UNIT 5 _POLITICAL AND LEGAL ENVIRONMENT

Objectives

After going through this unit you should be able to:

- explain the rationale for undertaking a political analysis of international marketing
- explain political risk and its dimensions
- describe method for assessing, measuring and managing political risk
- discuss the importance of legal environment in international marketing
- trace development and scope of international law
- explain the Incoterms
- explain the role of WTO.

Structure

5.1 INTRODUCTION

The buoyancy or depression of the stock market in the immediate pre-election and post-election period clearly demonstrates the impact of political changes on business conditions. A government by its perspective on business enterprise influences the business environment. For any firm involved in marketing, the role government assumes will influence its activities. The government may choose to allow and in fact provide free and fair competition, choosing to let the economic direction of the country be directed by business entities as in the case of U.S.A., or it may choose to provide the economic direction itself

Although a firm regards itself as an economic entity, it is drawn and affected by political developments. It therefore becomes necessary for the firm, particularly an international firm to monitor not only the domestic but also the international political environment. Since the international business firm operates in a host country and as a guest of that country, it becomes particularly important for it to monitor the developments taking place in the domestic political environment of the host country.

The three main concerns facing any international business entity are political stability, the government's orientation and nationalism.

While political stability is necessary for a business entity, it is particularly important for an international business firm because they reflect the success or failure of any business concern, for political stability is often associated with stability of economic policies. Changes in regime, violence and cultural divisions based on language or other factors can lead to a very uncertain environment in which to conduct business. The other concerns facing international business are orientation of the government and nationalism. The orientation of the government can very often reveal whether International business can survive in that country or not. A country's ideological leaning may be capitalism, socialism, a mixture or other form. In the last years remarkable changes have been taking place in the ideologies of many countries. The most dramatic example has been the collapse of the communist USSR and Eastern Europe and its replacement with market led policies and ideologies. Another dramatic change has been seen in the opening up of Chinese economy along with India. Similarly, many African countries are abandoning their centrist leanings in favour of market led economies, for example, Zimbabwe and Tanzania. Nationalism also influences this variable because the business entity has to exist and operate within that country. Nationalist lineage can be lead to expropriation of foreign held assets. These concerns through their impact give rise to political risks.

After the crash of the Mexican market in mid 90's the editors of Business Week offered the following :

"It certainly makes sense to invest in the 3 billion new customers entering the global economy. Growth rates will be higher that in the more mature economies of the West for decades to come. Some of the best prospects for healthy earnings are in emerging markets. But the risk/reward ratios remains higher in Latin America arid Asia, and money managers should recognise this cold, hard, fact. Money managers taking a second shot at higher returns in a emerging markets would be wise to hire a few political risk analysts. a couple of area specialists, and even one or two people who know something about military affairs Political stability is as important as economic opportunity when investing in societies striving to make the difficult transition to capitalism and democracy".

5.2 POLITICAL RISK: A DEFINITION

An international business entity is a guest of the host country and, therefore, the host country reserves the right of not only allowing it access but also of expropriating it. It also can influence the scale and dimensions of the operations through its policies. Political risk is thus the vulnerability of returns of a project to the political acts of a sovereign government. This definition gives rise to several issues but the most important issue is that political risk is associated with blockage of funds and expropriation (or domestication of investment) by the foreign government, for a firm operating across its national borders. The exporting firm also faces political risks because political developments also affect the areas of import restriction, tax controls, price controls, exchange regulations, counter trade etc. which can create a major impact on the value of the exporting firm and its survival.

Blockage of Funds

An issue associated very closely with the subject of political risk is a temporary or permanent blocking of funds. Blockage of funds refers to the fact that although a business entity may own the funds and still hold property rights, it cannot export its earnings. This was a common problem faced by Indians during Idi Amin's rule in Uganda. Although the government did not formally make any announcements regarding take over of property, it had become almost impossible for the firms to repatriate their earnings in any form.

Domestication

Domestication refers to transfer of control of foreign investment to national ownership to . bring the firm's activities in line with national interests. It differs from expropriation in the sense that It is a gradual encroachment of freedom of operation of a foreign operator. There are three types of domestications. They are; firm initiated domestication, government initiated domestication, and predetermined domestication. Whereas firm initiated and predetermined domestication involves low level of risk, government initiated domestication is ranked at par with expropriation. The difference in risk profile is a product of discount factor used in the capital budgeting decision. While in case of predetermined and self-initiated domestication, the firm has the freedom to use discount rates having known the project life, in the case of government initiated domestication both variable are unknown or unplanned for. Besides, in a government initiated domestication programme, the economics of the operation may go haywire as companies are instructed to sell off a certain percentage of their stake by a given date.

Expropriation

The most extreme case of political vulnerability is expropriation. Expropriation refers to the government confiscation of property with or without proper reimbursement. Even where reimbursement is forthcoming, it doesn't equate with the value of the firm, which is the summation of future earnings by a firm. Reimbursement is often fixed keeping in mind the book value of assets. Modem economic history is replete with cases of expropriation. It may occur for a number of reasons, including the desire to retain national assets, as a "hostage" situation in international disputes, for example the seizure of Union Carbide's assets after the Bhopal disaster in India.

While these risks are faced by firms operating within the boundaries of the host countries, companies operating from outside the political boundaries are also influenced by political risks.

These risks often manifest themselves in form of exchange control, import restrictions, tax controls, price control, counter trade and other similar measures. These risks are often interlinked with economic problems and perception of the government regarding these economic problems. Normally, when a government perceives a trade gap emerging, it may announce a measure or a combination of these measures. It may also be a result of the economic direction that a government wishes to impart to its country. Thus, when India decided to focus on self- reliance, several import restrictions were imposed. However, today the situation is quite different. Firms exporting to foreign markets may also be influenced by price controls. The Government of India declares minimum price ceiling for apparel exporters in order to avoid unfair competition amongst them and to maximise foreign exchange earnings. It is thus, not necessary for a firm to be producing in international markets to be influenced by political risks although the extreme form of political risks is witnessed only by such firms and MNC's.

Activity-1

What is political risk? How do bilateral and multilateral relations influence the risk profile?

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5.3 ASSESSING AND MANAGING POLITICAL RISK

Once the existence and the impact of political risk has been noted, it becomes necessary for any international marketer to assess and manage political risks.

Assessment and management of political risks involve three basic steps:

- Recognising the existence of political risk and its accompanying consequences.
- Developing plans and policies in advance to cope with such risk.
- Maximising compensation in the event of expropriation

Several indices have been developed to measure country specific risk. They involve taking socio-economic variables, societal conflict variables and governmental process index into account. But for an international marketer wishing to undertake a broad analysis, before involving himself into specifics (the more it is specific the more the time and money it takes) answering the following questions could be useful.

What is the current form and system of government? Are the economic policies stable? Is capital flight taking place? These three steps entail the political risk identification process.

ASSESSING POLITICAL RISKS

It has been observed, that international managers when entering new markets recognise the existence of political risk but refuse to give it the required significance. This is more so because although the existence of political risk has been widely accepted, the definition of political risk does not explain whether such risk is country specific or firm specific. Here the discussion entails assessment of both country specific risk and firm specific risk.

1) Country Specific Risks

Country specific risk refers to risk arising out of doing business with a specific country.

- What is the current political system in existence?
- What is the stability and permanency of government policy?
- What are the encouragements the business firms will receive as a result of political activity?

Answering these questions involves going into the political history of that country to understand whether it follows a monarchy, dictatorship or parliamentary form of government. Even where parliamentary form exists, whether their exists a single party, a two patty, a multi-party or a dominating party system, and what are the ideologies each of these parties have with respect to business enterprise. Such an analysis can help in the country assessment process. Although such analysis are carried out by various institutions like S & P, Moodys etc. and are available for public consumption, most MNCs prefer to undertake their own analysis.

Many countries try to reduce perceived risk by promoting inward investment through the provision of tax breaks, free ports, enterprise zones etc., which are not tied as in partnering. The key is to look at what the disadvantages are. If the government mainly wishes to attract the mobile investor, or overcome say poor local skills, one has to assess what would happen if the scheme was withdrawn once the capital had been committed. Similarly if viability depends on incentives rather than real return on investment, the question is, is the venture really worth it?

2) Firm Specific Risk

Although business units undertake country risk assessment they have realised that political risk does not manifest itself equally among various firms. This is the major assumption underlying country risk assessment. It has been observed that sometimes firms in the same country receive differential treatment as in the case of Cerro Corporation and Macrona Mining Corporation and the Peruvian government attitude towards them. While Cerro Corporation was expropriated, Macrona Mining Corporation was encouraged.

This example brings out the fact that political risk is not equally distributed within a country and even within a country within a specific industry.

It is commonly believed that firm specific political risk arises because of the following:

a) Size and visibility

b) Product handled

c) Attitude of the company

These are explained briefly below:

a) Size and Visibility

It has been observed that MNCs like to indulge themselves in business on a large scale to derive the benefit of economies of scale. They also undertake massive advertisement programmes for creating brand preferences. This, it has been observed, causes resentment among local businessmen who feel that the MNC is taking more than its fair share of business. They create pressure on the government to take steps to restrict MNC's operations often in the name of protecting domestic industries.

b) Product Handled

The product handled by an MNC or an international business house also influences the attitude a government will adopt towards it. If the ruling government perceives that the product handled by the foreign company is crucial for the economic development of the country or it is socially/strategically important then the attitude might be favourable whereas if the company is perceived as undertaking marketing or production of non-essential items then the likelihood of the attitude being unfavourable is quite high.

Phillip Cateora and John M. Hess have developed the following questionnaire for deciding upon the attitude meted out to the business.

1. Is the availability of supply of the product ever subject to important political debates? (sugar, salt, gasoline, public utilities, medicines, foodstuffs)
2. Do other industries depend upon the production of the product? (cement, power, machine tools, construction machinery, steel)
3. Is the product considered socially or economically essential? (key drugs, laboratory equipment, medicines)
4. Is the product essential to agricultural industries? (farm tools and machinery, crops, fertilizers, seeds)
5. Does the product affect national defence capabilities? (transportation industry, communications)
6. Does the product include important components that would be available from local sources and that otherwise would not be used as effectively? (labour, skills, materials)
7. Is there local competition or potential local competition from manufacturers in the near future? (small, low investment manufacturing)
8. Does the product relate to channels of mass communication media? (newsprint, radio equipment)
9. Is the product primarily a service?
10. Does the use of the product, or its design, rest upon some legal requirements?
11. Is the product potentially dangerous to the user? (explosives, drugs)
12. Does the product induce a net drain on scarce foreign exchange?

If answers to each of these questions were *scored* from 1 to 10, from a strong no to a strong yes the highest scoring products would be subject to maximum political risk.

c) The Attitude of the Company

The attitude of the company is also important. A foreign business enterprise must realise that it is a guest of the host country and is there only on their invitation. If a firm realises this fact then the political risk is minimised because it will realise that it must contribute to the national goals of the host country if it wants to continue doing business in that country.

In the example of Cerro v/s. Macrona Mining Corporation both belonging to the mining industry one was encouraged by the Peruvian government while the other firm was discouraged. This was essentially because Macrona realised its position as a guest of the country, making contribution to the furtherance of achievement of national objectives; also making known the fact the role it was playing, whereas Cerro Corporation undertook no such task and therefore was doled out an unfavourable decision.

A systematic checklist to assess political vulnerability

Political vulnerability should be assessed by using a systematic checklist. Such a checklist should include the following:

Variables	High	Medium	Low
The fine's own country's relations with other countries			
Sensitivity of the product or industry			
Size and location of operation			
Visibility of firm			
Host country's political situation			
Company behaviour - is it a good corporate citizen?			
Contribution to host country			
Localisation of operations			
Subsidiary dependence			

The answers can thus be assessed and fed into the investment discussion.

Activity-2

Based on the above checklist, hypothetically decide if it is feasible to invest in Pakistan.

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5.4 MANAGEMENT OF POLITICAL RISK

The insecurity arising out of political risk, especially risk of loss of investment and information, in foreign lands can be minimised through proper management of political risk. Political risk management process can be undertaken either before the investment is made or after the investment is made. The former refers to pre-investment planning whereas the latter refers to post-investment planning.

1) PRE-INVESTMENT PLANNING

Under the pre-investment planning for political risk management, four options are available to the international marketer. They are:

a) Avoidance

b) Insurance

c) Negotiating the Environment

d) Structuring the Investment

a) Avoidance

As the name suggests, this method involves avoiding political risk by not undertaking any foreign investment. However, this is an option, which can be exercised only prior to the decision of going international.

b) Insurance

Today, several business and non-business entities have come up which underwrite the insurance of political risk. Any businessman can have his political risk underwritten for him.

Although varying premiums are charged for different business activities, the international businessman now, has open to him the option of insuring his political risk of expropriation.

However, insurance does not offer a full coverage because insurance companies underwrite the book value *of* assets whereas the value of the firm is dependent upon the stream of future earnings. Any expropriation would mean a lowering in the value of the firm. What insurance does is that it minimises the losses through underwriting the value of assets. Today about 90 to 95% of the insured value is recoverable. In India, Export Credit Guarantee Corporation undertakes the role of insuring political risks.

c) Negotiating the Environment

Negotiating the environment refers to agreements drawn up between the company and the ruling government. It clearly states the rig its and undertakings of each party: It is also referred as concession agreements.

The only drawback with this method is in countries with low degree of political stability where the emergence of new ruling party may mean repudiation of the earlier contract by the new government.

d) Structuring the Investment

This is a strategy being followed today by most companies and involves diversification of investment so that it is a not concentrated in any one country. Thus, Chrysler Corporation distributed its investment in Peru, Brazil, Argentina and Detroit. In Peru itself, only 50% of the auto truck parts ware manufactured. Therefore, expropriation of Chrysler would have the implicit consequence of loss of the trucks being manufactured in Peru. Therefore, it did not make sense for the Peruvian government to expropriate Chrysler.

Similar to diversification of in the investment decision the firm can also undertake financial structuring. This involves raising capital along with the government participation i.e., some portion is contributed by MNC whereas the remaining is raised from *the* domestic sources viz. the foreign government and its citizens.

2) POST-INVESTMENT PLANNING

All the strategies discussed above refer to the pre-investment period. Political risk also arises even after the investment decision has been taken, which means the firm is already committed so far as the country is concerned: Therefore, the company must evolve strategies even after the investment decision has been taken so as to minimise the losses and to maximise the compensation in case of expropriation. These strategies include the following:

a) Planned Divestment

b) Short-term Profit Maximisation

c) Change of Benefit/Cost Ratio

d) Develop Local Stockholders

e) Adaptation

These strategies are explained briefly below:

a) Planned Divestment

This refers to divestment of assets in the foreign country over a fixed period of time so as to minimise the risk involved. Effectively, this strategy involves recovery of the invested capital along with desired return over a fixed period of time after which the productive asset is sold to the local citizens.

b) Short-term Profit Maximisation

If at all the expropriation is to occur, there is always some advance notice. This strategy involves sacrificing long-term goals in favour of short-term objectives. In the light of the developing circumstances, the firm cuts costs and increases profit margins to recover the initial investment.

However, this strategy instead of working for the firm may work against it in the sense that when a company starts undertaking such measures the host government is often forced to the decision of expropriation (even if it was initially against it), because it does not see any forthcoming benefits.

c) Change of Benefit/Cost Ratio

Another available strategy for preventing or postponing expropriation involves changing the benefit/cost ratio.

Before taking over the foreign investments, a government usually undertakes a cost benefit analysis of the advantages and the disadvantages associated with expropriation. If the, analysis can be made lopsided in favour of the firm by increasing the cost v/s the benefit, then, probably the expropriation decision may be withheld.

d) Develop Local Stockholders

What Sears did in Latin America was that it made sure that most of its products were manufactured within the country for sale. For doing this, they promoted business for specific product category. By promising guarantee they even helped some of their business associates get off the ground. These businessmen now strongly identify with the Sear's stores and therefore would prevent the expropriation of Sears Roebuck from their country. This strategy of developing local stakes has worked wonders for minimising the political risk involved and often has even resulted in favourable treatment being meted out to them.

e) Adaptation

Businessmen today have learnt that it is not necessary to own assets, to earn profits. Profits can also be earned through management contracts. Indian experience of management contracts in Middle East countries has demonstrated the existence of this fact.

In Venezuela, the expropriated oil companies have been given management contract for oil exploration, drilling etc. This strategy of beating the political risks is known as adaptation.

Thus the options available to minimise political risk can be shown as below in Exhibit 5.1.

Exhibit 5.1 Coping with Political Risk

DIRECT APPROACHES

Negative Approaches

- Control of raw material
- Control of transportation to international markets
- Control external markets citizens
- Licence or patent restrictions under international law

Positive Approaches

- Concession agreements
- Joint venture with government
- Joint venture with local banks,
- Local sourcing of raw materia

INDIRECT APPROACHES

- Insurance
- Capitalised Firms
- External Financing

Source: Rodrignez and Carter, *International Financial Management.*

Activity-3

a) What is country risk? How is it different from firm specific risk?

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b) Market access and market entry decisions are linked with country risk analysis. Explain.

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5.5 INTERNATIONAL MARKETING AND THE LEGAL ENVIRONMENT

The legal/political aspect is very important in global marketing. Every business operates within the jurisdiction of legal system. The legal system is an inevitable component of the environment within which a business operates. The commercial law existing within any country influences not only each and every variable of marketing mix but also the environment within which a business operates. This has a direct bearing on the management of global marketing plan. "International law" can be defined as rules and principles that states and nations consider binding upon themselves. This raises two interesting characteristics of international law. The first is that "law" belongs to individual nations and international law only exists to the degree that individual nations are willing to relinquish their rights. The second is the lack of an adequate international judicial and administrative framework or a body of law which would form the basis of a truly comprehensive international legal system. The international business is also subject to political decrees made by governments both in "home" and "host" countries. Home governments can apply pressure not to deal with disapproved parties. These measures may include the refusal to grant an export licence, or withdrawal of export guarantee cover. The host government may take measures like taxation, ownership controls, operating restrictions or expropriation.

Thus for example, the advertising laws in Germany are so strict that it is best advised for the international marketer to get himself good legal counsel before framing his advertising strategy in Germany. In fact all over Europe there exist different set of laws preventing promotion of products through price discounting. These laws are based on the premise that such practices differentiate buyers. This example reflects the influence on only one of the variable of marketing mix. Laws may exist for other variables of marketing mix viz. product, price, and place. Thus monitoring the legal environment is also essential. *International Business* came out with an article indicating areas where management should consider the laws before framing their strategy.

They include watching out for rules regarding:

- Retail price maintenance
- Product quality
- Packaging
- After sales commitment
- Price controls
- Property rights which includes immovable property and intellectual property (patents, trade marks, copy rights etc.)
- Regulations
- Cancellation of agreements.

Not only does the legal system influence the marketing management process but also the environment within which the marketer has to operate. Thus while one country may promote competition within its markets through its legal system, another country may try to protect its industry and thereby restrain competition.

In USA anti-trust legislation influences all mergers, takeovers, and business practice, which are in restraint of trade. The verdicts awarded are governed by paragraph one of Sherman

Act. Thus for example, Gillette was prevented from taking over Braun A.G. of Germany, which was an electric razor manufacturer, on the grounds that it would distort competition.

Activity-4

How does the legal system in India influence domestic marketing? What are the laws that an international marketer must keep in mind for marketing in India?

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5.6 THE DEVELOPMENT AND SCOPE OF INTERNATIONAL LAW

All exports operate within an institutional environment, which is made up of a set of political, social and legal ground rules. These ground rules form the laws of all production, exchange and distribution and give rise to certain expectations and assurances about the actions of others, and give order and stability to the means of doing business. The most important rules in any system are those defining, allocating and enforcing property rights, and rules and conventions defining allowable and non-allowable forms of cooperation and competition (standards, rules of contract, fair trading etc).

The domestic marketer is aware of the jurisdiction of the legal system and the bearing it has on his activities. But when he crosses national frontiers to market or produce his product in a host country; the problem of legal system arises on two counts. They are:

a) Every country has its own legal system

b) The legal systems of the world are not harmonised and are in fact based on contradicting political philosophies

The legal system that exists in different countries of the world are antecedents of one of the two legal philosophies. They are common law and code law philosophies.

Common law finds its roots in Britain and is practised today in U.S.A., Britain and Canada. The basis of common law is tradition, past practices and past ruling of higher courts that look upon similar problems within the accepted set of laws. On the other hand, code law is based on Roman law and is an all-inclusive system of written rules that encompass all eventualities. This basis for legal system can be witnessed in many countries of the world.

It must be pointed out here that while these represent the basis of various legal systems, the legal systems in different countries of the world are by no means identical. This difference between code law and common .law has been pointed out to you to make you aware of the fact that the bearing of these two distinct philosophies on judgements awarded in case of commercial disputes can be radically different. To illustrate let us take the interpretation in case of non-fulfilment of required conditions of a contract under `Act of God'. What constitutes an `Act of God' in code law, is not necessarily incorporated under common law. Thus while strike may be looked up under `Act of God', in code law it will definitely not be accepted as a reason for non-fulfilment of the contract under common law. The development of international law took place in late sixteenth century in an effort to deal with international political issues like granting recognition to new countries and for maintaining world peace.

The developments in international commercial law, however, started taking place only in the 19th century with law of sea coming in as late as 1958. These developments took place on a state-by-state basis as international trade grew in volume and value. This fact accounts for different legal systems existing in different countries of the world and based on conflicting legal policies.

International law deals with upholding order. Originally it recognized only nations as entities, but today it also incorporates role played by individuals. International laws may be defined as a set of rules and regulations which the nations consider binding upon themselves. This definition brings out two important characteristics of international law.

They are absence of existence of a comprehensive legal system. There is no truly comprehensive body of law because as stated earlier, international commercial law is of recent birth. This has had a direct impact on the existing administering authorities. As of today there are only a few international bodies for administering justice. They include the International Court of Justice founded in 1946 and the World Court at the Hague. Besides this, is the fact that no nation can be forced into these rules as stated in the line `consider binding upon them' which brings us to the fact that all nations recognise the sovereignty of the legal systems and therefore international judgements are based on the premise of `good of humanity' and not on basis of any particular country's legal system.

Issues in International Legal Environment

Most issues in the legal/political environment centre around the following:-

i) "Institutional environment" - made up of political, social and legal ground rules within which the global marketer must operate.

ii) Property rights - patents, trademarks.

iii) Taxation - what taxation schemes will be faced abroad?

iv) Recourse - possibility and length of action with the possibility of image damaging necessitating arbitration.

v) Movement of equity and expropriation threats - often necessitating protocols or the signing of trade frame working agreements.

Efforts to regulate the international legal system include individual country efforts, like the USA International Trade Commission and the GATT system. The WTO (discussed later in Section 5.8) is a set of norms and procedures which member governments have accepted to create order and predictability in international trade relations.

5.7 INCOTERMS

The cornerstone of international marketing, especially, in the Indian context, is product export. Consequently, the basic legal document than an exporter is concerned with is the international sales contract.

Export transactions necessarily involve movement of goods from one country to another. The basic task of an export contract is to allocate the risks and costs of export shipments between the exporter and importer.

Simultaneously, it also seeks to provide a system through which disputes, if any, can be settled, in case either party fails to honour what the contract has provided in the first instance.

The allocation of risks and costs are done by taking the delivery point as the benchmark. Various types of contracts have, therefore, been developed with different delivery points. International Chamber of Commerce has codified the contract terms commonly used in international trade and has also standardised their interpretation in their publication entitled Incoterms, 2000. This codification has almost universally been accepted and majority of Indian firms use these terms while negotiating export contract.

What are INCOTERMS: International Contract Terms or Incoterms in short is a series of international sales terms that divides transaction costs and responsibilities between buyer . and seller. Incoterms losely corresponds to the U.N. Convention on Contracts for the International Sale of Goods.

Incoterms make international trade easier and help traders in different countries to understand one another. These standard trade definitions that are most commonly used in international contracts are protected by ICC copyright. Incoterms are standard trade definitions most commonly used in international sales contracts. Devised and published by the International Chamber of Commerce, they are at the heart of world trade. Among the best known Incoterms are EXW (Ex works), FOB (Free on Board), CIF (Cost, Insurance and Freight), DDU (Delivered Duty Unpaid), and CPT (Carriage Paid To).

ICC introduced the first version of Incoterms - in 1936. Since then, ICC expert lawyers and trade practitioners have updated them six times to keep pace with the development of international trade. Most contracts made after 1 January 2000 will refer to the latest edition of Incotenns, which came into force on that date. The correct reference is to "Incoterms 2000". Unless the parties decide otherwise, earlier versions of Incoterms - like Incoterms 1990 - are still binding if incorporated in contracts that are unfulfilled and date from before 1 January 2000.

Correct use of Incoterms goes a long way to providing the legal certainty upon which mutual confidence between business partners must be based. To be sure of using them correctly, trade practitioners need to consult the full ICC texts, and to beware of the many unauthorized summaries and approximate versions that abound on the web.

Incotenns have been explained here below:

i) EX-Works

One of the simplest and most basic shipment arrangements places the minimum responsibility on the seller with greater responsibility on the buyer. In an EX-Works transaction, goods are basically made available for pickup at the shipper/seller's factory or warehouse and `delivery' is accomplished when the merchandise is released to the consignee's freight forwarder. The buyer is responsible for making arrangements with their forwarder for insurance, export clearance and handling all other paperwork.

ii) FOB (Free On Board)

One of the most commonly used-and misused-terms, FOB means that the shipper/seller uses his freight forwarder to move the merchandise to the port or designated point of origin. Though frequently used to describe inland movement of cargo, FOB specifically refers to ocean or inland waterway transportation of goods. "Delivery" is accomplished when the shipper/seller releases the goods to the buyer's forwarder. The buyer's responsibility for insurance and transportation begins at the same moment.

iii) FCA (Free Carrier)

In this type of transaction, the seller is responsible for arranging transportation, but he is acting at the risk and the expense of the buyer. Where in FOB the freight forwarder or carrier is the choice of the buyer, in FCA the seller chooses and works with the freight forwarder or the carrier. "Delivery" is accomplished at a predetermined port or destination point and the buyer is responsible for Insurance.

iv) FAS (Free Alongside Ship)

In these transactions, the buyer bears all the transportation costs and the risk of loss of goods. FAS requires the shipper/seller to clear goods for export, which is a reversal from past practices. Companies selling on these terms will ordinarily use their freight forwarder to clear the goods for export. "Delivery" is accomplished when the goods are turned over to the Buyer's Forwarder for insurance and transportation.

v) CFR (Cost and Freight)

This term formerly known as CNF (C&F) defines two distinct and separate responsibilities-one is dealing with the actual cost of merchandise "C" and the other "F" refers to the freight charges to a predetermined destination point. It is the shipper/ seller's responsibility to get goods from their door to the port of destination. "Delivery" is accomplished at this time. It is the buyer's responsibility to cover insurance from the port of origin or port of shipment to buyer's door. Given that the shipper is responsible for transportation, the shipper also chooses the forwarder.

vi) CIF (Cost; Insurance and Freight)

This arrangement similar to CFR, but instead of the buyer insuring the goods for the maritime phase of the voyage, the shipper/seller will insure the merchandise. In this arrangement, the seller usually chooses the forwarder. "Delivery" as above, is accomplished at the port of destination.

vii) CPT (Carriage Paid To)

In CPT transactions the shipper/seller has the same obligations found with CIF, with the addition that the seller has to buy cargo insurance, naming the buyer as the insured while the goods are in transit.

viii) CIP (Carriage and Insurance Paid To)

This term is primarily used for multimodal transport. Because it relies on the carrier's insurance, the shipper/seller is only required to purchase minimum coverage. When this particular agreement is in force, Freight Forwarders often act in effect, as carriers. The buyer's insurance is effective when the goods are turned over to the Forwarder.

ix) DAF (Delivered At Frontier)

Here the seller's responsibility is to hire a forwarder to take goods to a named frontier, which usually is a border crossing point, and clear them for export. "Delivery" occurs at this time. The buyer's responsibility is to arrange with their forwarder for the pick up of the goods after they are cleared for export, carry them across the border, clear them for importation and effect delivery. In most cases, the buyer's forwarder handles the task of accepting the goods at the border across the foreign soil.

x) DES (Delivered Ex Ship)

In this type of transaction, it is the seller's responsibility to get the goods to the port of destination or to engage the forwarder to move the cargo to the port of destination uncleared. "Delivery" occurs at this time. Any destination charges that occur after the ship is docked are the buyer's responsible.

xi) DEQ (Delivered Ex Quay)

In this arrangement, the buyer/consignee is responsible for duties and charges and the seller is responsible for delivering the goods to the quay, wharf or port of destination. In a reversal of previous practice, the buyer must also arrange for customs clearance.

xii) DDU (Delivered Duty Unpaid)

This arrangement is basically the same as with DDP, except for the fact that the buyer is responsible for the duty, fees and taxes.

xiii) DDP (Delivered Duty Paid)

DDP terms tend to be used in intermodal or courier-type shipments. Whereby, the shipper/seller is responsible for dealing with all the task involved in moving goods from the manufacturing plant to the buyer/consignee's door. It is the shipper/seller's responsibility to insure the goods and absorb all costs and risks including the payment of duty and fees.

The various Incoterms can be grouped into four categories, denoted by *the first* letter in the three-letter abbreviation.

- Under the "E"-term (EXW), the seller only makes the goods available to the buyer at the seller's own premises. It is the only one of that category.
- Under the "F"-terms (FCA, FAS; and FOB), the seller is called upon to deliver the goods to a carrier appointed by the buyer.
- Under the "C"- terms (CFR, CIF, CPT, and CIP), the seller has to contract for carriage, but without assuming the risk of loss or damage to the goods or additional costs due to events occurring after, shipment or dispatch.
- Under the "D"- terms (DAF, DES, DEQ, DDU and DDP), the seller has to bear all costs and risks needed to bring the goods to the place of destination.

5.8 WORLD TRADE ORGANISATION (WTO)

The past 50 years have seen an exceptional growth in world trade. Merchandise exports have grown on average by 6% annually. Total trade in 2000 was 22-times the level of 1950. GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.

The multilateral system was developed through a series of trade negotiations, or rounds, held under GATT. The first rounds dealt mainly with tariff reductions but later negotiations included other areas such as anti-dumping and non-tariff measures. The last round – the 1986-94 Uruguay Round - led to the WTO's creation.

The negotiations did not end there. It continued after the end of the Uruguay Round. In February 1997 agreement was reached on telecommunications services, with 69 agreed in the Uruguay Round. In the same year 40 governments successfully concluded negotiations for tariff-free trade in information technology products, and 70 members concluded a financial services deal covering more than 95% of trade in banking, insurance, securities and financial information.

In 2000, new talks started on agriculture and services. These have now been incorporated into a broader agenda launched at the fourth WTO Ministerial Conference in Doha, Qatar, in November 2001. The agenda adds negotiations and other work on non-agricultural tariffs, trade and environment, WTO rules such as anti-dumping and subsidies, investment, competition policy, trade facilitation, transparency in government procurement, intellectual property, and a rang~ of issues raised by developing countries as difficulties they face in implementing the present WTO agreements.

The deadline for the negotiations is 1 January 2005.

While GATT no longer exists as an international organization, the GATT agreement lives on. The old text is now called "GATT 1947". The updated version is called "GATT 1994.

GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

From 1948 to I 994, the General Agreement on Tariffs and Trade (GATT) provided the rules for much of world trade and presided over periods that saw some of the highest growth rates in international commerce. It seemed well-established, but throughout those 47 years, it was a provisional agreement and organization.

The original intention was to create a third institution handling international economic cooperation, to join the "Bretton Woods" institutions now known as the World Bank and the International Monetary Fund. The complete plan As envisaged by over 50 countries, was to create an International Trade Organization (ITO) as a specialized agency of the United Nations. The draft ITO Charter was ambitious. It extended beyond world trade disciplines, to include rules on employment, commodity agreements, restrictive business practices, international investment, and services.

Even before the charter was finally approved, 23 of the 50 participants decided in 1946 to negotiate to reduce and bind customs tariffs. With the Second World War only recently ended, they wanted to give an early boost to trade liberalization, and to begin to correct the large legacy of protectionist measures which remained in place from the early 1930s.

This first round of negotiations resulted in 45,000 tariff concessions affecting $10 billion of trade, about one-fifth of the world's total. The 23 also agreed that they should accept some of the trade rules of the draft ITO Charter. This, they believed, should be done swiftly and "provisionally" in order to protect the value of the tariff concessions they had negotiated. The combined package of trade rules and tariff concessions became known as the General Agreement on Tariffs and Trade. It entered into force in January 1948, while the ITO Charter was still being negotiated. The 23 became founding GATT members (officially, "contracting parties").

Although the ITO Charter was finally agreed at a UN Conference on Trade and Employment in Havana in March 1948, ratification in some national legislatures proved impossible. The most serious opposition was in the US Congress, even though the US government had been one of the driving forces. In 1950, the United States government announced that it would not seek Congressional ratification of the Havana Charter, and the ITO was effectively dead. Even though it was provisional, the GATT remained the only multilateral instrument governing international trade from 1948 until the WTO was established in 1995.

Exhibit 5.2 GATT Trade Rounds

Year	Name of the Round	Subjects covered	Countries
1947	Geneva Round	Tariffs	23
1949	Annecy Round	Tariffs	13
1950-51	Torquay Round	Tariffs	38
1955-56	Geneva Round	Tariffs	26
1960-61	Dillon Round	Tariffs	26
1964-67	Kennedy Round	Tariffs and anti-dumping measures	62
1973-79	Tokyo Round	Tariffs, non-tariff measures, framework agreements	102
1986-94	Uruguay Round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO etc.	125

For almost half a century, the GATT's basic legal text remained much as it was in 1948. There were additions in the form of "plurilateral" agreements (i.e. with voluntary membership), and efforts to reduce tariffs further continued. Much of this was achieved through a series of multilateral negotiations known as "trade rounds" - the biggest leaps forward in international trade liberalization have come through these rounds which were held under GATT's auspices.

In the early years, the GATT trade rounds concentrated on further reducing tariffs. Then, the Kennedy Round in the mid-sixties brought about a GATT Anti-Dumping Agreement. The Tokyo Round during the seventies was the first major attempt to tackle trade barriers that do not take the form of tariffs, and to improve the system. The eighth, the Uruguay Round of 1986-94, was the latest and most extensive of all. It led to the WTO and a new set of agreements.

The Uruguay hound

It took seven and a half years, almost twice the original schedule. By the end, 125 countries were taking part. It covered almost all trade, from toothbrushes to pleasure boats, from banking to telecommunications, from the genes of wild rice to AIDS treatments.

It was quite simply the largest trade negotiation ever, and most probably the largest negotiation of any kind in history.

At times it seemed doomed to fail. But in the end, the Uruguay Round brought about the biggest reform of the world's trading system since GATT was created at the end of the Second World War. And yet, despite its troubled progress, the Uruguay Round did see some early results. Within only two years, participants had agreed on a package of cuts in import duties on tropical products - which are mainly exported by developing countries. They had also revised the rules for settling disputes, with some measures implemented on the spot. And they called for regular reports on GATT members' trade policies, a move considered important for making trade regimes transparent around the world.

WORLD TRADE ORGANISATION (WTO)

The World Trade Organization came into being in 1995. One of the youngest of the international organizations, the WTO is the successor to the General Agreement on Tariffs and Trade (GATT).

So while the WTO. is still young, the multilateral trading system that was originally set up udder GATT is well over 50 years old.

The WTO's overriding objective is to help trade flow smoothly, freely, fairly and predictably.

It does this by:

- Administering trade agreements
- Acting as a forum for trade negotiations
- Settling trade disputes
- Reviewing national trade policies
- Assisting developing countries in trade policy issues, through technical assistance and training programme
- Cooperating with other international organizations

Structure: The WTO has more than 140 members, accounting for over 97% of world trade. Around 30 others are negotiating membership. Decisions are made by the entire membership. This is typically by-consensus. A majority vote is also possible but it has never been used in the WTO, and was extremely rare under the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top level decision-making body is the **Ministerial Conference** which meets at least once every two years. Below this is the **General Council** (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body.

At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council.

Numerous specialized committees, working groups and working parties deal with the individual agreements and other areas such as the environment, development, membership applications and regional trade agreements.

The WTO agreements

The WTO's rules - the agreements - are the result of negotiations between the members. The current set were the outcome of the 1986-94 Uruguay Round negotiations which included a major revision of the original General Agreement on Tariffs and Trade (GATT).

ATT is now the WTO's principal rule-book for trade in goods. The Uruguay Round also created new rules for dealing with trade in services, relevant aspects of intellectual property, dispute settlement, and trade policy reviews. The complete set runs to some 30,000 pages consisting of about 30 agreements and separate commitments (called schedules) made by individual members in specific areas such as lower customs duty rates and services market-opening.

Through these agreements, WTO members operate a non-discriminatory trading system that spells out their rights and their obligations. Each country receives guarantees that its exports will be treated fairly and consistently in other countries' markets. Each promises to do the same for imports into its own market. The system also gives developing countries some flexibility in implementing their commitments.

FUNCTIONAL AREAS

Goods

It all began with trade in goods. From 1947 to 1994, GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important rules, particularly non-discrimination.

Since 1995, the updated GATT has become the WTO's umbrella agreement for trade in goods. It has annexes dealing with specific sectors such as agriculture and textiles, and with specific issues such as state trading, product standards, subsidies and actions taken against dumping.

Services

Banks, insurance firms, telecommunications companies, tour operators, hotel chains and transport companies looking to do business abroad can now enjoy the same principles of freer and fairer trade that originally only applied to trade in goods.

These principles appear in the new General Agreement on Trade in Services (GATS). WTO members have also made individual commitments under GATS stating which of their services sectors they are willing to open to foreign competition, and how open those markets are.

Intellectual Property

The WTO's intellectual property agreement amounts to rules for trade and investment in ideas and creativity. The rules state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout-designs and undisclosed information such as trade secrets - "intellectual property" - should be protected when trade is involved.

Dispute Settlement

The WTO's procedure for resolving trade quarrels under the Dispute Settlement Understanding is vital for enforcing the rules and therefore for ensuring that trade flows smoothly. Countries bring disputes to the WTO if they think their rights under the agreements are being infringed. Judgements by specially-appointed independent experts are based on interpretations of the agreements and individual countries' commitments.

The system encourages countries to settle their differences through consultation. Failing that, they can follow a carefully mapped out, stage-by-stage procedure that includes the possibility of a ruling by a panel of experts, and the chance to appeal the ruling on legal grounds. Confidence in the system is borne out by the number of cases brought to the WTO - almost 250 cases in seven years compared to, some 300 disputes dealt with during the entire life of GATT (1947-94).

Policy Review

The Trade Policy Review Mechanism's purpose is to improve transparency, to create a greater understanding of the policies that countries are adopting, and to assess their impact. Many members also see the reviews as constructive feedback on their policies.

All WTO members must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO Secretariat.

Development and Trade

Over three quarters of WTO members are developing or least-developed countries. All WTO agreements contain special provision for them, including longer time periods to implement agreements and commitments, measures to increase their trading opportunities and support to help them build the infrastructure for WTO work, handle disputes, and implement technical standards.

The 2001 Ministerial Conference in Doha set out tasks, including negotiations, for a wide range of issues concerning developing countries. Some people call the new negotiations the Doha Development Round.

Before that, in 1997, a high-level meeting on trade initiatives and technical assistance for least-developed countries resulted in an "integrated framework" involving six intergovernmental agencies, to help least-developed countries increase their ability to trade, and some additional preferential market access agreements.

A WTO committee on trade and development, assisted by a sub-committee on least-developed countries, looks at developing countries' special needs, Its responsibility includes implementation of the agreements, technical cooperation, and the increased participation of developing countries in the global trading system

Technical Assistance and Training

The WTO organizes around 100 technical cooperation missions to developing countries annually. It holds on average three trade policy courses each year in Geneva for government officials. Regional seminars are held regularly in all regions of the world with a special emphasis on African countries. Training courses are also organized in Geneva for officials from countries in transition from central planning to market economies.

5.9 SUMMARY

Upon crossing the national borders an international marketer is faced with a new political environment. As every marketer realises the implication of political environment on business, it becomes necessary for him to understand and gauge the political risk he is undertaking and the options available to him for managing the same. So also he must undertake an analysis of the legal environment. Managers involved in international marketing are not supposed to be experts in law. What is necessary is to have an appreciation of the legal problems that may arise while negotiating or implementing an export contract. Once that perspective is developed, it would be a good idea to prepare a checklist, with the help of legal experts, which can be used for guiding future managerial action. The correct business approach to law is not to find out what legal solutions are there to a dispute, which has occurred, but what should be done to prevent occurrence of disputes. This is because legal processes even in a purely domestic country setting can take a long time. When foreign countries and foreign laws are involved, time and costs can be so enormous that an exporter would be well advised to forget legal solutions and accept the los.

This unit details out the need and importance of analysing and managing political risks. These risks can be country specific and/or firm specific. Management of political risk involves pre-investment as well as post-investment planning. A number of strategic options under both the categories have also been discussed. Correct use of Incoterms goes a long way to providing the legal certainty upon which mutual confidence between business partners must be based. Thirteen Incoterms (Ex-works, FOB, CIF etc) have been discussed in this unit. The last section of the unit explains the background, importance and functions of the World Trade Organisation.

5.10 SELF-ASSESSMENT QUESTIONS

1. What do you understand by the term political risk? In your opinion is it country specific or firm specific or both? Elaborate giving examples.
2. What are the major components that make up political risk? Why is it important for Government to have a regulatory framework?
3. What is the management process available for managing political risk?
4. How is the WTO different from GATT? What functions is WTO expected to perform?
5. What are Incoterms? Explain some of the commonly used Incoterms.

5.11 FURTHER READINGS

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