

Global trade risk: Understand it, then manage it



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To turn export opportunities into sales – and to get paid in full for those sales – is the ultimate measure of success for the exporter.

But, when conducting business transactions in foreign markets, there are many risks that can derail even the best laid plans. Being aware of those risks is the first step in learning how to manage them.

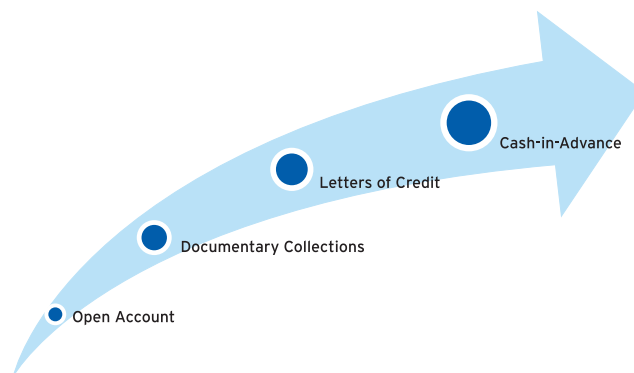
Types of risk, ways to manage

Risk #1: Commercial (payment) risk

The most obvious risk to exporters is the risk of non-payment or delayed payment by foreign buyers. But to compete head-to-head in today's global marketplace, exporters need to offer attractive sales terms that accommodate the needs of foreign buyers but also minimize payment risk. Consider which one of the following four widely recognized payment methods might work best for you and your customers.

- **Payment strategies – Hierarchy of risk**

- **Cash-in-Advance** is the most secure payment method for exporters because payment is received before the goods are delivered. But since this is the least attractive option for buyers, exporters who use this method of payment may lose sales to competitors who offer more favorable payment terms.



Risk #1:
Commercial (payment) risk

Risk #2:
Country risk

Risk #3:
Foreign exchange
(currency) risk

- **Letters of Credit (LCs)** offer a neutral-ground option to buyers and sellers. For exporters, LCs are useful when credit information about the buyer is difficult to obtain. With the LC, the buyer obtains a commitment from a bank that payment will be made to the exporter, if all the terms and conditions of the LC are met. Although the buyer is protected (no payment is made until the goods have been delivered), he or she must pay the bank for the service.

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- **Documentary Collections (D/Cs)** use banks as intermediaries on both sides of the transaction, remitting and collecting payments based on documents that are exchanged. Drafts are used to facilitate the sale either immediately or at a specified future date. D/Cs offer no verification process and limited protection to the exporter.
- **Open Account** is the simplest and least costly method, but offers the least protection to the exporter. Goods are shipped and delivered before payment is due. Foreign buyers are accustomed to open account transactions, so exporters who want to be competitive in the global marketplace may consider this option if they manage the risk of non-payment by using export credit insurance. More on that in a moment.

Risk #2: Country risk

- **Country risk can take many forms, such as:**

- Unforeseen political or economic events that can interrupt normal business activity and/or affect a customer's ability to pay on time.
- Convertibility risk, or the risk that the local currency will not be convertible to the currency needed to make payment to the exporter.
- Transfer risk, or the risk that the buyer is unable, due to legal or other barriers, to transfer funds in the foreign currency to the place of payment when it is due.

- **Credit insurance helps manage risk**

Most of the commercial and country risks described above can be managed with export credit insurance. One such provider of these policies is the Export-Import Bank of the United States, an independent government agency dedicated to helping small businesses succeed in the global marketplace.

In addition to financing export activities, the Export-Import Bank's export credit insurance policies help small U.S. exporters manage the risk of non-payment by:

- Providing access to export credit risk insurance on their foreign accounts receivable.
- Extending competitive credit terms to foreign buyers.
- Insuring against specific, short-term loss due to political risks on a selective basis.

Risk #3: Foreign exchange (currency) risk

The final global trade risk discussed here is foreign exchange risk, or the risk of financial loss due to the devaluation of a foreign currency against the U.S. dollar. Foreign exchange risk is the reason why many U.S. exporters prefer to sell in U.S. dollars. But today, more and more creditworthy foreign buyers are demanding to pay for imported goods in their local currency.

- **Strategies to manage currency risk¹**

Small U.S. exporters who choose to transact in foreign currencies can use one or more of the common foreign exchange strategies for reducing short-term currency risk.

- **Hedging with Forward Contracts** – This strategy allows the exporter to “lock in” an exchange rate on a future transaction that is made in a foreign currency. In this way, forward contracts allow U.S. exporters to eliminate currency risk on a transaction-by-transaction basis.
- **Hedging with Options** – This strategy is often used when there is some doubt in the exporter's mind that the sale will be completed and monies collected by a specific time. Under a foreign exchange option, the exporter acquires the right, but not the obligation to deliver an agreed amount of foreign currency to the buyer/lender in exchange for U.S. dollars at a specified rate on or before the expiration date of the option. Because an option contract provides a cushion against loss, there is a fee involved.
- **Non-Hedging Risk Management** – The simplest strategy of all is to simply conduct transactions in the foreign currency. The sale can be done in cash on the spot with no currency-exchange complications.

The following resources offer much more about managing the risks and rewards involved in selling into foreign markets:

- U.S. Department of Commerce, International Trade Administration, <http://trade.gov/>
- *Trade Finance Guide: A Quick Reference for Exporters*, U.S. Department of Commerce, International Trade Administration, April 2008 edition.
- The Export-Import Bank, <http://www.exim.gov/products/insurance/index.cfm>
- Export.gov, http://export.gov/finance/eg_main_018098.asp

¹ Changes in foreign currency exchange rates will affect the value of currency transactions. Foreign transactions may entail greater risks than domestic transactions due to currency exchange rates; political, diplomatic, or economic conditions; and regulatory requirements in other countries. Financial reporting standards in foreign countries typically are not as strict as in the United States, and there may be less public information available about foreign companies. These risks can increase the potential for losses.