

The Upgraded Complex of Payment Methods Following Expansion of Contract Manufacturing in International Trade

Andrius Jarzemskis^{1,*}, Ilona Jarzemskiene²

¹Department of Business, Faculty of Economics and Business Administration, Vilnius University, Vilnius, Lithuania

²Department of Logistics and Transport Management, Faculty of Transport Engineering, Vilnius, Lithuania

Email address:

andrius.jarzemskis@evaf.vu.lt (Andrius Jarzemskis), ilona.jarzemskiene@vilniustech.lt (Ilona Jarzemskiene)

*Corresponding author

To cite this article:

Andrius Jarzemskis, Ilona Jarzemskiene. The Upgraded Complex of Payment Methods Following Expansion of Contract Manufacturing in International Trade. *Journal of Business and Economic Development*. Vol. 8, No. 1, 2023, pp. 12-21. doi: 10.11648/j.jbed.20230801.13

Received: March 17, 2023; **Accepted:** April 6, 2023; **Published:** May 10, 2023

Abstract: The problem of payment for goods in international trade is associated with the risk experienced by both the seller and the buyer. Various scholars have been conducting research in this area for five decades, and the business literature and literature for university students include a complex of methods in which payers operate in international trade transactions. On one side of the block-shape complex, it is customary to display the payment methods that pose the greatest risk to an exporter, and on the other side of the block-shape complex, the methods that pose the least risk to an exporter. The same methods, in reverse order, have the lowest risk for an exporter on the first side of the block-shape complex and the highest risk for an importer on the right side of the block-shape complex. In principle, such a block-shape complex is represented by many authors by stylizing graphically and describing the advantages and disadvantages of each method. According to the classic block-shape complex, the lowest risk for an exporter is to receive money in advance, the higher risk is to sell under a letter of credit - a letter of credit, the medium risk is to sell under the documentary collection method, and the highest risk is for the open account method and consignment. From an importer's point of view, these risks are in reverse order. The lowest risk for an importer is the consignment method, the following methods are arranged in order of increasing risk as follows: open account, document collection, letter of credit and prepayment. All these methods are represented in the classical complex, not reflecting the contractual case of production. The authors of the article conducted a qualitative study among the contract manufacturers of goods operating in Eastern Europe and importers of their products - brand owners. The conducted research allows to include the method of payment before production into the classic complex of five payment methods.

Keywords: Payment Methods, International Trade, Export, Import, Open Account, Credit Letter, Contract Manufacturing

1. Introduction

There are many ways to pay for goods in international trade. The problem of payment for goods is associated with the risk experienced by both the seller and the buyer. A seller wants to be sure that he will get money for the goods sold, and a buyer wants to be sure that he will get the goods for the money he paid. Trust between seller and buyer depends on many factors [1]. If the seller and buyer have a long experience of cooperation, trust is significantly higher, but if the seller and buyer meet for the first time, there will be no trust. Another aspect is cultural. Buyers and sellers working in the EU and USA have a higher level of trust in business partners than, for example, in South

American, Asian or African countries [2, 3]. However, mistrust is well-founded, as there are many examples of fraud, when either money is not paid or goods are not delivered [4].

There are several solutions to this payment problem, all of which involve a third party, usually banks. Banks serve more than 90 percent of all international trade transactions [5]. Banks are used for international trade transactions using various forms of banking intermediation.

Various scholars have been conducting research in this area for five decades, and the business literature and literature for university students include a complex of methods in which payers operate in international trade transactions [6, 7, 8, 9]. On one side of the block-shape complex, it is customary to display the payment methods that pose the greatest risk to an

exporter, and on the other side of the block-shape complex, the methods that pose the least risk to an exporter. The same methods, in reverse order, have the lowest risk for an exporter on the first side of the block-shape complex and the highest risk for an importer on the right side of the block-shape complex. In principle, such a block-shape complex is represented by many authors by stylizing graphically and describing the advantages and disadvantages of each method.

The first side of the block-shape complex represents advance payment for the goods, which means that the goods will be shipped to an importer only when an exporter receives payment. The second side of the block-shape complex represents consignment trading, which means that an importer will pay an exporter for the goods only when an importer sells the goods to the end user. These two payment options are extreme, the first is the riskiest for an importer and the second for an exporter. In the middle, payment methods such as a letter of credit issued by the bank, as collateral with documents (money for documents), payment with a delay after receiving the goods (open account) are displayed.

This block-shape complex is depicted in many textbooks and is also depicted and described by various government agencies whose mission is to promote export business and educate entrepreneurs [6-9].

However, this block-shape complex underestimates the increasingly widespread new circumstances. In a post-Fordist society, the "push" type of supply chains has replaced the "pull" concept [5]. The smile curve reflects the three-decade-old paradigm of manufacturing "anywhere" because the value of manufacturing and final assembly is the lowest in the entire business cycle [10]. The product developer and brand owner often outsource production to so-called contract manufacturers [11]. Contract manufacturers are gaining popularity in many industries, such as pharmaceuticals, textile industry, electronics industry. Contract manufacturers and assemblers are usually in a vertical alliance partnership with their customers, the brand owners [12, 13].

The purpose of this article is to include in the conceptual complex of international payments for goods cases when an international trade transaction takes place between contract manufacturers and their customers - brand owners. The second chapter of the article examines the literature and conceptualizes the currently existing methods of international trade payment for goods. The third chapter of the article describes the methodology based on which the research was conducted in the case of contract manufacturers. The fourth chapter presents the results of the study and provides an expanded complex of international trade payment methods. The fifth chapter of the article presents the conclusions and discussion for further research.

2. Literature Analysis on Conceptual Methods of International Trade Payments

Many authors of textbooks or business educational literature distinguish five methods of payments in

international trade, and schematically depict it as in the drawing below [6-9, 14-17].

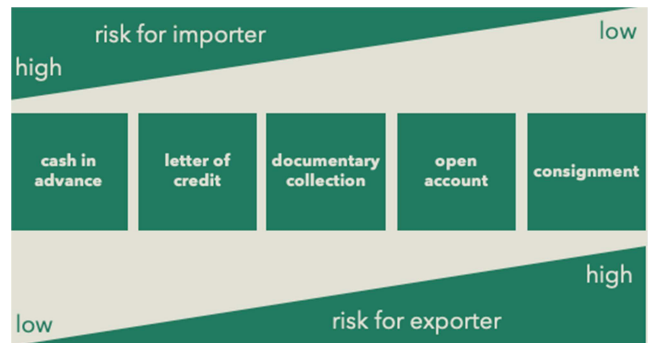


Figure 1. Classic complex of international trade payments methods.

This conceptual model reflects the distribution of risk between an exporter and an importer, such a model can be found in many textbooks for students, as well as in business educational literature, on the websites of state export promotion agencies (Figure 1). According to this scheme, the lowest risk for an exporter is to receive money in advance, the highest risk is to sell under a letter of credit - a letter of credit, the medium risk is to sell under the documentary collection method, and the highest risk is for the open account method and consignment. From an importer's point of view, these risks are in reverse order. The lowest risk for an importer is the consignment method, followed by the order of increasing risk as follows: open account, collection of documents, letter of credit and prepayment.

2.1. Cash in Advance

The first method of international trade is commonly referred to as cash in advance. This method means that the manufacturer ships the goods from his warehouse only when payment for them is received, that is, when the buyer's money reaches the seller's bank account. This method of payment is very useful for the seller, because there is no risk that the buyer will not pay. In other words, the buyer pays in advance. This payment method is very risky for the buyer. After transferring the money to the seller's bank account, the buyer may not receive the goods or may receive damaged, incomplete or incorrect goods [5]. Of course, the sales contract and INCOTERMS define responsibility, insurance and impose obligations on the seller, but in global practice there are many cases where the buyer suffers losses [5]. Legal protection of the terms of the contract does not always ensure the fulfilment of obligations, international courts are often expensive, and even court decisions are not always enforced, for example when the seller goes bankrupt. There are also cases of fraud from sellers, and it is extremely difficult to reach and claim goods from a seller in another country or even another continent [18, 19].

This payment method is mainly applied to those buyers about whom there is not enough information, whose country's economic or political situation is unstable or whose currency is not convertible. If the seller of the goods occupies a

dominant position in the market and can impose favourable terms on the buyer, then in this case the prepayment method will also be chosen.

Although it seems that this payment method is unacceptable to the buyer, this method is still applicable and depends on the size, history, and reputation of the buyer - seller. If the buyer is a new, little-known company, then the manufacturer is unlikely to agree to export the goods without receiving advance payment. Importers agree to pay manufacturers in advance if they verify that the manufacturer is a company with many years of experience and a good reputation in the market. This payment method is often used in the B2C e-commerce segment. When buying in an online store, the buyer usually pays money in advance and only after that the product is sent to him. In order to gain the trust of customers, electronic stores, especially those trading in international markets, apply a refund policy. Money is returned if the product is not

delivered to the buyer or is damaged, and some stores offer the option to simply return the product if you do not like it. However, in all these cases, the buyer has to trust the seller and assume all the risks for himself.

In terms of risk distribution between an importer and an exporter, this payment method is more favourable to the seller. In this case, he receives the money before sending the goods. This means that an importer pays for the goods, and in some cases for transport and insurance, before he or his agent has accepted the goods. Meanwhile, an exporter is compensated for non-fulfilment of the contract and protected against payment delays or insolvency.

By immediately transferring funds, the buyer is not guaranteed whether the seller will fulfil his obligations under the contract. The goods may not be delivered at all, not sent, sent later or do not match the order in terms of quantity or quality, and the buyer may no longer receive the funds paid.

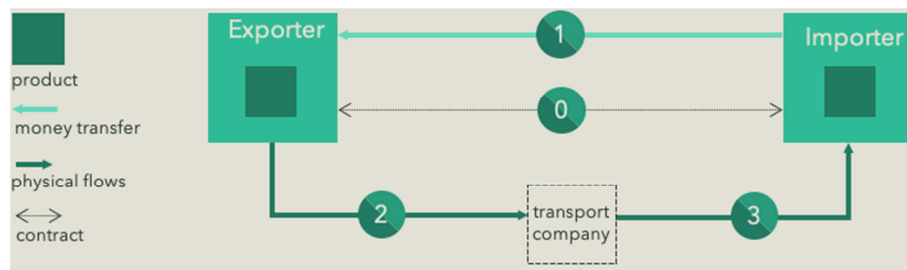


Figure 2. Cash in advance payment.

Schematically (Figure 2), the sequence of actions in this payment method is simple [20]. After signing the contract (0), an importer makes a money transfer to the account indicated by an exporter (1). After receiving the payment, an exporter gives the goods to the transport company (2), which takes the goods and hands them over to an importer (3). Transport payment, insurance and risk are shared by an exporter and an importer according to the international trade conditions INCOTERMS, choosing one of the conditions [21].

2.2. Letter of Credit

However, an importer often does not agree to pay in advance due to the above-mentioned risk of not receiving the goods. In order to reduce an importer's risk, third parties -

banks - are often used [19, 22]. This way of trading is less risky for an importer. According to this method, an importer is guaranteed to receive the goods, and the money will reach an exporter only when an importer signs on the consignment note, thus confirming that the goods have arrived. After an exporter delivers the goods to an importer and receives his confirmation that the goods have been delivered, he is also guaranteed to receive the money. This guarantee is provided by the bank. Banks are usually more trusted than trading partners, especially if they are international banks with a good reputation. Banks receive a commission for this mediation service. More than 90 percent of international trade transactions take place through the mediation of banks [23, 24].

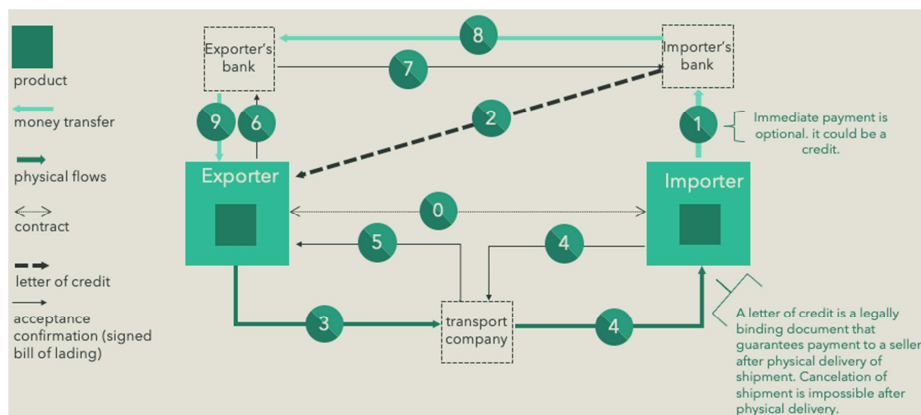


Figure 3. Payment by letter of credit.

This method of payment for international trade is carried out in the following steps [25, 26, 27]. First, an exporter and importer sign a trade contract (0). An importer applies to his bank and from the relationship with the bank an importer deposits funds in the bank, transfers funds to his bank or takes a bank credit for import (Figure 3). An importer's bank then issues the letter of credit that it has provided to the buyer to an exporter (2). This letter of credit is a guarantee to the seller that he will receive money if and when he delivers the goods. After receiving the letter of credit, the goods sent by an exporter are handed over to the transport company (3). The transport company hands over the goods to the buyer and at the same time a letter from an importer confirming that the shipment has been delivered is received (4). This confirmation is usually signed on the consignment note. "Transport company" will return this confirmation to an exporter (5). Although with the development of information technology there are also electronic confirmation methods, nevertheless, in international trade, an exporter often requires original documents with the signature of an importer. An exporter submits the proof of delivery of these goods - the bill of lading signed by the buyer - to his bank (6), and the latter submits it to an importer's bank (7). After receiving this confirmation, an importer's bank transfers the money to an exporter's bank (8), and finally payment achieves exporter (9). In this form of payment, an importer can no longer withdraw his deposited funds from his bank unless an exporter fails to deliver the goods to him. In this case, an importer will have to prove to his bank that he did not receive the goods from an exporter within the agreed time. An importer's bank basically guarantees an exporter that if the goods have already been sent by an exporter, the buyer can no longer cancel the transaction and refuse the goods. [28]. More detailed risks, conditions and insurance during transportation are determined by INCOTERMS [21].

In other words, a letter of credit is essentially a document that allows one party, such as an importer's bank, to pay another party, an exporter, a debt owed by a third party, such as an importer. The letter of credit is issued at the request of the bank client and according to his instructions. The bank issuing the letter of credit is usually located in an importer's country [1].

According to the nature of the bank's obligation, letters of credit can be divided into revocable, irrevocable, irrevocable unconfirmed and irrevocable confirmations. A revocable letter

of credit is not very reliable for the seller because the bank is not legally obligated to pay [28, 29].

Although the letter of credit poses a lower risk for an importer, an importer is not protected from the case if the quality characteristics of the delivered goods do not meet the requirements or standards. The fact of goods delivery in this case is sufficient proof that an importer's bank needs to pay an exporter's bank for the goods [18, 30].

2.3. Collection of Documents

Document collection is similar to trade payment using a letter of credit (Figure 4). In case of collection of the document, a third party - the bank - is used [16, 17]. The essential difference from a letter of credit is that in case of collection of the document, if the quality parameters of the goods do not meet the conditions set by an importer and this becomes clear already after the physical delivery of the goods, then an importer has the opportunity to cancel the order of the goods and not pay money, and the goods are returned to an exporter [6].

According to this payment method, an exporter has the right to the goods until the buyer fulfils an exporter's requirements: he pays for the goods or undertakes to pay for them after a certain time. So, if an importer refuses to pay for the goods because they do not meet the requirements, then an exporter continues to be the owner of the goods. In turn, banks act only as agents issuing documents for the fulfilment of export conditions, that is, they do not assume any obligations, unlike when paying with a letter of credit. This payment method is recommended when the buyer and seller trust each other, and the buyer's financial condition is not in doubt [28]. The partners must be convinced that the payment cannot be hindered by force majeure, and the payment operations of the buyer's country are unrestricted and under special control [31].

The buyer and the seller enter into a contract for the supply of goods (0), which provides for payment in the form of collection. An exporter sends the goods, presenting them to the transport company (1), which concludes a contract for the transportation of goods with the seller and accepts the goods for transportation, issuing a bill of lading to the seller. An exporter submits this document together with collection instructions to the transferring (own) bank for collection (2), and the carrier delivers the goods to an importer (2).

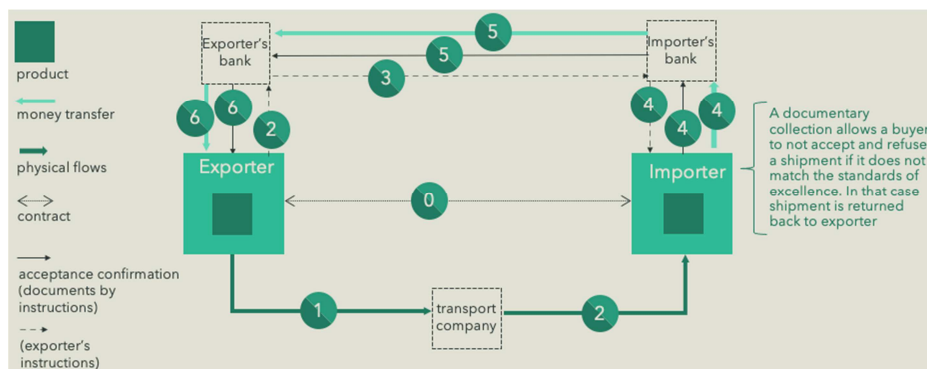


Figure 4. Payment by documentary collection.

According to the seller's application, the bank prepares its instructions to the buyer's bank and sends them together with the documents provided by the seller to the bank of the buyer's country (3). The collecting bank informs an importer about the collection order received on his behalf, and familiarizes him with the payment conditions. If the buyer accepts, otherwise undertakes to pay for the documents when the due date is reached or pays them immediately, the bank will hand over these documents to him (4). In this case, the bank does not undertake to make the payment itself, it is only obliged to make the payment at the customer's request. When the payment deadline arrives, an importer's bank debits an importer's account to pay the accepted bill and forwards these funds to an exporter's bank (5), which then transfers the money to an exporter and returns the acceptance documents approved by an importer (6). According to international practice, each counterparty pays the fees of its own country's banks in connection with the payment by collection of documents [17].

2.4. Open Account

An open account is a trade arrangement (0) in which goods are shipped to a foreign buyer (1) and given to him (2) before payment is made and without a written guarantee of payment

(Figure 5). In this case, the buyer pays after receiving the goods and the invoice (3). Depending on the terms of the contract, the payment term may be set differently. In practice, a delay of one month, two months or even three months of payment is usually met. This way of trading is risky for an exporter, because an importer may not pay for the goods for various reasons [1, 6, 7, 8, 9]. Debt collection in another country is a much more complicated, lengthy and expensive process than in your own country [28, 29]. It is not always possible to collect the debt, for example after the bankruptcy of an importer. An exporter agrees to this method of payment unless an exporter and importer have a partnership of many years, are long-term partners in a non-property alliance, or an exporter and importer have capital ties. This is how it is sold to subsidiaries, or how companies belonging to the same parent company trade with each other. [32]

Mutual relations are based on the creditor-debtor basis [28, 31]. In this case, the transaction is financed by the seller. Although an exporter has a strong interest in selling the goods, his position is not secure as the goods and documents are dispatched before payment is received. The seller must be sure that he will be paid, even in the case of issuing a check or accepting a bill of exchange. Another option is to insure yourself against the risk of insolvency.

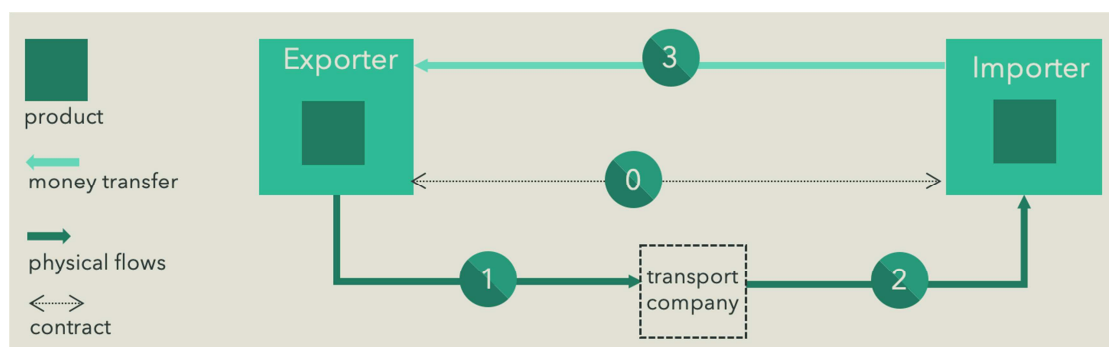


Figure 5. Payment by open account.

2.5. Consignment

With the consignment payment method, the processes are very similar to the open account method, but an exporter receives payment only when an importer sells the goods to his customers [6, 9, 22, 31]. After concluding the

consignment contract (0), an exporter sends the goods to the foreign buyer (1) and gives them to him (2). An importer then sells these goods to his customer (3). After receiving the money from his customer, an importer pays to an exporter according to the terms of the consignment agreement (Figure 6).

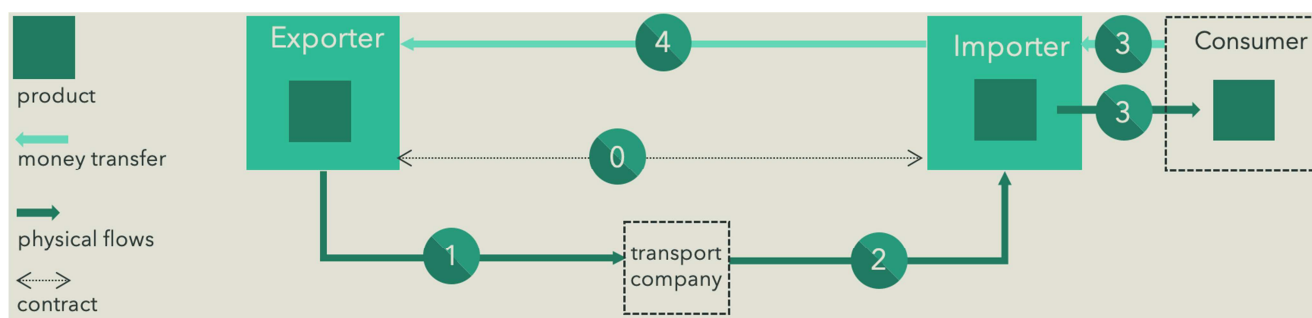


Figure 6. Payment by consignment.

This trade method is the riskiest for an exporter [15], because it is not known in advance how long an importer will sell the goods to his customers. In the end, it is not known at all whether it will be possible to sell those goods. Exporters use this method only when trading with very reliable partners, usually their representatives abroad - subsidiaries, branches [1]. This trade method can be applied when the manufacturer has a large amount of production in its warehouses and there is a lot of competition in the foreign market [10]. In this case, an importer practically takes no risk, this type of trade requires minimal investments, the goods do not require working capital.

2.6. Incompleteness of the Classic Complex of Five Payment Methods

Summarizing the five most frequently analysed international trade payments methods, it can be said that they are all widely applicable to the general case where an exporter already has a manufactured product. Exporters are usually manufacturers or manufacturers' agents or distributors.

Henry Ford, who was the first to apply the principles of economies of scale and specialization in mass production of cars, started the so-called Fordist stage of business globalization. Serial production of the "Ford T" model, which began in 1913, is a symbol of this stage. At this stage, the main focus was on increasing production efficiency and volumes. This was greatly boosted by export volumes. Export has become the most popular way of doing international business [5]. The scale of export growth of industrialized countries led to the growth of the gross domestic product of these countries. Globally, the differences in the size of the gross domestic product between the leading countries - the US, the UK, France, Germany, Italy and the rest of the world - began to widen. At that time, there was a great demand for industrial products in the world. Industrial production was needed for agriculture, the construction sector and even individual consumers. Manufacturers focused on the affordability of products. Mass production of homogeneous products led to lower production costs and lower prices. Automobiles, household appliances, and other personal consumption goods have become affordable for middle-income residents in the United States and many Western European countries.

As world production and exports increased in the 20th century, supply became saturated [5]. Consumers could choose which manufacturer's product to buy. Competition between manufacturers has begun. Many manufacturers in the USA, Germany, Italy, France began to compete, but in the Fordist society competitive advantage was mainly sought through price. Product quality was also important, but it was mostly perceived through functional properties, reliability and durability. Global business was dominated by the so-called "push" paradigm, which meant that the manufacturer produces goods, places them in warehouses, and the further sale of these goods is already the concern of salespeople and marketing and distribution specialists. The so-called make-to-stock phase prevailed [5].

In the second half of the 20th century, beginning in the 1970s, consumers became increasingly picky about their products, and manufacturers realized that no matter how efficiently a product was produced, if the product did not sell, it would mean a loss [5, 12]. This idea fundamentally turned the concept of global business upside down. The conformity of the product to the specific needs of the customer and the speed of availability of the product have become as important as the price. Manufacturers had to change the concept of mass production "in stock" to production on demand, or the so-called "pull" concept.

The concept of "pull" is basically based on the diversity of the assortment and the economy of scope. As long as the manufacturer produced a single product according to the Fordist paradigm, the probability of selling all products from the warehouse was high, but when manufacturers began to produce a wide range of products, it became risky to manufacture to the warehouse. For example, even a car of the same brand and model can have different body colours, different engine power, different interior details, tires and rims, even different gearboxes and types of fuel. There may be several hundred variations of the product, and it is really risky for the manufacturer to produce cars of all variations in the warehouse, because not all of them will find their buyer. It is even more difficult to plan the required inventory level for each variation. Therefore, more and more manufacturers have moved to a new business paradigm, where the customer's order comes before the start of production. The user is allowed to choose all car parameters from the set offered by the manufacturer. The production of the car starts only after the order is placed by the user [5]. This make-to-order paradigm eliminates economies of scale in final product assembly, but economies of scale remain in component manufacturing. [12] Although different components may be fitted to the same car, the components themselves are the same. Thus, economies of scale shifted from final assembly to component manufacturing, and assortment diversity began to dominate final product assembly. This paradigm is called "post-Fordist" [5].

In the post-Fordist paradigm, the value of production efficiency has become relatively lower. The USA and Western European countries have outsourced both the production of components and the assembly of the final product to Asian countries, where labour is cheaper [33]. The greatest value in post-Fordism goes to the product brand, product development R&D activities and innovations, as well as product distribution, marketing, and after-sales service. This is described by the "smile curve" proposed by Acer founder Stan Shih in 1992 [36].

R&D activities are mostly concentrated in the United States in the field of logistics and distribution, dominated by the Mediterranean and North Sea regions of Western Europe, the coasts of China, and the West Coast of the United States. Production is concentrated on the coasts and islands of southern Asia, the East and West coasts of South America. Areas near the sea and the largest port cities were chosen as production sites, as this greatly reduces both the delivery of

raw materials to factories and the logistics costs of exporting finished products.

Some multinational corporations have moved their production units to cheaper production locations in Asia or South America, some have bought existing factories there, some have invested and built factories. However, some multinational corporations refused to control production themselves and to have their own factories. So-called private label manufacturers and contractual manufacturers as concept have emerged. These are the manufacturers who make the output of a certain type of industry to order. For example, in the pharmaceutical or computer industry, the brand owner can choose which factory to manufacture its product or its individual component [34]. Most of the time, the name of that factory is not even known to the end users, and in the same factory, goods are produced by manufacturers of different brands, who are often competitors in the market [35]. Thus, the production of components or the assembly of the final product is perceived as an outsourced service. The term "offshoring" is used to describe such a service. In essence, it can be said that independent manufacturers have emerged that only provide a physical manufacturing service to brand owners. In this case, the question arises as to who should be considered a manufacturer, because the brand owner often has no production capacity at all, but only controls R&D activities, intellectual property of the created product, and marketing tools. However, the highest added value and profit in this case corresponds to the brand owner. This is described by the "smile curve" proposed by Acer founder Stan Shih in 1992 [36].

The decline in the value of production has created the conditions for more and more brand owners to abandon their production capacity and look at production as subcontracting. Since the 1990s, more and more international companies have outsourced production to other countries. So, in case of contract manufacturing, the actual manufacturer is often a little-known company that custom-makes products for the brand owner, which the brand owner will then distribute under its own name in various markets [37].

In the case of contract manufacturing, the methods of international payments described in sections 2.1-2.5 are not very convenient. In order to conceptualize the payment method in case of contract manufacturing, the author conducted a study, the methodology of which is briefly described in chapter 3, and the results are presented in chapter 4.

3. Methodology

In order to investigate which payment method is most often applied in the case of a contract manufacturer, a qualitative study is chosen. Qualitative research in this case has an advantage over quantitative research because it not only reveals in more detail the choice of exporters' trade payment method, but also describes its reasons and deeper motivations. However, the payment method is quite sensitive commercial information. Before choosing the research method, several

pilot interviews with exporting producers revealed that the payment method is one of the competitive advantages. For example, brand owners often include payment method among many parameters when choosing a contract manufacturer. In contract manufacturing, the contractual relationship between the brand owner and the contract manufacturer is non-disclosure and is considered a very serious trade secret. For this reason, quantitative research using online data collection platforms would be difficult to implement. Due to commercial confidentiality, contract manufacturers seek not to disclose this information, even during a personalized quantitative survey. Statistical information from banks is also not available, because they store data through which transfers are made. Information on the total values of letters of credit issued by banks or amounts of export credits is available, but it is not possible to filter out the details of what part is involved in the transactions between the contract manufacturer and the brand owner. Banks themselves rarely have information about cases of contract production.

Taking into account the above arguments, a qualitative survey method was chosen - interviews. Interviews were conducted with 28 contract manufacturers operating in Eastern and Central Europe. These contract manufacturers are mostly SMEs, many of them are family businesses, and the companies are not listed on stock exchanges. The customers of these contract manufacturers, mostly international companies listed on stock exchanges, are among the market leaders in certain industries. Among the investigated companies were representatives from the clothing industry, the pharmaceutical industry, the furniture industry, the metal products industry, and the wood products industry. Contract manufacturers were interviewed about the most common payment methods and risks arising from the transaction between the brand owner and the contract manufacturer. The results of the interviews made it possible to supplement the classical complex of international trade payment methods by including the case of contract manufacturing.

4. Research Results and an Improved Set of Payment Methods

The research revealed that contract manufacturing can be any of the five payment methods described in Chapter 2, but contract manufacturing has several important differences compared to a traditional exporter producing own-brand products. In the case of contract manufacturing, profit margins are usually lower than those of a traditional manufacturer of own-brand products. This is because the value of contract manufacturing is the highest profit in the entire value chain for the product creator and brand owner and for distribution and sales. In the absence of large profit margins, contract manufacturers focus on economies of scale and aim for the largest possible production volumes. However, a contract manufacturer often serves more than one customer. For example, during the interview, representatives of the pharmaceutical industry, representatives of the clothing

industry revealed that production plans are made several months to years in advance, and the customers are quite diverse. Customers who are brand owners usually order production in batches. More specific examples would be brand owners in Switzerland who contract fruit production in Poland or Slovakia. A clothing brand in Spain orders contract manufacturing in Lithuania or Ukraine. A clothing brand in Italy outsources contract manufacturing in Bangladesh. A US car manufacturer outsources the production of an auto part to Mexico. In any case of the above examples, the contract manufacturer has to purchase raw materials before starting production. Of course, there are different cases of vertical integration. Some contract manufacturers have equity ties with the brand owner, but there are quite a few cases in the market where contract manufacturers operate independently. Thus, before starting production, the contract manufacturer assumes a certain risk when purchasing raw materials. Most often, the risk manifests itself in the fact that if the customer refuses to buy the ordered production from the contract manufacturer, the contract manufacturer will not have the opportunity to sell it himself. Intellectual property rights limit this possibility for the contract manufacturer. Only the trademark owner has the right to distribute the goods produced by him, or that the trademark owner will grant such rights.

During the interview, the companies, who did not want to name themselves, revealed the problem of refusing to buy the product from the contract manufacturer. In such cases,

contract manufacturers incur both the costs of the production process and the costs of purchasing raw materials, but the income from the order is equal to zero. In the market, there are also cases of selling goods on the black market, when the contract manufacturer cannot officially sell the manufactured goods. Such cases often occur with contract manufacturers located in Asian countries. It is not uncommon for well-known brands that end up on the black market to be manufactured on the same contract manufacturer's equipment as the officially traded goods. This case is considered a violation of the law, and the offenders are subject to criminal liability. However, this method does not benefit either the contract manufacturer or the brand owner.

The reluctance of the brand owner to buy the product when the contract manufacturer has produced it has several reasons. One of the cases may be the brand owner's dissatisfaction with the quality of the manufactured product. When an importer buys a ready-made product, he can make sure of the quality of the product and take samples before buying. However, if an importer orders a contract manufacturer to produce the product, an importer can only trust that the produced product will meet the quality standards and requirements. Thus, we have a case where an importer buys something that the manufacturer has not yet produced and, in most cases, the raw materials for which have not even been purchased.

In this case, the most common method of deduction is pre-production partial financing.

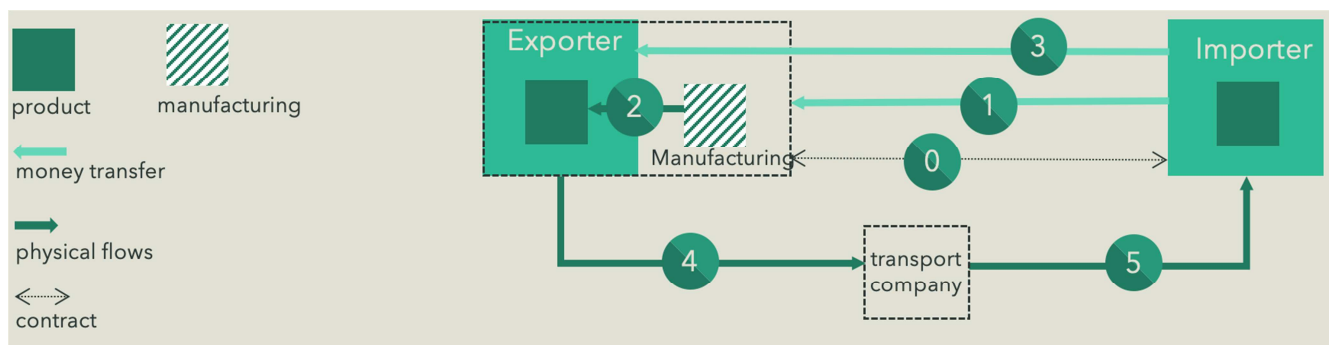


Figure 7. Manufacturing pre-payment.

This method of payment (Figure 7), as revealed by the interview, has been used in the case of contact production quite widely for three decades, but it is not included in the classical model of the variety of payment methods in international trade. Under this method, an exporter and importer sign a contract manufacturing agreement (0). Under this contract, an importer pays an advance fee to an exporter before the start of production (1). The amount of this advance payment can be negotiated differently between an exporter and an importer. For example, there may be a case where an importer pays the full value of the raw materials in advance. In this case, the manufacturer risks only the costs of the production process itself. Another case is when a percentage of the price of the exported product is agreed, for example 50 percent. An advance payment made by an importer in advance

is important evidence of an importer's intention to purchase the entire production.

After producing the products, an exporter usually demands payment for the entire production (3) and only then sends the goods (4-5). In this business model, an exporter, since he has small profit margins, in most cases seeks to reduce business risk and not apply the open account method, although there are cases of collection of letters of credit or documents for the export of already manufactured products.

Due to the popularity of contract manufacturing, and the payment method characteristic of it, it can be classified as a conceptual payment method. Although this payment method is essentially an addition to the prepayment method, payment before the production of the product is still quite a significant differentiator than simply prepayment for the product.



Figure 8. Contemporary complex of international trade payments methods.

In the modern complex of international trade payment methods (Figure 8), risks are distributed similarly to the classic one. Exporters have the lowest risk in the case of payment at the start of production, while importers have the highest risk. In fact, this amount of risk for importers is greater than in the case of prepayment for already manufactured goods, because next to an exporter's reliability and transport risk, there is a production risk.

5. Conclusions and Insights for Further Discussion

The literature analysis showed that the most common methods of international trade are advance payment, letter of credit, collection of documents, open account and consignment. All these methods are applied depending on the relationship between an exporter and an importer, on their mutual trust, and the duration of the cooperation experience. In a post-Fordist society and with the development of globalization, the added value of production has declined relative to the value of product creation and branding. Brand owners increasingly began to subcontract production to contract manufacturers. The additional risk of production and procurement of raw materials arising from cases of contract manufacturing led to the spread of another method of payment for international trade. Importers often pay the contract manufacturer before production begins, and these amounts depend on the value of the raw materials purchased by the manufacturer.

The research presented in the article is qualitative in nature and is limited to the opinions of a small number of managers in a few industries. Payment methods are commercially sensitive information, so neither importers nor exporters are willing to openly provide their details and company names. However, it would make a lot of sense to estimate the proportions of different payment methods in different industries and regions. This study reflects the opinions of more contract manufacturers and exporters operating in Eastern Europe, but different research results are possible in other continents due to differences in culture and business financing ecosystems.

References

- [1] Mariassunta Giannetti, Mike Burkart, and Tore Ellingsen (2011) "What You Sell is What You Lend? Explaining Trade Credit Contracts", *Review of Financial Studies*, 24 (4), p. 1261–1298. doi: 10.1093/rfs/hhn096.
- [2] Helga Kristjansdottir, Þ. Ö. Guðlaugsson, Svala Guðmundsdóttir and Gylfi Dalman Aðalsteinsson, (2017). Hofstede national culture and international trade. *Applied Economics*, 49 (51), p. 5792–5801. doi: 10.1080/00036846.2017.1343446.
- [3] Ricahrd M. Steers, Carlos J. Sanchez-Runde, Luciara Nardon, (2010) *Management across cultures, challenges, and strategies*. New York: Cambridge University Press.
- [4] 04 Vincente Cuna (2007). Suppliers as Debt Collectors and Insurance Providers. *Review of Financial Studies*, 20, p. 491–527. doi: 10.1093/rfs/hhl015.
- [5] Rodrigue, J-P (ed) (2020), *The Geography of Transport Systems*, New York: Routledge.
- [6] The International Trade Administration, U.S. Department of Commerce. Methods of Payment. Available at <https://www.trade.gov/methods-payment>
- [7] AliExpress, Available at <https://seller.alibaba.com/businessblogs/pkxkp76iz-a-guide-to-payment-methods-in-international-trade>
- [8] OSCORE Association through a Cooperative Agreement with the U.S. Small Business Administration. Available at <https://www.score.org/resource/blog-post/choosing-international-terms-payment-your-business>
- [9] The Institute of Export and International Trade. Methods of Payment. Available at https://www.export.org.uk/page/Methods_of_Payment
- [10] 10 Richard Baldwin, and Javier Lopez-Gonzalez, (2015). Supply-chain trade: A portrait of global patterns and several testable hypotheses. *The World Economy*, 38 (11), p. 1682–1721. doi: 10.1111/twec.12189.
- [11] Ronald W. Cotterill, William P. Putsis and Ravi Dhar, (2000). Assessing the Competitive Interaction between Private Labels and National Brands. *The Journal of Business*, 73 (1), p. 109–137. doi: 10.1086/209634.

- [12] Yongjiang Shi, and Mike Gregory, (2003). From Original Equipment Manufacturers to Total Solution Providers: an emergence of Global Manufacturing Virtual Network in electronics industry. *International Journal of Service Technology and Management*, 4 (4-6), p 331–346. doi: 10.1504/IJSTM.2003.003619.
- [13] Pol Antràs and David Chor, (2013). Organizing the global value chain. *Econometrica*, 81 (6), p. 2127–2204. doi: 10.3982/ECTA10813.
- [14] Cuong Nguyen, Dung Dinh and Thanh Doan, (2018). The determinants of the choices of payment methods for goods and services transaction in Vietnam. *International Journal of Applied Science*, 1 (2), p. 84–92. doi: 10.30560/ijas.v1n2p84.
- [15] Rhys Bollen, (2007). The history and operation of international payment system. *Journal of Banking and Finance Law and Practice*, 18 (27), p. 1–33. Available at SSRN: <https://ssrn.com/abstract=1756074>
- [16] Kathleen P. Fuller and Michael B. Glatzer, (2003). Method-of-payment choice for international targets. *Advances in Financial Economics*, 8, p. 47–64. doi: 10.1016/S1569-3732(03)08003-4.
- [17] Andreas Hoefele, Tim Schmidt-Eisenlohr and Zhihong Yu, (2016). Payment choice in international trade: Theory and evidence from cross-country firm-level data. *Canadian Journal of Economics*, 49 (1), p. 296–319. doi: 10.1111/caje.12198.
- [18] Kemal Türkcan, (2016). Evolving Patterns of Payment Methods in Turkish Foreign Trade. *World Journal of Applied Economics* 2 (1): 3-29. doi: 10.22440/EconWorld.J.2016.2.1.KT.0015.
- [19] Sangyeon Hwang and Hyejoon Im, (2019). Why did the terms of payment in international trade change so much? *Applied Economics Letters*, 26 (7), p. 576-581. doi: 10.1080/13504851.2018.1488042.
- [20] Ngoc Thang Doan, Thi Kim Chi Vu, Thi Cam Thuy Nguyen, Thi Hong Hai Nguyen, and Kieu Trang Nguyen, (2020). Cash-in-advance, export decision and financial constraints: Evidence from cross-country firm-level data. *International Review of Economics & Finance* 69 (4) p. 75–92. doi: 10.1016/j.iref.2020.04.013.
- [21] International Chamber of Commerce, (2020). Incoterms 2020 – International Commerce Terms.
- [22] Udo Milkau, (2019). International payments: Current alternatives and their drivers. *Journal of Payments Strategy and Systems*, 13 (3), p. 201–216.
- [23] Hashim, Rosmawani Che, Ahmad Azam Othman, and Akhtarzaite Abdul Aziz, (2012). Principle of Autonomy in Letter of Credit: Malaysian Practice. *IJUM Law Journal* 19, p. 201–42. doi: 10.31436/ijumlj.v19i2.9.
- [24] Hamed Alavi, (2016). Mitigating the risk of fraud in documentary letters of credit. *Baltic Journal of European Studies*, 6 (1), p. 139–156. doi: 10.1515/bjes-2016-0006.
- [25] Harald Badinger and Thomas Url, (2013). Export Credit Guarantees and Export Performance: Evidence from Austrian Firm-Level Data. *The World Economy*, 36, 1115–1130. doi: 10.1111/twec.12085.
- [26] Banu Demir (2014). Trade Financing: Challenges for Developing-country Exporters. *CESifo Forum*, 15 (3), 2014, p. 34–38.
- [27] Vicente Cunat, (2007), Trade credit: suppliers as debt collectors and insurance providers. *Review of Financial Studies*, 20, p. 491–527. doi: 10.1093/rfs/hhl015.
- [28] Ying Zhang, (2003). Documentary letter of credit fraud risk management. *Journal of Financial Crime*, 19 (4), p. 343–354. doi: 10.1108/13590791211266340.
- [29] Leora Klapper, Lu Laeven, and Raghuram Rajan, (2012). Trade Credit Contracts. *Review of Financial Studies*, 25 (3), p. 838-867. doi.org/10.1093/rfs/hhr122.
- [30] Simona Mateut, and Piercarlo Zanchettin, (2013). Credit Sales and Advance Payments: Substitutes or Complements? *Economics Letters*, 118 (1), 173-176. doi: 10.1016/j.econlet.2012.10.020.
- [31] Kemal Turkcan, (2015) Evolving patterns of payment methods in Turkish foreign trade. *World Journal of Applied Economics*, 65410, p. 1–67. doi: 10.22440/EconWorld.J.2016.2.1.KT.0015.
- [32] Van Tien Nguyen and Ngoc Thang Doan, (2022). Open account, import decision and financial constraints: A cross-country firm-level study. *International Journal of Finance & Economics*, 27 (1), p. 1–20. doi: 10.1002/ijfe.2628.
- [33] Gene M. Grossman, and Esteban Rossi-Hansberg, (2008). Trading tasks: A simple theory of offshoring. *American Economic Review*, 98, p. 1978–1997. doi: 10.1257/aer.98.5.1978.
- [34] Susan Spiggle, Hang T. Nguyen, and Mary Caravella, (2012). More than fit: Brand extension authenticity. *Journal of Marketing Research*, 49, (6), p. 967–983.
- [35] Fiona Scott-Morton, and Florian Zettelmeyer, (2004). The Strategic Positioning of Store Brands in Retailer-Manufacturer Negotiations. *Review of Industrial Organization*, 24, 161–194. doi: org/10.1023/B:REIO.0000033350.25229.d6.
- [36] Armando Rungi and Davide Del Prete, (2018). The smile curve at the firm level: Where value is added along supply chains. *Economics Letters*, 164 p. 38–42. doi: 10.1016/j.econlet.2017.12.038.
- [37] Laurence Carsana, & Alain Jolibert, (2018). Influence of iconic, indexical cues, and brand schematicity on perceived authenticity dimensions of private-label brands. *Journal of Retailing and Consumer Service*, 40, p. 213–220. doi: 10.1016/j.jretconser.2017.10.006.