

11.3: Countertrade

Learning Objectives

1. Understand what countertrade is.
2. Recognize why companies engage in countertrade.
3. Know two structures of countertrade.

What Is Countertrade?

Some countries limit the profits (currency) a company can take out of a country. As a result, many companies resort to **countertrade**, where companies trade goods and services for other goods and services; actual monies are involved only to a lesser degree, if at all. You can imagine that limitations on transferring profits would make the world less flat; so too would the absence of countertrade opportunities in situations where currency transfer limitations are in place. Countertrade is also a resourceful way for exporters to sell their products and services to foreign companies or countries that would be unable to pay for them using hard currency alone.

All kinds of companies, from food and beverage company PepsiCo to power and automation technologies giant the ABB Group, engage in countertrade. When PepsiCo wanted to enter the Indian market, the government stipulated that part of PepsiCo's local profits had to be used to purchase tomatoes. This requirement worked for PepsiCo, which also owned Pizza Hut and could export the tomatoes for overseas consumption.

This is one example of countertrade, specifically counterpurchase. By establishing this requirement, the Indian government was able to help a local agricultural industry, thereby mitigating criticism of letting a foreign beverage company into the country.

Another example in which companies exchanged goods and services rather than paying hard currency is Bharat Heavy Electricals Limited (BHEL), the largest power generation equipment manufacturer in India. BHEL wanted to secure additional overseas orders. To accomplish this, BHEL looked for countertrade opportunities with other state-owned firms. The company entered into a joint effort with an Indian, state-owned mineral-trading company, MMTC Ltd., to import palm oil worth \$1 billion from Malaysia, in return for setting up a hydropower project in that nation. Malaysia is the second-largest producer of palm oil in the world. Because India imports an average of 8 million tons of edible oil every year but consumes 15 million tons, importing edible oil is valuable. Utpal Bhaskar and Asit Ranjan, "Bhel Looking at Counter-Trade Deals to Secure Overseas Orders," *Live Mint*, May 11, 2010, accessed November 18, 2010, <http://www.livemint.com/2010/05/11224356/Bhel-looking-at-countertrade.html>.

Why Do Companies Engage in Countertrade?

One reason that companies engage in this practice is that some governments mandate countertrade on very large-scale (over \$1 million) deals or if the deal is in a certain industry. For example, South Korea mandates countertrade for government telecommunications procurement over \$1 million. When governments impose counterpurchase obligations, firms have no choice but to engage in countertrade if they wish to sell goods into that country.

Countertrade also can mitigate the risk of price movements or currency-exchange-rate fluctuations. Because both sides of a countertrade deal in real goods, not financial instruments, countertrade can solve the inflation risk involved in foreign currency procurement. In effect, countertrade can be a better mechanism than financial instruments as a way to hedge against inflation or currency fluctuations. Sang-Rim Choi and Adrian E. Tschoegl, "Currency Risks, Government Procurement and Counter-Trade: A Note," *Applied Financial Economics* 13, no. 12 (December 2003): 885–89.

Finally, countertrade offers a way for companies to repatriate profits. As you'll see in Chapter 15, some governments restrict how much currency can flow out of their country. (Governments do this to preserve foreign exchange reserves.) Countertrade offers a way for companies to get profits back to the home country via goods rather than money.

Structures in Countertrade

The very first trading—thousands of years ago—was based on barter. **Barter** is simply the direct exchange of one good for another, with no money involved. Thus, barter predates even the invention of money.

Does barter still take place today? Yes—and not just among two local businesses exchanging something like a haircut for a therapeutic massage. Thanks to new innovations and the Internet, barter is taking place across international borders. For example,

consider the Bartercard. Established in 1991, Bartercard functions like a credit card, but instead of funding the card through cash in a bank account, a company funds the card with its own goods and services. No cash is needed. Over 75,000 trading members in thirteen countries are using the Bartercard, doing \$1.3 billion in cashless transactions annually. Bartercard website, accessed November 23, 2010, bci.bartercard.com.

In a **counterpurchase** structure, the seller receives cash contingent on the seller buying local products or services in the amount of (or a percentage of) the cash. Simply put, counterpurchase occurs when the seller receives cash but contractually agrees to buy local products or services with that cash.

Disadvantages of Countertrade

Countertrade has a tarnished image due to its associations with command economies during the Cold War, when the goods received were often useless or of poor quality but were forced upon companies by command-economy government regulations. New research is showing that countertrade transactions have legitimate economic rationales, but the risk of receiving inferior goods continues. Peter W. Liesch and Dawn Birch, “Research on Business-to-Business Barter in Australia,” in *Getting Better at Sensemaking*, ed. Arch G. Woodside, Advances in Business Marketing and Purchasing, vol. 9 (Bingley, UK: Emerald Group Publishing, 2001), 353–84. Most countertrade structures, except for barter, make sense only for very large firms that can take a product like palm oil and—in turn—trade it in a useful way. That’s why BHEL partnered with MMTC on the Malaysia countertrade deal—because MMTC specializes in bulk commodities. Similarly, PepsiCo was able to make use of the tomatoes it was required to counterpurchase because it also operates a pizza business.

KEY TAKEAWAYS

- Countertrade refers to companies that trade goods and services for other goods and services; actual monies are involved only to a lesser degree, if at all. Although countertrade had a tainted reputation during the Cold War days, it’s a useful way for exporters to trade with developing countries that may not be able to pay for the goods in hard currency.
- Companies engage in countertrade for three main reasons: (1) to satisfy a foreign-government mandate, (2) to hedge against price and currency fluctuations, and (3) to repatriate profits from countries that limit the amount of currency that can be taken out of the country.
- Barter is a structure of countertrade that has been around for thousands of years and continues today. Counterpurchase is a countertrade structure that involves the seller receiving cash contingent on the seller buying local products or services in the amount of (or a percentage of) the cash.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What are some of the disadvantages of countertrade?
2. Describe an example of how counterpurchasing works.
3. Does barter still make sense in the modern world? Who might engage in barter? What advantages might they gain?

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