

The Role of Documentary Credit in the Financing of Foreign Trade: a Theoretical and Practical Approach

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Abstract:

The methods of financing international trade operation play an important role in the development of foreign trade. Therefore, our research objective is to answer the following problematic question: what is the role of documentary credit in the financing of foreign trade? To do this, we analyzed data taken from the Foreign Bank of Algeria. The results of our study show the importance of documentary credit in financing international trade operations in a global environment shaped by economic uncertainty, legal disparities, and geopolitical risks, this tool continues to be one of the most trusted and widely used instruments in cross-border business relationships.

Keywords: Documentary credit, FBA, international trade, financing trade, payment techniques

1. Introduction:

The field of international trade concerns the study of commercial transactions of goods and services between different countries. This process is associated with globalization and integration into a global market, characterized by the free movement of capital, services, goods, people, technology, and information between nations.

Countries' performance is driven by the contributions of their companies to global trade. Therefore, international trade finance plays an important role in the economic sphere.

International trade finance refers to the methods used to finance international trade. The objective is to reduce the risks associated with transactions that take place internationally. These risks are multiplied. In fact, there encountered country risk, including political risk (obstacles to the smooth running of trade), sovereign risks (default of payment of a country), and the risk of non-transfer linked to the liquidity crisis of countries. In addition, there is the systemic risk, which can be market risk linked to an unfavorable evolution of local interest rates, and inflation rates, which can be a systemic credit risk linked to the business world of the countries (G. LEGRAND & H.MARTINI, 2007).

International trade financing takes many forms, including documentary remittance and documentary credit. A documentary credit is a payment method that facilitates and secures international transactions. The importer or customer contacts their bank, and through a documentary credit, the bank undertakes to pay the price of the goods or services to a beneficiary (the exporter) within a specified period. This payment method is generally used when the transaction amounts are very large and the risk of non-payment is high.

In this study, we will examine documentary credit and its importance in the international trade financing process in detail. Therefore, we posed the following research question: What is the role of documentary credit in foreign trade financing?

To clarify the research question, we formulated the following secondary questions:

Q1: What are the different theories of foreign trade?

Q2: What is documentary credit and what are its different types?

Q3: How does documentary credit contribute to foreign trade financing?

To answer our questions, we formulated these research hypotheses:

H1: Since Adam Smith and his theory of absolute advantage, international trade theories have evolved, from theories of international trade based on technological disparities to the new theory of international trade focused on imperfect competition.

H2: A documentary credit is a document evidencing a payment commitment entered into by a buyer's bank with the seller. The different categories are classified according to the level of security, the method of execution, and the financing needs.

H3: In foreign trade financing, banks play a key role, whether they are issuing or advising banks. They are therefore key players in documentary credit.

To conduct this research, we will analyze data from the Algerian External Bank during the two years 2021 and 2022.

Our research plan is divided into three axes: first, we will present a theoretical overview of international trade, and we will present the different theories and the various international trade financing operations. Second, we will outline the concepts related to documentary credit through a presentation of its definition and its different types, the procedure for using documentary credit during an import transaction, and we will conclude this point with a presentation of the advantages and disadvantages of this payment technique. Third, we will study the data published in the annual reports of the Algerian External Bank during the two years 2021, 2022, and 2023 through the presentation and analysis of the main data recorded during this period and which are directly related to our research question.

2. Theoretical Overview of International Trade:

2.1. Theories of International Trade:

2.1.1. Theories of International Trade Based on Cost Differences:

2.1.1.1. Adam Smith and the Theory of Absolute Advantage:

International trade theory has played an important role in the evolution of international trade and the concept of developing trade between nations. Adam Smith had the merit of expanding the advantages of the division of labor and the specialization of tasks within the nation. He asserted that each country has an interest in

specializing in the production of the good for which it enjoys an absolute advantage, provided that it is obtained at a lower price than abroad.

2.1.1.2 Ricardo and the Theory of Comparative Advantage:

Adam Smith emphasized the "absolute benefits of specialization." David Ricardo reinforced this thesis by demonstrating, through his famous "Theory of Comparative Advantage," that a country can benefit from foreign trade even if it is at an absolute disadvantage in all goods.

2.1.1.3 Heckscher, Ohlin, and Samuelson (HOS) and Differences in Resource Endowments between Countries:

These economists based their theories of international trade on differences in resource endowments between countries and on the "relative abundance of a factor of production." According to HOS, "each country has a commodity-oriented production that makes intensive use of the factor with which it is well-endowed and tends to export it" (Rainelli, 2003).

2.1.2. International Trade Theories Based on Technological Differences

In these international trade theories, the technology sought is primarily linked to the elements that influence firms' production techniques. Technical advances, innovation, and research and development (R&D) are associated with this technology. The early 1960s saw the emergence of this theory, which took one of its best-known forms in the "product life cycle" theory described by Vernon R. (1966).

2.1.3. International Trade According to the New Theory

Based on critiques of traditional international trade theory, the foundations of the new theory were developed. The main distinction lies in the fact that the previous theory is based on perfect

competition, while the new theory uses the notions of imperfect competition.

Within the new theory, the explanation of international trade is based on two key elements: increasing returns to scale and product diversification. (Rainelli, 2003).

2.2. International Trade Finance

There are numerous financing methods for international trade transactions (imports and exports), and importers and exporters are looking for a solution that guarantees optimal payment security and speed. To ensure these transactions are carried out under optimal conditions, banks offer a variety of payment and financing methods that are increasingly tailored to the needs of various stakeholders.

2.2.1. Definition of International Trade Finance

International trade finance refers to all existing methods for financing international trade and reducing the risks associated with these transactions. An international transaction, whether for goods or services, brings together an importer and exporter, commercial banks, national export agencies, and financial institutions.

Trade finance refers to banking products that help companies manage their international payments and the associated risks when conducting cross-border trade transactions.

2.2.2. The importance of international trade finance

Trade finance plays two vital roles. First, it provides exporters and/or importers with the working capital needed for their international activities. Second, it mitigates the risk of non-payment associated with these international transactions. Indeed, it is risky for an exporter to ship their goods before payment, exposing them to the risk of non-payment by the importer. Furthermore, if an importer pays for goods before receiving them, they face the risk of non-delivery if the exporter encounters problems producing the goods or goes bankrupt. It is for these two main risks that international trade

transactions most often rely on external actors, such as banks, which can provide credit to finance these transactions, or insurers, which offer insurance against non-payment or non-delivery. (Henimann, 2016). It is, therefore, justified to use products involving intermediaries because of the delay between the signing of a commercial contract and the actual exchange of goods or services.

2.2.3 The different methods of financing international trade.

The development of international transactions has been facilitated by the use of financing instruments and guarantees that provide security for sellers and buyers.

It is essential to distinguish the difference between a payment instrument and a payment technique. Payment techniques refer to the procedures to be followed and executed to carry out an international trade financing transaction. A payment instrument, on the other hand, refers to the physical form that serves as a payment medium, whether physical, such as a check, or electronic transactions such as a bank transfer.

In our research, we will focus on payment techniques, which are divided into two types: documentary payment techniques (documentary credit, documentary collection) and non-documentary payment techniques (direct collection, cash on delivery, foreign account).

3. General Concepts of Documentary Credit:

Documentary credit, a method recognized for its unparalleled reliability, offers assurance to both exporters and importers. Although other payment options exist, such as documentary collection or free transfer, they are generally adopted when trust between the parties is established.

3.1. Definition of Documentary Credit

A documentary credit is an agreement by which an ordering party (buyer) requests its bank to make available to a person it designates (supplier), through a bank, a sum of a specified amount. The exporter

(supplier) may benefit from this sum if they provide proof that they have properly shipped the goods (submission of a transport document, e.g., bill of lading) and have met a number of conditions (submission of various other documents such as a certificate of origin, insurance, etc.) (guide RUU 600).

Documentary credit is governed by the Uniform Customs and Practices (UCP) of the International Chamber of Commerce, which is recognized and applied worldwide. The latest version of which came into force on July 1, 2007. (Teulie & Topsacalian, 1997). Therefore, it is a payment commitment made by the issuing bank at the request of an ordering party, the buyer, in favor of a beneficiary, the seller.

3.2. The Different Types of Documentary Credit (Letter of Credit)

There are, of course, different types of letters of credit to suit different situations. Each letter of credit is a combination of the following three characteristics (Documentary Letters of Credit, A Practical Guide.):

- A letter of credit can be sight or term. If it is sight, it allows the beneficiary to be paid immediately upon presentation of the documents. If it is term, the payment date is later and pre-established in the sales contract.
- It can be revocable or irrevocable. If it is revocable, it can be canceled by the issuing bank without notice to the beneficiary. If it is irrevocable, it cannot be canceled without the beneficiary's consent.
- It can be confirmed or unconfirmed. A letter of credit will be confirmed if the advising bank (the seller's) confirms that all the documents accompanying the letter of credit are in order. Since this bank is usually located in the beneficiary's country, the beneficiary will be reassured by having a second guarantee from a bank they know.

According to Chehrit (2007), Documentary credit is divided into three types.

- Depending on the degree of security, or the degree of trust between the trading partners: There is a revocable documentary credit, characterized by the fact that the buyer has the option to cancel this type of credit any time through their bank and without notifying the beneficiary. There is never any guarantee of payment. This type of credit is, therefore, more beneficial to the buyer than to the supplier. There is also an irrevocable documentary credit, where the issuing banker cannot renounce their commitment to the beneficiary and the intermediary bank, while the originator cannot revoke or cancel their order.
- According to the method of implementation: After receiving the credit notification from his bank, the exporter proceeds with the preparation and shipment of the goods. He obtains the transport document, as well as the supporting documents requested by the importer, then draws up the final invoice in accordance with the terms of purchase stipulated in the contract. After having prepared all the documents, the exporter submits them to his bank in accordance with the opening conditions for obtaining the credit.
- Depending on the financing method: In international trade, it is common for the exporter not to be the producer or provider of the exported goods and services, but rather a trading company or business that purchases or subcontracts products and services for resale. Furthermore, in this type of trade, transferable documentary credits and restart clauses, which are derived from "traditional" documentary credit, address a major concern regarding the financing of this type of trade.

3.3 The Steps Involved in an Import Transaction Using a Documentary Credit

Regarding the procedure for a transaction carried out using a letter of credit, the first step is obviously the signing of the sales contract between the importer and the exporter. Next, the buyer

submits a letter of credit request to their bank (issuing), which then requests the seller's bank (advising) to notify their client of the letter of credit request. After this step, the advising bank then sends the L/C to their client, notifying them that it has no liability in this regard unless the latter has agreed to confirm the letter of credit.

Subsequently, after receiving the letter of credit, the seller must verify that all the accompanying terms are acceptable to them. If not, they have the option to request changes from the buyer. Once satisfied, they ship the goods. He then takes care of preparing all the necessary documents (description of goods, invoicing, proof of shipment, etc.) and sends them to his (notifying) bank.

After comparing the documents with the letter of credit, the bank sends the documents to the issuing bank and requests payment for the goods, and then pays its customer (the seller). The documents are checked again by the issuing bank, which sends them to its customer (the buyer) in exchange for payment for the goods or a promise to pay on the due date. Obviously, this payment is transferred by the issuing bank to the advising bank.

3.4 Advantages and Disadvantages of Using a Letter of Credit in Foreign Trade Financing

3.4.1 Advantages

The advantages for the seller are numerous. First, letters of credit offer a secure payment method and therefore a lower-risk business opportunity, as the bank ensures payment under the contract. Second, for the buyer, letters of credit guarantee that payment will only be made when the terms of the letter are met. Thus, the buyer can specify contractual requirements, such as the delivery date of raw materials or the goods purchased.

3.4.2 Disadvantages.

However, it does have some drawbacks:

- Complex and slow procedure: too many documents required, too many deadlines, strict formalities.

- Bank fees can be high when there are many unforeseen circumstances.
- Unsuitable for rapid transport: goods arrive before the documents, forcing the customer to request a bank letter of guarantee (which incurs an additional cost).
- Due to the issuing bank's coverage of the buyer's commercial risk, it may be forced to request guarantees from its client, such as blocking a portion of the funds or setting an outstanding documentary credit amount that cannot be exceeded. The buyer also has the option of asking the banks to carry out the same transaction. In addition, it may be refused by the banks, which can be difficult to communicate to its foreign supplier.

4. Presentation and Analysis of the Role of Documentary Credit in Foreign Trade Financing

4.1 Research Methodology

Our research methodology is based mainly on a descriptive analysis of the results achieved by the BEA during the two years 2021 and 2022 published respectively in the BEA annual reports for the years 2021 (BEA, rapport d'activité annuel, 2021), 2022 (BEA, rapport d'activité annuel, 2022) ET 2023 (BEA, rapport d'activité annuel, 2023).

The statistical interpretation of data recorded by the BEA allows us to explain the main variables relevant to our research question and the relationships between them in order to formulate relevant conclusions.

4.2. Presentation and Analysis of Results

In this section, we will present the main results related to our research question, namely: the role of documentary credit in relation to other financing methods, the contribution of the BEA in foreign trade financing, and the main clients of the Algerian External Bank (Banque Extérieur d'Algérie).

4.2.1. The role of Documentary Credit in Relation to other Financing Methods

Table I. The Contribution of Payment Techniques to Foreign Trade and Financing

| Financing Techniques | 2021 | 2022 | 2023 |
|----------------------|--------|--------|--------|
| Payment order | 37.82% | 48.17% | 53.06% |
| Documentary delivery | 23.60% | 25.32% | 22.43% |
| Documentary credit | 38.58% | 25.51% | 24.51% |

Source: Designed by the Researcher based on the BEA's annual reports for 2021, 2022 and 2023

According to information recorded by the External Bank of Algeria, it is evident that the documentary credit technique was widely used during the years 2021 and 2022. This can be explained by the advantageous characteristics of this technique compared to the other two. According to the International Chamber of Commerce, the documentary credit is an extremely precise and universal method, as it is based on established rules and practices.

4.2.2. The BEA's Contribution to Foreign Trade Financing

Table 2. BEA Disbursements during 2021, 2022, and 2023, Amounts in Millions of USD

| Amounts | 2021 | 2022 | 2023 |
|--|----------|----------|----------|
| The general amount of disbursements (import) | 11771.41 | 10254.14 | 11781.51 |

Source: Designed by the Researcher based on the BEA annual reports for 2021, 2022 and 2023.

The data collected in 2022 decreased by 12.89%, reaching \$1,517.27 billion, compared to the data collected in 2021 (i.e., \$11,771.41 billion), and decreased by 12.96%, reaching \$1,527.37 billion, compared to the data collected in 2023 (i.e., \$11,781.51 billion).

These results can be attributed to the fact that during 2022, the global economy was affected by the Ukrainian conflict, which had negative consequences on the global economy, particularly on the agri-food and energy markets. In addition, the repercussions of the COVID-19 pandemic were still being felt worldwide. Algeria also implemented an import restriction policy, which had a direct impact on the total amount of imports.

4.2.3 Main clients of the Algerian Foreign Bank.

Table 3. Distribution of Direct Debits by Economic Sector

| Economic sector | Years | | |
|-------------------------|-------|------|------|
| | 2021 | 2022 | 2023 |
| Public companies | 52% | 52% | 32% |
| Private companies | 22% | 27% | 19% |
| Central administrations | 26% | 21% | 49% |

Source: Designed by the Researched based on the BEA annual reports for 2021, 2022 and 2023.

The data shows that public enterprises were the main client of the Algerian External Bank during the two years under review, namely 2021 and 2022, accounting for 52% of total imports. The second largest client was the private enterprise sector, which saw a significant increase in 2022 (27%) compared to the results recorded in 2021 (22%).

However, during 2023, the central government sector ranked first with a percentage of 49%, which can be explained by the increased use of this financing technique by this sector.

This can be explained by the specific characteristics of the Algerian economy, which relies primarily on the public sector, particularly the hydrocarbon sector.

5. Conclusion.

International trade is growing and intensifying. However, this development is accompanied by an increase in the risk associated with the financing conditions for this trade. This risk is greater the larger the transaction.

To finance these international trade transactions, operators benefit from different payment methods. There are numerous methods with varying characteristics, such as security and speed.

In our research, we closely analyzed the documentary credit payment technique.

The results obtained show us that, unlike the other payment methods mentioned above, the documentary credit aims to meet the needs of both the buyer (the importer) and the seller (the exporter). In addition to being a payment method, it also serves as:

- A trading method that allows the purchase of goods and merchandise using two banks: the importer's and the other's.
- A negotiation option with a bank guarantee that allows the recipient to obtain a price and/or payment term.
- An element of comfort and security, as it ensures payment for the goods shipped or the service provided in accordance with the terms and conditions of the contract.

Furthermore, it has been observed that public companies are the main clients of Algeria's external bank, a fact reinforced by the nature of the country's economy, which relies primarily on the hydrocarbon sector.

Hence, we can say that documentary credit still occupies an important place in foreign trade financing despite the multitude of

other payment techniques and the adoption of new rules, such as Incoterms 2020 relating to international trade. This is a set of rules updated as global trade evolves and allows the buyer and seller to effectively and unambiguously conform to the terms of the transaction.

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