

## **Module - 31**

# **International Trade & Risk Associated with International Trade**

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## **Lesson - 31**

### **International Trade & Risk Associated with International Trade.**

#### **Highlight & Motivation:**

With the globalization and advent of e-commerce, international trade flows have increased manifold. With increased opportunities of export and import, the attendant risk associated with international trade flow has also increased. Not that the risk associated with international trade was always there.

As exporters and importers from different countries, separated not only by physical distance but by socio political conditions, international trade was always been quite risky.

In this module, different types of risk faced by parties in international trade have been discussed as well as how parties mitigate these risks has been focused upon.

#### **Learning Objectives:**

This session covers:

- **Introduction to different types of trade risk**
  - **Credit risk**
  - **Carriage Risk**
  - **Currency Risk**
  - **Country risk.**
- **Features of International Trade Document**
- **INCOTERMS associated with export-import pricing**
- **International Chambers of Commerce.**

## **31.1: Introduction to International Trade:**

International trade (export and import) forms the essence of international finance. With exporters and importers happening between entities spanning across the world, separated not only by physical distance but by policy regulations different countries, certain protocols, rules and regulations have developed so that exporters and importers are bound to perform their side of bargain.

With globalization of business, companies are sourcing raw materials from different parts of the world, identifying suppliers who would provide goods at the best price, selling products in markets where companies would get the best price irrespective geographical distance.

When exporters and overseas importers do not know each other, operate in different countries with each country having its own rules and regulations, the international trades risk increases enormously. The supplier may not supply the right kind of product, may not deliver the goods on proper time, may not supply the negotiate amount etc. Similarly, after the goods, the overseas importer may reject the goods citing quality standards, may not pay the amount as per negotiated terms and in proper time. In fact, for a SME (small and medium Sized Enterprise) the international trade risk is substantial as one payment default or rejection of exported material by the SME to a foreign entity may be death knell for the SME.

## 31.2: Risks associated with International Trade.

International trade risk can be categorized as followings:

1. **Credit Risk**
2. **Carriage Risk**
3. **Currency Risk**
4. **Country Risk**

**Credit risk** is the risk that the buyer will not pay to the seller after receiving the goods.

**Carriage risk** is the risk that there could be possible loss of cargo in transit or unusual delay in delivering the goods at the destination due to delay in transit. **Currency risk** is nothing but the change in exchange rate negatively affecting the exporter or overseas importer. **Country risk** is defined as the loss that may arise from conducting business in a specific foreign country. Country risk is defined as the relates to the likelihood that changes in the business environment, socio political scenario, financial and other policy regulations, that reduce the profitability of doing business in a country. Many research studies have focused on how country risk impacts trade flows. One interesting paper is mentioned here. Ryan(2009) studied whether country risk is relevant in determining with which countries a company does business, in addition to whether these countries are democratic. He finds that sociopolitical risk is an important part of assessing country risk and a country with a higher level of democracy and a lower level of country risk experience higher trade flows. Though much other interesting research has been undertaken by researchers, this aspect has not been elaborated in greater detail in this session.

Country risk is also manifested by complex and rigid export-import policy i.e, a country's export/import policy may undergo frequent change, a country may not have policy regarding intellectual property rights, a country's banking system may not be robust, a country etc. OECD undertakes a country risk classification among member nations. More details about OECD country risk quantifications aspects are available at [http://www.oecd.org/document/49/0,2340,en\\_2649\\_34171\\_1901105\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html)

Hence in this session, a detailed discussion on how companies mitigate the international trade risk and what are policy guidelines available for grievance redressal are discussed.

### 31.3: Features of International Trade Document:

Credit risk is the major risk faced by exporters. Similarly, overseas importers face the risk of substandard goods supplied by the exporters, not receiving goods in proper time. Exporters, overseas importers may disagree on who bears the freight and transportation charges, the insurance charges unless both parties agree to common terms before the goods are exported. Hence both parties must agree on contract with explicit details on all aspects of trade so that there is no ambiguity in trader terms, duties responsibilities of both parties.

The contract must contain all aspect of the export-import details. It must be as comprehensive and as detailed so that there is no ambiguity regarding the roles and responsibility of both parties.

The **contract document** normally contain

- Quantity, Product, Standards and Specifications
- Inspection
- Total Value of Contract and Terms of Delivery
- Taxes, Duties and Charges
- Period of Delivery/Shipment
- Packing, Labeling and Marking
- Terms of Payment-- Amount/Mode & Currency
- Discounts and Commissions, Licenses and Permits
- Insurance
- Documentary Requirements
- Guarantee
- Arbitration Agent

The contract document must cover detailed information regarding the above listed items. A specimen of contract detail is given in **Box 31.1**.

### **Box 31.1 BRIEF SPECIMEN CONTRACT FORM FOR SALE PURCHASE TRANSACTIONS**

**Source:** [http://www.indiandata.com/trade\\_policy/export\\_procedures.html#7](http://www.indiandata.com/trade_policy/export_procedures.html#7)

- I. **Name and address of the parties**.....( correct appellation and complete address of the parties)
- II. We, the above named parties have entered into this contract for the sale/purchase, etc. .... (brief purpose of the contract) on this .....(date) at .....(place)..... subject to the following terms and conditions:
  - a.**Goods** .....
  - b.**Quantity** .....**Quality**..... (Describe the quantity, quality and the other specifications of the goods precisely as per the agreement. An agency for inspection/certification of quality and/or quantity may also be stipulated).
  - c.**Price**..... **Mode of payment** .....(Quote the price, terms, i.e. **ex-works/FOB(free on board) CIF(Cost, Insurance & Freight) etc. in the currency agreed upon and describe the mode of payment i.e. payment against L/C(letter of credit)/DA (document against acceptance) /D/P(document against payment)etc. It is also desirable to mention the exchange rate.**)
  - d.**Shipment**.....(Specify date of delivery and the maximum period upto which delivery could be delayed and for which reasons, port of shipment and delivery should be mentioned).
  - e.**Packing and marking**.....(Requirements to be specified precisely)
  - f.**Insurance** .....(State the type of insurance cover required, i.e. **FPA(free from particular average)/WA (with average)/ All Risks**, etc. State also the party responsible for insurance)
  - g.**Brokerage/Commission** .....(if any payable may be mentioned)
  - h.**Passing of the property and of risk.** The property or ownership of the goods and the risk shall finally pass to the buyer at such stage as the parties may agree, i.e. **when the goods are delivered at the seller's place of work/pass the ship's rails/are covered by insurance etc. as per agreed terms).**

#### **Arbitration**

Arbitration clause recommended by **the Indian Council of Arbitration:** "All disputes or differences whatsoever arising between the parties out of relating to the construction, meaning and operation or effect of this contract or the breach thereof shall be settled by arbitration in accordance with the rules of the arbitration of the Indian Council of Arbitration and the award made in pursuance thereof shall be binding on the parties."(or any other arbitration clause that may be agreed upon between the parties).

All aspects given in **Box 31.1** must be analyzed in detail before a party commits to the counterparty. As international trade payment/receipts are zero sum games (one party benefits at the cost of another party), counterparties have to thorough knowledge on these trading terms.

### 31.4: Terms associated with export-import pricing:

In international trade, the export pricing is governed by host of factors besides the price of goods like, who bears the costs associated with customs clearance, freight insurance, loading and unloading expenses. When two parties are entering into a contract to buy& sell goods from each other, both parties should be clearly aware of who is bearing which costs.

Hence, it is very important that both trading parties understand the trade terms in no uncertain way. Parties belonging to different countries may not be aware of different trading practices followed by different countries. To bring in some kind rationalization and standardization, **incoterms** were developed. Incoterms are set of international rules that govern most commonly used foreign trade. Incoterms help in mitigating **carriage risk**. Incoterms were developed by **International Chambers of Commerce (ICC)**, is a registered trademark of ICC.

Incoterms have **four major** categories:

**Table 31.1: INCOTERMS**  
( Source: FEDAI Handbook on “ Documentary Credits & Standby Credits”)

Column 1	Column 2
Group E (Departure)	EXW (Named Place)
Group F (Main Carriage Unpaid)	FCA(Named Career) FAS(Named Place) Free on Board (Named port of Shipment)
Group C (Main Carriage Paid)	CFR (Named port of Destination) CIF (Named port of Destination) CPT (Named port of Destination) CIP (Carriage Insurance Paid to)
Group D (Arrival)	DAF (Named Frontier) DES (Named port of Destination) DEQ (Named port of Destination)

**Group E** (with only one term), in which, the seller makes the good available at the seller's own premises. In the **Group F**, the seller delivers the goods to a carrier appointed by the buyer. The seller deposits the goods to the carrier nominated by the buyer and seller does not bear the expenses of the carrier. **"F"** indicates that seller deposits the goods with the carrier free.

The third group, **Group C**, the seller contracts for the carriage, but without assuming risk of loss of damage to the goods or additional costs due to the events occurring after shipment or dispatch. **"C"** indicates that seller bears some cost even after the seller has deposited the goods at the named place.

In **"Group D"** terms, the seller bears all costs and risk needed to bring the goods to the country of the destination.

Major difference between **Group C** and **Group D** becomes clear when the goods get damaged in transit. If the contract terms are of **Group C** in nature, the seller can not be held responsible.

Now let us understand the meaning associated with words given in **Column 2** of **Table 31.1**.

**EXW (name of a place):** It indicates that the seller has the responsibility is to make goods available to the buyer at works or factory at the mentioned place. EXW indicates **"ex warehouse"**. Once the buyer picks the goods from the factory, then all the costs and risk associated with bringing the goods from the factory site to the buyers' desired destination is borne by the buyer. In such kind of pricing agreement, major risk is undertaken by the buyer. This term is the easiest to administer.

**Free on Rail(FOR)/Free on Truck(FOT):** These terms are used when the seller pays for packing and delivery. Delivering the goods at a named point into the custody of a carrier (Rail or truck or airport) fulfills the seller's obligation. Seller undertakes all expenses up to delivery of the goods into the custody of a carrier. The seller deposits the goods into the custody of the first carrier (named by the buyer) at the named place. This term is suitable for all modes of transport, including carriage by air, rail, road, and containerized/multi-modal transport.



**Free Alongside Ship (FAS) (name of the loading port):** It means that the seller fulfills its obligation, when the goods have been placed alongside the ship or vessel. Once the goods have been placed alongside the ship, the seller's obligation is fulfilled. The buyer has to bear all costs and the risk of loss or damage to the goods from that moment. The buyer has to contract with the sea carrier for transporting goods to the destination and pay the freight. Also export customs clearances and documentation charges are borne by the seller.

**Free on Board (FOB) (name of port of shipment):** In a FOB, the seller has to place the contracted goods on board of the ship. Sellers' responsibility ends the moment the contracted goods are placed on board the ship, free of cost to the buyer at a port of shipment named in the sales contract. A seller merely depositing the goods at the port of shipment will not suffice. **"Receive for Shipment Bill of Lading"** must be converted to **"Shipped on Board Bill of Lading"**. In addition, export customs clearances and documentation charges are borne by the seller.

A **bill of lading** is a type of document issued by a transportation company to a shipping company. The shipper acknowledges the receipt and shipment of goods. In addition to acknowledging the receipt of goods, a bill of lading also mentions the details of the ship on which the goods have been placed, their intended destination, and the terms for transporting the shipment to its final destination, consignee details to which party the goods are going to be delivered. In the bill of lading, it is clearly mentioned that whether cost of freight/carriage has been paid or not. **"Freight Prepaid"** indicates that the shipper has already been paid the freight charges and the overseas importer does not have pay any freight charges. However if bill of lading indicates **"Freight collect"**, then the overseas importer must pay the freight charges before collecting goods from the shipper.

**Cost and Freight (C&F) (named post of destination):** The seller pays the freight charges to bring the goods to the port of destination. Once the goods reach the port of destination, the point of delivery is fixed to the ship's rail. The expenses from arrival of ship at destination port are borne by the seller.

**Cost Insurance Freight (CIF) (named port of destination):** In all respect CIF is same as C&F except the fact that the seller has to buy a insurance to cover against any risk of loss or damage to the goods till the goods reach the named port of destination.

**Freight or Carriage Paid (DCP) (named destination):** Whenever the goods are to be carried by land transports, the DCP comes into picture. Both national and international transport by road, rail and inland waterways can form the part of DCP. The seller contracts for the carriage of the goods and pays all costs associated with the transfer of goods to the named destination. Normally the seller's obligation comes to an end when the goods are delivered and costs paid to the first carrier. In case the buyer wants the seller to insure the goods till destination, the buyer would have to mention words "including insurance" before the word **"freight or carriage paid"**.

**"EXS/EX-Ship (named port of destination):** It indicates that the seller will make available goods in the ship at a specific port of destination. The seller beards all costs associated with transferring the goods to the port of destination. The seller bears the freight, insurance and loading costs associated until the goods are loaded to the ship. The buyer has the responsibility to take necessary clearance from the customs officials and any cost associated with transferring the goods from the port of destination to the actual point of sale is borne by the overseas importer.

**EXQ/Ex-Quay (named port of destination):** In EXQ, the seller will make available the goods in the quay or wharf. The seller bears the additional costs associated with transferring goods from the ship and unloading it to the quay or wharf.

**Delivered at Frontier (DAF) (named place):** It is used mainly when seller and buyer agree to exchange goods at the "frontier" indicating the border of a country. Normally this term is used when goods are transported by rail or road. The seller's obligation is fulfilled when the goods arrive at the frontier. The costs associated with the customs clearance is borne by the buyer.

**Delivered Ex Ship (named port of destination):** The seller fulfills the obligation to deliver when the seller delivers the goods on board of a ship at the named port of destination. All costs associated with bringing goods to the named port of destination is borne by the seller.

**Delivered Ex Quay (Duty Unpaid) (named port of destination):** Once the seller delivers the goods on the quay at the named port of destination, the buyer takes it from there. The import clearance activities and costs are undertaken by the buyer. Import duty is paid by the buyer.

### Short Questions:

1. What are the risks associated with International Trade Risks? Briefly explain how these risks are mitigated by exporting and importing parties.
2. What features should be there in a sale and purchase contracts to mitigate counterparty risk?
3. What are different groups in INCOTERMS?

### References:

- Ryan Baird, ( 2009) "The Importance of Country Risk in Determining Trade Flows: The Preference for a Sure Thing"  
[http://www.allacademic.com/meta/p\\_mla\\_apa\\_research\\_citation/1/6/7/9/6/p167964\\_index.html](http://www.allacademic.com/meta/p_mla_apa_research_citation/1/6/7/9/6/p167964_index.html)
- **BRIEF SPECIMEN CONTRACT FORM FOR SALE PURCHASE TRANSACTIONS**  
[http://www.indiandata.com/trade\\_policy/export\\_procedures.html#7](http://www.indiandata.com/trade_policy/export_procedures.html#7)
- INCOTERMS, Source: FEDAI Handbook on “ Documentary Credits & Standby Credits”.