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East European Countertrade: The Trend Toward Bilateralism in Trade With the West

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An Intelligence Assessment

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EUR 85-10065
April 1985

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East European Countertrade: The Trend Toward Bilateralism in Trade With the West [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, East/West Regional Economics Branch, EURA, [redacted] 25X1
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East European Countertrade: The Trend Toward Bilateralism in Trade With the West [redacted]

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Summary

Information available as of 1 February 1985 was used in this report.

Eastern Europe's[1] trade with the West[2] has been marked in the 1980s by an increase in countertrade—transactions in which the exporter accepts goods or services from the importer as payment. The USSR and Eastern Europe have long used countertrade to increase import capacity by circumventing the problems of poor export competitiveness and lack of hard currency and to facilitate planning by reducing uncertainty in trading relations with the West. In the early 1980s, the East Europeans stepped up their demands for countertrade in an effort to limit the impact of financial problems and soft export markets. [redacted] 25X1

[redacted] countertrade now accounts for about 30 percent of trade with the West for the financially strapped East European countries (Poland, Romania, and Yugoslavia) and for 10 to 20 percent of trade for the other countries. [redacted] the shares could run as high as 40 to 50 percent for the most active countertrading countries, but we believe these estimates are somewhat inflated. Nonetheless, countertrade is comparatively more important in Eastern Europe's trade with the West than it is in total world trade. [redacted]

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Countertrade proved a useful expedient during the region's 1981-83 financial crisis. It was one of several options available to the East Europeans to deal with their financial problems and was attractive because it resulted in less economic burden than administrative controls on imports and domestic austerity measures. The hard currency outlays saved by countertrade transactions may have equaled as much as a third of the region's debt service costs and helped moderate reductions in Western imports. Countertrade also helped limit the decline in East European exports caused by soft markets in Western Europe. [redacted] 25X1

While helpful in a period of financial stress, we believe countertrade will do more harm than good to Eastern Europe's trade performance in the long run. Using Western suppliers as an outlet for otherwise unsaleable goods weakens incentives to upgrade the quality and efficiency of production. [redacted] 25X1 some East European trade officials contend that long-term reliance on countertrade tends to perpetuate uncompetitive production, shelters Eastern enterprises from valuable marketing experience, and damages the image of Eastern goods. In our view, linking exports to the willingness of Western partners to accept countertrade is a less promising basis for achieving strong export gains than working to meet market requirements for price and quality. [redacted] 25X1

[1] Eastern Europe includes Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania, and Yugoslavia. [redacted]

[2] West refers to developed and developing nonsocialist countries. [redacted]

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While many East European officials recognize that countertrade is a poor solution to the region's export problems, in our judgment, the East Europeans will continue to rely heavily on countertrade to sell to the West:

- Chronic problems with hard currency exports will probably worsen as a result of the growing technological edge the West has over Eastern Europe, stiffer competition from the more industrialized LDCs, and tougher Soviet demands for better quality goods from Eastern Europe.

- Planning and foreign trade bureaucracies in Eastern Europe still favor countertrade because of its compatibility with intra-Bloc trading mechanisms. Only Hungary seems committed to fundamental reforms that may weaken the institutional bias for countertrade.

- Businessmen anxious for sales seem ready to accept countertrade as one of the costs of competing in Eastern Europe. Many Western banks and firms have a vested interest in promoting countertrade because of investments made in trading companies that specialize in countertrade with both LDCs and the Soviet Bloc. [redacted] 25X1

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Countertrade Definitions

The term "countertrade" refers to any transaction in which the exporter commits himself to take products from the importer or importer's country in full or partial payment for his deliveries. This can happen in a variety of ways, but the terminology used to describe the various forms of countertrade is inconsistent and often confused. In general, four main types of countertrade occur in East-West commerce: barter, counterpurchase, buy-backs, and offsets. 25X1

Barter

In straightforward barter, goods are exchanged directly between the Eastern and Western partners without exchange of cash, pricing of goods, or financing. Barters are difficult to conclude because of problems in finding a party that will receive one type of goods and simultaneously deliver another and in determining their relative value. In some cases, the contract may limit the Western partner's purchase commitment to only a portion of his sale with the balance paid in cash. It is generally difficult, however, for the East Europeans to obtain financing for the cash payment because Western banks and credit insurers oppose making the repayment of credit contingent upon the Western supplier's purchase of Eastern goods. Because of a variety of complications, barter has become much less common in East-West trade than it was in the immediate postwar period. 25X1

Counterpurchase

Counterpurchase has become the predominant countertrade variant in East European trade with the West because it circumvents some of the limitations of barter. Counterpurchase involves two separate but linked contracts, each involving cash payment for goods. One contract involves the sale of goods to the Eastern side; the other involves the Western exporter's commitment to buy (or have a third party buy) products from the importer up to and even exceeding the amount of the original sale within a stipulated period (usually one to three years). A major advantage to the Western seller is that he is paid at once in convertible currency and lenders are more willing to provide credit because payment of the export contract is not contingent upon counterdeliveries. 25X1

Buy-Back

In buy-back deals—sometimes referred to as compensation—the Western firm supplies technology, equipment, and even entire plants in return for goods produced using the plant or equipment (resultant products). In contrast to counterpurchase, which involves repayment in nonresultant products, buy-back deals generally involve very large sales, extend over a long period of time, and require substantial bridge financing to cover the time lag between delivery of equipment and resultant production. Buy-back is less common than counterpurchase because Western firms generally are looking for raw materials, which are in short supply in Eastern Europe. 25X1

Offset

Offset is a system by which the Western exporter incorporates goods from the Eastern partner in the product he sells. Like buy-back, offset transactions are more long term and are more closely linked to industrial cooperation than to the commercial practices of counterpurchase and barter. 25X1 [redacted] 25X1

East European Countertrade: The Trend Toward Bilateralism in Trade With the West [redacted]

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Introduction

Countertrade has been a fixture of East European trade with the West since World War II. Over this period it has evolved from simple barter to complicated deals involving several parties. East-West countertrade began to attract attention during the 1970s when East European countries tried to stem rising hard currency trade deficits by pressing Western suppliers to take Eastern goods in return. Severe financial problems in the early 1980s caused most East European regimes to increase demands on Western suppliers to accept countertrade. These arrangements provided some shortrun gains during a period of financial stress, but over the longer term we believe that reliance on countertrade will hinder improvement in the region's export competitiveness. [redacted]

This paper will contrast the shortrun gains with the longer term problems associated with increased bilateralism in trade with the West. It will review briefly the evolution of countertrade prior to the region's financial crisis in the 1980s and will examine in more detail its role in helping Eastern Europe adjust to reductions in Western credit. This paper will consider the outlook for East-West countertrade, for alternatives to such trading arrangements, and for the implications of these trade policies for Eastern Europe. [redacted]

Development of East-West Countertrade

Countertrade, primarily barter arrangements, played an important role in European trade in the immediate postwar years when the rebuilding economies of Eastern and Western Europe lacked the convertible currency needed to conduct normal commerce. The use of countertrade diminished within Western Europe as the region's economies strengthened, particularly after 1958 when West European currencies became fully convertible. The USSR and Eastern Europe, however, continued to rely on simple forms of countertrade in dealing with the West because they lacked hard currency and trade credits and because countertrade was compatible with intra-Bloc trading mechanisms. [redacted]

A surge in East-West trade in the 1970s increased the complexity of countertrade, especially through the conclusion of long-term buy-back deals. As the Soviet Bloc became more dependent on Western imports, the regimes used countertrade as a way to adjust their foreign trade planning to uncertain Western markets. By establishing specific Western purchase commitments extending over a long period of time, central planners aimed to moderate fluctuations in exports, facilitate the formulation of long-range trade plans, ensure adequate earnings to repay Western credits, and provide for increased import capacity. [redacted]

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Most of the large buy-back deals concluded in the 1970s involved Soviet purchases of Western machinery and equipment on credit for the development of the USSR's energy and raw material sectors (see figure 1). Western suppliers found such arrangements attractive because they promised large machinery sales at a time of soft markets in the West and repayment through long-term deliveries of energy and raw materials at favorable prices that the firms could use in production or readily sell. Eastern Europe concluded fewer long-term deals because—except for Poland—the region could not offer significant amounts of energy or raw materials for countertrade. East European buy-back deals generally involved deliveries of chemicals and machinery (see table 1), but these arrangements covered a smaller amount of the region's capital goods imports than in the case of the USSR (see figure 2). [redacted]

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Even with the buy-back deals, [redacted] only about 10 percent of Eastern Europe's trade with the West was conducted through bilateral channels in the early 1970s. Easy access to Western financing limited the need to match imports with offsetting exports, but it also laid the basis for growing financial problems, which eventually led to an upswing in East European demands for countertrade. The East Europeans anticipated that imported Western technology would generate the additional exports needed for debt repayment. Systemic inefficiencies, poor marketing skills, quality

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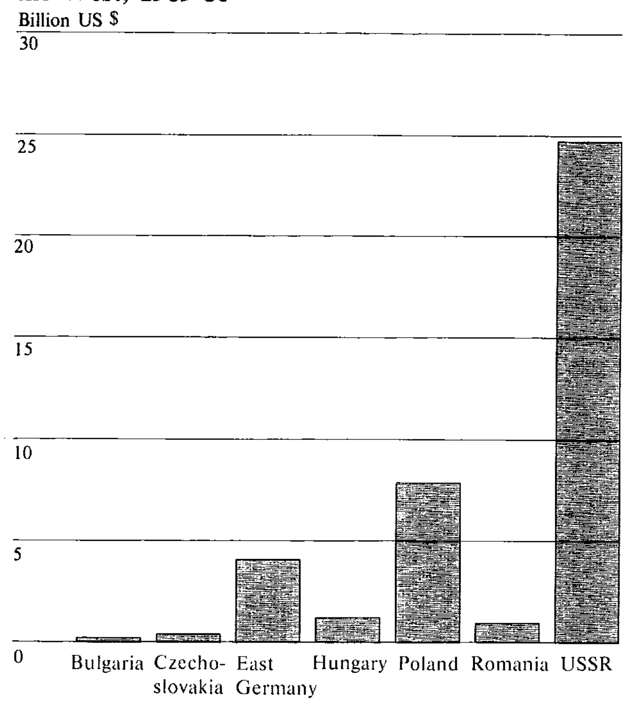
control problems, and, in the West, recession and protectionism curtailed strong gains in sales. As hard currency trade deficits and debt mounted by the mid-1970s, most regimes intensified demands on Western suppliers to take goods, especially machinery and consumer goods, as payment. 25X1

While attracted to deals offering energy and raw materials at discount prices, Western firms generally had limited interest in countertrade involving East European manufactured goods. These products often were low in quality or difficult to sell in the West because of import restrictions; otherwise, the East Europeans probably would have marketed them under more conventional arrangements. Western firms—willing to accept countertrade as the price of making a sale—faced the problem of disposing of Eastern counterdeliveries. West German, French, Austrian, and Italian companies were the most willing to negotiate countertrade deals with Eastern Europe. A sizable subindustry of firms developed—notably in Austria—to act as middlemen in buying and selling countertrade goods. Although facilitating deals, these so-called switch traders made countertrade more costly and complex than conventional trade. These difficulties posed major obstacles to small firms; consequently, large multinational corporations that could more easily absorb or dispose of Eastern goods through their extensive supply networks and diverse operations became the dominant participants in countertrade with Eastern Europe. 25X1

Even with renewed East European interest in countertrade, these trading arrangements apparently still accounted for a comparatively small share of East-West trade by the late 1970s. Although East European buyers often demanded that counterpurchases cover as much as 50 percent of an import contract, the OECD concluded that countertrade in the late 1970s accounted for no more than 15 to 20 percent of total hard currency trade in countries where it was most widely practiced (Romania, Poland, and Bulgaria) and for less than 10 percent in other countries. 25X1

Figure 1
Eastern Europe-USSR: Buy-Back Deals With the West, 1969-80



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Responding to Financial Crisis

The collapse of Eastern Europe's creditworthiness in the early 1980s resulted in a sharp cutback in credit to the region. With the exception of Czechoslovakia and Bulgaria, the regimes all but exhausted hard currency reserves in trying to meet debt service payments that could no longer be financed through more borrowings. Lack of cash and credits left the East Europeans with little choice but to reverse the decadelong trend of large hard currency trade deficits through cuts in imports and concerted efforts to boost exports. 25X1

East European economic managers, in our view, had four options to improve their balance of trade:
- Administrative controls on imports.
- Adjustment policies to reduce domestic demand for imports and to free up more production for exports.
- Systemic reforms to provide incentives for exports and to improve the efficiency and quality of production.
- Commercial policies to boost exports through aggressive price cutting, countertrade, and industrial cooperation. 25X1

Table 1
Large East European Buy-Back Deals With the West in the 1970s

Western Country	Western Supplier	East European Country	Year Signed	East European Imports	Import Value (*million US $*)	East European Exports	Planned East European Export Value (*million US $*)	Outcome and Comments
France	Technip	Bulgaria	1975	Ethylene plant	50	Machinery and engineering goods, petrochemicals	NA	NA
West Germany	Friedrich Uhde	East Germany	1976	Polyvinyl chloride complex and related equipment	451	Polyvinyl chloride and soda lye	NA	Exports to equal 30 percent of output over eight to 10 years; project apparently working as planned.
Japan	Toyo Engineering, Mitsui	East Germany	1977	Two petrochemical plants	450	Petrochemicals	NA	Most of the chemicals Japan received probably were sold to third countries via trading houses.
France	Citroen	East Germany	1978	Turnkey plant	330	Transaxle units and parts (300,000 per year)	NA	In 1982 France imported $12 million worth of parts, increased to $20 million in 1983.
United States	Steiger	Hungary	1976	Technology and parts for tractor manufacturing	80	Tractor axles	20	Has worked out well. Steiger has purchased more axles than called for in the agreement.
France	Citroen	Romania	1977	Design, engineering, and parts for automobiles	170	"Olcit" cars	Half of annual production	The French have not accepted any of the cars because of failure to meet quality standards.
United Kingdom	Petrocarbon Development Ltd.	Poland	1975	Polyvinyl chloride and chlorite plants	400	Polyvinyl chloride	NA	The Poles used most of the credits for these projects to cover financial obligations. Poland, nonetheless, has exported coal, copper, and chemicals to the Western firms despite strike disruptions in 1980 and 1981.
Belgium	Unknown	Poland	1975	Coal-mining equipment	335	1.5 million tons of coal per year for 10 to 15 years	335	
Austria	Voest Alpine	Poland	1975	Steel products	287	Coal	348 over nine years	
West Germany	West German Consortium	Poland	1976	Equipment for expanding Poland's copper industry	125	40,000 tons of copper per year plus some copper products	800 to 1,000 over 12 years	

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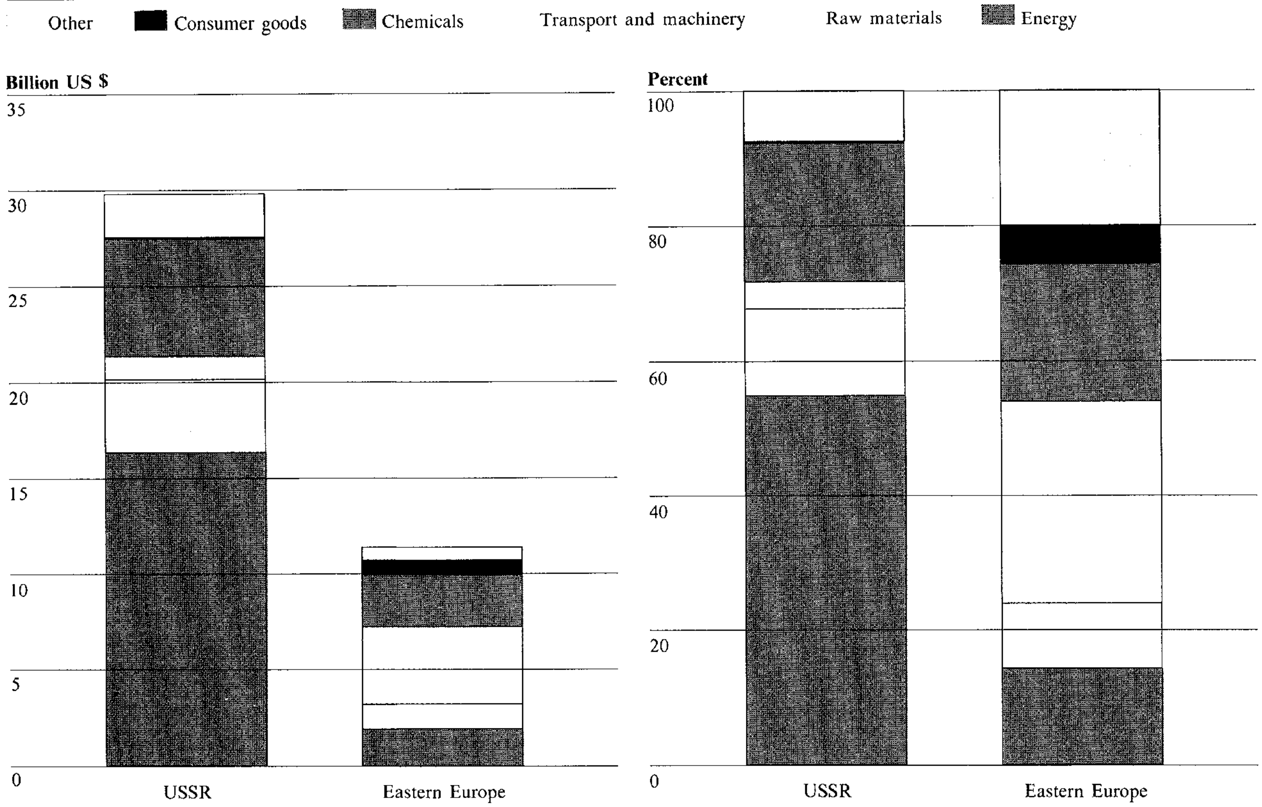
Figure 2
Planned East European and Soviet Exports to the West Under the Buy-Back Arrangements Signed, 1969-80
Note scale changes



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From the perspective of planning and foreign trade bureaucracies, adoption of more aggressive commercial policies seemed an attractive strategy to counter the swift contraction of trade credits because they promised the quickest payoff with the least cost. Import cuts and restraints on demand—primarily on investment—were unavoidable, but the regimes wanted to minimize such measures out of political concern over the popular reaction to austerity. The payoff from systemic reform would have been too slow and uncertain to be much help in a period of financial crisis. Moreover, vested interests in party, government, and enterprise management probably would have watered down reform programs.

Of the various commercial policies considered, countertrade was more promising than price cutting or industrial cooperation. The scope for aggressive price cutting was limited by the threat of antidumping actions by Western countries. Western firms generally have not been enthusiastic about entering into industrial cooperation arrangements with Eastern Europe, and the returns take several years to be realized. Faced with an immediate financial crunch, the East Europeans had little choice but to press suppliers even harder to accept payment in goods. Western firms looking to sell to Eastern Europe recognized that they had to meet these conditions given the region's severe financial problems.

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At the onset of the East European financial crisis, only Romania mandated the use of countertrade for hard currency imports. Most of the other countries increased reliance on countertrade without making it an explicit requirement. Although the regimes varied considerably in the type of arrangements they preferred, [redacted] reported several trends:

- Most countries increased the share of their import costs that they tried to cover through counterdeliveries (see table 2).

- The lack of hard currency compelled many regimes to demand countertrade for priority imports that they had previously purchased for cash. In late 1984, a Polish firm had a tentative agreement with a US company to purchase $6 million worth of badly needed X-ray equipment and film. In return, the US firm agreed to purchase $10 million worth of coal and chemicals.

- The goods offered as counterdeliveries became even less attractive. There was a movement away from agricultural commodities, energy, and semifinished goods—which are somewhat easier for Western firms to resell or to use in their own production—toward machinery, which entails problems in quality, service, and spare parts (see figure 3). Because of the pressing need for cash, foreign trade organizations tried to sell more marketable goods for hard currency while attempting to offer less desirable goods in countertrade deals. [redacted]

The countries that suffered the most severe financial problems gave the most attention to countertrade:

- In 1980, *Romania's* President Ceausescu announced that all foreign trade organizations must link planned imports of machinery and equipment and all nonplanned imports to counterpurchases of Romanian machinery and equipment. Bucharest subsequently pressed holders of overdue supplier credits to accept goods in lieu of cash.

- Although *Poland* demanded relatively small countertrade ratios for imports going to key export sectors, in most other sectors the ratios rose to between 60 and 90 percent, [redacted] Polish enterprises, however, often failed to enforce their demands because shortages of goods limited barter with Western companies.

Table 2 *Percent*
Countertrade Ratios Demanded by East European Buyers, [a] 1976, 1980, and 1983

	1976	1980	1983
Romania	30 to 40	50 to 70	60 to 80
Poland	25 to 30	20 to 50	60 to 90
Yugoslavia	30	40 to 60	60 to 80
East Germany	20 to 40	20 to 50	50 to 75
Hungary	0	15 to 50	30 to 50
Bulgaria	40 to 50	40 to 60	40 to 60
Czechoslovakia	30 to 40	15 to 50	35 to 50

[a] The ratios in this table reflect typical maximum countertrade demands made by East European buyers. Western suppliers can usually lower these requirements in contract negotiations, particularly for higher priority imports.

Source: Surveys of Western businessmen reported by *Business Eastern Europe*.

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- In 1982, *Yugoslavia* adopted legislation requiring $103 worth of counterpurchases for every $100 worth of imports of raw materials, semifinished goods, and consumer goods in short supply. Yugoslav firms were allowed to offer higher quality goods to meet these needs while less desirable goods were to be used in countertrade to purchase capital equipment. In this way, the authorities promoted imports of goods needed for production and consumption at the expense of investment goods. [redacted] 25X1

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The sudden unavailability of credits and weak Western markets in the early 1980s led both *East Germany* and *Hungary* to begin insisting on counterpurchase deals. Prior to the credit crisis, Hungary generally opposed the use of countertrade while East Germany focused mainly on long-term buy-back deals linked to the construction of complete plants. In addition to counterpurchase deals, the East Germans have earned substantial hard currency in recent years by acting, in effect, as middlemen in multiparty barter-switch deals. Items the East Germans have resold for cash include oil, metals, and raw materials obtained 25X1
through barter with developing countries, as well as goods obtained on clearing account from West Germany. [redacted] 25X1

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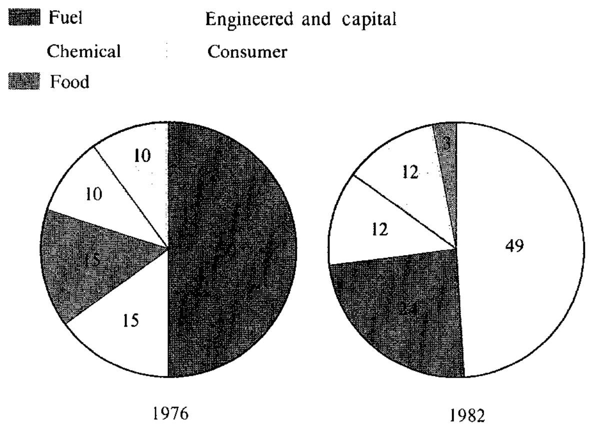
Figure 3
USSR-Eastern Europe: Change in Catagories of Goods Offered in Countertrade, 1976 and 1982

Percent



[redacted]
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Because of their reasonably strong financial positions, neither *Czechoslovakia* nor *Bulgaria* had to adopt substantially tougher policies on countertrade in response to the credit crisis. The Bulgarians have long sought buy-back and offset deals to modernize their industry and expand hard currency export capacity but with meager results. Bulgaria has had more success in negotiating arrangements in which it provides construction and engineering services in return for Western machinery and equipment used in joint ventures in developing countries. Czechoslovak buyers often raise the possibility of countertrade in negotiations with Western firms, but generally do not insist on such arrangements except in the case of large purchases and low priority imports. [redacted]

Impact on Trade With the West

Measuring the impact of tougher East European demands for countertrade is difficult. [redacted] countertrade has increased its share of Eastern Europe's trade with the West since the late 1970s, but reliable data on its magnitude are impossible to find. Published statistics do not distinguish countertrade from conventional trade. [redacted] Some recent estimates [redacted] asserted that 40 to 50 percent—and possibly even more—of East European imports from nonsocialist countries are tied to countertrade. [redacted] this may be reasonably accurate for trade in captial goods (particularly for countries facing the most severe hard currency shortages), but it probably is too high for total trade. [redacted]

[redacted] countertrade probably accounts for 20 to 30 percent of the region's trade with nonsocialist countries, that is, $15-20 billion annually of which $10-15 billion is with the developed West. There are, however, important differences among countries:

- Romanian officials have stated in the press that countertrade accounts for 30 percent of the country's $5 billion in trade with the West, well short of Bucharest's goal.

- According to embassy reporting, Polish trade officials recently told Western executives that countertrade accounts for 8 to 10 percent of Poland's total trade, equivalent to about 25 to 30 percent of its $6.4 billion trade with the West.

- Yugoslavia announced in the press that the countertrade variant established by 1982 legislation accounted for about 15 percent of its $14.3 billion hard currency trade in 1983; we estimate conventional countertrade probably accounted for an additional 5 to 10 percent.

- The other East European countries have not reported comparable statistics, but, [redacted] we estimate that the countertrade shares for East Germany and Bulgaria are on the order of 15 to 20 percent and no more than 10 percent for Hungary and Czechoslovakia. [redacted]

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Based on OECD and GATT studies, we estimate countertrade accounted for nearly 6 percent of international trade in 1983.[3] Even for LDCs, where countertrade has attracted much attention in the past few years, only about 10 percent of total imports—and 4 percent of imports from industrial countries—were linked to countertrade deals. Total world countertrade deals are estimated by the OECD to have totaled approximately $95 billion in 1983. [redacted]

An important measure of countertrade's importance to Eastern Europe is the extent to which it helped ease financial constraints during the 1981-83 credit crunch. If we assume that 20 percent of imports were paid for by countertrade arrangements, this would have saved on hard currency outlays that could be used instead to cover almost 30 percent of the region's debt service during this period. The absence of countertrade would have resulted in an average annual reduction in imports of 18 percent instead of the 11-percent average annual cut actually made over the three years. These measures overstate countertrade's significance because some counterexports presumably could have been sold without linkage to imports. Nonetheless, countertrade played a useful role in helping these countries deal with their external financial crisis. [redacted]

Countertrade probably also helped limit the decline in East European hard currency exports in 1981-83 caused by soft markets in Western Europe. Perhaps paradoxically, depressed conditions in the West may have strengthened the hand of the East Europeans because Western firms anxious for sales were more amenable to countertrade requirements. According to Western business press [redacted] many firms took countertrade goods they might have rejected under more normal circumstances, including items that could only be sold for scrap. While Western suppliers would try to negotiate the most favorable prices possible for their deliveries and counterpurchases, many firms were prepared to accept some reduction in normal earnings to enter or maintain their position in East European markets. [redacted] Western chemical firms were accepting a growing volume of Romanian chemicals as payment on overdue supplier loans and to preserve established commercial ties. This may explain the growth in Romania's chemical sales to the OECD in recent years when many of its other exports have declined. 25X1 Countertrade may have contributed to the surprisingly strong growth in East Germany's exports. [redacted] the generally better quality of East German manufactured and consumer goods has made counterpurchase deals more feasible than with other East European countries. Resales of oil and other commodities obtained through barter deals, however, have probably played a more important role in boosting East German exports to the West. [redacted]

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Although countertrade apparently has contributed to export growth for Yugoslavia, we believe it has worked against Belgrade's efforts to restore financial health because Yugoslav enterprises have used countertrade to circumvent regulations designed to build up the country's foreign exchange reserves. In conventional trade, a Yugoslav firm had to surrender 60 percent of the proceeds from hard currency exports to the Yugoslav National Bank, compared with only 20 to 40 percent in countertrade. Because of this incentive, Yugoslav firms often exported goods in countertrade deals that otherwise could have been sold directly for cash. This evasion of foreign exchange regulations contributed to Belgrade's failure to rebuild its depleted hard currency reserves in 1983 and complicated negotiations on Yugoslavia's 1984 refinancing agreement with Western banks. [redacted]

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Outlook

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Most East European countries claim that they do not want to increase their use of countertrade. [redacted] Warsaw would prefer not to barter exports for imports. The Poles claimed that continuing shortages of exportable goods limit their ability to use countertrade. Instead the Poles want to obtain imports on credit and

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[redacted]

Countertrade Deals: The Good, The Bad, and The Romanians

Negotiating a countertrade deal with an East European buyer is filled with pitfalls for a Western firm. Western businessmen are at a disadvantage because they cannot be sure of the quantity, price, and quality of goods they must purchase. The East European side knows the exact goods it wants to purchase, the price, and the countertrade ratio it will require. Eastern negotiators will often wait until just before signing contracts to bring up countertrade demands in order to prevent the Western partner from raising his price to cover the cost of disposing of countertrade goods. The East European side will generally try to impose tight restraints on the list of goods available for counterpurchase, the time limit for Western purchase, and potential resale markets. The East European objective is to require the purchase of less marketable goods with little delay and to prevent the Western firm from reselling in established markets. The Eastern side will generally try to guarantee Western counterpurchases by demanding a sizable penalty clause covering nonfulfillment of contract. [redacted]

Faced with these difficulties, many companies try to negotiate price discounts and other concessions in lieu of countertrade obligations. Nonetheless, some companies, particularly chemical firms and commodity traders, are able to profit from both the import and export contracts of countertrade transactions because they can more readily use or resell basic products from Eastern Europe. West European companies generally are in a better position to accept countertrade than US firms because some electrical components, clothing, textiles, shoes, and household items offered by the East Europeans meet West European standards. In addition, West European firms can more readily accept chemicals, steel, and cement, which have comparatively high transportation costs, because of the shorter distances involved. Japanese trading companies also are better able to negotiate successful countertrade deals than US firms. The Japanese can rely on extensive marketing networks in East Asia to dispose of East European goods, often by bartering the East European products for goods from third countries. [redacted] 25X1

Even when a firm carefully negotiates a deal, it can still end up losing money. Many Western suppliers have been ready to make counterpurchases in good faith only to find that the East European side cannot or will not supply goods originally listed as available for counterexport. This leaves the Western firm with the choice of either taking worthless goods in payment or paying a penalty—which can run up to 100 percent of the contract—for nonfulfillment of contract. [redacted] 25X1 25X1

Western businessmen [redacted] *have the most trouble negotiating satisfactory countertrade terms with the Romanians. Romanian foreign trade organizations are notorious for reneging on the promised quality of counterexports. According to press reports, Japanese firms trapped into purchasing Romanian goods have found one solution to the cost of countertrade with Bucharest. They simply request delivery of the heaviest Romanian machinery available so that they can sell it immediately as scrap.* [redacted] 25X1 25X1

export for cash to generate the funds needed to meet debt service requirements. [redacted] Belgrade is discouraging the use of countertrade by reducing the amount of hard currency export earnings from conventional trade that a Yugoslav firm must surrender to the National Bank. [redacted] some easing in demands for countertrade from East German, Czechoslovak, and Hungarian buyers as their ability to borrow from Western banks has improved. [redacted]

Only Romania seems committed to pressing for more countertrade. In his recent speech to the Romanian party congress, President Ceausescu endorsed countertrade as a means to expand economic relations with the West. But even Romanian foreign trade officials have acknowledged that the push for more countertrade would be balanced by an effort to receive

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payment in cash for Romanian exports. Deputy Foreign Trade Minister Stanciu told the Western press that, while Bucharest wants to increase countertrade deals, most exports will not be tied to imports because the Romanians also want to pay back their hard currency debt in the next few years. [redacted]

Despite apparent reluctance to increase countertrade, we believe that it will continue to play an important role because Eastern Europe is likely to face increasing difficulties in exporting to the West. Reductions in investment and imports of Western capital goods in recent years have widened the technological gap between Eastern Europe and the West. The East Europeans also are facing stiffer competition from the more industrialized LDCs in Western markets. Growing Soviet demands for better quality East European goods in return for deliveries of energy and raw materials may reduce the amount of East European goods available for sale in the West. We expect that the combination of these factors will compel the East Europeans to continue pressing Western suppliers to take less attractive goods as payment. [redacted]

The East Europeans are unlikely to give up countertrade because it is a long-established way of doing business. With the possible exception of Hungary, East European foreign trade organizations continue to favor countertrade because they perceive that it promises stability and facilitates planning. Moreover, West European businessmen, in particular, seem to accept countertrade as a necessary evil. Since Western firms expect that the East Europeans will remain strapped for cash, we believe businessmen anxious for sales will accept countertrade as one of the costs of competing in Eastern Europe and will even initiate countertrade offers in the hope of clinching deals. Many Western banks and companies also have a vested interest in promoting countertrade because they have made significant investments in divisions or companies that specialize in countertrade with both LDCs and the Soviet Bloc. Even though Western governments generally disapprove of state-mandated countertrade because it reduces the efficiency of world trade, governments are reluctant to interfere with the activities of domestic exporters. [redacted]

Western Governments: Searching for a Consensus on Countertrade

Caught between theoretical objections and the reality of business, OECD governments have struggled for nearly a decade to establish a position on East-West countertrade. Since 1977 the OECD and the EC have debated the issue and ordered studies, but progress toward a Western consensus has been extremely slow. Most governments want to establish ground rules with the Soviet Bloc that would make it easier for Western firms to deal with Eastern demands. Some governments, however, are concerned that a code of conduct would imply official endorsement of state-mandated countertrade as a normal practice. The USSR and Eastern Europe have persistently pressed for such official endorsement but have balked at Western efforts to discuss the commercial problems posed by their practices in CSCE sessions and the United Nation's Economic Commission for Europe. The Soviet Bloc has argued that some countertrade deals—notably buy-back arrangements—contribute to the growth of East-West trade while counterpurchase and barter deals are a response to "discriminatory" Western restrictions on their exports. [redacted]

Countertrade with developing countries, particularly switch trading involving Western firms, LDCs, and Communist countries, seems likely to grow. Switch transactions were fairly common in the 1950s, but declined in number and importance as LDCs and CEMA countries began conducting more of their trade in hard currencies. This practice, however, is enjoying a revival as a result of the financial problems encountered by both developing countries and Eastern Europe. According to press [redacted] a growing number of multinational firms and Western banks trying to make new sales or collect on old debts are proposing various types of switch trade arrangements to the East Europeans and LDCs. [redacted]

Implications for Eastern Europe

Countertrade has been a useful expedient during a period of financial problems and soft export markets in the West, but we believe it may do more harm than good to Eastern Europe's trade performance in the long run. In our view, this is particularly true of counterpurchase and barter deals. Longer term relationships with Western firms through buy-back and offset deals and other forms of industrial cooperation offer better prospects for obtaining modern technology and marketing skills needed to be competitive in the West. [redacted]

Western businessmen and even some East European economic officials argue that reliance on countertrade tends to perpetuate uncompetitive production, shelters Eastern enterprises from valuable marketing experience, and damages the image of East European goods. When Western firms looking for sales accept goods that the East Europeans may not be able to export otherwise, the East Europeans have little incentive for innovation or improvement in the quality of their production and marketing. In our view, linking exports to the willingness of Western partners to accept countertrade is a less promising basis for achieving strong gains in sales than working to meet market requirements for price and quality. [redacted]

When the East Europeans sell marketable goods through countertrade, they may often receive less for their exports than they would in normal trade. Since Western businessmen find countertrade transactions more costly and complex to arrange than conventional deals, they often raise the price of their goods or demand discounts on the price of East European counterdeliveries. [redacted] Western firms may often agree to countertrade because they can make a profit on disposing of the counterdeliveries—a gain the East Europeans could capture with better knowledge of the market. A Western firm, for example, recently bartered agrochemicals with a Czechoslovak foreign trade organization because it could sell them to a French company for a higher price than the Czechoslovaks demanded. [redacted]

[redacted] the most beneficial direction of development for countertrade would be an increase in industrial cooperation. Longer term arrangements that go beyond a one-time sale or purchase of goods offer better possibilities for improving East European export performance because sustained contact with Western firms can provide a continuing flow of technology, technical and marketing skills, incentives to maintain quality standards, and stable markets. Cheap Eastern labor and improved access to CEMA markets are the principal attractions to the Western partner. Industrial cooperation arrangements can include buy-back and offset deals, subcontracting where the Eastern partner is a regular supplier of components, joint research and 25X1 development, coproduction where each partner makes some components that contribute to the other's final product, and joint marketing in either partner's market or in a third country. Certain East European countries are even interested in establishing joint ventures with equity of both partners either in Eastern Europe or in the West. [redacted] 25X1

Over the past few years, the East Europeans have taken steps to make cooperation and joint ventures more attractive to Western businesses:

- Hungary, whose 1972 legislation authorizing foreign equity participation in joint ventures had attracted disappointingly few takers, in 1982 autho- 25X1 rized the creation of duty-free zones. Mixed companies in duty-free zones would be exempt from import duties and certain wage and benefit regulations if they export the end product.

- Bulgaria introduced a joint venture law in 1980 and has been pursuing cooperative relationships in electronics and the automotive sector with Western (particularly Japanese) firms. 25X1 25X1

- Yugoslavia has been revising its joint venture legislation in a bid to attract more foreign capital without increasing its debt and to obtain the help of Western firms in developing stronger export industries and promoting import substitution.

- Although long reluctant to enter into industrial cooperation arrangements with Western firms, the 25X1 East Germans agreed in 1984 to supply diesel engines to Volkswagen beginning in 1988 in return 25X1 for a production line, truck chassis, and trucks. [redacted] 25X1

East European–LDC Countertrade

The OECD estimates that countertrade accounts for as much as 30 percent of trade between the Soviet Bloc and the LDCs. The OECD apparently includes in its estimate goods exchanged through bilateral clearing accounts in addition to transactions involving linked export and import contracts—the typical countertrade deal with firms from developed countries. Bilateral clearing trade probably accounts for most East European–LDC countertrade; nonetheless, barter transactions and switch deals involving several countries and firms are common between the regions and have grown in importance as a result of the financial problems faced by both Eastern Europe and the Third World. [redacted]

Romania is the most aggressive East European country in trying to arrange countertrade deals with LDCs. Most of these efforts are directed at bartering oilfield equipment, machinery, and chemicals for petroleum from oil-producing countries. The other East European countries also seek out opportunities to swap finished goods for oil, food products, and raw materials from developing countries. While the East Europeans generally will use the LDC imports as industrial inputs or additions to consumer supplies, in recent years several countries—notably East Germany—have resold bartered LDC goods for hard currency to help ease liquidity problems. Many proposed deals are never completed, however, because the LDC cannot identify any East European items that it wishes to import, or the East European partner fails to deliver acceptable goods on time. [redacted]

An important aspect of East European–LDC countertrade is the use of switch trades to acquire Western goods or repay hard currency debts with bilateral clearing account balances. [redacted]

Clearing account balances between Eastern Europe and the LDCs are not directly convertible into cash but represent purchasing power for goods manufactured in the countries subscribing to the clearing agreement. The agreement may provide that the country with a surplus in bilateral trade can turn over its balance to a third party. The third party, in turn, can use the surplus to acquire goods from the deficit country and—through a series of transactions—convert these goods into hard currency. [redacted]

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A West German firm, for example, delivers $470,000 worth of machinery to Romania (see figure 4). Romania, which has a bilateral clearing surplus with Morocco, pays the West German firm in Moroccan clearing dollars. The Romanians discount the clearing currency by 6 percent, giving the West Germans a 500,000 clearing-dollar credit. The West German firm, unable to use the clearing currency, contacts a switch trader who in turn locates a Dutch firm interested in buying from Morocco. The switch trader purchases the clearing dollars from the West German firm for $470,000 and sells the balance to the Dutch firm for $475,000. The Dutch firm uses the clearing balance to import from Morocco. As a result of this transaction, the Romanians obtain Western goods without using hard currency while eliminating a clearing account surplus with Morocco. [redacted]

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Because of problems in collecting on credits from both LDCs and East European countries, Western companies and even some banks have been trying to use switch trades to liquidate their claims. A firm holding a claim on an East European country, for example, will try to arrange a purchase from an LDC that has a clearing deficit with the same East European country. The firm will then either use or resell the LDC import and liquidate its claim on the East European country, while the LDC's clearing deficit is reduced. Arranging such deals obviously is complicated, and the rate of success appears low relative to the effort invested. [redacted]

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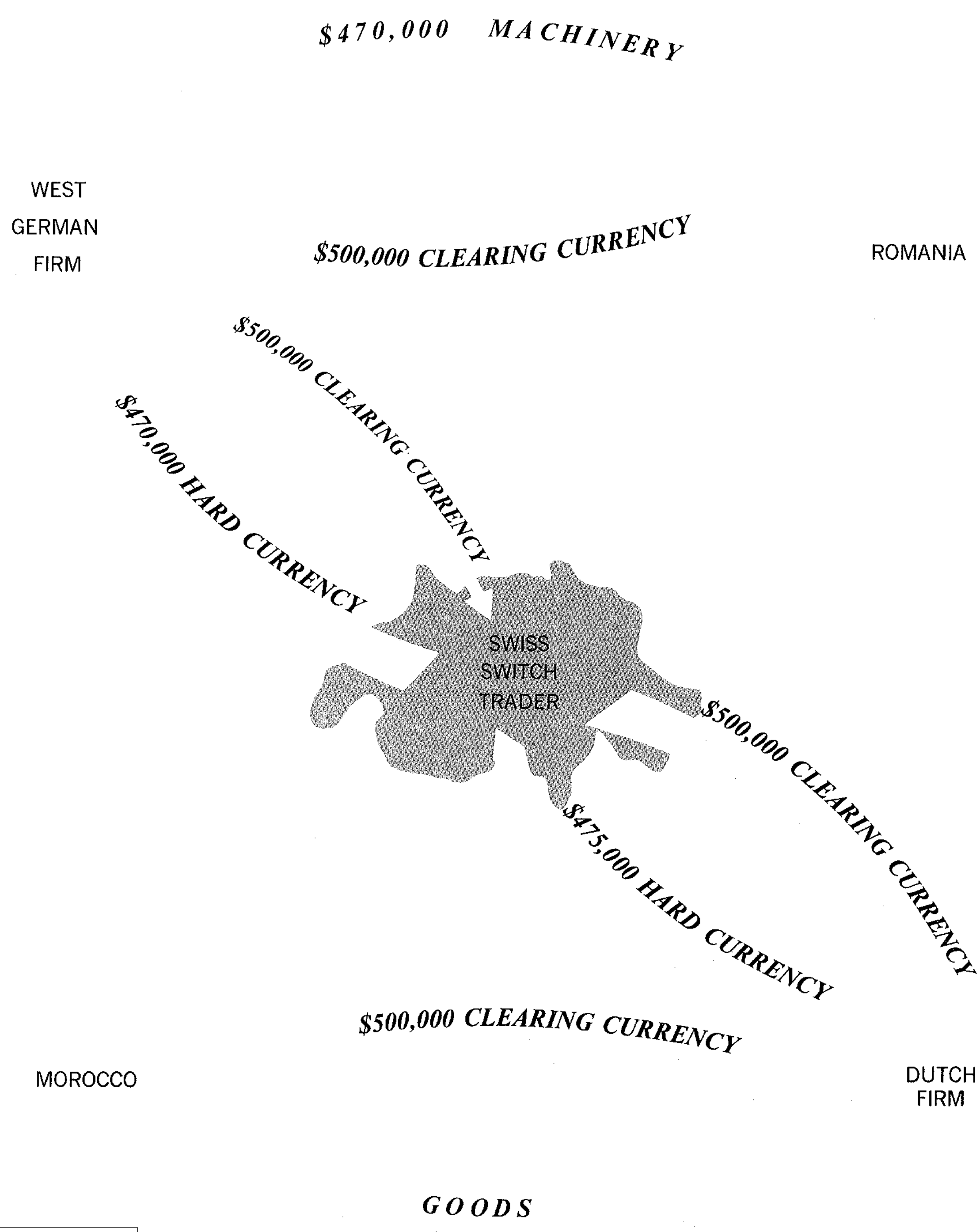
Figure 4
Flow of Good and Money in an LDC-East European Switch Deal



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Although the East Europeans extol the virtues of industrial cooperation, achievements to date have been limited. [redacted] concluded that less than 10 percent of East-West trade has resulted from such agreements. Even Hungary, which together with Poland has been in the forefront of cooperation deals, has estimated that these arrangements account for only 6 to 7 percent of its exports to the West. [redacted]

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The new East European initiatives are unlikely to change the attitude of Western businesses significantly and permit the development of useful alternatives to current countertrade practices. Western firms continue to regard investment in East European joint ventures as risky. Despite its newly liberalized joint venture regulations and generally good reputation with Western business, Hungary so far has attracted only one duty-free-zone joint venture. While Western businessmen are somewhat more interested in cooperative arrangements, they still view Eastern proposals with caution, according to press articles. Western companies are skeptical that they can rely on Eastern partners to meet contract deadlines and quality standards. East European regimes can easily impose administrative measures that can add costs and undermine a Western firm's rights in a cooperation agreement. Moreover, in many cases, the partners' interests eventually clash, particularly when the East Europeans want to push exports to hard currency markets while the Western side wants to use a cooperative deal to enter the CEMA market. [redacted]

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Appendix

Countertrade Policies of the East European Countries

The countries that suffered the most severe financial problems and consequent decline in hard currency trade—Romania, Poland, and Yugoslavia—have given the most emphasis to countertrade. East Germany and Hungary, which rarely demanded counterpurchases during the 1970s, became more aggressive in dealing with Western suppliers when their financial positions weakened in 1981-82. Although Bulgaria has not encountered severe financial problems over the past three years, Sofia regularly exerts pressure on Western suppliers to accept countertrade. Czechoslovakia did not alter its commercial policies significantly, reflecting its good financial health and relatively low priority on hard currency imports. [redacted]

Romania

Romania has tried to enforce the toughest countertrade demands. In December 1980 the government issued a decree requiring all foreign trade organizations to link planned imports of machinery and equipment and all nonplanned imports to counterpurchases of Romanian machinery and equipment or, in exceptional cases, to purchases from other sectors. When Romania went into arrears on its foreign debt, Bucharest told holders of overdue supplier credits that they had to accept goods in lieu of cash if they wanted repayment in the near future. [redacted]

[redacted] the new rules complicated foreign trade management, leading to complaints from industries requiring Western machinery and other imported inputs. In a speech to economic managers in 1981, President Ceausescu defended the policy as part of his plan to eliminate Romania's foreign debt. "Without the principle of compensation, nothing can be imported. We have taken the decision to allow no further increase in our foreign debt and to reduce it from this year onward. We shall import no more unless we have the wherewithal to pay and unless the compensation we require is forthcoming from the firms concerned." [redacted]

The Romanian Government claims that countertrade is a response to import restrictions imposed by Western countries on Romanian products. Bucharest has offered to exempt from countertrade requirements any country that liberalizes restrictions on Romanian exports. In 1982 Romania made a deal with the European Community (EC) to relax its demands. The EC liberalized some import restrictions on Romanian goods, but EC members are still encountering high countertrade demands from Romanian buyers. [redacted]

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Poland

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Despite the severity of Poland's financial crisis, the trend toward countertrade seems less pronounced than in Romania. Western suppliers of goods such as electronic components and agricultural chemicals used in export industries face small countertrade ratios. In most other sectors, however, the ratios have increased to between 60 and 90 percent. Because of their cash shortage, the Poles have joined the Romanians in trying to arrange straight barters or barter-like deals that require minimal cash payments. Such transactions are particularly awkward for Western firms, but the Poles—unlike the Romanians—occasionally will offer marketable items such as coal and raw materials for barter. [redacted] 25X1

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Polish enterprises often are unable to enforce their demands because shortages of goods restrict what can be traded with Western companies. Some Western suppliers have made the best of a difficult situation by reversing the countertrade process through advance purchases. The Western partner buys Polish goods on the strength of the Polish firm's commitment to buy something from the Western importer within a stipulated period. The Western company has greater control over the quality of the goods received, and the proceeds from the sale of the Polish products are kept in the West to ensure that hard currency is available to cover later sales to the Polish firm. [redacted] 25X1 25X1

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Yugoslavia

Because of Yugoslavia's decentralized system of economic management, legislation on countertrade requirements adopted by federal authorities often has had little impact on foreign trade practices. At least through 1982, the republics held most of the authority for conducting foreign trade. Enterprises in republics that were net hard currency earners and whose banks had good access to Western credit markets paid much less heed to official guidelines on countertrade than enterprises from poorer regions. [redacted]

Even with this diversity, Yugoslav demands grew more stringent as the country's financial position deteriorated. Between 1978 and 1982, businessmen reported that counterpurchase requirements—usually on imports over authorized quotas—rose from 30 percent for all goods to 60 percent for machinery and spare parts, 80 percent for raw material and semifinished goods, and 100 percent for all other goods. In an effort to balance trade bilaterally, Belgrade required after 1980 that counterexports must be sold to the country supplying the initial imports. [redacted]

In 1982 Belgrade adopted new legislation on the use of countertrade for importing raw materials, semifinished goods, and consumer goods in short supply:

- Yugoslav firms purchasing such items had to require $103 of counterpurchases for every $100 worth of imports.
- The Western supplier had to purchase the Yugoslav goods in advance of his own delivery.
- Only newly developed Yugoslav goods or those subject to Western import restrictions could be offered as counterdeliveries. [redacted]

Yugoslav authorities reasoned that this policy would generate an excess of exports over imports, would reduce the need for trade credit as a result of advance purchases, and would open up new markets for Yugoslav goods. By reserving more desirable goods for countertrade arrangements, the authorities hoped to promote imports of goods needed for current production and consumption at the expense of imports of machinery and equipment. This was consistent with Belgrade's overall plan to reduce investment. By having access to better quality exportables, Yugoslav enterprises presumably would be more aggressive and successful in linking imports to exports. [redacted]

East Germany

Before the credit squeeze of the 1980s, East Germany did not often demand counterpurchases for imports of consumer goods, semifinished products, or machinery. East Berlin's use of countertrade centered mainly on buy-back deals for the construction of complete plants, particularly in the chemical industry. The sudden unavailability of Western credits in 1982 and weak Western markets escalated East German demands for counterpurchases to pay for semifinished products and consumer goods. More important than counterpurchases, however, was East Germany's role as a middleman in multiparty countertrade deals. East Germany's Intrac trading organization, which specializes in the international trade of oil and nonferrous metals, helped East Berlin weather the financial squeeze by functioning as a barter-switch trader. Intrac generated substantial hard currency earnings by reselling for cash the oil, metals, and raw materials obtained in barter deals with developing countries as well as goods obtained on clearing account from West Germany. [redacted]

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Hungary

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Hungary has made the least use of countertrade among the East European countries and has even criticized certain types of countertrade. In 1977, the Ministry of Foreign Trade expressed opposition to demands for counterpurchases in cases where the Hungarian enterprise would try to press on Western partners poor quality goods that it could not sell or for which it has no marketing organization. Countertrade was permissible only in cases where the Western firm would be the end user or where it had an established marketing organization. The Hungarians wanted long-term commercially based arrangements rather than one-time sales that could undermine the reputation of Hungarian goods. [redacted]

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Before 1983 Hungarian foreign trade enterprises did not require counterpurchases for planned imports for which hard currency had been allocated. (Unplanned imports required 100 percent countertrade.) According to the business press, in early 1983, because of

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Hungary's severe hard currency problems, foreign trade enterprises began pressing for more countertrade arrangements with Western suppliers. Western businessmen reported that Hungarian buyers began demanding counterpurchases covering 30 to 50 percent of imports.

Bulgaria

Until financial problems escalated countertrade demands from Romania, Poland, and Yugoslavia, Bulgaria generally sought the highest level of countertrade among the East European countries. The poor quality of Bulgarian manufactured goods and Sofia's decision in the late 1970s to reduce its hard currency debt compelled foreign trade enterprises to demand 40 percent to 60 percent counterpurchase ratios from Western firms, even for priority imports. The Bulgarians tried to stress long-term cooperation through buy-back agreements rather than one-time counterpurchase deals. But lack of Western interest in Bulgarian goods—except for some food products and petrochemicals—limited the number of major countertrade agreements with Western firms. Sofia had some success in penetrating Third World markets through joint ventures with Western firms in which the Bulgarians provided construction and engineering services in return for Western machinery and equipment used in the projects.

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Thanks to its relatively strong financial position and low level of dependence on hard currency trade, Bulgaria did not have to toughen its countertrade policies during the East European credit crunch. The Bulgarians, however, have continued to seek buy-back and offset deals in order to modernize their industry and expand their hard currency export capacity. Sofia has been particularly active in trying to develop cooperative deals with Western firms that would establish a manufacturing base for finished goods or components in the electronics and automobile industries. The Bulgarians have also continued to pursue arrangements in which they can provide services in return for Western participation in joint ventures in developing countries.

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Czechoslovakia

Czechoslovakia lagged behind most of the other East European countries in using countertrade during the 1970s because it believed its goods were competitive on Western markets. Because of Prague's reasonably strong hard currency position, the regional debt crisis did not result in much change in Czechoslovakia's commercial practices. Western businessmen have reported some Czechoslovak demand for counterpurchases, but on the whole Prague has preferred to impose sharp cutbacks in imports and to press suppliers for financing to offset the decline in bank credits.

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