THE UTILITY OF THE BARTER AGREEMENT IN INTERNATIONAL COMMERCIAL TRADE

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ABSTRACT: This paper tries to explain how barter, as an economic institution, can help deal with the problem of contract enforcement across national borders in international trade and within borders in transition economies.

KEY WORDS: countertrade; barter; agreement; contract; offset; transaction; negotiation; sales; import; export.

JEL CLASSIFICATION: K12, K33.

Contracts are essential for many economic activities. Any economic relationship that involves some quid pro quo needs to be supported by some contractual arrangement to make sure that the parties involved abide to their obligations. But contracts are worth only as much as their enforcement can be relied upon.

Difficulties in contract enforcement are important impediments to international transactions in the world economy and to domestic transactions in transition economies. In international trade, national sovereignty interferes with contract enforcement because national borders demarcate national jurisdictions.

Such demarcations segment markets and impose severe transaction costs on exchanges across national jurisdictions. The hazards involved in international transactions are often disregarded, but they make headlines each time a sovereign debtor threatens to stop servicing its debt, as it happened in the international debt crisis in the 1980s or in the Russian Financial crisis in 1998.

In transition countries, poorly developed legal and financial institutions make contract enforcement unreliable and impose severe transaction costs on any economic activity. These costs become prohibitively large in times of historic change and revolution.

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Unstable business partner relationships and rapidly changing social norms limit the extent to which economic exchanges can be sustained by reputation, by repeated interaction or by embedding them in social networks.

This paper tries to explain how barter as an economic institution can help deal with the problem of contract enforcement across national borders in international trade and within borders in transition economies.

Barter trade has received much attention lately. But it is not a new phenomenon. In the 1980s, in the aftermath of the international debt crisis, barter became prevalent in international trade with developing countries and Eastern Europe. Since the 1990s, with the domestic debt crisis in transition economies, barter has continued to be a dominant phenomenon in domestic trade in these countries. What explains the appearance of barter in international trade in the 1980s and in domestic trade in transition countries in the 1990s? What makes barter, or countertrade, as it is more generally called, preferable to conventional forms of trade?

In particular, the term “barter” is used with different meanings, sometimes as a term that refers to countertrade transactions in general, sometimes in a more specific sense. “Countertrade” is used as the general term to denote transactions in which a party from an industrialized country supplies goods, services, or technology to a second party in an Eastern European or developing country, and in which, in return, the first party purchases from the second party an agreed amount of goods, services, or technology.

A distinctive feature of countertrade is the existence of a link between the two transactions, the import and the subsequent export. Countertrade transactions take a variety of forms. The three forms are “barter,” “counter purchase,” and “buyback.”

Barter in the strict sense of the word refers to an import that is paid entirely or partly with an export from the latter country without using foreign exchange. Counter purchase refers to a transaction in which the import is paid with foreign exchange but the industrialized country commits to buy export goods from the Eastern European or developing country in return. Buyback is a transaction in which the first party supplies a production facility and the parties agree that the supplier of the facility will buy goods produced with that production facility. All three forms of countertrade are frequently observed in international trade.

The actual countertrade can take many different forms. The first form is barter. This form of countertrade has received a lot of press; however, it is the least practiced. Barter is a simultaneous two-way trade. In other words, I'll give two glass beads for your one shell. This is one of the oldest forms of countertrade...the least practiced, but the most written about.

The second type is offsets. They pertain mostly to military and commercial aircraft sales. The name comes from the fact that part of the cost of the product is offset by purchasing products in the country where the goods are being sold.

Offsets are divided into two parts. First, direct offsets: like McDonnell Douglas sold MD 82 mid-size passenger aircraft to China. The contract included provisions for the Chinese to manufacture aircraft components such as doors to be used for landing gears, passengers, and cargo.
The second form of offsets is indirect offset. These are goods that are not used in the products sold to that country. A good example: the price of DC-9s sold to Yugoslavia was indirectly offset by the purchases of Elan skis.

The third type of countertrade is clearing accounts. This form normally occurs between Eastern European countries and the LDC's (less developed countries). The LDC ships products to one East European nation, creating an accounts payable entry on that country's trade books (country A owes US$ for this product).

One country can then satisfy the entry with either its own products or it can be satisfied by another country that comes along and buys first's country's debt. For example, we may sell product to Brazil and receive payment from one of Brazil's trading partners. Sometimes it is part cash and part products from that country.

The fourth type of countertrade is compensation--also known as cooperation or buy-back. In an effort to promote an understandable lexicon, it's preferable to call it compensation. This is where a company agrees to build a plant or to sell technology into a country. The company then gets compensated for technology or capital with exported products produced by that plant.

The last type of countertrade is counter purchase. Counter purchase is an agreement between two business units to buy from each other in carrying amounts over varying periods of time. This transaction creates hard currency that is then used in turn to purchase products.

Forecasting the size of countertrade is very difficult because countertrade information is not collected and recorded in any one place.

There have been many estimates put forth by the U.S. government, the United Nations and various independent studies. The general consensus is that countertrade is somewhere between 10% and 20% of all world trade.

A recent study at the Centre for Advanced Purchasing Studies found that in the companies that answered the survey, countertrade rose 74% as a portion of sales agreements. (The survey covered a four year period ending in 1989.)

In other words, in 1985, 5% of the sales contracts involved countertrade; and by 1989, 9% of the sales contracts involved countertrade. In terms of total dollar volume, countertrade grew 30% from $13.6 billion in 1985 to $17.7 billion in 1989. This study also had some other very interesting findings:

- A majority of companies participate in countertrade due to a requirement of a foreign government or customer. Countertrade therefore is not being utilized as an aggressive marketing tool.
- Those companies that have utilized countertrade have found it to be an effective way of expanding sales and improving efficiency in operations.
- Companies can avoid the pitfalls of countertrade by involving countertrade experts and their purchasing departments early in the negotiation.
- The purchasers surveyed reported 71% more advantages than disadvantages, indicating that their experiences with this form of trade practices have been largely positive. From another point of view, Elderkin & Norquist, in their book "Creative Countertrade," say that companies countertrade in order to:
1. Expand or maintain foreign markets by using online tools, such as forex or another foreign exchange program
2. Increase sales
3. Sidestep liquidity problems
4. Repatriate blocked funds
5. Clean up bad debt situations
6. Build customer relationships
7. Keep from losing markets to competitors
8. Gain foreign contracts for future sales
9. Find lower-cost purchasing sources

There are six main types of countertrade
1. Offset
2. Counterpurchase
3. Tolling
4. Barter
5. Buyback
6. Switch Trading

1. **Offset.** Offset has traditionally been used by governments around the world when they have made major purchases of military goods but is becoming increasingly common in other sectors. There are two distinct types:
   - direct offset: "the supplier agrees to incorporate materials, components or sub-assemblies which are procured from the importing country. In some large contracts, successful bidders may be required to establish local production. Direct offset has been particularly common for trade in defence systems and aircraft."
   - indirect offset: "the purchaser requires suppliers to enter into long term industrial (and other) co-operation and investment but these are unconnected to the supply contract and may be either defence related or in the civil sector."

   The overall objective of offset either, direct or indirect, in the defence sector generally to promote import substitution and to minimise the balance of payments deficit for military purchases by developing an indigenous industrial defence capability.

2. **Counterpurchase.** A foreign supplier undertakes to purchase goods and services from the purchasing country as a condition of securing the order. Counterpurchase is generally imposed for two reasons: first, to stimulate exports and second, to alleviate the balance of payment deficit resulting from imported goods.

3. **Tolling.** Manufacturers, in regions such as the Former Soviet Union, may sometimes be unable to service customers because they lack the foreign exchange to buy raw materials. In a tolling deal, a supplier himself provides the raw material (steel ingots, say) and hires capacity of the factory to turn it into finished goods (e.g. steel tubes). These are then bought by a final customer who pays the supplier in cash - throughout the process the supplier retains ownership of the material as it is proccessed by the factory." - this is similar to Contract Manufacturing where the Contractor provides much of the materials.
4. Barter. Barter is one of the most common methods of Countertrade. "In a barter deal, goods are exchanged for goods - the principal export is paid for with goods (or services) from the importing market. A single contract covers both flows and in the simpler case, no cash is involved. In practice, however, the supply of the principal export is often released only when the sale of the bartered goods has generated sufficient cash."

This means if one country sells mining equipment to another country in return for cigars - they will probably hold some of the mining equipment back until they have made some good profit from the cigars.

5. Buyback. Here, suppliers of capital plant or equipment agree to be paid by the future output of the investment concerned. For example exporters of equipment for a chemical plant may be repaid with part of the resulting output from the factory. This practice is most common with exports of process plant, mining equipment and similar orders. Buyback arrangements tend to be much longer term and for larger amounts than counterpurchase or barter deals.

6. Switch Trading. Imbalances in long term bilateral trading agreements sometimes lead to the accumulation of uncleared credit surpluses in one or other country. For example, Brazil at one time had a large credit surplus with Poland. These surpluses can sometimes be tapped by third countries so that, for example UK exports to Brazil could be financed from the sale of Polish goods to the UK or elsewhere. Such transactions are known as 'switch' or 'swap' deals because they typically involve switching the documentation (and destination) of goods on the high seas.

The Growth of Countertrade. The growth of countertrade is fuelled by several factors. First, in addition to looking at the advantages for the company that countertrades, one must also look at what advantages a country gets from countertrade. These are:

- Additional hard currency generation.
- Marketing expertise that they may not otherwise have. This point is brought out in a recent Wall Street Journal article which describes how McDonnell Douglas had helped to bring a foreign-based snack food product to Spain.
- Technology advances that the country would not otherwise have.

The global demand for international credit is the second growth factor. The need for credit is increasing at a time when banks are less willing or able to finance these transactions. This forces many purchasers and exporters to turn to countertrade to finance the business transaction.

However, international banks are short of capital to meet standards set by the bank for International Settlement in Basel, Switzerland. By 1993, international banks were required to have a minimum capital to risk asset of 8%. Europe's 12 largest banks already have met this 8% target, versus only three of the Japanese top 12 banks, and 11 of the U.S.'s 12 largest banks.

The next growth factor is that the demand for consumer goods has increased with the opening of Eastern Europe and the government changes in Latin America. The demand for consumer goods far outstrips many countries’ ability to generate hard currency to pay for these goods.
And last, convertibility will not diminish the growth of countertrade since convertibility does not necessarily mean availability of the hard currencies. Country advantages, bank credit crunch, growing demand for consumer goods, and convertibility will push the demand for countertrade to new heights.

All of these things--country advantages, bank credit crunch, growing demand for consumer goods and convertibility--will push the demand for countertrade to new heights.

Countertrade policy is defined here as the company's attitude toward countertrade. While countertrade strategy is defined as the approach the company takes to countertrade planning and transactions. There are two basic types of countertrade policies: company advantage and mutual advantage.

Under a company advantage policy, countertrade/offset is used primarily for the company's benefit (to make a sale, to maintain market share, etc.), with the needs of the buyer country being met at the minimum possible levels. Most companies follow this policy.

The effectiveness of the company advantage policy varies. At best, it results in a satisfactory arrangement for both seller and buyer. At worst, it can be a disaster; companies may try to get out of their obligations once the sales contract is signed--on the theory that it will be easier to pay the penalty than carry out the offset--and then get into a lot of trouble with the buyer country.

In contrast, companies with a mutual advantage policy give the needs of the buyer country equal weight with their own. Under this policy, the company is concerned with the goals of the buyer country (i.e., modernization, industrialization, balancing trade, increasing living standards, etc.), and how the countertrade transaction will help achieve these goals. These companies are willing to meet the challenge of achieving mutual benefit through countertrade, and in most cases their efforts are successful.

The choice of a countertrade policy may be an early and deliberate decision on the part of the company president. More often, however, the policy evolves slowly, growing out of the company's experiences in trading with different companies. If the company trades with "good" countries--those in which the state trading officials are well-intentioned, straightforward, and efficient in carrying out their side of the deal--it will probably develop a mutual advantage policy.

There are also some cases in which the company begins to follow a mutual advantage policy in a particular country because of a foreign-born executive's loyalty to that country, and then expands the policy to include trade with other counties.

Companies which have countertraded with "problem" countries usually hate countertrade; depending on how difficult their experiences are, they will either approach countertrade with extreme caution or wish it would disappear.

If the company has encountered corrupt foreign officials, slow delivery or non-delivery of counter purchase products, poor quality products, sudden changes in product availability, demands for the moon (secret product formulas, proprietary technology, etc.) or other aggravations, it can hardly be blamed for following a company advantage policy.
On the other hand, some companies whose countertrade transactions run relatively smoothly still resent having to countertrade. This resentment may be due to something concrete, such as lowered profits, or to something intangible, such as a belief in the pure forms of free trade and fair competition. Sometimes the company is simply new to countertrade, and wants to move cautiously until it builds up expertise.

Countertrade policies may change over time, due to many factors. These include changes in corporate leadership, the weight of accumulated countertrade experiences, profit levels, and the overall international trade and financial environment. Coca-Cola Co. operates under a mutual advantage policy through Coca-Cola Trading Co. In most countries, Coca-Cola goes much further than simply selling syrup and taking back local products; the company transfers food and beverage technology and assists in developing foreign marketing programs.

Most of these programs are designed to help the countries penetrate the American market. For example Coca-Cola assisted Yugoslavia and Romania in the production of wine for the American market, advising them on American taste in wines and appropriate package designs, as well as making agreements with American wine distributors.

In Turkey, Coca-Cola set up a joint venture to produce tomato paste for the American market and other markets, providing management and technology for the plant. Coca-Cola generally tries to set up a partnership with customer countries.

Avon, Colt Industries, and Grumman International are examples of companies following a company advantage policy. Avon uses countertrade to release blocked funds; they build plants in various countries and export part of the production in order to generate hard currency.

Avon products made in developing countries are exported to other developing countries, rather than to industrial countries. (Unlike most products, 80% of the cost of cosmetics is promotion; thus there is no cost advantage in making cosmetics in low-wage countries for export to industrial markets. Avon does not accept counter purchase products.

Colt's defence divisions do a small amount of countertrade in order to compete with foreign defence firms. They usually limit their countertrade obligations to sourcing or counter purchase; they do not buy back or export products related to the original sale. Counter purchases are liquidated through trading companies.

In some countries, the countertrade regulations may specify such things as additionality (exports above the usual level), specific markets for exports, or prohibition of the use of third-party traders. These points must also be negotiated, if the company feels unable to carry out the proposed obligations under specific restrictions.

The contracts are signed when the negotiations are completed: one for the sale and one for the countertrade. In sales implementation, the company should adhere to the promised delivery schedules. In the implementation of the countertrade/offset obligation -- which may include counter purchase, buyback, technology transfer, joint ventures or sourcing--the company should make periodic progress reports to the buyer country. Throughout the countertrade implementation period, the company should make periodic cost-benefits evaluations.
An authorized agency of the buyer country will issue a certification when the countertrade obligations have been fulfilled. At this point, the company should do a cost-benefit analysis. The analysis should be used as guide for improving future countertrade transactions.

"Countertrade is inherently an ad hoc activity - practice varies according to local regulations and requirements, the nature of the goods to be exported and the current priorities of the parties involved. Also, the terms used to describe the main modes of trading vary, often interchangeably causing confusion. " - which is a fancy way of saying - countertrade can be a lot of things depending on who is involved

Elderkin and Norquist, in their book "Creative Countertrade," say that companies countertrade in order to:

- Expand or maintain foreign markets
- Increase sales
- Sidestep liquidity problems
- Repatriate blocked funds
- Clean up bad debt situations
- Build customer relationships
- Keep from losing markets to competitors
- Gain foreign contracts for future sales
- Find lower-cost purchasing sources

**Four main reasons why countertrade is used:**

- Money - some people cannot pay in the currency you want
  "to enable trade to take place in markets which are unable to pay for imports. This can occur as a result of a non-convertible currency, a lack of commercial credit or a shortage of foreign exchange"
  - The Political Environment - local jobs and industry
    "to protect or stimulate the output of domestic industries (including agriculture and mineral extraction) and to help find new export markets"
  - The Political Environment - rules and regulations to protect the host country
    "as a reflection of political and economic policies which seek to plan and balance overseas trade"
  - "to gain a competitive advantage over competing suppliers." ¹

Countertrade Examples. Finally, a few examples of countertrade. The first is the well known Pepsi/USSR trade whereby Pepsi-Cola delivers syrup that is paid for with Stolichnaya Vodka. Pepsi has the marketing rights of all Stolichnaya Vodka in the U.S.

Recently Pepsi has made another innovative step by taking 17 submarines, a cruiser, a frigate, and a destroyer in payment for Pepsi products. In turn, this rag tag fleet of 20 naval vessels will be sold for scrap steel, thereby paying for Pepsi products being moved to the Soviet Union.

In another instance, Fisher Controls International, a subsidiary of Monsanto, counter purchased ball bearings and chair frames to be sold in Western Europe in a countertrade opportunity for control valves sold to Romania.

¹ By: C.G. Alex and Barbara Bowers
This countertrade purchase activity set Fisher apart from its competitors, and enabled it to be awarded the contract. In another case, Monsanto is helping one of its customers in Argentina gain increased exports goods of finished goods. The exported goods contain Monsanto products, which results in increased sales.

When countertrade is used in a proactive manner, it becomes a total quality activity of "meeting your customers needs." We all know this results in increased sales and profits.2

After 1989, domestic barter in Russia exploded after macroeconomic stabilization in 1994 from 5 percent of GDP to 60 percent in 1998. In Ukraine the share of barter in industrial sales is estimated to have been 51 percent in 1997.2 The survey of 200 firms by the Russian Economic Barometer (1999) since 1992, in turn, suggests that noncash payments rose steadily from 8 percent in 1992 to 54 percent in mid-1998. Since the financial crisis in August 1998, barter and the use of other money surrogates have started to decline, accounting for 43 percent of sales of industrial firms in February 1999.

The importance of barter varies across transition economies. In twenty transition economies and shows that Croatia exhibits the highest share of barter of 33 percent in 1999. Russia and Ukraine show a barter share of about 24 percent and Central European countries like Hungary, Poland, and the Czech Republic have barter shares between 0.8 and 4.7 percent. It is also interesting to see that some of these countries experienced an increase in the importance of barter over time, like Croatia, and Ukraine, while barter declined in Uzbekistan, Kazakhstan, and Moldova.

In Uzbekistan, the fall of barter was particularly pronounced. In international trade a similar boost of countertrade was experienced in the 1980s, when the international debt crisis led to a dramatic decline in private lending to developing and Eastern European countries. Even though debtors hesitated to invoke total repudiation, commercial banks were reluctant to provide new loans, sceptical that they would ever be repaid in full. As highly indebted countries found it increasingly difficult to finance their imports, unconventional forms of trade and trade financing experienced resurgence, including countertrade.

Bussard (1987) reports that the number of countries engaged in countertrade rose from 27 in 1979 to 88 in 1984. Likewise the number of countertrade transactions that was reported by a group of survey respondents increased on average by 50 percent between 1980 and 1981, by 64 percent between 1981 and 1982, and by 117 percent between 1982 and 1983.5 Hammond (1990) observes that precedents of this striking comovement of debt and countertrade can be found in the late nineteenth century and in the depression of the 1930s.

In both environments, contract enforcement is problematic, and hence conventional contracts cannot be relied on as the main mechanism to sustain economic exchange. In international trade, the enforcement of contracts is in the hand of national authorities. If, for whatever reason, these authorities fail to perform this function, trade partners have no higher instance to which they can turn to enforce the law due to the lack of supranational authorities. Similarly, in transition economies, relying on

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2 BarterNews issue #17, 1988
contracts is problematic as long as state authorities have not established a functioning legal system, and hence contract enforcement through state authorities cannot be counted on.

If contract enforcement through state authorities cannot be relied on, trade partners have to seek other means of protecting their interests in business transactions. One possible substitute for formal contracts would be relying on reputation as an enforcement mechanism.

Trade partners voluntarily stick to the terms of the contract if the risk of losing their reputation and of not being able to do business in the future is a sufficiently large punishment for misconduct. However, the extent to which reputation can help as an enforcement mechanism is limited. In the context of international trade, Bulow and Rogoff (1989a) have shown that reputation may fail to induce sovereign countries to repay their debt. And even if this reputation mechanism sustains some international trade, firms may look for means to overcome the limits set of this mechanism. In transition economies the problem is even more conspicuous, since in times of historic change the future is uncertain and business partners may not know whether they or their partners will be in business in the future for a variety of reasons.

Thus, in both environments, trade partners may look for alternative means to enforce contracts and to sustain their economic activities. If contract enforcement is weak, problems may arise on both ends of a business transaction: the seller may fail to deliver the good, and the buyer may fail to pay for the goods. If buyers have no cash to pay, and thus face liquidity constraints at the time of delivery, the business transaction can take place only if the seller can trust the buyer to pay in due course. On the other hand, the buyer is willing to engage in a business transaction only if she can trust the seller to deliver the right goods.

Both problems are prevalent in trade and transition. In each environment, enforcing the payment of goods can pose serious problems. In the aftermath of the debt crisis in the 1980s, highly indebted countries were liquidity constrained and could not finance necessary imports. Given their level of indebtedness, debt repayment could not be relied on. The debtor country could create more liquidity by not repaying its debt rather than receive a new loan. Similarly, firms in the former Soviet Union are highly indebted, vis-a-vis each other, vis-a-vis the state, and vis-a-vis their workers. The phenomenon of inter-firm tax and wage arrears exploded in the 1990s, making it more likely that these firms would repudiate on their payments.

As a conclusion, it is important to underline the important role of the barter agreement over traditional credit arrangements. The main difference between a promise of future money and a promise of future goods is that goods have superior credit enforcement properties as compared to money.

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