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The ALADI Treaty and Letter of Credit Transactions in Latin America

I. Introduction

The Association of Latin American Integration, Reciprocal Payments and Credits Agreement (the ALADI Treaty) is a multilateral agreement signed in August, 1982 by representatives of the Central Banks of Argentina, Bolivia, Brazil, Colombia, Chile, Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. Similar agreements have been in effect since 1965. The ALADI Treaty governs the flow of funds between Latin American countries by replacing the international payment mechanisms that have been traditionally utilized. These changes in procedure result in greater intraregional trade by reducing the need for hard-currency U.S. dollars and the risk of local currency inconvertibility, and by providing a mechanism for replacing cross-border foreign private bank risk with local central bank risk.

II. The ALADI Treaty and Its Impact

A. BACKGROUND

Most Latin American central banks now require that apart from certain specific exceptions, all payments to be made to or received from signatory countries of the ALADI Treaty be channeled through this mechanism.¹ As a result eighty-five percent of all intraregional trade now flows through the

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1. See Banco Central de la República Argentina, Circular Cobros y Pagos Externos (Circular Concerning External Charges and Payments) (COPEX 1), III, Convenio de Créditos Recíprocos 1.5.1 Pagos, [hereinafter cited as Circular]. For a related development, see Ferrere, *New Trends in Latin American Foreign Trade: The LAIA and its Work*, 19 INT'L LAW. 933 (1985).

Treaty.² A high point was reached in 1981 when \$9.3 billion in ALADI Treaty transactions occurred.³ In 1983 six billion dollars worth of trade flowed through the ALADI Treaty.⁴

Under standard international payment mechanisms, importers pay exporters through private commercial banks located in each Latin American country. These banks then pay each other directly or through the transfer of funds to a common correspondent bank. The common correspondent bank will typically be a large, money-center bank (*i.e.*, a bank that is located in New York or another relatively free-market location) which, upon instructions from the paying bank, will normally credit funds held in the account of the paying bank to the account of the receiving bank. Under the ALADI Treaty, however, payments between Latin American countries may flow through the respective Latin American central banks.⁵ Each central bank in turn maintains lines of credit to each other central bank (total available lines of credit now approach \$2.7 billion),⁶ and only the net amounts owed between each central bank need be paid, in U.S. dollars, at the end of each four month period.⁷

(During 1983 of the six billion dollars in total ALADI Treaty transactions the net paid totalled only \$1.5 billion,⁸ thus saving the Latin American countries approximately \$4.5 billion in hard currency.)

B. TYPICAL TRANSACTION CYCLE

A typical transaction cycle begins after an importer and exporter (both located in Latin American countries that have signed the ALADI Treaty) have agreed to a sale/purchase transaction and have received any governmental approvals necessary to complete the transaction (*e.g.* receipt of import and/or export licenses). Under the ALADI Treaty several forms of payment can be utilized by the importer (as are acceptable to the exporter). These include open account payments, payments made against documents,

2. Report of the Secretaría General, ALADI, Cooperación Financiera Monetaria, at 10 (February 6, 1984).

3. Report of the Secretaría General, ALADI, Compensación Multilateral de Saldos y Líneas de Crédito Recíproco (Multilateral Compensation of the Reciprocal Lines of Credit and Balances) (ALADI/SEC/d; 87.2) at 28, Cuadro #10, (Feb. 6, 1984).

4. *Id.*

5. Asociación Latinoamericana de Integración Convenio de Pagos y Créditos Recíprocos (The Agreement of the Association of Latin American Integration on Reciprocal Payments and Credits) [hereinafter cited as ALADI Treaty], articles 1,2, and 6. The regulations of the ALADI Treaty [hereinafter cited as ALADI Treaty Agreement Regulations] are appended to the Treaty. A copy of the ALADI Treaty and Regulations may be obtained from: General Secretary, ALADI, Cebollati 1461, Montevideo, Uruguay.

6. *Id.* at Cuadro #1.

7. ALADI Treaty, Agreement Regulations, article 10.

8. *See supra* note 3.

payments made against avaled drafts, payment made against guaranteed promissory notes, and payments made under sight or time letters of credit.⁹

For purposes of illustration, the following describes the typical transaction cycle when a sight letter of credit is used. In such instance the importer solicits the assistance of a local bank (the importer's bank or opening bank) authorized by the local central bank to operate under the ALADI Treaty. The importer requests the opening bank to open a letter of credit in favor of the exporter for the agreed amount of U.S. dollars. If the opening bank agrees to open the letter of credit, typically it will send notice via tested telex to a bank designated by the exporter and located in the exporter's country (the exporter's bank). The letter of credit bears the notation "To be reimbursed through the ALADI Treaty."¹⁰ At the same time a copy of the letter of credit is sent by the opening bank to the importer's central bank. Upon receipt of the letter of credit the exporter's bank advises the letter of credit to the exporter. At the request of the exporter, the exporter's bank may also add its confirmation to the letter of credit. At shipment date the exporter will present the documents required by the letter of credit to the exporter's bank.

Each central bank has promulgated its own set of regulations to implement the ALADI Treaty. As a result the detailed payment mechanism will vary slightly at this point. Generally, however, if the documents are in order the exporter's bank will pay the exporter the amount of local currency that is equivalent to the U.S. dollar amount of the letter of credit.¹¹ On a same day basis the exporter's bank will then forward the documents to the importer's bank, and will request and receive immediate reimbursement from the exporter's local central bank.¹²

In some countries (*e.g.* Argentina), the exporter's central bank will not just deliver the amount of local currency which at the official exchange rate equals the U.S. dollar amount of the letter of credit, but will actually deliver U.S. dollars to the exporter's bank.¹³ Typically the exporter's bank will then be required to sell such U.S. dollars to a third party in return for the local currency needed to pay the exporter. This mechanism has the benefit of allowing the exporter to receive that amount of local currency that a free market rate would bring. On the other hand the exporter's bank may sell such U.S. dollars back to the central bank in return for the local currencies needed. This mechanism has the benefit of reducing the risk of foreign

9. ALADI Treaty, Agreement Regulations, article 2.

10. ALADI Treaty, Agreement Regulations, article 2, c) and d).

11. See for example, Banco Central de la Republica Argentina, Circular Cobros y Pagos Externos (External Credits and Payments), COPEX-1, III and ALADI Treaty, Part Three.

12. *E.g., id.*, at 2.1.4 Reembolso de las operacionas (Reimbursement of operations), and ALADI Treaty, article 11.

13. *Id.*

currency nonavailability since on a net basis with the exporter's bank, the central bank is, in fact, only paying local currency.

Upon receipt of the documents sent by the exporter's bank and specified in the letter of credit, the opening bank requests payment from the importer. Although each Latin American country has its own detailed implementing mechanism, generally the importer is required to pay the opening bank that amount of local currency that equals the amount of U.S. dollars due under the letter of credit. The opening bank presents that amount of local currency to the importer's central bank (or to a third party if desired and regulations permit) requesting that the funds be converted into the U.S. dollars needed. If a third party is used the U.S. dollars purchased are typically transferred directly to the importer's central bank. This mechanism has the benefit of allowing the importer to receive that amount of U.S. dollars that a free market rate would bring. Otherwise, the importer's central bank is requested to hold the U.S. dollars purchased from it as the payment due under the letter of credit. This latter mechanism has the benefit of reducing the risk of foreign currency nonavailability since on a net basis, with the central bank, the importer's bank is, in fact, only paying local currency.

At the end of each four month period (end of April, August and December) the importer's central bank and the exporter's central bank total all transactions between them to determine the net amount owed. The debtor central bank then transfers the net amount of U.S. dollars owed to the creditor central bank. Credit lines are available should a debtor central bank wish to postpone payment.¹⁴

1. *Risk Analysis*

The Latin American branches of major money-center banks and local Latin American banks authorized to operate within the ALADI Treaty assume different, and in most cases, less risks when transacting ALADI Treaty business than under standard international payment mechanisms. However, an authorized bank's failure to act in accordance with the provisions of the ALADI Treaty may leave that bank outside the benefits provided by the Treaty.

2. *Import Transactions*

The opening of import letters of credit under the ALADI Treaty subjects the opening banks to importer credit risk. This occurs because the opening bank takes the risk that at maturity the importer will be unable to pay the

14. ALADI Treaty, Part Two, articles 21-28.

amount of the letter of credit. The importer also takes devaluation risk which has credit risk implications for the opening bank. In the case of a devaluation occurring after the opening of the letter of credit but prior to payment date, the referenced amount of U.S. dollars becomes more expensive in local currency terms. As a result, the opening bank takes the risk that the importer will be unable to provide the referenced amount of U.S. dollars (or the now greater local currency equivalent). Contrary to the obligations incurred under a standard letter of credit, it would seem ALADI Treaty import letters of credit do not involve a cross-border commitment of payment by the opening bank to the exporter or to the exporter's commercial bank. Instead, these letters of credit are said to limit reimbursement to the mechanisms established in the ALADI Treaty.¹⁵

Ideally, if the beneficiary does not receive payment he should have no right of action directly against the opening bank. The beneficiary should only have a cause of action against his own commercial or central bank. As the ALADI Treaty letter of credit limits reimbursement, the opening bank's only commitment should be to pay the importer's central bank. Additionally, through the ALADI Treaty each central bank guarantees to convert the local currency provided by the opening bank into the U.S. dollars needed for transfer to the exporter's country.¹⁶ Thus, the ALADI Treaty provides comfort to banks that open such letters of credit in the Latin American countries where U.S. dollars are scarce—and at times nearly impossible to obtain.

3. *Export Transactions*

Under article 10 of the Treaty, a locally authorized commercial bank which confirms and pays an ALADI Treaty letter of credit to an exporter is to be repaid from the central bank of the exporter's country, without regard to whether the importer's commercial bank is still an authorized institution or whether the importer's commercial bank or the importer's central bank has or will make payment.¹⁷ Since payment between central banks is made on a net basis, however, the exporter's central bank may not in fact be expecting any funds from the importer's central bank. Additionally, as the clearing between central banks takes place every four months, payment by the exporter's central bank to the exporter's commercial bank will almost always be due prior to the clearing date. As a result, when a bank located in the exporter's country confirms to an exporter an ALADI Treaty letter of credit opened by an authorized bank of an importer's c, risk of repayment

15. Interview with Oscar Paris, ALADI Secretary and with Ignacio Posadas, Legal Advisor to ALADI, in Montevideo, Uruguay, Nov. 19, 1984.

16. ALADI Treaty, article 10.

17. *Id.*

should be seen to rest with the central bank of the exporting country, not, as is usual with the opening bank in the importer's country.

Contrary to the risks accepted by a bank that confirms a standard letter of credit it appears that a bank that confirms an ALADI Treaty letter of credit does not bear the risk of nonrepayment from the opening bank in the importer's country. The confirming bank here only appears to run the risk of nonrepayment from its own local central bank. Thus, for the confirming bank, the greater uncertainties typically involved in cross-border transactions may be avoided.

III. Summary

The ALADI Treaty provides a payment mechanism now widely used throughout Latin America for international trade transactions. In a time of economic recession throughout the continent, the provisions of the ALADI Treaty increase trade flows by reducing the need for scarce, hard-currency U.S. dollars. Additionally, by reducing the cross-border risks typically faced by banks operating in Latin America and by guaranteeing the convertibility of the local currency payments required, the ALADI Treaty encourages an increase in the amount of local bank credit available. This, in turn, should help to stimulate economic recovery in Latin America.