THE M & E HANDBOOK SERIES

Finance of Foreign Trade

D. P. Whiting

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M Tech, BSc (Econ), AIB, MInst AM

SIXTH EDITION

Pitman Publishing Limited
128 Long Acre, London WC2E 9AN

A Longman Group Company

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First published 1966
Reprinted 1967
Second edition 1969
Reprinted 1970
Reprinted 1971
Third edition 1973
Reprinted 1974
Reprinted 1975
Fourth edition 1977
Reprinted 1979
Fifth edition 1981
Sixth edition 1986

British Library Cataloguing in Publication Data
Whiting, D. P.
Finance of foreign trade.--6th ed.-(The
M & E handbook series, ISSN 0265-8828)
1. Commerce 2. Finance
I. Title
382 HF1008

ISBN 0-7121-0661-8

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Typeset, printed and bound in Great Britain

Preface

Britain must import goods in order to live, and to enable her to import she must also be able to sell her goods abroad. Foreign trade is therefore vital and it is important that as many people as possible, in industry and commerce, should understand the methods by which foreign trade is financed. This book is designed both to give the general reader a thorough grasp of these methods and to meet the requirements of students preparing for the Institute of Bankers' examination in Finance of International Trade. It meets the requirements of students studying the subject as part of a BTEC National or Higher National course, and is also intended for students studying Finance of International Trade for the Final Examination of the Institute of Freight Forwarders and for those students preparing for the International Trade and Payments examination of the Institute of Export.

This sixth edition has been produced at a time when the pound is floating and its value which rose on the strength of the UK's oil revenues has fallen back again. It has therefore been difficult to use exchange rate values that can be expected to be truly realistic during the foreseeable future. However, such changes as do occur should not destroy the usefulness of the arithmetic exchange rate examples given.

This new edition contains the English text of the 1983 revision of the Uniform Customs and Practice for Documentary Credits, which came into operation in October 1984.

Method of study. The student is advised to work through each part of the book in strict sequence. Read quickly through the text to get the broad picture of the contents and then, on reading a second time, do so in more detail, making sure that you understand each paragraph before passing on to the next. The student should then read the text a third time and memorise the essential facts.

Progress Tests. These tests are based on past examination questions and are meant for self-examination and revision. They are placed at the end of each chapter and should not be attempted until the chapter has been thoroughly learnt. Try to answer each question in full and then check your answer with the text (by means of the chapter and

paragraph references printed after each question). Make frequent use of these tests as they are the best way of memorising the subject.

Test Papers and Examination Technique. At the end of the book are Appendixes of test papers and hints on examination technique. Do not attempt any of these test papers until you have mastered the hints on examination technique and have achieved complete confidence in answering the Progress Tests at the end of the relevant chapters.

When you attempt a test paper, do it under strict examination conditions and mark yourself by checking with the section references to the appropriate part of the text.

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PART ONE

FOREIGN TRADE

CHAPTER I

Background to Foreign Trade

IMPORTANCE OF FOREIGN TRADE

1. Britain's foreign trade position. Britain is an island of more than 50 million people, which has to import going on for half its food requirements and the major part of its raw materials. To import food she must export and to a considerable extent she sells manufactured goods overseas, which involves importing raw materials. This was the general picture until twenty to thirty years ago, i.e. importing food and raw materials and exporting manufactured goods, but since then our imports of manufactured goods have risen rapidly to the point where they are as much in terms of value as our exports of manufactured goods. In 1983 our imports of manufactured and semi-manufactured goods exceeded exports of such goods by £2,000 million.

A large part of world trade is still financed in sterling. It is thus desirable that the external value of the pound (the pound in terms of foreign currencies) should be maintained. This means that Britain must ensure that the costs and prices of her goods are kept in line with those of other countries so that she can sell her goods. Furthermore, the domestic demand for goods must be kept within bounds, so that goods for export are not deflected to the home market and imports do not become excessive.

2. The law of comparative costs. By specialising in the output of those goods in the production of which they have the comparative advantage (because, for instance, they are nearer the source of raw materials), countries can increase the total output of goods. However, such specialisation necessitates the exchange of goods between countries.

The following highly simplified example illustrates this economic law. By each using two units of economic resources, one in the production of each commodity, countries A and B produce the following quantities of potatoes and wheat.

	Potatoes	Wheat
Country A	10 units	3 units
Country B	4 units	11 units
	14 units	14 units

Country A obviously has the comparative advantage in the production of potatoes and country B has the advantage in the production of wheat. If they specialise (ignoring possible economies or diseconomies of increasing the scale of production) the outputs would be as follows.

Country A 20 units of potatoes
Country B 22 units of wheat

In reality, country A might well have the relative advantage in the production of both commodities, but would nevertheless find it worth while specialising in the commodity in which it had the greater advantage. The outputs of both commodities are increased and if they trade with one another both countries can consume more of both commodities, that is to say, their real national incomes will be increased.

3. Self-sufficiency. It is possible for a country to be self-sufficient using, for instance, artificial rubber instead of natural rubber if the latter cannot be produced at home. To be self-sufficient does deny a country, and other countries besides, the advantages of comparative costs being exploited to the full. Political barriers also make trading between some nations difficult, so that the full advantages of mutual trading are never achieved.

4. Capital investment. In trading with the rest of the world a country may export more than it imports. This enables the country concerned to send capital overseas for investment, and if capital is invested in the underdeveloped countries it is filling a vital need. Underdeveloped countries must obtain capital from overseas, as their living standards are too low for them to provide it themselves. Capital from overseas enables the less advanced nations to carry out capital expenditure projects, such as building power stations and carrying out irrigation schemes, which will increase their output of goods and services in the future and improve their living standards. As more prosperous communities, their demands for imported goods would then of course rise, and through the development of overseas trade their living standards, and those of other countries, would continuously improve.

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THE GEOGRAPHICAL PATTERN OF TRADE

5. Trade with Europe. Since the mid-1960s there has been a dramatic change in the geographical distribution of both our imports and our exports. Even before we joined the European Economic Community our trade with Western Europe was increasing more rapidly than that with the rest of the world, but this growth was of course stimulated by our entry into the EEC.

The data in Table I show how between 1967 and 1984 the percentage of our total imports which came from the EEC rose from 27 per cent to 45 per cent and comparable figures in respect of our exports show a similar increase. These increases were mostly at the expense of our trade with North America and the other developed countries, the importance of which, in terms of the *share* of our trade, diminished.

TABLE I. THE GEOGRAPHICAL DISTRIBUTION OF TRADE

	1967(%)	*1984*(%)
UK imports from:		
EEC	27	45
Rest of Western Europe	13	12
North America	20	16
Other developed countries	10	5
Oil-exporting countries	9	8
Rest of the world	21	14
UK exports to:		
EEC	27	45
Rest of Western Europe	16	17
North America	16	14
Other developed countries	13	7
Oil-exporting countries	5	4
Rest of the world	22	13

BALANCE OF TRADE AND BALANCE OF PAYMENTS

6. The balance of trade. The difference between a country's imports of merchandise and its exports is called its balance of trade. Throughout the twentieth century up to 1980 Britain had an unfavourable balance of trade with the exception of the years 1956 and 1958. In 1980 the balance of trade swung very firmly in favour of Britain mostly as a result of our exports of North Sea oil but moved against us again in 1983 and 1984.

7. The balance of payments. An adverse balance of trade need not

worry the country concerned if it is offset by a favourable balance in respect of its invisible trade. Whereas the balance of trade is concerned with trade in *goods* (visible trade), invisible trade is concerned with *services*, including banking, insurance and shipping services, and earnings from overseas investment (the provision of capital is a service for which Britain receives payment in the form of profits and dividends). The difference between a country's exports and imports of invisibles represents its net invisible earnings (assuming that exports exceed imports) and if these are added to the balance of trade the balance of payments on current account is arrived at.

In addition to the current balance of payments, account must be taken of the currency flow to arrive at the total of official financing necessary to balance the balance of payments overall. Before considering the overall position, Table II should be studied. This shows that in 1983 there was an adverse balance of trade amounting to £1,165 million which was fully offset by net invisible earnings, thus producing a favourable balance of payments on current account of £3,246 million. In 1984 the visible deficit was again offset by the invisible surplus, but the balance of payments surplus was very much reduced.

TABLE II. UK BALANCE OF TRADE AND PAYMENTS 1982–4

(Source: C.S.O. *Financial Statistics*)

	£million		
	1982	*1983*	*1984*
Visible balance	2,055	−1,165	−4,255
Interest, profits and dividends (net)	1,162	2,540	3,050
Services (net)	3,762	4,087	4,243
Transfers (net)	−2,056	−2,216	−2,414
Total invisibles (net)	2,868	4,411	4,879
Current balance	4,923	3,246	624

8. Capital account. A favourable balance of payments enables a country to export more capital overseas than is imported. There is usually a two-way traffic in capital; that is, a country will receive capital from overseas where, for instance, foreign companies are opening up

subsidiary companies in that country, and the country will also send capital overseas. Every year, Britain invests a great deal of capital overseas, in addition to gifts (which are included in "invisibles"). Britain also imports capital when, for instance, an American corporation opens up a subsidiary company in Britain or buys up a British company. Account must also be taken of the currency transactions of the banks and the amount of import and export credit. This then leads to an overall position (*see* Table III) which has to be financed from official sources.

9. Financing the overall position. The government offsets the overall position by its transactions with the IMF and other monetary authorities, by foreign currency borrowing or by building up or depleting its reserves. Reference to Table III shows that in 1982 the favourable balance of payments on current account was more than offset by the outflow of capital from the UK. The authorities repaid some of the money previously borrowed from the IMF, but borrowed from other sources and reduced our foreign currency reserves by £1,421 million. In 1983 and 1984 further outflows occurred which exceeded the current balance of payments and to finance the overall deficits it was necessary to borrow in foreign currency and to deplete the reserves still further.

RECTIFYING A DEFICIT

10. Restricting imports. World trade is expanding year by year and a country might, therefore, quite reasonably expect a steady growth in both its imports and its exports. If imports increase more rapidly than exports, a balance of payments deficit on current account will be incurred and at first sight the most obvious thing to do to put matters right would appear to be to restrict imports. It must be remembered, however, that to restrict shipments from other countries will reduce their ability to buy our goods, which may well make the position worse in the long run.

If an analysis of imports shows that the growth was in shipments of raw materials, necessitated by expanding production of manufactured goods, then it may be wise to refrain from imposing controls of any kind, financing the deficit in the balance of payments by borrowing from overseas, in the hope that at least some of the increased production will be exported.

Even if the rapid growth in imports is attributable to greater imports of finished goods, the best action may not be to restrict them directly, especially as import controls bring retaliation. A better alternative might be to dampen down the excessive home demand for consumer goods (*see* **12** below).

TABLE III. UK BALANCE OF PAYMENTS 1982-4

	£million		
	1982	*1983*	*1984*
Current balance	4,923	3,246	624
Investment and other capital transactions:			
Official long-term capital	−337	−389	−407
Overseas investment in the United Kingdom	3,487	5,188	4,024
UK private investment overseas	−10,725	−11,580	−14,918
Overseas borrowing or lending (net) by UK banks and others	956	−502	2,423
Exchange reserves in sterling:			
British government stocks	−212	227	188
Banking and money market liabilities	438	786	1,089
Other external banking and money market liabilities in sterling	4,134	3,167	5,163
Trade credit	−1,385	−1,532	−451
Other transactions	252	−476	−398
Total investment and capital transactions	−3,392	−5,111	−3,287
Balancing item	−2,815	1,049	1,342
Allocation of Special Drawing Rights	—	—	—
Total affecting official financing *(including current balance)*	−1,284	−816	−1,321
Official financing:			
Net transactions with overseas monetary authorities	−163	−36	—
Foreign currency borrowing (net)	26	249	408
Official reserves (drawings on +, additions to −)	1,421	603	913
Total official financing	1,284	816	1,321

11. Obligations under GATT. Britain is a signatory of the General Agreement on Tariffs and Trade (GATT), designed to reduce trade barriers and bring about the maximum possible rate of growth in world trade. Under GATT, member countries have, by concerted action, reduced the level of tariffs between one another. On several occasions they have set about reducing tariffs by mutual agreement and have set themselves a target, i.e. 20 per cent, for the average level of reductions to be achieved. Once a country has reduced its tariffs in this way it cannot raise them without the agreement of the other GATT members. The 15 per cent surcharge on imports of manufactured and semi-manufactured goods, imposed by the government in 1964, was therefore contrary to both the letter and the spirit of the Agreement. It was, however, fairly generally accepted as necessary to overcome a balance of payments crisis, but only on condition that the surcharge was quickly removed, which was the case.

The GATT applies not only to tariffs, but also to quota restrictions and other import controls as well.

12. Monetary measures. If there is clear evidence of inflation, i.e. excessive purchasing power compared with the amount of goods and services available, and the excessive demand is causing imports to rise, there is a good case for using monetary measures to dampen down the demand. The use of such measures in this way has become generally known as a "credit squeeze". The monetary measures have included the following.

(*a*) *Interest rates*. By bringing about a rise in interest rates generally, money is made dearer to borrow and borrowing is discouraged. If interest rates are reduced, then borrowing is encouraged. Purchasing power is thus reduced or increased. For more than 270 years Bank Rate, the minimum rate of interest at which the Bank of England would discount first-class bills for the discount houses, was the predominant rate of interest and other rates changed up and down in association with it. In 1972 Bank Rate was replaced by Minimum Lending Rate, but this also has been placed in abeyance and instead the Bank of England has a number of interest rate bands, which are not published, but within which it will discount bills for the discount houses. It still has a powerful influence on interest rates in general through its activities in discounting bills and can quite effectively bring about an increase or a decrease in the rates.

Internationally, a change in interest rates in a financial centre such as London will either attract short-term capital from overseas or cause it to flow out of the country. An inflow of foreign currency into Britain brought about by higher interest rates helps to finance a balance of

payments deficit, if there is one, and strengthens the value of sterling in terms of other currencies. This is partly because of the increased demand for sterling for investment purposes and partly because of the restoration of confidence in sterling resulting from the fact that Britain appears to be putting her house in order by dampening down domestic demand.

(*b*) *Open market operations*. By selling Treasury bills in the market, the Bank of England can "mop up" some of the excess of funds in the money market. Those institutions that buy the bills pay for them with cheques which reduce the banks' cash and force them to be restrictive in their attitude towards making advances and forcing up interest rates. The Bank of England can achieve the opposite effect by buying bills and thus increasing the supply of funds in the market and encouraging a downward movement in short-term interest rates.

(*c*) *Special deposits*. These are a set proportion of eligible liabilities which the banks are called upon to pay over to the Bank of England in cash. To do this may necessitate selling investments or restricting advances in order to maintain their reserve assets. However this measure has not been used since 1980, though the Bank has the power to reintroduce it at any time should it consider it necessary to do so.

(*d*) *Directives to the banks*. The Chancellor of the Exchequer can issue directives to the banks through the medium of the Bank of England, requesting them to adopt a restrictive policy concerning their advances generally, but to give priority to exporters. Since 1972 less use has been made of this method of control.

Up to 1980 the Chancellor of the Exchequer issued directives to the banks through the medium of the Bank of England, requiring them to restrict the level of their advances or to give priority to particular types of borrowers such as exporters. In the 1970s the directives were concerned also with the rate of growth of interest-bearing deposits. When the banks increased their deposits, and hence the money supply, by paying attractive rates of interest, they were penalised by the imposition of supplementary special deposits, on which no interest was paid if their deposits increased beyond a set limit.

(*e*) *Reserve ratios*. It is possible for a government or, if it has the powers, a central bank, to prescribe a minimum ratio to its liabilities which a bank must hold in certain liquid assets. By increasing the size of this requirement, the government could restrict the ability of the banks to increase their advances. A Reserve Ratio was imposed upon the British banks up to 1980, but since then there has been no such requirement. The banks and licensed deposit-takers are obliged to maintain a non-operational account balance at the Bank of England equal to one-half per cent of their eligible liabilities but this is not intended as a reserve requirement. The eligible banks must also lend a

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