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Uses and Limitations of Countertrade

Statement of
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Mr. Chairmen and Members of the Subcommittees:

We are pleased to be here today to discuss with you our recent work in the area of countertrade and barter. In the past 5 years, we have reviewed several different aspects of countertrade in the world trading system. It is a widely held view that international trade in exchange for money is the most efficient way of trading, and that countertrade is less efficient and less desirable. However, countertrade is being used in international markets because current circumstances - such as the LDC debt crisis, highly competitive markets for certain products, and substantial government involvement in the economies of some countries - are conducive to its use. In fact, the U.S. Trade Representative has commented that in the current imperfect world of international trade, countertrade is better than no trade at all. The spirit of this statement is reflected repeatedly by trade officials throughout the world. Countertrade and other alternative trading practices are viewed as marketing tools to help gain sales that otherwise might be lost. Despite the fact that countertrade may be useful in some circumstances, and the government should not prevent its voluntary use by private parties, the U.S. government should work to discourage government mandated countertrade imposed as a condition of export sales.

RECENT GAO WORK ON COUNTERTRADE

In recent years we have examined a variety of different forms of countertrade, including offsets and barter. In 1983, we reviewed the use of barter to acquire National Defense Stockpile materials and concluded that its potential was limited. In 1984, we assessed trade offsets and co-production requirements in foreign military sales and concluded that foreign military sales credits or grants should not be used directly or indirectly to expand the industrial base of a foreign country at the expense of the U.S. industrial base and U.S. jobs. In 1985, we found that countertrade is a major emerging issue in export competition in a case study of the Brazilian export market. In 1986, we testified on the growth in military offsets. Our March, 1987 report, Alternative Trading Practices for International Grain Trade (GAO/NSIAD-87-90BR), examined the world wide practice of countertrading grain. And, most recently, at the request of Representative Byron L. Dorgan, we examined the U.S. Department of Agriculture (USDA) compliance with the pilot barter program requirement in the Food Security Act of 1985.

DEFINITIONS OF COUNTERTRADE

We reviewed a variety of definitions for countertrade in the course of our work. We found that the word "countertrade" is the umbrella term which encompasses a variety of different types of trading arrangements. As a general proposition, countertrade can be defined as any contractual commitment imposed as a condition of purchase by the importer on the exporter. It generally involves the take back of goods and/or services. For example, barter is a type of countertrade; it is the straight exchange or swap of goods of comparable value. Counterpurchase links exports and imports of sometimes unrelated goods by requiring the purchase, over time, of importing country goods in return for the sale. Buyback or compensation trade is an agreement whereby the supplier of technology or equipment agrees to receive as compensation the products made with that equipment. Offsets, which are commonly associated with military exports, are arrangements in which local production is a condition of the export sale. The term offset includes direct offset, meaning buyback, and indirect offset, meaning counterpurchase. Other forms of offset include subcontracting, technical assistance, investment, and marketing of goods and services of the buyer country. Clearing accounts are accounting methods for tracking compliance with countertrade requirements of a country or company. Switch transactions consist of taking a clearing account credit and selling it at a discount to another buyer (switching from one account to the other).

EXTENT OF COUNTERTRADE

There is no accurate and complete body of data on the extent of countertrade. No national or international agency systematically collects such information on a comprehensive basis. We reviewed a wide variety of published studies, examined government documents, and interviewed government representatives, bank officials and international traders to develop information on all types of countertrade transactions. This type of information is difficult to verify because of the inherent secrecy associated with such business confidential arrangements. However, based on the information we developed, we believe the volume of world countertrade is relatively small, but not insignificant. This observation is consistent with a 1983 Organization for Economic Cooperation and Development (OECD) estimate that countertrade is approximately 4.8 percent of world trade. A somewhat larger estimate of 8 percent was made in 1984 by the General Agreement on Tariffs and Trade (GATT).

Because there is limited data on countertrade, it is very difficult to quantify its impact on world trade. However, given the complexity and inherent secrecy of such transactions, it is questionable whether it will ever be possible to collect accurate and complete data with which to assess countertrade's extent and impact.

U.S. EXPERIENCE AND POLICY IN COUNTERTRADE

The U.S. Barter Program of 1950-1973

Barter of agricultural commodities was used by the United States to dispose of surplus agricultural commodities. The program exported about $6.65 billion of surplus agricultural products between 1950 and 1973. In return, the U.S. government received: (1) strategic materials for the National Defense Stockpile; (2) foreign-produced supplies and services for overseas military installations; and (3) materials for projects of the Agency for International Development (AID). The barter program was suspended in 1973 when Commodity Credit Corporation (CCC) stocks were largely depleted, the Defense Stockpile goals changed, and the strong foreign commercial export market no longer justified the need for a barter program to sell agricultural surpluses. Barter negotiations were complex and time-consuming. In addition, U.S. officials were concerned that the bartered commodities were displacing U.S. cash sales.

U.S.-Jamaica Barter Agreements

In February 1982 and November 1983, the CCC signed three barter agreements with Jamaica providing for the exchange of bauxite for nonfat dry milk, anhydrous milk fat, tin, and tungsten valued at $47 million. The barter arrangements, initiated by President Reagan, sought to bring the U.S. bauxite inventory to the desired level; dispose of excess dairy products in U.S. warehouses, and provide needed assistance to Jamaica. It was difficult to reach agreement with Jamaica on prices for the dairy products and the bauxite. Because the United States was publicly committed to this deal, there was little incentive for Jamaica to comply with competitive market conditions in the price negotiations.

FORMULATION OF U.S. COUNTERTRADE POLICY

Current U.S. countertrade policy was developed by an Inter-Agency Working Group (Chaired by the Office of the U.S. Trade Representative) in 1983. The Group concluded that the U.S. Government generally views countertrade as contrary to an open, free trading system. However, as a matter of policy, it will not oppose private U.S. companies' participation in countertrade unless such action could have a negative impact on national security.

In January 1984, the Administration formed the Working Group on Barter under the auspices of the National Security Council's Emergency Mobilization Preparedness Board. The Working Group was charged with determining whether particular countertrade proposals were in the best interest of the country. According to a USDA official, the Working Group considered only a couple countertrade proposals and rejected them. The Working Group on Barter was disbanded because the National Security Council determined that the group's work had essentially been completed. The decision was formalized in an NSC directive issued in December, 1985.

Current Barter Initiatives

Two sections of the Food Security Act of 1985 call for bartering agricultural commodities for other products. The first section, Section 1129, requires USDA in fiscal years 1986 and 1987 to carry out a pilot barter program under which USDA is required to barter with at least two countries, with priority being given to those countries having food and currency shortages. The pilot program would barter surplus CCC commodities for "strategic or other materials...for which national stockpile or reserve goals established by the law are unmet..." Normal commercial trade channels must be used to the extent practical.

The second section, Section 1167, states that if the strategic petroleum reserve falls below prescribed levels, the Secretary of Energy may request the CCC, to the maximum extent practicable and with approval from the Secretary of Agriculture, to make available CCC commodities worth at least $300 million to barter for petroleum products including crude oil. This section also requires the Secretary of Agriculture to provide technical assistance relating to bartering of agricultural commodities and products to U.S. exporters who request such assistance.

USDA reported to Congress on January 2, 1987, that no agreements had been concluded for the pilot barter program, although USDA stated that it intends to continue its efforts to comply with the law. Further, in March of this year, we testified that USDA had made no progress on any barter initiatives.

During our current review of the 1985 Food Security Act barter provisions, we found that USDA did not initially give a priority to this provision of the law. In fact, in 1986 USDA did essentially nothing to implement these requirements. USDA did not contact foreign governments seeking barter arrangements for strategic materials or private commercial channels about such arrangements. However, USDA officials emphasize that they are now working towards compliance with the law and are continuing efforts to initiate substantive discussions with several countries regarding barter.

Officials of several agencies cited a variety of reasons why they believed the pilot barter program, specifically, and barter deals in general are difficult to implement. For example, OMB officials pointed out that the delay in implementing the pilot barter program was probably due to the fact that the 1985 Farm Bill was among the most complicated farm bills ever enacted and that USDA had its "hands full" carrying our the various mandates of the bill. The OMB officials further stated that the pilot barter program probably did not have a high priority and USDA did not have enough people to give it sufficient attention until some of the higher priority items in the bill had been completed. In addition, problems in interagency cooperation existed, such as disagreements over the relative value of the commodities to be exchanged.

USDA officials advised us that they had taken no action to implement the barter program in fiscal year 1986 due to the Administration's assessment of stockpile requirements. In July, 1985 the Administration completed a study which recommended reductions in the stockpile. The study concluded that the stockpile had only one material, germanium, in a shortfall position. Since this material is primarily found in France and South Africa, and neither country lacks food or foreign exchange, it appeared impossible to officials at USDA for them to comply with the law. In contrast, Congress did not concur with the Administration's assessment and in the Defense Authorization Acts of 1986 and 1987 prohibited any reduction in the stockpile below 1984 levels until October 1, 1987.

In addition, there appeared to be interdepartmental disagreements over reimbursement and accounting procedures. In fact, USDA and the General Services Administration have not yet settled their accounts over the bauxite exchanged for CCC commodities in the three Jamaica barter transactions.

Beginning in January 1987, USDA initiated proposals which could lead to the fulfillment of the pilot barter program mandate. To do so, USDA adopted a policy which combined the intentions of both barter sections in the Food Security Act of 1985 and developed proposals for bartering surplus agricultural commodities for petroleum for the Strategic Petroleum Reserve. USDA contacted the Department of Energy about the potential for bartering with two countries for petroleum, and the two agencies are currently discussing implementaton mechanisms. While it is possible for USDA to enter into two barter agreements before the end of the fiscal year, remaining obstacles and necessary work will make it difficult to meet the statutory deadline.

REVIEW OF GRAIN COUNTERTRADE AS AN ALTERNATIVE TRADING PRACTICE

Based on discussions with officials from trading partner countries and an examination of world wide practices of grain countertrade, we concluded it is unlikely that U.S. grain sales through countertrade arrangements would substantially increase U.S. grain exports. Grain is generally unsuited for countertrade because of its low profit margin, readily available market information, and price fluctuations. We identified and analyzed 2300 countertrade transactions which took place between January 1953 and May 1987 and found only 125 of these transactions, or 5.4 percent, involved grain.

Currently, there is a glut of grain on world markets which has lowered prices. Because of pressures to dispose of surpluses, a government grain barter/countertrade program would likely end up as a disguised subsidy. If that were the case, it would be simpler to just sell the grain at a discount. In any event, such a measure would not attack the causes of oversupply of grain on world markets nor alleviate the complaints about poor quality of U.S. grain being shipped in commercial transactions.

Recent USDA research shows that one area in which countertrade may be a useful tool for exporting U.S. agricultural commodities is in certain developing countries and centrally planned economies. Because many of these countries have both a shortage of hard currencies and state trading organizations controlling their commodity imports, countertrade arrangements may make a contribution.

PERCEPTIONS OF USEFULNESS

Certain general principles regarding the usefulness and limitations of countertrade are generally recognized. These are listed below. We also found that in the United States, the expertise that exists in countertrade is primarily in the private sector. In other countries, countertrade expertise may be found in the private sector or in government state trading organizations.

Market Development

Countertrade has been used to establish new marketing relationships with the objective of promoting future cash sales. To take advantage of the marketing skills of major exporting companies, countries have used countertrade to find markets for new exports. For example, Thailand used countertrade to export corn, and Brazil to export computers. Indonesia put plywood on its list of eligible countertrade items in hopes of developing new markets. Countertrade can also provide market opportunities in countries where the government plays a central role in economic decision making.

Enhancing Competitiveness

Countertrade can be used as an inducement to close a deal. The state trading organizations of Australia (Australian Wheat Board) and South Korea (KOTRA) are authorized to use countertrade if required to consummate a sale.

Creative Financing

Countertrade allows countries without large foreign exchange reserves to import products they would not otherwise be able to afford. Traders claim that by relating each import to a corresponding export, they can save foreign exchange. One method is to establish bank accounts in local currencies (clearing accounts), where deposits covering purchases can be made in local currencies instead of foreign exchange. Use of this mechanism may help imports continue even when foreign exchange is in short supply.

Hidden Discounts

All products have a price at which they can be sold. Countertrade can be used to provide hidden discounts. Such arrangements may merely disguise a dumping practice and are considered illegal under the GATT. The sale of take-back hams that were part of a well reported countertrade deal was challenged before agencies of the U.S. government as a violation of U.S. antidumping laws.

Political Ties

Countries use countertrade to strengthen political relationships. Such trade agreements buttress strategic security agreements or regional political integration. The three Jamaican barter agreements are an example of the usefulness of countertrade in these circumstances. They were used to show support for the Jamaican Government and to provide a form of foreign aid. Another example is the Latin American Integration Association (ALADI) which urges its members to use countertrade to strengthen regional economic and political ties. Additionally, the Department of State and the Department of Defense support certain co-production or licensed production agreements because they foster NATO standardization of equipment and enhance national security interests.

Assurance of Supply Access

If a country imports most of an essential commodity, a countertrade arrangement may appear to give an advantage to a country which locks in supplies through a long term countertrade agreement. An example of this was France's attempt to improve its access to oil through countertrade with Middle East suppliers following the second oil crisis.

Creation of an Industrial Base and More Jobs

Offsets or countertrade of high technology products or defense equipment have been cited often as fostering economic development in terms of jobs and an industrial base. The hope with this type of countertrade is that the development of skills among the population and the construction of an industrial plant will produce components of a sophisticated technology which could be used as a base for economic development. The Department of Defense has noted increasing demands from developing countries like Turkey, South Korea, and Egypt to co-produce highly sophisticated weapons systems like the F-16 and the M1 tank. There is concern, however, inside and outside the U.S. Government, that these countries are developing defense industries which may later compete with U.S. defense industries.

LIMITATIONS TO COUNTERTRADE

Costly Process

The technical difficulties of arranging countertrade contracts are enormous. It is inefficient, cumbersome, and complex. According to a Commerce Department senior economist, 1 out of 20 countertrade negotiations are completed, and only 1 out of every 3 completed countertrade transaction is profitable. Negotiations are extremely time consuming and require a high level of expertise and a network of trading contacts to be able to successfully complete a deal.

Business Risks

The true terms and profitability of sales under countertrade may not be known until products are resold on local markets. Because countertrade contracts are complex, and fulfilling contract terms is difficult at times, the risk of noncompliance is greater than for a cash or credit sale. In addition, because trading companies are often needed to dispose of disparate products, transaction costs are higher. Further, there is also the risk of losing money with countertrade because of inexperience. For instance, a company that makes airplanes may not know much about the marketing of tourism, wine, or canned hams. We have been told by Argentine officials about receiving as part of countertrade deals substandard Soviet trucks that did not have spare parts with which to repair them. We have also heard about a U.S. company who received dates infested with insects under the take back provisions in a countertrade agreement. Inexperience is reported to have caused Austria's national steel company to lose $1 billion dollars in a countertrade deal. A Canadian multinational food conglomerate was able to absorb Yugoslavian furniture received in return for exported Canadian feed grain by using it to decorate its offices.

Displacement of Products

Take-back products can cause problems. They have the potential for displacing domestic products with imports and have the reputation of being of inferior quality. Argentina cancelled countertrade negotiations with Mexico when a domestic chemical industry complained of competing imports. And Brazil lost a market in a third country when the coffee it countertraded with Poland was sold by Poland to the third country, displacing Brazil's cash market.

No Savings of Foreign Exchange or Market Development Costs

As just mentioned, countertrade has the potential for displacing cash sales which ultimately hurts a country's economy. Although countertrade can balance the value of exports with imports, when it is used to trade products commonly sold for cash countries do not gain because they forego foreign exchange earnings. For example, Argentina and Brazil need these earnings to service their international debts. Since the transaction costs are so high in countertrade, it would appear to be more efficient for a country to directly hire the services of an expert marketing organization rather than go through the elaborate process of countertrading.

CONCLUSION

Countertrade is not a basis for a viable alternative world trading system. However, in today's world market -- characterized by intense international competition, the LDC debt crisis, the unprecedented U.S. trade deficits, and significant foreign government involvement in the economies of a number of potential export market -- countertrade plays a role in world trade. While it does not appear to offer many benefits for developed countries, and is generally accepted to be less efficient and more cumbersome than cash-based export or import sales, it is still viewed by some as a useful and necessary tool. Given that reality, U.S. businesses will be faced with circumstances in which they will have to countertrade in order to close a deal. If the government tried to impede its voluntary use by U.S. businesses the likely result would be lost exports sales. In the final analysis we believe it is usually better to make an export sale through countertrade than not to export at all. However, the U.S. government has an important role to play by working to discourage government mandated offset requirements and other countertrade practices that are imposed as a condition of export sales.

Mr. Chairmen, this completes my statement, and I will be happy to try to answer any questions you may have.