FINANCE OF INTERNATIONAL TRADE 1

October, 2017

Instructions to Candidates

1. This examination has five (5) questions
2. Answer ***any four (4)*** questions.
3. Each question carries **25** marks.
4. Start each answer to a question on a fresh page.
5. Please number your answers.
6. Use relevant illustrative practical examples in as far as possible.

'There are different types of risks that a firm should be aware of when it decides to operate in the international market.' Discuss any four types of risks that are referred to in the quotation. In your answer, clearly explain how each of the four risks arises. **[25 marks]**

Question 2

Define countertrade and discuss three types of countertrade that you consider suitable for Zimbabwe. Give three reasons why you consider them suitable for Zimbabwe. **[25 marks]**

Question 3

Briefly describe the following methods of payment for international trade. In your answer, mainly focus on time of payment, availability of goods to the buyer and risks to both the exporter and importer.

(a) Drafts (bills of exchange) **[9 marks]**

(b) Consignments **[8 marks]**

(c) Open accounts **[8 marks]**

Question 4

(a) Define the foreign exchange market and explain its three roles in international trade. **[13 marks]**

(b) Briefly explain the roles of the following participants in the foreign exchange market:

(i) Speculators **[4 marks]**

(ii) Central banks **[4 marks]**

(iii) Foreign exchange brokers **[4 marks]**

Question 5

What is the purpose of an export credit insurance in international trade? Clearly explain at least five benefits of export credit insurance. **[25 marks]**

END OF QUESTION PAPER!

SUGGESTED SOLUTIONS

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Question 1

Any business transaction has a degree of risk. The four major risks of international trade are:

- Commercial risk: this refers to the probable losses arising from the market or the transacting partners. An important measure is to secure that the trading partners are reliable. It is also important to take into account the partner's possible bankruptcy.
    - Risk arises from: operational problems, weaker partners, poor execution of strategy, etc.
- Financial risk: -this refers to the risk that contains financial loss to firms. This type of risk usually appears as a result of instability and losses in the financial market produced by changes in interest rates, currencies, stock prices, etc.
    - Risk arises from: currency exposure, foreign taxation, inflationary, etc.
- Country risk: -refers to the possibility that fluctuations in the business environment in another country where firms are doing business may impact badly their operations or payment for imports resulting in financial loss. Country risk varies from one country to another.
    - Risk arises from: economic failures, social and political instability, etc.
- Cross-cultural risk: –refers to a situation or occurrence where a cultural miscommunication puts human value at stake. This is tends to influence the mindset and work styles of employees
    - Risk arises from: cultural differences, decision making styles, etc.

Question 2

Countertrade is trade that is carried out wholly or partially in goods rather than hard currency. Examples of types of countertrade that are suitable for Zimbabwe include:

- Barter: -this is the direct exchange of goods and services between two parties. In this form of trade money does not change hands between the trading partners. However, the value of the goods to be exchanged is determined using an agreed currency.
- Clearing arrangement –a form of barter trade in which the counterparties contract to purchase a certain amount of goods and services from one another. This arrangement introduces the concept of credit to barter transactions. This means bilateral trade can take place that does not have to be immediately settled.
- Switch trade: -this is the purchase by a third party of one country's clearing agreement imbalance for hard currency, which is in turn resold. The second buyer uses account balance to purchase goods and services from the original clearing agreement counterparty that had the account imbalance.

The above types of countertrade are suited for Zimbabwe for a number reasons including:

- Shortages of foreign currency
- Lack of credit
- Lack of a well developed private sector

Question 3

(a) Drafts (bills of exchange) **[9 marks]**

- Time drafts (documents against acceptance): when the shipment has been made, the buyer accepts (signs) the presented draft
  - ✓ Time of payment: on maturity of draft
  - ✓ Goods available to buyers: availed before payment
  - ✓ Risk to exporter: relies on buyer to pay
  - ✓ Risk to importer: relies on exporter to ship goods as described in documents

(b) Consignments **[8 marks]**

- The exporter retains the actual title to the goods that are shipped to the importer.
  - ✓ Time of payment: done at time of sale by buyer to third party
  - ✓ Goods available to buyers: availed before payment
  - ✓ Risk to exporter: allows importer to sell inventory before paying exporter
  - ✓ Risk to importer: None

(c) Open accounts **[8 marks]**

- The exporter ships the merchandise and expects the buyer to remit payment according to the agreed upon terms.
  - ✓ Time of payment: as agreed upon
  - ✓ Goods available to buyers: availed before payment
  - ✓ Risk to exporter: relies completely on buyer to pay account as agreed upon
  - ✓ Risk to importer: None

Question 4

(a) A foreign exchange market is the mechanism by which a person or firm transfers money from one country to another. In international trade, the foreign exchange market has the following roles:

- Transfer of money: -this is important because international transactions involve parties in countries with different national currencies. While each country may want to deal in its own currency, international transactions are invoiced in hard currency.
- Provision of credit: -since the movement of goods between countries takes time, inventory in transit has to be financed.

- Minimizing foreign exchange risk: -this market provides 'hedging' facilities for transferring foreign exchange risk.

(b) The roles of different participants in the foreign exchange market:

(i) Speculators: -are involved in the buying and selling foreign currency with the ultimate purpose of making profit. They operate in their own interest and pocket all the profit from exchange rate changes.

(ii) Central banks: -use the foreign exchange market to acquire or spend the country's foreign exchange reserves as well as to influence the price at which their own currencies are traded.

(iii) Foreign exchange brokers: -facilitate trading between dealers without themselves becoming principals in the transaction. For their services, they charge commission and maintain access to hundreds of dealers throughout the worldwide.

Question 5

An export credit insurance is issued by a financial institution or a government agency that is set up to promote exports. This allows exporters to secure pre-shipment financing or post-shipment financing from a banking institution without difficulties. Export credit insurance involves insuring exporters against risks. Such risks can either be commercial or political. Commercial risk arises from factors like the non-acceptance of goods by the buyer, failure of the buyer to pay debt and the failure of foreign banks to hour documentary credits. Political risk arises from factors like war, blockage of foreign exchange transfers, currency devaluation, etc. Benefits of export credit insurance include:

- Ability of exporters to offer buyers competitive payments
- Protection against risks and financial costs of non payment
- Access to working capital
- Protection against losses from foreign exchange fluctuations
- Reduction of need for tangible security when borrowing from banks