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PROS AND CONS OF COUNTERTRADE : A CRITICAL NOTE

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Summary: Countertrade is just a package deal of exports, imports, and secured finance. Also, most countertrade goods are unloaded via brokers or traders. The basic issue therefore is why the barter country doesn't sell directly to a broker. True motives for countertrade could be (a) ideology, (b) reduction of transaction costs in setting up interlinked contracts involving many parties, and especially (c) the desire to hide trade, sales prices, inefficiencies, subsidies, overvalued exchange rates, protectionism, etc. Other frequently-cited "advantages" of countertrade trade are dubious, superficial or even incorrect: obtaining better terms of trade, automatic balance of payment equilibrium, risk-aversion and risk-shifting on behalf of Socialist decision makers, reduction of problems created by protectionism in the West, and allowing a country to trade, to acquire technology, and to create employment even in the absence of international reserves. Finally, countertrade has some distinct disadvantages: in most cses it leads to lengthy negociations and complicated transactions, hidden protectionism (both in the West and in the countertrade country), and inefficient decisions.

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Pros and Cons of Countertrade:
A Critical Note

The purpose of the present note is not to explain the many variants of countertrade[1]; a reasonable understanding of this matter is assumed. Rather, the objective is to demystify countertrade, which, in the eyes of many students, seems to be a panacea for all kinds of problems. In Section One we characterise countertrade as basically a package deal of simple, standard trade and finance transactions. Section Two critically discusses the most popular arguments in favour of countertrade, while Section Three outlines the inherent disadvantages.

1. The essence of countertrade

The recent rise of countertrade has often been associated with the balance-of-payments problems and lack of hard currency reserves of developing countries and socialist economies. Under these circumstances, it is said, countertrade allows a country to import goods or to acquire technology without having to pay in scarce hard currency. In the same vein, countertrade is said to provide the advantage of automatic equilibrium on the trade balance, while simultaneously creating or protecting employment[2].

Let us confine ourselves, at this stage, to the lack-of-reserves argument. The standard ways of obtaining hard currency are exporting, or obtaining loans. So the questions really are: is standard trade possible, and, if so, why do the parties involved settle for a barter deal instead of the standard solutions?

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1. In the present note, "countertrade" is used in a general sense, and includes pure countertrade, buy-back arrangements, countertrade, compensation agreements, etc.
2. E.g. D. Francis, The Countertrade Handbook, Woodhead-Faulkner, Cambridge, 1987, pp. 9-13; or Dossier SNE, Compensation Tiers Monde 1, Juin 85, p. 26-27.

In idealised markets, classical trade is no problem -- even in the absence of reserves. If the importing country is lucky enough to possess standard commodities traded on organised exchanges, *earning cash* is straightforward. If no staple goods are available at present, but sufficient exportables are forthcoming in the future, *obtaining secured credit* should be equally easy. Security for the loan can be achieved by selling forward the future commodities on organised futures exchanges and by having the proceeds of the sale earmarked as security for the loan, e.g. by having the proceeds of the forward sale paid out not to the exporting country but to a trustee, who then uses the money to pay back the loan. The forward or futures price will take into account the expected future spot price, the convenience yield, and the risks (interest rate risk, the non-diversifiable market covariance risk, and, via the Exchange's tax, also the default risk[3]).

Standard commodities are, of course, not exactly a growth business; and presumably any exporter would already be selling its available staples on the world markets. Genuine export growth accordingly is to be sought in processed goods. For most of these potential exportables, there are no well-developed spot or forward markets[4], so the above idealised scenario is not valid. Under these more realistic circumstances, the Eastern country or LDC might have to find the final customers rather than relying on a market. This may be quite difficult and expensive, as the exporting country very often does not have the marketing knowledge, necessary relations, bargaining power, and/or distribution network. In that case it is rational to enlist an *intermediary*. This could be a specialised trading firm who buys

3. In Futures markets, the Clearing Corporation assumes the risk of non-delivery.
4. This could be the case even for staple commodities if the maturities are too long. Beyond six months, futures market often lack sufficient depth, and prices may therefore not really be reliable "market" prices; and, futures contracts beyond one year are simply non-existent.

from the country (spot or forward); and a fee will have to be paid which, in the presence of sufficient competition, will be a normal compensation for the risks and costs taken over by the trader. The intermediary might even be a form of rudimentary Exchange, which matches supply and demand between its members[5]. Alternatively, the products may be directly sold, spot or forward, not to a professional trader or via an exchange, but to a Western firm that produces and/or distributes similar goods. This is a standard, subcontracting arrangement[6]. It would provide the exporter with a stable, predictable income, which could pay for future imports or could be earmarked as security for a loan. Since the Western buyer of the goods usually produces similar goods and often even owns the trade mark and the technology, the Western partner is in a better position to assess returns and risks than even a specialised broker would be. Like any middleman, the Western firm may also be better placed to overcome implicit trade barriers such as an unfavourable country-image.

Notice that, although such middlemen do play a big role in barter-type transactions, we have not described countertrade yet; all we have said is that Western commodity markets or Western partners can be used to facilitate exports, and even to provide guarantees for loans if forward deals or long-term purchase contracts (subcontracting) are tied to a loan agreement. And these classical solutions are always possible -- if an acceptable price is asked, and the necessary fees are paid to the middlemen.

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5. Countertrade Exchanges are discussed in K.H. Harte, Legal Implications of Countertrade and Countertrade Transactions, in B.S. Fisher and K.M. Harte (eds), Countertrade in the World Economy, Praeger, 1985, p. 221.
6. Such a contract is implicit in a buy-back. The non-countertrade version of this contract is as follows: a LDC or Socialist country buys P&E plus know-how, and pays in the usual fashion, with the financing loan serviced and secured via a standard long-term subcontracting deal signed with a Western producer or distributor of the product. The buyer may or may not be the same firm as the chief contractor in the turn-key project.

All variants of countertrade basically are just of this form: sell spot or forward to a middleman, and have the proceeds used to pay for imports or to amortise a loan that finances an earlier or simultaneous import transaction. Conversely, countertrade therefore is not really a way of trading without cash, but a deal where imports, secured loan, and exports are all part of one package. Many of the alleged advantages of countertrade thus are

- either advantages of trade *per se* (earning money to pay for imports of goods or technology, creating employment, etc.), or
- advantages from using a middleman (easier access to distribution channels, marketing expertise, etc.), or
- advantages of forward deals (risk-shifting).

Likewise, the pros and cons of a buy-back deal are just the pros and cons of any turn-key and technology-transfer contract plus the pros and cons of any long-term subcontracting deal. If we really want to explain countertrade-type trade, we have to answer the question why package deals are preferred over separate deals. When discussing the pros and cons of countertrade-type arrangements, the present paper accordingly takes the (unbundled) standard solution as the basis for comparison, rather than the "no trade" alternative. The "no trade" null hypothesis assumes that the standard solutions are just impossible. This is an extreme point of view. Standard trade *may* more difficult or less profitable than countertrade (although we question even that), but it surely is not infeasible.

As we will argue below, one crucial characteristic of countertrade is that it offers vast opportunities to hide what's going on, and may therefore lead to economically inefficient decisions. In order to isolate this aspect from the other issues, we will initially assume away this motive. The initial assumption therefore is that all parties are aware of the true costs and proceeds of the deal. Also, we'll assume that Western firms prefer more money to less; that is, a profitable proposal is accepted, and a loss is rejected unless it is seen as an investment that produces sufficient gains later on.

2. Advantages of Package Deals: A Critical Look

2.1. The Planning Ideology

(Pure) barter or buy-back deals involving Socialist Economies do fit in with the ideology of a centrally planned economy, with its emphasis on quotas and long-term planning rather than on a market mechanism with independent decision centra reacting on price signals. This argument would fail to convince most economists, and even Communist countries (or most of them) seem to have lost faith in it. It presumably was a motive in the early days of barter trade only.

2.1. Better Terms of Trade

Both Developing and Socialist Countries view countertrade as a way to change the rules of the International Trade game, felt to be to the advantage of the developed world and its multinationals[7]. Countertrade is viewed as a way to pry open Western markets, using the stick-and-carrot policy of "no exportation without importation". There are obvious barriers to entry for new exporters. For instance, in the early 80's, thirty to forty percent of the international trade of the US, UK and Japan was intra-company trade[8] rather than open, arm's length trade where any outsider would have a fair chance. By forcing the multinational to buy countertrade goods, trade is created (or at least diverted towards Southern countries).

This argument overlooks the fact that most countertrade goods are not directly sold by the Western contractant himself. Rather, the

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7. Dossier SNE, Compensation Tiers Monde 1, Juin 85, p. 27.
8. Transnational Corporations in World Development, Trends and Prospects, U.N., New York, 1985, p. 89.

latter seeks a price from a trader. Such a trader presumably judges the product on the basis of its intrinsic or perceived qualities, and cannot be forced to take them in; also, the trader is not influenced by the Western exporter's concern for export profits. And the LDC could have brought the goods to the traders' attention directly, via direct mail or visits or participation in trade fairs; presumably, the trader, when contacted directly, would still judge the product on the basis of its intrinsic or perceived qualities. One cannot seriously argue that direct deals are impossible. In spite of all existing entry barriers, new products *are* brought to new markets continuously. Chilean Santa Rita 1985 (Cabernet Sauvignon) is sold directly to e.g. Belgium's Grand Bazar, without tying it to countertrade; and there is no obvious reason why Bulgaria would not be able to do the same with its Plovdiv 1985 (also a Cabernet Sauvignon). If Chile can catch the GB's attention, Bulgaria can do so too.

Since direct trade is always possible, the Developing Country's implicit belief must be that it could not have obtained itself the same terms by directly dealing with a trader, or that the marketing costs can be shifted to the Western partner without correspondingly inflating the valuation of the goods supplied by the Western firm[9]. If the cost of marketing the bartered goods is really shifted (or partially shifted), this merely is an indirect way to obtain a lower price for the Southern or Eastern country's imports; there is no obvious reason why the same price decrease could not have been obtained under normal, unbundled negotiations. One could argue that the Western exporter will take over the marketing cost because his export profit is at stake. But this misses the point: also when negotiating a price under standard open trade, the exporter's profit is at stake; and if

9. Such a belief is also implicit in texts by Western authors when they mention trade creation as one advantage. See e.g. D. Francis, o.c., p. 11; T. B. McVey, Policy Issues in Countertrade, in B.S. Fisher and K.M. Harte (eds), Countertrade in the World Economy, Praeger, 1985, p. 268; Dossier SNE, Compensation Tiers Monde 3, Octobre 85, p. 32..

the LDC customer's bargaining position is strong enough to shift some costs to the Western firm, the same bargaining position should have led to a similar price decrease under standard trade.

Accordingly, a more promising alley seems to be that the Western contractant can get better terms from the trader, so that the barter country and the Western firm, as a group, gain from transfering the marketing effort. One version is that the Western firm has more experience or better bargaining skills than a Developing Country. Another version of the argument hinges on the respective bargaining position. A direct approach to a trader would place the would-be exporter in a weak position, since the broker knows that the exporter desperately wants to get rid of its goods. But this argument seems to overlook competition. If one trader offers ridiculous prices, the exporter should turn to another broker. It is one thing to say that Bulgaria's Vinmonopol has no established links with the major Western distributors, but claiming that it cannot get hold of a list of brokers is far less convincing. The argument also overlooks the fact that, basically, the Western firm is in a similar position as the barter country. It has to get rid of the goods too, and it can turn to the same competing trading firms if the terms are unattractive.

Even assuming that the western firm, somehow, does get better terms from a broker, it is not obvious that this advantage would be passed on to the barter country. One would expect that at least part of the extra gain would be pocketed by the Western exporter, as a compensation for the inconvenience of countertrade, or simply because the Southern exporter is in a weak bargaining position or has little negotiating skills. Moreover, by dealing with Western markets in a very indirect way, the Developing Country foregoes the opportunity to learn about those markets or to acquire expertise in bargaining. It can hardly be efficient, in the long run, to keep working via Western firms who sell to brokers who then sell to the standard distributors. At best, this could be a very temporary first method of entry.

In short, it is not clear whether the conditions offered by a Western firm (who then sells to a broker) would be systematically better than the terms the countertrade country would have obtained directly from such a trader. Unfortunately, this is an eminently untestable issue.

2.3. Cost of contracting and agency costs.

Under very specific circumstances, there may be economies in replacing the forward sales contract, the loan, and the escrow arrangement by a single contract with one firm. We think we can make a decent case for a buy-back deal, where the plant's output is explicitly linked, via a patent or brand name, to a specific Western producer.

Let us first look at reasons to link the Plant & Equipment project to the subcontracting deal. For one thing, by assumption the production technology is partly proprietary, or at least the Western buyer of the output wants to ensure a very specific production process. For the sake of confidentiality and/or efficiency, the Western buyer of the output then logically also becomes the chief contractor in the turn-key/technology-transfer contract. Second, if the plant's output is associated with one particular Western firm who owns the brandname or the patent, there also is substantial information asymmetry with respect to the value of the technology and the market potential of the product. The Western firm's willingness to buy back a substantial part of the output then acts as a signal about the value of the technology, and would reduce the information asymmetry problem[10].

10. Another potential signal would be a substantial equity participation, but that often is legally impossible or politically undesirable.

Given that, for the above reasons, only two partners are involved in the turn-key project and the long-term purchase contract, there are also some potential arguments for bringing the financing into the same package. Even assuming that proceeds of the long-term sales contract are earmarked for amortisation of a loan, a bank would nevertheless extend the credit to the reserves-starved buyer of the plant only if the default risk on the subcontracting deal is taken over by the Western firm. One reason is that banks are not in the business of taking risk; and an established Western firm is a better risk than a near-bankrupt country. Second, the banks again know that the Western firm has better insight into the value and uncertainties of the technology and of the product's market. Given the fact that, in the case of a bank loan to the LDC country, a guarantee would be needed anyway, the Western firm might as well borrow directly from the bank, and use the loan to build the plant. Both alternatives are essentially similar. A more positive reason for a package-deal is that outside financing may not even be necessary. If the Western firm does have the means to finance the deal out of its reserved earnings, the package-deal avoids the bid-offer spread that would have to be paid to a bank if the LDC had obtained a guaranteed loan[11].

To sum up: with asymmetric and proprietary information, the drafting, monitoring, and implementation of one contract probably is cheaper and easier than three separate but interlinked contracts -- the turnkey-project, the loan agreement, and the long-term sales contract. Note however that for most countertrade-like deals there is no such proprietary or asymmetric information. So one cannot invoke the above argument for the run-of-the-mill countertrade transaction. The inverse may even be true. In reality banks do play a large role in many

11. This assumes that the Western firm would have invested the excess funds in the capital market. An alternative is to pay out these funds as dividends, which would entail personal taxes.

countertrade contracts other than buy-back deals and bare-bone barter; France's S.N.E. even calls them generally indispensable[12]. And even when no financial middleman is involved, the costs and complications of contracting can be huge; we will expand on this in Section Three. So the reduction of contracting costs may play a role in some contracts, but cannot offer an universal explanation for countertrade-type deals.

2.4. Creating trade and employment.

Countertrade is not a way to trade without cash; rather, it is, at best, a packaged way of obtaining secured trade finance. It does create employment, gives access to technology, and allows imports, but all these advantages are advantages of trade *per se*, and have nothing to do with the essence of countertrade, to wit the packaging of immediate or future exports with secured finance for imports.

2.5. Risk-Shifting

Intimately related to the planning ideology is the extreme degree of risk-aversion on behalf of Socialist Country decision makers. This thesis was well illustrated in an article by XXX, who offers it as the explanation for buy-back deals. A list of the risks born by the Western contractant may look as follows:

* *Price risk*. In all deals involving future delivery of goods there is an implicit forward contract. This means that the Western firm takes the price risk inherent in a forward position -- i.e. the risk of a drop in the value of the goods caused by unexpectedly low demand or high supply[13].

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12. Dossier SNE, Compensation Tiers Monde 3, Octobre 85, p. 32.
13. We interpret risk as related to uncertainty in cash flows, not the "regret" of not having taken the (ex post) best decison. With a "regret" type of approach, no risk-shifting seems to be possible. Uncertainty about cashflows, in contrast, is eliminated

* *Uncertainty about the fair forward value.* The Western firm in a countertrade deal does not usually have the guidance of a market price (which is a consensus of all traders' perceptions of future value distributions); in reasonably efficient markets a consensus price is more reliable than a price convened by just two parties.
* *Delivery risks.* The Western firm takes large risks that are, in principle, diversifiable but cannot be hedged in the case of a countertrade deal -- to wit the risk of late delivery, substandard quality, or outright default (see also Section Three). In contrast, when a firm buys forward on a well-organised futures exchange, the Clearing House takes over (and largely diversifies away) this type of uncertainty. These risks lead to discounts that increase with the horizon of the contract, and with the degree of processing: staple commodities get low discounts, machinery needs the largest subsidy.
* *No secondary market.* On an organised exchange it is easy to entirely liquidate one's position. This is difficult in the case of countertrade. To be true, a firm could conceivably sell forward, to another Western party, its previous forward purchases; but it still bears the risk that the countertrade country defaults on the original contract[14]. Also transfering the entire contract is difficult, since the agreement of the countertrade country would be needed.

If countertrade-country decision makers are extremely risk-averse, barter or buy-back does provide a way to shift the uncertainties. But any forward-type deal has two edges. The LDC's risk is that the contractual deliveries may create unexpected shortages in its home market. In planned economies, these would lead to waiting lines in lieu of price rises, but the difference

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if the Southern exporter sells forward his products on a futures market or via a subcontracting arrangement.

14. In this case also a "reverse" price risk is run: if the countertrade country doesn't deliver, the Western firm that has covered its forward purchases is actually harmed by an unexpectedly high price rather than by an unexpectedly low price, since it will have to buy spot in order to fill its own delivery obligation.

is not substantial. And also the LDC shares the uncertainty about the fair forward price. In short, as far as risk is concerned, barter or buy-back is not a panacea.

A second caveat is that the risk-shifting argument, like the lack-of-reserves factor, may explain why countries want to sell goods forward, or why countries want to enter into long-term sales contracts with traders or with Western firms that produce and sell similar goods. Yet it does not explain the tying of export, import, and financing contracts into one package deal, which is the essence of countertrade-type transactions. In order to explain package deals we'd have to fall back on other explanations, like better terms or lower contracting costs.

2.6. Protectionism in the West

A popular explanation of countertrade is protectionism in the west. This argument is puzzling. If tariffs or quota apply when say Bulgaria sells its wine directly to a trader, the same tariffs or quota still exist when Coca Cola imports the same wine. Instances where a single firm has enough influence to change trade laws must be very rare indeed. A more general interpretation of the "protectionism" argument is (non-tariff) barriers to entry. We have already dealt with this: the implicit and unsubstantiated assumption is that the LDC or Socialist Country could not obtain the same result if they directly dealt with a trader. The raison d'etre of intermediaries is to provide contacts with distributors and, where necessary, officials[15], or to give the product a different image by marketing it under a different brand name or by improving the product's image in some other way. There is no need to tie i.e. exports to imports and

15. Officials may have some discretion in the application of trade barriers. For example, the U.S. Customs recently decided to re-classify four-wheel-drive light trucks under the heading of trucks rather than (low-taxed) passenger cars.

financing, when the purpose merely is to use the services of an intermediary.

2.7.. Balance-of-Payments Equilibrium

The balance-of-payments argument can be interpreted in a loose sense, as meaning that for every import contract there is also export revenue. Countertrade, by imposing a minimal purchase constraint, would then give the Developing Country more opportunities to import. We have already argued that export revenue can be obtained without countertrade too, e.g. by exporting via an intermediary, and then using the currency proceeds to pay for imports; or by signing a forward sales contract and getting import finance on that basis. Again, there is no need to bundle all this into a countertrade deal. An alternative (and more hands-off) balance-of-payments policy could be to allow the exporters to auction off their hard currency among candidate importers. This would ensure the same zero-trade-balance effect, would give substantial incentives to exporters, and could if necessary be complemented with active support for the country's exporters.

If balance-of-payments considerations are not inspired by a lack of reserves, but rather is a result of ideology, the argument loses even more of its appeal. In fact, we will classify this as one of the disadvantages.

3. Disadvantages of Countertrade

3.1. Opportunities to hide what's going on.

A package deal creates opportunities to hide the true proceeds and costs. In general, these amounts are not made explicit, as there are ample opportunities and incentives to use offsetting misrepresentations of the true costs and proceeds.

One motive for price-hiding arose in the case of OPEC countries, who have frequently used payment in kind in order to hide sales below the posted cartel price. If the contract does mention a value, that contractual oil price can easily be inflated to meet the OPEC floor; the Western exporter then builds in the discount into his own price, or, equivalently, inflates the price of his goods by the same factor. On occasions, OPEC countries have also treated countertrade exports as not being part of normal trade, and therefore irrelevant with respect to their export quota for crude[16]; in this last instance, not only the price but even the very existence of trade is more or less camouflaged.

In other cases, countertrade allows countries to get away with the poor quality or noncompetitiveness of its products without having to openly accept a low price. The discount (or conversely the degree of overestimation of the sales value) can be substantial, ranging from 2 to 10% for staple commodities and even from 25 to 40% for finished products[17]. Making explicit the true price may be politically unpopular or psychologically undesirable; and it may also create problems with anti-dumping regulations.

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16. The formal contractual price might be in accordance with the OPEC floor, but the discount is given by accepting an inflated value for the imported goods.
17. Dossier SNE, Compensation Tiers Monde 1, Juin 85, p. 29; Dossier 2, Juillet 1985, p. 60.

Note that this form of camouflage is not the monopoly of Socialist Economies and LDCs. In the West, politicians routinely use compensation agreements in arms and aviation deals to fool the voters (and possibly themselves too), and/or to hand out presents to producers and workers in selected industries. What voters get to see are impressive announcements of compensating deals, allegedly creating N jobs for n years. But these engagements are hard to control and to enforce in the first place; a large part of these contracts may just replace standard trade that would have taken place anyway. And if the contract does lead to genuinely additional orders, this very often means that the benefiting firms were not competitive, and are therefore inobtrusively subsidised by the taxpayers. H. Candries of Flemish Aerospace Group (which groups the potential subcontractors for aviation deals) mentioned that Belgium paid BEF 22 billion too much for its F-16 fighter planes. Belgium had insisted on local assembly and local purchasing, and in the end it in fact paid almost twice the price Denmark had obtained for simple off-the-shelf F-16s[18]. Simultaneously, MacDonnell-Douglas complained that they could not find sufficiently competitive Belgian subcontractors to meet the F-16 compensation contract[19]. This is an example of how protectionism in the west leads to tied trade -- although not the type of example that people usually have in mind when the make a link between Western protectionism and countertrade.

Moreover, the advantage of potential, additional orders (trade diversion) is reduced (or even potentially reversed) when other countries also play the game and steal production from each other. During Bombardier's negotiations with Belgium for the delivery of 500 jeeps, Canada unexpectedly came in on Bombardier's side by threatening to revoke an earlier order for Belgian FN guns. The net effect of this type of game would not be more jobs; rather, the overall consequence would be a

18. De Standaard, ??/??/??, p. ??.
19. ???

misallocation of production to inefficient producers. Of course, given the fact that others do play that game, each country has an incentive to join it; and all parties then become locked in into a prisoners' dilemma.

Thus far we've looked at the countertrade country, i.e. at the government insisting on countertrade or compensation. At the other side of the contract, also the Western firm may accept the risks and burdens of financing and trading without explicitly calculating the true associated costs and proceeds. In general, countertrade (where the true prices and fees are often not made explicit) can hide the true profitability of a deal. So managers may unwittingly accept a bad contract, or may use countertrade as a way to get money-loosing pet projects accepted[20]. Another motive on behalf of Western companies mirrors one of the countertrade-country's possible objectives: by countertrade, the Western can hide a discount on their own products; if made explicit, such a discount might set a precedent invoked by other customers, may fall foul of anti-dumping laws, or may start a price war.

Hiding what's going on may be a major explanation of countertrade and compensation deals. Yet this is not a factor most economists would be happy about.

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20. In their "Introduction to Corporate Finance" textbook, Brealey and Myers present convincing evidence of a positive correlation between upward biases in profit forecasts and the degree of potential personal achievement offered by a project. The value of (boring) replacement projects is typically underestimated, extensions of existing programmes are somewhat overestimated, and new projects are associated with a very clear upward-biased profit forecast. Presumably a similar bias could exist for exotic projects like a buy-back deal with say China, or a "loss-leading" entry move into say the Hungarian market.

3.2. Insistence on bilateral equilibrium on the trade balance

Unconditional insistence on bilateral equilibrium is a disadvantage. First and foremost, there is nothing wrong with a temporary overall deficit caused by e.g. windfall losses in domestic production or by imports of capital goods: international capital markets, like national capital markets, serve to smooth away variations in consumption and to separate investment decisions from consumption decisions. Countertrade deals or their "unbundled" equivalents can only be justified as a second-best solution in the near-absence of international reserves: it is better to have some complicated trade with guarantees and securities than no trade at all. But insisting, as a matter of principle, on a permanent equilibrium imposes needless constraints that lead to unnecessarily complicated deals and inefficient solutions.

Moreover, although an equilibrium on the trade balance may be desirable in the long run, this is to be understood in a multilateral way. There is nothing wrong with Belgium importing oil from Saudi-Arabia, the US importing endives and chocolate from Belgium, and Saudi-Arabia importing cars and wheat from the US: although each bilateral balance would show a serious disequilibrium, the overall balance can be perfectly all right. Insisting on bilateral rather than multilateral equilibrium is tantamount to rejecting some of the advantages of international specialisation; it is an artificial, pointless constraint that can not lead to efficient solutions in general.

Note, in passing, that the bilateral approach to the balance of payments is not confined to Socialist and Developing Countries. Also the US is currently paying special attention to trading partners with substantial bilateral surpluses; and countries like France have occasionally been making similar noises[21], or have

21. Dossier SNE, Compensation Tiers Monde 1, Juin 85, p. 31.

even resorted to "voluntary" export restraints or Poitiers tricks.

3.3. Cost and Complications of Contracting

Among the potentially valid reasons for countertrade we mentioned contract simplicity and elimination of financial middlemen. This would be the case for e.g. buy-back contracts and for the (rare) bare-bones barter deals. Note however that, in many countertrade-type transactions, financial intermediaries are again brought in via the back door. The risks inherent in pure barter or in switch trade can be shifted by a double Letter of Credit; or a trustee (escrow) account can be used to provide a reciprocal guarantee. Also in compensation deals a trustee is often involved, and bank guarantees are used in lieu of posting a bond in countertrade[22]. Apparently, avoiding the financial middleman and reducing the number of contracts cannot be a universal explanation for package deals. Also, banks often seem to be willing to issue Letters of Credit (at a cost), which is basically equivalent to extending a loan to the LDC.

Other potential sources of contractual complications are:
- a countertrade or countertrade transaction can lead to tax complications. Taxation is on an accrual basis, and the fair market value of the goods received is often hard to establish[23]. Another problem arises with establishing the timing of the accrual when goods are unloaded via a countertrade exchange[24].
- unloading goods at substantial discounts from a stated (and inflated) contract price may violate fair trading practices legislation or anti-dumping regulations[25].

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22. See D. Francis, o.c., pp. 60-81; S.N.E., Compensation Tiers Monde 3, passim.
23. K.M. Harte, p. 224 sqq.
24. Ibid., p. 226.
25. Ibid., p. 234.

- the elements of reciprocal dealing, tying, and exclusive dealing present in countertrade and countertrade transactions may violate anti-trust law[26].
- Countertrade and countertrade "pose serious issues in terms of basic GATT obligations. The problems are exacerbated by the fact that countertrade is most commonly used by state-controlled economies: the GATT rules are difficult, if not impossible, to reconcile with those countries' extensive government involvement in commercial decisions"[27]
- the single-contract nature of compensation contracts poses problems when the countertrade part of the deal is to be discharged by a third party: there are issues of confidentiality, and problems with a third party being principal to only part of the contract[28].
- the lists of goods in compensation deals and in countertrade: "are often unrepresentative of what is actually available, and will almost always include a depressing array of low-quality, overpriced, unsaleable goods"[29]. Penalties are sometimes ridiculously low, as was the case in the Bombardier deal[30]. So it is hard to come up with a satisfactory, foolproof contract.
- there are often limitations with respect to the markets in which the countertrade goods are allowed to be sold; and problems arise when the countertrade goods are sold by the Western partner to a traditional customer of the countertrade country[31].
- there are difficulties in obtaining (Government) export insurance contracts for the non-monetary part of the payment in

26. See Idid., p. 235 sqq., for US and EC anti-trust law implications for such transactions.
27. R. M. Gadbaw, The implications of Countertrade under the General Agreement on Tariffs and Trade, in B.S. Fisher and K.M. Harte, o.c., pp. 254-266; the quote is from p. 264.
28. D. Francis, o.c., p. 16.
29. Ibid., p. 35;
30. B. Van de Walle, Het Bombardier Dossier, K.U.Leuven, D.T.E.W., 1990.
31. Ibid., p. 54.

compensation trade, for export contracts that are conditional on a countertrade contract, and for switch trade[32].
- legal problems also exist with the penalty clause in countertrade: if the second contract is not fulfilled, is the defaulting party free of its obligations when the bond is called or the penalty is paid[33]?

Apparently, all this can be satisfactorily settled, or at least the contractants can live with the problems. Yet it must be clear that a general requirement to offset any import transaction with export transactions makes for lengthy negotiations, complicated deals, etc. It is rumoured that up to 90% of all countertrade proposals never reach the contract stage. Insisting on countertrade as a matter of principle, to some extent means a voluntary return to the dark (moneyless), middle ages, where a hungry blacksmith had to find a farmer whose horse lost a shoe before a transaction could be made. Avoiding all this bother is what money, and lending/borrowing, was invented for. To be true, Countertrade Exchanges or umbrella arrangements reduce part of these problems, but they remain hard to negotiate and expensive to run; and their costs are passed on to the users[34].

Problems not only exist with respect to matching of supply and demand; even when that matter is settled, all other risks of standard trade are still present. And the fact that two trade contracts are combined, plus the fact that a contract with a trading company is also involved, seems to lead to an explosion in the list of contingencies. D. Francis chronologically lists the following risks that have to be born in mind when drawing up a compensation contract[35]:

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32. D. Francis, o.c., p. 16 and pp. 82-91; S.N.E., ibid., p. 51, 54, 60.
33. Ibid., p. 55.
34. D. Francis, o.c., p. 149.
35. D. Francis, o.c., pp. 56-58.

- repudiation/cancellation of export contract or insolvency of buyer, before establishment of soft letter of credit; same, after the soft letter of credit is established;
- repudiation/cancellation of agreement with trading company; insolvency of trading company, subsequent failure to complete contract;
- repudiation/cancellation of contract to supply countertrade goods by, or insolvency of, supplier;
- disruption/cancellation or frustration of agreement between importer of principal export goods and countertrade goods supplier;
- soft letter of credit may not contain the right clauses *re* drawings, or expires before principal export goods and drawing made;
- hard letter of credit expires before countertrade goods shipped;
- goods shipped but countertrade goods are not;
- shipping documents do not conform to soft letter of credit requirements;
- export goods shipped, but countertrade goods are not; countertrade goods shipped, but export contract cancelled, repudiated, or importer fails through insolvency; or goods prove to be unacceptable to trading company;
- shipping documents do not conform to hard letter of credit requirements.

3.4. Countertrade is a Passive Trading Strategy

Countertrade may be a way to break open markets and to create trade; but it is a very passive way. Often governments just sit and wait until a Western corporation wants to trade; only then a list of countertrade goods is presented, which the Western exporter than hands over to traders and brokers. There is no reason not to get in touch with the latter intermediaries independently. Apparently, some of the goods *can* be sold, so there is no reason to wait. Moreover, the direct approach cuts out one layer between the producer and the ultimate customer. This would generally imply a saving in terms of transaction costs, or would avoid a spread kept by the Western exporter. A more active approach would also help the LDC to acquire a better insight into how markets work, expertise in negotiating and marketing, etc. In the long run, the passive and indirect approach of countertrade cannot be in the LDC's interests.

4. Conclusion

We have discussed possible advantanges and disadvantages of countertrade-type transactions, taking an economic, analytical perspective. Regrouping the arguments, the following motivations for countertrade may be listed (some of them being purely subjective, or economically unconvincing):

- a *belief* in a planning system, or in the efficiency of centralised trade;
- a *belief* that the Western firm offers better terms than a trader, or that marketing costs can be shifted without inflation in the price of the imported goods.
- failure in financial markets: in the absence of futures markets and risk-taking trade finance firms, industrial corporations sometimes finance or guarantee risky deals that would be refused by commercial banks.
- the desire to hide trade, sales prices, inefficiencies, subsidies, overvalued exchange rates, protectionism, etc.
- in rare cases, savings in contract costs.

All these factors may explain why some countries prefer package deals over simple, open trade and secured financing transactions. But in the long run an active export policy would be in the country's best interests.