Countertrade, Barter, and Offsets

Verzariu

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New Strategies for Profit in International Trade

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To Tonina, Cristina,
and Giulia, my personal guiding constellation

About the Author

Prior to forming his own trade consulting firm, Pompiliu Verzariu was a business counselor in the International Trade Administration of the U.S. Department of Commerce. For nearly a decade he has advised U.S. firms on structuring specific countertrade transactions and on organizing in-house countertrade units.

Since 1981, he has held annual lectures on countertrade and joint ventures at the National Center for Science and Management of the Dalian Institute of Technology in the People's Republic of China.

Dr. Verzariu is the author of the widely read and translated primer, *Countertrade Practices in East Europe, the Soviet Union, and China* (U.S. Department of Commerce).

Preface

The past decade has witnessed a succession of political, economic, and monetary instabilities in many areas of the world. As a result of the change in world economic conditions which the energy crisis initiated in the mid-1970s, the economic growth of many developing countries has been stymied.

The uneven distribution and increasingly impaired flow of financial, technical, and natural resources between the world's nations have driven an expanding number of developing countries to impose conditions on western exporters, linking imports of western goods with exports of their domestic products. This compensatory initiative is supposed to open new export markets for developing nations (thereby alleviating trade and payment imbalances), support the industrialization efforts of these countries, and remedy their lack of foreign exchange. Because of economic pressures, compensatory requirements are occasionally imposed by industrialized countries with deteriorating economies in their trade with other developed nations.

The specter of compensatory demands confronts many exporting firms with prospects they are not equipped to handle, especially small firms or those specializing in a single product. Concern about the impact of compensatory practices on a company's exports is now graduating from the export manager's tier to the company's corporate boardroom. Indeed, increasing compensatory pressures in the marketplace (as well as intensified competition for export market shares which has resulted from the slowdown in world trade) require that U.S. exporters be at least conversant with basic notions about the practice. They will need to know how to cope with it if they are to compete successfully in world markets and attempt to turn imposition into opportunity.

This book is intended to acquaint private-sector company executives and public officials with basic information about the practice and to make them more knowledgeable about compensatory obligations that they may face. Because each compensatory arrangement is responsive to the evolving needs of the parties involved, its structure varies as a function of country, product, and time. Relying on creative financing and marketing, the structure of such an arrangement most often defies a precise model.

Facts and figures related to the global expansion of compensatory practices are at present changing as a function of the trading parties' learning processes, their perceptions of need, and the proposed uses for such arrangements (e.g., as related to marketing or financing considerations). To compensate for the variable circumstances and applications of compensatory practices in international markets, the reader may best be served by becoming versed in general criteria of preventive or proactive marketing strategies and in the principles of risk assessment related to compensatory transactions. Thus, the following chapters on compensatory trade emphasize reasons and reasoning and aim at the development of planning steps, support services, and an awareness of risks peculiar to compensatory arrangements in general. The reader can then design applications to suit his own specific needs in marketplaces worldwide.

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Compensatory Trade as an International Issue

The post–World War II years saw increased economic interdependence fostered by expanded trade relations among nations with differing political convictions and diverse economic systems. Today, when shrinking export markets, industrial overcapacity, and contraction of international credit are straining the world's trade system, nations are groping to find innovative means to sustain previously achieved trade levels and to redress deteriorating economic conditions.

The inadequacy of financial transfers to compensate for diminishing market-transfer privileges has driven many developing countries and an increasing number of developed countries to impose conditions that link imports of foreign goods with exports of domestic products or conditions that are tied to commitments to maximize the domestic content of the transactions. These compensatory practices foster contractual quid pro quo arrangements designed to:

Alleviate or overcome shortages of foreign exchange

Support the continuation of industrialization programs

Promote exports of counterdelivered goods which may be in low demand in targeted foreign markets

Sustain the goods' export prices in the face of declining demand

The Nature of Current Compensatory Arrangements

Compensatory arrangements (CAs), mostly involving exchanges of products, have found application periodically during times of worldwide economic sluggishness. But while previous bilateral trade tie-ins after the two world wars occurred in environments dedicated to reconstruction, today's arrangements follow more than two decades of sustained economic growth which, aided by expansion of international trade ties and liberal credit, has fostered global economic interdependence and has heightened social aspirations and economic demands by third world countries.

Thus most CAs of today do not lend themselves to the bilateral models tested in the past, which involved primarily exchanges of goods under government-mandated or -abetted agreements. Instead, current CAs have the option of making full use of the international network of commercial and financial linkages established in the last three decades, in order to multilateralize through the inclusion of additional parties located in diverse countries (e.g., a firm's overseas subsidiaries, multinational brokers) what essentially started as a bilateral commitment. Today's CAs, involving on occasion the transfer of services, may require creative marketing and financing approaches that conform to the particular nature of the products traded and to the evolving needs of the contracting parties. Examples are:

Settlements of compensatory obligations by taking advantage of preferential trade arrangements (e.g., by procuring, in part or whole, the exports or by routing related counterdeliveries through subsidiaries of western firms operating in developing countries, thereby benefiting from settlements in soft currencies and from tariff rebates)

Risk-sharing initiatives (e.g., investment by an exporter in the importer's production capacity with the intent to upgrade the quality of the counterdeliveries)

Allocation of the exporter's resources to worldwide brokerage activities that will benefit the importer (e.g., assistance in creating new export opportunities resulting in revenues for the latter)

Not every compensatory transaction involves complex arrangements. Indeed, many CAs are still implemented on a bilateral basis. At the same time, many developing countries considering the adoption of compensatory practices are doing so with circumspection, as they educate themselves in the use of this new tool which is expected to provide them with economic benefits in a world of declining opportunities.

We recognize three stages in the educational evolution of companies and government agencies engaging in CAs. In the first stage, the trading parties attempt to conclude transactions with little or no outside guidance or assistance. Inexperience and overestimation of ability to perform render many of the contracted arrangements uneconomical. In this stage, the importing government's attitude is to shift all risk associated with the marketing of counterdelivered goods to the western exporter. Many east-west trade CAs negotiated in the late 1960s fell within this category. In the second stage, additional parties (e.g., traders, brokers) are looked upon for assistance from the early stages of negotiations. For the importing countries, government involvement entails administrative directives or resolutions intended to create guidelines for compensatory transactions in which their nationals engage. Most current CAs fall in this category. Finally, in the third stage, compensatory strategies become part of the planning process of both importers and exporters. The CA options explored by the trading parties may include utilization of the importer's production resources in the transaction, investment, and financing schemes, as well as sourcing and routing goods, components, and equipment so as to reduce the importer's net outlays of foreign exchange. For the importing countries, government involvement entails active assistance to the CA by facilitating, for example, the sourcing of counterdeliveries from diverse industrial sectors of the country. This category corresponds to CAs usually undertaken in the trade between two developed countries involving, for example, military or civil aircraft offset arrangements (see Chapter 4). It is the type of CA that third world countries will strive to imitate in the future.

Types of Compensatory Trade Agreements

In the broadest sense, "compensatory arrangements" refer to a whole range of business arrangements (e.g., coproduction, subcontracting, technology transfer, investment, and export generation) whereby an exporter commits himself contractually to cause or actually generate desired benefits such as revenues for the importer. Under CAs, acceptance on the part of the exporter of such arrangements is imposed by the importer as a condition to import. Thus, a main goal of CAs is to reduce or eliminate, over a stipulated period of time, the net outflow of foreign exchange for importers.

CAs may be dictated by government-sponsored requirements for minimum domestic content for specified foreign imports, as in Australia, or as a condition on foreign investment prescribing export quotas for the resulting production, as in India. CAs may also be implemented under government-to-government bilateral agreements. These agreements may either facilitate the transferal of reciprocal market access privileges between two nations—beyond tariff treatment prerogatives—or may impose conditions intended to redress trade imbalances. Some agreements, in the form of bilateral clearing agreements (e.g., between Brazil and Poland), trade protocols (e.g., Japan and the People's Republic of China), or trade investment treaties (e.g., the Caribbean Basin Initiative promoted by the U.S. government), may stipulate or facilitate trade and investment between two nations under preferential terms, often to the potential detriment of another nation's exports. Other agreements, specifying conditions for reciprocity in the commerce of two nations, may aim at balancing the trade levels of the two countries.

In a narrower sense, CAs involve the linked trade obligations of two commercial enterprises in two countries involving exchanges of products, technology, and services, as stipulated in their import and export contracts. Such offsetting obligations, usually undertaken under separately financed and parallel contracts, may also be encouraged by government policies, as in Norway tying offshore oil concessions to foreign contributions to the development of the Norwegian industry. They could be on a *best-effort* basis, as in some western European countries; involve only government procurement contracts, as in Indonesia; be required for specific industrial sectors, as in Austria; or be required for all foreign trade transactions, as in Romania. These types of CAs, commonly referred to as *countertrade transactions*, will be discussed under their various forms in Chapter 3.

The public sector agreements are intended to integrate economies of particular countries, recognize special political relations existing between two nations, or fulfill national demand for raw material resources. Generally, compensatory agreements are designed to minimize trade and payment imbalances. Such agreements foster bilateralism and tend to introduce rigidities and distortions in the world's economy. Once introduced, these are hard to eradicate, given the inertia inherent in government actions and the domino-like interdependence of nations. In the long run, such agreements are likely to result in shifts in industrial-production capacity and in sourcing from developed to developing countries, and are likely to perpetuate shortcomings in the marketing skills of the latter countries.

Causes and Longevity of Compensatory Trade

Whether the present downturn in the growth of the world's economies is related to the long-term economic cycles predicted by the Russian economist Nikolai Kondratieff, or whether it can be traced to identifiable socioeconomic causes, the onset of the global economic slowdown coincided with the occurrence of the worldwide energy crisis of the mid-1970s. The crisis signaled an end to the era of cheap energy, which had contributed so much to international industrial growth. It further accentuated already existing uneven flows of financial and technological resources among the world's nations and sired a chain of interrelated events whose consequences are lasting and conducive to bilateral arrangements.

During the late 1970s, oil-importing nations faced with mounting payment deficits found it expedient to finance their deficits through debt rather than through adoption of belt-tightening measures. In doing so, developing countries in particular were encouraged by the willingness of private banks to finance borrowing against future earnings forecast on past performances and were encouraged by western governments' policies providing for liberal credits, subsidies, and guarantees designed to boost exports in the face of shrinking world markets. Political pressures to continue social and industrial modernization programs, conceived during earlier and more prosperous years, also contributed to national debt accumulations, leading to today's situation in which interest on foreign debt constitutes the single biggest drag on the finances of an increasing number of developing nations.

The debt-repayment crunch is forcing nations such as Brazil, Mexico, Argentina, Poland, and Romania to allocate an inordinate portion of their foreign exchange earnings to debt payments rather than imports. Pressures for debt reschedulings are also mounting in other developing countries, as about one-third of total external debt and about half of the commercial bank debt fell due in 1982. It is estimated that the servicing of debt by the world's debtor countries would require an annual export surplus of between $80 and $100 billion. But it is unrealistic to expect the world markets to absorb such a surplus, given current economic conditions. Brazil's near-default in May 1983, as well as the inability of Latin American and other third world debtors to meet their financial targets, leaves little choice to major creditor banks but to scramble reluctantly to arrange additional loan packages for their financially strapped clients at a time when smaller banks are cutting down their credit participation to third world nations. As a result, the specter of default and the problem of repeated debt reschedulings are now straining the world's financing resources to cope with anticipated and unexpected crises.

Today the lending to developing countries by private banks, which carry the bulk of the approximately $800 billion debt these nations now owe (compared with the $100 billion owed in 1973), is slowing sharply. The slowdown is further jeopardizing the developing nations' ability to service interest payments and to sustain economic growth, while it puts added pressure on western governments and international financial institutions such as the International Monetary Fund to expand their lending programs to the third world. The increasingly difficult task of securing the needed bridge-loan financing to service debt, coupled with apprehensions that their countries' futures have been mortgaged to pay foreign bankers, could also tempt some major debtor countries to impose moratoriums on repayments or to impose unilateral debt-rescheduling terms, as Argentina did in 1982.

The credit squeeze is forcing developing nations to revise their previous plans for economic growth which relied on building industrial bases to process raw materials at home. Past policies of import substitution based on capital-intensive heavy industrialization are being shelved in favor of smaller-scale public works projects which are low in foreign exchange cost and are labor-intensive. Economic retrenchment is resulting in imports being slashed, industrial production being crippled, and standards of living being reduced. These factors, as well as mounting unemployment in developing countries with large populations, are raising fears that political instabilities could accompany economic ones if the nations have to endure more than a few years of recession and stagnation.

As a result, many foreign-exchange-poor developing countries are pressing for CAs as a way to carve export markets for their manufactures against protectionistic pressures in sluggish western markets, as a hedge against volatile prices for their commodity exports, and as suasion for investment of foreign resources in local industries. The long-term nature of the economic problems besetting developing countries points to uneven recovery among these nations, tied to their ability to move up on the high-technology ladder of manufacturing and to attract foreign investment. CAs may well provide one of the means for fulfilling the latter goals and be looked upon by these nations as a desirable tool of trade for as long as their credit and exports will be constrained. Given the feeble recovery pace projected for the world's economies, well below the growth experienced in the aftermath of previous recessions, and because of the high debt-service burden carried by the third world, the prospects for global credit relaxation and strong trade expansion for developing nations' exports appear dim in the near term.

The developed nations, upon whose economic growth is predicated any hope for the recovery of the developing countries, are themselves staggering under the triple weight of budget deficits, high real interest rates, and gradual, uneven recovery from recession. Economic recovery in the industrialized countries has already begun, but it is encumbered by excess industrial capacity, which has suffered from competing new capacity established in third world countries; by mounting unemployment, which is projected to approach 9 to 10 percent of the labor force, or about 32 to 35 million people in 1984; and by dismal prospects for exports to the developing countries which are cutting down on their purchases of western goods and services. As trade frictions, sectoral trade restrictions, and protectionistic pressures (the latter hiding under the euphemisms "orderly marketing," "fair trade," and "voluntary restraints") have intensified worldwide, the developed countries are increasingly treating international commerce as an extension of national economic policies and are preferring to deal with problems of trade competition through bilateral accommodations. For example, French and German banks demand that any new loans to Brazil be tied to their countries' exports to Brazil, and countertrade is increasingly promoted by western exporters as a