

Hochschule für angewandte Wissenschaften (HAW) Hamburg

Lecture Notes:  
International Trade and  
Foreign Direct Investment  
(Draft Release)

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Term: Summer Term 2010

# AGENDA

1. Introduction - International Trade Trends and Developments
2. Why do Companies trade?
3. Forms of International Trade
4. Regulations in Foreign Trade
5. Trade Finance
6. Risk Management in Foreign Trade
7. Introduction to FDI (Trends and Developments)
8. FDI-related Theories - Why do Companies invest abroad?
9. Types / Forms of FDI
10. Risk Management in FDI

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## Definition of International Trade / Globalisation



*“International trade is the exchange of goods and services across international borders. In most countries, it represents a significant share of GDP. While international trade has been present throughout much of history, its impact has been on the rise in recent centuries, mainly because of industrialisation, advanced transportation, multinational corporations, etc... In fact, it is probably the increasing prevalence of international trade that is usually meant by the term "globalisation".”*



# History of Global Trade (I)

## The different phases

- Can be traced back to medieval times
  - examples: silk from China, gold from South Africa, etc...
- First major phase of global trade:
  - 14th to 16th century
  - rise of...
    - ...major trading centres like Florence, Venice, London, Antwerp, Hamburg, Lübeck, etc.
    - ...powerful trade-dynasties (Fugger, Medici) and trade-syndicates (Hanse)
  - decline and fall due to the (anything but peaceful) creation of territorial states in Europe / negative influence of governments on trade (multitude of tariffs, etc...)



## History of Global Trade (II)

### The different phases

- Second major phase of global trade (17th to 18th century):
  - emergence of major colonial powers (England, Spain, Portugal, Netherlands)
  - but: no free trade (regulated by colonial governments)
- Third major phase of global trade (18<sup>th</sup> to 19th century):
  - industrialisation (capital markets: GB 9% invested abroad)
  - rapid technical developments (telegraph, etc.)
  - liberalisation (reduction of trade barriers)
  - average growth of export volume: 3.5% p.a. (1870 to 1914)
  - export-quota Western Europe: 18% (of GNP)  
(compare USA in 2005 = 7% !!!)



## History of Global Trade (III)

### The different phases

- Fourth major phase of global trade (globalisation):
  - ....overall strong resemblances to the third phase...
  - (re-)liberalisation of markets
  - liberalisation of capital movement
  - revolutionary technical developments (internet, etc...)
- Conclusions:
  - ongoing process...
  - ...that has undergone different evolutionary stages...
  - ...and that is NOT irreversible! (pendulum-swings)



## Excursion: Trade barriers

- Tariff-based barriers
- Non-tariff barriers (“neo-protectionism”):
  - import quotas
  - red tape
  - quality / environmental / social requirements
  - license procedures
  - anti-dumping measures

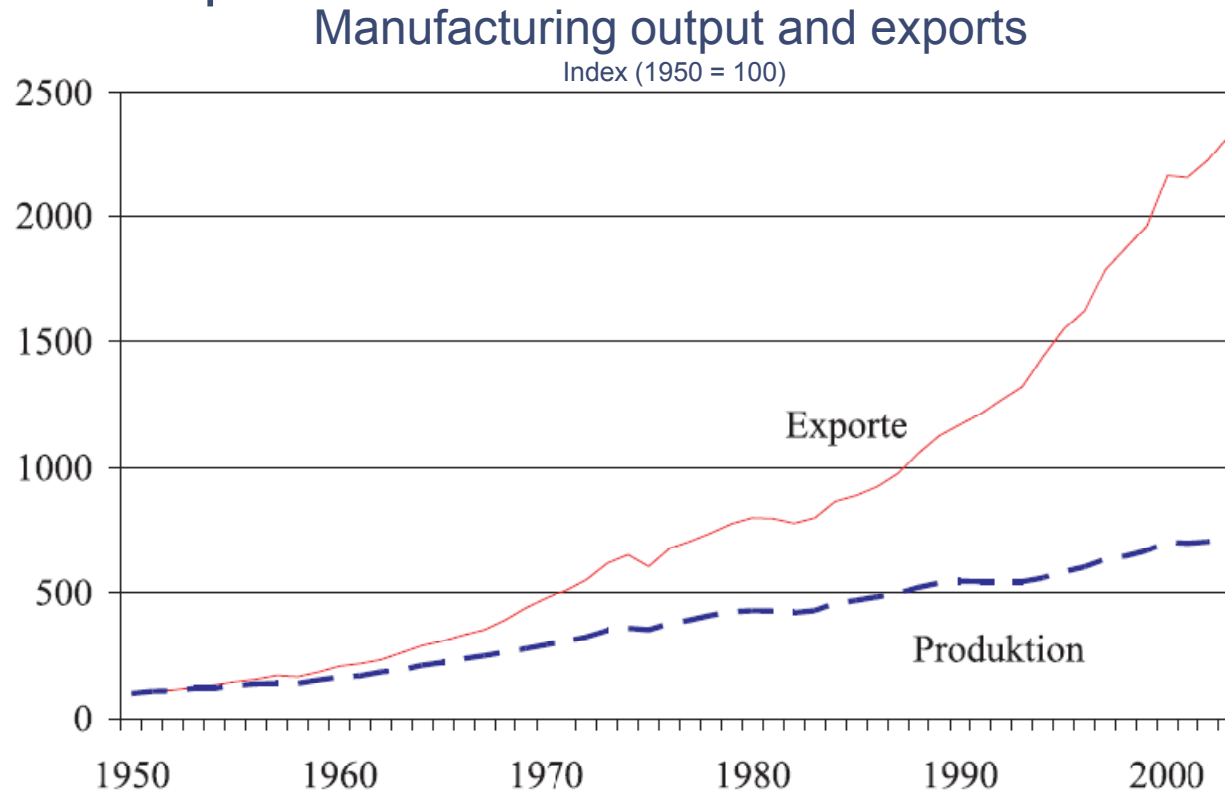
[when exporters sell to foreign markets below cost in order to achieve a long-term monopoly position (by driving local producers into insolvency)]

- Ever-increasing importance of non-tariff barriers [worldwide more than 800 registered / 20% of worldwide imports are affected (2005)]



# Current Trends in International Trade (I)

## Output and exports



- Rising rates of exports compared to production-levels
  - export intensity (2003) has more than tripled ( $2324 : 722 = 3,22$ )
- Service sector? - evidence points to the same trend



## Current Trends in International Trade (II)

### Export and GDP growth

- .....and it goes on.....

#### **World trade and output developments, 2002-05**

(At constant prices, annual percentage change)

|                                 | 2002 | 2003 | 2004 | 2005 |
|---------------------------------|------|------|------|------|
| Merchandise exports             | 3.5  | 5.0  | 9.5  | 6.0  |
| Merchandise<br>production       | 0.8  | 3.5  | 4.0  | ...  |
| GDP at market<br>exchange rates | 1.7  | 2.6  | 4.0  | 3.1  |
| GDP at PPP                      | 3.0  | 4.0  | 5.1  | 4.3  |

*Source:* WTO; IMF, World Economic Outlook.

# Current Trends in International Trade (III)

## Trade volumes



- What volumes are we talking about?

### World exports of merchandise and commercial services, 2005

(Billion dollars and percentage)

|                     | Value | Annual percentage change |      |      |      |
|---------------------|-------|--------------------------|------|------|------|
|                     | 2005  | 2000-05                  | 2003 | 2004 | 2005 |
| Merchandise         | 10120 | 10                       | 17   | 21   | 13   |
| Commercial services | 2415  | 10                       | 15   | 19   | 11   |

Source: WTO.



# Current Trends in International Trade (IV)

## Merchandise trade by region

World merchandise trade by region and selected country, 2005  
(Billion dollars and percentage)

|  | Exports |                          |      |      |      | Imports |                          |      |      |      |
|--|---------|--------------------------|------|------|------|---------|--------------------------|------|------|------|
|  | Value   | Annual percentage change |      |      |      | Value   | Annual percentage change |      |      |      |
|  | 2005    | 2000-05                  | 2003 | 2004 | 2005 | 2005    | 2000-05                  | 2003 | 2004 | 2005 |
| World  | 10121   | 10                       | 17   | 21   | 13   | 10481   | 10                       | 17   | 22   | 13   |
| North America                                | 1478    | 4                        | 5    | 14   | 12   | 2285    | 6                        | 8    | 16   | 14   |
| United States                                | 904     | 3                        | 5    | 13   | 10   | 1733    | 7                        | 9    | 17   | 14   |
| Canada                                       | 360     | 5                        | 8    | 16   | 14   | 320     | 6                        | 8    | 14   | 14   |
| Mexico                                       | 214     | 5                        | 3    | 14   | 14   | 232     | 5                        | 1    | 15   | 12   |
| South and Central America <sup>a</sup>       | 351     | 13                       | 15   | 29   | 25   | 294     | 7                        | 6    | 28   | 22   |
| Brazil                                       | 118     | 17                       | 21   | 32   | 23   | 78      | 6                        | 3    | 31   | 17   |
| Other South and Central America <sup>a</sup> | 232     | 11                       | 12   | 28   | 26   | 216     | 8                        | 7    | 27   | 24   |
| Europe                                       | 4353    | 11                       | 19   | 20   | 8    | 4521    | 10                       | 20   | 20   | 9    |
| European Union (25)                          | 3988    | 10                       | 19   | 19   | 7    | 4120    | 10                       | 20   | 20   | 8    |
| Germany                                      | 971     | 12                       | 22   | 21   | 7    | 774     | 9                        | 23   | 18   | 8    |
| France                                       | 459     | 7                        | 18   | 15   | 2    | 496     | 8                        | 21   | 18   | 5    |
| United Kingdom                               | 378     | 6                        | 9    | 14   | 9    | 501     | 8                        | 13   | 20   | 6    |
| Italy  | 367     | 9                        | 18   | 18   | 4    | 380     | 10                       | 20   | 19   | 7    |
| Other Western Europe                         | 233     | 10                       | 14   | 18   | 14   | 182     | 8                        | 15   | 16   | 10   |
| Switzerland                                  | 126     | 9                        | 15   | 18   | 6    | 121     | 8                        | 15   | 16   | 9    |
| South-East Europe                            | 132     | 21                       | 29   | 34   | 17   | 219     | 19                       | 33   | 36   | 18   |
| CIS  | 342     | 19                       | 27   | 36   | 29   | 216     | 21                       | 27   | 31   | 25   |
| Russian Federation                           | 245     | 18                       | 27   | 35   | 34   | 125     | 23                       | 25   | 28   | 28   |
| Africa                                       | 296     | 15                       | 26   | 30   | 29   | 248     | 14                       | 21   | 29   | 16   |
| South Africa                                 | 52      | 12                       | 23   | 26   | 13   | 67      | 17                       | 40   | 39   | 16   |
| Africa less South Africa                     | 244     | 16                       | 26   | 31   | 33   | 181     | 13                       | 16   | 26   | 16   |
| Oil exporters <sup>b</sup>                   | 166     | 18                       | 33   | 41   | 45   | 63      | 17                       | 17   | 34   | 17   |
| Non oil exporters                            | 78      | 11                       | 18   | 18   | 12   | 118     | 11                       | 15   | 22   | 16   |
| Middle East                                  | 529     | 15                       | 20   | 30   | 36   | 318     | 15                       | 15   | 26   | 19   |
| Asia   | 2773    | 11                       | 19   | 25   | 15   | 2599    | 12                       | 20   | 27   | 16   |
| Japan  | 596     | 4                        | 13   | 20   | 5    | 516     | 6                        | 14   | 19   | 14   |
| China  | 762     | 25                       | 35   | 35   | 28   | 660     | 24                       | 40   | 36   | 18   |
| Four East Asian traders <sup>c</sup>         | 731     | 9                        | 19   | 25   | 12   | 676     | 8                        | 15   | 27   | 14   |
| India  | 90      | 16                       | 16   | 33   | 19   | 132     | 21                       | 26   | 37   | 35   |

- Germany is the “export champion”

...as long as you don't look on commercial services trade...

(but...look at China...)



# Current Trends in International Trade (V)

## Trade of commercial services by region

World trade of commercial services by region and selected country, 2005  
(Billion dollars and percentage)

|  | Exports |                          |      |      |      | Imports |                          |      |      |      |
|--|---------|--------------------------|------|------|------|---------|--------------------------|------|------|------|
|  | Value   | Annual percentage change |      |      |      | Value   | Annual percentage change |      |      |      |
|  | 2005    | 2000-05                  | 2003 | 2004 | 2005 | 2005    | 2000-05                  | 2003 | 2004 | 2005 |
| World  | 2415    | 10                       | 15   | 19   | 11   | 2361    | 10                       | 14   | 18   | 11   |
| North America                                | 420     | 5                        | 5    | 11   | 10   | 373     | 7                        | 9    | 15   | 10   |
| United States                                | 353     | 5                        | 5    | 11   | 10   | 289     | 7                        | 8    | 15   | 10   |
| Canada                                       | 51      | 5                        | 7    | 11   | 9    | 62      | 7                        | 14   | 13   | 10   |
| Mexico                                       | 16      | 3                        | 0    | 12   | 12   | 22      | 5                        | 3    | 10   | 12   |
| South and Central America <sup>a</sup>       | 68      | 8                        | 10   | 16   | 20   | 70      | 5                        | 4    | 14   | 22   |
| Brazil                                       | 15      | 11                       | 9    | 21   | 28   | 22      | 7                        | 6    | 12   | 38   |
| Other South and Central America <sup>a</sup> | 53      | 7                        | 10   | 14   | 17   | 48      | 4                        | 3    | 15   | 15   |
| Europe                                       | 1233    | 11                       | 19   | 19   | 7    | 1119    | 11                       | 19   | 16   | 8    |
| European Union (25)                          | 1104    | 11                       | 19   | 19   | 7    | 1034    | 10                       | 19   | 16   | 7    |
| Germany                                      | 143     | 12                       | 20   | 15   | 7    | 199     | 8                        | 19   | 13   | 4    |
| United Kingdom                               | 183     | 9                        | 15   | 23   | -1   | 150     | 9                        | 13   | 20   | 4    |
| France                                       | 114     | 7                        | 15   | 12   | 4    | 103     | 11                       | 20   | 18   | 7    |
| Italy  | 93      | 11                       | 19   | 17   | 13   | 92      | 11                       | 20   | 10   | 15   |
| Other Western Europe                         | 77      | 11                       | 16   | 23   | 12   | 57      | 13                       | 15   | 23   | 14   |
| Switzerland                                  | 45      | 10                       | 15   | 24   | 9    | 25      | 10                       | 11   | 25   | 7    |
| South-East Europe                            | 52      | 12                       | 35   | 23   | 15   | 29      | 13                       | 27   | 30   | 19   |
| CIS  | 40      | 18                       | 16   | 23   | 20   | 58      | 20                       | 17   | 24   | 18   |
| Russian Federation                           | 24      | 20                       | 20   | 25   | 20   | 38      | 18                       | 16   | 23   | 15   |
| Africa                                       | 57      | 13                       | 26   | 20   | 12   | 66      | 12                       | 16   | 19   | 15   |
| South Africa                                 | 10      | 16                       | 59   | 14   | 17   | 12      | 16                       | 52   | 26   | 19   |
| Middle East                                  | 54      | 11                       | 27   | 14   | 12   | 80      | 11                       | 19   | 20   | 11   |
| Asia   | 543     | 12                       | 10   | 26   | 19   | 595     | 10                       | 10   | 25   | 15   |
| Japan  | 107     | 8                        | 8    | 25   | 12   | 136     | 3                        | 3    | 22   | 1    |
| China  | 81      | 22                       | 18   | 34   | ...  | 85      | 19                       | 19   | 31   | ...  |
| Four East Asian traders <sup>b</sup>         | 175     | 8                        | 9    | 18   | 9    | 165     | 8                        | 8    | 21   | 10   |
| India  | 68      | 33                       | 21   | 66   | ...  | 67      | 29                       | 23   | 53   | ...  |

- ...if you do, it's only second winner after the USA.
- Soon, China will top the ranking!
- Excursion: What are commercial services?
  - intellectual property and multimedia
  - telecommunications
  - travel services
  - financial services

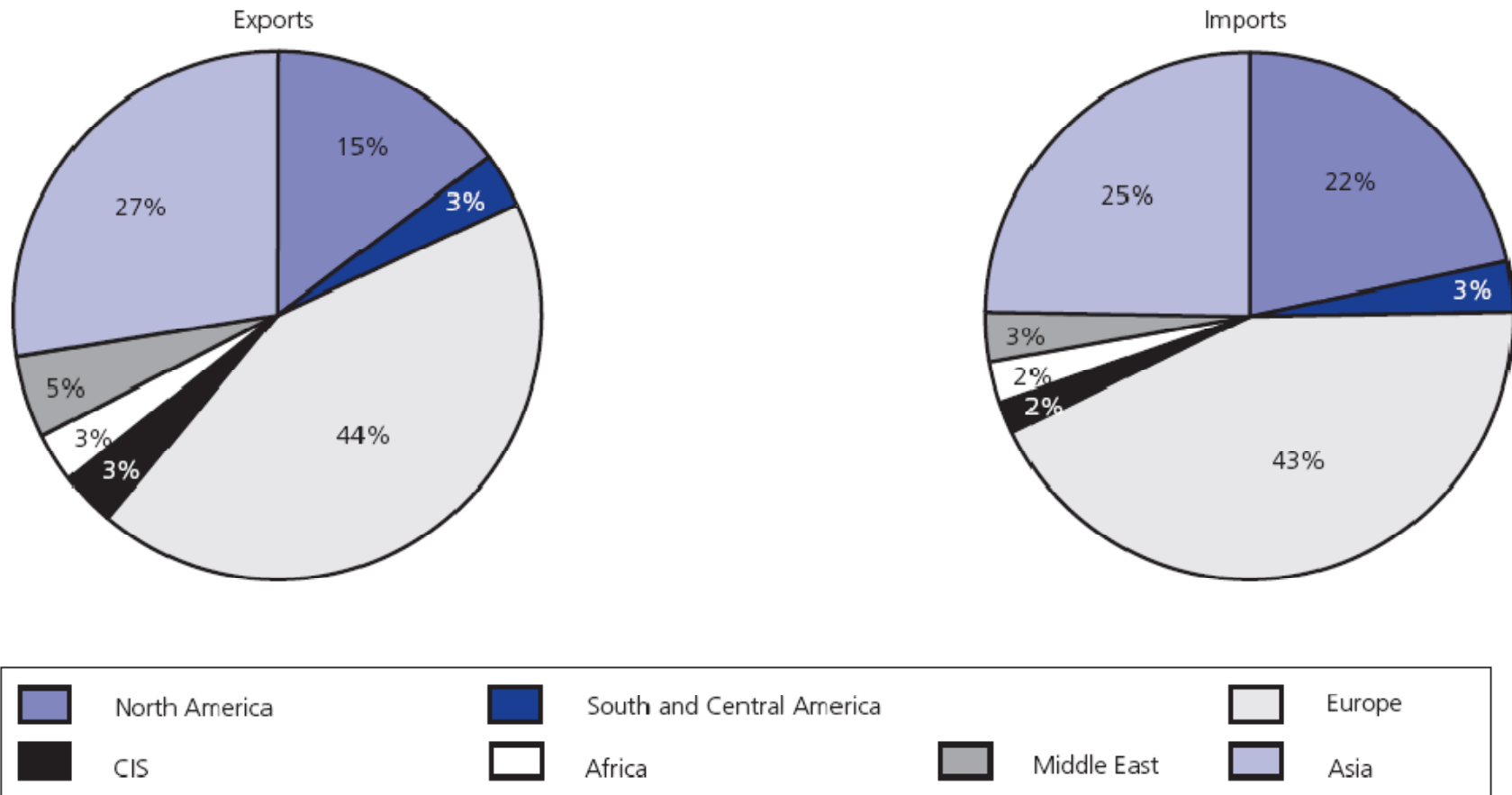
# Current Trends in International Trade (VI)

## Share in merchandise trade by region



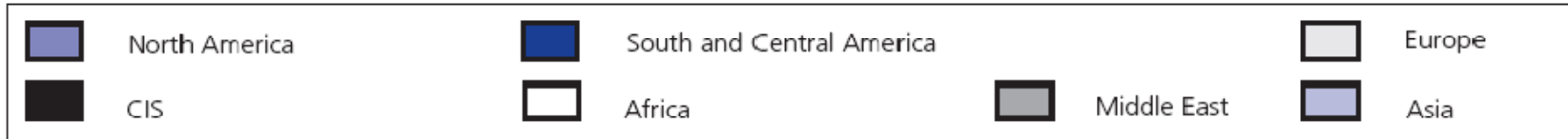
Share in world merchandise and commercial services trade by region, 2005  
(Percentage share)

### Merchandise

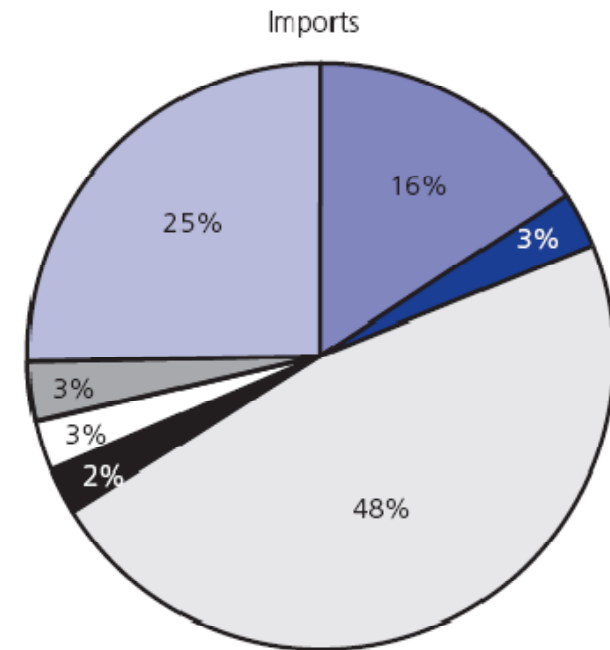
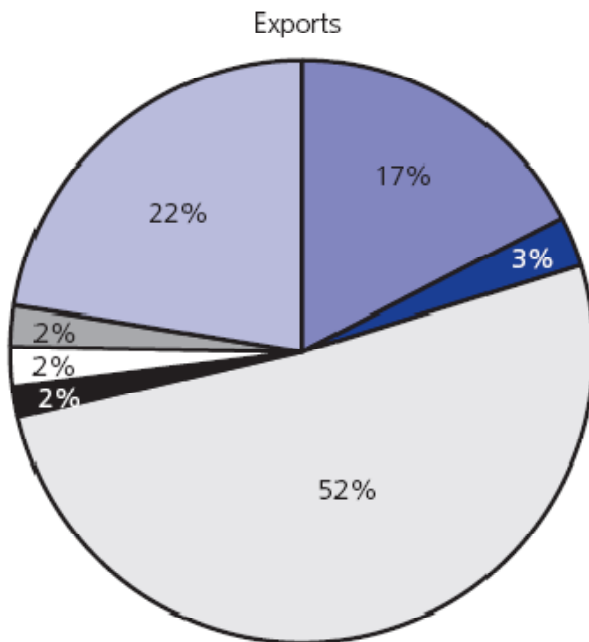


# Current Trends in International Trade (VII)

## Share in commercial services trade by region



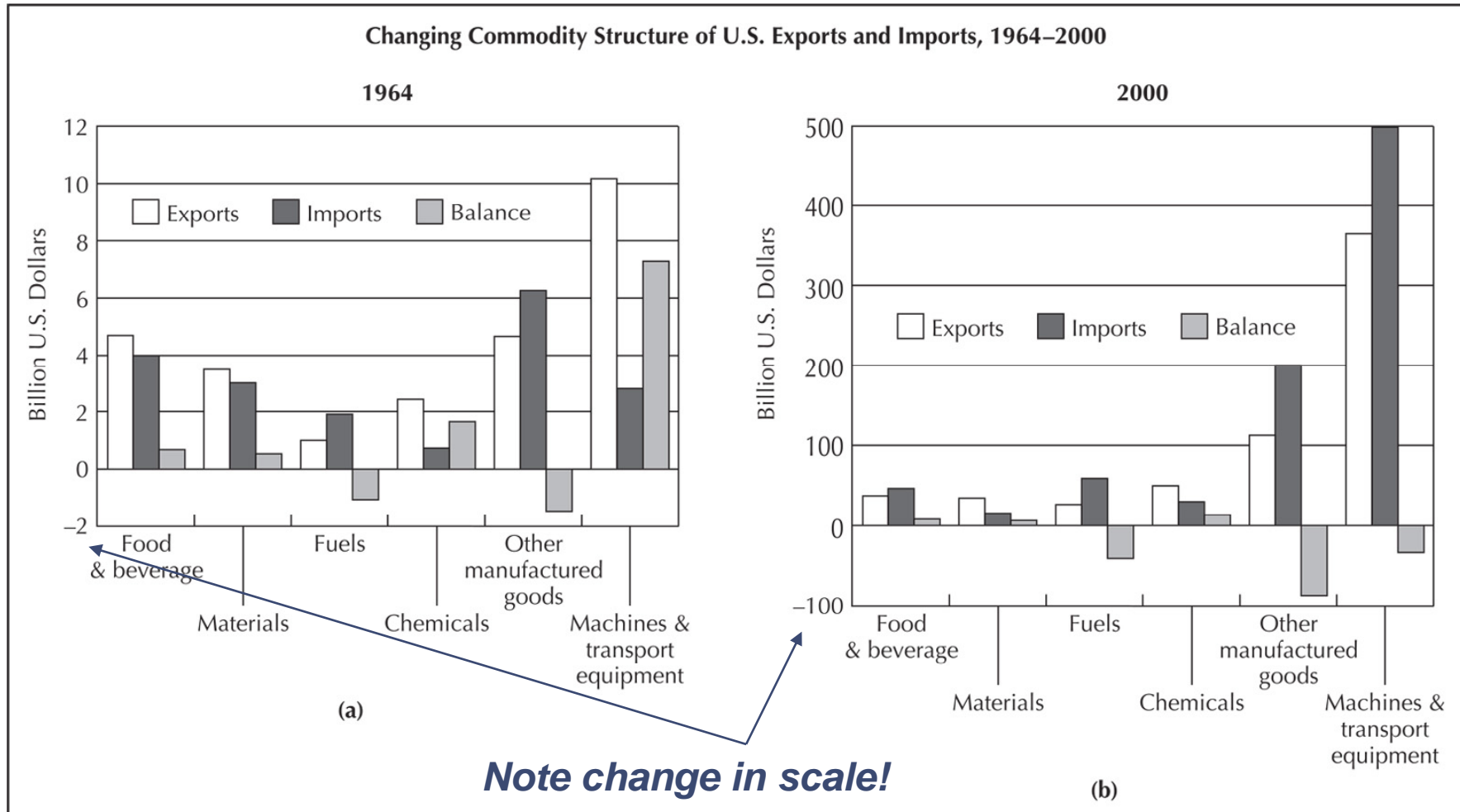
Commercial services



Source: WTO.

# International Trade Patterns (I)

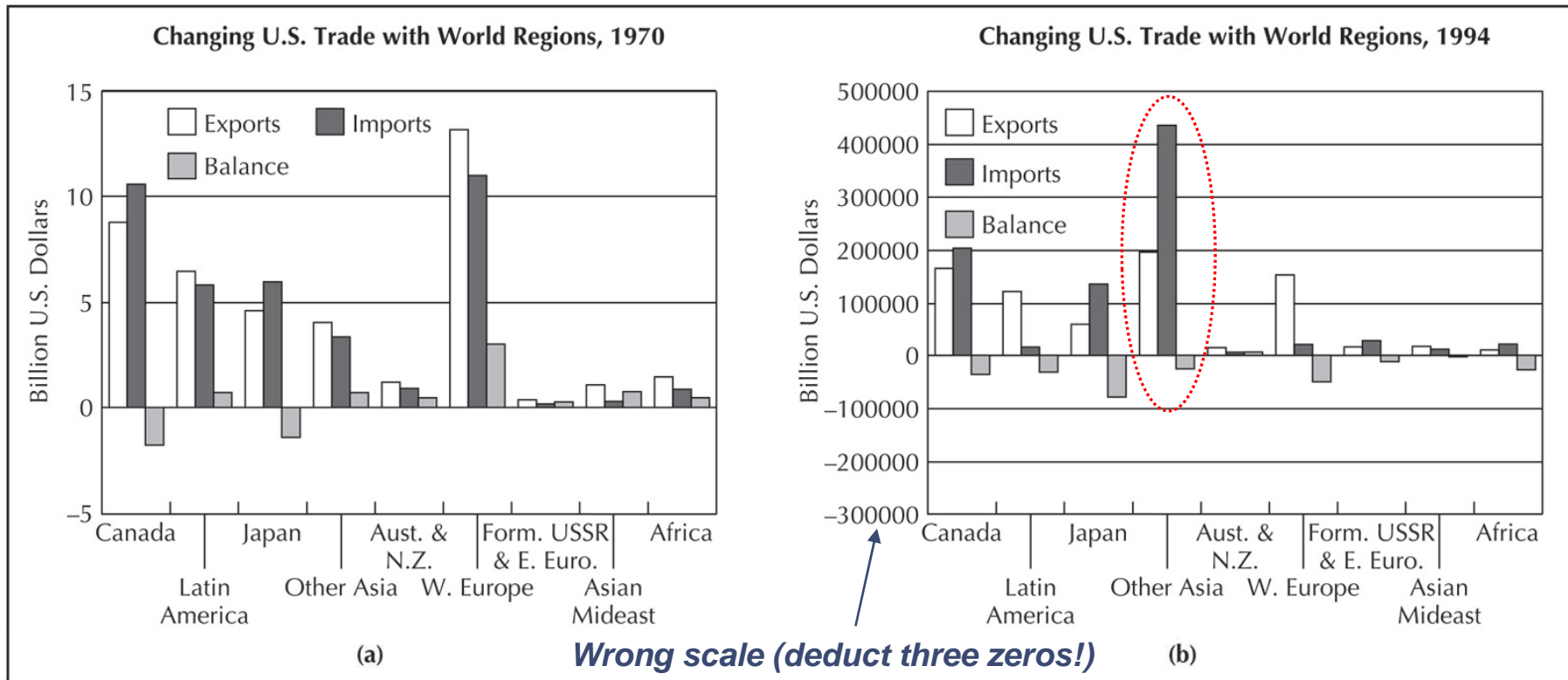
## Commodity structure - USA



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# International Trade Patterns (II)

## Geographic structure - USA

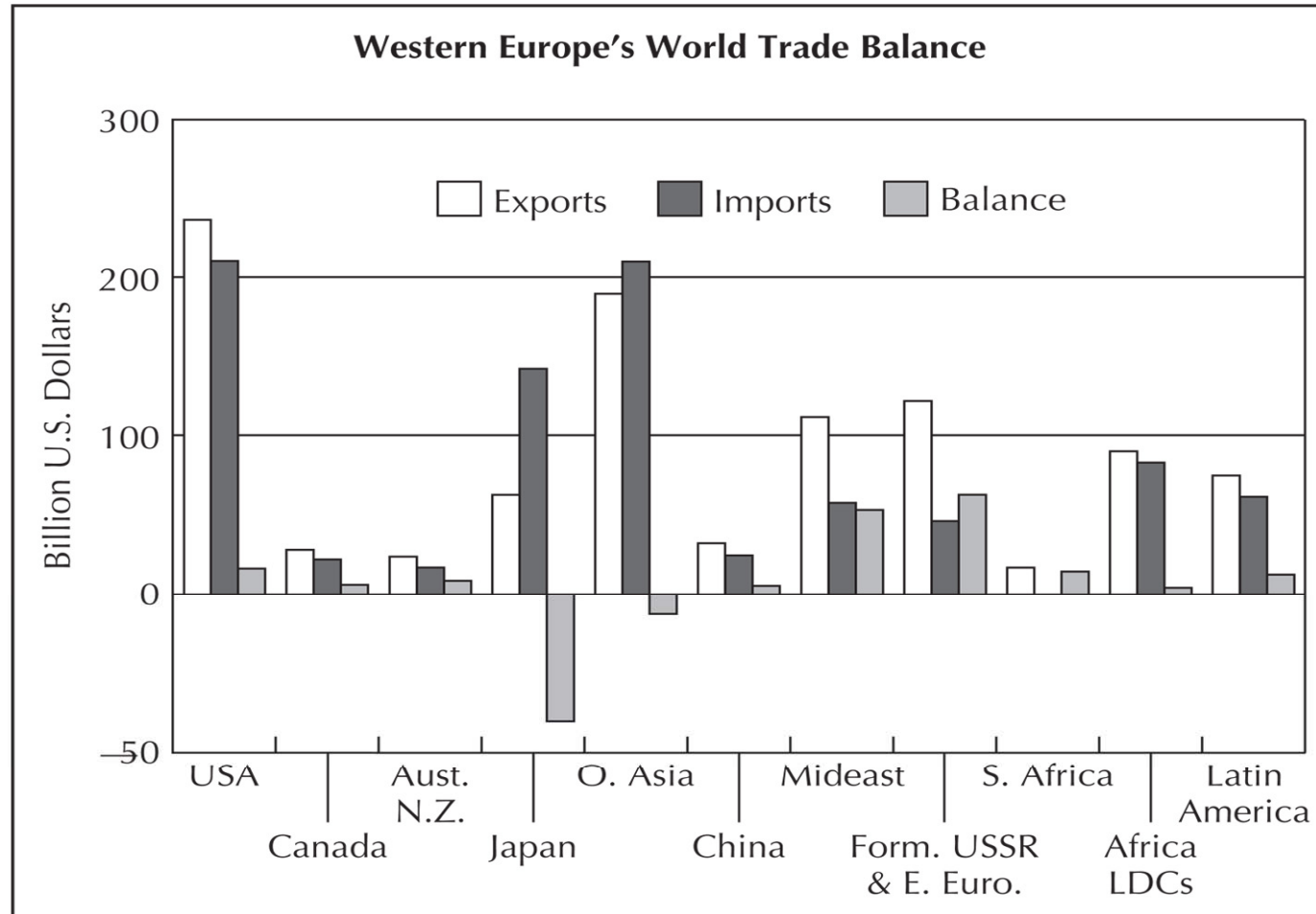


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# International Trade Patterns (III)

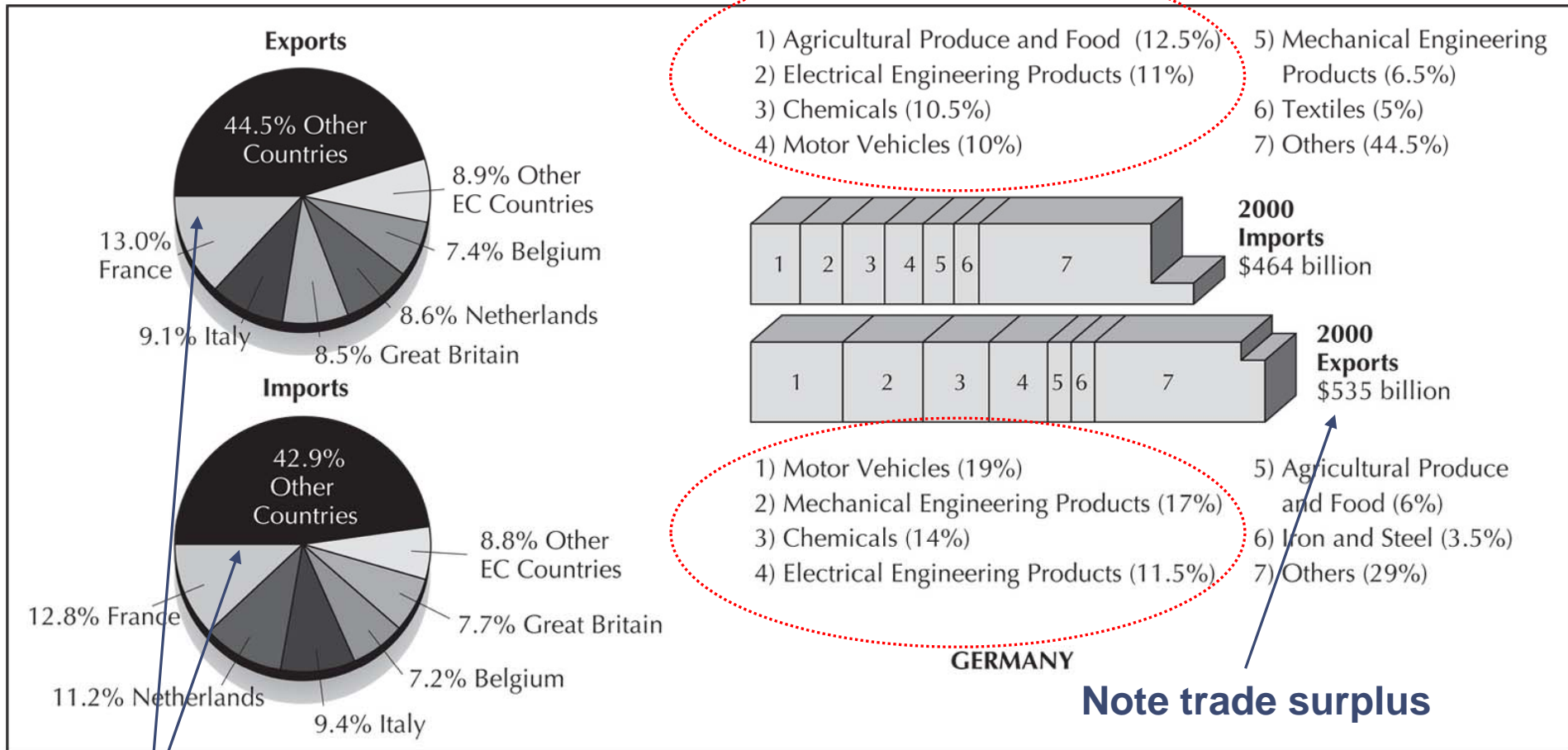
## Geographic structure – Western Europe



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# International Trade Patterns (IV)

## Geographic structure – a specific look at Germany

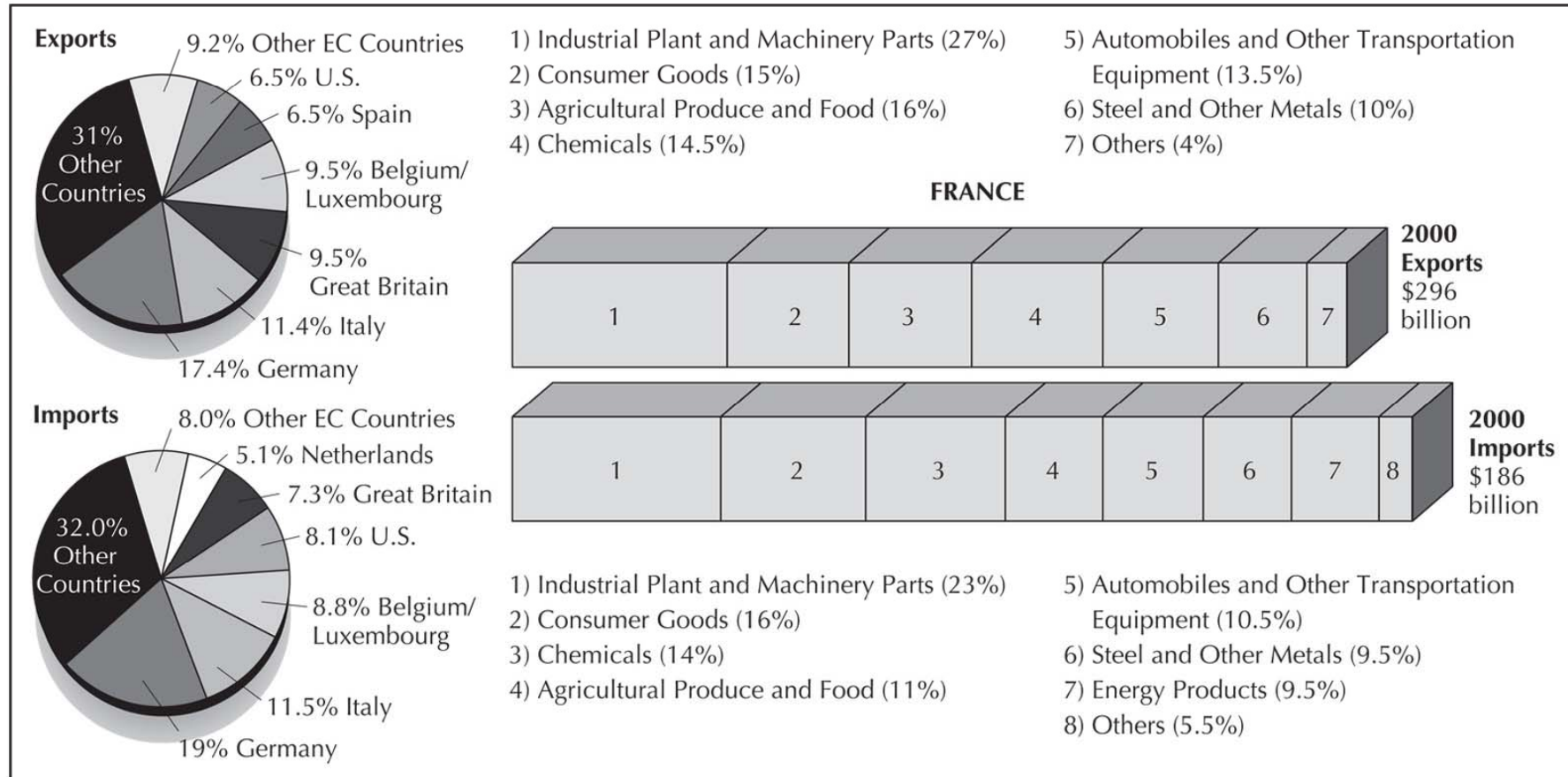


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**Note strong presence outside of Europe**

# International Trade Patterns (V)

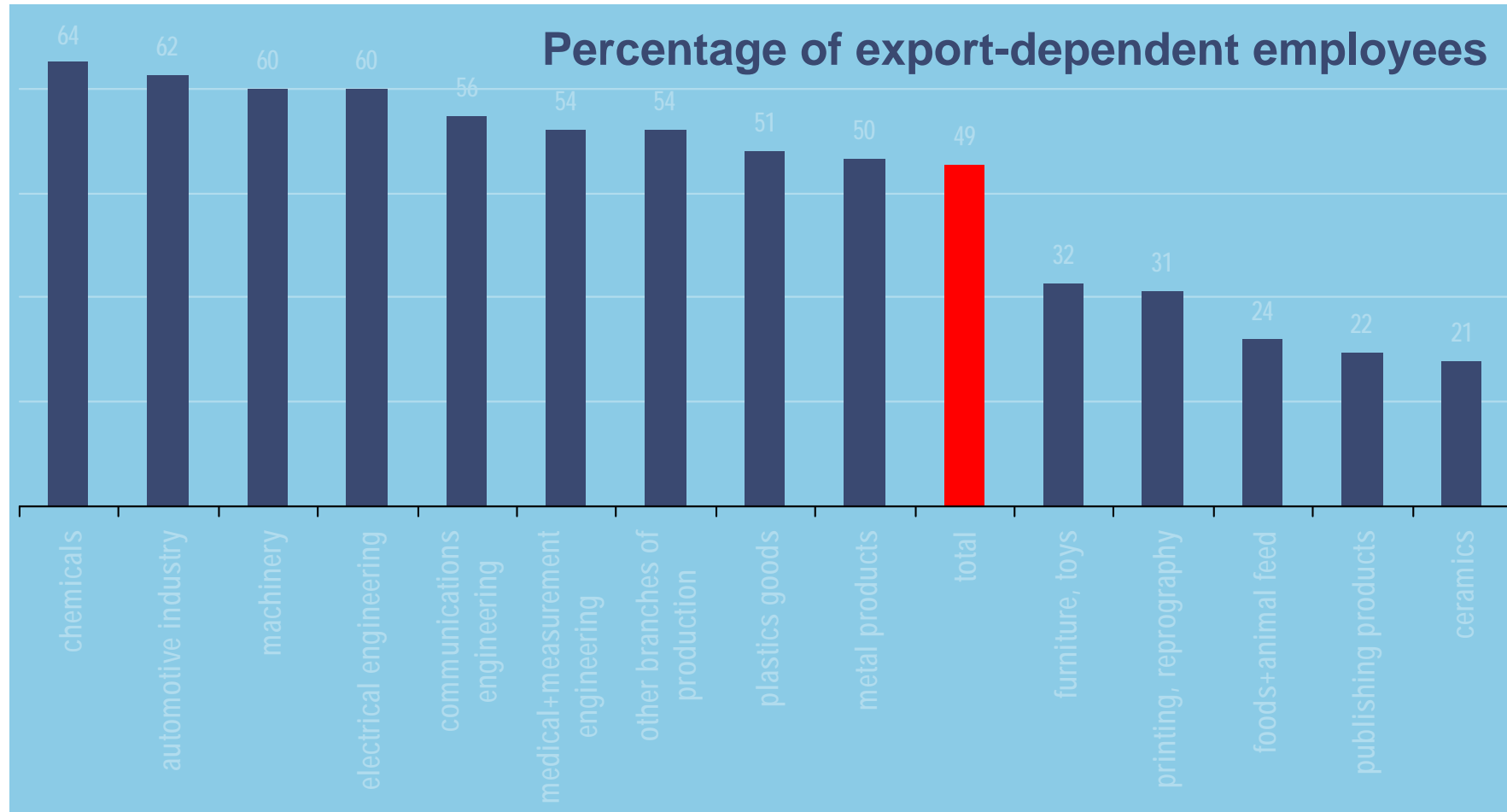
## France: strong European ties



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# International Trade Patterns (VI)

## Export-dependence of German employment



Chemical products excluding pharmaceutical products

Source: German „Sachverständigenrat“



# International Trade Patterns (VII)

## Conclusions

- International trade is a major economic driver with a clear impact on GDP-development.
- It has expanded and changed (geographically and structurally) rapidly in the last 50 years but still is - in many ways - not as global as it was prior to World War I (third phase of global trade).
- Global trade is dominated by three major blocks (EU, Asia, USA), with the EU (25) occupying the top-spot. / Reasons:
  - the relative wealth of European countries
  - the small sizes of the countries and their relatively strong reliance on neighbours for markets (like states in the USA in many ways)
  - highly developed transportation system.
- Germany is one of the most (if not the most) trade-oriented economies in the world and thus its economic development relies heavily on trade, especially in specific industries such as automotive, machinery, chemicals, etc...

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# Why Companies Trade (I)

## Motives for imports

- Predominant import-motives:
  - Certain...
    - resources
    - raw materials
    - products
    - goods...are not available in home markets.
  - price differentials (local vs. international suppliers)
  - quality differentials (local vs. international suppliers)
  - international diversification of sourcing partners in order to mitigate risks and reduce dependencies

# Why Companies Trade (II)

## Motives for exports

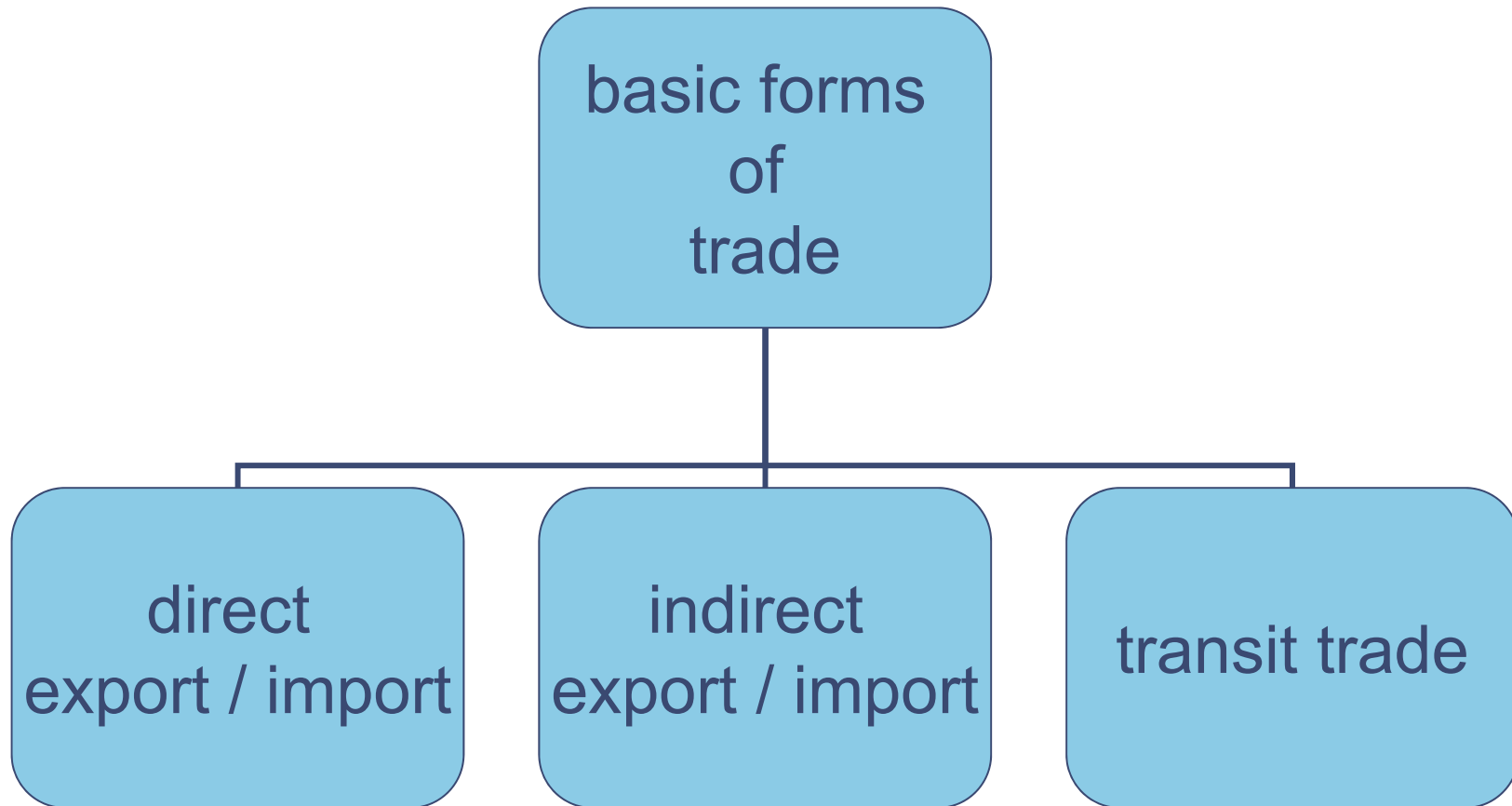


- Export-motives:
  - search for bigger profits (possibly because of strong(er) competition in home market than in foreign market or due to saturation of demand in home market)
  - risk mitigation with regard to sales and profit performance (varying international business / trade cycles)
  - economies of scale
  - spontaneous demand by foreign customers (e.g. Tamagotchi)
  - making use of local experience (competitive advantage) in foreign markets
  - making use of experience to be obtained in foreign markets
  - varying exchange rates that lower the price of home market products for foreign customers (in terms of their currency)
  - requests by home market customers to accompany them in the course of their foreign expansions (e.g. financial service sector, trade finance)
  - fear of falling behind in comparison with exporting competitors
  - support of exports by (semi-)governmental institutions (especially ECAs)

# AGENDA

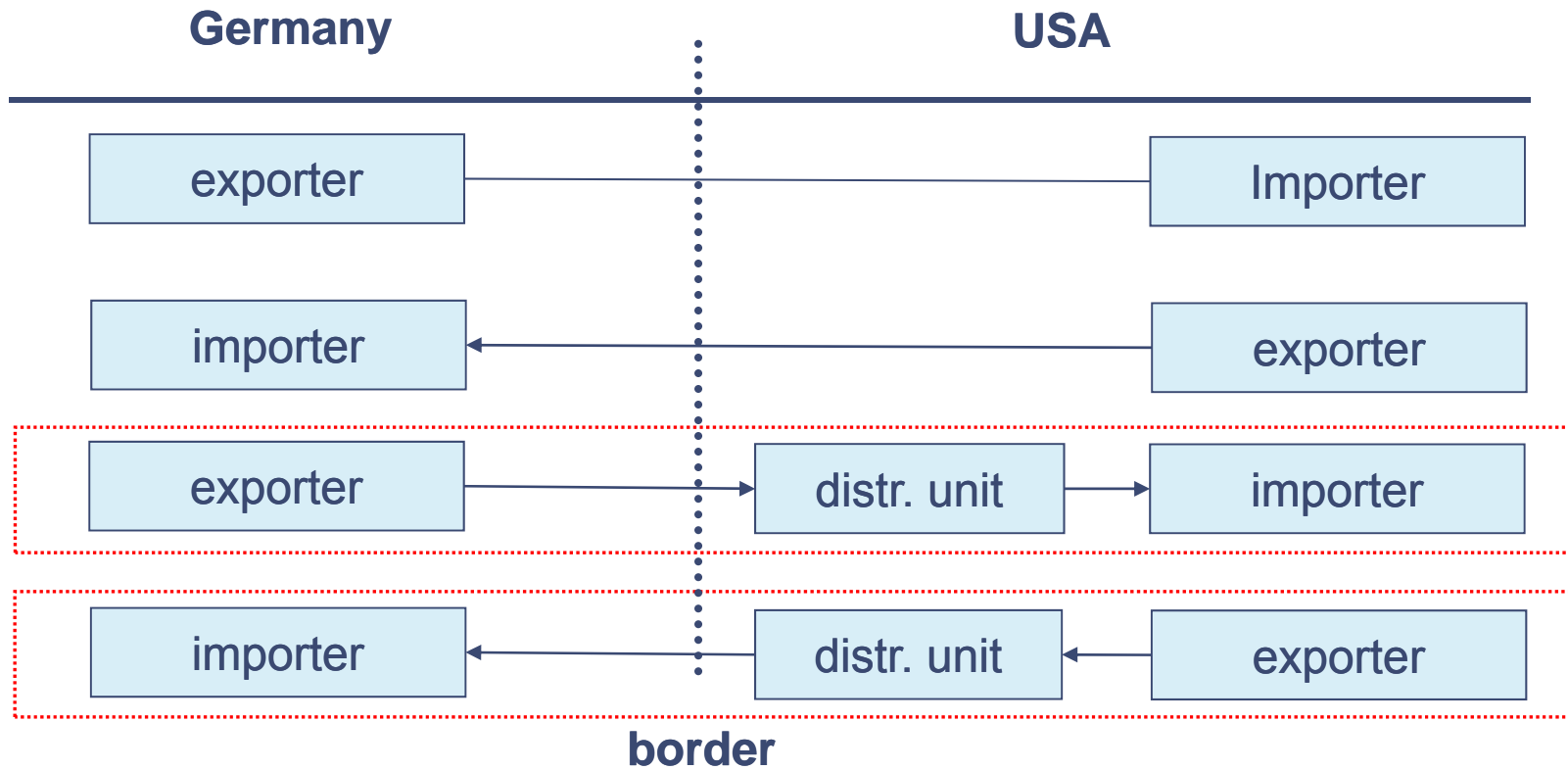
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# Basic Forms of International Trade (I)



# Basic Forms of International Trade (II)

## Direct export / import





# Basic Forms of International Trade (III)

## Alternatives for direct exports





# Basic Forms of International Trade (IV)

## Characteristics of direct export

- Especially for capital goods and in inner-European trade
- Direct contact to customers
- Direct marketing possibilities (image, advertisement etc.)
- Requires good own knowledge of foreign markets
- Necessity for own acquisitions and market relations
- Own export department
- Own delivery warehouse
- Own customer service, sparepart stocks
- Longer sales distances
- Longer-term supplier credits
- Rising capital needs
- Higher credit risk



# Basic Forms of international Trade (V)

## Alternatives for direct imports





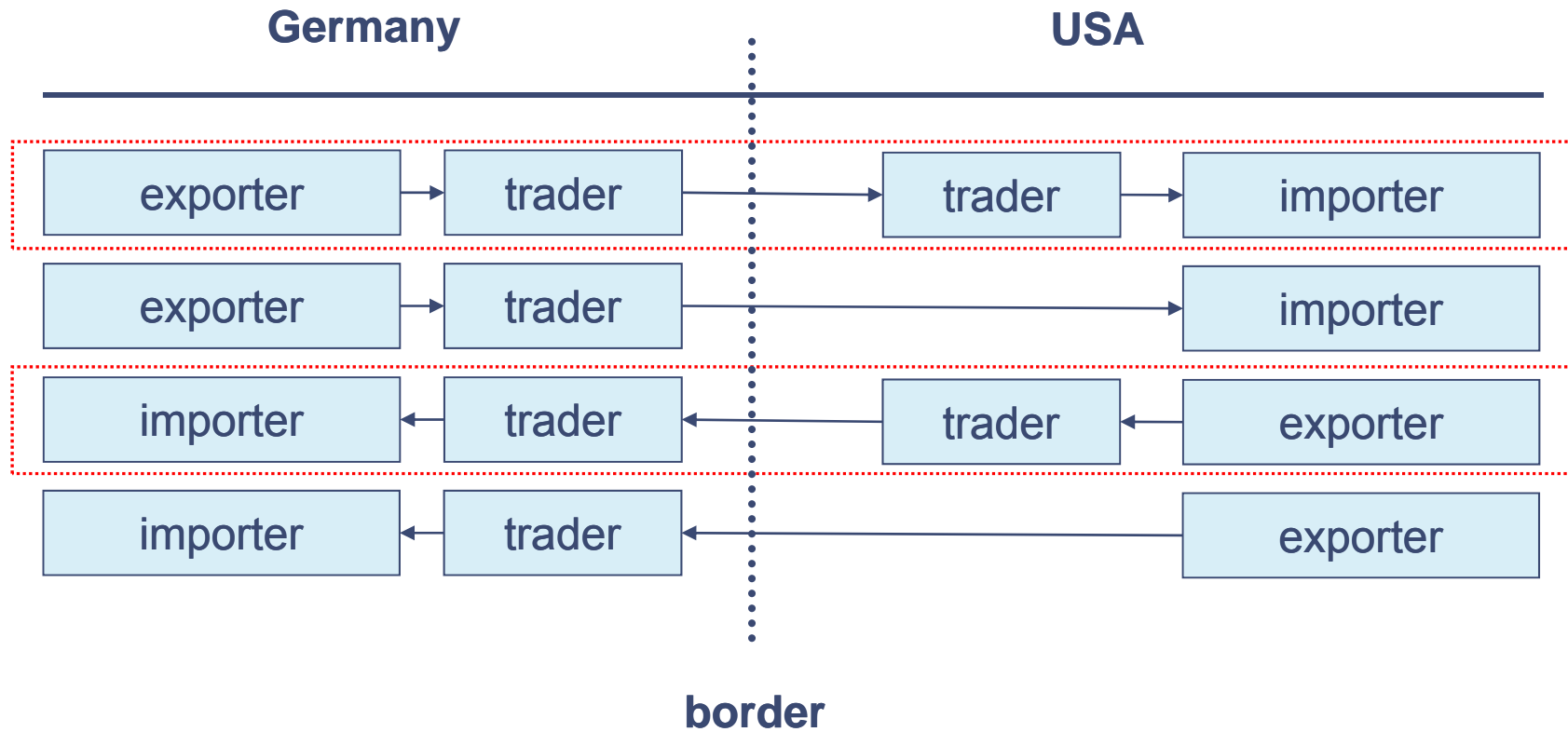
## Basic Forms of International Trade (VI)

### Characteristics of direct import

- Direct contact to suppliers
- Especially for raw materials and unfinished products (from developing countries)
- Continuous demand: typically long-term arrangements for larger quantities, continuous material flow
- But also: spontaneous purchases via auctions
- Speculations or price hedging via commodity exchanges, own market overview, own acquisition
- Transport risk typically stays with the importer
- Higher need for capital
- If necessary: own procurement / purchase representation
- If necessary: building of a self-operated import warehouse

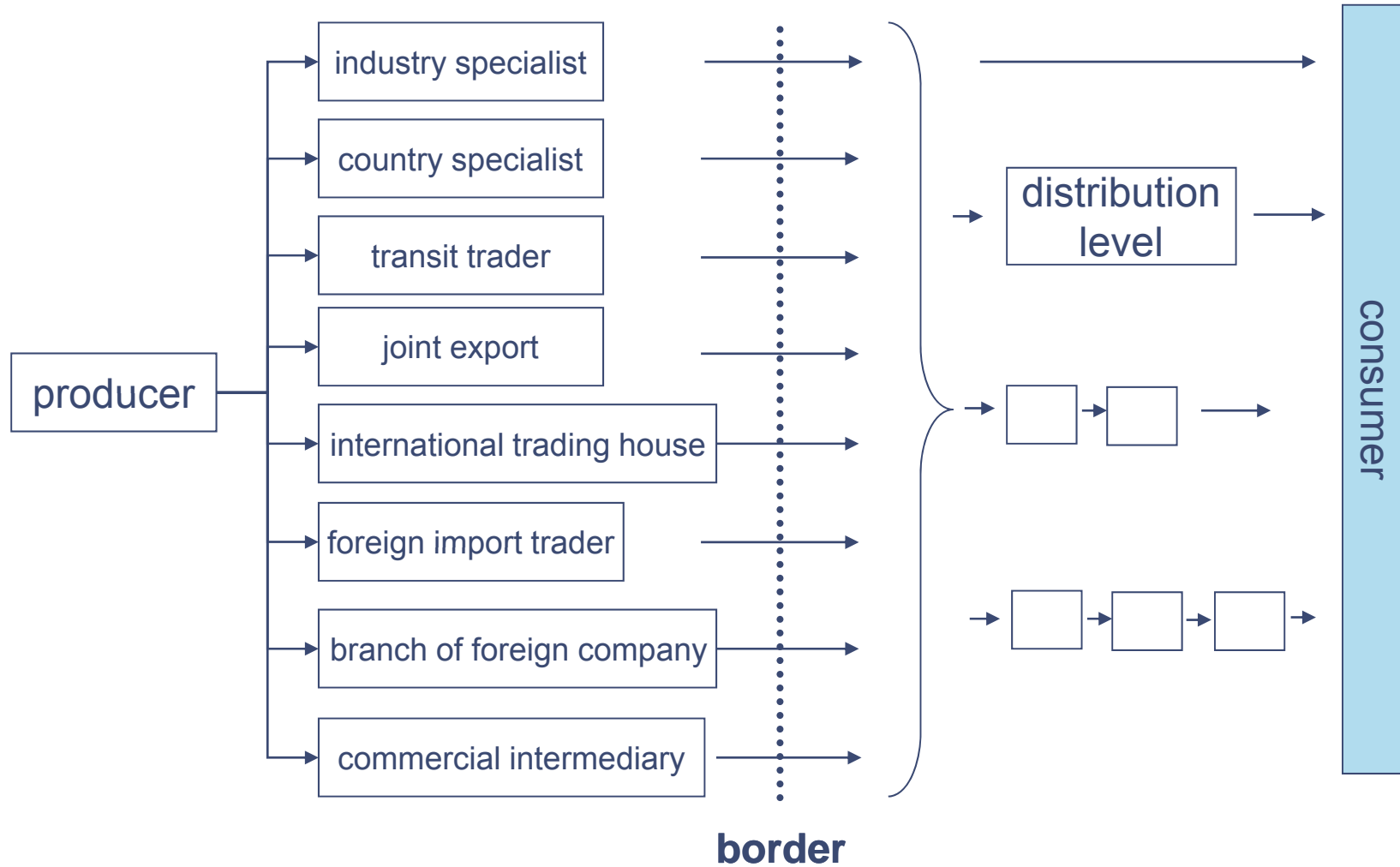
# Basic Forms of International Trade (VII)

## Indirect export / import



# Basic Forms of International Trade (VIII)

## Alternatives for indirect export





# Basic Forms of International Trade (IX)

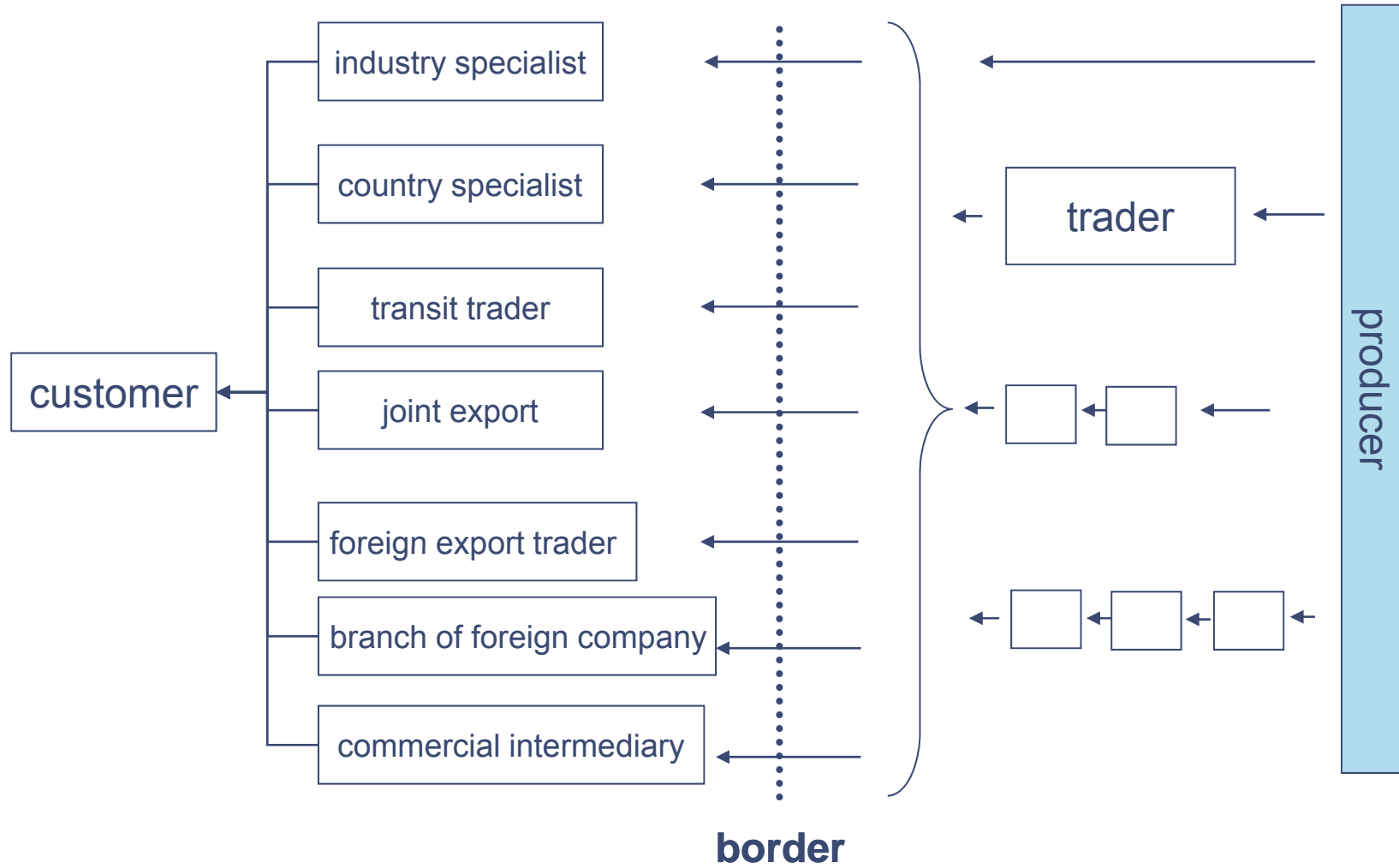
## Characteristics of indirect export

- Domestic sales for the producer
- Distribution through foreign trade companies (FTC)
- FTC has to have knowledge about country specific sales network and transport chains
- FTC has to have market experience (often specialised for specific markets or product groups)
- Risk due to market distance (“Bedarfsferne”) of producer
- Risk that FTC may demand sales exclusivity
- Preferred by small and medium-sized („Mittelstand“) producers
- No capital need by the producer for storage and distribution
- But very limited steering possibilities
- Preferred for small and/or irregular sales, unproblematic serial products
- Producers avoid the building of own marketing network



# Basic Forms of International Trade (X)

## Alternatives for indirect export





## Basic Forms of International Trade (XI)

### Characteristics of indirect import

- Import needs only temporary and/or small quantities
- Broadly diversified imports from many countries
- Good prices by bulk purchase by foreign trade company (FTC)
- Use of market experience and specialisation of FTC
- Testing possibilities
- Processing of goods by FTC according to domestic taste and quality expectations (you get exactly what you want)
- No sources of supply problems
- Normally permanent readiness for supply



# Basic Forms of International Trade (XII)

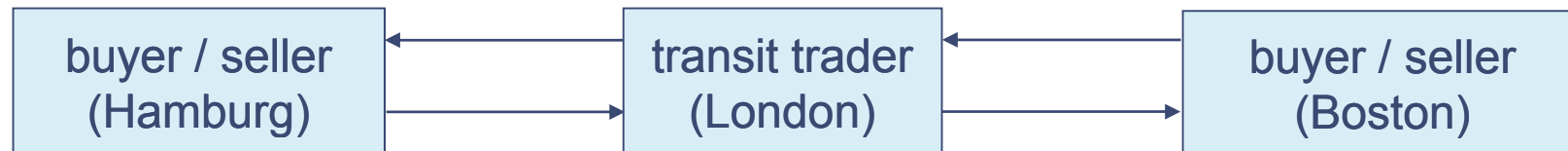
## Transit trade

- Three Parties in three countries involved in the contracting process...

### active transit trade



### passive transit trade

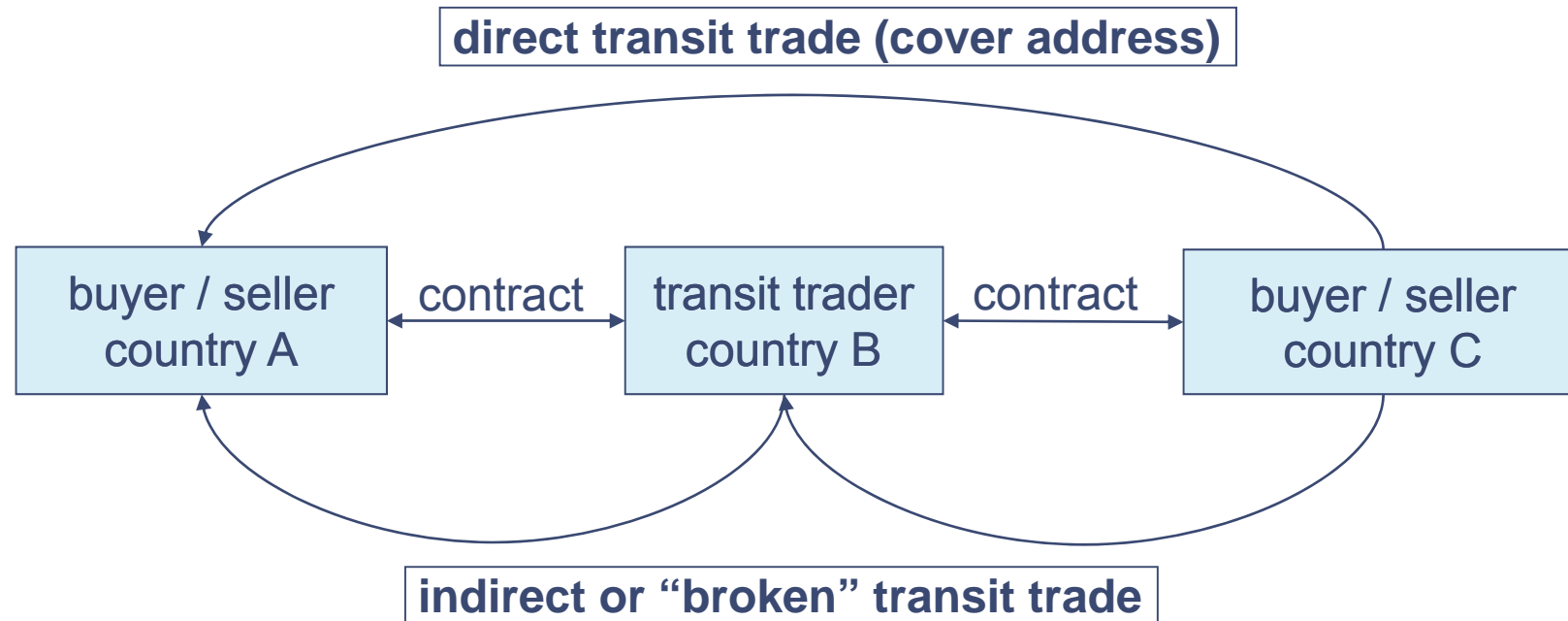




# Basic Forms of international Trade (XIII)

## Transit trade

- ...but not necessarily in the delivery-process



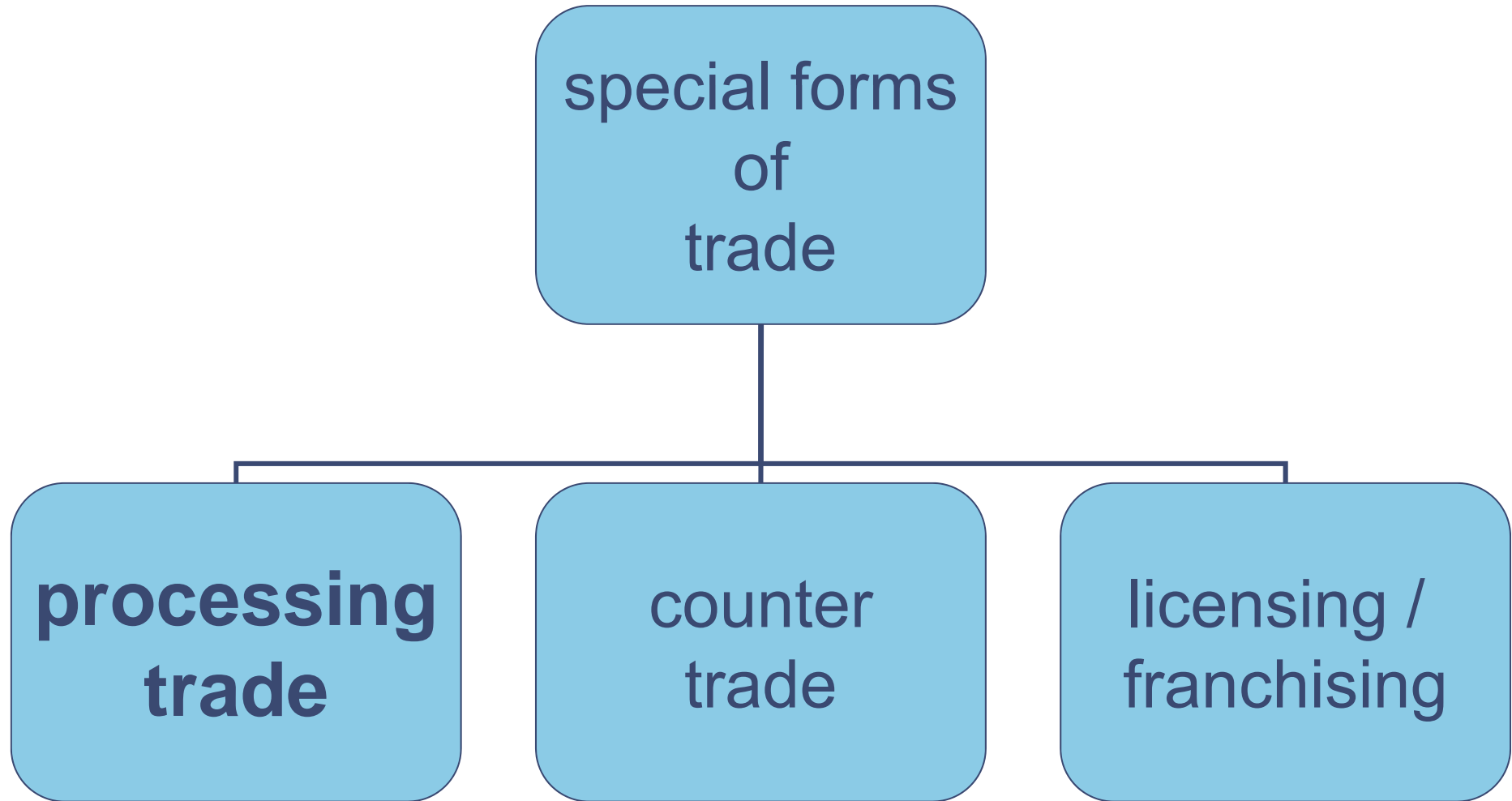
# Basic Forms of International Trade (XIV)



## Transit trade

- Typically carried out by FTC (next to indirect import / export activities)
- Traditionally used for trade in resources (copper, oil, gas, etc.) or raw materials (cotton, tobacco, etc.)
- Today: virtually unlimited product range
- Often linked to counter-trade arrangements (e.g. with developing countries - see upcoming slides)

# Special Forms of International Trade (I)





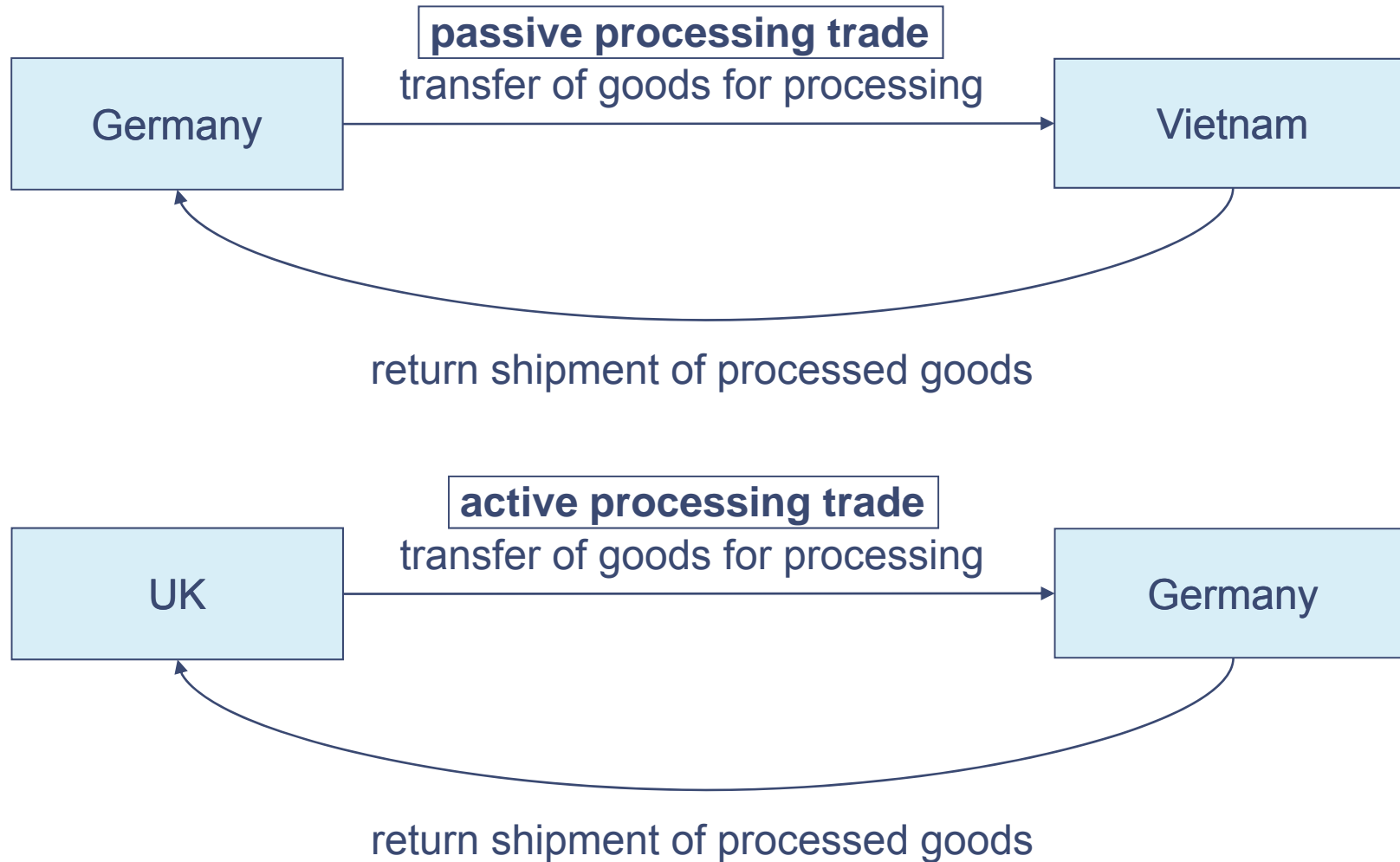
## Special Forms of International Trade (II)

### Processing trade

- Definition: processing, treatment or alteration of goods in a foreign country
- Exception: special zone processing trade (goods do leave the customs area but not the sovereign territory)
- Special importance typically lies with
  - wage differentials
  - stage of technological development
  - transport costs
  - smooth overall production process
  - tariff / trade regulations (e.g. allowed processing period)

# Special Forms of International Trade (III)

## Processing trade





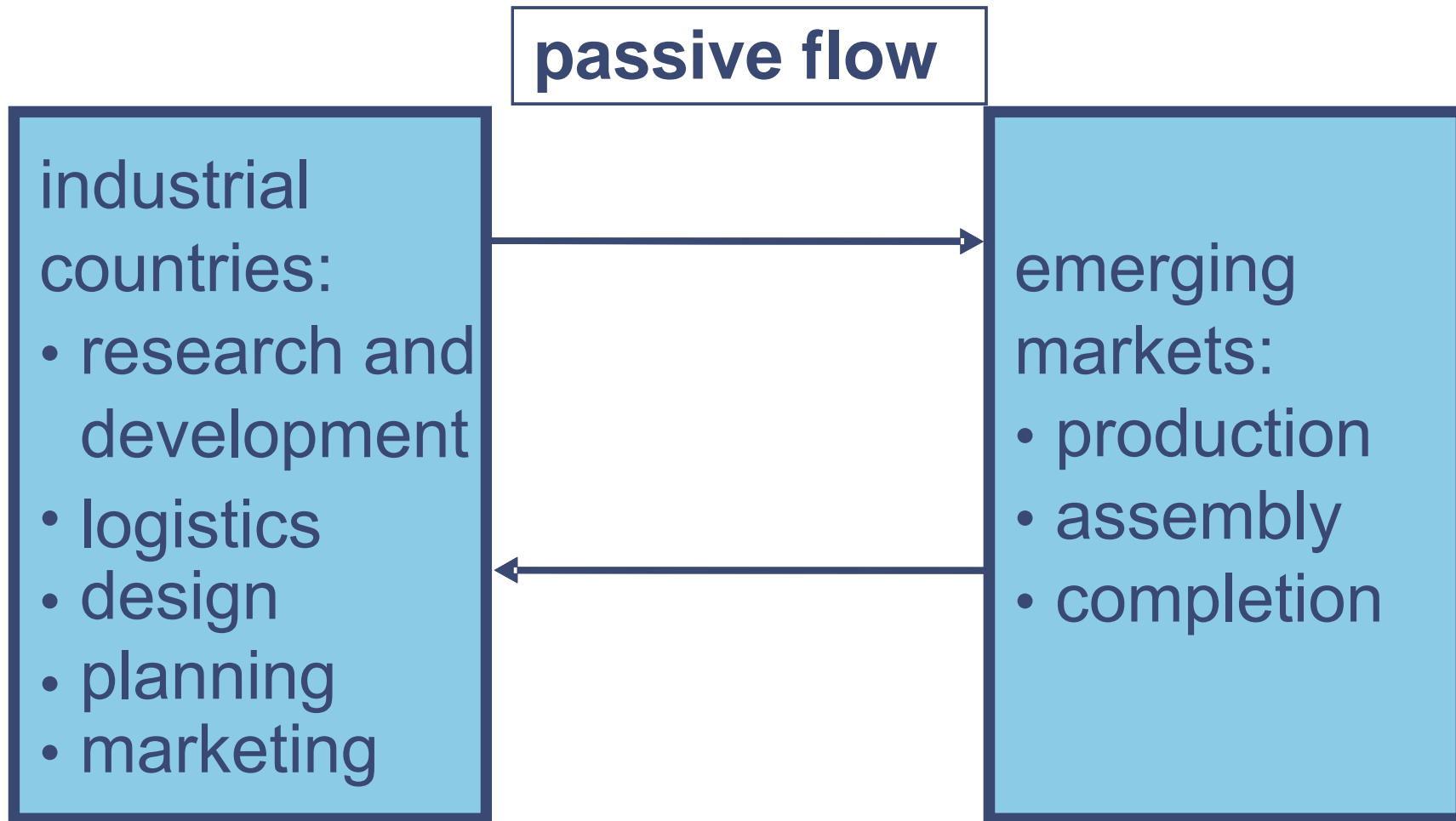
## Special Forms of International Trade (IV)

### Processing trade

- Passive processing trade:
  - currently concentrated on Southeast Asia and the south eastern part of Europe
  - major reason: wage differentials
  - but watch out for (possible):
    - lower productivity
    - problematic political, judicial and/or macroeconomic conditions in processing country
    - insecure transportation routes
    - low quality standards

# Special Forms of International Trade (V)

## Processing trade



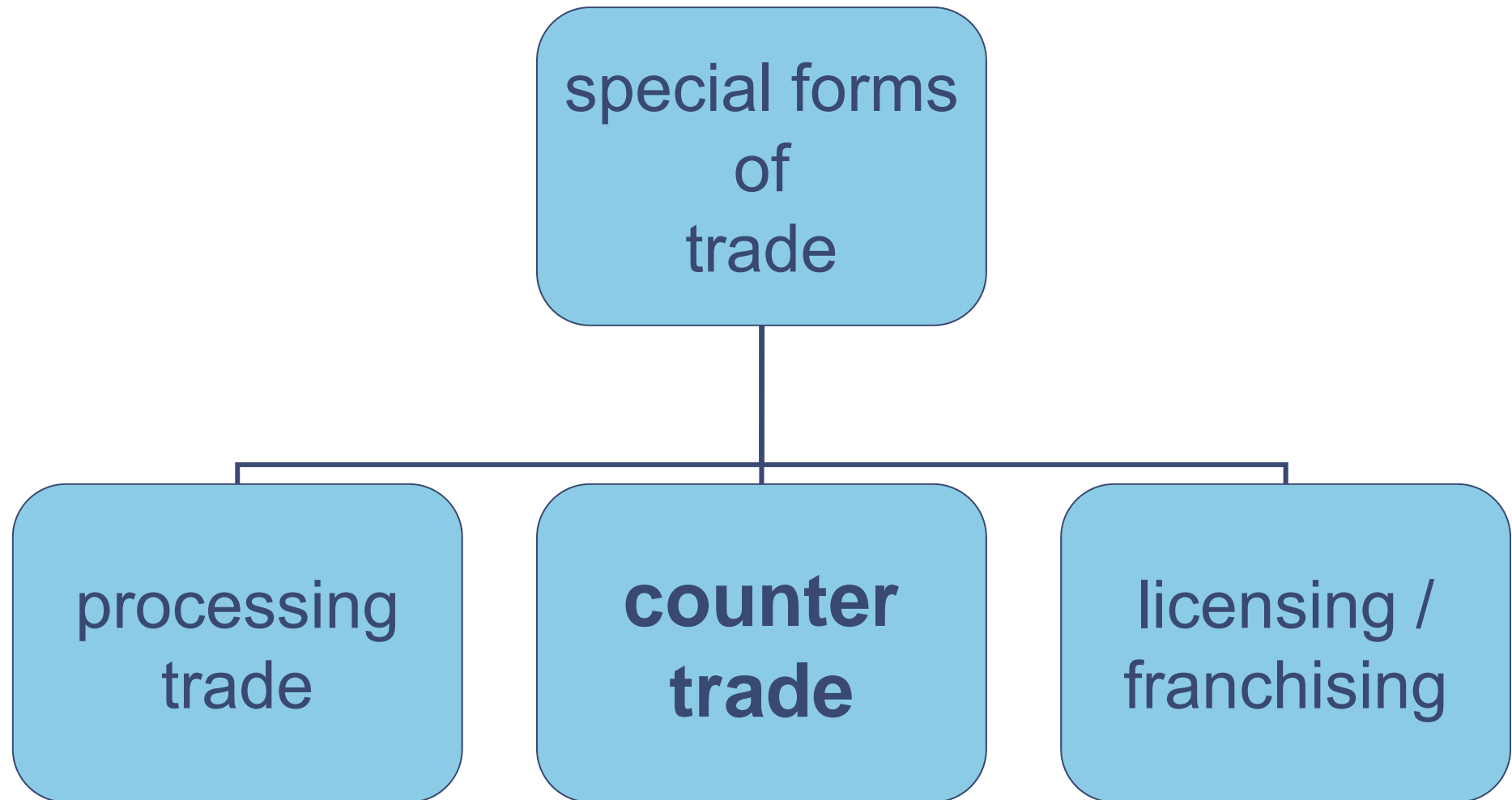


# Special Forms of International Trade (VI)

## Processing trade

- Active processing trade:
  - concentrated on industrial countries
  - major reasons:
    - advanced stage of technological development
    - supply / delivery capabilities
    - quality
    - custom-designed solutions
  - but watch out for (possible) wage-problems
  - also occurs in:
    - guarantee- / service transactions

# Special Forms of International Trade (VII)



# Special Forms of International Trade (VIII)

## Countertrade (1)



- Definition:

“Are these transaction which have - as a basic characteristic - a linkage, legal or otherwise, between exports and imports of goods or services in addition to or in place of financial settlements”
- Importance:
  - in 1972 only 15 countries were engaged in countertrade
  - in 1996 over 100 countries were engaged in countertrade
  - American Countertrade Association estimates that 25% of world trade is carried out as countertrade

# Special Forms of International Trade (IX)

## Countertrade (2)



- Reasons for countertrade:
  - lack of hard currency (debt crisis, volatile foreign exchange rates)
  - desire for bilateral trade relations
  - a mode of entering a foreign market (producer hopes that receiving party will open up new marketing channels / expand markets)
  - the use of countertrade permits the covert reduction of prices and therefore allows the circumvention of price and exchange controls
- Reasons against countertrade:
  - efficiency concerns:
    - trade results from the ability of two parties / countries to purchase specific goods from one another rather than from competition
    - result: uncompetitive products may be marketed
    - consequence: abilities of countries to adjust their industries to a more efficient production may be hindered



## Special Forms of International Trade (X) Countertrade (3)

- Main types of countertrade
  - barter
  - compensation
  - counterpurchase
  - buyback
  - offset
- Sometimes debt swaps are also included (e.g. debt-for-nature swaps: where firms or entities buy what are otherwise considered to be nonperforming loans at substantial discounts and return the debt to the country in exchange for the preservation of natural resources).

# Special Forms of International Trade (XI)

## Countertrade (4)



- Barter:
  - direct exchange of goods of (approximate) equal value
  - earliest form of trade
  - historic examples:
    - late 17th century Georgetown university charged its students part of their tuition fee in foodstuffs and required them to participate in the construction of university buildings
    - 1920ies in Europe (hyperinflation – decreasing value of paper money on an hourly basis)

# Special Forms of International Trade (XII)

## Countertrade (5)



- Compensation:
  - modern version of barter
  - both products are valued in specified currencies and invoiced in these currencies
  - transaction may be of unequal value for each side
  - payment may be partly in products and partly in currency
  - arrangements typically cover relatively short periods of time
  - transactions do not need to take place simultaneously but are covered by a single contract (making contractual issues simple but timing often a bit unmanageable)



## Special Forms of International Trade (XIII) Countertrade (6)

- Counterpurchase:
  - also known as parallel barter
  - two contracts are signed and delivery, invoicing and payment are carried out independently
  - exchange is frequently not of precisely equal value / some amount of (excess) cash is often involved
  - arrangements sometimes cover up to five years
  - accounts for largest volume of current countertrade
  - better designed for medium to large companies or established countertrade firms than for small entities

# Special Forms of International Trade (XIV)

## Countertrade (7)



- Buyback:
  - one party agrees to supply technology or equipment that enables the other party to produce goods with which the price of the supplied products / technology is repaid
  - important factor: quality / contractor-builder typically retains control over plant operation and employee training
  - best describes many turnkey projects (contractor agrees to handle every detail of initial setup for foreign client)
  - example: Levi's transferred its know-how and trademark to Hungary. A Hungarian firm began producing jeans. Some of the plant-output is sold domestically (by the Hungarian producer), and the rest is marketed in Western Europe by Levi's, in compensation for trademark and know-how.

# Special Forms of International Trade (XV)

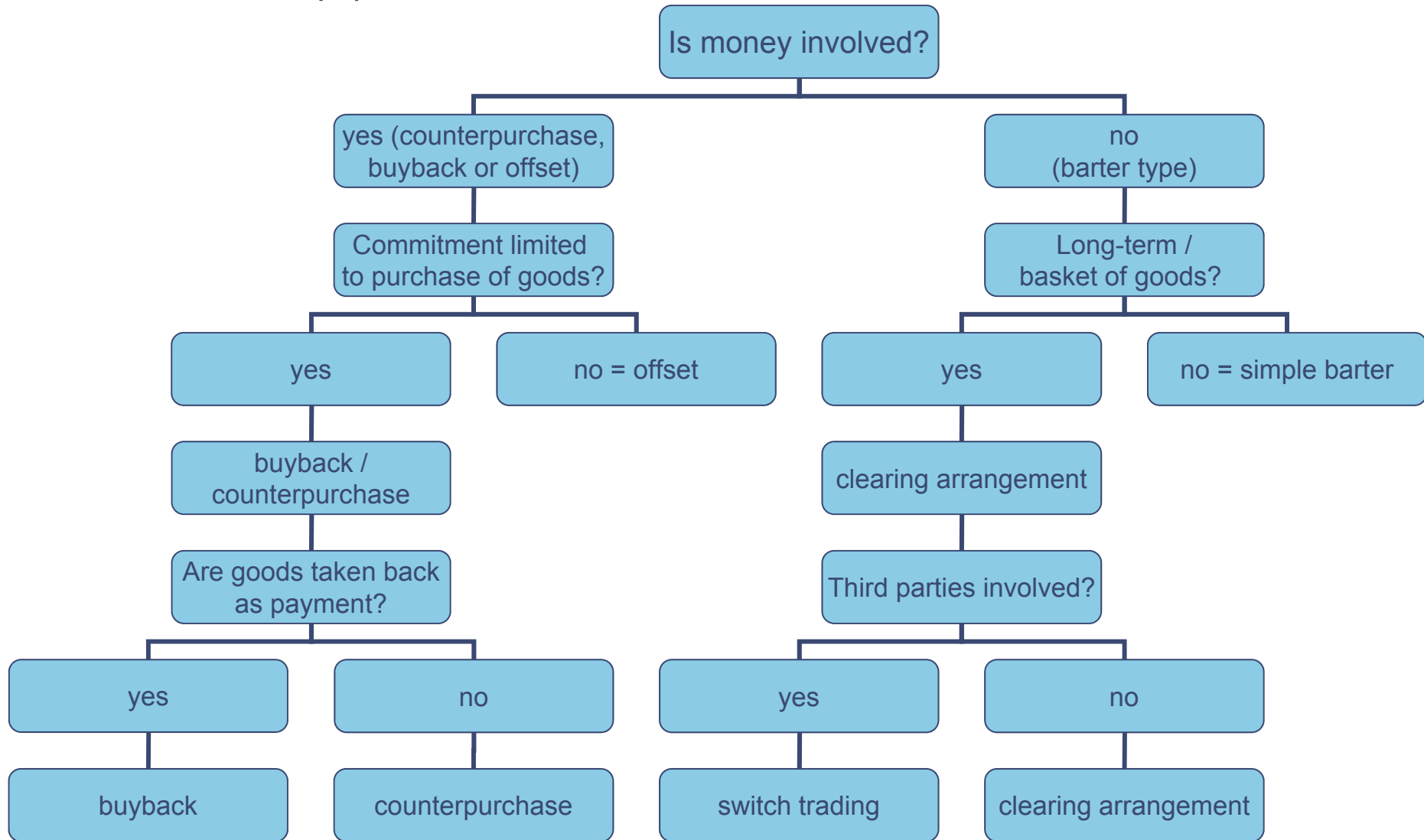
## Countertrade (8)



- Offset:
  - industrial compensation mandated by governments
  - typically occurs in connection with defence-related transactions
  - exporting companies agree to...
    - local sourcing
    - local subcontractor production / co-production
    - FDI (in unrelated sectors)
    - technology transfer, etc...
  - in order to reduce current account / balance of payment effects for importer
  - Offsets frequently reach or even exceed the price of defence equipment [South Africa example (NIP/DIP)].
  - The US weapon industry alone is estimated to complete about USD 1 billion to USD 3 billion annually in defence offset transactions.

# Special Forms of International Trade (XVI)

## Countertrade (9)





## Special Forms of International Trade (XVII) Countertrade (10)

- In-house advantages:
  - can be more profitable
  - customer contact
  - better control
  - more flexibility
  - more Learning
- In-house disadvantages:
  - accounting and legal expertise required
  - reselling problems
  - recruitment and training costs
  - less objectivity
  - unexpected risks and demands for counter trade (e.g. McDonnell Douglas vs. meat-packers union)

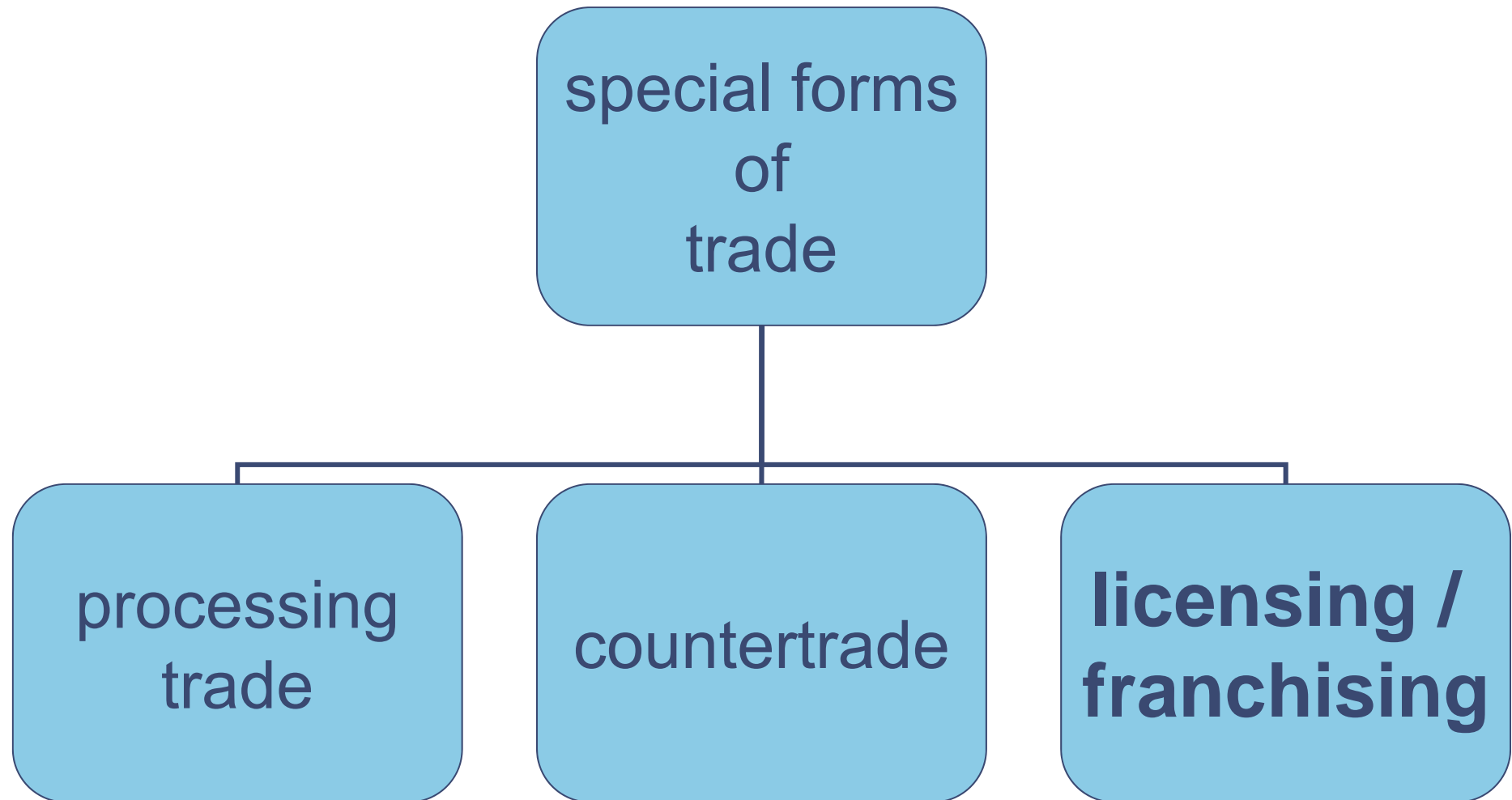
# Special Forms of International Trade (XVIII)

## Countertrade (11)



- Third party advantages:
  - export specialists
  - customer contacts
  - reselling contacts
  - legal and accounting expertise
  - more objectivity
- Third party disadvantages:
  - may be expensive
  - distanced from customer
  - less flexibility
  - less confidentiality
  - less learning

# Special Forms of International Trade (XIX)





## Special Forms of International Trade (XX) Licensing / Franchising (1)

- Definition of licensing:  
“Licensing represents the transfer of the right to use (often time-limited) proprietary rights (patents, registered designs, patterns, copy rights, trademarks) or of processing and management know-how from licensor to licensee for fees”.
- License fees can be paid in the form of:
  - lump sum payments
  - continuous fees (depending on sales, profits,...)
  - shares
  - other licenses (countertrade)
  - return deliveries at special conditions (countertrade)



# Special Forms of International Trade (XXI)

## Licensing / Franchising (2)

- Different forms of licensing:
  - process licenses
    - right to use intellectual property regarding individual production processes
  - product licenses
    - right to produce entire products (and to market them)
  - marketing licenses
    - right to use marketing know-how and strategies of the licensor
  - trademark licenses
    - right to use the trademark of the licensor (e.g. Davidoff)

# Special Forms of International Trade (XXII)

## Licensing / Franchising (3)



- Definition of franchising:  
“The vertical cooperation of legally independent companies based on a long-term contract (franchisor - franchisee) including the transfer of rights and obligations to sell specific products or services using the name, trademark, equipment, etc. and the organisation and marketing concept of the franchisor on the franchisee’s account in a clearly defined area”.



# Special Forms of International Trade (XXIII)

## Licensing / Franchising (4)

- Characteristics of franchising:
  - legally independent contract partners
  - management of the franchisee according to the principles and wishes of the franchisor
  - management concept and marketing / communication strategy defined by franchisor
  - trademark provided by the franchisor
  - exclusivity guarantees (for franchisee)
  - guarantees not to market competitors products (for franchisor)
  - other franchise agreements for non-competitive products possible
  - financial support (by franchisor for franchisee) in form of credit agreements / payment terms (e.g. net 90 days,...)

# Special Forms of International Trade (XXIV)

## Licensing / Franchising (5)



- Pros of licensing / franchising:
  - use of market know-how and customer relations of licensee / franchisee
  - no / reduced transportation fees due to local production
  - no huge amounts of capital expenditures required (for licensor / franchisor)
  - no / reduced danger of expropriation for licensor / franchisor (no capital transfer)
  - circumvention of trade barriers (local content requirements)
  - relatively secure profits at low risk (for licensor / franchisor)

# Special Forms of International Trade (XXV)

## Licensing / Franchising (6)



- Cons of licensing / franchising:
  - technology transfer
  - (sometimes) difficult search for competent and trustworthy partners
  - complex contractual negotiations
  - misuse of know-how by licensee / franchisee
  - licensee / franchisee may become future competitor
  - influence on the image of the licensor / franchisor (in case of low quality production by licensee / franchisee)
  - capex-requirements for licensee / franchisee
  - appropriate design of fees (without knowing the foreign market)

# AGENDA

1. Introduction - International Trade Trends and Developments
2. Why do Companies trade?
3. Forms of International Trade
4. Regulations in Foreign Trade
5. Trade Finance
6. Risk Management in Foreign Trade
7. Introduction to FDI (Trends and Developments)
8. FDI-related Theories - Why do Companies invest abroad?
9. Types / Forms of FDI
10. Risk Management in FDI



# Regulations in Foreign Trade (I)

## Introduction to export controls

- Exporting is not a right, it is a privilege that can be regulated, restricted or revoked for reasons of:
  - national security concerns (incl. terrorism)
  - foreign policy
    - danger to the peaceful coexistence of peoples / nations
    - adverse effects of exports on foreign relations
  - short supply
- Companies (typically) want to conduct foreign trade transactions in compliance with national and international law. Consequently, exporters need to be aware of the (most important) regulations.



# Regulations in Foreign Trade (II)

## National regulations / Bilateral agreements

- National regulations
  - examples:
    - Germany:
      - Außenwirtschaftsgesetz (AWG)
      - Kriegswaffenkontrollgesetz (KWKG)
    - USA:
      - Export Administration Act
      - Patriot Act
- Bilateral agreements
  - ECA-regulations (country ceilings, etc.)
  - Bilateral debt rescheduling



## Regulations in Foreign Trade (III)

### International regulations / Multinational organisations

- International regulations
  - example: the Wassenaar Arrangement (former COCOM)
    - regulations regarding the export of defence-related goods
- Multinational organisations
  - EU (customs codex / dual-use directive)
  - WTO/GATT
  - UN (full-, partial-, weapon embargos)
  - International Chamber of Commerce (Incoterms)



## Regulations in Foreign Trade (IV)

### Excursion: WTO / GATT (1)

- The World Trade Organisation (WTO)
  - established on 1st January 1995 (based on GATT)
  - located in Geneva, Switzerland
  - members: 149 countries (12/2005)
- Task: “A global organisation dealing with rules of trade between nations”.
- Membership is
  - open (to sovereign states and customs unions)
  - diverse (developed, developing, least developed countries and economies in transition)

# Regulations in Foreign Trade (VI)

## Excursion: WTO / GATT (2)

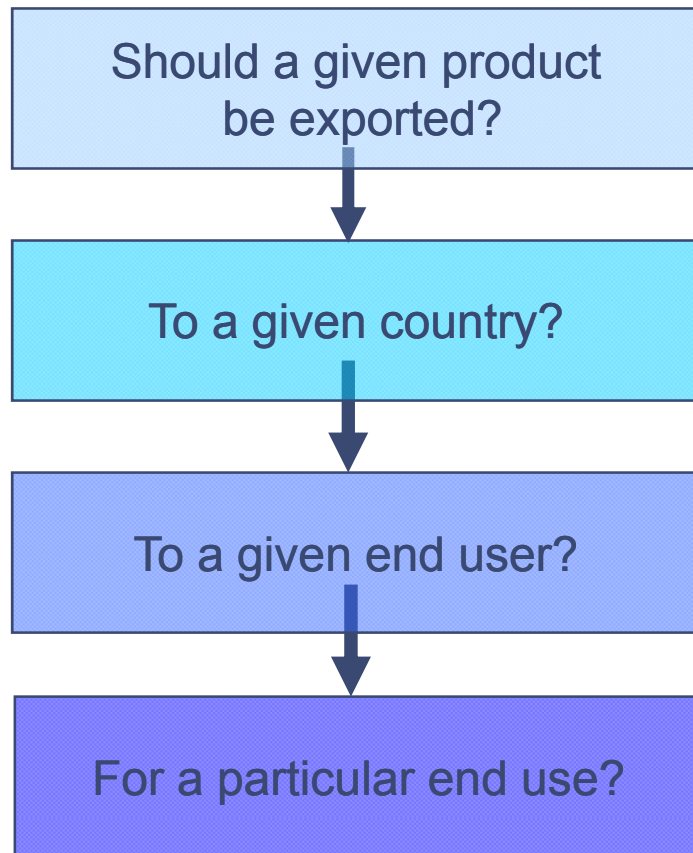


- Most important principles:
  - Most favoured nation (MFN) rule
    - requires that any favourable treatment granted to a product originating in or destined for any other country, to be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other member states;
    - but permitted exceptions exist in free trade areas (NAFTA, MERCOSUR, COMESA and ASEAN) and customs unions (EU).
  - National treatment rule
    - provides that internal taxes, charges, laws and regulations must not be applied to imported or domestic products so as to afford protection to domestic production.

# Regulations in Foreign Trade (VII)



Decision steps in the export control process



- Red flags for exporters:
  - customer is reluctant to provide end-use and end-user information
  - customer lacks familiarity with the product
  - customer refuses installation or service contracts
  - product is incompatible with end-user's resources or environment
  - stated end-use is incompatible with customary application of the product
  - intermediate consignee's location is suspect
  - freight forwarder is designated as foreign consignee or end-user
  - buyer is evasive or unclear when questioned

# Regulations in Foreign Trade (VIII)

## Incoerms / definition



- **International Commercial Terms**
  - developed by the International Chamber of Commerce (ICC) in the 1980ies (but going back to 1930ies / revised in 2000)
  - Internationally known abbreviations and specifications telling the buyer and seller in export transactions
    - who has what responsibility (transportation risk, documentation process) and...
    - ...(more importantly) who pays for what (transportation costs, insurance cost, customs clearance, duties)?



# Regulations in Foreign Trade (IX)

## Incoterms / major groups

- There are four groups of INCOTerms:
  - E-clauses, e.g. EXW
    - merchandise is principally picked up at seller's warehouse / only very low costs for exporter
  - F-clauses, e.g. FOB, FCA, FAS
    - exporter transfers merchandise to freight forwarder without paying the main transport
  - C-clauses, e.g. CFR, CIF
    - exporter pays main transport and (part of) insurance
    - risk transfer occurs upon transfer to freight forwarder
  - D-clauses, e.g. DDU, DDP
    - exporter bears all costs to a specific destination



# Regulations in Foreign Trade (X)

## Incoterms / complete list

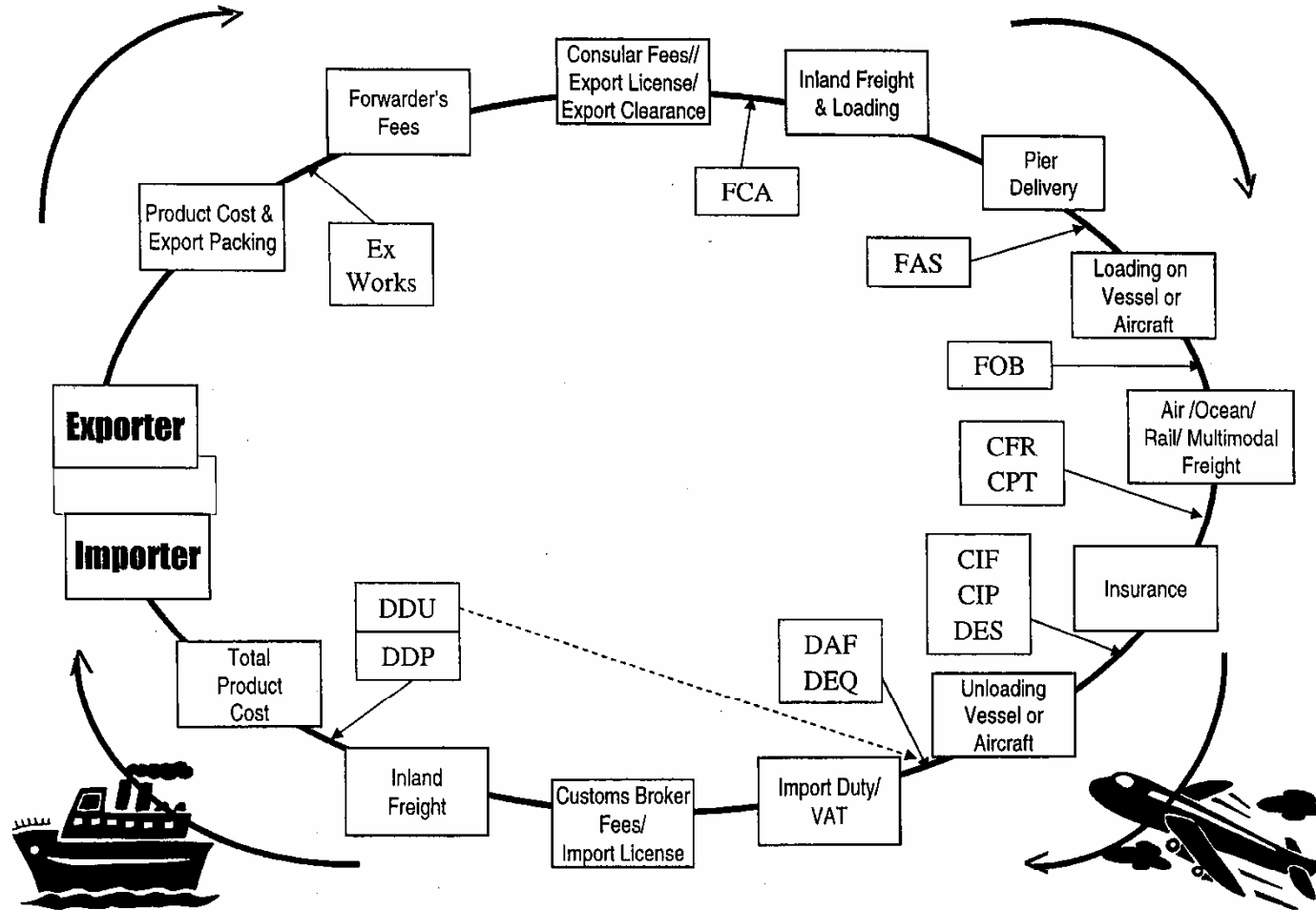
- EXW - Ex works
- FCA - Free carrier (multimodal: container, air, rail, road)
- FAS - Free alongside ship
- FOB - Free on board (maritime only, FCA for other types of carriage)
- CFR - Cost and freight (on board only)
- CIF - Cost, insurance and freight (on board only)
- CPT - Carriage paid to (in custody of carrier)
- CIP - Carriage and insurance paid to (in custody of carrier)
- DAF - Delivered at frontier (rail, road)
- DES - Delivered ex ship
- DEQ - Delivered ex quay (cleared for import)
- DDU - Delivered duty unpaid (place)
- DDP - Delivered duty paid

# Regulations in Foreign Trade (XI)

## Incoterms / overview

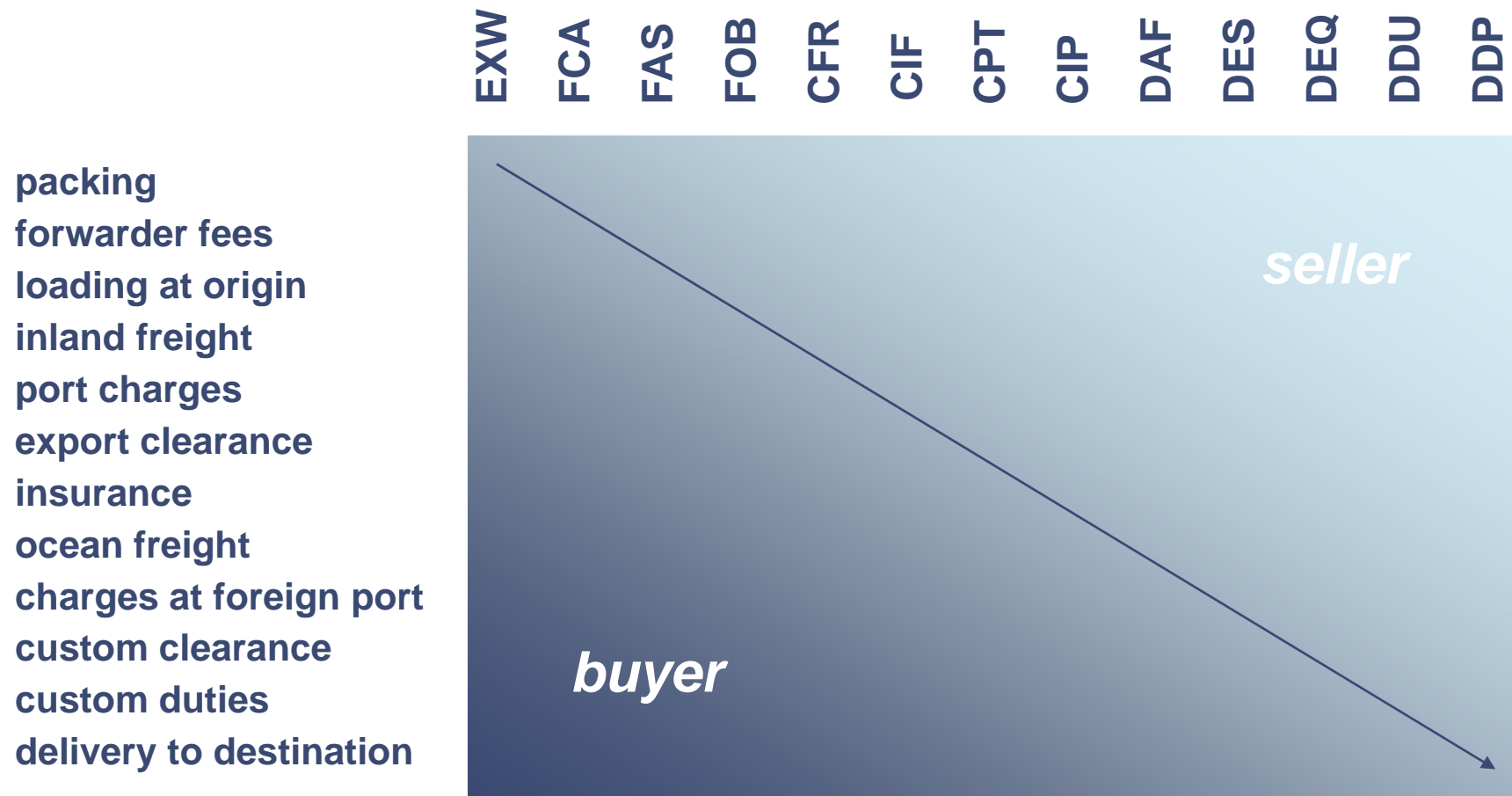


### Incoterms 2000



# Regulations in Foreign Trade (XII)

## Incoterms / range of responsibilities



# Regulations in Foreign Trade (XIII)

## Most common incoterms



| Term   | Definition  | Risk  | Cost  | Include on quotation                    |
|--|---|---|---|---|
| EXW<br>Ex works                              | Buyer arranges for pick up of goods at the seller's location. Seller is responsible for packing, labeling and preparing the goods for shipment on a specified date or time. | Buyer assumes all risk.   | Buyer pays all transportation costs.  | n / a                                   |
| FCA<br>Free carrier                          | Seller is responsible for costs until the buyer's named freight carrier takes charge.   | seller and buyer  | split   | n / a                                   |
| FAS<br>Free alongside ship (over water only) | Buyer arranges for the ocean transport. Seller is responsible for packing labeling, preparing the goods for shipment and delivering the goods to the dock.                  | seller: until the goods reach the dock<br>buyer: from dock to destination | buyer: all ocean transport costs<br>seller: is responsible for costs associated with transporting the goods to the dock | costs of transporting goods to the dock |

# Regulations in Foreign Trade (XIV)

## Most common incoterms



| Term   | Definition  | Risk   | Cost  | Include on quotation                 |
|--|---|--|---|--------------------------------------|
| <b>FOB*</b><br>Free on board<br>FOB should also never be used unless you specify what and where such as "FOB ocean vessel at New York City". | Seller arranges for ocean transport of the goods, preparing the goods for shipment and loading the goods onto the vessel. The goods ship ocean freight collect. | buyer: once the items are on board                                     | seller: wharfage (charges to load the goods onto the ship) and freight forwarder fees | costs, until on board                |
| <b>CFR</b><br>Cost and freight   | Seller has the same responsibilities as when shipping FOB, but shipping costs are prepaid by the seller instead of shipping collect.                            | Seller: assumes the risk until the shipment reaches the overseas dock. | seller: costs of freight fees up to destination                                       | add freight to cost of product       |
| <b>CIF</b><br>Cost, insurance, and freight   | Seller has the same responsibilities as when shipping CFR with addition of including a marine insurance policy.   | seller: until the shipment reaches the overseas dock                   | seller: insurance and freight forwarder fees  | insurance, freight and cost of goods |

# AGENDA

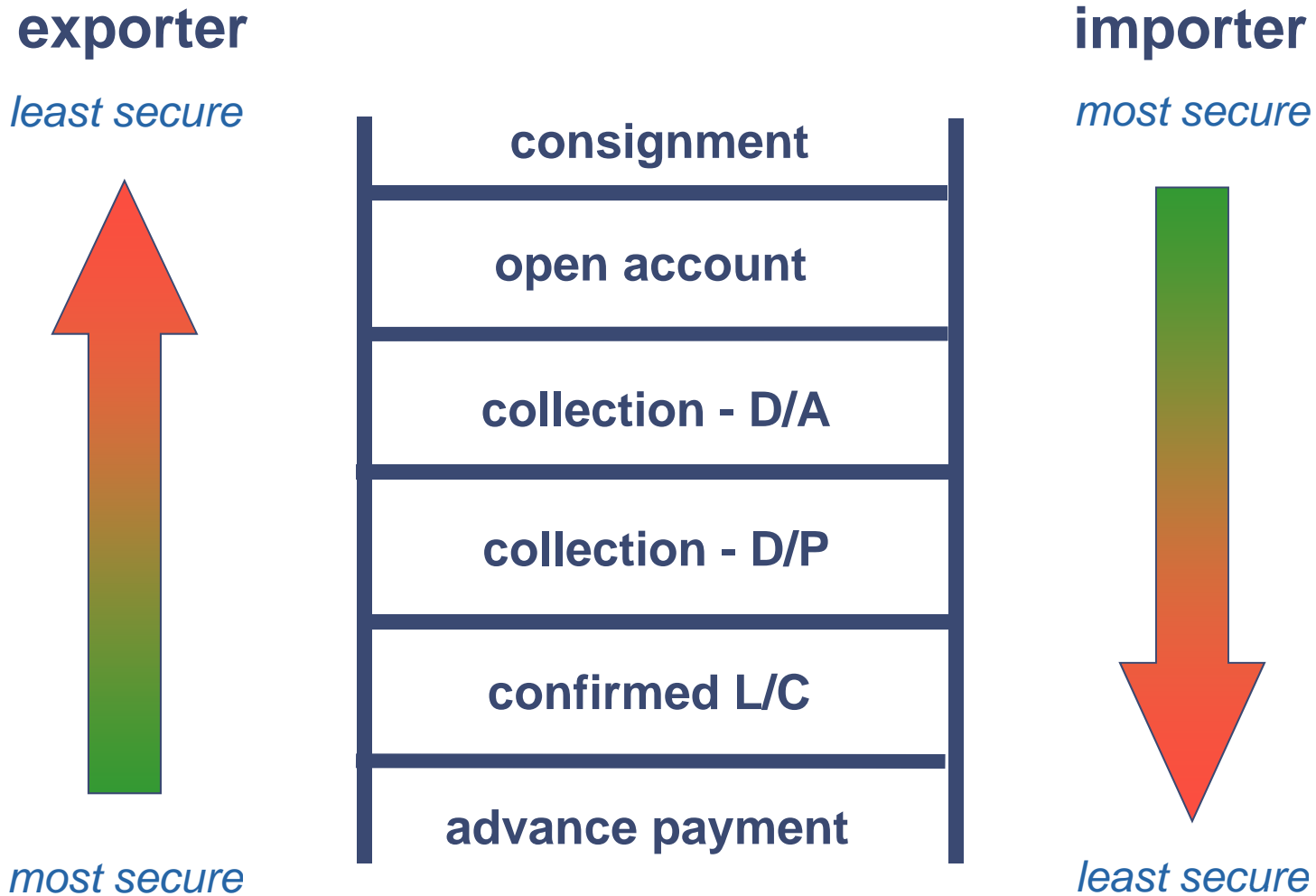
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# AGENDA

- Trade Finance
  - Payment terms / Risk ladder
  - Short-term financing
  - Medium- to long-term and special financing

# Trade Finance (I)

## Payment terms / Risk ladder



## Trade Finance (II)

### Consignment



- Consignment selling allows the importer (consignee) to defer payment until the imported goods are sold.
- Titles to the traded goods remain with exporter (consignor).
- Consignee attempts to sell goods to a third party; keeps profit-margin and remits rest to consignor.
- Entire risk burden (ownership risks / payment risks) lies with exporter / consignor; goods may be difficult to retrieve if necessary.
- Due to the extreme extend of risk taken by the exporter, consignment selling is typically only used between related entities (e.g. affiliates of multinational companies).



## Trade Finance (III)

### Open account

- Seller provides merchandise to buyer in return for payment at a later, predetermined date (typically net 30 to 180 days after receipt of goods / services).
- Advantage: greater sales flexibility but very high risk for seller:
  - seller may decline acceptance of merchandise
  - seller may accept merchandise and fail to pay
  - no written evidence of buyer-obligations except invoice / purchase order
  - difficult overseas litigation
- Very low risk for buyer:
  - can withhold payment in case of questions regarding quality / quantity
  - can inspect the merchandise prior to taking ownership
- Seller needs to investigate creditworthiness of buyer thoroughly and put significant trust in buyer...
- ...or enter into an export credit insurance scheme.



## Trade Finance (IV)

### Documentary collections (1)

- Documentary collections are a payment procedure based upon specific instructions received by banks from the seller involved in a trade transaction.
- Two types:
  - Documents Against Acceptance (D/A)
    - receipt of funds from the buyer (by assigned bank) in exchange for the transfer of documents
  - Documents Against Payment (D/P)
    - acceptance of drafts by the buyer in exchange for documents
- Buyer only receives merchandise after making payment (D/P) or commitment in writing to pay at a future date (D/A)



## Trade Finance (V)

### Documentary collections (2)

- Seller's risks:
  - rejection of merchandise by buyer (D/A and D/P)
    - costs from shipping
    - limited reselling opportunities for special merchandise
  - nonpayment at specified date (D/A); buyer has the merchandise, seller only has a promise to pay
- Buyer's risks:
  - merchandise may not be of required quantity / quality (involved bank(s) only monitor documents)
  - buyer must pay / make commitment prior to receiving merchandise

## Trade Finance (VI)

### Documentary collections (3)



- **Players / process:**
  - **principal / drawer:** seller or exporter who initiates the collection process by drawing a draft on the buyer
  - **drawee:** buyer on whom the draft is drawn and payment is expected
  - **remitting bank:** drawer's bank which is entrusted to handle the commercial documents
  - **collecting bank:** bank in buyer's country which the seller / the remitting bank uses to receive / handle documents
  - **presenting bank:** collecting bank that submits draft to the buyer for payment (D/P) or acceptance (D/A); typically identical with collecting bank



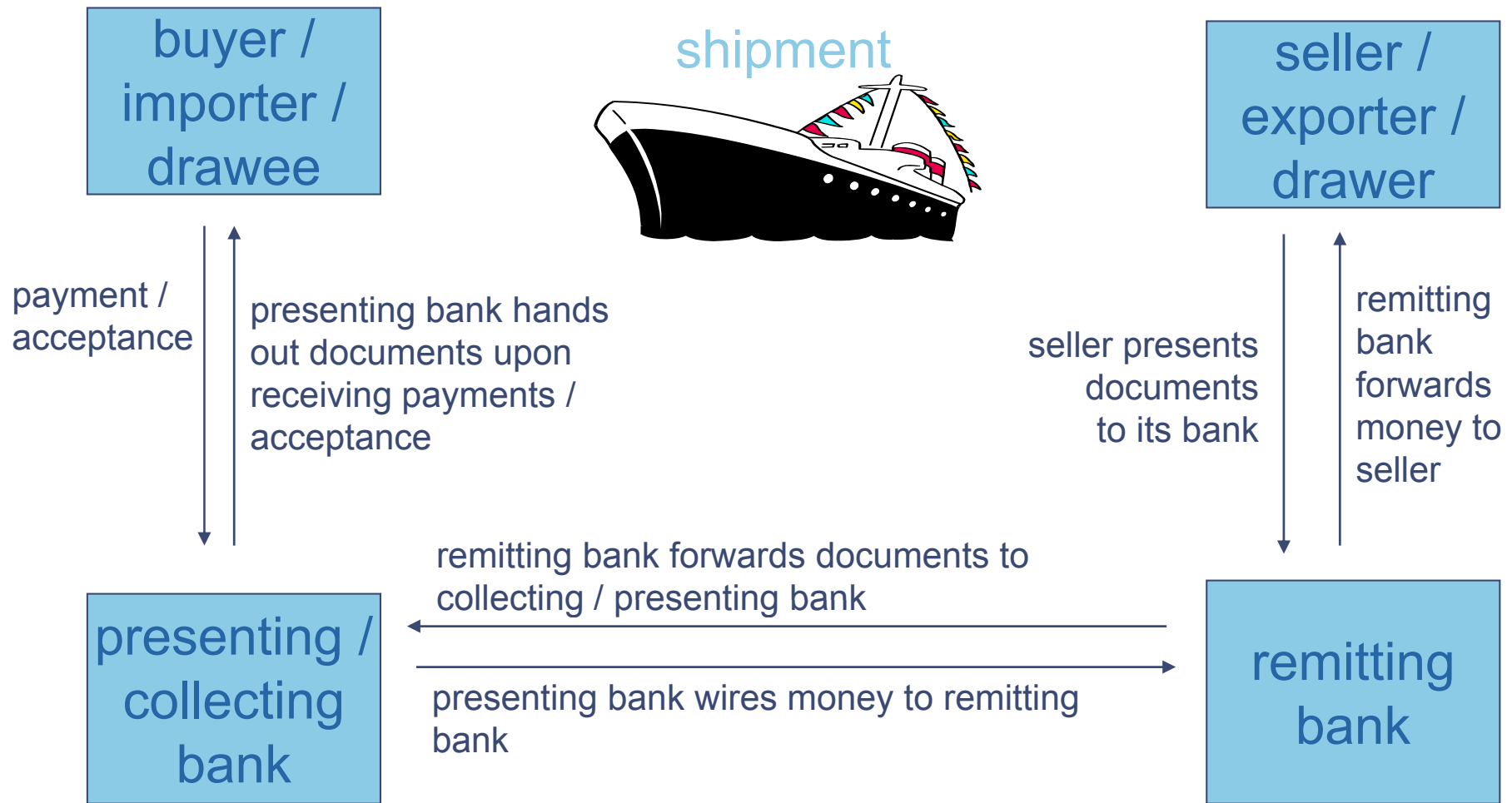
## Trade Finance (VII)

### Documentary collections (4)

- General documentary collection process:
  - seller / drawer ships
  - seller / drawer presents documents to remitting bank
  - remitting bank sends documents to a correspondent (collecting) bank
  - collecting / presenting bank releases documents against buyer's payment / acceptance
  - presenting bank wires funds to remitting bank
  - remitting bank pays seller

# Trade Finance (VIII)

## Documentary collections (5) / documentary flow





## Trade Finance (IX)

### Excursion: Drafts (1)

- Definition: Unconditional order in writing ordering importer to pay on demand or at a fixed or determinable future date the amount specified on its face (also known as “bill of exchange”).
- Serves three important functions:
  - provides written evidence - in clear and simple terms - of a financial obligation
  - enables both parties to potentially reduce their costs of financing
  - provides a negotiable and unconditional instrument (payment must be made to any holder in due course regardless of disputes regarding underlying commercial transaction)

# Trade Finance (X)

## Excursion: Drafts (2)



- Types of drafts:
  - sight drafts: must be paid on presentation or else be dishonored (D/P)
  - time drafts: payable on future date and as such a useful financing device; maturity is known as *usance* or *tenor*
  - drafts can be clean - meaning unaccompanied by other documents - (which occurs rarely) or documentary (for trade issues)
    - becomes an *acceptance* after being accepted by the drawee; the party accepting a draft incurs the obligation to pay at its maturity
      - banker's acceptance: draft accepted by a bank
      - trade acceptance: draft drawn on and accepted by a commercial enterprise
  - Exporter can hold the acceptance or sell it at a discount.

## Trade Finance (XI)

### Letter of credit (L/C) / definition



*“A documentary credit is a conditional bank undertaking of payment. It is a written undertaking by a bank (issuing bank) given to the seller (beneficiary) at the request, and on the instructions of the buyer (applicant) to pay at sight or at a determinable future date up to a stated sum of money, within a prescribed time limit and against stipulated documents. The issuing bank is putting out its credit and good name for the sake of the buyer.”*



## Trade Finance (XII)

### Letter of credit (L/C) / parties (1)

- **Buyer / applicant:** submits an application requesting an L/C with specific instructions on how to proceed with the L/C
- **Seller / beneficiary:** must - by accepting an L/C - agree to its terms and conditions (shipment of goods and processing of documentation); if all terms and conditions are fulfilled, the beneficiary receives the agreed upon payment
- **Issuing bank:** buyer's bank who issues the L/C (against L/C fees) and thus substitutes its credit risk for that of the buyer
- **Advising bank:** receives L/C, verifies authenticity, and delivers it to the beneficiary; if the advising bank in turn substitutes its credit risk for that of the issuing bank, it becomes the so-called *confirming bank*



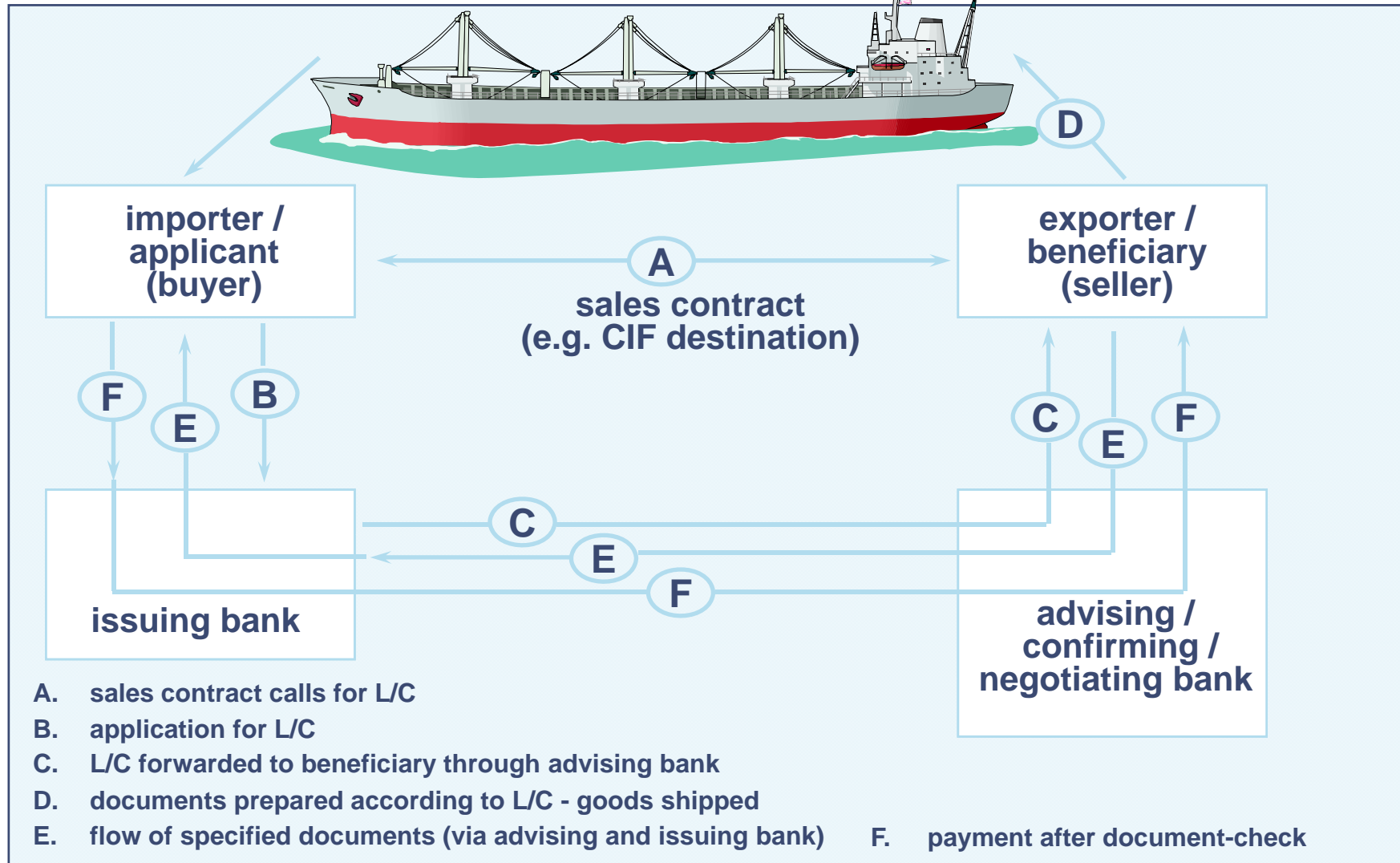
## Trade Finance (XIII)

### Letter of credit (L/C) / parties (2)

- **Paying bank:** bank authorised to pay out the L/C to the beneficiary (typically the advising / confirming bank)
- **Negotiating bank:** bank which facilitates the process of document compliance, examination and payment
- **Reimbursing bank:** may be solicited by the issuing bank to provide payment to the paying / confirming bank once the L/C has been fulfilled and payment approved; usually occurs when the issuing bank does not have an account with the advising / confirming bank

# Trade Finance (XIV)

## Letter of credit (L/C) / process overview





## Trade Finance (XV)

### Letter of credit (L/C) / types (1)

- **Irrevocable:** An irrevocable L/C cannot be revoked or cancelled unilaterally by any party once it has been issued, unless all other parties agree.
- **Revocable:** A revocable L/C may be amended or cancelled by the issuing bank at any moment and without prior notice to the beneficiary. Revocability must be stated in the agreement (if not, it is considered irrevocable).
- **Unconfirmed:** bears only the guarantee of the issuing bank and thus does not have the credit assurance of another bank. The beneficiary should look to the creditworthiness of only the issuing bank, and not to any intermediary.
- **Confirmed:** is a credit in which a second guarantee is added to the letter of credit by another bank. If the issuing bank should be unable to honour its payment obligation, the confirming bank has to step in.
- **Sight:** Payment is at sight without delay.



# Trade Finance (XVI)

## Letter of credit (L/C) / types (2)

- **Usance / time:** L/C calls for payment at a future date rather than at sight. Under this kind of L/C, usance (time) drafts will be presented together with required documents. If documents comply with LC-terms the draft is accepted by the collecting-bank. The draft is a negotiable instrument, it enables the beneficiary to receive funds prior to the draft maturity date (on a discounted basis).
- **Deferred payment:** basically identical with time-L/C (payment at a later date) but without involving freely tradable drafts. The beneficiary must wait until the deferred payment period has ended.
- **Straight:** L/C requires the beneficiary to present documents and request payment at the counters of a specific bank.
- **Negotiable:** L/C allows the beneficiary to employ any bank (and not just the advising bank) as payment vehicle. Other banks honour the L/C at their own risk.
- **Standby:** L/C functions like an insurance. L/C is “passive”, that is, it is not drawn upon by the beneficiary unless one party of a trade transaction fails to meet its obligations (e.g. if an exporter fails to deliver the specified quality, an importer may draw on an standby-L/C).



## Trade Finance (XVII)

### Letter of credit (L/C) / advantages

- Exporter:
  - provide a means of prompt payment to the seller provided the documentary details are fulfilled
  - strongly reduce credit risk (confirming bank) and thus reduce need for extensive credit investigation
- Importer:
  - will only be required to pay if the conditions of the credit are met and documents have been inspected
  - may allow better (cheaper) sales terms

## Trade Finance (XVIII)

### Letter of credit (L/C) / disadvantages



- Banks handling letters of credit deal in documents only. Any dispute with regard quality, quantity, etc. of merchandise does not concern the bank at all. The bank makes its decision as to the acceptability of the individual documents solely based upon those documents versus the L/C-terms and conditions!!! Consequently, L/Cs cannot lend soundness to a transaction that was not basically sound at its inception.
- Even if the smallest discrepancies exist between L/C-terms and conditions and actual documentation, the shipment can be rejected by the buyer (some statistics show an initial rejection rate of up to 50%!).



# Trade Finance (XIX)

## Letter of credit (L/C) / common documentary discrepancies

- General
  - description of goods in invoice does not match L/C
  - marks and/or numbers differ / incorrect names and/or addresses
- Drafts
  - drawn on wrong party
  - drawn payable on an indeterminable date
- Transport documents
  - required number of originals not presented
  - shipment made between ports other than cited in L/C
- Insurance
  - shipment is underinsured
  - wrong insurance documents
- Deadlines
  - late shipment
  - late presentation of documents

**be careful while formulating  
L/C-terms and conditions / while  
putting together the documentation!!!**



## Trade Finance (XX) Advance payment

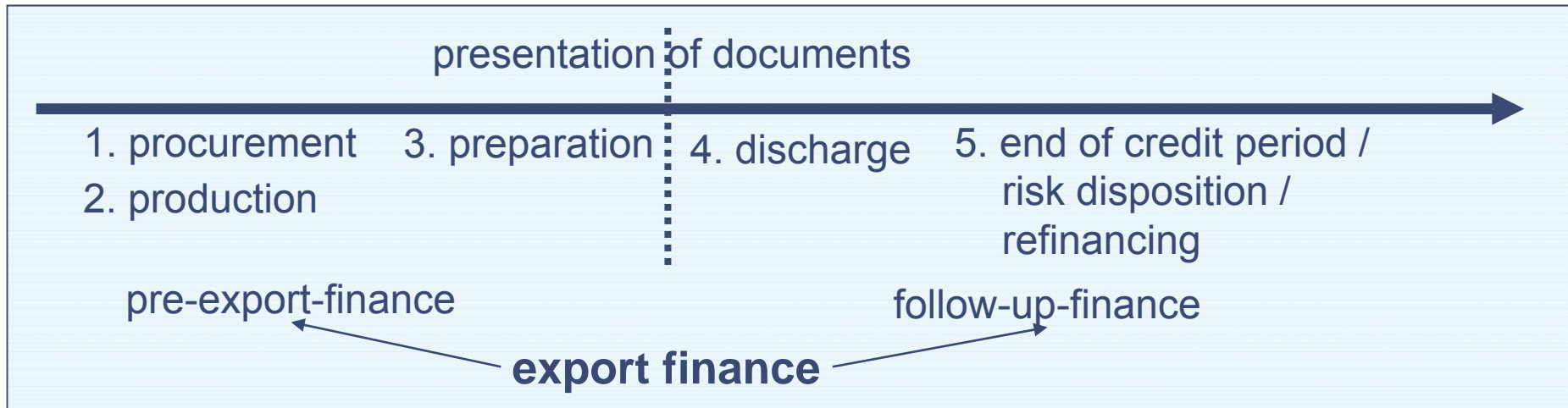
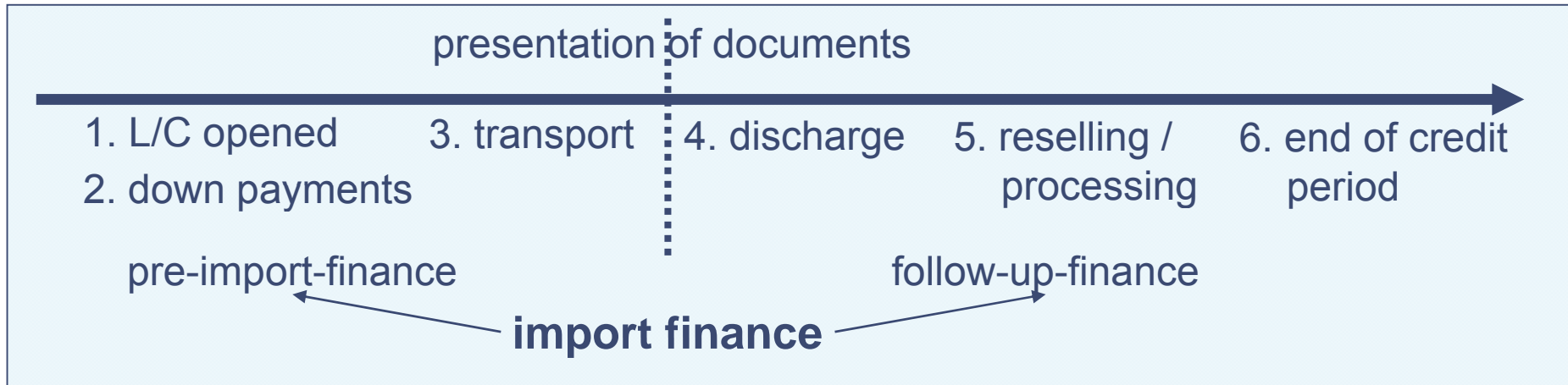
- Buyer needs to pay prior to receiving the merchandise.
- Upon receiving payment, seller ships merchandise via a prearranged method of transport.
- Buyer (typically) has no inspection possibilities, making this method of payment extremely risky (for the importer).
- Easier to agree upon for the buyer, if the seller provides the buyer with a (partial) standby-L/C (with a nonperformance trigger).

# AGENDA

- Trade Finance
  - Payment terms / Risk ladder
  - Short-term financing
    - Overview
    - Pre-export-commodity finance
    - Commercial papers (CP)
    - Accounts receivable financing
    - Factoring
  - Medium-, long-term and special financing

# Trade Finance (XXI)

## Short-term financing overview





## Trade Finance (XXII)

### Commodity pre-export finance / definition

- Definition: A loan is made with recourse to the exporter whereby the security is provided by the assignment of export sales contracts and receivables.
- Repayment comes from the export proceeds paid by identified and reputable buyers directly to the lender.
- Commodity pre-export finance is the basic form of structured commodity finance. The future sale of the commodity will provide the borrower with the means to repay the financing.



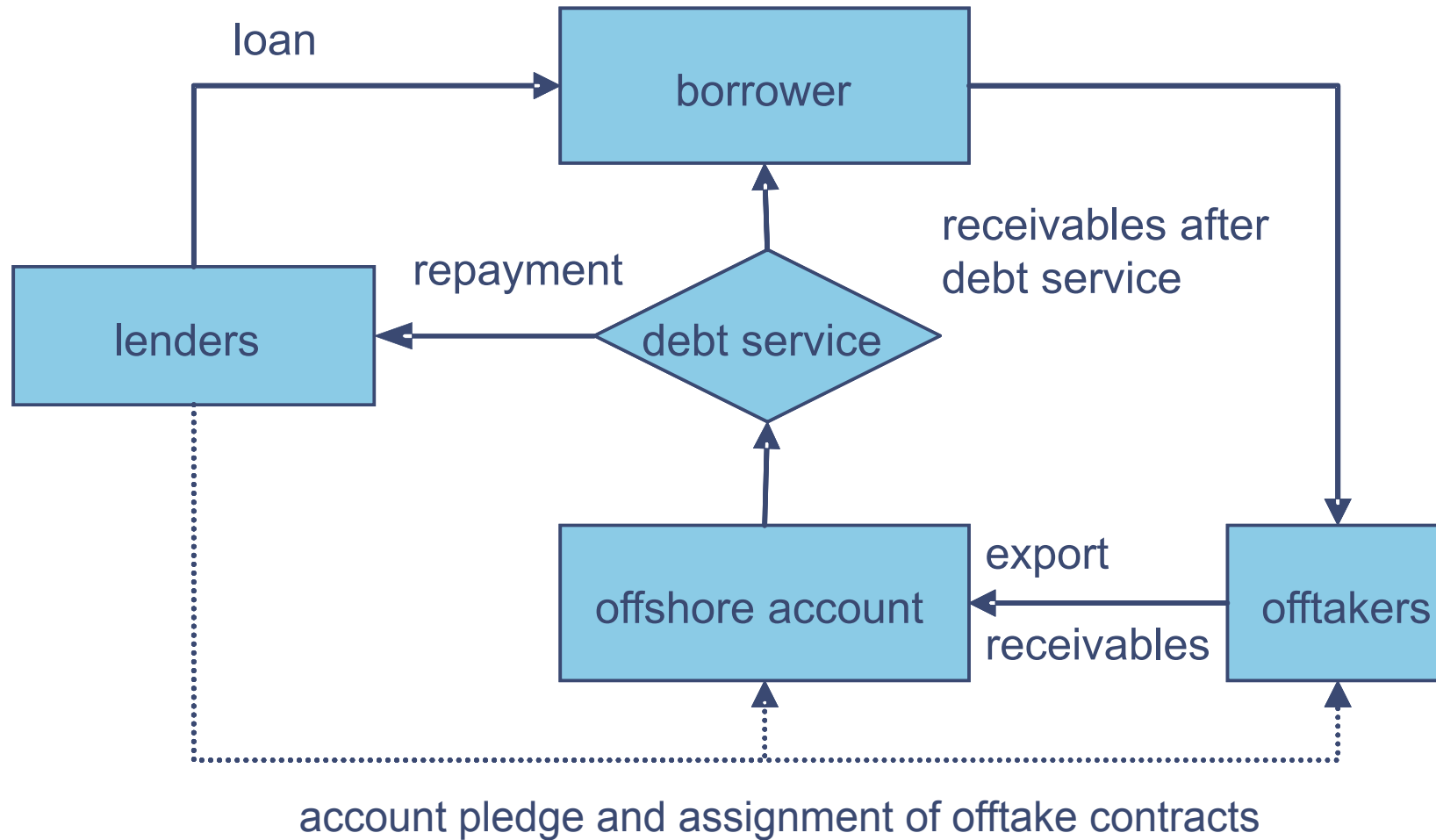
## Trade Finance (XXIII)

### Commodity pre-export finance / process overview (1)

1. sales contract between exporter and offtaker
2. sales proceeds assigned / pledged to lending bank
3. after assignment / pledge, bank advances loan to exporter
4. exporter ships merchandise to offtaker
5. importer makes payment to escrow account controlled by bank
6. loan is repaid from escrow account
7. excess cash (after debt service) released to exporter

# Trade Finance (XXIV)

## Commodity pre-export finance / process overview (2)





## Trade Finance (XXVIII)

### Commercial papers

- CPs are short-term, unsecured *promissory notes* (a written, dated and signed two-party instrument containing an unconditional promise by the maker to pay a definite sum of money to a payee on demand or at a specified future date) sold by large corporations on a discount basis to institutional investors or other corporations.
- Commercial paper market is composed of the
  - dealer (require line of credit) and
  - direct-placement markets.
- Overall costs of CPs are usually below all-in costs of acceptance financing or short-term bank credits.



## Trade Finance (XXIX)

### Accounts-receivable-backed-loans

- Loans by banks or finance corporations (banks typically offer better / lower interest rates) which are backed by accounts receivable as a collateral.
- Collateral / loan evaluations are based on
  - quality of pledged accounts (low-quality accounts may be rejected)
  - size of pledged accounts (small accounts may be too costly to handle)
- Types:
  - Non-notification: Customers / importers are not notified that their accounts have been pledged. They forward all payments from pledged accounts to the lender / exporter.
  - Notification: Customers / importers are notified that their accounts have been pledged to the lender. Remittances are made directly to the lending institution.

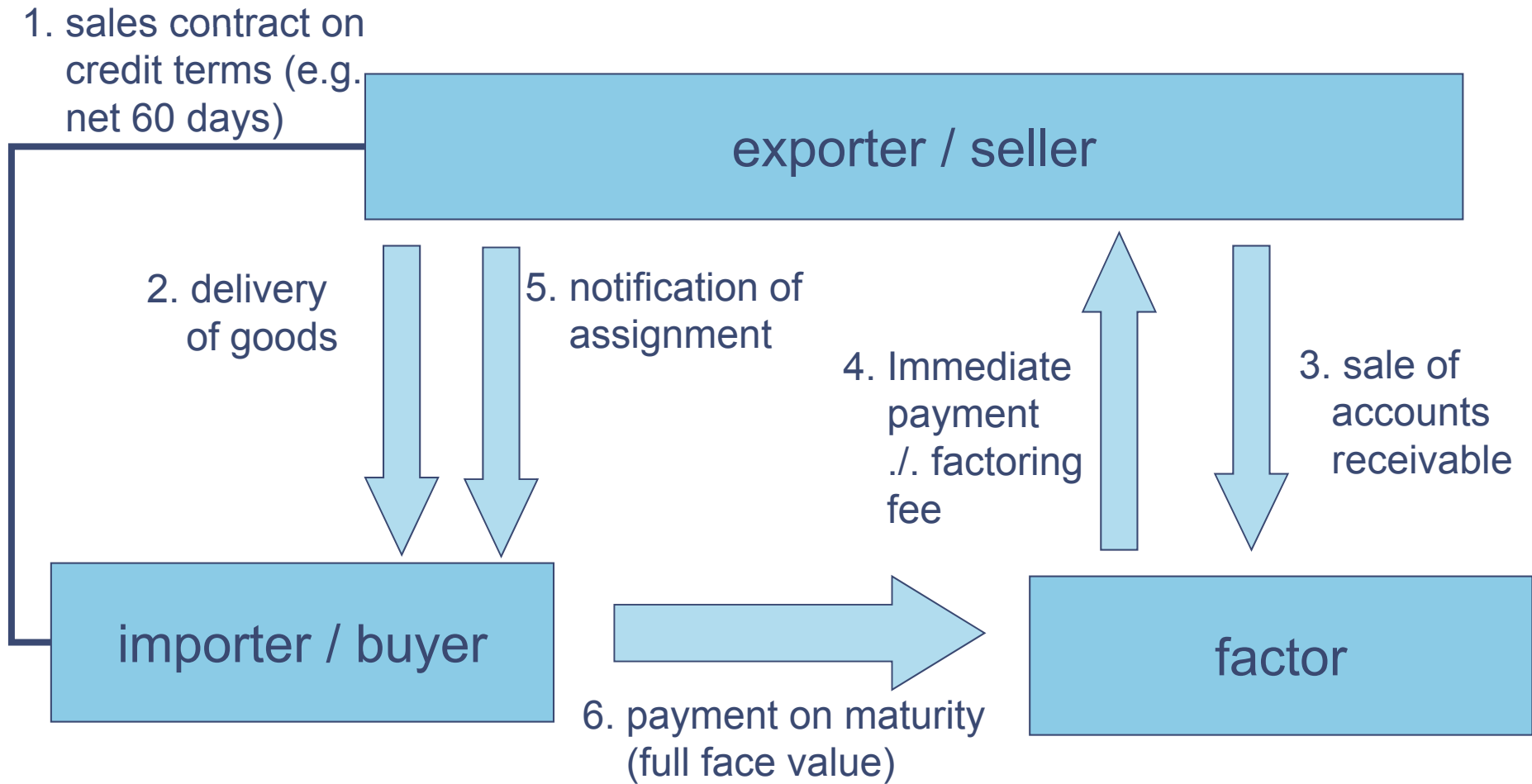


## Trade Finance (XXX) Factoring / definition

- A “factor” buys the exporter’s accounts receivable at a discount, thereby accelerating their conversion into cash.
- Typically this is done in a **non-recourse** basis (factor assumes all credit and political risk except disputes - e.g. on quality - between original parties) but **recourse** (exporter keeps all risks) and/or **modified recourse** (risk sharing between exporter and factor to a pre-set limit) factoring also exists.
- Often factors insist on handling a major part of an exporter’s accounts receivable in order to avoid being stuck with “bad risks” only.
- Firms with substantial export business or SME without a proper foreign credit and collections department often use factoring as a short-term financing device.

# Trade Finance (XXXI)

## Factoring / typical process flow (normal factoring)





# Trade Finance (XXXII)

## Costs of (normal) factoring

- Example:
  - factored amount: USD 1 million
  - tenor: 90 days receivables
  - discount rate: 2.5% *per month*
  - non-recourse fee: 1.75%
- If Exporter decides to factor \$ 1,000,000.-- for 90-days receivables without recourse:

|   |                     |
|---|---------------------|
| face amount of receivables                              | \$ 1,000,000.--     |
| <i>./. 1.75% non-recourse fee</i>                       | \$ 17,500.--        |
| <i><u>./. 2,50 % p.m. discount for three months</u></i> | <u>\$ 75,000.--</u> |
| amount received by exporter (immediately)               | \$ 907,500.--       |

- On an annualized basis:

$$APR = \frac{17,500 + 75,000}{1,000,000 - 17,500 - 75,000} \times \frac{365}{90} = 41.34\%$$

- It is expensive, but still very useful for the occasional exporter and the exporter having a geographically diverse portfolio of accounts receivable (in both cases it is difficult to internalize the collection process).

# AGENDA

- Trade Finance
  - Payment terms / risk ladder
  - Short-term financing
  - Medium, long-term and special financing
    - Forfaiting
    - ECA-financing / medium- to long-term loans
    - ECA-financing / project- and structured finance

# Trade Finance (XXXIII)

## Forfaiting / definition



- Forfaiting is derived from the French term “à forfait” (“in *Bausch und Bogen*”). It refers to the concept of selling medium- to long-term export receivables [often guaranteed by a third party (government, banks, IFI)] to a financial institution (forfaiter).
- The forfaiter assumes the credit risk and collects the amount owed from the importer / guarantor (non-recourse, apart from performance issues).
- Similar to factoring, however, forfaiting usually covers very large single transactions (> US\$ 500,000) for a term of between one and five years, whereas factoring generally involves a smaller continuous stream of short-term receivables.
- The underlying debt instrument typically is a promissory note signed by buyer and guaranteed by a reputable bank / government entity.
- Forfaiting has been a major financing tool in Europe for decades.



## Trade Finance (XXXIV)

### Forfaiting / process overview

1. forfaitor quotes all-in financing rate (usually way before merchandise is sold)
2. buyer / importer agrees
3. financing rate is added to the cost of merchandise and included in the total invoice and promissory notes values
4. seller / exporter ships goods and presents documents
5. forfaitor pays seller / exporter in full (at a discount of the promissory note face-value)
6. on maturity forfaitor receives full face value of promissory note (merchandise costs plus financing rate)

# Trade Finance (XXXV)

## ECA-financing / definition



- ECA = Export Credit Agencies
- The basic role of an ECA is to support and encourage exports (and outward investment) by providing financial support, through insuring or guaranteeing international trade and investment transactions and, in some cases, providing loans or finance directly.
- ECAs are governmental or government-backed institutions which are backed by taxpayers' money. Consequently they can take risks that commercial insurance companies cannot take (coverage of non-marketable risks only).
- Nearly every developed nation has an own ECA [examples: Euler-Hermes (Germany), US-EXIM (USA), NEXI (Japan), COFACE (France), EDC (Canada), etc.]

# Trade Finance (XXXVI)

## ECA-financing / reasons



- Macroeconomic / political
  - promotion of exports (especially in the field of capital equipment) as key objective of government's economic policy
  - opening-up of new markets especially in developing countries / emerging markets where commercial cover is difficult or impossible to obtain (especially for long-term capital goods transactions)
  - support of partners abroad in difficult phases of development and restructuring
- From an exporter's perspective
  - protection against political and commercial risks
    - secures one of the largest assets: accounts receivable
    - protects cash-flows
    - effective risk management tool

# Trade Finance (XXXVII)

## ECA-financing / main business models



| Model                                     | Definition   | Countries                        |
|---|--|----------------------------------|
| <b>private company acting as an agent</b> | <ul style="list-style-type: none"> <li>Government has an exclusive arrangement with a private company that issues policies as agent for the government.</li> </ul> | France<br>Netherlands<br>Germany |
| <b>government department / facility</b>   | <ul style="list-style-type: none"> <li>Separate department of the government operating under the authority of a government minister, secretary etc.</li> </ul>     | UK<br>Switzerland                |
| <b>state-owned agency</b>                 | <ul style="list-style-type: none"> <li>autonomous institution owned by the government (or governments if regional)</li> </ul>                                      | Canada, USA,<br>Turkey, Japan    |
| <b>government provider of reinsurance</b> | <ul style="list-style-type: none"> <li>Government will only provide reinsurance to insurers.</li> </ul>  | Australia                        |



# Trade Finance (XXXVIII)

## ECA-financing / rules

- OECD-Consensus regulates
  - maximum tenor / length of credit
  - repayment profile
  - interest rates [Commercial Interest Reference Rate (CIRR)]
    - minimum interest rates among all member countries in order to prevent excessive interest rate subsidies to national exporters in order to obtain competitive advantages
    - based on weighted average of rates on governments bonds denominated in Euro, US-Dollar, GB-Pound and Yen plus 1% p.a.
  - multi-sourcing / local costs
- Berne Union:
  - goods sold mainly on short terms
- WTO-Agreement on Subsidy and Countervailing Measures:
  - prohibition of export subsidies in the field of *marketable* risks

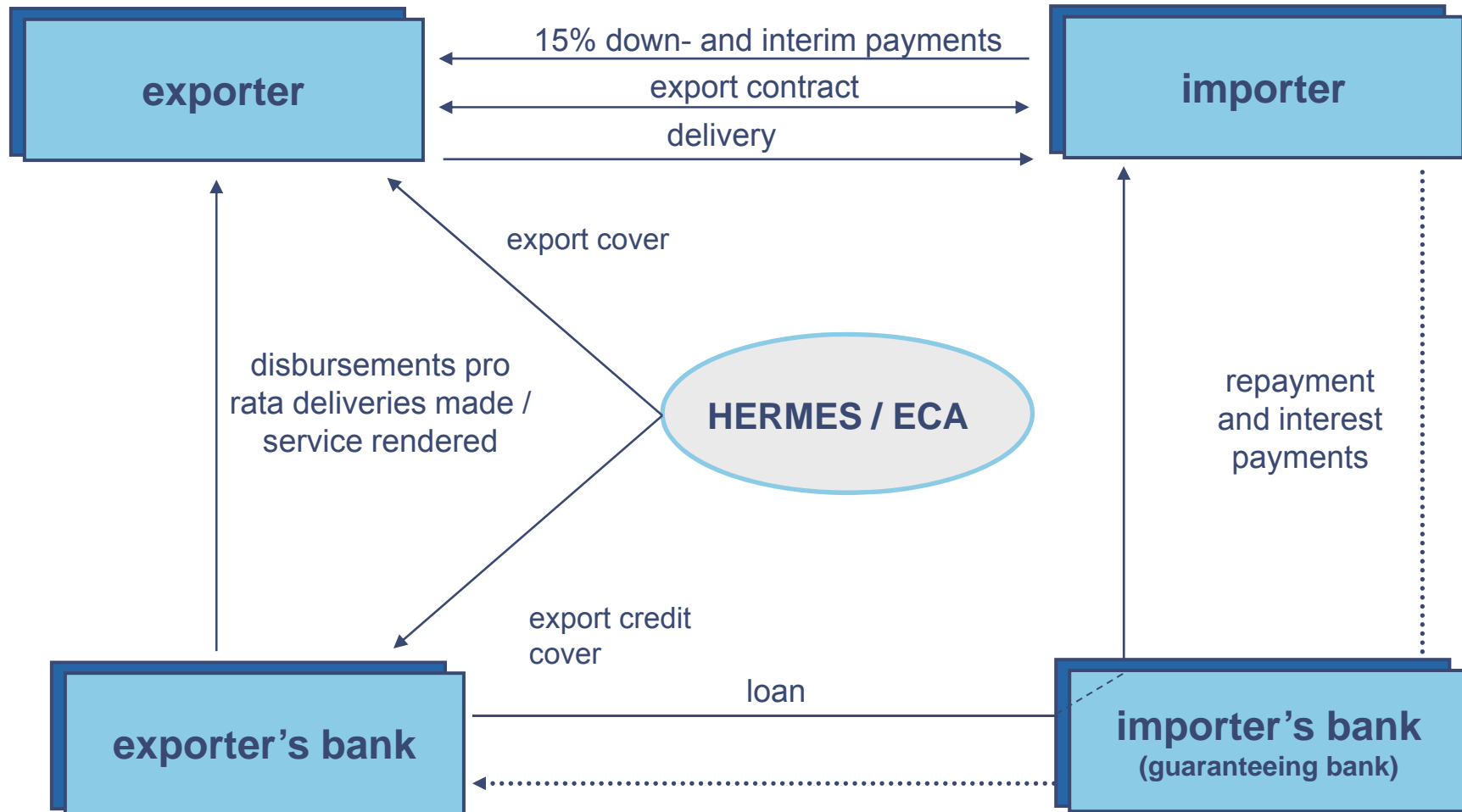


## Trade Finance (XXXIX) ECA-financing / types of coverage (extract)

- Short-term cover facilities
  - single export contract
  - revolving export guarantees (same foreign buyer)
  - comprehensive policy (covering the exporter's whole turnover)
- Medium- and long-term cover facilities (> 12 months)
  - single export contract
  - framework credit cover
  - project financing
  - structured financing

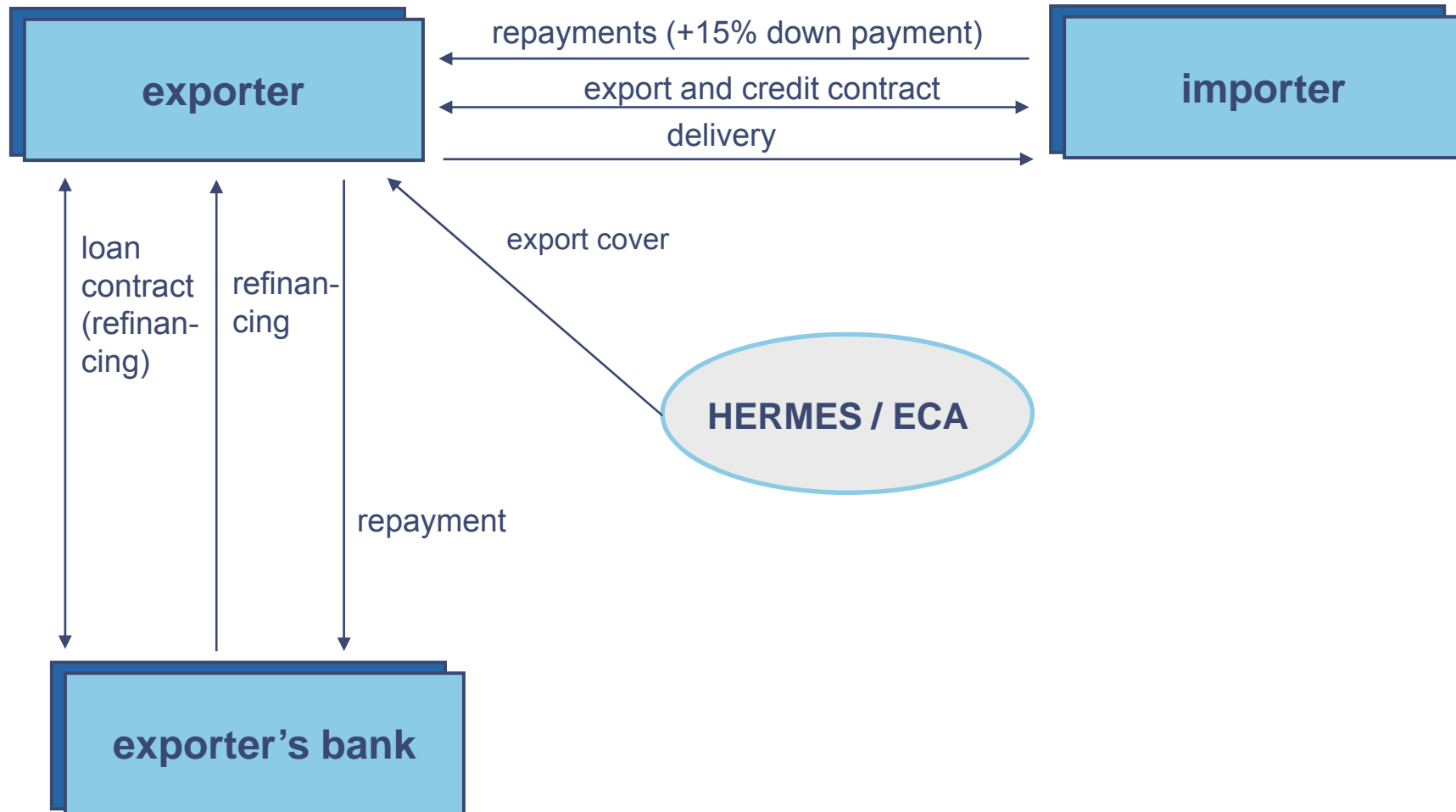
# Trade Finance (XXXX)

## ECA-financing / buyer's credit



# Trade Finance (XXXXI)

## ECA-financing / supplier's credit





## Trade Finance (XXXXII)

### ECA-financing / percentage of cover (Euler-Hermes)

- Supplier credit guarantees
  - 85% for protracted default (private / public buyers)
  - 85% for commercial risks (private buyers)
  - 9% for political risks (private / public buyers)
- Pre-shipment risks guarantees
  - 95% for all risks (coverage of cost incurred only)
- Buyer credit guarantees
  - 95% for all risks



## Trade Finance (XXXXIII) ECA-financing / types of covered risks

- Commercial risks
  - insolvency
  - protracted default (failure to pay within six months after the due date)
- Political risks
  - nationalisation, expropriation or other acts by a higher authority which in their effects are equivalent to an expropriation
  - war or other armed conflicts, revolution or insurrection
  - impossibility of converting or transferring amounts



## Trade Finance (XXXXIV) ECA-financing / eligibility criteria

- Job promotion / safeguarding
- Supplies from the New Federal States
- Promotion of (German) SMEs
- Environmental aspects
- Situation of competition / market entry
- Technology and know-how transfer
- Social and developmental criteria
- Solvency of the debtor
- Quality of the securities
- Country risks, payment experience, cover policy
- Contract risks and legal uncertainties in the buyer's country
- Experience and competence of the German applicant
- Tried and tested technology



## Trade Finance (XXXXV) ECA-financing / costs

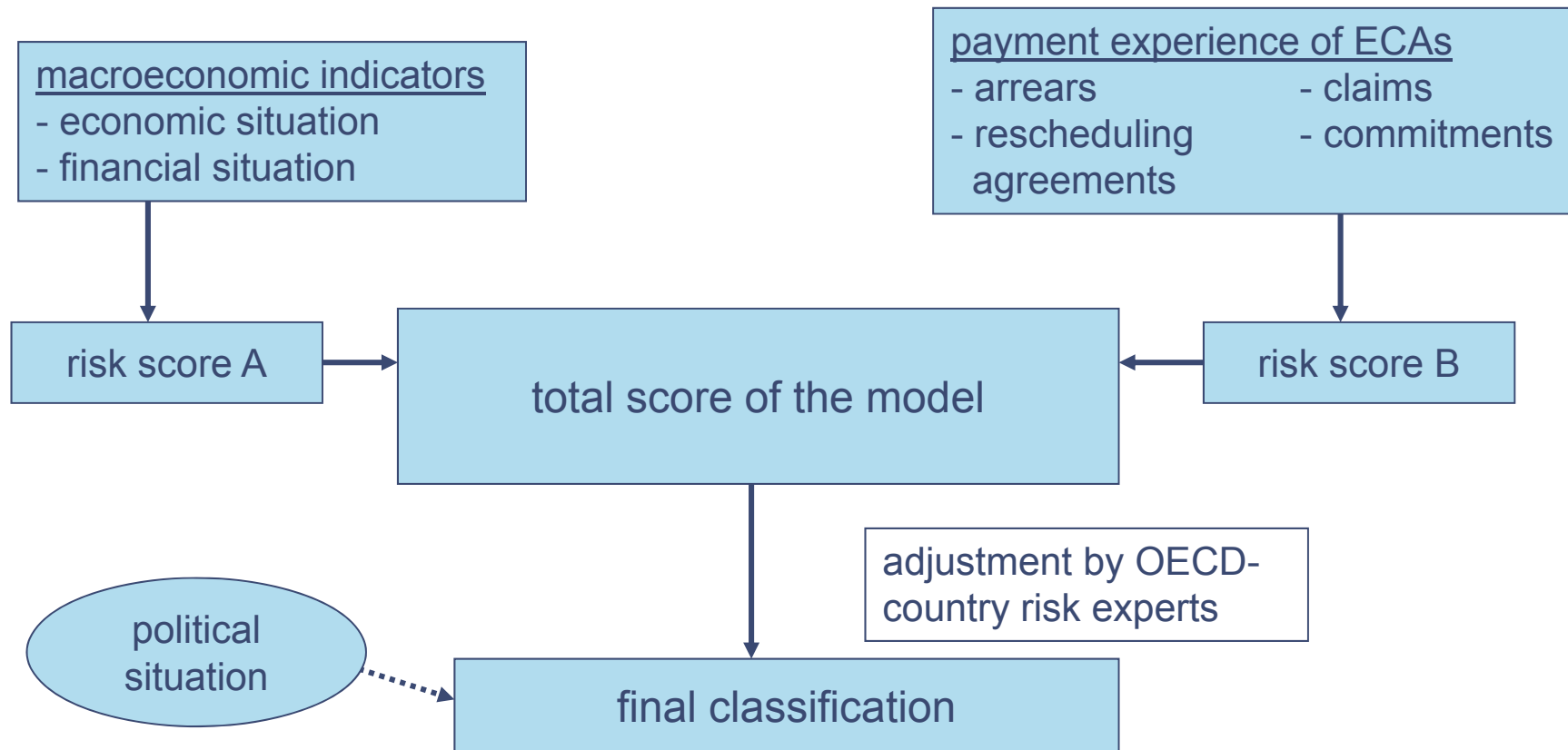
- Insurance premium should ...
  - ... be risk based
  - ... level the playing field amongst ECAs
  - ... be cost covering
  - ... be transparent among ECAs
  - ... apply to medium- and long-term business (OECD-Consensus)
- Basic guideline: OECD-country risk categories
  - seven categories
  - categories binding on all participating OECD-members
  - no distortion of competition regarding sovereign risk
  - regular review of country classifications
- Other factors: individual buyer's risk and length of risk period

# Trade Finance (XXXXVI)

## ECA-financing / costs / OECD-country model



### OECD-country risk categories (seven categories):



# AGENDA

- Trade Finance
  - Payment terms / Risk ladder
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    - ECA-financing / project- and structured finance

# Trade Finance (XXXXVII)

## Project- and structured (export) finance / general definitions



- Project Finance
  - Financing of a project earning sufficient revenues to cover operating costs and debt service.
- Structured Finance
  - “Conventional” export credit transactions related to already existing borrowers with additional collaterals (e.g. assigned export revenues) and further project finance elements.





## Structured & Project Finance: What is the Difference?

### Structured (Typical)

- Existing company borrower financing an expansion
- Full recourse to borrower
- Analyze historical & projected cash flows
- Limited “perfection of security”

### Project Finance

- SPV borrower financing a greenfield project or expansion
- Limited recourse to parent companies
- Analyze project’s future cash flows
- **Complex documentation to perfect security**



## Trade Finance (XXXXIX)

### Project finance / Why is it used?

- Reasons:
  - insulation of sponsors
  - non-consolidation of project debt onto sponsor's balance sheets
  - sharing of risk with others
  - sponsor's ability to borrow limited by covenants - negative pledge
  - sponsor engaging in multiple projects compelling need for external financing
  - tax advantages in some jurisdictions

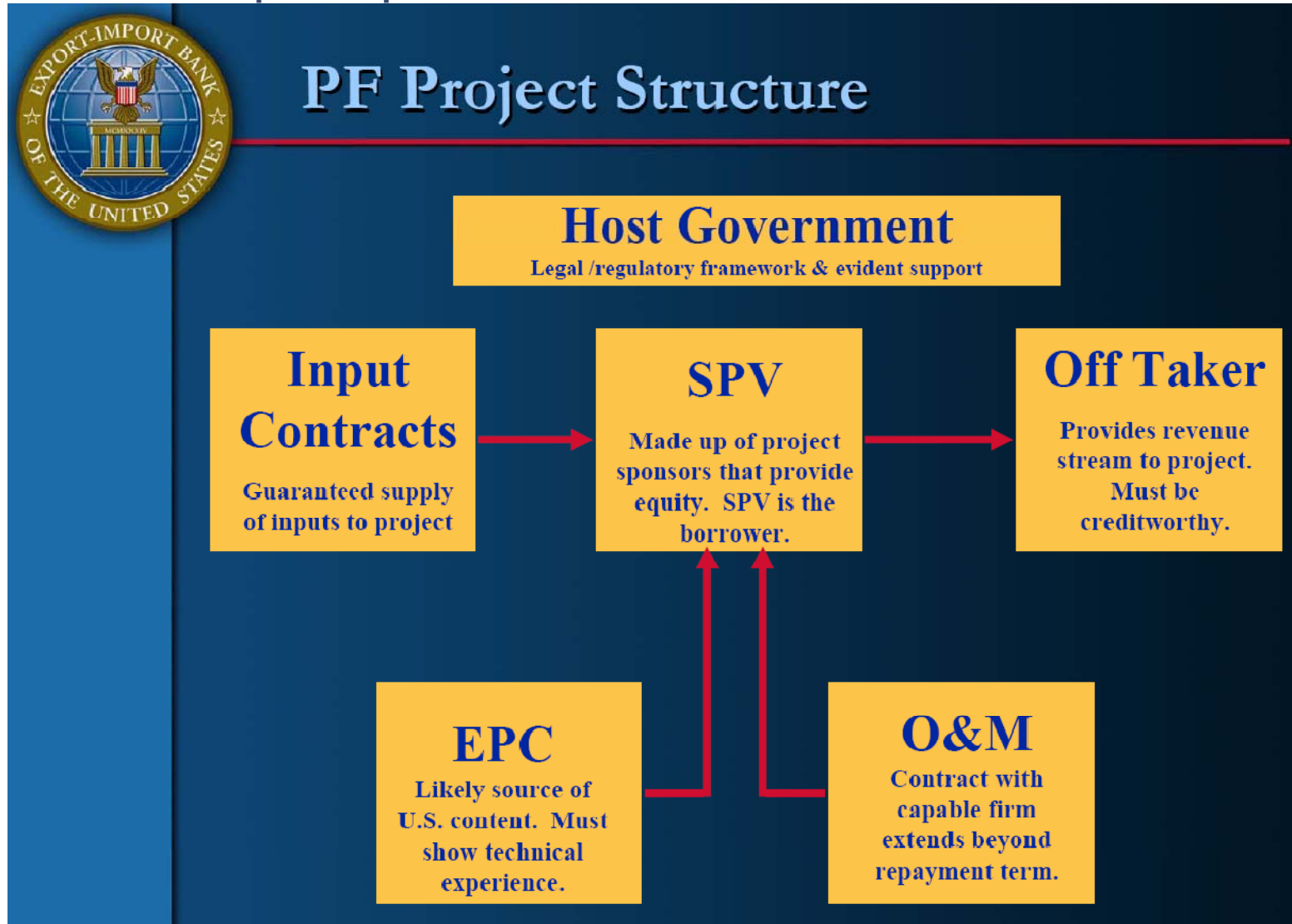


## Trade Finance (XXXXXX) Project finance / basic features

- legally / commercially independent project company (SPV)
- economic viability (sufficient cash flow to cover operation costs and debt service)
- no or very limited recourse against project sponsors / shareholders
- fair burden sharing (risk-spreading scheme involving all parties participating in the project)
- no or limited sovereign liability (no state guarantee)
- foreign exchange guarantee for local currency projects
- stable security package

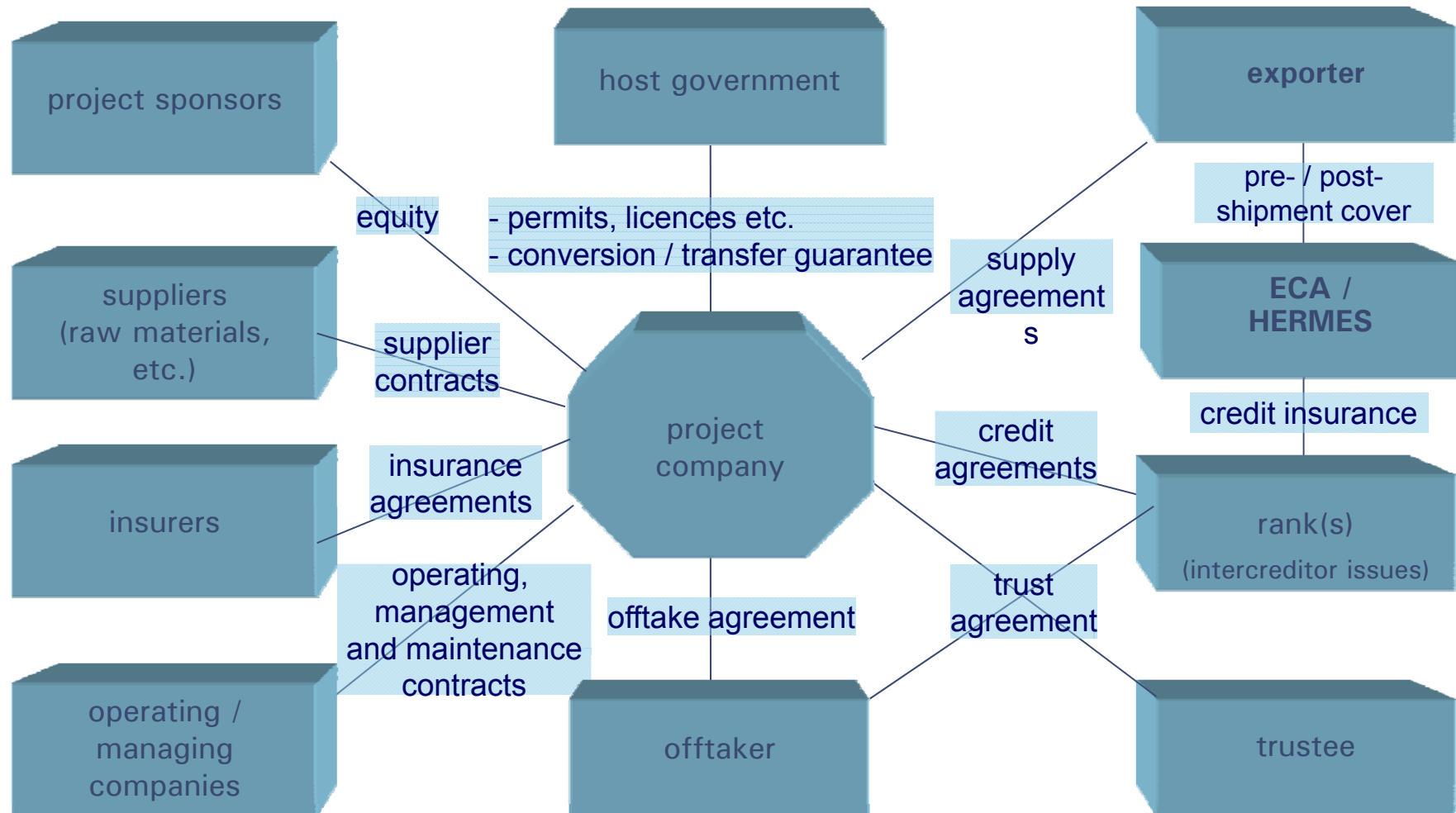
# Trade Finance (XXXXXXI)

## Project finance / principal structure



# Trade Finance (XXXXXII)

## Project finance / project spider





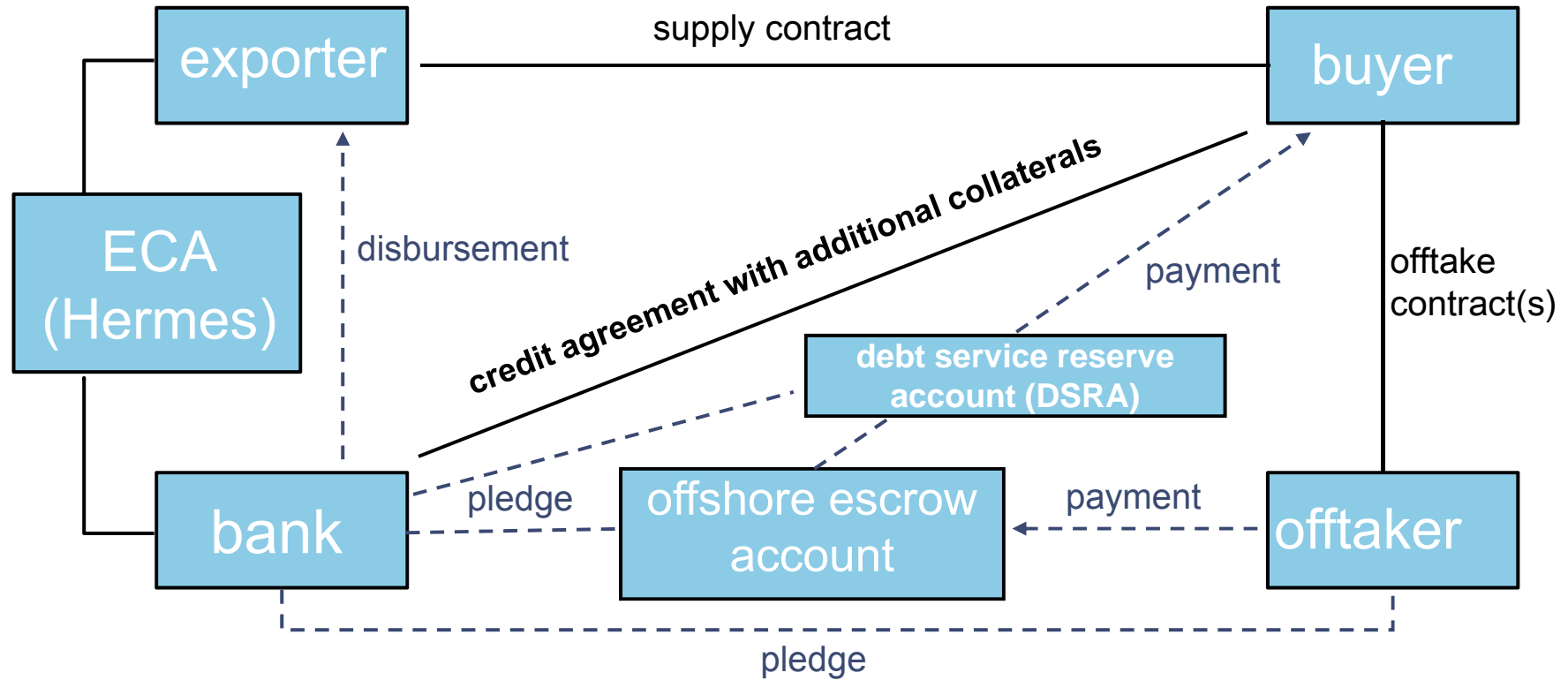
## Trade Finance (XXXXXIII)

### Structured finance / basic features

- existing company as borrower, full recourse during the whole lifetime of the loan
- in principle acceptable creditworthiness of the respective borrower
- commercially viable project (green field or major extension)
- sufficient additional proceeds deriving from the existing production facilities
- elaborated security package (assignment of proceeds, escrow account, etc.)
- appropriate support of governmental institutions on a case-by-case basis

# Trade Finance (XXXXIV)

## Structured finance / basic structure



➔ buyer = (typically) existing entity / no SPV!

# AGENDA

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2. Why do Companies trade?
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8. FDI-related Theories - Why do Companies invest abroad?
9. Types / Forms of FDI
10. Risk Management in FDI



# Risk Management (I)

## Basic process

1. Obtain risk transparency
2. Achieve risk neutralisation
  - risk ladder
  - risk insurance (ECA or private and transport / marine)
  - guarantees / securities (bid bonds, performance bonds, stand-by L/C, etc.)
  - financial derivatives (forwards, futures, options, swaps)
  - natural hedging / internal hedging
3. If neutralisation is impossible, try to arrange risk sharing / shifting (e.g. partial insurance, some export promotion schemes) or...
4. ...decide to take the risk (and get paid for doing that).



## Risk Management (II)

### Main types of risks in trade transactions

- Commercial risk
  - a party does not fulfil its obligations (payments, quality, etc.)
- Transportation risk
  - goods are destroyed during transport or become damaged
- Exchange risk
  - currency fluctuations may severely affect the value of trade transactions / capital controls may prevent currency conversions entirely (political risk)
- Political risks
  - policy changes, wars, embargoes, etc. may prevent the conclusion or reduce the value of trade transactions

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## Introduction to FDI (I)

### Definition - What is FDI?

- “FDI always includes **long-term cross border capital investments** in combination with the **possibility of influence**. Under an operational form of this definition and in accordance with international requirements, an equity threshold of 10% of equity or voting rights is generally used”. (Source: Deutsche Bundesbank)
- FDI differs from financial and portfolio investments (F&P) in the sense that **F&P investments contain interest and risk motivated capital transfers abroad without the primary aim to gain a significant influence** on the management of the company.

# Introduction to FDI (II)

## Excursion: FDI vs. F&P



|                             | <u>FDI</u>   | <u>Portfolio investments</u>                    |
|-----------------------------|--|---|
| Motivation                  | profit and control orientated  | profit and risk orientated                      |
| Resources to be transferred | capital, technology, employees know-how, profits from foreign markets, tangible assets | capital   |
| Forms                       | shares in capital of existing companies, founding of new company                       | shares, bonds, real estate and investment funds |
| Time                        | long-term  | short- to mid-term                              |



# Introduction to FDI (III)

## Overall FDI-trends in recent decades

- Until 2000: almost continuous and rapid growth in FDI for two decades
- Decline between 2000 and 2003 (attributed to Asian crisis, new market crash) / ongoing resurgence since 2003
- Growth mostly due to uncoordinated actions of governments in lowering barriers to FDI together with a new perception of FDI
- FDI has grown considerably faster than world trade and is typically driven by:
  - “push factors”: business cycle conditions, macroeconomic policy changes in industrial countries (changing role of institutional investors, tax issues and vertical specialisation)
  - “pull factors”: changes in policy by (developing) countries, liberalization of capital accounts and domestic stock markets, privatisation, raising equity caps on foreign investment, providing information, providing better investment rules and possibilities (investment climate), horizontal specialisation



# Introduction to FDI (IV)

## Excursion: Brownfield vs. Greenfield (1)

### **Brownfield (M&A)**

#### Pro:

- quick to execute / fast entrance
- preempt competitors
- possibility to use existing production-, employment- and operation concepts
- possibly less risky

#### Con:

- often disappointing results
- overvaluation of firms due to optimism about value creation (hubris) / difficulties in finding the right price
- culture clash
- problems with proposed synergies / Post Merger Integration problems (PMI)

### **Greenfield**

#### Pro:

- can build subsidiary it wants (individual production-, employment-, location- and operation concepts)
- avoidance of cartel restrictions
- investment can be distributed over longer period

#### Con:

- slow to establish
- high planning and implementation costs
- risky (misjudgment of external factors)
- (possibly) preemption by aggressive competitors



# Introduction to FDI (V)

## Excursion: Brownfield vs. Greenfield (2)

| Settlement strategy                          | Greenfield Investment    | Brownfield Investment |
|--|--------------------------|-----------------------|
| Criteria                                     |                          |                       |
| Market access                                | delayed                  | instantly             |
| Market share                                 | has to be acquired       | is taken over         |
| Capital investment                           | successive increase      | high initial amount   |
| Location                                     | free to choose           | unchangeable          |
| View / host government                       | often sponsorship        | often defensiveness   |
| Technology                                   | use of latest technology | set                   |
| Integration                                  | no problem               | difficult             |
| Number of sellers and capacity of production | increase                 | stay the same         |

Source: Pausenberger (1994)



## Introduction to FDI (VI)

### Excursion: Brownfield vs. Greenfield (3)

- Central factors influencing the decision to found or buy a company:
  - market entry options
  - predominant market and competition situation
  - time requirements
  - availability of (financial) resources
  - costs and profit elements
  - factors of risks and chances



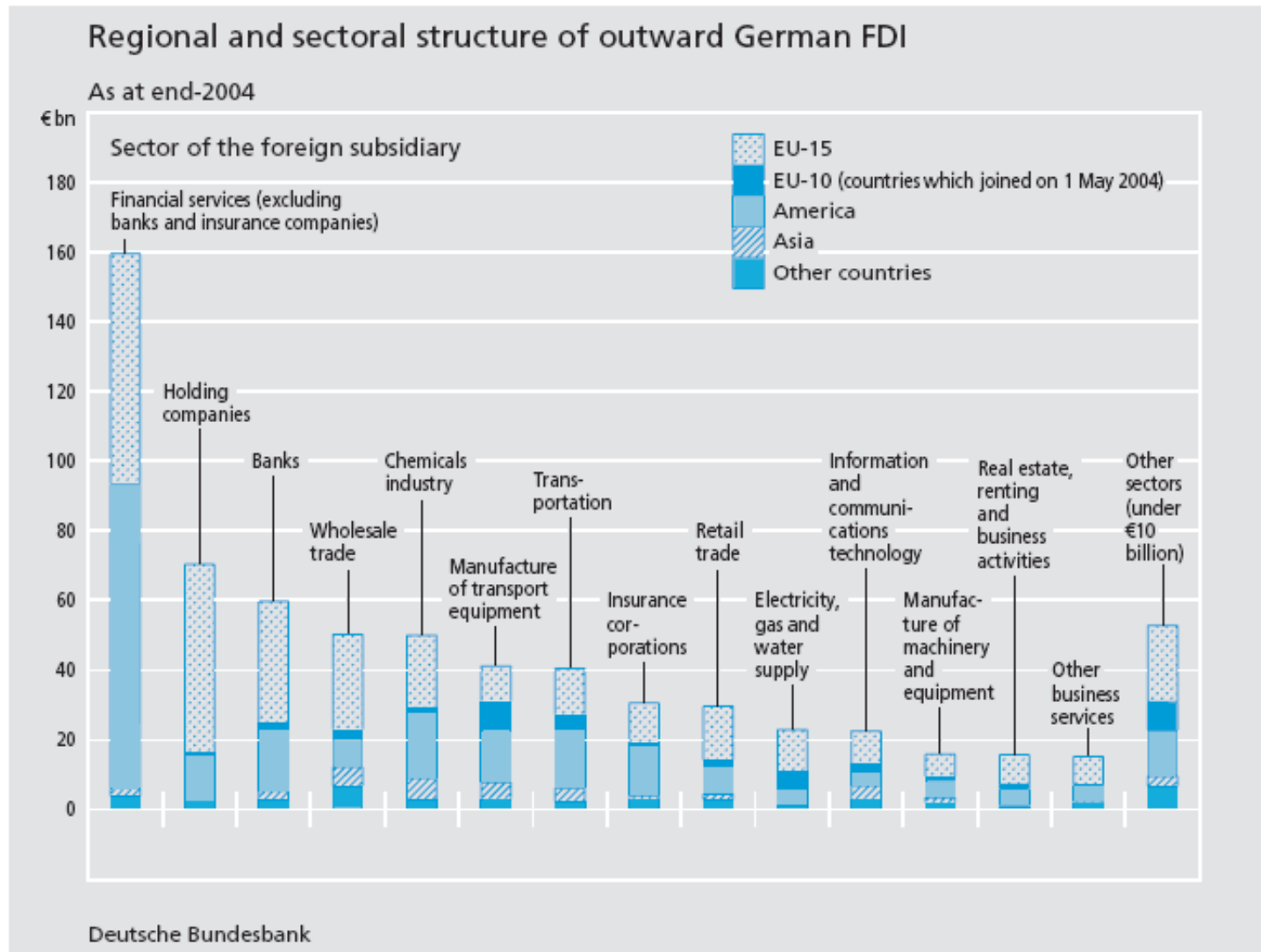
# Introduction to FDI (VII)

## A specific look at Germany - overall trends



# Introduction to FDI (VIII)

## A specific look at Germany - overall trends





## Introduction to FDI (IX)

### A specific look at Germany - effects on employment

- Crucially depend on motives for FDI
- (Backward) vertical integration is typically motivated by cost saving motives and thus often leads to a transfer of jobs away from Germany.
- Horizontal integration is typically motivated by the wish to access a foreign market and often includes positive job-effects for Germany.
- The German Bundesbank finds in 09/2006 that thus far *“horizontal FDI, the primary purpose of which is to help open up markets, is the dominant form”*.



# Introduction to FDI (X)

## Excursion: horizontal vs. vertical FDI

- Horizontal FDI (investing in new markets):
  - (end)product is produced in potential distribution market
  - primary reason: getting access to new markets (e.g. because of local content requirements) / improving service and/or sales activities
  - typically takes place between countries with a similar economic structure such as France and Germany
  - example of Brownfield horizontal FDI: (planned) acquisition of ABN AMRO by Barclays Capital
- Vertical FDI (investing in suppliers and/or distributors):
  - includes fragmentation of production process and spinning-off of parts of the production chain to foreign subsidiaries
  - typically results from different factor endowments such labour costs
  - example of Greenfield vertical FDI: construction of gypsum-mines by Knauf (a German world market leader in construction material processing) in foreign countries



## Introduction to FDI (XI)

### A specific look at Germany - reasons for German FDI

....Bundesbank findings confirmed by recent DIHK-survey...

| Funktionsschwerpunkte der Auslandsinvestitionen deutscher Industrieunternehmen<br>in Prozent |   |   |                              |
|--|---|---|------------------------------|
|  | Auslandsproduktion<br>zur Kostenersparnis | Auslandsproduktion<br>zur Markterschließung | Vertrieb und<br>Kundendienst |
| 2000   | 34  | 29  | 37                           |
| 2001   | 29  | 27  | 44                           |
| 2003   | 42  | 26  | 32                           |
| 2004   | 39  | 24  | 36                           |
| 2005   | 34  | 26  | 40                           |
| 2006   | 31  | 27  | 42                           |

Source: 2006 Survey by the German International Chamber of Commerce (DIHK)

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# AGENDA

- FDI-related Theories
  - The unfortunate Hymer
  - Product Life Cycle (PLC) by Vernon
  - OLI-Theory by Dunning
  - Porter's Diamond Theory



## FDI-related Theories (I)

### Imperfect competition as FDI-driver

- Explaining FDI flows has been at the centre of economic studies for a long time.
- The topic is complex, involving several special fields of economics.
- What is clear is that **in a perfectly competitive economy, there would be no FDI at all!** / Question: Why wouldn't there be any FDI in such a world?
- Consequently, nowadays economists focus on aspects of **imperfect competition** to explain FDI-flows.



## FDI-related Theories (II)

### The unfortunate Hymer (1)

- Hymer (1960) asked the basic question:  
“How can a foreign company compete successfully in an unfamiliar market, where it must be at a disadvantage compared to local firms?”
- Answer:  
“For firms to own and control foreign value-adding activities they must possess some kind of innovatory, cost, financial or marketing advantages - specific to their ownership - which is sufficient to outweigh the disadvantages they face in competing with indigenous firms in the country of production.”



## FDI-related Theories (III)

### The unfortunate Hymer (2)

- Specific ownership advantages:
  - access to raw materials
  - reduction of transaction costs by replacing an arm's length market-based transaction with an internal firm transaction
  - intangible assets such as patents, trademarks, superior management skills, etc.
  - economies of scale / scope
- Unfortunately....
  - ...Stephan Hymer was killed in a car accident soon after his thesis regarding FDI was completed, and his work was almost forgotten for a while.
  - After years, several other economists picked up his findings and elaborated on them (see Dunning's OLI-Theory).



## FDI-related Theories (IV)

### Vernon (1)

- Vernon (1966) developed the product life cycle model (PLC) based on a critique of the comparative advantage theory, especially the failure of the theory
  - to deal with the role of innovation in explaining trade patterns and
  - to pay attention to the role of economics of scale in determining trade patterns.



## FDI-related Theories (V)

### Vernon (2) - description of product life cycle (PLC)

- Phase of innovation: through the development of a new product a company reaches a monopoly position in its home market / demand is (rather) price inelastic / innovation is expected to come from developed countries as high income is expected to spur new ideas / innovativeness
- Phase of export: assumption - foreign companies do not have the technology to produce the newly developed product yet / consequence - export is undertaken to satisfy the rising demand abroad



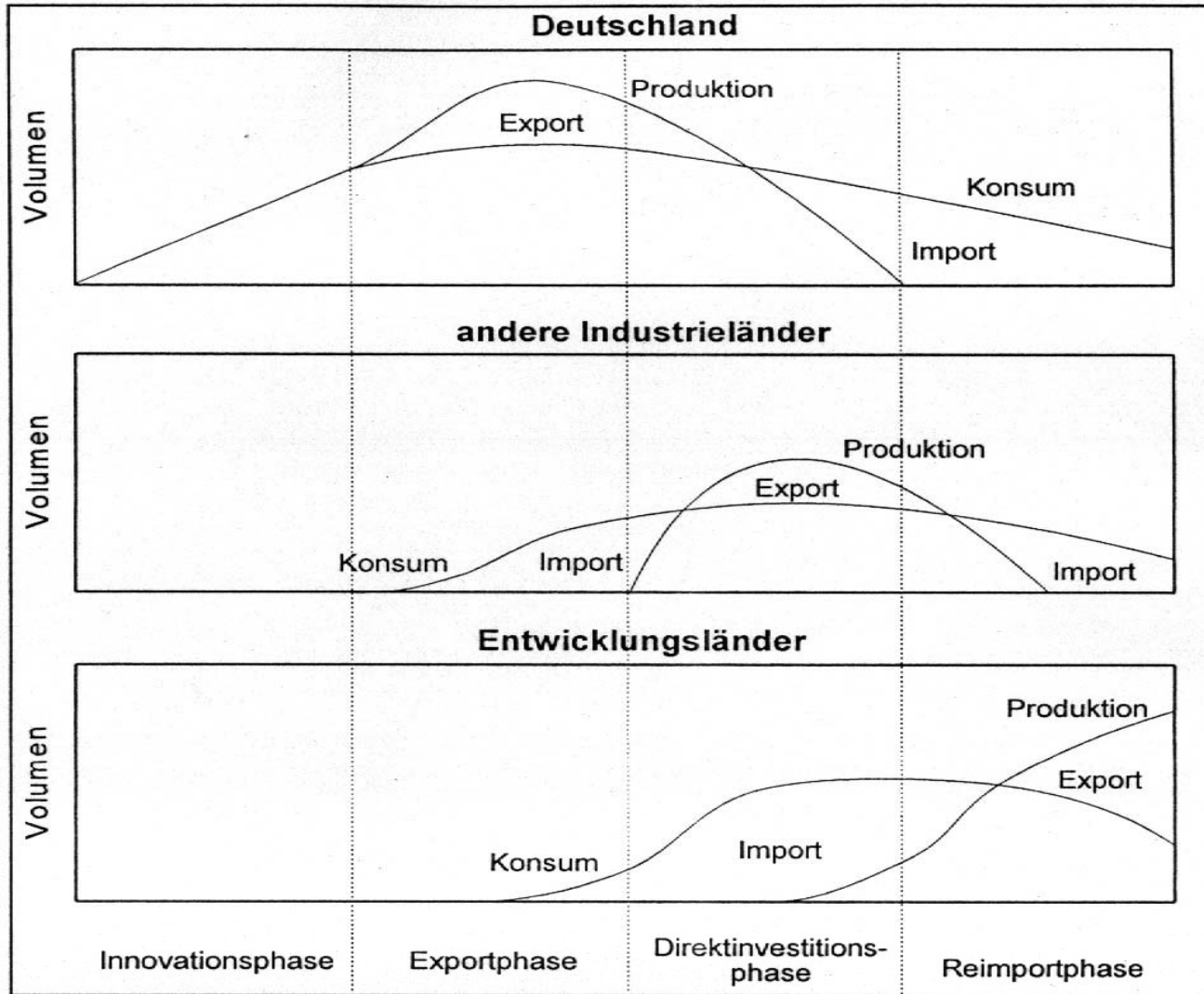
## FDI-related Theories (VI)

### Vernon (3) - description of product life cycle (PLC)

- Phase of FDI: increasing familiarity (and income) abroad lead to rising demand for the product / grade of standardisation for the product is growing leading to mass-production possibilities / inventing company starts to set up production lines abroad (FDI) to satisfy foreign market-demand
- Phase of re-import: due to comparative cost advantages the entire production is shifted abroad / overall demand at home and abroad can be satisfied by re-importing (where necessary)

# FDI-related Theories (VII)

## Vernon (4) - description of product life cycle (PLC)





## FDI-related Theories (VIII)

### Dunning's (1993) OLI-theory (1)

- If a company wants to service a foreign market from a local production site, it must have access to firm-specific advantages or be able to acquire these at lower cost. This is called ownership specific advantages (O-advantages).
- Given that ownership-specific advantages exist, it must be in the best interest for the firm to use these itself, rather than sell them or license them to other firms. These are internalization (I-advantages), which can arise because an internal hierarchy may be a more efficient way of organizing transactions than market-based arm's length transactions.
- In addition to O- and I-advantages, it must be in the investing company's interest to use these in combination with at least some factor inputs located abroad. These are location specific advantages (L-advantages).
- Combination of O-, L- and I-advantages = O-L-I-paradigm of international production



## FDI-related theories (IX)

### Dunning's OLI-theory (2) - O-advantages

- Technology: (better products, management techniques, marketing skills)
- Industrial organisation and size: may be better equipped for innovation, to fight price wars, to cope with legal problems, to take advantage of economies of scale / scope, etc.
- Access to markets: e.g. due to political circumstances, etc.
- Finance: ability to raise money more easily (reputation, less variability of profits) □ → can be seen as a form of geographical diversification
- Note that the presence of ownership advantages suggests some form of market failure → imperfect competition



## FDI-related theories (X)

### Dunning's OLI-theory (3) - L-advantages

- Transportation costs
- Unexploited economies of scale / scope
- Factor endowments
- Tax regulations / concessions, tariff rates, quantitative restrictions
- L-advantages can be strengthened by national governments
- Examples:
  - providing better infrastructure (roads, ports, airports, etc.)
  - providing a sound and transparent legal framework
  - providing better education / workforce
  - providing attractive tax-schemes



## FDI-related theories (XI)

### Dunning's OLI-theory (4) – I-advantages

- (No) costs of negotiation vs. expensive contracting procedures
- Issue of “proving” the profitability of the venture
- Brand image
- Not wishing competitors to “catch up”
- Underutilised (managerial) economies of scale
- Transfer pricing possibilities



## FDI-related Theories (XII)

### Dunning's OLI-theory (5) - suggestions

- The OLI-theory suggests that the greater the O- and I-advantages possessed by firms and the more the L- advantages of creating, acquiring (or augmenting) and exploiting these advantages from a location outside its home country, the more FDI will be undertaken.
- Where companies possess major O- and I-advantages but the L-advantages favour the home market, domestic investments will be preferred to FDI and foreign markets will be supplied via exports.
- When firms possess O-advantages which are best acquired, augmented and exploited from a foreign market, but by way of inter-firm alliances, then FDI will be replaced by a transfer of limited assets or the right to their use (licensing, franchising).

## FDI-related theories (XIII)

### Dunning's OLI-Theory (6) - how to service a market



| Market service | O-adv | I-adv | L-adv |
|----------------|-------|-------|-------|
| FDI            | yes   | yes   | yes   |
| Trade          | yes   | yes   | no    |
| Licence        | yes   | no    | no    |



## FDI-related Theories (XIV)

### Dunning's OLI-theory (7) - four types of FDI in the OLI

- Resource seeking FDI:
  - to seek and secure natural resources e.g. minerals, raw materials, or lower labour costs
  - examples: VW opening up plants in the Czech Republic to produce and re-export (parts) to Germany / BHP Billiton in Africa and Latin America
- Market seeking FDI:
  - to open up and exploit new markets for the firms' (finished) products
  - unique possibility for some type of services for which production and sales / distribution have to take place simultaneously (telecom, water supply, energy supply)
  - examples: billion dollar T-Mobile investment in the American carrier Voicestream / RWE Water investments in USA and UK



## FDI-related Theories (XV)

### Dunning's OLI-theory (8) - four types of FDI in the OLI

- Efficiency seeking:
  - to restructure existing investments in order to achieve an efficient internal organisation
  - international specialisation whereby firms seek to benefit from differences in product and factor prices and to diversify risk
  - example: Daimler Chryslers' regional supply centres
- Strategic asset / capabilities seeking FDI:
  - strategic operations through the purchase of existing firms and/or assets in order to protect O-specific advantages to sustain or advance competitive position
  - acquisition of key established local firms / preventing acquisition by competitors
  - acquisition of local capabilities including research and development, knowledge and human capital
  - acquisition of market knowledge / preventing market entrance by competitors
  - examples: big international mergers such as Daimler/Chrysler, BHP/Billiton; takeover of small silicon valley companies by SAP, Microsoft, etc.



## FDI-related Theories (XVI)

### Dunning's OLI-theory (9) - question

- Approximately one-third of world trade is intra-firm trade, taking place within MNCs.
- Can the OLI-theory explain this phenomenon?



## FDI-related Theories (XVII)

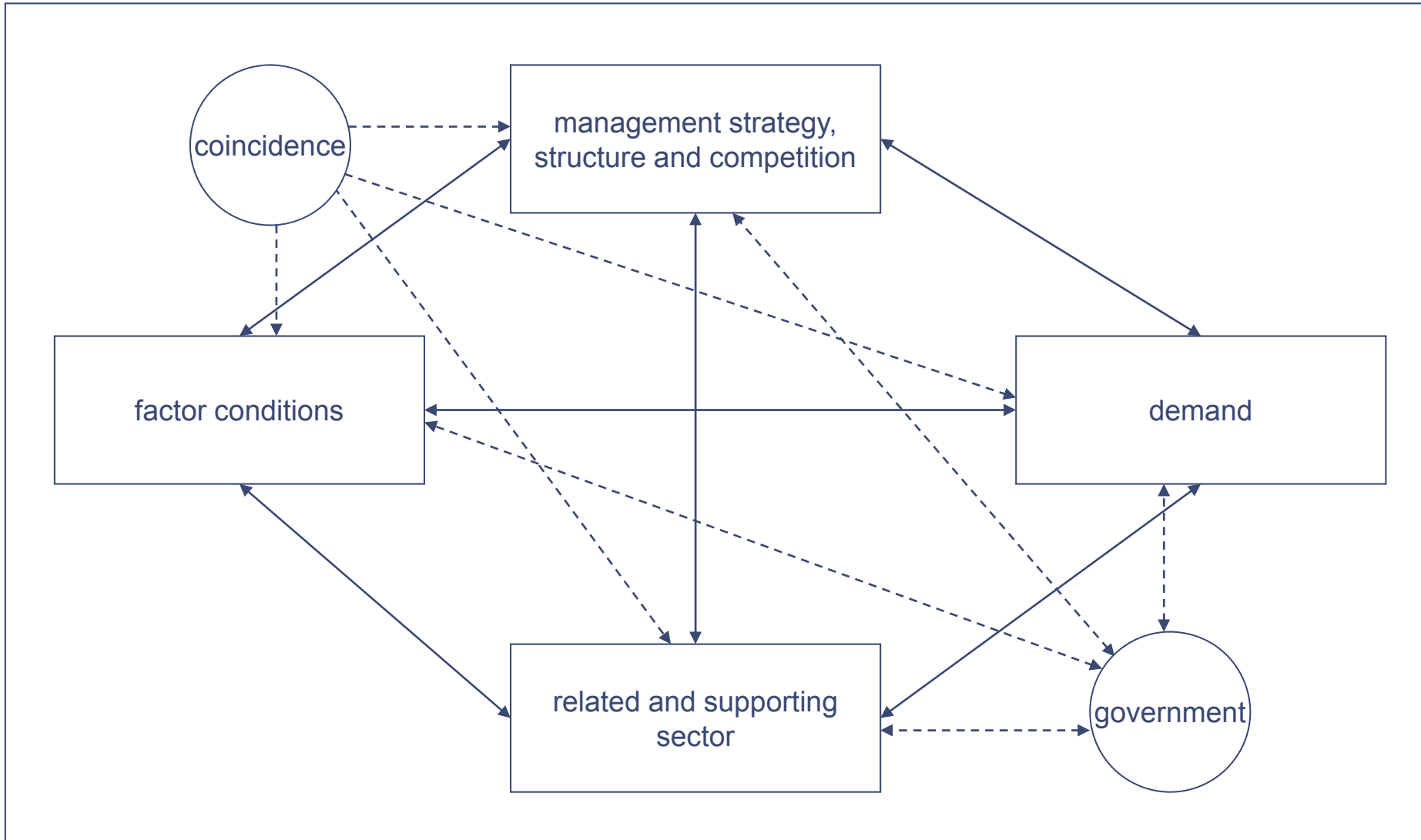
### Porter's diamond theory of internationalisation (1)

- Core observation: world-wide successful companies (global players) often originate from the same country
- Thesis: Companies receive especially favourable conditions in the home country. These enable them to take action internationally and gain advantages in competition against foreign companies abroad.
- According to Porter the following national factors are advantages in competition:
  - factor conditions
  - demand
  - related and supporting sectors
  - management strategy, structure and competition

Source: Porter (1991)

# FDI-related Theories (XVIII)

## Porter's diamond theory of internationalisation (2)



Source: Porter (1991)

# AGENDA

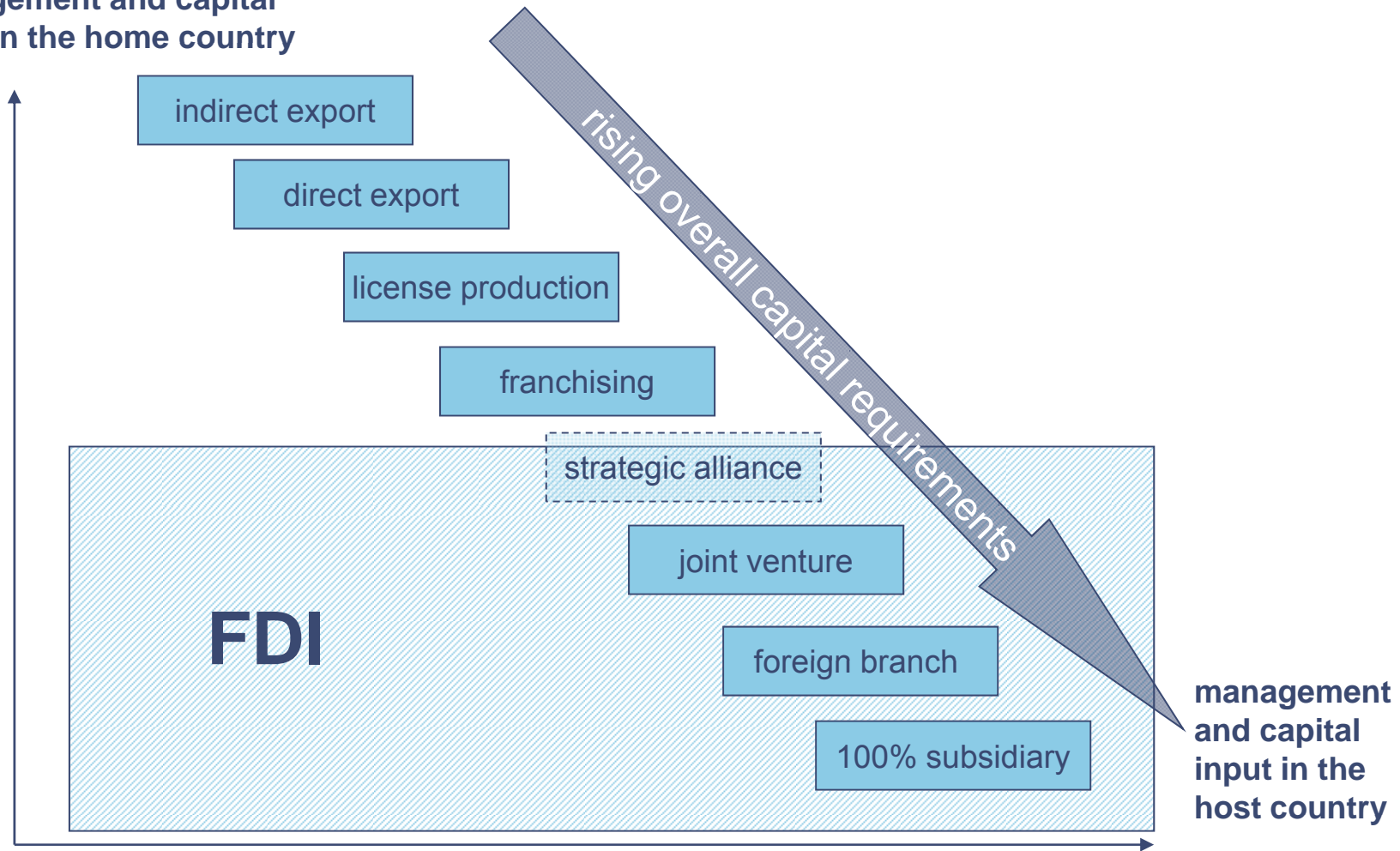
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# Types / Forms of FDI (IV)

## Different internationalisation strategies / modes of entry



management and capital input in the home country



Source: Schenk (1994), Gerber (1980)

## Types / Forms of FDI (V)

### Different internationalisation strategies / strategic alliance (1)



- A strategic alliance is the formalised and long-term co-operation with other companies [often with (former) competitors - example: airline industry].
- The aim of a strategic alliance is to compensate one's own weaknesses with the strength of the potential partner in order to improve one's own competitive position on a long-term basis.
- Specific criteria of strategic alliances are as follows:
  - often no capital investment of partners necessary
  - dominant in research and development and production
  - main focus typically lies on the exchange of information, know-how and immaterial goods
  - long-term yet time-wise limited co-operation
  - mainly occurs in high-technology and service sectors.

## Types / Forms of FDI (VI)

### Different internationalisation strategies / strategic alliance (2)



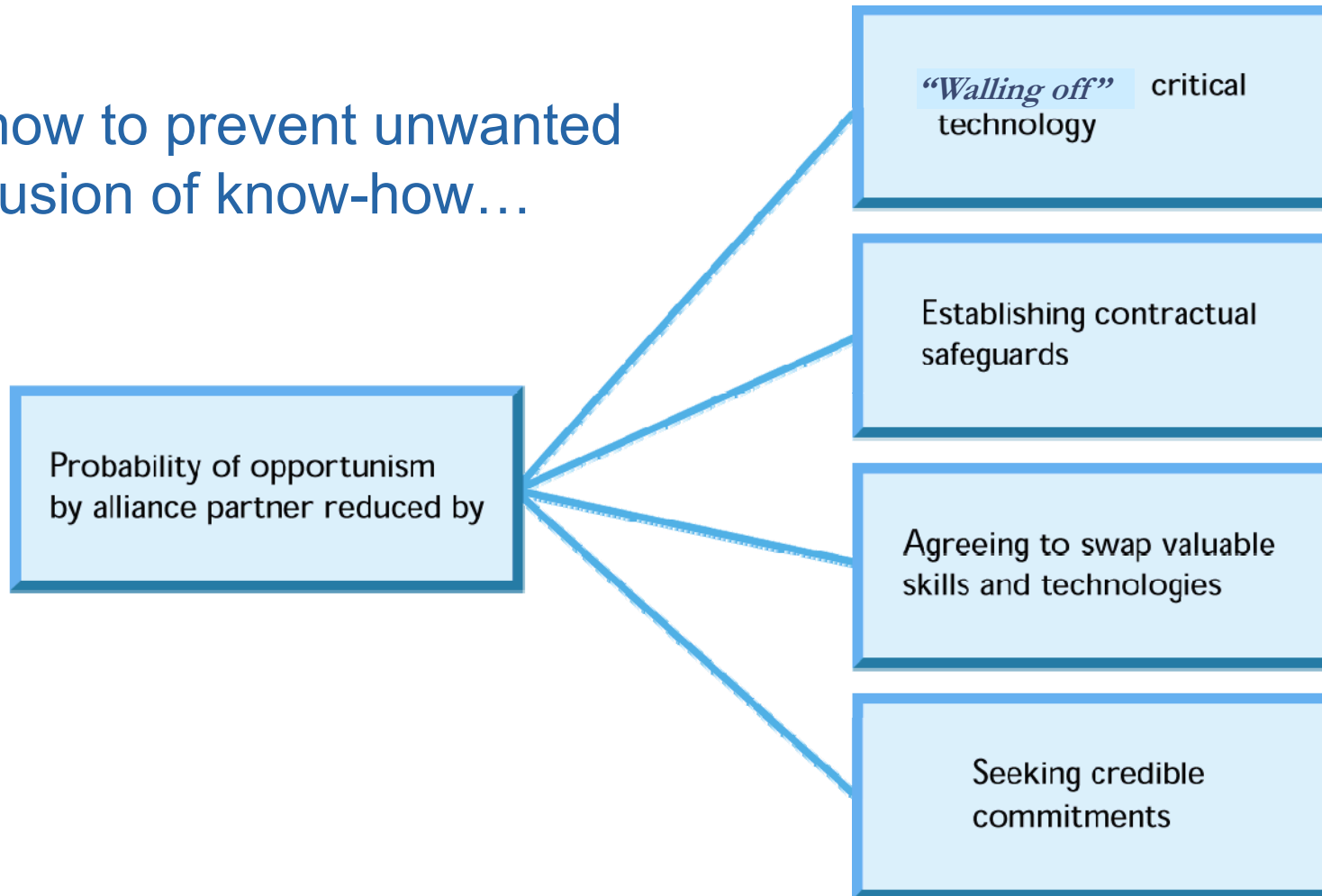
- Pros:
  - resource advantages through the link of short financial and personnel resources, and access to the partners' legally protected technologies
  - time advantages by shortening the time for developments through the connection of resources, early integration of systems and the reduction of double work in research and development
  - cost advantages by the use of free capacities and the realisation of cost depression effects
  - market advantages by the combination of sales activities
- Cons:
  - risk of loss of advantages in competition due to the unwanted diffusion of know-how
  - high planning, organisation and controlling costs
  - problems in human resource policies

# Types /Forms of FDI (VII)

## Different internationalisation strategies / strategic alliance (3)



...how to prevent unwanted diffusion of know-how...



## Types / Forms of FDI (VIII)

### Different internationalisation strategies / joint ventures (1)



- A joint venture describes a joined capital investment as well as a sharing of management and risks in a specific project. It constitutes a contractually fixed and long lasting co-operation.
- It is the combination of factual, personnel and financial resources as well as the know-how of two or several partners creating an independent legal entity.
- The aim of a joint venture is to realise various goals that each partner would not be able to achieve alone. Therefore the primary target consists of the achievement of synergy effects.



## Types / Forms of FDI (IX)

### Different internationalisation strategies - joint ventures (2)

| Criteria                                    | Forms  |
|---|--|
| Fields of co-operation                      | <ul style="list-style-type: none"><li>•research and development, procurement, production, sales or other activities</li></ul>                                    |
| Number of partners                          | <ul style="list-style-type: none"><li>•two vs. multiple partners</li></ul>   |
| Direction of co-operation                   | <ul style="list-style-type: none"><li>•horizontal, vertical or lateral</li></ul>   |
| Profile of resources among partners         | <ul style="list-style-type: none"><li>•congruent vs. complementary</li></ul>   |
| Ratio of investment                         | <ul style="list-style-type: none"><li>•majority-, parity- or minority- joint venture</li><li>•fade-out-joint venture (decreasing share of one partner)</li></ul> |
| Potential influence of the partners         | <ul style="list-style-type: none"><li>•balanced (shared management joint venture)</li><li>•domination of one partner</li></ul>                                   |
| Duration and importance of the co-operation | <ul style="list-style-type: none"><li>•short- to mid-term co-operation (operative importance)</li><li>•long-term co-operation (strategic importance)</li></ul>   |
| Motives for the co-operation                | <ul style="list-style-type: none"><li>•voluntary co-operation</li><li>•forced co-operation through regulations of host country</li></ul>                         |

# Types/Forms of FDI (XI)

## Different internationalisation strategies / joint ventures (4)



- Pros:
  - opportunities to make use of the partners' resources, knowledge of the local market and country development (especially useful for small and mid-sized companies)
  - limitation of risks
  - avoidance of legal restrictions for 100% subsidiaries
  - decrease in risk of expropriation
  - achievement of cost and synergy advantages
- Cons:
  - target and attitude conflicts
  - high co-ordination costs
  - decrease in flexibility and ability to react during the decision process
  - risk of unintentional diffusion of knowledge and asymmetric learning

# Types / Forms of FDI (XII)

## Different internationalisation strategies / foreign branch (1)



- Foreign branches (*“Auslandsniederlassungen”*) are foreign entities that are personally, legally and financially dependent on their respective mother companies.
- Forms of foreign branches are:
  - according to activities shifted abroad they can be differentiated as research and development-, procurement-, production-, sales branches (example: BNP Paribas Frankfurt)
  - production branches can be further divided into:
    - foreign assembly: where parts for final product mainly originate from the home country
    - foreign production: where due to cost reasons or to local content restrictions most parts originate from the host country

# Types / Forms of FDI (XIII)

## Different internationalisation strategies / foreign branch (2)



- Pros:
  - limited personnel and organisational complexity
  - tax advantages
  - direct control
  - elimination of possible restrictions in trade
  - elimination of risks in exchange rate
  - risk diversification through the distribution of procurement and production to various countries
- Cons:
  - full liability of parent company (under different laws, example: banking industry)
  - possible loss of economies of scale through decentralised structure of the production line
  - (eventually) high capital investment
  - economic and political risks
  - fairly high control costs in the head office
  - restricted flexibility due to long-term binding of resources

## Types / Forms of FDI (XIV)

### Different internationalisation strategies / 100% subsidiary



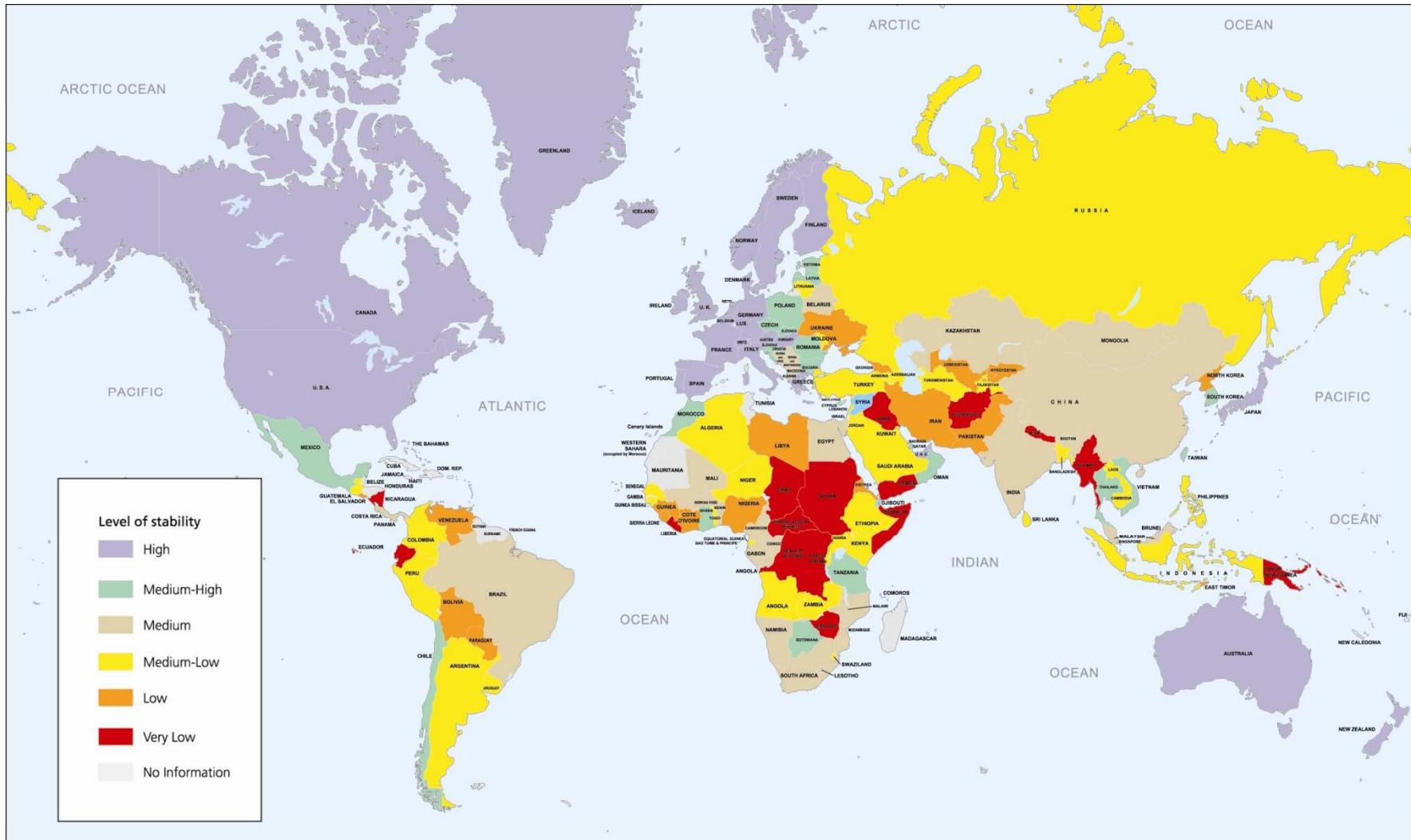
- A 100% subsidiary represents a form of ownership in which the parent company owns and controls the foreign entity but is (typically) not liable from a judicial perspective.
- Pros (compared to foreign branch):
  - typically no liability
  - (potentially) positive transfer-pricing effects
- Cons (compared to foreign branch):
  - tax considerations

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# Risk Management in FDI (II)

## Importance of political risk



Source: Eurasia Group



## Risk Management in FDI (III)

### Political risk overview

- Definition of political risk: any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.
- Current top-political risks:
  1. confronting a nuclear Iran
  2. increased U.S. protectionism
  3. Nigeria: a fraying nation
  4. Iraq: another tough year
  5. prospects for social unrest in China
  6. continuing risk of avian influenza
  7. transformation of global terrorism
  8. new challenges from the left in Latin America



## Risk Management in FDI (VI)

### Strategies to mitigate political risk (1)

- Shared ownership reduces both the likelihood and the potential severity of loss.
- Enter into a joint venture with local investors:
  - to establish local support for the firm, and
  - to provide better information on the country's political / economic conditions.
- Limit the amount of capital invested in the local subsidiary / affiliate.



## Risk Management in FDI (VII)

### Strategies to mitigate political risk (2)

- Integrative strategy:
  - integrate within the social / economic fabric of the local country
  - borrow funds locally to lessen investment exposure should nationalization occur
  - train managers to become familiar with local culture, customs, etc.
- Defensive strategy:
  - keep fixed investments and assets to a minimum by leasing whenever possible, and by retaining research and development activities domestically
  - maintain ability to move operations quickly and easily to another country
  - minimize reliance on local services and utilities



## Risk Management in FDI (VIII)

### Political risk insurance

- Typically provides protection against three broad types of risks:
  - seizure and destruction of assets
  - currency inconvertibility
  - interference with contractual performance
- Sources are very limited internationally
  - MIGA, OPIC
  - ECAs (EDC, Euler-Hermes, etc.)
  - private insurers: AIG, Chubb, ACE, Zurich



## Risk Management in FDI (IX)

### Political risk insurance - a look at Germany (1)

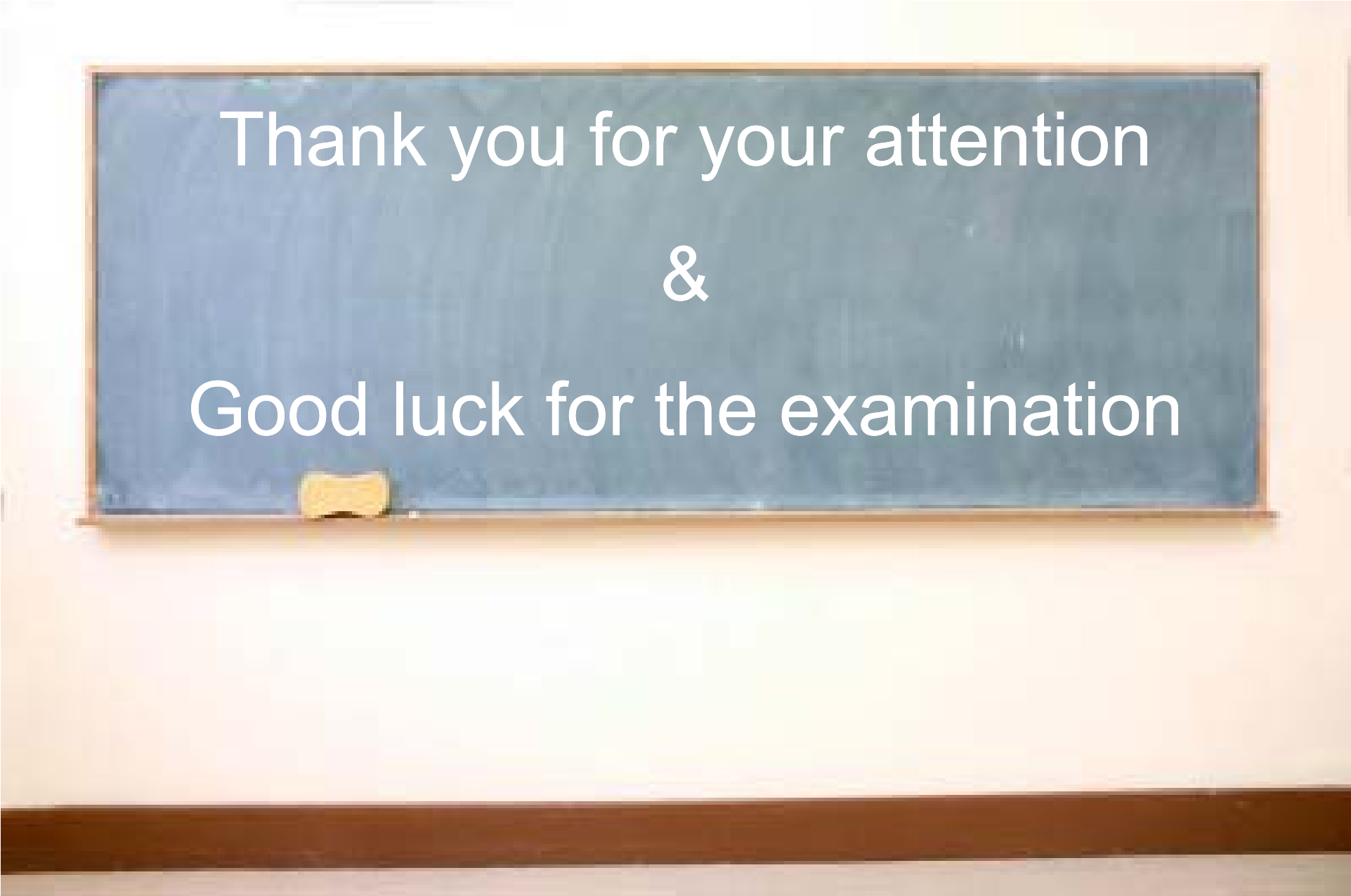
- Insurance scheme handled by PwC and Euler-Hermes (for the German Government)
- What can be covered
  - equity participation
  - formation, capital increase or purchase of shares
  - endowment capital provided to a foreign branch
  - investment-like loans (long-term loan)
  - other rights qualifying as assets
    - (e.g. bonds, concession agreements - usually in connection with oil and gas investments -, etc.)



# Risk Management in FDI (X)

## Political risk insurance - a look at Germany (2)

- covered risks
  - nationalisation, expropriation or other acts by a higher authority which in their effects are equivalent to an expropriation
  - breach of legally binding commitments by government or other entities directed or controlled by the government (enhanced flexibility with regard to providing sub-sovereign risk cover)
  - war or other armed conflicts, revolution or insurrection or acts of terrorism in connection with such events
  - impossibility of converting or transferring amounts deposited with a solvent bank for transfer to Germany
  - payment embargoes or moratoriums

A blue chalkboard with a wooden frame is mounted on a light-colored wall. The text is written in white, sans-serif font. A small yellow eraser is visible at the bottom left of the chalkboard.

Thank you for your attention  
&  
Good luck for the examination