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**Risks of Currency and Method Choices of Chinese Enterprises' Export Settlement and Countermeasures: An Investigation on the Canton Fair**

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**Risks of Currency and Method Choices of Chinese Enterprises' Export Settlement and Countermeasures: An Investigation on the Canton Fair**

**Abstract**

Due to the depreciation of US dollars and the shortcomings of L/C settlement method, Chinese enterprises have come across some new tendencies of change in choices of export settlement currency and method, such as the reduction of using US dollars as a settlement currency, the increase of using T/T payment method, and the decrease of using L/C payment method. The paper analyzes and concludes that these trends of change are the reasonable choice of Chinese enterprises to conform with the law of market, but at the same time, they may bring about some potential risks to them, therefore, they is suggested to take some countermeasures to handle these changes.

**Key words:** Chinese enterprise, international settlement method, payment currency; investigation

**Introduction**

International settlement refers to the clearing activities for credits and liabilities aroused as a result of international economic, social and political exchanges between nations. It is normally divided into three major methods or means such as remittance, documentary collection and documentary credit. But different methods of international settlement may mean

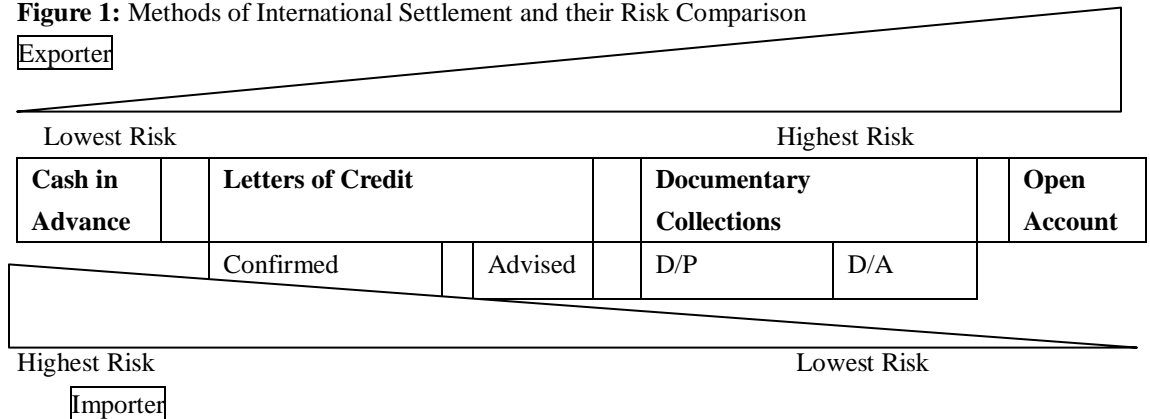
different levels of banking fees, risks and operation procedures. Therefore, it is of great importance for importers and exporters to make a careful research on how to choose a proper means of international settlement in order to guarantee their security and benefits in an increasingly complicated environment for international trade.

In normal situations, the selection of

international settlement method relies on the consideration of each party involved in a transaction on the degree of settlement risks. Based on the following figure (See Figure 1), we can see that the exporter is most likely to choose the means of international settlement which is cash in advance while the importer is most willing to the means of international

settlement which is open account. However these two means of international settlement has a very serious problem which is the imbalance of risks. In contrast, other means of international settlement such as L/C and collection, especially L/C, can provide both parties with more balanced and acceptable levels of risks.

**Figure 1: Methods of International Settlement and their Risk Comparison**



To balance the sharing of risks by using appropriate means of settlement is an essential factor for facilitating the successful signature of an international trade contract in international marketing management (Hao Zhongtao, 2009). This means that if a trader in a trade international market only considers its own risks and costs with caring the other party's in the choice of methods of settlement, e.g. the exporter insists on the choice of cash in advance or the importer insists on the choice of open account in international trade, there will be no international business between them as there is a lack of mutually beneficial and acceptable means of settlement. Balancing the sharing of risks by using appropriate means of settlement refers to the compromise of each party in international trade in the choice of methods of

payment based on the two parties' credit standing and mutual business relationship. For a new business relationship, or a counterparty with low level of creditworthiness, it is suggested to insist on the use of L/C, or to use the most secure type of payment method, or to use the mixed means of international settlement, while for a long-established relationship of trust, or a transaction involving a small sum of dealing or a very low degree of risks, low-cost or less-conservative methods of international settlement can be used so as to enhance the promotion of sales in international marketing.

Traditionally, L/C has always been used by the exporter as the first choice for the settlement of international trade transactions. In the 1970s and 1980s, it accounted for over 85% of the

total volume of intentional trade settlement (Guo Jianjun, 2005) as a result of its unique feature that is to provide a mutually secure way of payment to both parties. The buyer can make sure of its security for delivery of goods as ordered through the arrangement of required documents for payment in the L/C while the exporter can ensure its safety of getting payment from the issuing bank through preparing and presenting documents which are in conformity with the specified terms and condition of the L/C. However, due to the complicated procedures and high banking fees, L/C tends to decline in use since the 1980s, especially in the new 21 century, T/T remittance, collection and mixed ways of international settlement are more and more widely applied by traders, which are actually replacing the position of L/C to become the mainstream means of settlement. In addition, another developing trend for international settlement is the possible change of currency use from U.S dollars to Euro dollars.

In order to testify the developing trends or changing features of international settlement and to analyze their potential risks and countermeasures, we make an empirical study

on the sampled 59 enterprise (chiefly pottery, gift and toy firms) participating in the recent Canton Fair. The results are discussed in the following.

**Settlement currency choices, risks and countermeasures**

**The trend of settlement currency choices**

Among the 59 investigated companies, there are 50 firms (accounting for 84%) which still use U.S. dollars as their only settlement currency for clearing international trade debts. In addition, there are also 8 firms which simultaneously use U.S. dollars and other currencies as a mixed choice for settlement currency, but there is only one firm which is a complete non-user of U.S. dollars as settlement currency for its international trade. However, there are more and more investigated firms using Euro dollars for settlement or quotation. Based on our research on the 37 enterprises in Canton Fair whose export destinations include the EU countries, we find there are over 30 percent of them having already used Euro dollars as their international currency and there are 16 percent of them considering to use in the near future. Please refer to Figure 2.

**Figure 2:** Firms exporting to the EU and their use of Euro dollars as settlement currency

Status of use	Number of firms sampled	Percentage
No use	9	24%
Considering to use	6	16%
Already used	11	30%
Never thinking	11	30%
Total	37	100%

From the data in Figure 2, it can be seen that as a result of the depreciation of U.S. dollar

against RMB yuan in these years, there are more and more firms considering to choose

other currencies as international settlement currency, and there are 46% firms exporting to Europe which have used or are considering to use Euro dollars as their settlement currency.

But on the other hand, it should be noted that the dominating position of U.S. dollar as the pricing and settlement currency in international is still difficult to be moved. Although Euro dollars tend to be more and more widely used as the pricing and clearing currency for international currency, yet the long-established habit of businessmen in using U.S. dollar as settlement currency can not be removed one night (Chen Yawen, 2006).

### **Potential risks of the trend**

As result of the depreciation of U.S. dollars against RMB yuan, the continuous application of U.S. dollar as the single pricing and settlement currency does exist the problem of undertaking huge foreign exchange risks, particularly for the party who exports products to importers in other countries and receives proceeds from them. Namely, the two-year soft currency position of U.S. dollar puts the exporter in a risky position when getting devalued payment from the importer.

At the same time, the more and more frequent use of Euro dollar may lead to potential risks of foreign exchange as well. This is because that the growing international position of Euro Dollar has been shaken by the monetary policies of the EU governments for depreciating Euro Dollars in order to deal with the global financial crisis caused by the U.S. sub-prime mortgage crisis since the end of 2008. According to the announced foreign exchange

quotation of Bank of China in recent three years, it can be seen a clear unstable and depreciative trend of Euro dollar against RMB. For example, in early 2007, 1 Euro dollar = 1026.65RMB yuan, tending to increase in value; In April, 2008, 1 Euro dollar = 1115.86RMB yuan, rising up to 8.7%; in October, 2008, 1 Euro dollar = less than 1100RMB yuan, depreciating to the new level; In May, 2009, 1 Euro dollar = 951.22RMB yuan, showing a great level of depreciation. Therefore, the more and more popular use of Euro dollar as the pricing and settling currency also involves foreign exchange risks for the exporter as a result of its depreciation.

### **Suggested countermeasures**

Concerning the risks caused by the trend, it is suggested that export enterprises should take the following measures to handle it, which include: Firstly, the exporter had better choose the hard currency to settle its export proceeds, namely those currencies which have a trend of appreciation against RMB yuan; Secondly, the exporter are suggested to try best to use RMB as its settlement currency whenever the currency is available in international or cross-border transactions with the countries or regions where cross-border RMB settlement is permitted;

Thirdly, the trader is suggested to use the same currency for clearing both its import and export transactions so as to offset the risks of foreign exchange; Finally, the exporter is suggested to take advantage of the hedging services like foreign exchange futures or options to fix the rate of exchange and to ensure to make acceptable profits.

**Settlement method choices, potential risks and countermeasures**

**The trend of settlement method choices**

Based on our empirical study on the enterprises

attending the 103th Canton Fair, it is found that T/T remittance is becoming the most frequently chosen method of international settlement by the sampled 31 traders, in particular the exporter. Please refer to Figure 3:

**Figure 3:** The Rate of Using T/T as a settlement method by the investigated exporters

Rate of Using T/T	Number of exporters	Percentage
Less than 10%	1	3%
10%-30%	2	6.5%
30%-50%	8	26%
50%-70%	6	19%
70%-90%	12	39%
More than 90%	2	6.5%
Total	31	100%

Another developing trend of international settlement method choices is that the use of L/C settlement is declining, which has become the second most frequently selected means of international settlement, which is in line with the developing trend of the whole world. In addition, according to different deals or trade partners, a mixture of both T/T and L/C or both L/C and collection is chosen by the exporter in order to compromise the risks for both parties.

**Possible reasons for more choices of T/T than L/C**

The underlying reasons for more exporters choosing T/T rather than L/C are seen as follows: Firstly, L/C is more expensive in terms of banking fees. For instance, in the banking charges of Bank of China, L/C is charged as banking fees at the rate of 1.25% while T/T is only 1%; Secondly, L/C is longer in receiving payment than T/T. For example,

based on the UCP600, the issuing bank and the

advising bank shall each have five banking days (extending over holidays) to determine whether to honor the documents or not; Thirdly, the circulation of funds by using L/C is slower than that by using T/T. For instance, in opening an L/C, the importer should deposit a certain sum of money in the bank as collateral for the issuance of L/C, usually 30% - 110% of the credit value. This sum of deposit will influence the circulation of the importer's funds, so in today's business environment where the buyer has a stronger bargaining power, the buyer may insist on choosing other means of payment instead of L/C from the protection of its own interests; Fourthly, the procedures of L/C are more complicated than T/T or collection. For example, it needs to be a very long time to complete the settlement by using L/C from its opening, advising, amending, presenting and negotiating to reimbursement. Any discrepancy happening may lead to the partial payment, deferred payment or even no payment from the issuing bank. However, in general, based on the

research result, 30% T/T is preferred by the importer and the exporter as well because of its quickness and convenience in banking procedures and cheapness in banking fees. Of course, the choice of T/T as a trend also depends on a long-established good relationship between the exporter and importer.

### **Potential risks of the trend**

Cash in advance and open account are two ways of T/T remittance, which may provide an extremely imbalanced protection to both traders. Cash in advance will be the best choice for the exporter but the most risky choice for the importer while open account or pre-shipment will be the most beneficial choice for the importer but the most risky choice for the exporter. Even if a 30% partial prepayment is selected, the remaining 70% may still face the potential risks of commercial credit from the importer. Thus, the trend of more and more frequently using T/T does contain a very serious risk of loss for the buyer if accepting cash in advance or prepayment and for the seller if accepting open account or deferred payment.

### **Suggested countermeasures**

It is recommended that both the importer and the exporter should be very cautious in choosing T/T as a settlement method for international trade. From perspective of the seller, firstly, it should not accept the T/T settlement method of open account unless the importer is a complete trustworthy business partner with a long history of good business relationships with it, or the importer is its affiliate firm or share-holding company in a large business group, or the transaction is only

a small amount which involves acceptable risks for the exporter. Secondly, In the case of deciding to use the T/T settlement method of open account, the exporter is suggested to conduct a guarantee from a financial institution to prevent any uncertain occurrence.

Thirdly, it is suggested to choose documentary collection as a means of payment to make sure the security of delivering the proceeds by means of controlling the title document though D/P at sight or D/P after sight. Forthly, it suggested to choose a mixed way of international settlement such partial T/T + L/C, T/T + documentary collection, or L/C + documentary collection in order to let both parties share risks and losses as a compromise method. Finally, it is suggested to insist on the use of L/C settlement method in circumstances of new business relationships, a large quantity of a transaction, or any transaction for which the trader is lack of sufficient confidence. And in choosing L/C as a settlement method, the exporter should also be very careful in checking and amending any clauses in the L/C which are difficult or impossible for the beneficiary to complete, such as various soft clauses, and should be very careful in the preparation and presentation of documents in order to avoid any discrepancy.

### **Conclusion**

Based on the empirical study on enterprises attending the Canton Fair, Chinese enterprises have come across some new tendencies of change in choices of export settlement currency and method, such as the reduction of using US dollar and the increase of using Euro dollar as a

settlement currency, the increase of using T/T payment method and the decrease of using L/C payment method, etc. These trends of change are the reasonable choice of Chinese enterprises to confirm with the law of market, such as the depreciation of US dollar against RMB yuan naturally leads to the reduction of using US dollar as a pricing and settlement currency, and the shortcomings of L/C settlement method such as high banking fees and complicated procedures result in the decrease of using L/C payment method. At the same time, the trends of change may bring about some potential risks to traders, and therefore, they are suggested to take some countermeasures to handle these changes.

Concerning the risks caused by the trend of currency choices, it is suggested that export enterprises should take the measures such as choosing the hard currency to settle its export proceeds, trying best to use RMB as its settlement currency whenever available, using the same currency for clearing both its import and export transactions, and using hedging services to fix the rate of exchange and to ensure to make acceptable profits. Concerning the risks caused by the trend of settlement method choices, it is recommended that the exporter should be not accept the T/T settlement method of open account unless the importer is a complete trustworthy business partner, or the transaction is only a small amount, choose documentary collection as a means of payment to make sure the security of delivering the proceeds, choose a mixed way of international settlement in order to let both parties share risks, insist on the use of L/C settlement method in circumstances of new

business relationships, a large quantity of a transaction, etc.

However, for Chinese firms in doing international business, the measures suggested for reducing the risks caused by the changes of currency choice and settlement method choice may have some limitations, for example, insisting on the use of RMB as the settlement currency to avoid risks may not be available for some countries as it is still not a completely free exchange currency in the international market. In addition, this research itself may have some limitations as well, for instance, this data collection is conducted based on the samples of enterprises participating in only one session of the Canteen Fair, which makes it necessary for further comparative studies in the future.

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