



Foreign Trade *Caveat Emptor*

BY ROBERT MENARD, CPP

No where is commercial warning of “caveat emptor” (let the buyer beware) sounded louder than in foreign trade. In this series of two articles, we will concentrate on the purchase and sale of goods from overseas suppliers.

Virtually every commodity can be sourced off shore: high technology devices like computers, lasers, and medical devices, machinery and equipment like bull dozers and incinerators, consumer goods like furniture and clothing, and basic industry products like cement and petroleum. Some products are expensive and time sensitive and shipped air freight. Others are so cheap and bulky that they fill the entire holds of ocean vessels.

The recalls from foreign sources due to quality failures have been so frequent that the purchasing community is reexamining the total cost of doing business overseas. Despite a cheap price, how much does it cost a food importer when then public reads about poison additives? What is the cost to the toy retailer left without inventory at the holiday season because of lead paint or choking hazards recalls?

Nevertheless, the trend toward procuring low priced goods from off shore sources is not likely to reverse any time soon. Proceeding with caution, here are some of the common practices and hidden costs involved in foreign trade.

The usual introduction to foreign goods is to buy from a US operating subsidiary of a non-US enterprise. In such cases, the US unit takes care of the details such as freight forwarding, duty, customs brokerage, ship nomination, and the like, but you pay a premium for that convenience. If you make limited foreign purchases, this is the preferred route. However, to be a serious player in foreign trade you must be fully conversant with the relevant provisions of international law.

The Convention for the International Sale of Goods (CISG) governs much of world trade in goods although not every country with which the US trades is signatory to it. The CISG is a rough international equivalent, with important distinct differences, to the Uniform Commercial Code (UCC).

Among the principles enacted within the UCC are the four requirements of a contract:

1. Offer and Acceptance
2. Exchange of consideration

continued on next page

Global factors

To put global trade in perspective requires an appreciation for the enormous demographic imbalances between the US and some of its favorite over seas suppliers.

- There are less than ten cities in the US with a population of over 1,000,000
- China has over two hundred
- China and India account for 37% of the world's population of 6.67 billion
- The US, with only 303 million constitutes less than 5%.

According to the World Bank, the annual Gross Domestic Product (GDP or total national output of goods and services) of the world is over 48 trillion US dollars, about 27% of which is attributable to the US, the single largest power. The US economy is approximately equal to that of the next five largest national economies combined, Japan, Germany, China, UK, and France.

China and India, the world's fourth and twelfth largest economies, account for only 7.5% of world GDP combined. Taking the math to per capita dimensions, 303 million Americans produce over 13 trillion economy dollars or about \$43,000 per person. The combined population of 2.47 billion Chinese and Indians produce \$3.5 trillion economy dollars, or \$1,400 per person!

The vastness of the available overseas workforce and its very cheap labor has had a significant influence on world manufacturing production. For the past quarter century, manufacturing increasingly has migrated toward low cost labor countries, first to Mexico and then the developing world, principally Asia.

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3. Competent parties

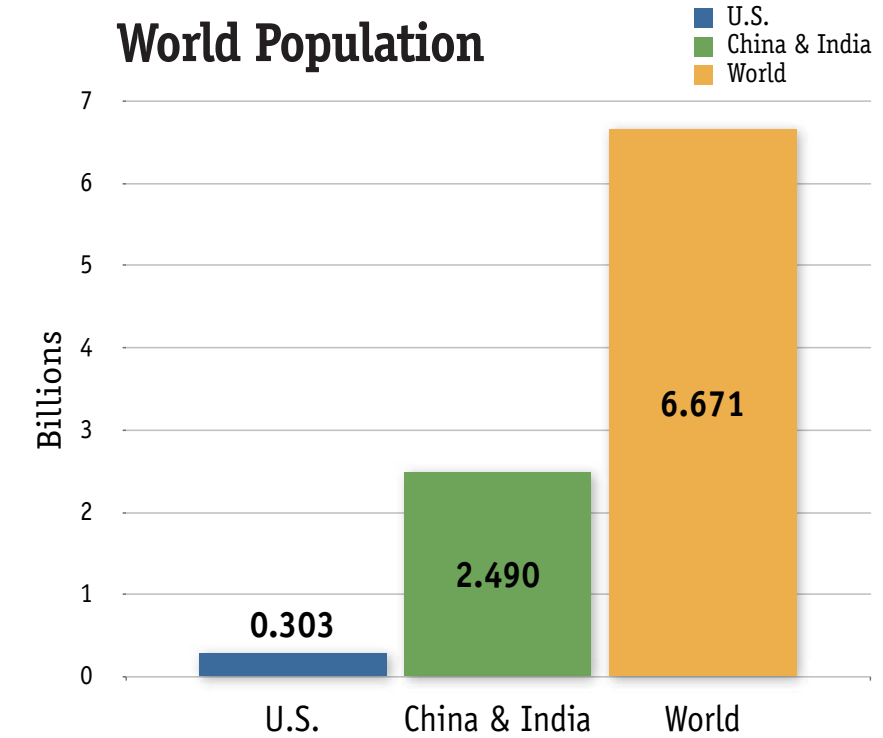
4. Legal subject matter

Under the CISG, requirement 3, competent parties, and 4, legal subject matter, are not necessary for a valid international contract. The reasoning is that the legality of goods varies by country as does the definition of "competent parties". Another important distinction is the CISG's elimination on the need to reduce the contract to writing.

Foreign trade is clearly not a decision to be made without extensive preparation. Visit the prospective countries and suppliers at least twice before you proceed. The cultural and business differences are significant and must be respected and accounted for in terms of cost.

Evaluating off shore sourcing requires identification of as many of the hidden costs as possible. The costs will come in four elements, *Quality, Service, Delivery, and Price*. As price has driven the manufacturing of goods to cheaper countries the need to examine the cost impact of the other three cost factors has grown. Let's examine the impact of each in the off shore sourcing decision to determine if buying goods overseas will provide the lowest Total Cost of Ownership (TCO).

The biggest challenge for manufacturing



is probably the workforce, which translates to *quality*. The workforce in much of the third world (not so much in the western world, Japan or Korea) lacks the culture and tradition of traditional manufacturing.

To eliminate some risk, consider obtaining raw materials and furnishing them to your off shore toll manufacturer. This may add cost up front, but minimize risks and exorbitant costs down stream. Establishing on site quality control to ensure that

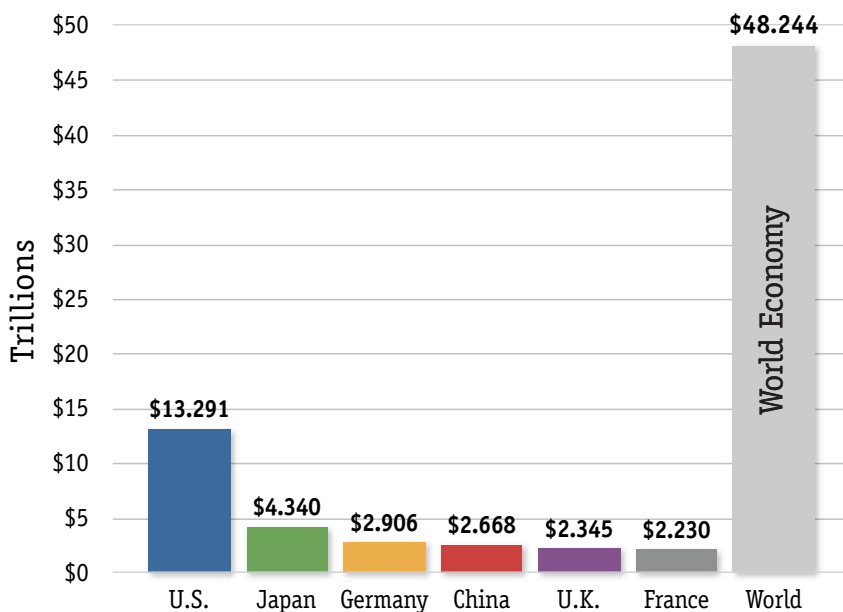
standards are met before any product is shipped is another cautious step and it adds some upstream cost that may avoid disasters downstream.

If Quality is under control, expect *delivery* to be the next most expensive cost element. Supply chain processes, particularly logistics, are not well developed overseas. The predictable result is that timeliness and companion measures of cycle time and inventory turns can be expected to suffer

Service in general, may be the least expensive element. For many foreign sources, service, maintenance, and similar functions are performed on site in the US, Canada, or other western countries.

As the world's economic leader, Americans tend to have a US-centric world view. The flip side of our economic prosperity is that the underdeveloped economies, which hold promise of low price, need to be managed if the venture is to yield the lowest TCO. The allure of cheap price goods often comes with many hidden costs.

Economic GDP by Country



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