Countertrade

This website will develop knowledge of Countertrade, which is a marketing technique and is not only helpful in increasing sales during economic and financial crises, but also taken as opportunity by the marketers to increase sales in good days. Apart from this bankers or financers also study this topic as this is one of the techniques used in structuring trade finance, especially in commodity financing area in the third world countries and emerging markets.

We will cover the definition of countertrade, its types, history, benefits, drawbacks, strategies and how to manage risks?

Understanding Countertrade

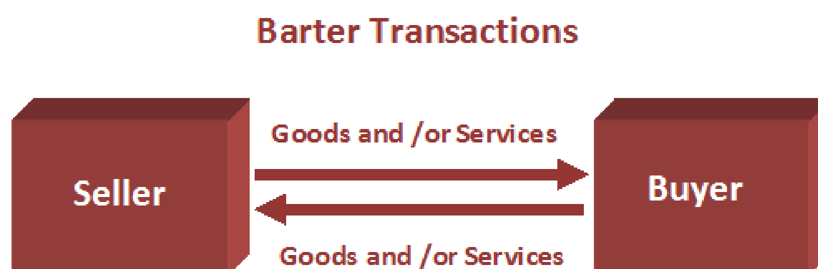
Countertrade is considered to be the oldest methods of payment in the known history. It means the exchanging of goods and services in whole or part, with other goods and services as payment, rather than with money.

Countertrade is a general term, which can be further divided into barter, compensation, buyback, Tolling, Clearing Arrangement, Switching Trading, Counter Purchase and Offsets

Types of Countertrade

Barter

In Barter, the goods and/or services are exchanged with other goods and/or services of equal value, where little or no money is paid by the buyer. This is the only trade activity with no money involved. Barter involves a single contract that covers both transaction flows.



Previously, this type of trade activity was more popular among the governments. Now due to the liberalization and privatization of commodities markets a “pure” barter trade arrangement is rarely used. This is because, it is said that barter is the most widely known and written about as compared to other types of countertrade, but least practiced by the governments.

However, barter trade is becoming popular between individuals or small business level instead at government level, especially in the poorer economies or during the crisis. Few interesting stories, which are seen in the news or on internet these days, are as follow

- A new barter market named *Mercado de Trueque* in Mexico City established by local government in March 2012 is helping the residents trade their trash for food in an effort to reduce the tons of waste by the mega city. The locals who are now making regular visits to the market held once a month in the city's Chapultepec Park bring glass, plastic and cardboard waste, which is separated and weighed. They are then given vouchers, which can be exchanged at a nearby farmers' market for vegetables. (Source: CNN News 'Trash for food' at Mexico City barter market by Rafael Romo, Senior Latin American Affairs Editor on June 19, 2012)

Compensation

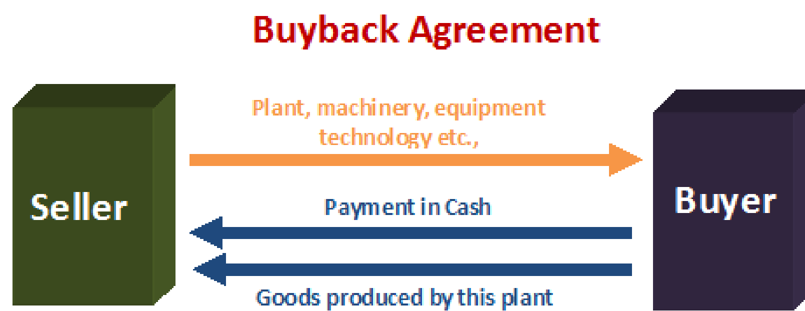
Some writers consider compensation and buyback as same type of countertrade, while others believe as two separate forms of countertrade. Here both compensation and buyback have been discussed separately.

Under this type of arrangement, the seller receives a part of the payment is cash and the rest in shape of products.

Buyback

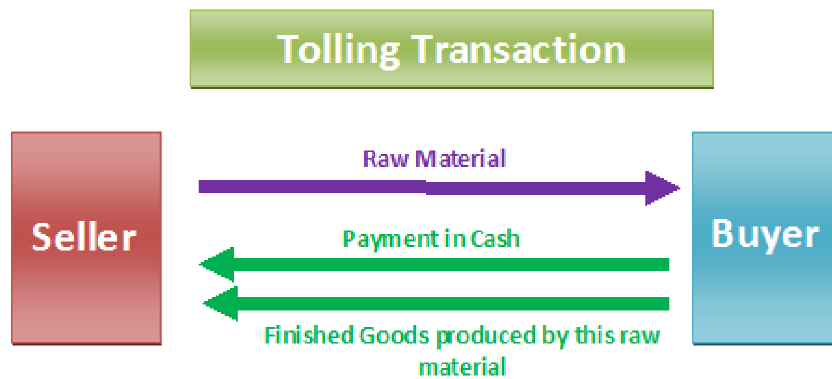
Under the buyback agreement, the seller supplies plant, equipment or technology and agrees to buy goods produced with that plant, or equipment as payment.

Typically, the Buyback deals are of much longer term and also of larger amounts. The seller of equipment can receive a part of the payment in the shape of products produced by that equipment and the remaining amount in the shape of cash.



Tolling

In tolling, the seller supplies raw material and receives finished goods produced from this raw material as payment from the buyer. Here also the seller can receive the payment partially in finished goods and partially in cash.

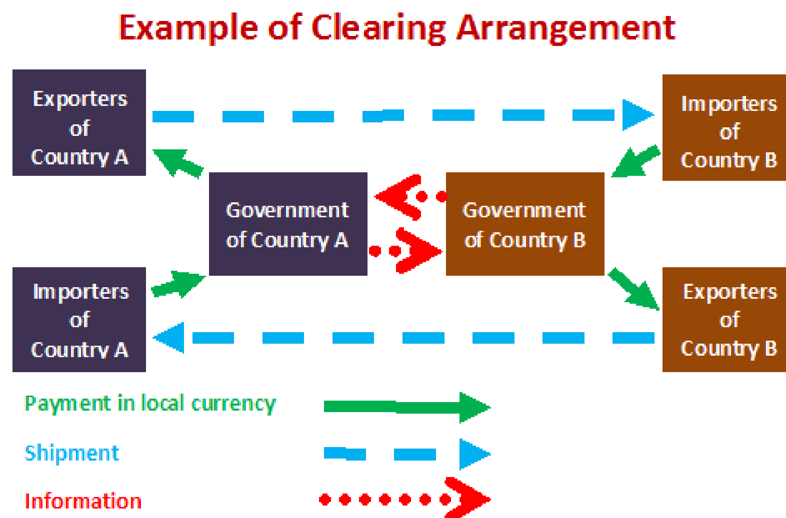


Typically, the tolling is more popular among the industries, where the finished good is also commodity. For example: crude oil converted to petroleum products.

Clearing Arrangements

This type of trading is between two or more than two countries in the shape of an agreement, under which agreed volume of goods are imported and exported over a specific time period without the payment of foreign currencies. At the end of the agreed time period, the balance is settled in an agreed foreign currency for example US Dollars.

Let us take an example of two countries Country A and Country B in the below diagram.



Both the countries sign an agreement for the period of one year. The exporters of country A will send the shipment to the importers of Country B, who instead of paying directly to the exporters of Country A for these shipments will pay to their government in their local currency. The government of Country B will just inform the government of Country A that the payment has been received. On the information of government of Country B, the government of Country A will pay to their exporter in their local currency.
The exporters of Country B and the importers of Country A will also do the same transaction.

Now, if you notice in the above example no payment in foreign currency has been done by any of the government to other government. Only the information of payments has been shared by both the governments during the period of the agreement.

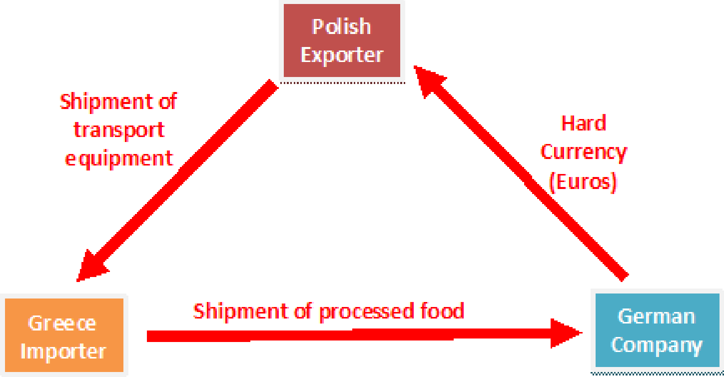
At the end of the period of the agreement, only the balance amount (if any) will be paid by one of the government in agreed foreign currency for example US Dollars. To understand this point we assume that Country A has exported the goods of US$ 10 million to Country B and Country B has exported the goods worth US$ 8 million to Country A. So, Country A has exported more US$ 2

million (10 – 8) to Country B. The balance of just US$2 million will be paid by Country B to Country A at the end of the period of the agreement.

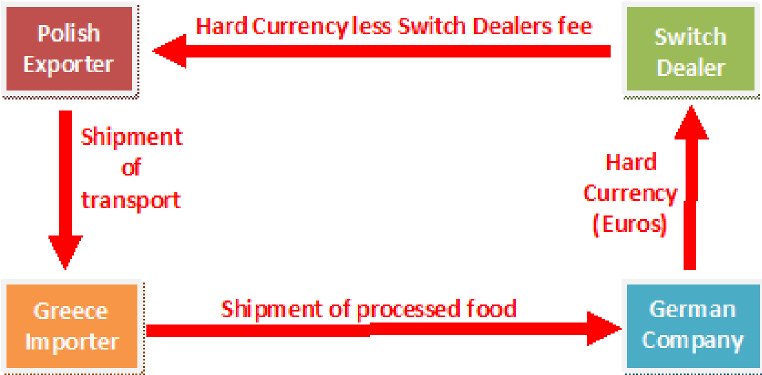
Now again, if we notice only the balance amount in foreign currency has been paid by one of the country at the end of period of the agreement, instead of paying the whole value of imports in foreign currency by both the countries. This saves the foreign exchange, which can be used somewhere else.

Switch Trading

Switch Trading involves the role of third party in a countertrade transaction. If a seller in the countertrade does not want goods offered by the buyer as payment, it may bring in third party to dispose of the merchandise offered by the buyer. For example: An exporter in Poland exports transport equipments to Greece and in return does not want processed food from the importer of Greece as payment. It can sell the processed food to a German company, which will pay in Euros to the Polish exporter, which is hard and convertible currency. The following diagram will make the example clearer.



In a typical switch trade transaction a switch dealer or trader is involved. If we again take the above example, the switch dealer will pay the Polish exporter in hard currency less the switch dealer's fee (disagio). The switch trader will find a German company, which will buy processed food from Greece importer and pay the switch trader in Euros. The following diagram will make the example clearer.



Switch Trading not only exists between the individual companies but it also has a role to play in clearing arrangements between the countries. If we consider the example already given under

the previous head ***Clearing Arrangement*** that Country A has exported the goods worth US$ 10 million to Country B and Country B has exported the goods worth US$ 8 million to Country A. So, Country A has a surplus balance of US$ 2 million (10 – 8) with Country B. At the end of the agreed period, if country B does not have US$ 2 million to pay to the country A, it's another trading partner Country C will pay US$ 2 million to country A. The following diagram will make the example clearer.

It is not necessary that in three of the above examples, the German company, the switch dealer or the country C only pay in hard currencies. Sometimes it is part cash and part goods or even sometimes whole of the payment is in the shape of goods – No hard cash.

Counter purchase

In counter purchase agreement seller receives the full amount in cash, but agrees to spend an equal amount of money in that country within a given time. In contrast to bartering, both parties pay for their purchases in cash but agree to fulfill their counter commitments. At the same time, transactions do not become part of a single contract, but are entered into two different contracts. Counter purchase is also called “Parallel Trading” or “Parallel Barter”.

Offset

Offset is the type of countertrade, which is mostly related to very high value of exports and/or medium to high technology capital goods supplied by a multinational corporations or a major manufacturer. It may be in many forms such as coproduction, license production, subcontractor production, technology transfer, overseas investment, research and development, technical assistance and training, or patent agreements etc.,

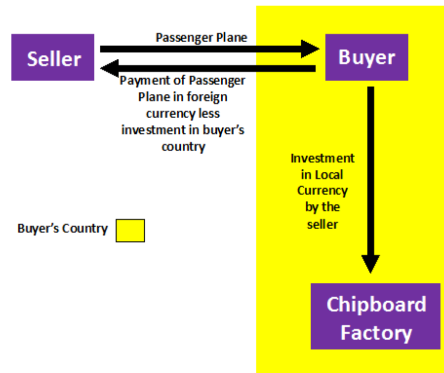
Offset activity can be divided into two main categories direct and indirect:

The offset is said to be ***direct*** when some components of the item sold are to be manufactured within the buyer's country and that the seller agrees to buy those components to use them in-house.

Let us take an example that an aircraft manufacturer sells a passenger plane to a buyer in another country and agrees with the buyer that some of the spare parts of the plane will be ordered and purchased in buyer's country and attach to the plane. The below diagram will make the example easier.

The offset is said to be ***indirect*** when the buyer requires the seller to enter into a long term industrial or other co-operation and investment, but this co-operation or investment is not related to goods supplied by the seller.

Let us take the same example of direct offset in which an aircraft manufacturer sells a passenger plane to a buyer in another country but here instead of buying the spare parts of passenger plane from the buyer's country, the seller agrees to invest in a chipboard factory in buyer's country. Now the chipboard is not related to passenger plane. This is called ***Indirect Offset***. The below diagram will make the example easier.



The benefits of offset agreement is that the importing country can save the foreign exchange on high value imports, avoid an increase in foreign debt, increase local employment, introduce state of the art technology in local industries, reduce dependence on foreign suppliers, and increase the level of foreign investment.

Offset has been popular among the governments all over the world, as they have been purchasing heavy military equipments, but now it is gaining momentum in other sectors also.

Typically, offsets deals are common in defense, aerospace and telecommunications sectors and also the local content "offset" is usually not more than 20% to 30% of the deal value.

After the collapse of Communism in Eastern Europe and the Soviet Union in late 1980s and in the beginning of 1990s, again countertrading started gaining momentum. These Post-Communist states have or had currencies that could not be converted and are short of reserves of foreign currencies that could be converted, making countertrading crucial for them in international trade.

Benefits of Countertrade

When there is a shortage of foreign exchange reserves, the countertrade is the best option for importing countries.

Countertrade is also one of the options to find and enter into new, difficult and challenging markets. For example: The former Soviet Union was very difficult market to enter. The Pepsi Cola Company accepted the challenge to enter this market, and they finally succeeded in 1972 by using the technique of countertrade. They sold Pepsi Cola Syrup (Concentrate) and purchased Stolichnaya Vodka from Russia against it. While telling the success story Mr. John G. Swanhaus Jr. of Pepsico said "it took us 13 years to negotiate our first agreement ……………. They were looking for a way to generate hard currency. When we signed our agreement, it was primarily because of the export trade, not because they were anxious to sell Pepsi-Cola in Russia. They only agreed to buy syrup from us after we agreed to buy vodka from them.'' *(Source: "From Russia With Perestroika: Caution" by Penny Singer published in New York Times on December 18, 1988)*

By adopting the policy of countertrade, a business has a competitive edge over its competitors.

Countertrade helps in the sales of surplus stocks produced or stored. For example: With the policy of countertrade, the businesses in developed countries can sell their stock, which have become outdated or obsolete at home due to the advancement in technology to the developing or poor countries of the world.

If it seems that a sale on credit can lead to bad debt situation, a seller can avoid this situation, by adopting the policy of countertrade.

An interesting thing noticed by adopting countertrade is that the businesses can hide the selling price of their product. Hiding the price of goods sold sometimes becomes very helpful in some situations. For example: Price cartels are considered an evil in business practices, in which producers in the same industry decide to cut production to raise the price for the consumers. If a member of the cartel wants to sell below the agreed prices, it can be done by countertrade. It is not easy to know the price of the goods exchanged in countertrade.

Other benefits of countertrade include increased employment and better capacity utilization.

Drawbacks of Countertrade

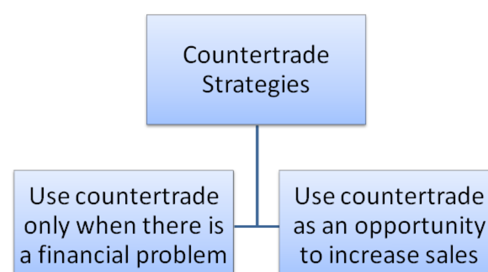
The goods, which are offered by customers does not have an in-house use. For example a manufacturer or supplier of consumer goods will receive medical equipment in exchange. Now, the business does not have any experience of handling and marketing of medical equipment. Expertise has to be hired or trained and manufacturing firms have to set up subsidiaries to handle countertrade arrangements or employ the services of trading companies specializing in medical equipments. All this cost more and is time consuming effort.

Lot of time is required to plan and research, what should be taken in exchange of the goods supplied. For every 10 to 20 deals that are talked about perhaps one gets done.

Countertrade deals are full of risks and uncertainties, especially when the deals are spread over number of years. There is a risk of availability and quality of goods to be delivered in future years.

Countertrade Strategies

Typically, we can divide the countries or organizations in two types. Each type adopts a different type of strategy for countertrade.



The ***first*** type thinks countertrade as a necessary evil. They only apt countertrade when they are facing some problem. For example: the countries which are facing the problem of less foreign exchange reserves and does not have enough foreign exchange to import, they adopt the policy of countertrade to get out of this problem. The examples are the countries which were part of Former Soviet Union or Eastern Europe. Also some countries of Africa, whose currency are not convertible.

In the same way this type businesses will also ONLY adopt the policy of countertrade if they are required by the foreign country to import from their country, otherwise they would not be allowed to export to that country or their own country makes mandatory for them to adopt countertrade if they want to import, or they are facing the problem of cash flow or they fear that a certain sale on credit can lead to bad debt situation, or they want to hide the price of their product due to any reason or they want to sell their surplus or obsolete stock or any other basis, which compels them to accept countertrade deal.

Whenever, these types of businesses come out of above mentioned problems, they will never agree to countertrade deals.

The ***second*** type does not think countertrade as necessary evil, but they take countertrade as an opportunity to enter new, difficult or challenging markets to increase their sales / exports or to have a competitive edge over their competitors.

Now both the countries (India and Malaysia) in the above example have enough foreign exchange reserves to pay for their imports. They do not face any foreign exchange problem but they take as an opportunity to increase their exports and save foreign exchange for imports. Also they will be able to create more jobs and increase tax revenues in their respective countries.

Managing Risk in Countertrade Deals

There are many risks associated with the countertrade transactions. Below are some of the risks discussed with their solutions.

Resale of Products received in payment of Sales

One of the distinctive risks associate with countertrade deals is that businesses often get those goods in payment for their sales, with which they are not familiar. This is perhaps the greatest risk, which any company faces in a countertrade deal. Now two types of risks are more likely to arise.

The first is that the customers of products, you receive in payment are not satisfied with the products as it does not meet the standards generally required, or fail to meet the warranties and/ or guarantees for the products being sold.

Secondly, there might be some third parties or stakeholders, which are negatively affected from the product received in payment of Sales. A legal claim from them can be an alarming and costly lesson to learn.

The first solution to mitigate this type of risk is NOT to acquire title to the products, which are received in payment for the sales, instead hiring an in-house trading company and to act as a broker for the transaction would be a wise decision.

If the countertrade deal has to last for a long time or has to run for years on regular basis, then establishing a trading subsidiary offshore in the country with favorable laws or having a joint venture with other companies such as traders would be a good option to consider.

Both Countertrade Contracts and Sales Contracts influence each other

In the normal transaction of currency, there is only one contract of sale, while in countertrade transaction; there are two contracts that is the sale contract and the countertrade contract. The problem in one contract has an impact on the other contract and so there is a risk of failure of the whole deal.

Again the solution is the same, hiring of in-house company, offshore trading subsidiary or a joint venture with the traders and consequently signing of two separate contracts, having no relationship. A careful drafting is essential to guarantee that the failed performance in one contract should not blow the other.

Pricing Risks

Several countertrade deals are longer term contracts, and the price of the products received against payment (also called countertrade products) can change considerably in international market over the period of the contract; especially when countertrade products are commodities. The companies having an industrial base, does not have any good understanding of

unpredictable nature of commodity prices in world market and so lack of experience can put them into losses in the resale of countertrade products.

The currency risks are of two types: the first is that currency is non-convertible or non-exchangeable to other currencies, when received or required. The second is that the value of the currency might fluctuate much and the party to the countertrade might get fewer dollars as expected.

The solutions to mitigate the risk of currency are the same, which is used in traditional or conventional transactions. They are hedging of foreign currency, political or non-commercial risk insurance etc.,

Non-Performance Risk.

Typically, non-performance risks include the shipment, late release of shipment, partial delivery, complete failure to deliver or delivery of damaged, substandard, or out-of-order products.

Unlike conventional transactions, where only importer presumes the risk of non-performance, in countertrade both the parties to the deal are exposed to such type of risk as both are accepting the goods or services in the deal.

One solution to ease non-performance risks in countertrade deal are to appoint an experience trader related to the goods to handle the import, which has to be received as payment.

Other solutions are the same as used in traditional transactions by the importers such as performance bonds / sureties, standby letter of credit, payment into an escrow account, deposit of product with the third party etc.,

Force Majeure.

This is legal concept and in simple words, the term *Force Majeure* means "non-performance due to actions beyond the limits of the party in default"

We can divide this term in two parts:

The ***first*** are the events which incurs due to the *"acts of god"/acts of nature"* such as floods, fire, earthquakes, hurricanes, severe winds etc.,

The ***second*** actions which incurs due to the "*acts of government*" are

- Government may Impose limitations, which could result in obstruction or interruption of the shipment or payment made by the party in default
- War, civil war, revolution or civil disturbances.
- New trade restriction or embargos
- Break or diversion of journey resulting in payment of additional freight or insurance charges
- Any other cause of loss occurring beyond the control of both the importer and exporter

The solutions to this type of risks are as follows:

The ***"acts of god"/acts of nature"*** can be covered under the general insurance policies, which indemnifies the loss or damage of goods against fire, floods, earthquakes, hurricanes, severe winds etc.,

The losses by the ***"acts of government"*** can be covered under the political or non-commercial risk insurance against offered by the credit insurance companies or Export Credit Agencies (ECAs). The example being the Spanish ECA **Compania Espanola de Seguros de Credito a la Exportacion (CESCE) (http://inglaterra.cesce.es/)** provides a credit insurance policy called a 'Compensation Transaction Insurance Policy' to Spanish exporters, who sell their products under countertrade deals.

The confirmed letter of credit is also a good idea as the seller’s bank endorses to pay to the seller.

Indirect bank guarantees and confirmed standby letter of credit are also the solutions to alleviate this kind of risk.

Payment Risks and Creditability

In traditional sales, the payment risk is concentrated to payment in some currency, while in countertrade deal; the payment is in the shape of goods and to some extent in the shape of currency.

Also in conventional deals, only the seller faces the payment risk, while in countertrade all the parties to the contract might presume the risk of payment.

The solutions to lessen the payment risk are the same, which is typically used in traditional or conventional sales. They are Letter of Credit, Credit Insurance, Bank Guarantees, purchasing of information from credit rating agencies etc.,

Dumping (Pricing Policy)

In dumping the manufacturer or seller charges a lower price for a product in the foreign market than the domestic market. There are two reasons to sell below the domestic market. The first is that the seller intents to drive the competitors out of the market, or create barriers to entry for prospective new competitors. When the competitors leave the market as they cannot offer low prices to the customer and the possible new competitors will not enter the market as there are no attractive profits to do the business, predatory price seller will raise the price of the product, as there is no competition left. Secondly, the governments of exporting country give special monetary benefit to their exporters as compared to local sellers in the shape of different type of exporting scheme to boost the exports in order to increase foreign exchange reserves, increase investment and create more jobs. Now, these special monetary benefits give an opportunity to the exporter to reduce the prices in international market as compared to the local market to increase the exports.

The negative effect of dumping to the importing country is that domestic industry is adversely affected, which results in increase in unemployment and less revenues to the government in the shape of taxes.

The penalty for dumping is an “anti-dumping duty” which is chargeable to the importer of the products by the custom authorities of the importing country.

In countertrade the risk of dumping is very common as the seller can easily hide the price of the product as the payment is in the shape of goods not the currency, which makes it very difficult to calculate the price and cost of the imported product. Also, as compared to traditional sales, where there is only one importer of the product, in countertrade both the parties to the agreement are importers to the product, so the risk of dumping lies with both of them. One can easily understand, the charge of anti-dumping duty on imported items means importing of products on the higher price than the price on which it was originally agreed upon.

The solution to avoid this type of risk can be that in the countertrade agreement, a clause can be added stating that it is the liability of the exporter or seller to indemnify the anti-dumping duty charged to the importer. A surety bond or a bank guarantee can be demanded by the importer in compensation to the loss in the shape of this type of duty.

Another idea is to appoint a trader or to act as an agent / broker and have another party import the product and take the risk.

Import Quotas

An import quota is a maximum quantity of a good that can be manufactured aboard and imported and sold domestically in a country in a specific period of time.

The basic objective of import quota is to decrease imports and increase domestic production of a good, thus controlling foreign competition. As the quantity of importing the good is limited, the price of the imported good raises consequently encouraging consumers to purchase more local goods instead of foreign.

The risk in import quota lies with the importer as for example Country A imposes a textile import quota to protect its domestic industry from foreign competition by restricting the import worth 100 million with country B in one year. Now if the textile products worth 100 million have already been imported in a particular year in Country A and the importer in Country A imports next 2 million worth textile products. The custom authorities of Country A will not allow these imports to their country, until next year. Waiting till next year will certainly affect the profitability of importer of Country A.

In countertrade transaction, as both the parties import, if one party is importing a product, which has import quota restriction, then it should study how the quota of that particular product is distributed in exporting country. Normally, the quota distribution is with some chamber of commerce, trade body/ association or government department in the exporting country. After studying the quota distribution, checks and balances can be incorporated in the countertrade agreement to avoid such type of risk. Getting help in this regard from a trade consultant or expert in the exporting country will be a good idea to tackle such kind of threat.

Use of Third Parties or Traders

The use of third parties or traders expert in goods received as payment for the sales have been repeatedly recommended as they are familiar with their product and most likely have a better affiliation and understanding of the problem associated with this product.

However, there are many risks linked with the appointment of third party or traders. They are as follows:

If the third party or traders is based in another country, especially in some third world country, then there are some more additional risks related to the government and political conditions in that country. These are as follows:

The solution to these types of risk can be Letter of Credit (L/C), Bank Guarantees or Surety Bond, Factoring, Forfaiting and Credit Insurance etc.,

If the third party or trader is incorporated in some third world country then confirmed letter of credit, Indirect Bank Guarantee, Export Credit Insurance (including non-commercial and political risk coverage) is the answer to cover these sorts of risks.