

## CASE 17.1 Countertrade: Counterproductive?

### 1. Discuss the pros and cons of countertrade as a form of trade.

Countertrade, as compared to monetary trade, may at first appear to be an outdated practice. Yet it offers a number of benefits to both trading parties as it moves inventory for both.

It is obvious that countries that demand countertrade have reasons to do so. First, a country can gain access to raw materials, products, and technology that it needs. Second, the country is able to dispose of items that it produces. Third, countertrade allows the country to conserve its hard currencies.

From a seller's perspective, countertrade allows the seller to gain access to a market that might otherwise be closed. Also the firm can largely ignore the costs of currency conversion as well as the movement of currency exchange rates. Furthermore, the firm can charge full price (or even more than that) because it gains leverage when goods are exchanged for other goods.

The benefits derived from countertrade also lead to problems. First, countertrade is a cumbersome and complex process, and all parties must consider the additional risk, time, effort, and costs involved. Second, the additional expenses inevitably and ultimately reduce the parties' profits. Third, the products involved may not be internationally competitive in terms of pricing and quality. Both parties' inflated prices increase the cost of international transactions. Finally, countertrade may encourage "covert dumping." A country may offer its goods at a discount so as to induce its supplying partner to participate, while the supplying partner may hastily dump the goods it receives in order to receive cash.

From the perspective of international trade, countertrade is a form of protectionism. A buyer, instead of buying from the most efficient producer, may end up buying from a manufacturer who is less efficient but more willing to use countertrade. Therefore, the buyer has to absorb all or part of such costs, and such costs in the end must be borne by consumers. The International Monetary Fund discourages mandatory countertrade programs as it believes that appropriate fiscal, monetary, and exchange rate policy can provide better results at lower costs.

**2. As a manufacturing firm located in a developed country, you are interested in taking advantage of the Eastern European markets' movement toward market-oriented economies. However, your potential customers lack hard currency and have asked you to consider countertrade. Are you willing to engage in countertrade? Why or why not?**

This case can be approached by relating the case to an ancient state of economic development. Early societies relied on barter to distribute goods and services. Tribes often specialized in making particular goods and exchanged them for other goods with other tribes. Economics textbooks view barter as an inferior method of exchange. It requires a "double coincidence of wants," and tribes had to negotiate to arrive at mutually agreeable terms of exchange. To complicate the matter, several time-consuming barter relationships were necessary before a tribe could acquire all items it desired. In the process, it might end up with certain

goods that it did not want. Frequently, goods being offered in exchange were of quite different values, and the goods might also be indivisible. Barter thus increases selling time while reducing the time available for production and retarding economic growth.

To overcome the problems associated with bartering, a common medium of exchange was devised. Early forms of money include beans, shells, pearls, beads, tea, pepper, sheep, pigs, cows, and slaves. These forms of money, however, had no standard unit of value, and the articles, being bulky, had problems with divisibility and transportation. Not surprisingly, silver and gold were subsequently used as money because of their convenient representation of value in little space and weight. Nowadays, hard currencies (e.g., U.S. dollar, German mark, and Japanese yen) are a common circulating medium which offers efficiency while facilitating trade.

Countertrade seems like a backward step as it bypasses hard currencies. Still a manufacturing firm should consider engaging in countertrade. Countertrade allows the firm to move its inventory and get rid of excess supply. It may also be the only way to enter a market. Among controlled Eastern European economies, countertrade is routine. As a matter of fact, the modern world of American television also sometimes uses bartering, and it is not uncommon for TV stations, TV show producers, and advertisers to exchange broadcast time, services, and products that each party needs.

One should keep in mind that conventional transactions require trade financing. Countertrade, likewise, should be viewed as another form of trade financing to meet the special needs of countries with international debt and liquidity problems.

If the manufacturer does not want to bother with the selling of the product taken from its customer, it can turn to intermediaries. The intermediaries may attempt to sell the product for a commission or may offer other products in exchange that the manufacturer may be able to use. In the case that the intermediaries buy the product at a discount, the practice does not differ much from factoring (i.e., a manufacturer sells a bill of exchange or a letter of credit at a discount for the purpose of receiving cash immediately).

Countertrade, not unlike monetary trade, presents both problems and opportunities, and it is unwise to dwell on the problems of countertrade. In conclusion, countertrade problems, whether real or psychological, do not prevent all goods from being converted into cash.