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Axel J. Halbach and Rigmor Osterkamp\*

## Countertrade with Developing Countries: New Opportunities for North-South Trade?

*Unconventional forms of international trade (such as counterpurchase, compensation deals and barter) have assumed rapidly growing importance, especially in many developing countries, as a consequence of the fall in commodity prices and the worsening of international debt problems since the oil price increases of 1973-74 and 1979. By using these trading methods countries expect to be able to ensure a continuation of the urgently needed flow of imports, open up new markets for surplus products and bring about greater export diversification as between both regions and products. The following article therefore focuses on the countertrade of Third World countries, both among themselves and with industrialised countries.*

The term "countertrade" is used in this article to cover all forms of trade involving the principle of bilateral compensation. Many types of countertrade are practised nowadays, allowing an almost limitless range of combinations and variants. Pure barter is one of the less important forms, the most common being counterpurchase, followed by buy-back and offset agreements. In all types of countertrade except pure barter, separate import and export contracts are concluded that give rise to separate payment obligations and are performed independently of one another. With counterpurchase the traded goods are generally of quite different types – machinery in exchange for raw materials, lathes in exchange for rattan furniture – whereas in a typical buy-back transaction the exchange goods are produced by the plant whose purchase they are helping to finance. In offset transactions large contracts, mostly for military equipment but also for large civilian projects, are linked with comprehensive co-operation agreements at various levels between the countries involved.

Compensation deals are often concluded under bilateral clearing agreements, particularly between governments with a shortage of foreign exchange and operating exchange controls. If such an agreement is in force (often accompanied by a reciprocal credit line, the so-called swing, which is generally interest-free), only

the resulting balances must be settled in hard currency at set intervals; otherwise trade is conducted without actual payment. Switch trading implies multilateral compensation, whereby a transaction involves a minimum of three parties and often more. Another form of transaction that must not be confused with clearing agreements is the so-called compensation framework agreement, which has recently been used increasingly frequently by firms in the Federal Republic of Germany and other OECD countries in their trade with the Third World. Unlike clearing agreements, these arrangements do not entail clearing accounts but simply state that the exporting firm is prepared to take goods worth a certain percentage of the contract value within a given period, usually five years.

### Scale of Countertrade

Only rough estimations of the scale of countertrade in relation to total world trade have been made, and they differ not only in the conclusions they reach (ranging from a few per cent to over 40%) but also in the definition of the phenomenon under examination. Including offset deals, a share of about 10% of world trade seems the most plausible estimate. It has probably now peaked, however, after growing rapidly in recent years. Involvement in countertrade differs widely from one region to another. Within the OECD ("North-North" trade) offset transactions are the predominant form, but in volume terms they account for only about 3% of trade between these countries owing to the substantial trade flows within the group. Among CMEA countries ("East-East" trade) between 70 and 100% of

\* Ifo Institute, Munich, West Germany. The article summarises the main findings of a research project commissioned by the German Federal Ministry for Economic Co-operation, Bonn. The full report has been published in German as No. 91 in the series "Forschungsberichte des BMZ" and can be obtained from Weltforum Verlag, Marienburgstraße 22, 5000 Cologne 51.

international merchandise trade is transacted in the form of countertrade. Compensation transactions between the West and the East ("North-East" trade, usually termed "East-West" trade) are estimated to account for between 20 and 30 % of the mutual trade volume. It is estimated that around 60 % of the developing countries' merchandise trade with the Eastern bloc ("South-East" trade) takes the form of countertrade deals, a large proportion of which are executed under bilateral clearing agreements. On the basis of figures for 1986/87, countertrade between OECD countries and the Third World ("North-South" trade) probably now accounts for between 10 and 15 % of merchandise trade between these country groups, while GATT estimates that such transactions have already reached 40 % within the Third World itself. There is a heavy concentration of countertrade deals in South Asia (India), South-East Asia and Latin America. Africa and the Middle East, by contrast, do not yet appear to have the economic and administrative structures needed to pursue a more systematic countertrade policy.

### Range of Products

Initially the exchange goods offered by developing countries were almost exclusively raw materials, but their product range has now widened considerably to include not only semi-finished and finished products but also increasingly services of various kinds. The commodities and semi-finished products typically offered are primarily standardised products such as minerals, metals, petroleum, steel, cement, fertiliser, coffee, cocoa, rubber, palm oil and occasionally cereals. The industrial manufactures involved are products that are not yet up to Western quality standards or are too expensive owing to unrealistic exchange rates or for which the exporting country itself does not yet have the necessary marketing expertise.

No further significant growth in countertrade in agricultural products is expected, leaving aside pure South-South trade. The greatest potential is perceived to be in co-operation agreements to exploit new raw materials deposits and finance capital-intensive plant construction and in mass production by light industry, where overcapacity necessitates a continual expansion of the market. Buy-back deals will therefore increase in importance. Countertrade involving services has been largely disregarded up to now, but this has possibly the greatest growth potential. Both developing and industrialised countries can offer a wide range of services in the fields of transport, banking, insurance, construction, advertising, tourism, entertainment and

training. Rights of various kinds, such as patents and licences, which could in principle be exchanged independently of pure merchandise transactions, have hitherto been linked only with specific countertrade deals.

The goods supplied by industrialised countries reflect the rich variety of the technologies they can offer. No particular product group can be identified as preferred countertrade goods, although the products of certain industries clearly predominate. After the two oil crises multinational companies concluded a great many compensation, buy-back and technology transfer agreements in order to secure stable long-term supplies of raw materials and safeguard their markets. More recently a further motive has been the growing worldwide overcapacity in certain products, especially iron and steel but also electronic goods, while keener competition in the motor industry, in machinery and plant construction and in certain high technology fields (aircraft construction, arms technology and nuclear energy) have brought an increasing willingness to accommodate the countertrade wishes of the Third World. As a rule, most countertrade deals in the West are concluded with industries in which there is overcapacity and/or particularly fierce competition. The only firms that can manage without countertrade transactions today are highly specialised monopolies with no real competition and offering products that constitute a high priority for developing countries.

### Causes and Objectives of Countertrade

The growing inclination of Third World countries to engage in countertrade is generally considered to have been spurred by a shortage of foreign exchange and the associated liquidity crisis in heavily indebted countries, where particular importance is attached to export promotion and diversification as a means of overcoming the crisis. Since under a multilateral free trade regime these aims should be attainable even without countertrade deals, from a micro-economic point of view countertrade can be attributed ultimately to marketing problems. Suppliers from developing countries face four main problems in this regard:

- ☐ the lack of markets for particular goods and services (unwillingness to compete on price);
- ☐ the lack of market transparency;
- ☐ restrictions on access to potential markets; and
- ☐ a lack of foresight (planning uncertainty).

As well as providing assistance with marketing, countertrade is expected to safeguard the country's ability to import despite the shortage of foreign exchange; the transfer of technology and know-how

also plays a role and ideally the developing country also hopes that countertrade deals will pave the way to long-term industrial co-operation.

In practice these motives are very often combined. Just as the reasons for engaging in countertrade spring from a whole raft of economic and political factors and problems, the expectations it raises can also be further differentiated. The desire to safeguard imports is associated with the expectation that keen competition among suppliers can be exploited in such a way that the demand to conclude countertrade deals will become a bargaining counter and that countertrade will bring better purchasing conditions and the hope of improved terms of trade. The use of countertrade as a marketing tool is based on the desire to have foreign expertise create an export market that would otherwise be more difficult or impossible to find for lack of marketing know-how. Parallel to this is the expectation that the necessary marketing knowledge may be acquired from Western manufacturing and trading companies. Co-operation and development represent the desire to be able to carry out a kind of investment planning and guidance via the industrial forms of countertrade (buy-back and offset arrangements) without having to depend solely on private direct investors.

For firms in industrialised countries countertrade deals are essentially a passive response to the unavoidable demands of the market. On the other hand, in view of increasingly acute international competition they have recently begun to use their willingness to engage in countertrade as an active marketing tool in an attempt to gain competitive advantages, maintain threatened market shares and penetrate markets that would otherwise be closed to them. Firms that are dependent on exports may go so far as to co-operate actively in the manufacture of a product in the developing country that can be exchanged for its own exports.

The attitude of trading countries and international organisations towards countertrade depends crucially on their individual interests and any legislation or guidelines that may exist. Most western governments, and hence also the OECD, officially support the relatively rigid standpoint of the GATT Secretariat, the IMF and the World Bank, which see countertrade as a violation of the principle of global welfare maximisation inherent in multilateral free trade. Companies in industrialised countries directly confronted with countertrade take a more pragmatic line; for them a countertrade deal is a deal like any other, albeit one entailing greater effort and cost that they will take into account if possible.

Among Third World governments and the international organisations representing their interests – primarily the United Nations and UNCTAD – the fundamental stance towards countertrade is shaped mainly by their individual interests and less by legal or theoretical economic considerations. Although their view therefore differs somewhat from that held in the West, their attitude towards countertrade is ambivalent. They are aware of the costs and risks associated with this form of trade and hence regard it as no more than a second-best solution, since their initial high expectations have not generally been met. For individual firms, however, for which the deciding factor is not the global prospect but the potential micro-economic advantages (securing imports of necessary intermediate products and spare parts), countertrade may often be essential to maintaining production.

It can be deduced from national and international pronouncements on countertrade that even the Third World no longer regards it as positively and uncritically as the current spread of this type of trading arrangement might suggest. Countertrade is clearly the child of necessity, the consequence of conditions that impeded trade and could be overcome or circumvented more easily with it than without it; it is not regarded, however, as a permanent solution or even as a welcome instrument for reshaping the structure of world trade.

### Fundamental Considerations

The crucial question is whether it can be proved that countertrade has helped wholly or partly to achieve the objectives countries have set themselves. However, it is still difficult to assess the impact it has had owing to the paucity of reliable data. The literature on the subject contains extremely few systematic empirical analyses; many works are very similar in content, often quoting one another and citing the same examples. Theoretical considerations of important aspects of countertrade may provide plausible explanations, but many claims appear to be largely unsubstantiated empirically. In this respect, a statistical analysis carried out by the Ifo Institute on the basis of broad country comparisons and long observation periods may give additional insights into the countertrade effects. We shall therefore first examine a number of fundamental points with regard to compensation trade before reporting the main results of earlier case studies. A further section will then deal with the results of our own statistical examination of important aspects of countertrade.

The main objection to countertrade is that it entails bilateralism. In certain circumstances free multilateral

trade leads to an optimum allocation of the supply of goods and services and hence to welfare maximisation worldwide. Competition is highly important in this context, matching supply to demand and hence forcing inefficient suppliers to improve their products or go out of business. This mechanism is immobilised under bilateral trade agreements, a fundamental characteristic of all countertrade transactions. Of course, supply and demand must be brought into equilibrium here too, but conditions are such that the optimum resource allocation achieved by multilateral free trade is unlikely to materialise. The deal is struck not with the party offering the best terms but with one prepared to engage in countertrade. The willingness to do so must often be bought with laborious and costly negotiations and large price reductions on exports or supplements on imports. Moreover, in view of the bilateral nature of the trade the size of the transaction is necessarily limited by the capacity of the weaker party. Hence it is highly probable that the widespread use of countertrade restricts trade, in contrast to the hopes of an increase in sales.

A further consideration stems from the fact that prices and the volume of sales are mutually dependent in any market. Hence in theory any attempt to sever this

relationship by means of countertrade deals at concealed prices (since in principle goods are exchanged for goods, even though the exchange ratio is obviously based on notions of price) can succeed only in imperfect markets subject to severe regional and temporal limitations. The price structure is bound to be affected over the long term, particularly as the essential element in barter and compensation deals, some would say their *raison d'être*, is the oversupply of a particular good. Unconventional trading practices, of which countertrade is one, perform an important function in implicitly or covertly correcting rigidly predetermined prices (in the context of cartels or quota agreements, for example) so that the market can clear at least partially. Viewed in this way, countertrade deals are both a result and a partial correction of market imperfections, though only a "second-best" solution. Of course, it must be borne in mind that overproduction must lead to price reductions sooner or later, with or without countertrade, but transactions of this kind may accelerate and reinforce the fall in price.

## Marketing Aspect

The marketing aspect is also highly important. The countries that insist on countertrade transactions see this as a way of using foreign marketing expertise to

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achieve sales they would themselves be unable to secure for lack of market knowledge. At the same time they hope that by using foreign know-how they will themselves gradually acquire the knowledge that will later allow them to switch to direct trade. The literature describes this as unrealistic, no doubt rightly so. It is not evident how their own level of competence can be enhanced by the use of foreign marketing expertise, which is a well-guarded asset of the firms providing it; indeed, it is much more likely that the opposite will be the case, in other words that countertrade will prevent them from acquiring the necessary marketing expertise themselves.

The latter conclusion is plausible only at first sight, however. On closer inspection it can be seen that the decision not to market goods oneself and the lack of direct contact with buyers abroad are typical of all "indirect" exports, as practised mainly by small and medium-sized manufacturers in all countries, including industrialised ones. The use of trading companies specialising in certain regions or industries is not confined to isolated cases but is the normal outcome of a weighing of costs and benefits, including those of acquiring marketing know-how. Since it is hardly realistic to assume that all the manufacturers of typical exchange goods would create their own marketing and sales organisations abroad if the countertrade option were not available, the decision not to market goods direct cannot be blamed primarily on recourse to compensation deals.

### **Import Capacity**

The decisive factors from the point of view of developing countries are the hopes that countertrade will enable them to increase their import capacity by boosting sales of their own products and to save scarce hard currency by exchanging goods for goods rather than for money. One advantage of countertrade undoubtedly lies in the elimination of price rigidity and the selective devaluation it implies, which means that product prices can be adjusted precisely to suit their particular markets, so that convertibility problems with national currencies can be overcome more easily without incurring the inflationary impact of a blanket devaluation. Foreign currency reserves only have to be drawn down to meet any remaining balance, but this would also be the effect of multilateral trade. Of course, the country will earn additional foreign exchange or increase its import potential only if sales of its products expand as hoped.

The developing countries also see countertrade as a means of improving their terms of trade. This

expectation is based on the notion that by linking imports to exports they can force rival suppliers to compete so fiercely with one another that imports can be obtained more cheaply than under a multilateral cash transaction. However, it is precisely multilateral trade in free markets that leads to such competition and to the optimum adjustment of product prices to the level of demand. Countertrade necessarily restricts the number of suppliers and hence curbs competition. For this reason alone it is therefore highly unlikely that countertrade transactions can lead to lower purchasing prices.

Similar considerations must be made with regard to the goods the developing country exports in exchange. As already mentioned, in most cases countertrade serves to dispose of surpluses and break down price barriers. The selective devaluation in the form of price reductions made possible by countertrade is an appropriate means to this end. Hence for the developing country the combined effect of countertrade is more likely to be an increase in import prices and a reduction in export prices, and hence a deterioration in its terms of trade rather than an improvement.

Another factor supports this assumption. Countertrade transactions almost always entail laborious and hence costly negotiations until a result is achieved that satisfies both parties or, as is often the case, the entire deal collapses. The costs of these time-consuming negotiations usually do not narrow the profit margin of the Western exporter but are added to the product price and thus borne fully by the developing country. This practice, which can be followed in all but a few instances, also tends to lead to a worsening of the developing country's terms of trade.

### **Bilateral Nature**

An important feature of countertrade that is repeatedly mentioned in the literature is its bilateral nature. It is acknowledged that countertrade can be a highly flexible and hence sensible instrument if used voluntarily to adapt rapidly to a particular emergency situation. However, all-embracing, rigid, state-imposed countertrade rules are regarded as much more problematic; their restrictive effect on trade is all the more serious the larger the number of states involved, the greater the proportion of individual countries' overall trade transacted in this way and the more pronounced the spillover of bilateralism to regions, sectors or enterprises within the country. The literature therefore concludes unanimously that countertrade is detrimental from the point of view of international welfare and not

only leads to a global reduction in the volume of trade but very often also results in the diversion of products from convertible to inconvertible currency areas. In not one instance has it been possible to find conclusive evidence of the hoped-for increase in sales. The only exception to this assessment possibly concerns South-South countertrade, to which trade-creation effects can be attributed in certain circumstances.

The effects of countertrade on the price structure in the markets in question are crystal clear. A distinction must be made here between countertrade deals in traditional products (raw materials) and those in non-traditional exports (mostly manufactures, but also services). In view of its primary function of marketing surplus output, countertrade in commodities accentuates falls in price, aggravates destabilisation and prolongs periods of weakness in commodity markets. In many instances the net result is merely to displace normal exports – goods in exchange for goods instead of goods in exchange for money. The Third World is therefore now focusing more strongly on non-traditional products, in the hope that product diversification will also bring a wider geographic spread of markets.

It is generally essential to call on foreign expertise to market non-traditional products. We have already described the consequences of this but also explained that they are not specific to barter trade.

As regards the terms of trade effects, some of the cases described in the literature show contrasting results. For example, it has been shown that under one bilateral trade agreement with the USSR India was able to secure more favourable terms than with conventional trade arrangements, whereas on the basis of other countertrade agreements with other countries it usually paid higher prices than those prevailing in the world market. Since the prices on which countertrade agreements are based are often very difficult to ascertain or are deliberately obscured, it is practically impossible to reach a universally valid conclusion on the basis of the literature available.

A number of other consequences of countertrade discussed in the literature will be touched upon only briefly here. For example, it is often pointed out that countertrade insulates countries from international competition, with the result that market disequilibria are not eliminated or structural aberrations corrected but indeed reinforced. By contrast, a more positive view must be taken of the attempt to use the so-called industrial forms of countertrade (buy-back and offset transactions) as a development instrument, although

here a danger lies in the impossibility of adjusting the exceptionally long-term agreements to changed world market conditions. Finally, it is seen as a problem that countertrade deals can usually only be concluded by large firms, so that small and medium-sized manufacturers in industrialised countries are at a disadvantage.

### Statistical Analysis

The purpose of the statistical analysis was to examine whether the increasing prevalence of countertrade worldwide had discernible effects on important economic variables and what form these effects took. Attention was focused on the developing countries, individually and as a group, on the macro-economic aggregates of importance for development and on indicators such as exports, imports, debt, terms of trade and so forth.

The method adopted was to compare countries with a high level of countertrade with those with a low level. In order to obtain groups that were as uniform as possible a further distinction was made between very poor developing countries, newly industrialising countries, highly indebted developing countries and countries with a relatively high proportion of industrial exports.

An important preliminary task was to classify developing countries according to their involvement in countertrade – high or low. Among the many options available, all imperfect in one respect or another, we finally decided to base the analysis on the data contained in the journal "Countertrade Outlook", chiefly because it has a uniform system of recording countertrade transactions, aims to be comprehensive and covers a very large number of countries, including many small ones.

The central questions addressed by the statistical analysis and the results obtained are outlined below.

□ *Is countertrade an instrument for intensifying South-South trade?* The long-term growth rates of trade between different groups of developing countries and between these and industrialised countries were compared.

In terms of total exports, a larger number of trade flows among groups of developing countries have intensified than have contracted. However, the picture is evenly balanced as far as exports of manufactures are concerned and actually the reverse as regards exports of capital goods, which are generally expected to have a stimulatory effect. In this product category all North-South trade flows have increased in relative importance.

The empirical analysis therefore shows that the intensification of South-South trade which may have been due to countertrade has been very limited so far.

□ *Has countertrade led to an acceleration in export and import growth?* In several cases there is no perceptible divergence between the import or export performance of countries with high and low levels of countertrade, either during the period before the expansion in such trade or afterwards. In the other cases, and significantly among NICs and highly indebted countries, there is a relatively clearcut divergence, in that intensive recourse to countertrade has patently not made for more dynamic export or import growth but has possibly impeded it.

Empirical analysis therefore points rather to a negative relationship between countertrade and the rate of growth of exports and imports.

□ *Can countertrade improve the trade balance and check borrowing?* The evidence shows that, with some exceptions, countries with a high level of countertrade have a higher long-term import-export ratio (imports divided by exports) than those with little involvement in countertrade and therefore have a faster rate of growth in debt. Moreover, it cannot be said that the relatively intensive use of unconventional foreign trade strategies is generally accompanied by a particularly successful reduction in the import-export ratio and thus with a significant check on the need to borrow.

Hence it could not be demonstrated empirically that countertrade improved the trade balance and reduced borrowing requirements.

□ *Does countertrade bring about an acceleration in industrial exports?* An analysis of industrial exports over time shows that where countertrade has been used intensively the rate of growth of industrial exports was not maintained or increased by the adoption of these practices. Countries that relied mainly on traditional foreign trade strategies did significantly better.

The evidence therefore indicates a negative correlation between the rate of growth in industrial exports and countertrade.

□ *Has countertrade led to export diversification?* It emerged that countries with a high level of countertrade had little success in their efforts to diversify their exports and were also noticeably less successful than countries with more conventional foreign trade strategies.

Here too, the empirical analysis indicates a negative correlation between export diversification and countertrade.

□ *Has countertrade had a beneficial effect on the terms of trade?* Engaging in countertrade has not caused the

terms of trade of countries with a high level of countertrade to perform significantly better than those of countries with a low level.

The empirical analysis therefore provides no evidence to support the claim that countertrade can improve the terms of trade.

□ *Are there typical characteristics that differentiate developing countries with a high level of countertrade from those with a relatively low level?* Whereas the time series analysis indicated that under the influence of bilateral forms of international trade the behaviour of important development variables showed marked differences between countries with high and low levels of countertrade, most of the supposed causal links could not be substantiated in the cross-section analysis. One important point is that foreign debt clearly has no significant impact on the intensity of countertrade. This is not implausible, since of all the bilateral forms of trade it is really only pure barter that eases the external debt burden, and then by displacing existing creditors' claims. It is also plausible, and indeed it almost goes without saying, that the most reliable link with the intensity of countertrade is to be found in variables measuring the size of the country and its level of development. The administrative infrastructure required for alternative forms of foreign trade and the necessary supply potential are more likely to exist in the larger and more advanced developing countries.

## Conclusions

It can therefore be concluded that on the whole countertrade has clearly not produced the benefits many Third World countries had expected. At least as far as the criteria we have examined are concerned – intensification of South-South trade, acceleration and diversification of exports, easing of the pressure to borrow and improvement of the terms of trade – countries with a high level of countertrade have managed no better than those with a low level, and some have fared much worse.

All in all, the experience of recent years has led developing countries to take an increasingly cautious attitude towards countertrade, although there are exceptions. Whereas some countries that were previously heavily involved in countertrade are now trying to reduce their reliance on this type of arrangement, other states are moving in the opposite direction. Nevertheless, the increasingly sceptical attitude should help avoid developments that are downright harmful and lead countries to prefer industrial forms of co-operation to pure trade arrangements.