INTERNATIONAL COUNTERTRADE

Edited by
CHRISTOPHER M. KORTH

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Contents

Exhibits

1

An Overview of Countertrade

CHRISTOPHER M. KORTH

This book covers a wide range of perspectives on countertrade: varieties; practices in different industries; practices in different parts of the world; various managerial considerations—finance, marketing, accounting, taxation, organization, and so on; and various specialized companies that can assist the company that wants or needs to countertrade. The authors represent both a cross-section of the entire industry worldwide and a variety of official agencies.

In this chapter a broad overview of the field of countertrade is given as a general background for those with a limited knowledge of the field.

DEFINITIONS

The first issue that needs to be addressed is that of semantics. Countertrade is a relatively new development for most of the companies and governments that are now involved in it. Although the basics are old—indeed, countertrade is the oldest method of business transaction—its modern sophistication is new, which is the principal interest of this book. Modern, commercial countertrade is also very international in scope.

As a result of these circumstances, the field of countertrade is weak in terms of its structure and systematic procedures. It is also weak with respect to terminology. As will be seen in the various chapters, there are sometimes ambiguities in terms of the exact meanings of the specialized vocabulary that is employed; this section discusses the various basic concepts. Also, when the terms are used in the following chapters, each author's specific meaning of the various terms will be made clear and his or her approach will be integrated, as much as possible, with the broad overview given here.

Countertrade

Countertrade is a relatively new term. Basically, it means the same thing as barter. *Barter* is the traditional term. However, some people think that barter has a primitive, even a negative, connotation. Some equate barter with the one-on-one exchanges in Indian markets in the middle of the jungle. Others see it in terms of efforts in the underground economy to evade taxes.

As a result of these image problems, many corporate financial and marketing or purchasing managers have encountered difficulty in convincing senior management to have an open mind about bartering. A new term can sometimes avoid the negative value judgments of older, more traditional terms. Therefore, the term *countertrade* is becoming more widely used. Both terms are widely used, however, and both are used in the following chapters.

Another reason for the use of a newer term is that there is little similarity between the primitive types of barter with which most people would be familiar and the sophisticated versions that are discussed in this book. Here, the authors discuss many modern refinements that require qualification to be understood clearly.

Simple Barter

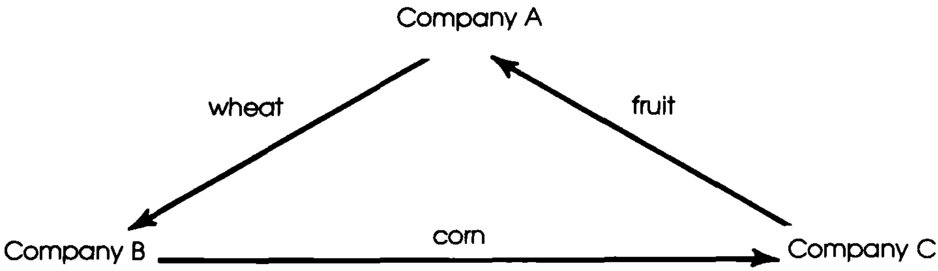
Barter takes many forms. However, the essence of any type of barter transaction is simply the exchange of one product (whether a good or a service) for another (e.g., one antelope hide for so many ears of corn, or your help in building my fence in exchange for my help in painting your house, or a shipload of oil in exchange for fertilizer). This type of exchange is what is known as *simple barter* (or *straight barter* or *pure barter*) as opposed to some of the much more sophisticated modern variations that are described later.

Deferred payment: Traditionally, barter transactions occurred simultaneously (e.g., three of my sheep in exchange, at the same time, for one of your cows). However, even in primitive markets, deferred-payment arrangements could be made (e.g., one sheep a month in exchange for 100 bushels of wheat after the harvest). This type of agreement created a type of barter credit.

Multiproduct trade: The barter transaction could involve not simply the exchange of one good or service by each seller but several, or many, on either side (e.g., beaver skins and deer pelts in exchange for grain, coffee, blankets, and tobacco). Since many products are not readily divisible (e.g., a dairy cow) and the seller's demand for the other's principal product may be limited (e.g., eggs), the expansion of the trading to include a variety of products greatly increases the flexibility of barter. (When combined with the aforementioned barter credits, multiproduct trade becomes even more flexible.)

EXHIBIT 1.1

MULTILATERAL BARTER



Multilateral barter: Another method in addition to multiproduct barter for circumventing some of the inherent limitations of barter caused by the restricted need each party commonly has for the other's goods or services is *multilateral barter*: several parties exchange goods. For example, Company A's wheat could be shipped to Company B, whose corn goes to Company C in exchange for fruit that is, in turn, shipped to Company A. (Exhibit 1.1.)

Thus barter can involve both goods and services. It may involve only two goods or services or many. It may involve two participants or several or many. It may involve simultaneous exchange or delayed compensation.

With simple barter, there is a direct exchange of goods between two parties. Only a single contract is signed. (In many of the informal deals, no contract at all is signed.) The agreement (whether written or oral) will specify both the specific type and the quantity of the goods or services to be traded. No middlemen are typically required. The goods or services will not be transferred to third parties. No money is involved (except indirectly, since in monetary economies both parties will tend to bear in mind some approximate monetary value for both products offered and products received). Such simple "pure barter" is relatively rare today.

Parallel Barter

A refinement over simple barter is *parallel barter*, or *counterpurchase barter*. It is essentially an adjustment to the fact that many companies will sell only in exchange for money (primarily hard currency); this could be for reasons of accounting practice, customs or exchange requirements, tax law, bank demands, or simply corporate policy. For example, commercial banks and government export-finance agencies commonly refuse to provide financing unless a contract provides for monetary compensation.

Under a parallel-barter agreement, two separate contracts, which specify the goods and services to be exchanged, will be signed. These goods or services are commonly, but not necessarily, of equal value. In addition, payment on each contract will need to be made with money (although frequently the means to pay on at least one side of the contract results from either barter-trade credit or bank credit.) Sometimes a parallel-barter agreement obligates one party to assist the other company in selling its products abroad.

Such arrangements are a form of barter because the two parallel contracts require a *quid pro quo* exchange of goods or services. Parallel barters are the predominant form of international countertrade today.

Offset: A special variety of parallel-barter arrangement is often called an "offset." For example, Northrop and General Electric committed themselves to market $150 million of Swiss goods as part of a $500 million contract for F–5 fighter aircraft. The offset could be either greater or smaller than the sale that was offset. Duke Golden discusses offset in detail in chapter 7.

Clearing-Account Barter

A more flexible format than either straight or parallel barter is clearing-account barter (or simply clearing arrangements). With clearing-account barter, each party agrees in the single contract to purchase a specified value of goods or services from the other country over a specified, often lengthy, period. Thus trade may be out of balance at the end of the first or even several years but will balance over the term of the contract.

Furthermore, this clearing-currency credit can often be used only within one country (although it can often be sold or transferred or switched to a third party). It is, in effect, a line of credit of a fixed amount, which is matched by a compensating line of credit in the other country. No money is actually involved in the trades in such barters. Each company or government thus provides the other with barter credits.

Frequently, clearing dollars can be used to purchase any of a variety of products. In other cases they can buy only a specified product. Nevertheless, clearing-account barter generally allows greater flexibility to either or both parties in terms of both time of drawdown on the "lines of credit" and types of products available. This form of barter occurs mostly between Communist countries or between a Communist and a less-developed country (LDC). It is, however, becoming more common between LDCs. However, there is nothing in the nature of clearing-account barter that would logically prevent it from being used by two private-sector companies in industrialized countries.

Buy-Back Barter

The fourth basic type of barter is a very special form that has evolved primarily in response to the reluctance of Communist countries to permit ownership of productive resources by the private sector—especially by foreigners. Although

Poland, Romania, and Hungary now permit joint ventures with corporations from outside of the Communist bloc, such arrangements are not common. Much more common is a sharing of the output without a sharing of the ownership: the *buy-back barter* (sometimes called *compensation agreement barter*).

The typical buy-back arrangement involves a company from abroad building a manufacturing or processing facility in a Communist country. The factory would be owned by the local government. The assistance that the private-sector company provides may take forms such as the inflow of equipment, financial capital, patents, technical and managerial assistance, or distribution assistance. In exchange, the contract provides that the company will "buy back" some of the output from the new facility at a reduced price (or even free) as its compensation. For example, Levi Strauss has entered into buy-back barter with Hungary. Part of the "Levis" that will be produced in that country will be sold in Hungary, but the rest will be sold in Western Europe by Levi Strauss. Also, Citroën signed a $370 million contract with East Germany to receive transmissions from a plant that the company is helping to set up for the East German government.

From the viewpoint of the Eastern European host government, this arrangement provides valuable Western assistance without sacrificing control and sometimes with little or no commitment of local capital. Also, continued Western assistance in quality control, technical training, and so on is frequently required.

From the viewpoint of the Western company, this buy-back arrangement can provide access to untapped markets in the Communist world (e.g., many of the contracts involve the company receiving a share of the gross revenues from all sales by the local government as well as from what the company itself sells) and can provide an alternative source of low-cost production for Western markets.

Buy-back barter is also becoming more common outside of the Communist countries, especially with the Organization of Petroleum Exporting Countries (OPEC) and some LDCs.

Switch Trading

The above scenario excludes a type of transaction that some authors list as a separate form of barter: *switch trading*. However, this is not really a separate form of barter but rather the inclusion of a middleman (essentially a broker) who serves to multilateralize the barter arrangement. The "switcher" could be involved in any of the four basic types of barter arrangements listed above. "Switching" is discussed by Barry Westfall in chapter 15.

The above terms and breakdown are somewhat different from most other discussions of barter. The terminology that is used here is designed to avoid ambiguity and to stress the barter nature of the various types of transactions. Exhibit 1.2 summarizes some of the major characteristics of the four varieties.

The four basic forms of barter suggest a variety of approaches that can offer creative financing or creative marketing opportunities to the corporate manager.

EXHIBIT 1.2

THE BASIC CHARACTERISTICS OF THE VARIOUS FORMS OF BARTER

	Number of Contracts	Is Money Used?	Is Credit Extended?	Is Exchange Simultaneous?	Predominance Today
Simple barter = straight barter = pure barter	1*	No	Possibly	Not Necessarily	Relatively Rare**
Parallel barter = counter-purchase barter	2	Yes	Yes	Not Necessarily	Very Common
Clearing-account barter	1	No	Yes	No	Common
Buy-back barter	1	Sometimes	Yes	No	Fairly Common

*either written or oral
**except on the retail level

In addition, other mechanisms have been developed to help make these four types of barter more flexible and easier to use. Whichever barter method is chosen, these tools offer alternatives to traditional monetary exchange—what has been called "the creative non-use of cash."

WHERE BARTER HAS SURVIVED

Barter has always found certain niches of markets in which it has survived—even during the strongest economic booms of modern industrialized economies. However, barter is especially attractive in relatively simple economies or, in more sophisticated economies, in circumstances in which the variety of goods and services is small and the goods are durable and easily transportable. Before the advent of money, all trade was necessarily on a barter basis.

Primitive Markets

Barter predominates in many parts of Latin America, Africa, and Asia, which have never fully entered the modern world (e.g., native markets in many developing countries throughout the world). In those areas, the nonmonetary economy is dominant.

Casual Barter

Another type of barter with a long history is casual barter between friends and associates. This is a portion of even the most modern economies in which, for various reasons, the participants choose to barter instead of use cash. Examples would include the exchange of farm products between farmers, the exchange of dental and medical services between a dentist and physician or even the exchange of babysitting services by mothers in a babysitting co-op. This is all part of the so-called underground economy.

Service Industries

One of the strongest sectors of barter is within certain service industries. For example, the communications media (including television, radio, and magazines) engage extensively in barter. Other major barterers are hotels and airlines. These industries offer a service (for example, advertising time or space, hotel rooms, and airline seats). These services cannot be inventoried: when the television or radio show "airs" or when the journal goes to press or when the hotel "beds down" for the night or when the plane leaves, that ad space, room, or airline seat for that date or flight is lost forever. Accordingly, there is a very strong incentive for the owners of those time or space "slots" to be creative in marketing them by barter.

The marginal cost of the ad space, room, or airline seat is low; therefore, the owners of those slots have shown themselves to be very flexible. Television ad time in exchange for either airline tickets or hotel rooms is a natural pairing; so also is airline tickets in exchange for hotel rooms.

This corporate barter is certainly not limited to exchange of services. For example, television game shows commonly barter for not only the hotel rooms and airline tickets for their contestants but for most or all of the prizes as well. Also, the national television and radio networks commonly provide local stations with free shows in exchange for air time on which the networks can run their ads. The local stations, in turn, receive ready-made programs in which the stations can run *their* ads.

Governmental Policy

Barter has long been a mainstay for Communist countries. For reasons of both politico-economic philosophy and the nature of their economic systems, the currencies of the Communist bloc are generally inconvertible. Those countries often have difficulty in selling to the West. As a result, those countries tend to be short of funds and have a long history of barter.

The Communist governments generally control most domestic production, domestic prices, foreign-exchange rates, and a major share of domestic demand. Market forces play little role. Barter has assumed a dominant role in the trade between Communist-bloc countries in order to (1) facilitate the system of imperative planning within the group, (2) increase their intraregional ties, (3) encourage regional autarky, (4) conserve hard currencies, (5) develop new export markets, (6) dispose of excess production, (7) increase the use of excess capacity, and (8) dispose of low-quality goods that are difficult to sell. The use of bilateral and multilateral barter arrangements has become a formal part of governmental policy. As an example, the Soviet Union exchanges a wide variety of products for Cuban sugar.

These intraregional ties have been weakening in recent years as the individual countries have aggressively sought non-Communist suppliers of industrial equipment and raw materials (e.g., oil). Nevertheless, between countries within the bloc, barter has remained a major vehicle for trade. It has also been increasingly important in trade with non-Communist countries. Bernard Conor addresses the issue of East–West countertrade in chapter 5.

Most Communist governments have carried their proclivity for barter over to their dealings with the LDCs. The rationale of the Communist countries is similar to that which results in barter between the centrally planned countries: the conservation of hard currencies, the establishment of tighter political ties with the bloc, the facilitation of the planning process, and the opportunity to dispose of the excess production or to use excess capacity. Since the Communist country tends to be the stronger country in these relationships with LDCs, it is commonly able to gain acceptance of its preference for barter.