
  - http://data.worldbank.org/indicator/IC.BUS.EASE.XQ
  - Singapore is 1st, the US - 7th, Germany-13, Mexico-43, China - 90, India-140, and Libya-188.

Economic Risk

- **Economic risk** - The potential for detrimental changes in fundamental economic goals of the country, or a significant change in the country's comparative advantage.
- Analysts examine traditional measures of monetary and fiscal policy (inflation/deflation trends, soundness of the financial system, tax policy, government expenditures and transfers relative to income, the government's debt situation), and, for longer-term investments, other real growth factors.

Sovereign Risk

- Associated with a government's becoming unwilling or unable to meet its loan obligations.
- In the event that a government decides not to meet its obligations, the private lender has little or no realistic recourse in the court system—in that it normally requires the permission of the government in order to sue it.   Frequently the country offers its creditors a fraction of the value to settle the debt –it can be pennies on the dollar. This is called giving the creditors a "haircut."
  - Creditors may not like this, but they have little recourse.
- A government's debt repayment history, any repudiation of such obligations in the past, and variables reflecting the government's ability to pay are factors used in assessing sovereign risk.
- The higher the risk, the higher the interest the country would have to pay on its debts.

Political Risk

- Risk arising from a change in political institutions, a change in government control, social fabric, or other non-economic factors.

- It covers the potential for internal and external conflicts, plus expropriation risk.
  - Many countries in the past have simply taken ownership of properties –as Saudi Arabia did long ago when it took the US and European oil investments and created ARAMCO. In some case appropriate reimbursement is done, but not in all.

- Analysts must examine qualitative factors such as relationships of various groups in a country, the decision-making processes of the government, and the history of the country.

Transfer Risk

- Risk is arising from a decision by a foreign government to restrict capital movements.
  - Greece instituted capital controls in mid 2015.
  - Several airlines quit flying to Venezuela in 2016 because they could not bring payments beck from Venezuela to their home country.
- Governmentally imposed restrictions can make it difficult or impossible to repatriate profits, dividends, or capital.
- Given that a government can change capital movement rules at any time, transfer risk applies to all types of investments.
- However, in economic terms, there are some variables that exhibit predictive value concerning if and when a country might find it necessary and/or advantageous to restrict capital movements. For example, a growing current account deficit as a percent of GDP might signal a more pressing need for foreign exchange to cover that deficit.
- The risk of a transfer problem increases if no offsetting changes develop in the capital account.

Exchange rate risk

- Risk associated with any unexpected adverse movement in the exchange rate.
- Exchange rates fluctuate on a continuous basis as a result of short-run factors such as currency speculation activities, changes in a country's import/export position, fluctuations in interest rates, and normal funds flows.
- Factors that reflect the degree of over- or under-valuation of a currency can help isolate and quantity exchange rate risk.
- Companies employ experts to assess the risk and make investment hedges against currency changes.
- The hyper inflation experienced by Venezuela in 2015 and 2016 created huge exchange rate risks for companies doing business there.

Neighborhood Risk

- Also known as location risk, this may be associated with spillover effects caused by problems in a region, or even by problems with a country's significant trading partners.
- Ex. When Brazil devalued its real in January 1999, that action had a devastating effect on the Argentine economy, effectively spelling the ultimate doom of that country's "convertibility" regime.
- The concept of "contagion" is at the core of this element of risk.
- Factors such as membership in international trading alliances, distance from economically or politically important countries and other aspects of geography provide key indicators of neighborhood risk.
- The European Union is very concerned that the crisis in Greece could spread to the next weakest economies like Spain and Italy. If Greece cannot repay its debts, banks will take huge losses. They will also worry that Italy or Spain is next and jack up the interest they must pay on their debt. This could cause either of them to be unable to pay their debt.
  - How many dominos might fall before the damage is contained?

Methods of getting paid for goods and services.

- A key aspect of any business is how you can get paid!

Payment Terms for International Trade

- There are five principal means of payment in international trade.
  1. Cash in advance
  2. Letter of Credit
  3. Drafts
  4. Consignment
  5. Open Account

- Associated with each is a different degree of risk to the exporter and the importer.
- The greater the protection afforded the exporter, the less convenient are the payment terms for the importer.
- The supplier must weigh the benefits in risk reduction against the cost in terms of lost sales.
- Example: Financing commodities –challenges and opportunities
  – http://www.economist.com/news/finance-and-economics/21667926-banks-cut-loans-commodity-producers-others-are-stepping-rubber-barons

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1. Cash in Advance

- The exporter will not ship the goods until the buyer has remitted payment to the exporter.
- This method affords the exporter the greatest protection and allows it to avoid tying up its own funds.
- Prepayment is often required of first-time buyers whose creditworthiness is unknown, or where there is political instability in the importing country.
- Due to competitive pressures, requiring payment in advance is not something that generally works for exporters unless they have a unique product or market niche.

2. Letter of Credit

- Instrument issued by a bank on behalf of the importer promising to pay the exporter upon presentation of shipping documents in compliance with a set of stipulated terms.
- This method may be viewed as a compromise between the seller and the buyer because it affords certain advantages to each party.
- The exporter is assured of receiving payment as long as it presents documents in accordance with the agreement.
- The advantage to the importer is that it does not have to pay for the goods until shipment has been made and documents are presented in good order.

3. Drafts

- This instrument, also known as a **bill of exchange**, is an unconditional written order ordering the buyer to pay on demand the face amount of the draft.
- The draft represents the exporter's formal demand for payment from the buyer.
- A draft enables the exporter to use its bank as a collection agent.
- Drafts may be either sight drafts or time drafts. Sight drafts must be paid on presentation. Time drafts are payable at some specified future date and as such become a useful financing technique.

4. Consignment

- Goods are only shipped, but not sold, to the importer.
- The exporter still retains actual title to the merchandise.
- The importer has access to the goods but does not have to pay for them until they have been sold to a third party.
- The exporter is thus placed in a position of having to trust the buyer to pay once the goods are sold, with very limited recourse in case of default.
- Because of the high risk, consignments are infrequently used except in special cases such as affiliated or subsidiary companies trading with the parent company.

5. Open Account

- Open account selling is the opposite of cash in advance, or prepayment.
- The exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.
- The seller is relying completely on the creditworthiness, integrity and reputation of the buyer, meaning obviously that open account terms carry the highest risk of nonpayment.
- Adding to the risk is that any subsequent collection activities that may be necessary will be guided by the laws and customs of the buyer’s country.
- Despite the risks, open account transactions today are widely used, especially among industrialized countries in North America and Europe where the overall volume of trade is very high and credit information is readily available.

Financing Techniques in International Trade

Bankers' Acceptances: An order to pay a specified amount of money to the bearer on a given date.

- Used primarily in international trade with the purpose of financing goods that have not yet been transferred from the seller to the buyer.
- The great strength of the banker's acceptance is that it can allow an exporter to receive funds immediately, yet allow an importer to delay its payment until a future date.
- The bank effectively substitutes its own credit for that of the borrower. In the process, it has created a negotiable instrument that is traded freely in money markets.
  - Clearly, the banks charge a premium for that service. As the acceptances are traded, there is a difference between bid and ask prices.

Accounts receivable financing, or **factoring**

- **Factoring**, which involves the sale of the seller's accounts receivable to a third party, is becoming increasingly popular as a trade financing vehicle.
- The third party, or factor, buys a company's receivables at a discount from face value, thereby accelerating their conversion to cash.
- As with any debt-like claim, there will be charges for the time value of money and the credit risk associated with the receivables.
- Most factoring is done on a non-recourse basis, meaning that the factor assumes all the credit and political risks (except those involving disputes between the transacting parties).
- Though becoming more widely used in international trade, factoring of foreign accounts receivable is less common that factoring of domestic receivables.
- Factors often utilize export credit insurance to mitigate the additional risk of a foreign receivable.

Forfaiting

- **Forfaiting** is the discounting, without recourse to the original holder, of medium-term export receivables (such as a promissory note or bill of exchange).
- These are normally very large transactions (in excess of $500,000) with the receivables being denominated in fully convertible currencies such as the U.S. dollar, the Euro, or the British pound sterling.
- Since the forfaiting institution (usually a subsidiary of a large international bank) assumes the risk of nonpayment, it must assess the credit worthiness of the importer just if it were extending a medium-term loan.
- As is the case with many international transactions, the critical nature of country risk analysis is readily apparent.

Agencies that Promote International Trade

- **Export-Import Bank of the United States. (**Eximbank) is the only U.S. government agency dedicated solely to financing and facilitating U.S. exports.
- Established in 1934, it's mission is to finance and facilitate the export of American goods and services and maintain the competitiveness of American companies in overseas markets.
- Eximbank's programs are generally designed to encourage the private sector to finance export trade by assuming some of the underlying credit risk and providing direct financing to foreign importers when private lenders are unwilling to do
- In 2015, the Export Import Bank became a political issue in which the Republicans wanted to kill the bank and the Democrats wish to continue it.
  - Prior to this year, Congress routinely voted to keep the bank operating. In fact in 2012, the last reauthorization passed the GOP-led House 330-93!
  - The Tea Party opposed it as a form of "corporate welfare."
  - http://www.nbcnews.com/news/us-news/six-things-know-about-export-import-bank-n399786
  - Authorization expired on July 1, but efforts are being made to revive it.
    - http://www.wsj.com/articles/effort-to-force-vote-on-ex-im-bank-reauthorization-gains-some-republican-support-14

Agencies that Promote International Trade contd.

- **Private Export Funding Corporation**. PEFCO, a private corporation, is owned by a consortium of commercial and industrial companies.
- Created in 1970 by the Bankers' Association for Foreign Trade to mobilize private capital for financing the export of big-ticket items (such as aircraft or power generation equipment) by U.S. firms.
- It purchases the medium- to long-term debt obligations (usually 5 to 25 years) of importers of U.S. products at fixed interest rates.
- PEFCO finances its portfolio of foreign importer loans through the sale of its own securities. These bonds are readily marketable since they are in effect secured by Eximbank-guaranteed loans.

Agencies that Promote International Trade contd.

- **Overseas Private Investment Corporation**. OPIC, formed in 1971, is a self-sustaining federal agency that provides U.S. investors with insurance against loss due to the specific political risks of expropriation, currency inconvertibility, and political violence, i.e., war, revolution or insurrection.
- Since 1971, OPIC has supported over $145 billion in U.S. investment overseas. To qualify, the investment must be a new one or a substantial expansion of an existing facility, and must be approved by the host government.
- Coverage is generally restricted to a maximum of 90% of equity participation.
- OPIC also provides business income coverage, which protects a U.S. investor’s income flow if political violence causes damage that interrupts operation of the foreign enterprise.
- While the cost of the coverage varies by industry and risk insured, these costs are not based solely on objective criteria.