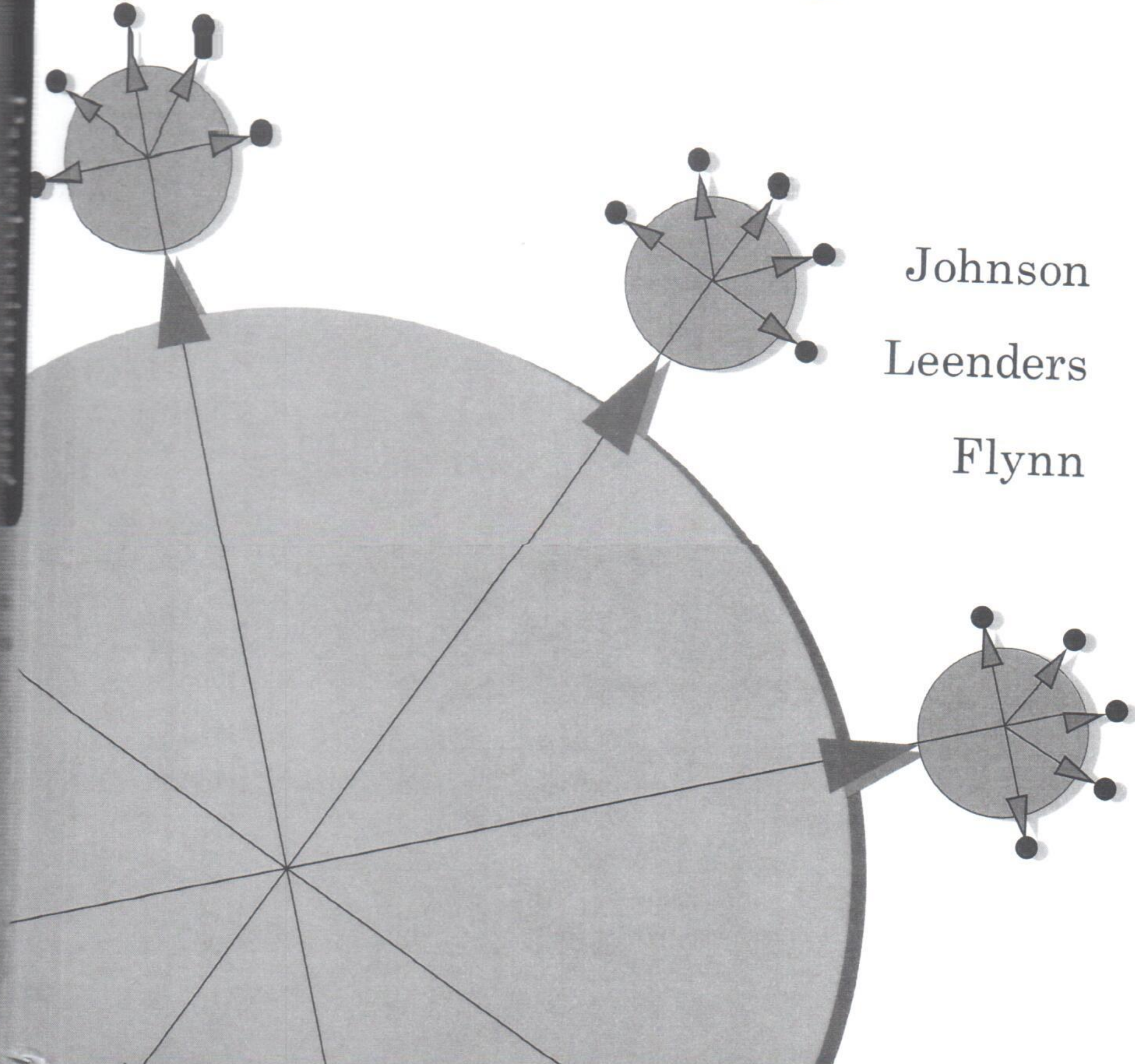
Fourteenth Edition

Purchasing *and* Supply Management



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Global Supply Management

Chapter Outline

that 21 percent of respondents were increasing sourcing outside North America, while only 9 percent were in 2009.[2] Over 50 percent of respondents to a Purchasing Bizconnect poll at the end of 2009 reported more nearshoring (sourcing offshore, but in closer proximity). Only 28 percent reported low-cost country sourcing as a growth strategy coming out of the recession.[3]

The total value of world merchandise imports in 2008 was $16.4 trillion. World merchandise includes agricultural products, fuels and mining products, and manufactures. Ten countries accounted for 50.7 percent of world merchandise exports. These were, in rank order, Germany, China, United States, Japan, Netherlands, France, Italy, Belgium, Russian Federation, and United Kingdom. Nine countries accounted for 49.9 percent of world merchandise imports. These were, in rank order, the United States, Germany, China, Japan, France, United Kingdom, Netherlands, Italy, and Belgium. In 2008 China overtook Germany as the leading exporter of manufactured goods (not total merchandise exports).

However, international trade is not restricted to goods alone. World commercial services imports in 2008, such as transportation, construction, communications, computer and information, insurance, and financial services, were $3.5 trillion. Nine countries accounted for 49.4 percent of commercial services exports in 2008. These were the United States, United Kingdom, Germany, France, China, Japan, Spain, Italy, and India. The EU and the United States accounted for 60 percent of world exports of commercial services. Ten countries accounted for 49.9 percent of commercial services imports in 2008. These were the United States, Germany, United Kingdom, Japan, China, France, Italy, Ireland, Spain, and the Republic of Korea.

The total value of U.S. merchandise imports in 2008 was $2.1 trillion. The bulk of U.S. imports came from Asia (35.1 percent), North America (25.8 percent), and Europe (18.9 percent.) The largest trading partners were the EU 27 (17.4 percent), China (16.4), Canada (15.6), Mexico (10.1), and Japan (6.6). As of October 2009, the top 10 countries with which the United States trades (imports and exports combined) are: Canada, China, Mexico, Japan, Federal Republic of Germany, the U.K., South Korea, France, Taiwan, and Brazil. These countries represent 67.78 percent of U.S. imports, and 61.37 percent of U.S. exports in goods.[4]

The total value of U.S. commercial services trade in 2008 was $368 billion.

Reasons for Global Purchasing

The reasons for sourcing from other countries are many and vary with the specific requirement. However, the underlying summary reason for using an offshore supplier is that better value is perceived to be available from that source than from a domestic one. A supplier's ability to be competitive is influenced by the overall competitiveness of the country. Therefore, embarking on a global sourcing strategy requires a level of country knowledge and analysis beyond that for a domestic supplier.

[2] "Global Purchasing Survey," *Purchasing,* May 18, 2009.

[3] D. Hannon, "Supply Trends Have Buyers Sourcing Closer to Home," *Purchasing,* December 17, 2009.

[4] U.S. Census, http://www.census.gov/foreign-trade/top/dst/current/balance.html. (Unless otherwise noted, all the data in this section came from the World Trade Organization, *International Trade Statistics 2009,* available online at www.wto.org).

The specific factor that makes the international buy look attractive will vary (technological know-how can shift from one country to another over time; the ability and willingness to control quality can change; and, from time to time, a stronger U.S. dollar makes the price of offshore goods more attractive). There are at least 10 specific reasons that may cause an offshore supplier to be selected as the preferred source.

1. Unavailability of Items Domestically

The first and oldest reason for international trade has been that domestic sources were unavailable. For example, cocoa and coffee, certain spices and fruits, chrome, and palladium are available only from certain countries.

As comparative economic advantage shifts, the location of manufactured products shifts. For example, the United States no longer manufactures televisions, and 90 percent of footwear is imported compared to only 2 percent in the 1960s. The manufacture of electronics parts, audio and telecommunications equipment, and computer and office equipment has moved from Japan and South Korea as manufacturers set up facilities in lower-cost countries or outsource to contract manufacturers in these countries.

Many global supply chains include numerous tasks. Intermediate unfinished goods often cross borders several times before final assembly. The World Trade Organization reports increasing trade in intermediate goods. Consequently, for many organizations, global supply has become a necessity.

2. Price and Total Cost

Most studies show that the ability of an offshore supplier to deliver product in the United States or Canada at a lower overall cost than domestic suppliers is a key reason to buy globally. While it may seem surprising that an offshore supplier can produce and ship an item several thousand miles at lower cost, there are several reasons why this may be the case for a specific commodity.

A. The *labor costs for manufacturing* offshore may be substantially lower than domestically. Many manufacturers in North America, Japan, and Korea have found that wage rate differences are great enough to offset other costs associated with offshore sourcing. Many manufacturers have either set up manufacturing facilities in lower-cost countries or outsourced to contract manufacturers.

Historically, manufacturers have chased low labor costs. When the export-led growth in Japan drove up wage rates for low-end, labor-intensive sources, the operations move to Korea and Taiwan, and from there to Southeast Asia and, more recently, the coastal provinces of China. As wage rates increase in coastal China, movement is into the interior of China or lower-cost countries such as Vietnam. And, as the gap closes between wage rates in China and Mexico, the closer proximity of Mexico to end product consumers means the lower shipping costs outstrip the lower Chinese wages. However, when evaluating labor costs, factors such as productivity and quality also must be taken into account.

For example, by the end of 2008 the 20 percent appreciation of China's currency against the dollar, plus the increase in the cost of freight and labor compared to a 20 percent drop in the value of the peso against the U.S. dollar, made Mexico a more attractive location than China for manufacturing for the United States. Cost drivers, including currency value and exchange rates, the cost of freight (largely influenced by fuel costs), and labor rates will continue to influence decisions about locating manufacturing. Chinese labor costs are about half of Mexico's—$1.69 per hour, on average, in 2007, compared to $3.46 per hour, according to the International Labor Organization (ILO). Estimates are that in another year or two hiring a Chinese worker will cost about 85 percent of what it costs to hire a Mexican worker.[5]

The *labor costs for services* also may be substantially lower in countries outside of North America, Western Europe, Japan, and Korea. Highly educated and capable professionals including lawyers, doctors, software developers, engineers, and professors reside in lower-cost countries. Enabled by technology, many buying organizations are outsourcing (buying instead of making in-house) and offshoring (sourcing from nondomestic suppliers) professional services.

For example, professional services that may be outsourced and offshored include legal research to India; medical services such as transcription, billing, coding, and insurance claims processing to India; interpretation of medical tests to radiologists in India or Australia; and software development to India, China, and Uruguay. Some services are multisourced and multishored to ensure coverage 24 hours a day, 7 days a week, 365 days a year.

B. The *exchange rate* may favor buying offshore. When the U.S. dollar gets progressively stronger, as was the case in the late 1990s, it effectively reduces the selling price of products bought from offshore suppliers. A weakened dollar makes imports more expensive and less attractive.

C. The *equipment and processes* used by the international supplier may be more efficient than those used by domestic suppliers. This may be because their equipment is newer or because they have been putting a greater share of their gross domestic product into capital investment. A good example of this is the steel industry in the Far East.

   A more recent example is Korean dominance in the dynamic random access memory (DRAM) market. With increasing Taiwanese and Chinese sales growth, other memory suppliers are forming alliances to compete. Because there are many more Taiwanese and Chinese companies that can invest in such a capital-intensive industry, Korean manufacturers may have difficulty maintaining long-term leadership despite superior technology and operational excellence.

D. The international supplier may be concentrating on certain *products, and pricing* export products at particularly attractive levels to gain volume. One practice is dumping which occurs when a product is sold in another country for less than either (a) the price in the domestic market, or (b) the cost to make the product. Dumping is illegal in some countries for certain products because the government wants to protect the domestic producer from what is perceived as unfair competition. While there are many attempts to prevent dumping practices, control of this is complex and has never been particularly effective. Some countries and regions have developed infrastructures and supply networks that support the efficient production of certain goods; for example, integrated circuits, computers, and computer parts in Malaysia; jewelry in Italy; clothes and shoes in China; and wire and cable assemblies in Mexico.

   Industry clusters may develop in a country. For example, the Monterrey, Mexico, industrial cluster has attracted many of the world's top manufacturers of industrial, commercial, and home refrigeration, heating, and air-conditioning equipment. LG has been there since 1988. It has also attracted parts and components suppliers. The largest producer of precision copper tube, China's Golden Dragon Precise Copper Tube Group,

[5] H. L. Sirkin, "Mexico: A Better Choice Than China? *Businessweek,* March 13, 2009.

third-party ones. This expedites cross-border trade and reduces or eliminates the time and cost of shipping and warehousing paper files.

Also, a Global Trade Management (GTM) IT system enables a virtual network of partners including suppliers and government agencies. A GTM speeds up compliance requirements such as product screening and foreign trade zone support. They enable faster information gathering and more data transparency. With the availability of Software as a Service (SaaS), these solutions are more affordable (See Chapter 4.)

6. *Better Technical Service*

If the offshore supplier has a well-organized distribution network in North America, better supply of parts, warranty service, and technical advice may be available than from domestic suppliers.

7. *Technology*

Increasingly, as domestic and offshore organizations specialize, technological know-how in specific lines varies. Particularly in the case of capital equipment, such as for the primary metals industry (steel and aluminum), offshore suppliers may be more advanced technologically than their North American counterparts.

On the services side, communications technology advancements and the availability of technologically sophisticated workers at lower wage rates than their domestic counterparts make offshoring attractive for software development, engineering and accounting services, technical support, customer support center operations, and some legal and medical services. For example, India has advantages in industries that rely on *soft* infrastructure (intangible assets) and excels at software and biotechnology.

Often governments encourage the development of *technology clusters or corridors*. Both India and China do this, but in different ways. These areas attract investment and create employment. They may include co-located science or business parks as well as colleges or training centers. They become magnets for outsourced IT work that can lead to overstressed infrastructure, escalating real estate costs, and a shortage of skilled IT professionals.

8. *Marketing Tool*

To sell domestically—made products in certain countries, it may be necessary to agree to purchase specified dollar amounts from suppliers in those countries. (See countertrade later in this chapter.)

9. *Tie-in with Offshore Subsidiaries*

Many firms operate manufacturing, distribution, or natural resource-based companies in other countries. A conscious decision may be made, particularly in the case of emerging markets and the least-developed economies, to support the local economy by purchasing there for export to the home country.

10. *Competitive Clout*

Competition tends to pressure the domestic supplier to become more efficient, to the long-term benefit of both that supplier and the buyer. Purchasers use imports or the threat of imports as a lever to pressure concessions from domestic suppliers.

2. Lead Time and Delivery

Improvements in transportation and communications have reduced the lead time for offshore purchases. However, there are four areas in which the buyer should anticipate additional lead time:

A. Establishing credit for a first-time international buyer often involves obtaining a letter of credit, which is a document that assures payment.

B. Even with improvements in transportation, the buyer may still experience delays, particularly with inland carriers in the foreign country.

C. Delays in domestic customs are also possible. Proper documentation and customs bonds help expedite shipments through customs. The customs bond allows goods to be released after inspection and lets the buyer pay duties later. Delays due to increased security or security-related emergencies should also be anticipated.

D. The time goods are in port, for both outbound and inbound, also depends on the number of ships in line for unloading and hours of port operations.

Selecting the mode of transport is an important decision in international sourcing because of long supply lines and greater risk of loss or damage. High-value, low-weight items may move by airfreight, and delivery time may be almost as short as from domestic suppliers. High-weight items that are costly to transport should move by ocean shipment. Lead time may be several weeks.

For high-bulk, high-weight, low-value commodities, such as steel, the buying firm must do a much longer-range planning job (which is possible in most firms) and must notify the offshore supplier promptly of any schedule changes. Also, the selection of the transportation carrier must be done with great care. To compensate for transport uncertainty, the buyer may insist that the supplier maintain a safety stock inventory in North America. Some type of performance bond also might be required.

Most large transportation services companies and international freight forwarders have information systems that allow shippers to track and trace shipments. Such information can be useful in inventory planning and can help identify potential problems, such as stockouts or production shortages.

3. Expediting

Because of distance, expediting an offshore supplier's production/shipment is more difficult. This places a premium on knowing a supplier's personnel and ensuring that they are responsive. Some firms also arrange to have an expediter on contract in the offshore country or to use personnel from a company-owned subsidiary closer to the supplier to assist with expediting problems.

4. Political, Labor, and Security Problems

Depending on the country in which the supplier is located, the risk of supply interruption due to governmental problems—for example, change in government or trade disputes—may be quite high.

The heightened risk of supply chain disruptions from terrorist acts, counterfeit goods, or unsafe products increases the time and cost of offshore sourcing. Every importer and exporter must have the knowledge and records about its products, where they were

For example, French electronics and media services company Thomson (known as the RCA brand in North America), which had its main operations in North America and Europe, relied heavily on suppliers in Asia. Given the large number of common requirements and suppliers, along with the geographical spread of manufacturing and laboratory facilities, the vice president of worldwide sourcing deemed it essential to increase the staffing of global commodity management. Therefore, a number of global commodity coordinators positions were created, each assigned worldwide responsibility for a specific group of common requirements.[10]

International Purchasing Office (IPO)

A third approach to global sourcing is the creation of international purchasing offices (IPOs). International purchasing offices can be focused on the basis of commodities, such as important raw materials, or on the basis of projects, such as large capital projects. Typically, IPOs are used when the company does not have a presence in the same geographic region where important suppliers are located. The logic of establishing IPOs is that the local presence of supply personnel can provide better access to suppliers and lower total costs. IPOs facilitate activities such as local sourcing and review, supplier development, materials management, quality control, and payment, and can employ local personnel thoroughly familiar with the language, culture, and way of doing business in that country or geographic area.

For example, when John Bradshaw became vice president of global procurement at Godiva Chocolatier in New York in 2007, he changed the name of purchasing to procurement and took the organization global. He assigned individuals to work in procurement in offices in regions where Godiva has operations—Brussels, Hong Kong, Tokyo, and Shanghai.[11]

Intermediaries

Should purchases be made direct from the supplier or through an intermediary? This depends on factors such as how much specialized international buying knowledge is available in the supply department and the volume and frequency of sourcing expected. Many firms use intermediaries for some or all of their global purchasing. The following list describes some of the options available.

Import brokers and agents. For a fee (usually a percentage of purchase value—and it can be as high as 25 percent), the broker or agent will assist in locating suppliers and handling required documentation. In most situations, title passes directly to the buying organization. The buyer, of course, must make sure the fee is reasonable with regard to the services performed.

Import merchant. The import merchant makes a contract with the buyer and then buys the product in its name from the foreign supplier, takes title, delivers to the place agreed on with the buyer, and then bills the buyer for the agreed-on price. Obviously, the buyer pays a fee (buried in the price paid) for the buying services provided.

[10] Ibid.

[11] S. Avery, "Godiva Transforms Purchasing into Global Procurement," *Purchasing*, January 14, 2010, http://www.purchasing.com/article/443489-Godiva_transforms_purchasing_into_global_procurement.php.

Seller's subsidiary. Purchasing from the North American subsidiary of an offshore supplier is a common approach. The subsidiaries provide the benefits of having a better location (right time zone), conducting business in English, and accepting payments in U.S. dollars. They also may provide credit terms.

Sales representatives. Some companies hire sales agents to represent them in various regions of the world. Typically, sales representatives handle low volume/value contracts and are paid a commission by the supplier that is included in the price of the goods.

Trading company. A trading company is typically a large firm that normally handles a wide spectrum of products from one or a limited number of countries. Trading companies are used extensively by Japanese firms to move products into North America. The advantages to the buyer of using a trading company are (1) convenience; (2) efficiency; (3) often lower costs, due to volume; (4) reduced lead times because it often maintains inventory in North America; and (5) greater assurance of the product meeting quality specifications because the trading company inspects in the producing country before shipment. But, as with any supplier, the buyer should assess the trading company carefully.

In global sourcing, the task of locating and evaluating potential suppliers, and selecting and managing chosen suppliers is more difficult than in domestic source selection. Also, decisions must be made about how to organize the supply process/function for efficient and effective global sourcing.

Information Sources for Locating and Evaluating Offshore Suppliers

Similar types of information sources are available to the global buyer as the domestic buyer. They are as follows:

1. The *Internet* can be used to gain access to Web sites for companies and government organizations. Most large and medium-sized companies have Web sites that describe their main products and services. Many governments have extensive Web sites that provide a variety of information, such as trade statistics and assistance for importing and exporting goods and services.

2. A number of *government sources* are available. The U.S. Department of Commerce can supply current lists of names and addresses of offshore suppliers, by general types of products produced. The district offices, located in most major U.S. cities, can be helpful in obtaining this information.

Almost all countries of the world maintain an embassy in Washington, D.C. The major industrial nations (and many of the lesser economically developed countries) maintain trade consulates in the United States and Canada (typically in Washington, D.C., or Ottawa, but many also have an office in other major cities, such as New York, Toronto, Miami, New Orleans, Chicago, San Francisco, or Los Angeles). Their role is to promote exports from their country so they will supply names of suppliers and background information.

3. The *chambers of commerce* located in major cities in the United States, Canada, and around the world will help buyers locate sources. The International Chamber of Commerce has contacts through its country branches around the world and will supply leads to possible sources.

4. Typically, the *supply department* of a company with experience in offshore sourcing is willing to share that information with other buyers, providing they are not direct competitors. The *local associations* of the Institute for Supply Management (ISM) and the Purchasing Management Association of Canada (PMAC) often can facilitate such an information exchange. The International Federation of Purchasing and Supply Management (IFPSM), made up of member nation associations, maintains a list of correspondents in many countries. These are buyers and supply managers who have agreed to supply to buyers in other nations information on suppliers in their own countries.

5. There are a variety of *supply chain partners* that can help locate sources. Current domestic suppliers often are in a position to supply information and leads on noncompetitive suppliers. Almost all major banks have an international trade department. In addition to supplying information on currency, payment, documentation procedures, and governmental approval procedures, a bank's international trade department can assist in locating potential sources.

Customers also can assist with locating international suppliers. This source of information can be especially useful when the customer also has international operations or markets for its products.

6. Every major industrial country has at least one *supplier locator directory*, similar to the commonly used *Thomas Register* for North American manufacturers. For example, *Kelly's Directory* publishes supplier locator directories for the United Kingdom as well as many of the countries in Europe, Africa, and Asia. Both *Thomas Register* and *Kelly* offer B2B search engines. The foreign trade consulate or embassy of any nation should be able to refer you to the appropriate directory for their country. Dun & Bradstreet (D&B) also has offices in many countries and can supply a D&B report on many firms.

7. *Importers and foreign trade brokers* stay informed about developments in the supply base of the countries with which they deal, and they can give the buyer a great deal of useful information.

The evaluation of a specific supplier's capabilities is more difficult than locating the supplier. Two key sources of evaluation information are the shared experiences of other supply people, which usually can be obtained simply by asking, and the supplier visit, which was discussed earlier in this chapter.

If a supplier visit is not made, the buyer should at least ask the potential supplier for information such as (1) a list of present and past North American customers, (2) payment procedures required, (3) banking reference, (4) facilities list, (5) memberships in quality specification-setting associations, and (6) basic business information, such as length of time in business, sales and assets, product lines, and ownership.

INCOTERMS

Shipping terms and responsibilities are more complex in international sourcing than in domestic transportation. The International Chamber of Commerce has created Incoterms (International Commercial Terms) as a uniform set of rules to clarify the costs, risks, and obligations of buyers and sellers in an international commercial transaction. Incoterms provide globally accepted definitions that avoid disputes over what the terms mean. They

Barter/Swaps

Barter involves the exchange of goods instead of cash. Typically, barter takes place when a country, which is short of hard currency, agrees to exchange its product for another country's product. This normally is a rather clean transaction, for the firms (countries) are exchanging equivalent dollar values. If goods of the same kind—for example, agricultural items or chemicals—are exchanged to save transportation costs, the arrangement is called a *swap*.

In a mixed barter, the seller ships product of a certain value—for example, motors—and agrees to take payment in a combination of cash and product—for example, wheat. It then is up to supply to resell the product for cash or to barter it to someone else. A commodity that changes hands twice is referred to as a *two-corner trade*. If it changes hands three times, it is a *three-corner deal*. Supply often gets involved in situations where working out the particular barters or swaps is both difficult and time consuming.

Offset Arrangements

Offsets are distinguished by the condition that one part of the countertrade be used to purchase government and/or military-related exports. Under these agreements, in order to make the sale, the selling company agrees to purchase a given percentage of the sales price in the customer country. The negotiation usually starts at 50 percent and then goes up or down from there. Whatever the figure agreed to, it then is up to supply to figure out how it can spend the specified amount for worthwhile goods or products. In some instances, the goods purchased later are resold, putting the supply department largely in the role of a trading company. Such resale occurs when supply cannot locate a supplier of suitable, needed merchandise in the customer country and simply makes a purchase of goods (that hopefully later will be salable) to complete the deal. Even if specific deals are unprofitable, firms engaging in countertrade usually are looking for long-term, meaningful, and mutually advantageous relationships with the other country.

When other countries buy North American–produced merchandise, they often push hard for offsets to gain access to technology, to get U.S. dollars, to increase employment, and/or to help maintain political stability by protecting jobs and domestic producers.

Counterpurchase

Counterpurchase agreements require the initial exporter to buy (or to find a buyer for) a specified value of goods (often stated as a percentage of the value of the original export) from the original importer during a specified time period.

Buyback/Compensation

In buyback agreements, the selling firm agrees to set up a producing plant in the buying country or to sell the country capital equipment and/or technology. The original seller then agrees to buy back a specified amount of what is produced by the plant, equipment, or technology. Buyback agreements can span 10 or more years.

Switch Trade

In switch trades, a third party applies its "credits" to a bilateral clearing arrangement. The credits are used to buy goods and/or services from the company or country in deficit. Usually a broker or trading house handles the switch.

Countertrade is used in situations where a country has a shortage of foreign exchange or a shortage of credit to finance its desired trade flows, wishes to diversify its foreign exchange earnings, or is encouraging the development of the domestic economy by promoting labor-intensive exports. The number of countries participating in countertrade has increased steadily and includes most of the United States' main trading partners, such as Canada, the United Kingdom, and China.

Although the U.S. government generally views countertrade as contrary to an open free-trading system, it does not oppose participation by U.S. companies. The Bureau of Industry and Security (BIS) reports annually to Congress on the impact of offsets in the defense trade on defense preparedness, industrial competitiveness, employment, and U.S. trade. U.S. firms entering into foreign defense sales contracts must report all offset transactions in excess of $5 million in contracts for the sale of defense articles or services, and offset transactions completed that were valued in excess of $250,000.

The exact value of international countertrade transactions is not known—secrecy surrounding the transactions typically prevents collection of these data. However, between 1993 and 2008, U.S. defense contractors reported entering into 677 offset agreements with 45 countries valued at $68.93 billion.[15]

Countertrade is also used in civilian government procurement projects, such as the sale of civilian aircraft, telecommunications, and technology systems. In the competitive global marketplace, the ability to meet countertrade requirements in a cost-effective manner offers a competitive advantage. Supply has a legitimate role in managing countertrade arrangements and should be involved early in the process. Supply can provide feedback on cost implications, the status of the countertrade market, sourcing information, and the availability of suppliers and identify opportunities for barter.

Unfortunately, supply is not always involved in the decision to engage in countertrade, but becomes involved after the decision has been made, at the stage where potential counterpurchases are being evaluated. Given the risks of countertrade—the possibility of poor-quality goods and services, the development of unprofitable deals, and the acceptance of goods and services that do not match marketing channels—the supply function should be consulted in the proposal evaluation stage.

Often, countertrade obligations present complex problems for supply managers. However, they may also provide the opportunity to develop lower-cost sources of supply in the world marketplace.

Because countertrade is a "way of life" for many supply professionals, several guidelines are suggested:

1. Decide whether countertrade is a viable alternative. If a company does not have the organization to do the international sourcing required, it should refuse to participate.
2. Build the cost of countertrade into the selling price.
3. Know the country—its government, politics, and regulations.
4. Know the products involved and what is available.
5. Know the countertrade negotiation process—offset percentage, penalties, and time period.

[15] U.S. Department of Commerce, Bureau of Industry and Security, *Offsets in Defense Trade, Fourteenth Study*, December 2009.

The Global Offset and Countertrade Association (G.O.C.A.) (formerly the American Countertrade Association—ACA) includes over 100 globally based companies engaged in countertrade and offset. The purpose of G.O.C.A. is to promote trade and commerce between companies and their foreign customers through a greater understanding of countertrade and offset. (www.globaloffset.org)

Foreign Trade Zones

Foreign trade zones (FTZ) are special commercial and industrial areas in or near ports of entry. Foreign and domestic merchandise, including raw materials, components, and finished goods, may be brought in without paying customs duties. FTZs are the U.S. version of what are known internationally as free trade zones. Merchandise brought into these zones may be stored, sold, exhibited, repacked, assembled, sorted, graded, cleaned, or otherwise manipulated prior to reexport or entry into the national customs territory.

U.S. FTZs are restricted-access sites in or near ports of entry. They are licensed by the Foreign Trade Zone Board and operate under the supervision of the U.S. Customs and Border Protection Service. Zones are operated under public utility principles to create and maintain employment by encouraging operations in the United States that might otherwise have been carried on abroad.

There are two categories of FTZs: general-purpose zones and subzones.

General purpose zones handle merchandise for many companies and are typically sponsored by a public agency or corporation, like a port authority.

Subzones are special-purpose zones, usually located at manufacturing plants. Subzones are usually preexisting manufacturing sites that operate under the guarantee of a local general-purpose site. There are no legal differences in the types of activities that can be undertaken at zones or subzones. According to government data, subzones accounted for approximately 89 percent of the $692 billion in activity in U.S. FTZs in 2008. This has been the pattern for 15 years. In 2008 there were 164 FTZs, with 254 facilities using subzone status.[16]

Each FTZ differs in character depending upon the functions performed in serving the pattern of trade peculiar to that trading area. The six major functions that may be conducted within a zone are

Manufacturing. Manufacturing involving foreign goods can be carried on in the zone area. Foreign goods can be mixed with domestic goods and, when imported, duties are payable only on that part of the product consisting of foreign goods. In some circumstances, the final assembled product may qualify for reduced duties, or might have no duties imposed if it has more than 50 percent U.S. content of labor or components. Such merchandise can be classified as "American made" for purposes of export under NAFTA. Besides reduced duties, there is a saving on interest, because duty payments are not due until the merchandise leaves the FTZ and enters the United States.

Transshipment. Goods may be stored, repacked, assembled, or otherwise manipulated while awaiting shipment to another port, without the payment of duty or posting a bond.

[16] U.S. Department of Commerce, *70th Annual Report of the Foreign-Trade Zones Board*, 2008.

North American Free Trade Agreement (NAFTA)

In 1994, the North American Free Trade Agreement (NAFTA) took effect for the United States, Canada, and Mexico to eliminate tariffs and nontariff barriers to trade. NAFTA created a free trade area of 444 million people producing $17 trillion worth of goods and services. Canada and Mexico are the two largest importers of U.S. exports and the second and third largest suppliers to the United States. Since the agreement, merchandise trade between the NAFTA countries has grown dramatically.

The final NAFTA provisions were implemented on January 1, 2008. To advance regional economic integration, member countries have to exercise their national autonomy, either individually or in concert. Actions that would build upon NAFTA are sometimes referred to as "NAFTA Plus" and include the possibility of creating a customs union, a free-trade area with a common set of external tariffs.

Currently, buyers must adhere to NAFTA's rules of origin. Goods that are wholly produced in the United States, Canada, or Mexico are classified as "originating goods" and are eligible for preferential reduced tariff rates. Other goods are taxed as if they were from any other country. Filling out and filing the certificate of origin is a major problem for many importers and a cost driver because of inconsistent and product-specific rules and documentation. Purchasers can file an annual blanket certificate if they anticipate buying the same goods more than once a year. Common external tariffs would enable the NAFTA countries to eliminate the agreement's rules of origin.[19]

The European Union (EU)

Efforts to increase cooperation economically and politically began in Europe after World War II. In 1993 four freedoms were agreed to: freedom of movement of goods, services, people, and money. In 2002, the euro became the sole currency of the EU member states allowing easier price comparisons and lower foreign currency transaction costs. Currently the debate is over whether or not a European constitution is needed, and if so, what form it should take.

As of January 2010, the EU included 27 member states, 23 official and working languages, and a total population of more than 500 million people.[20]

ASEAN

The Association of South East Asian Nations (ASEAN) was established in 1967. Today it includes 10 South East Asian countries (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Burma/Myanmar, Philippines, Singapore, Thailand, and Vietnam). The ASEAN Free Trade Area (AFTA) was created in January 1992 to eliminate tariff barriers and with a view to integrate the ASEAN economies into a single production base creating a regional market of 500 million people.[21]

Mercosur

Mercosur was established in 1991 and encompasses Argentina, Brazil, Paraguay, and Uruguay in a customs union. As of January 2010, Venezuela's request for membership still

[19] http://www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta

[20] www.europa.eu

[21] www.aseansec.org

employing more than 1 million people, a source of $40 billion in Mexican exports.[18] With the North American Free Trade Agreement (NAFTA) eliminating North American trade barriers, the future of the maquiladora operations has been called into question. However, maquiladora operations are a critical and successful dimension of Mexico's economy.

Bonded Warehouses

Bonded warehouses are utilized for storing goods until duties are paid or goods are otherwise properly released. Ownership is approved by the Treasury Department. They are under bond or guarantee for the strict observance of the revenue laws of the United States. The purpose of bonded warehousing is to exempt the importer from paying duty on foreign commerce that will be reexported or to delay payment of duties until the owner moves the merchandise into the host country. Goods can be stored for three years. At the end of the period, if duty has not been paid, the government sells the goods at public auction.

All merchandise exported from bonded warehouses must be shipped in the original package unless special permission has been received from the collector of customs. Any manufacturing must be conducted under strict supervision and the resulting items must be reexported.

Temporary Importation Bond (TIB) and Duty Drawbacks

A temporary importation bond (TIB) permits certain classes of merchandise to be imported into the United States. These are articles not for sale, such as samples, or articles for sale on approval. A bond is required, usually for an amount equal to twice the estimated duty. While there is a fee for the TIB, the net effect is that no duty is paid on the merchandise, provided it is reexported. The TIB is valid for one year, with two one-year extensions possible. However, if the goods are not exported on time, the penalty can be twice the normal duty, which is why the TIB must be for twice the normal duty.

Duty drawback permits a refund of duties paid on imported materials that are exported later. The buyer enters into a duty drawback contract with the U.S. government, imports the material for manufacture, and pays the normal duty. If the final manufactured or processed product is exported within five years of import, duty drawback can be obtained. There are three main types of duty drawback: direct identification drawback, substitution drawback, and rejected merchandise drawback. Provisions for duty refunds differ slightly under each type.

REGIONAL TRADING AGREEMENTS

Efforts to eliminate trade barriers result in bilateral, regional, and global trade agreements. Supply managers should know who the major trading partners with their countries are, what trade agreements are in place, and what opportunities exist in emerging economic markets.

Several major regional trading agreements are described below. Data on trading patterns of the majority of the countries in the world or regional trading blocks are available from the World Trade Organization. The WTO hosts an interactive database of international trade statistics from 1948 to the present.

[18] *AlixPartners 2009 Manufacturing Outsourcing Cost Index™—Overview and Highlights,* May 2009, http://www.alixpartners.com/en/MediaCenter/News/tabid/56/language/en-US/ItemID/18/Default.aspx.

North American Free Trade Agreement (NAFTA)

In 1994, the North American Free Trade Agreement (NAFTA) took effect for the United States, Canada, and Mexico to eliminate tariffs and nontariff barriers to trade. NAFTA created a free trade area of 444 million people producing $17 trillion worth of goods and services. Canada and Mexico are the two largest importers of U.S. exports and the second and third largest suppliers to the United States. Since the agreement, merchandise trade between the NAFTA countries has grown dramatically.

The final NAFTA provisions were implemented on January 1, 2008. To advance regional economic integration, member countries have to exercise their national autonomy, either individually or in concert. Actions that would build upon NAFTA are sometimes referred to as "NAFTA Plus" and include the possibility of creating a customs union, a free-trade area with a common set of external tariffs.

Currently, buyers must adhere to NAFTA's rules of origin. Goods that are wholly produced in the United States, Canada, or Mexico are classified as "originating goods" and are eligible for preferential reduced tariff rates. Other goods are taxed as if they were from any other country. Filling out and filing the certificate of origin is a major problem for many importers and a cost driver because of inconsistent and product-specific rules and documentation. Purchasers can file an annual blanket certificate if they anticipate buying the same goods more than once a year. Common external tariffs would enable the NAFTA countries to eliminate the agreement's rules of origin.[19]

The European Union (EU)

Efforts to increase cooperation economically and politically began in Europe after World War II. In 1993 four freedoms were agreed to: freedom of movement of goods, services, people, and money. In 2002, the euro became the sole currency of the EU member states allowing easier price comparisons and lower foreign currency transaction costs. Currently the debate is over whether or not a European constitution is needed, and if so, what form it should take.

As of January 2010, the EU included 27 member states, 23 official and working languages, and a total population of more than 500 million people.[20]

ASEAN

The Association of South East Asian Nations (ASEAN) was established in 1967. Today includes 10 South East Asian countries (Brunei Darussalam, Cambodia, Indonesia, Lao Malaysia, Burma/Myanmar, Philippines, Singapore, Thailand, and Vietnam). The ASEA Free Trade Area (AFTA) was created in January 1992 to eliminate tariff barriers and w a view to integrate the ASEAN economies into a single production base creating a region market of 500 million people.[21]

Mercosur

Mercosur was established in 1991 and encompasses Argentina, Brazil, Paraguay, Uruguay in a customs union. As of January 2010, Venezuela's request for membership

[19] http://www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-

[20] www.europa.eu

[21] www.aseansec.org

needs ratification by Paraguay. As associate members, Bolivia, Chile, Colombia, Ecuador, and Peru can join free-trade agreements but are not part of the customs union. Often referred to as the Common Market of the South, Mercosur is four times as big as the EU in area, encompasses more than 250 million people, and accounts for more than three-quarters of the economic activity on the continent (2008 combined GDP of US$1.1 trillion).[22]

Andean Community

The Andean Community (Spanish: Comunidad Andina de Naciones or CAN) includes Bolivia, Colombia, Ecuador and Peru. CAN originated in 1969 with the ultimate aim to create a Latin American common market. A free trade area was established in 1993 and a common external customs tariff in 1994. CAN has a combined population of 98 million, and a GDP in 2008 of US$745.3 billion.

CAN and Mercosur, the two main South American trading blocs, agreed in 2008 to engage in negotiations to form the Union of South American Nations (USAN). CAN is also negotiating with the EU to obtain more favorable trading relations.[23]

The World Trade Organization (WTO)

The World Trade Organization (WTO) continues to play an important role in shaping world trade. Following the Uruguay Round of trade negotiations, the WTO was formed on January 1, 1995. It replaced the General Agreement on Trade and Tariffs (GATT), which had been in existence since 1947. The WTO is the international organization overseeing the multilateral trading system.

In 2010, the WTO had 153 member countries, which account for more than 90 percent of world trade. Its overriding objective is to help trade flow smoothly, freely, fairly, and predictably. The WTO accomplishes this objective by administering trade agreements, acting as a forum for trade negotiations, handling trade disputes, monitoring national trade policies, assisting developing countries in trade policy issues, and cooperating with other international organizations. While GATT dealt mainly with trade in goods, WTO also has new agreements on trade in services and intellectual property rights.[24]

EMERGING MARKETS

Although there is no common definition of an emerging market, generally speaking it refers to countries undergoing rapid economic change. By most accounts this category includes large economies such as the BRICs—Brazil, Russian Federation, India, and China. It also has been used to describe Vietnam, Thailand, Malaysia, Mexico, Indonesia, and South Africa as well as economies in Eastern Europe and Latin America.

According to Goldman Sachs, since 2007, the biggest emerging markets—Brazil, Russia, India, and China—have accounted for 45 percent of global growth, almost twice as much as in 2000–06 and three times as much as in the 1990s. These, and other emerging economies, represent huge opportunities for sourcing and supply management.

[22] www.mercosur.int
[23] www.comunidadandina.org
[24] www.wto.org

How does a supply manager identify and assess the risks and opportunities of any particular emerging market? What questions should be asked? and Where can the answers be found? One resource is the annual *Global Competitiveness Report* published by the World Economic Forum. The group defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. Every country is measured on 12 pillars of competitiveness: institutions, infrastructure, macroeconomic stability, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market sophistication, technological readiness, market size, business sophistication, and innovation.[25] Determining the risks and opportunities in a country requires a level of knowledge and analysis beyond what is required for domestic sourcing. Assessments in the *Global Competitiveness Report* may aid supply decision makers in identifying opportunities and risks in emerging economies.

Conclusion

In our global economy, it is nearly impossible for most companies to rely on the domestic supply base for 100 percent of purchased goods and services. For many organizations, global supply management has become a reality, as they are forced to seek out world-class suppliers to maintain their competitive position. The benefits of global procurement extend beyond simple price and cost advantages. Firms may purchase products and services abroad to gain access to better technology, secure items not available domestically, or purchase better-quality products.

While managing a global supply network can represent an important opportunity, it does provide a number of significant challenges. Consequently, the capability of managing global supply chains effectively can be a source of competitive advantage.

[25] K. Scwab, *The Global Competitiveness Report 2009–2010* (Geneva: World Economic Forum, 2009), pp. 17–20.

Questions for Review and Discussion

1. What are the factors/forces that have caused the increase in global trade? What changes do you think will occur in the next 10 years?
2. Why have North American firms become actively involved in global purchasing?
3. What do firms see as the principal advantages to be gained when they buy globally?
4. How can the buying firm minimize the problem areas connected with global buying? Which do you feel are most serious?
5. How can the buyer best get a list of potential international sources? Evaluate potential suppliers?
6. What are the pros and cons of buying direct versus using some form of intermediary?
7. What are the forms of countertrade, and what problems do they cause for the buyer? How can the buyer help make countertrade work?
8. How can the buyer make effective use of foreign trade zones?
9. What advantages are there for buyers affected by the North American Free Trade Agreement (NAFTA)? What is a certificate of origin? Why does the buyer need to be concerned with this?
10. What are Incoterms? What factors should be considered when selecting an Incoterm?