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Countertrade in the Middle East and South Asia: A Growing Phenomenon

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A Research Paper

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Countertrade in the Middle East and South Asia: A Growing Phenomenon

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A Research Paper

This paper was prepared by [redacted] Office of Near Eastern and South Asian Analysis. It was coordinated with the Directorate of Operations. Comments and queries are welcome and may be directed to the Chief, South Asia Division, NESA, [redacted]

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Countertrade in the Middle East and South Asia: A Growing Phenomenon [redacted] 25X1

Key Judgments

Information available as of 16 September 1985 was used in this report.

Countertrade—trade that links one transaction to a reciprocal transaction—has grown rapidly over the past two years in the Middle East and South Asia, enabling countries in the region to discount prices, especially of oil; conserve hard currency; enter new markets; and increase existing market shares for their goods. Middle Eastern and South Asian countries were involved in countertrade deals worth at least $32 billion in 1984 and, based on partial reports, at least $24 billion by mid-September 1985. Countertrade accounted for more—perhaps much more—than 8 percent of trade in the region during 1984. [redacted] 25X1

US firms were involved in at least $1 billion of this countertrade in 1984, and they have contracted for at least $2 billion already in 1985. Countertrade with Communist countries—about 25 percent of the total we have documented for the region—accounted for about $7 billion in 1984 and at least $5.5 billion so far in 1985. Much of this countertrade falls under clearing accounts—agreements requiring periodic settlement of balances—with India and Egypt. [redacted] 25X1

Oil is the commodity most frequently involved in countertrade by Middle Eastern and South Asian countries. [redacted] this countertrade grew from about 1 million barrels per day in 1983 to as much as 2.5 million barrels per day in 1984. OPEC members use countertrade to violate the cartel's price guidelines by granting illegal discounts. Middle Eastern countries have often exported oil—or other primary products—to US, other Western, and South Asian manufacturers who mainly wanted to sell their own products in the Middle East and have had to resell the oil or other items received at additional expense. [redacted] 25X1

Iran, with its foreign exchange reserves at very low levels and facing tough competition in oil markets, is the major countertrader in the region—and probably the world. It accounted for about 25 percent of the value of regional countertrade we have identified since 1983. Most of the trade is conducted with large trading houses in Austria and Japan and through a government-to-government agreement with Turkey. [redacted] 25X1

Middle Eastern nations have turned increasingly to countertrades called offsets—which require the seller to enter into coproduction, subcontracting, and/or direct investment in the purchasing country. We expect the

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countries of the region to increase their demands for offsets that help them expand and diversify their economies. These deals often involve transfer of US technology and cost US jobs. 25X1

Countertrade by Middle Eastern countries will continue to grow in the near term, mainly because a soft oil market will present continued hard currency stringencies for oil exporters and thus incentives to cheat on OPEC prices. The countries of the region will increasingly require US and other countertrade partners to subcontract to and coproduce with their firms in part to gain access to technology. 25X1

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Countertrade in the Middle East and South Asia: A Growing Phenomenon [redacted] 25X1

The Regional Setting

Virtually every country in the Middle East and South Asia engages in countertrade:

- Iran and Iraq, made cash poor by war, countertrade whenever possible to conserve hard currency. They cheat on OPEC prices by granting illegal discounts through countertrade.
- Saudi Arabia has countertraded more than $1 billion worth of oil for civilian aircraft and will soon sign a contract for at least $4 billion worth of military aircraft.
- Israel uses countertrade to acquire modern weapons technology.
- Libya forces creditors to accept oil instead of cash.
- Jordan countertrades phosphate to increase its market share.
- Afghanistan has been forced to take unusable Soviet goods in return for fruit and hides. [redacted] 25X1

Using an extremely conservative methodology, we have been able to document that at least 8 percent of the region's trade in 1984 was countertrade. On the basis of the large number of deals that we did not count, we believe that the share may have been as much as 15 to 20 percent. Our analysis of evidence from interviews, journals, industry and financial press, [redacted] reveals that at least 65 countertrade contracts worth more than $32 billion were signed in 1984. Partial reports through mid-September reveal that at least 92 such contracts, worth more than $24 billion, were signed in 1985. There were apparently only a few, small deals in 1983.[1] [redacted] 25X1

Oil is the commodity most frequently countertraded by Middle Eastern and South Asian countries. [redacted] as much as 2-2.5 million barrels per day are countertraded, most of it by Arab producers. Only about 1 million barrels per day were countertraded in 1982-83. With the current official oil price much higher than the spot market price, members of OPEC have the incentive to cheat on price rules, and countertrade is one method used. [redacted] 25X1 25X1 25X1 25X1

Forms of Countertrade

Countertrade includes at least six distinct forms of trade. In each the flow of goods in one direction is linked—or countered—by another flow of goods, usually in the opposite direction:

- Barter *is the direct exchange of goods for goods without the direct use of money.*
- Counterpurchase *involves otherwise separable, but contractually linked sales. For example, India has proposed to buy Iranian oil, but only after Iran agrees to buy Indian goods.*
- Buybacks (or compensation agreements) *require a company or government to provide equipment or money for a project and to take payment, usually over a period of years, in the product of the enterprise.*
- Offsets *are common in military and aerospace deals and require a contractor to license to, coproduce or subcontract with, or directly invest in domestic firms.*
- Clearing accounts *specify that trade will occur for an agreed period. At the end of the period all outstanding balances must be settled.*
- Switch trading *refers to any or all of the above forms when three or more countries are involved.* 25X1

[redacted] 25X1

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[1] The present wave of countertrade is generally regarded to have started in 1982 when Indonesia instituted a mandatory counterpurchase policy for government import contracts. [redacted] 25X1

[redacted] 25X1

Trading partners of the Middle Eastern and South Asian nations have been slow to resist the trend to countertrade because the alternative is often no trade at all. Costs are considerably higher than those associated with cash sales, however, and profits are reduced accordingly. [redacted]

Case Studies
The following case studies illustrate the magnitude and variety of motives for which countries of the Middle East and South Asia turn to countertrade (see figure 1). [redacted]

Iran. Tehran probably countertrades more than any other nation in the world because of its need to conserve hard currency (see figure 2). It faces a serious foreign exchange shortage because of its oil price policy and the loss of trade caused by the war with Iraq. [redacted]

[redacted] we have documented that the value of countertrades with Iran since 1983 is at least $13 billion, about 25 percent of the countertrades that we have confirmed in the region. Iran's official foreign exchange assets dropped from over $20 billion in 1979 to $5 billion at the end of 1984, and only about $2.5 billion was readily accessible to Tehran (see figure 3).[2] Current exchange holdings may be even lower because of the soft world oil prices and Tehran's need to maintain food and military expenditures. Iran even briefly attempted to import only through countertrade. It sees countertrade as conforming with Islamic principles, which stress bilateral balancing of exchanges.[3] [redacted]

After a shortage of foreign exchange led Iran to briefly prohibit noncountertrade in March 1985, Tehran developed a system of foreign trade that restricts use of cash to purchases of essential items. All other goods must be purchased via countertrade, with Iran mainly supplying oil, or making deferred payments. Western firms eager to enter the Iranian market

Estimates of the Value of Countertrade

Countertrade is often shrouded in secrecy—"the good countertrade deal is the one you do not hear about." A major business newspaper investigating countertrade found that many executives refuse to discuss the topic. Experienced countertraders say contracts are often signed without amounts being specified. They claim that, at the time of signing, they do not know the value of the goods that will be traded. Estimates of the value of worldwide countertrade in 1984 vary widely. The IMF estimates that 1 percent of world trade, or about $19 billion, was countertrade; the GATT estimates that 8 percent of world trade, or about $155 billion, was countertrade. Reliable business press reports estimate countertrade at 40 percent, or about $776 billion.

Our method of estimation was to count contracts signed in 1984 and 1985 and to add their dollar values. The method is extremely conservative and probably underestimates the number and value of contracts signed. Our estimate excludes hundreds of deals in various phases of negotiation: some were described as ready to be signed and may have since been completed. None of these, however, were counted in our tally. Moreover, many reports of signed contracts list only the kinds of goods involved ("oil for refrigerated goods" or "jute for machine parts") and provide no information about dollar amounts or physical quantities. Because no dollar figure can be reliably estimated, we did not include these deals in our value estimate.

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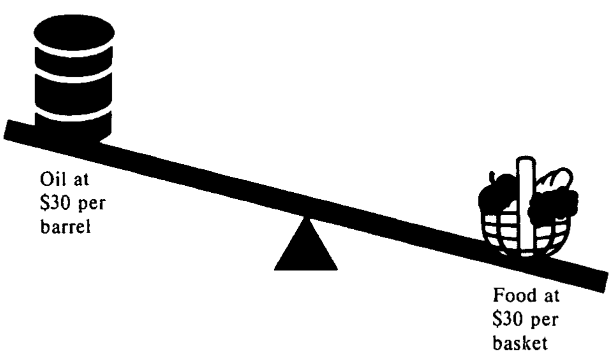
[2] About $1.1 billion is held in an escrow account to meet US claims to be settled by the claims tribunal at The Hague; much of the rest is tied to loans to less developed countries. [redacted]

[redacted]

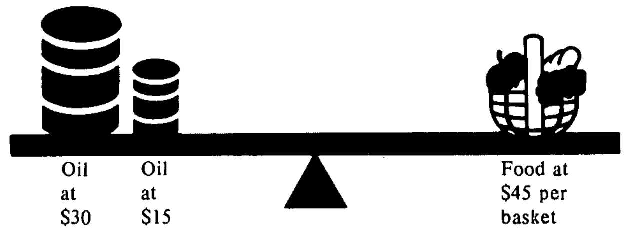
How Countertrade Allows Price Discounting

When oil barter was introduced, it violated the spirit, if not the letter, of OPEC rules: until this year OPEC rules made no mention of barter; further, the rules made no mention of what members could pay for the goods they received or when they had to take delivery of the goods. OPEC rules were amended in January 1985 to explicitly prohibit price discounting via barter, but by then the practice had become widespread. It had even become official policy in several states.

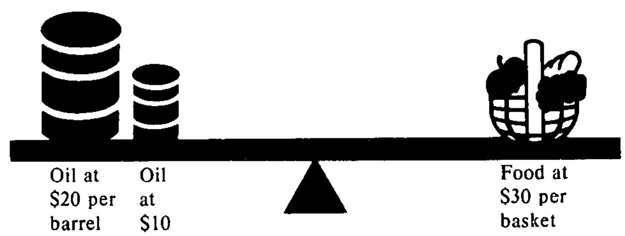
One widely used method of price discounting occurs through overvaluing the item to be purchased. Suppose, for ease of illustration, that the official OPEC price of the oil involved is $30 per barrel and that the spot market price is $20 per barrel. The OPEC member wishes to barter for a basket of food worth $30. The food producer has no incentive to trade for oil at $30 per barrel, since he can purchase the same oil on the spot market for $20 per barrel.



The OPEC member simply declares the basket of food to be worth $45 and agrees to barter 1.5 barrels of oil for the food.



When 1.5 barrels of oil are traded for food worth $30, the oil has a true value of $20 per barrel.



A second widely used method of discounting involves interest rates—including the fact that $30 worth of a commodity to be delivered in the future has a present value of less than $30.[a] *A middleman may arrange to accept oil today at the official price of $30 per barrel and deliver $30 worth of food in the future. The middleman will then sell the oil at spot prices, "deposit" an amount less than $30 in a "bank," and let interest accrue until the deposit and interest reach $30 on the date the food is to be delivered. He then "withdraws" the $30, buys the food, and delivers it. The discount is the amount by which the "deposit" is less than $30. That amount will depend upon the interest rate and the length of time between receipt of the oil and the delivery of the food.*

[a] *The statement is true even without inflation.*

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Some Disadvantages of Countertrade

"Economists curse countertrade; bankers say they despise it," according to a respected business journal. The reason is that countertrade is inherently inefficient. The United States, most other OECD countries, and the GATT oppose countertrade because its tied trades violate the principle of free trade. The IMF opposes countertrade because it denies exporters the unconditional right to their foreign currency earnings and because countertrade can be used to avoid paying creditors.

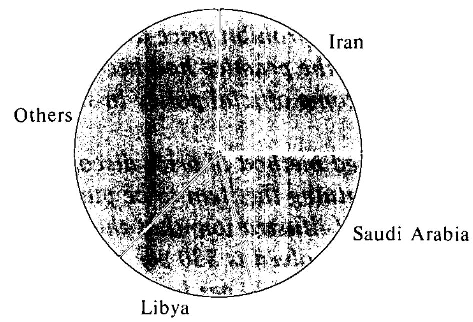
Because countertraders often do not shop for the best price and quality as they do in free markets, countertrade distorts trade patterns, leads to less than optimal allocations of resources, and increases cost. Reliable business press reports that countertrade deals are 7 to 9 percent more costly than cash sales. Contracts may be hedged in a variety of ways, including specification of flexible terms to permit adjustments in response to price changes, explicit dealings with assumable risk, and insurance policies, each of which involves additional costs, as does the need to hire middlemen or trading houses or to establish in-house countertrading departments.

Countertraders often must resell purchases at disadvantageous prices. Their trading partner may increase the supply of a resource to pay them, leading to a decrease in price—especially in small markets. A survey of US businesses in late 1983 found that 72 percent of the goods received by US firms in countertrade were unwanted and had to be resold—or countertraded—to someone else. We believe that these findings are still valid.

US producers who engage in countertrade find that negotiations are cumbersome and time consuming. The fact that every countertrade entails at least one reciprocal transaction makes negotiations more complex and prone to failure than negotiations over traditional sales.

[redacted]

Figure 1
Countertrade by Middle Eastern and South Asian Nations, 1985



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and/or unwilling to extend credit have scrambled to put together barter deals. Large foreign trading houses are often required to organize groups of small companies to meet the $100 million minimum Tehran has imposed on barter deals, according to [redacted] financial press reports. [redacted]

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Countertrade has significantly raised the transaction costs of Iran's foreign trade, resulting in active opposition by many Iranian technocrats. One major European trading house, typical of many, has received commissions as high as 18 percent to put together barter deals. Turkish traders, who can send goods to Iran by land, have taken advantage of their position to add markups estimated at between 20 and 30 percent on deals that fall under a $3 billion government-to-government countertrade accord. Turkey achieves a

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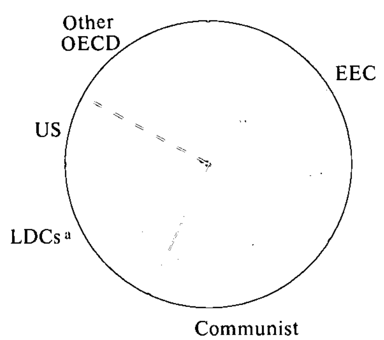
Figure 2
Partners of Middle Eastern and South Asian Nations in Countertrade, 1985



[a] Including intraregional countertrade.

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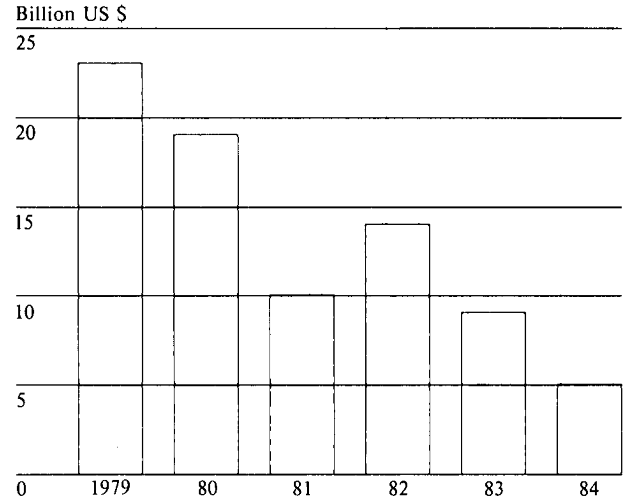
Figure 3
Iran: Official Foreign Exchange Assets, 1979-84



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substantial portion of its countertrade volume by acting as a clearinghouse for goods on the way to Iran, [redacted]

Tehran has had some success using countertrade to increase nonoil exports. Yugoslavia, for instance, signed a $700 million accord in February 1985 to take nonoil goods worth 15 percent of Yugoslavia's exports to Iran, according to reliable Western press reports (see table 1). [redacted]

Most Western firms dealing with Iran appear content to accept countertrade as long as the terms of trade allow a sufficient profit. A few large firms—middle-size Japanese trading houses, for instance—are probably even incurring short-term losses to maintain their position in a potentially lucrative market. Major firms involved in construction projects that the Iranians consider essential and that have found countertrade arrangements unacceptable have been able to improve terms by using their market power. Other firms have appealed to, and perhaps paid off, senior Iranian officials. [redacted]

Iraq. Facing serious problems meeting its debt payments this year, Iraq has tried to get most of its creditors to accept oil instead of cash or to reschedule payments. Some creditors, France, for example, have refused to take oil because of the uncertainties over the oil market. Other creditors, Turkey, for example, have been forced to take oil at higher than spot prices—in effect accepting less than full payment rather than deferrals. [redacted]

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Many large construction projects in Iraq are financed by oil barter. For instance, French and Italian firms agreed in August 1984 to take 1.2 million barrels of Iraqi crude as a downpayment for constructing a lubricating oil refinery near Baghdad. Before the French and Italians could find a buyer, the price of the Iraqi oil fell by slightly more than $2 per barrel, and the companies lost more than $2.4 million on the downpayment, according to the oil industry press. Baghdad is to pay the balance of $35 million over the next several years in crude oil, refined products, or cash. The firms risk further losses if oil or refined products are used. [redacted]

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Table 1
Selected Iranian Countertrades Since 1983 [a]

Trading Partner	Commodity Imported by Iran	Amount of the Deal (*million US $*)	Status of the Deal
Austria	Food	1,000	Contracted
	Miscellaneous (via large trading house)	1,000	Contracted
	Miscellaneous, including oilfield equipment	250	Contracted
	Equipment (from West Germany in a switch trade)	40	Contracted
Belgium	Chemicals, fertilizer, wool	200	Contracted
	Industrial renovations	70	Contracted
	Chemicals	46	Contracted
Brazil	Manufactured goods, materials, services, equipment	850	Memorandum of understanding (MOU) signed
	Electrical equipment, metal, paper, agricultural equipment, chemicals, food	348	Delivered
Canada	Miscellaneous	300	Contracted
China	Unspecified	35	Contracted
East Germany	Miscellaneous	345	Delivered
West Germany	Cars, trucks	300	Contracted
	Spare parts	300	Contracted
	Trucks, equipment	200	Contracted
	Expansion of auto and truck factory	200	Contracted
	Car and truck parts and kits	180	MOU signed
	Animal feed	3	Contracted
Greece	Miscellaneous	1,000	Contracted
Japan	Tires	200	Delivered
New Zealand	Lamb	300	Contracted
	Lamb (separate deal)	300	Contracted
North Korea	Weapons	30	Delivered
Pakistan	Commodities	200	Contracted
Spain	Food, steel, industrial goods	246	Contracted
	Miscellaneous goods	200	Contracted
Sweden	Automobiles and other goods	600	Contracted
Switzerland	Rice (from Argentina and Colombia), tea (from Sri Lanka and India), steel products (from Romania), dredging equipment (from Spain)	200	Contracted
Syria	Cement	20	Contracted
Taiwan	Miscellaneous	300	Contracted
Turkey	Metals, machinery, electrical goods, chemicals, plastics, miscellaneous (as a clearinghouse)	3,000	Contracted
Uruguay	Rice	31	Contracted
Yugoslavia	Assorted commodities	700	Contracted

[a] Dozens more countertrade deals are under consideration.

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In another major barter deal, Iraq agreed to import 100,000 Brazilian-manufactured Volkswagens during 1985 and 1986. Iraqi oil worth $630 million will be sent to Petrobras, the oil company of Brazil, which will sell it and pay Volkswagen of Brazil, according to the oil industry press. The deal was concluded in December 1984 after 14 months of negotiations.

Saudi Arabia. The Saudis concluded a $1.34 billion barter in 1984 of as many as 50 million barrels of crude oil for 10 Boeing 747s, Rolls-Royce engines, and spare parts. The US Embassy in Riyadh reports that in the 1984 deal the Saudis effectively discounted the price of the oil by up to $2 per barrel by overvaluing the planes. The Saudis temporarily increased production by as much as 1 million barrels per day and made full delivery during the summer of 1984, adding greatly to oil price volatility, according to the oil industry press.

Although Riyadh was among the last OPEC members to use the countertrade device and the Saudis denied that the barter violated OPEC rules, the deal was viewed by OPEC members as a major change in Saudi oil policy and justification for others to break OPEC price guidelines.

Because Riyadh is concerned about its declining share of the oil market, it is considering other barter deals.[4] A $4 billion deal for at least 48 British Tornado fighters and 30 Hawk jet trainers was approved in principle in mid-September, with signing scheduled before the end of the month, according to Western press reports.[5] A large unspecified portion of the payment will be in Saudi crude oil. The United Kingdom, itself an oil exporter, will have explicit Saudi permission to resell the oil. OPEC members usually try to prevent resale of their oil, since resales occur in the spot market and diminish the cartel's ability to control prices.

[5] Each of the cited oil-for-planes barters ended being significantly larger than preliminary reports indicated as additional special equipment, more spare parts, and/or maintenance contracts have increased the value of the contract.

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Minister of Petroleum and Mineral Resources Yamani opposes all such barter because it undermines OPEC. 25X1

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In March 1983 Riyadh turned to offsets—a form of countertrade requiring the seller to enter into coproduction, subcontracting, and/or direct investment in the purchasing country—to acquire technology, increase domestic employment, and keep foreign exchange at home. Despite rules requiring all government contractors to subcontract at least 30 percent of the contract value to Saudi-owned firms, offsets have not increased domestic content significantly because of shortages of skilled Saudi labor. Foreign firms, especially those in technologically advanced industries, report that some Saudi subcontractors are hiring foreign firms to work under the Saudi firms' names. Saudi officials recognize these problems and have been lax in enforcing the rules. 25X1

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The Saudi air defense system, Project Peace Shield, will entail offsets from US contractors of at least $1.2 billion. The entire amount must be spent, according to the contract, on nonpetroleum industries in Saudi Arabia, many of them involving high technology. For example, Saudia, the government airline, is likely to participate in joint ventures with General Electric to establish an aircraft engine overhaul facility or with Boeing to establish an airframe maintenance, repair, and support center. Projects to make

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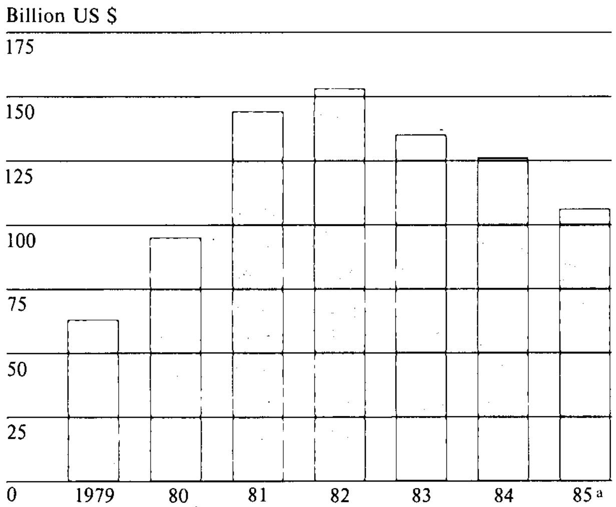
Figure 4
Saudi Arabia: Official Foreign Exchange Assets, 1979-85



[a] Estimated.

[redacted]

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electrical and telecommunications equipment and to provide computer services have been approved under the Peace Shield offset program, according to financial and oil industry press reports. Other projects remain to be specified. [redacted]

United Arab Emirates. Like Saudi Arabia, the United Arab Emirates (UAE) has used barter deals to cheat on OPEC price rules and to conserve declining foreign exchange reserves. When the UAE exercised its option to purchase a second squadron of 18 Mirage 2000s in December 1984, the French agreed to equip the planes with advanced gear and to accept oil in at least partial payment. [redacted] The oil industry press reported that Abu Dhabi discounted the price of the oil by 13 percent. [redacted]

Jordan. Jordan countertrades mainly to increase its share of the world phosphate market, requiring contractors with the Jordanian Government to accept 35- to 50-percent payment in phosphate. The US Embassy in Amman reports that the Jordanian Air Force and a US firm concluded a $115 million barter of phosphate for an automated command and control defense system in December 1984. The Air Force soon after proposed a $200 million phosphate-for-helicopters barter with another US firm, but the deal has apparently fallen through because the US company realizes that it will not be able to sell the phosphate without a decrease in price. [redacted] 25X1

Israel. Israel promotes offset trades for a variety of reasons. Offset arrangements provide:
- A source of financing.
- Technology that allows Israeli firms to compete successfully for US defense contracts.
- A way to incorporate Israeli design into weapon systems to ensure compatibility with US weapons.
- A boost to the health of the Israeli defense industry and the Israeli economy as a whole.
- A tool to keep skilled labor from leaving Israel.
- A sign of political support.[6] [redacted] 25X1

More than $500 million of Israeli export sales have been tied to offset agreements, according to the Israeli business press. Israeli law requires an offset in any deal in which an Israeli Government agency or state corporation imports goods and services worth more than $500,000. [redacted]

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Libya. Libya uses countertrade to cheat creditors by paying them less in oil than they would have been paid in cash. After completion of contracts calling for cash payments, the Libyans have stated that they could not pay cash and that the deals would be converted to barter, according to oil industry and financial press reports. Creditors from Italy, Greece, Turkey, India, and South Korea were told that they could take oil as payment—at official OPEC prices—or nothing; Turkish contractors were sent about 19 million barrels of Libyan crude in payment for a $700 million debt. The implied price was about $7 per barrel above the then-current spot market price. Other Libyan creditors suffered similarly. [redacted]

Libya has helped Nicaragua through oil barter. A $15 million deal signed in January 1985 provides for better-than-world prices for the coffee, sesame, cotton, and bananas that Nicaragua will barter for Libyan crude, according to the US Embassy in Managua. [redacted]

India. India has been among those cheated by having to accept oil in payment of Iraqi debt. Indian firms were obliged to accept 400,000 tons of Iraqi crude and 100,000 tons of sulfur in September 1983 as partial payment of $95 million in debt. Although Iraq discounted the price of the oil, the amount offered did not satisfy the entire debt, and Baghdad insisted upon refinancing the balance on terms extremely unfavorable to the Indians. Indian losses outweighed gains from discounting. [redacted]

[redacted] New Delhi also accepted Libyan crude in June 1984 for $132 million in debt to Indian public-sector firms, but, because Libyan crude is unsuitable for use in Indian refineries, New Delhi had to find a way to dispose of it. New Delhi marketed the crude at its own expense initially. Now it sells the crude through major trading houses at terms that have not been made public. [redacted]

India has expanded the scope of its own countertrade activity. It plans to import more from countries that counterpurchase Indian exports. An Indian Ministry of Commerce committee, established in 1984, has been considering ways to overcome obstacles to counterpurchases. Among problems cited in the Indian press are jurisdictional disputes among Indian agencies, with some officials unwilling to accept a loss on one part of a linked transaction in return for a greater profit for another agency. [redacted] 25X1

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[redacted] New Delhi has been trying to negotiate an agreement with Iran since early 1985 to exchange Iranian oil for Indian goods. Indian tea would be left off the list from which the Iranians would make their selections because Iran already willingly buys Indian tea. [redacted] 25X1

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New Delhi also engages in countertrade through buyback arrangements. It is negotiating, for example, to help construct a fertilizer plant in Saudi Arabia and take payment in fertilizer. [redacted] 25X1

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Egypt. Offset agreements have helped Egypt gain new Third World customers for its arms industry. According to Western business journals, Egypt has gained access to so much French arms technology through offset agreements that Cairo may soon emerge as a competitor of France, especially in the market for less technologically advanced weapons.[7] Egypt has also been lobbying for offset clauses in the US military aid program for FY 1986. [redacted] 25X1

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Pakistan. Islamabad has taken steps to increase greatly the volume of its countertrade because declining worker remittances and serious trade imbalances have drastically cut its foreign exchange reserves. Pakistan's exports under countertrade were at the rate of $186 million per year for the first eight months of FY 1985. [redacted] 25X1

[redacted] 25X1

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Table 2
Pakistan: Balance of Payments [a]

Million US $

	1981	1982	1983	1984	1985
Current account	−991	−1,610	−554	−1,028	−1,710
Trade balance	−2,765	−3,450	−2,989	−3,334	−3,590
Exports (f.o.b.)	2,798	2,319	2,627	2,668	2,540
Imports (f.o.b.)	5,563	5,769	5,616	6,002	6,130
Net services and transfers	1,774	1,840	2,435	2,306	1,880
Worker remittances	2,095	2,224	2,886	2,737	2,400
Long-term capital (net)	581	746	1,276	882	900
Gross disbursements	956	1,092	1,301	1,234	1,300
Amortization	−516	−492	−386	−542	−550
Other	141	146	361	190	150
Other and short-term capital	772	629	390	−34	−30
Financial gap	−362 [b]	235	−1,112 [b]	180	840

[a] Fiscal year ending 30 June of the stated year.
[b] Surplus for the fiscal year.

[redacted] 25X1

[redacted] Ac-cording to the US Embassy in Islamabad, Pakistan's exports had not been determined at the time the contract was signed, but it was assumed that they would be predominantly raw cotton, textiles, and leather goods. [redacted]

Algeria. Algeria is not a major countertrader, but it has proved to be an extremely shrewd and practical bargainer when it has had to be. [redacted] In many countertrades, however, Algeria overvalues the goods received and provides early delivery of the oil, both methods of granting hidden discounts. [redacted] in April 1985, Algeria agreed to barter 1.4 million barrels of crude oil to a Japanese company for construction equipment that was assigned an artificially high value, making the oil seem worth $30 per barrel. The Japanese firm sold the oil in the spring, but it has until October to deliver the equip-ment. [redacted] 25X1 25X1

The Algerians have eliminated the requirement that small and middle-size Italian firms accept goods in return for their services, according to the US Embas-sy in Rome. The policy probably reflects a realization that smaller firms are not likely to be diversified enough to market the goods and may decide not to trade rather than take oil for goods. [redacted] 25X1 25X1 25X1

Countertrade With Communist Countries

Middle Eastern and South Asian countries have engaged in countertrade, mainly in the form of clear-ing accounts, with Communist states for many years. Countertrade with Communist countries, however, has increased for the same reasons that it has in-creased with the West: hard currency difficulties, demands that exports be linked to imports, and the soft oil market. Countertrade with Communist coun-tries—about one-quarter of the countertrade we have documented for the region—amounted to at least $7 billion in 1984 and at least $5.5 billion in the first 25X1 25X1 25X1 25X1

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Cashless Trade Hits Creditors

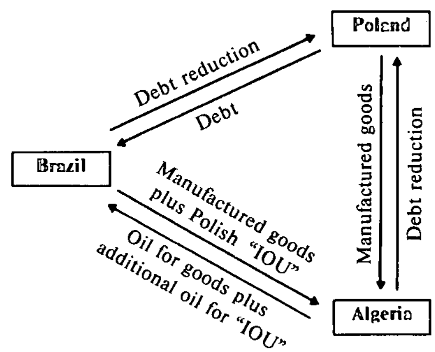
We believe that some debtor nations engage in countertrade to avoid obtaining cash that would have to be paid to creditor nations. Cashless trade also facilitates avoidance of monetary reform measures that the IMF and World Bank may desire. The IMF will not make a loan to any country that requires countertrade. [redacted]

For example, an Algerian-Brazilian-Polish switch trade, accepted in principle in February 1985, will allow all three nations to gain from trade while avoiding obtaining any money that could be claimed by creditors who are not involved in the trade:

- *Poland has a debt to Brazil.*
- *Brazil wants oil, and Algeria wants manufactured goods.*
- *Algeria agrees to barter its oil for Brazilian manufactured goods and to barter additional oil for a Polish "IOU."*
- *Algeria and Brazil will be even since equal values will be exchanged. Poland's debt to Brazil will be reduced, since part of it will be transferred to Algeria.*
- *Algeria will settle with Poland by accepting Polish manufactured goods in amounts equal to the debt.*

[redacted]

Figure 5
Algerian-Brazilian-Polish Switch Trade[a]



[a] Although switch trades are more costly to arrange than bilateral trades, switch trades increase the number of options available and lessen problems of matching desires and offers.

[redacted] 25X1

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eight months of 1985. Most of that countertrade is through clearing accounts between Communist countries and India and Egypt. Communist nations generally have hard currency problems of their own and also believe that countertrade is more compatible with central planning than cash sales, since countertrade is supposed to avoid the uncertainties of the market:

- India and the USSR, New Delhi's second-largest trading partner, traded more than $3 billion through a clearing account in 1984.[8] For more than a decade India has sent agricultural products and low-quality consumer goods to the USSR in exchange for oil. We believe that, in the future, New Delhi will be obliged to increase merchandise exports to Moscow to balance payments for military purchases. 25X1

- Egypt obtains an array of civilian and military goods from the USSR through two clearing accounts, one for civilian goods and one for military goods. Cairo has also bartered miscellaneous goods to Czechoslovakia for manufactured goods, fertilizer to Hungary for steel goods or cement, and cotton to China for tea, according to press reports.

- Pakistan will obtain 175,000 metric tons of much-needed wheat through a switch trade in which Bulgaria and Czechoslovakia will obtain wheat from Australia and then trade it to Pakistan, [redacted] 25X1 [redacted] Pakistan and Bulgaria will barter 25X1

[redacted]

25X1

$164 million of goods in FY 1985, a 100-percent increase over FY 1984. Other East European countries are reselling, at a discount, unwanted Pakistani goods obtained in barter, [redacted] Pakistan will import electrical equipment and spare parts from the Soviets and will export cotton, textiles, surgical instruments, and sporting goods under a barter agreement signed in May 1985, according to the US Embassy in Islamabad and various press reports.

- Afghanistan is forced to barter with the Soviet Union on terms set by Moscow; [redacted] Afghanistan had to accept two large generators that it cannot use because of lack of fuel.[9] Bulgaria has a clearing account with Afghanistan that provides very favorable exchange rates to Bulgaria. Sofia imports goods from third countries solely for reexport to Afghanistan to earn foreign exchange from the increased Afghan payments.

- Bangladesh has bartered with the Soviet Union since 1972, and it also has barter agreements with Poland, Bulgaria, Czechoslovakia, Hungary, Romania, China, and North Korea.

- Libya barters oil to the USSR for arms. [redacted] Qadhafi will go to Moscow in the fall and that he will try to obtain Moscow's agreement to accept oil in payment of Libyan debt. Moscow had earlier insisted upon payment in hard currency.

- The USSR has refused Algeria's request that Moscow accept oil as payment for debt. Algeria's offer to settle its trade deficit with the USSR by sending refined oil products was refused in 1984, and the Soviets were not accommodating on other economic matters, according to the US Embassy in Moscow.

- Sri Lanka had significant barter agreements with several Communist countries in the 1960s but has not renewed many of them. A barter agreement signed with China in 1952 was recently replaced by a trade agreement providing for payment in convertible currency in all trades. Less than 5 percent of Sri Lanka's trade is now with Communist countries, according to the US Embassy in Colombo. [redacted] 25X1

25X1

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[redacted]

Outlook

Countertrade by Middle Eastern and South Asian countries will continue to grow, at least until the oil market strengthens. We do not foresee any fundamental change in the other conditions that caused those countries to begin countertrading:

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- OPEC members will still have the incentive to cheat each other and violate OPEC rules.

25X1

- Because the liquidity and debt problems of some countries in the region will not soon be resolved, cashless trade will continue to retain its appeal.

- Both combatants in the Iran-Iraq war have entered into long-term barter arrangements that will keep them countertrading for some time. They will countertrade for military goods as long as the fighting continues and then will countertrade for nonmilitary goods as they rebuild their countries after the war. [redacted] 25X1

25X1

We believe there will be an increase in demand for offset programs. Other countries that have observed the success of Israel and Saudi Arabia will begin to make demands of their own. Egypt has already requested offset agreements from the United States. [redacted] 25X1

25X1

We do not agree with business journalists and economists who view the growth of countertrade as a response to the recession in the West and expect countertrade to decrease with the return of prosperity. We observe that the volume of US countertrade with Middle Eastern and South Asian countries has increased during the marked economic recovery in the United States. The volume of countertrade with other

25X1

Western countries has grown as their industrial sectors—those most likely to use the primary goods that Middle Eastern and South Asian countries export—have improved. We expect to see more countertrade between countries in the region. Oil importers with hard currency shortages, such as Pakistan, will seek countertrade with countries such as Iran. We believe that the Saudis will continue to conserve hard currency, in part by turning to buyback arrangements in construction projects, as in the case of the fertilizer factory construction being negotiated with India. 25X1

Implications for the United States

We share the view of private-sector and US Government countertrade specialists that the greatest area of concern about countertrade for the United States is offset programs, which—by definition—require technology transfer. There is also the risk that US technology will be reexported to third countries, including the USSR. Offset programs that require US producers to build and equip modern factories abroad, train local personnel, and transfer technological knowledge can only reduce—and in some cases eliminate—the comparative advantage that is much of the economic basis for US trade with countries of the region. 25X1

Western firms will continue to countertrade, despite the concern over transfer of US technology and the increased costs of countertrade. Even though profitability suffers, firms protect market shares, particularly in the oil-producing countries where a foothold will enable the firms to expand operations when the oil market begins to recover. Countertrade can also be used as a financing technique to avoid the strength of the US dollar. In some cases, Western firms may also see countertrade as a way to keep production lines open. 25X1

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