## 6.0 Growth of Countertrade and the World Trading System

'Money' was invented to replace the oldest form of trading system – barter trade, which was often regarded as an old-fashioned means of exchange and was believed to be a complicated and costly system. Today, barter trade had evolved into various elaborated forms of countertrade that were alleged by many advocate as complementing the current trading system. Unsynchronized fiscal and monetary policies among trading countries will perpetuate currency instability and therefore, money will be the most volatile commodity in the money mediated trade (Huszagh, 1986). To some extent, countertrade may serve as the solution to the problems of 'money', rather than 'money' as the solution to the problems of countertrade. In fact, countertrade practices have been treated as marginal phenomena in the dominant money mediated international trading system (Cohen & Zysman, 1986). Nevertheless, general trade theories view countertrade as economically inefficient and costly (Raghavan, 1986). It was seen as potentially distressing the rules, procedures and structures of the current open, free trade system.

The growth of countertrade has reach to a stage where every single government or corporation might not dare to ignore. As the world is busy propagating countertrade as an efficient strategy for both governments and private firms in achieving economics and policies objectives, we start to ponder whether the growth of countertrade is really doing wonders to the international trading, or is it bug that challenges it? And if it is a bug, then why is this bug growing instead of being eliminated? This section will seek to analyze these issues.

Before addressing these issues, remarks had to be made that countertrade significant effect were not merely on the growth figures presented above, it also reflects a gigantic business practice incorporating tens of thousands of people, reaching far beyond the market for commodities, featuring manufactured products, services and even military and technology articles. There are various organizations set up to provide expertise in facilitating countertrade practices. Organization such as the American Countertrade Association (ACA) consist of seven executive members who includes high-level employees of Motorola, GE, and Boeing; and the Defense

Industry Offset Association (DIOA) consist of 65 member companies, representing nearly 100 percent of the US military aerospace prime contractors in 1998. ACA and DIOA hold joint biannual conferences in years 1998, 2000 and 2002 (Brauer, 2002). In addition, a cursory Internet search finds various websites on barter and countertrade that proves the cultivation of its practices, such as the International Reciprocal Trade Association (www.irta.com), National Association of Trade Exchanges (www.nate.org), Barter Trade UK (www.bartertradeuk.com), Barter Consultant (www.barterconsultants.com), and etc.

### 6.1 Countertrade: A Wonder or A Bug?

As noted earlier, money was invented to alleviate many obvious inconveniences of barter or barter-like trade. As moneytized international trading grows countertrade was assumed to grow under conditions of disorder, but also presumed to disappear just as quickly once normalcy had been restored (Cohen & Zysman 1986). It was noted that countertrade does derives benefits to developed and developing countries in terms of preserving hard currency, shifting future markets risks, reducing transaction costs, as an export strategy/competitive advantage and as debt repayment medium; but do these really happen. Cases and examples presented above represent some benefit to the advocate in the short run, but what will happen in the long run?

Mirus & Yeung has another point of view on the benefits generated by countertrade as discussed above. Their 1993 studies argued that some of the explanation on motivations and benefits by previous studies by others are suspected. First of all, let consider the alleged benefits of resolving foreign exchange shortage. According to Mirus & Yeung (1993), there are two possible interpretation of foreign exchange shortage which are not mutually exclusive. First is that a country's currency is fixed at too high a price and the government is running out of reserves to defend the exchange rate, which is a balance-of-payment issue. According to monetary approach to balance-of-payments, the balance-of-payments is equal to the change in the demand for domestic money minus the change in the supply of money created by monetary authorities. The change in the demand for money is positively related to income growth and inversely related to the opportunity cost of holding money. While countertrade is unlikely to effect domestic money creation, it can affect the economic efficiency, which is the change in the demand for money by changing income and the opportunity costs of holding money. For example, if countertrade is efficiency enhancing, it stimulates income growth and thus helps to improve country's balance of payments. Moreover, if the efficiency gain leads to a lower inflation rate and thus a lower opportunity cost of holding money, the demand for money will also grow, causing further improvement in the balance of payments. As countertrade is a bundled transaction, which is the exchange of goods and services are implemented either concurrently or inter-temporally, it does not facilitate transactions that allow more efficient economic exchanges. Though, if countertrade does improve the balance-of-payments, it is due the long term effects of economic efficiency, not because of using countertrade in purchasing imports.

The second interpretation of foreign exchange shortage, according to Mirus & Yeung (1993) is, a country is running out of foreign exchange and credit to buy the additional imports it desires. These countries can use countertrade to raise its imports consumption. However, countertrade can be viewed as using future exports to finance current imports and hence it is doubtful to believe that countertrade can increase current imports beyond what a well functioning capital market would allow, and thus may impair the country's import in the long run. This finding also supported by Brauer (2002) where he stated that countertrade is an attempt to push non-competitive products onto the world market and not a wise means to preserve the scarce foreign exchange reserve.

The claim that countertrade is a way to reduce forward market risks may need further studies. Countertrade is seen as a form of forward selling of exports with the forward price determined by the current price of imports that would reduces the risks associated with the uncertainties in prices of future exports as well as the future export demand. This means that the shift of forward market risks in export prices comes at the cost of a put option of exports with a zero exercise price that suggests that one kind of risks is replaced by another, thus not obvious that countertrade reduces risks (Mirus & Yeung, 1993).

They also commented on the use of countertrade to promote exports and reduce search costs. Countertrade exchanges make use of the comparative advantage of a foreign firm in marketing and reduce the domestic producer's market creation and search costs. When foreign marketing skills are used, the domestic producers do not acquire much market knowledge. Using countertrade to promote or stimulate exports is a short-cut that saves marketing cost on the one hand but sacrifices learning on the other. This strategy may thus have undesirable long-run implications that led to anticipation that the domestic producer's export would not be sustainable in the long run. This is further supported by Brauer (2002) in an analysis on offset trading that 'offsets do not offer additional trade, they merely displace it and probably destroy some of it' and thus it is hardly to the advantage of the developing countries to hand over the responsibility for marketing their products to foreign trading partners, which is a secondary activity for them.

Besides, countertrade is also seen as a means for some firms or countries to access to protected markets where the firms or countries are obliged to undertake countertrade agreement by the local government or firm. In this situation, the accessing firms or countries, in some degree, were coerced by the local government or firm. A coerced trade may leads to trade diversion and trade distortion that will eventually lead to welfare diminishing effect (Brauer, 2002).

In addition to the above, countertrade such as offset might cause job loss to an importing country. According to Brauer (2002), there is evidence that the US loses some military jobs on account of arms trade offset agreements with highly industrialized countries such as the Netherlands and Switzerland. There are countries, such as Spain, had abandon dreams of an integrated, comprehensive, indigenous arms industry, which will be generated via arms trade offsets. Besides, the dumping and flooding of surplus products of the exporter country into the importer's country will also cause competition to the local producers that may hurt the microeconomic of the country.

Even though governments of developing countries tried to enhance their technology development and enhancement through countertrade and offset, however this may not happen. A country's technology potential depends on the state of its human and physical capital that need to be grown indigenously; and these developing countries were lack of necessary capital. Technology transfer and training do not transfer this capital in a self-sustaining manner due to the interest of the transferring country that if they transfer their technology, competition will be created. Hence, the transferring country will only transfer outdated technology and further develop its own technological expertise, hence leaving the receiving country behind (Brauer, 2002). Albeit the receiving countries recognize this and can partially protect themselves if they negotiate buy-back deals that required the transferring country to buy-back products made with the transferred technology, at some point in time the countertrade agreement ends and unless the receiving country has the ability to sustain the momentum it will fall behind again.

Countertrade are also does not seemed as an efficient debt repayment medium for the developing countries. In fact, the growth of countertrade may illustrate that the world is so in debt especially developing countries, that they are so poor in convertible foreign exchange to finance their desire imports, which force them to resort back to the complex and costly trading arrangement. The shadowy side of countertrade can also be seen from its threat posed to the current open multilateral international trading system, yet to mention the other problems such as complex, costly and risky which had been discussed in the drawbacks of countertrade above. Countertrade deals are seemed to be created to circumvent the obstacles of the current trading system (Cohen & Zysman 1986).

With the above regards, countertrade as a trading tool can do wonders to the international trading is questionable. It may give short-term release to the conducting countries but may be devastating in the long term. If this is so, then you may ask, 'why is it growing'?

### 6.2 Why countertrade grows?

The analysis of this question lies in the center of the world trading system. The growth of the unhealthy trading practices, countertrade, raise the question whether the current trading system is sufficient to support the world trade – North-South trade, East-West trade and South-South trade and so on. So, what's wrong with the current world trade?

a) Economic instability

The current international trading system pursues growth at all costs, through trade and investment liberalization, and sees economic growth and increase consumption as ends in itself. It was believed that free trade automatically brings about economic growth, but what seems to happen is that rich countries have accumulated their wealth behind protective trade barriers rather than as a result of opening their markets. Liberalization or free market theory which based on the ideal of perfect competition such as, amongst other things, perfect knowledge about all products and markets, all prices reflect the true costs of a product and there are no monopolies, oligopolies or cartels; just does not happen. The theory was rooted in developed western culture and economic condition that does not necessarily applicable across the world. Therefore, in many developing countries, 'trade liberalization has resulted in deteriorating terms of trade and has also increased volatility threatening the security of livelihoods and incomes'(UNDP, 2003a). Overall, the situation of least developed countries (LDCs) in relation to trade is deteriorating. Between 1970 and the mid 1990s, LDCs suffered a cumulative decline of 50% in their terms of trade, which means that the revenue from a given volume of exports can now only purchase half the previous quantity of imports that could have been bought (UNDP, 1997). The UNDP has recently confirmed the deteriorating trade position of poorer countries. Whilst most of the world's richest countries improved their terms of trade between 1980 and 1998, 19 of the world's 25 poorest countries experienced declining terms of trade over the same period. In both Nigeria and Uganda, their terms of trade fell by about 70% (UNDP, 2001).

Key principles of free trade, such as comparative advantage, export-led development and globalization, have been discredited. The deregulation of financial markets and the revolution in information and communication technology has stimulated massive growth in short-term (often speculative) capital flows, causing numbers of financial and banking crisis, hence undermining developing countries' economies. According to IMF (1998), an analysis of 53 countries (22 industrialized, 31 developing/emerging countries) between 1975 and 1997 found that there are a total of 158 currency crises, 55 currency crashes, 54 banking crisis and 32 cases of currency and banking crises. The analysis also compared the frequency of crises between industrial and developing countries and found that industrial countries had fewer currency and banking crises than developing/emerging countries during the period. This result was shown in Table 4.

**Table 4: Number of Crises in Industrialized and Developing/Emerging Countries, 1975-1997**

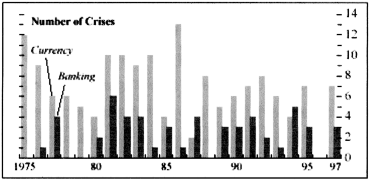
| | Industrialized Countries | Developing/Emerging Countries | Total |
|---|---|---|---|
| **Currency crises** | 42* | 116 | 158 |
| **Currency crashes** | 13 | 42 | 55 |
| **Banking crises** | 12 | 42 | 54 |
| **Currency and banking crisis** | 6 | 26 | 32 |

Source: IMF 1998

* excluding Germany, US and Hong Kong

The frequency of both currency and banking crises are shown in Chart 2 below where there were more currency crisis than banking crisis occurred in the period.

**Chart 2: Number of Crises**




Source: IMF 1998

The financial crisis and banking crisis had caused various developing countries in a mess. The financial crisis in Asia, for example, triggered massive and almost instantaneous capital flight. It is estimated that over 50 million more people in Asia fell into poverty. In East Asia alone, unemployment increased by 3.3 million. The only major growth economy in the developed world, the US, had to absorb surplus and cheap production from Asia causing unemployment and a very large trade deficit in the US. Impacts were also felt elsewhere around the world. For example, cheaper exports from Thailand also caused the closure of a German Electronics company in the UK with the loss of 1,100 jobs. Following the Asian crisis, global economic growth slowed down to about 2%, its lowest level for five years. Export commodity prices also declined, with severe impacts on African countries dependent on primary raw material (UNDP, 1999). Not only were growth prospects severely reduced but there was a human cost as well, including increased prices for essential goods, bankruptcies and even suicides. For example, in 1999, the UNDP reported that between 1975 and 1997, average GDP per capita in industrialized countries increased by approximately 50%. Conversely, average per capita GDP for least developed countries fell by approximately 15% (UNDP, 1999). Trade and investment in least developed countries - particularly in Africa - has been concentrated on primary commodities. Because of fluctuating commodity prices in global markets this also leads to increased economic insecurity in these countries. The trade system ignores the fact that increasing consumption is depleting natural capital (the environment) as well as the financial capital of countries on which the global economy is based. Besides, the present free trade system was not promoting sustainable and equitable development in international trade.

There calls for more open, liberal and deregulated economic conditions in order to attract foreign direct investment. However, the relationship between deregulation and foreign direct investment is questionable in terms of that even governments deregulate their economy, this does not mean that there will be a large flow of foreign direct investment into the country. For example, in 2001, China attracted US$47 billion in foreign direct investment that makes China the largest recipient of foreign investment in the region and in the developing world. Although China recently has joined the WTO, it is not renowned for its deregulatory approach to investment or any other sector of its economy (UNCTAD, 2000). Hence, foreign direct investment is much more likely to be attracted to countries with a large market base and cheap labor, discounting the fact that whether the market has a good infrastructure and a good skill base. This shows that the trading system characterized by the majority of foreign direct investment goes to a minority of countries whilst the others are abandoned in a supposedly globalize economy.

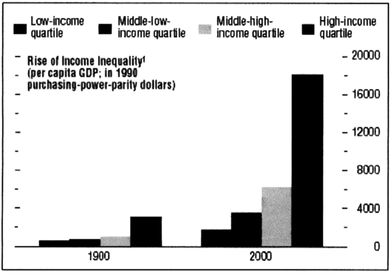
b) Trading system is increasing inequality company in the UK with the loss of 1,100 jobs. Following the Asian crisis, global economic growth slowed down to about 2%, its lowest level for five years. Export commodity prices also declined, with severe impacts on African countries dependent on primary raw material (UNDP, 1999). Not only were growth prospects severely reduced but there was a human cost as well, including increased prices for essential goods, bankruptcies and even suicides. For example, in 1999, the UNDP reported that between 1975 and 1997, average GDP per capita in industrialized countries increased by approximately 50%. Conversely, average per capita GDP for least developed countries fell by approximately 15% (UNDP, 1999). Trade and investment in least developed countries - particularly in Africa - has been concentrated on primary commodities. Because of fluctuating commodity prices in global markets this also leads to increased economic insecurity in these countries. The trade system ignores the fact that increasing consumption is depleting natural capital (the environment) as well as the financial capital of countries on which the global economy is based. Besides, the present free trade system was not promoting sustainable and equitable development in international trade.

There calls for more open, liberal and deregulated economic conditions in order to attract foreign direct investment. However, the relationship between deregulation and foreign direct investment is questionable in terms of that even governments deregulate their economy, this does not mean that there will be a large flow of foreign direct investment into the country. For example, in 2001, China attracted US$47 billion in foreign direct investment that makes China the largest recipient of foreign investment in the region and in the developing world. Although China recently has joined the WTO, it is not renowned for its deregulatory approach to investment or any other sector of its economy (UNCTAD, 2000). Hence, foreign direct investment is much more likely to be attracted to countries with a large market base and cheap labor, discounting the fact that whether the market has a good infrastructure and a good skill base. This shows that the trading system characterized by the majority of foreign direct investment goes to a minority of countries whilst the others are abandoned in a supposedly globalize economy.

b) Trading system is increasing inequality

The importance of countertrade as a trading tool is more apparent in developing countries that do not fit well in the current rule of the world trading system. The world trade system has increased the wealth of a narrow band of society. There is a widely shared perception that there is much more inequality in the distribution of income and wealth today as shown in Chart 3 below. The chart shows that per-capita income has risen faster in the rich countries (high-income quartile) than in the poor countries and at different speeds in different sub-periods. This applies to the distribution within nations as well as between nations. Worse still, inequality is growing and there is nothing on the horizon to indicate a reversal in this trend. The winners have been both the developed countries and the wealthiest people, whilst poor and developing countries have been marginalized.

**Chart 3: Differential Income Growth**




Sources: World Economic Outlook, May 01, 2000

[1] Countries' populations have been assigned to income quartiles according to GDP per capita in each country; each quartile contains 25% of world population.

Trade liberalization does not benefit the majority of the world's population. Small companies are expected to compete in the global economy along with the likes of Microsoft, Monsanto and Mitsubishi even though there is a massive difference in both wealth and economies of scale. The influence of transnational corporations in global trade policy is immense and growing. At the beginning of the new Millennium, more than a quarter of the developing world were still living in poverty and more than 100 million people in the developed world were living below the income poverty line. The trade system is exacerbating this situation, particularly by marginalizing the poorest and least influential communities around the world. This can be illustrated by UNDP report in 1999 that the richest 20% of the world's population had 95% of all commercial lending, 94% of all research and development, 86% of world gross national product, 82% of world trade, 81% of all domestic investment, 81% of all domestic savings and 68% of all Foreign Direct Investment (FDI). In contrast, the poorest 20% has only 1% of world GDP and 1% of FDI (UNDP, 1999).

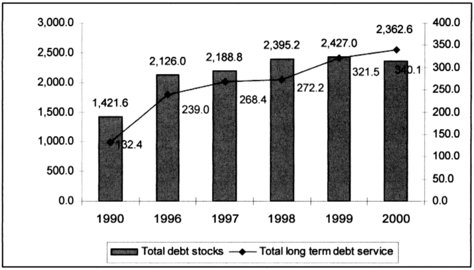
The inequality caused by the trade system is also increasing between the 'knows' and 'know-nots'. Knowledge - particularly information, communications and biotechnology – is proving to be one of the key assets of the 'new' economy. This has marginalized the 'know-nots' who have been kept out of the knowledge sector and excluded those unable to share in the knowledge revolution due to difficulties relating to cost, language and literacy. The trade system protects the intellectual property of knowledge-rich companies rather than diffusing knowledge and transferring technology. In spite of the one-country one vote structure of the WTO, powerful countries still wield enormous influence, often determining negotiating agenda amongst themselves, and putting pressure on smaller, poorly resourced countries to conform. The concerns of rich communities, rich people and rich companies all appear to be heard more readily by the WTO than those of the poor. WTO Agreements - such as the Agreement on Agriculture (AOA), the Trade-related aspects of Intellectual Property Rights (TRIPs) and the Sanitary and - Phytosanitary Measures Agreements - are increasing global inequality and insecurity (particularly because of their impact on food production and consumption) and favor rich countries and big businesses. This can put smaller countries, many of whom do not have the capacity or the opportunity to participate in the full range of negotiations at a severe disadvantage. Thus, for example, many developing countries who were opposed to the results of the agriculture and TRIPs negotiations in the Uruguay Round were still forced to accept them or risk being isolated in the global economy.

c) Huge debt crisis

The opportunity the current financial system provides for money to be exchanged for more money, making the moneyed richer. The major threat of the current trading/financial system is the expanding volatile in short-term gross capital flows. The most extraordinary growth has been in the interest rate and currency derivatives. In 1995, the estimated value of outstanding contracts trade over the counter or on organized exchanges was around $US57 trillion and had escalated to $US86 trillion in 1998, which is an increased of 51% in 3 years time (The Treasury, 1999). The weakness was further highlighted by the ability of reversible short-term capital flows that mainly due to the change of capital market sentiments that brought by either the emergence of relevant new information on market creditworthiness or prospect, or the irrational 'herd-like' changes in prevailing market opinion. For example, during the 1997 Asian financial crises, Bank of International Settlements (BIS) estimated that the net private capital inflow into the region (namely China, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand) fell from $US81 billion in 1996 to outflows of $US45 billion in 1997, and $US66 billion in 1998 (The Treasury, 1999).

The immense scope for gambling-like speculation provided by the huge volumes of debt-based securities in a system that permits sales on interest, margin, short selling and other exotic currency derivatives cause the increased instability of the system accompanies by volatile exchange rates and in some cases, collapsing currency values, and frequent job losses that root the reasons why more countries falls in huge debt crisis. Beside, countries that borrowed heavily to finance development projects had been hurt by high interest rates, adding by their financial or liquidity difficulties; had intensified their debt burden. The external debt burden of many developing countries has increased significantly in the last decade. For example, total debt stocks and total long-term debt service for developing countries had been increase by 66.2% and 156.9% in the 10-years period respectively as indicated in Chart 4.

**Chart 4: Debt and Debt Services for Developing Countries[2], 1900-2000 (US$billion)**

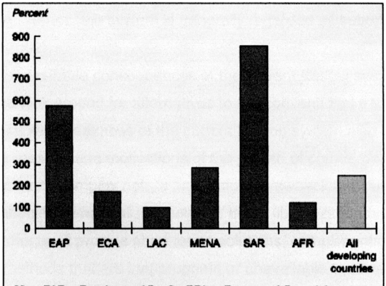



Source: World Bank and OECD External Debt Statistics various issues

[2] Developing countries in East Asia & Pacific, Europe & Central Asia, Latin America & Caribbean, Midddle East & North Africa, South Asia & Sub-Saharan Africa.

Besides, the situation was also intensified when some of the developing countries' foreign-exchange reserves are inadequate to service their short-term debts. From Chart 5, the distribution of foreign-exchange reserves to short-term debt varies considerably across regions. Latin America's net foreign-exchange reserves are below its short-term debt. Europe and Central Asia , and Sub-Saharan African net foreign-exchange reserves are well below two times its short term debt; while Middle East and North Africa is around three times. The exception case will be the high reserves in East and South Asia which were the consequence of the financial crisis in the late 1990s. Overall net foreign-exchange reserves for all developing countries are only about two-and-a-half times short-term external debt.

**Chart 5: Ratio of Net Foreign-Exchange Reserves to Short Term Debt in Developing Countries** *(Regenerated from Suttle, 2003.)*




*Note:* EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MENA = Middle East and North Africa, SAR = South Asia, and AFR = Sub-Saharan Africa.
*Sources:* World Bank Debtor Reporting System and staff estimates; IMF International Financial Statistics.

The debt factor may be deem as the most prevalent underlying reason for the growth of countertrade; where the developing countries has the demand but no money to pay for them, while developed countries has no other way but to agree to accept payment in countertrade in order to access to developing countries market.

The expanding global economy requires new skills and unconventional strategies. The philosophy of capitalism that regards profit maximization by ways of globalization and deregulation as the only legitimate concern of the international trading system hurt many developing countries that desired for fast economic development. In fact, some of the problems facing governments and industries in developing countries are the calls for more deregulation and liquidity in the international trading system, which was also epitomized by the process of globalization that cause these industries to face increasing risks and ever growing intensity of competition in the globalize environment. The complicated and unconvincing monetary and fiscal policies recommended to improve the system's efficiency; and the instability of the financial and trading system, were featured in many of the currency crisis in the past decades that affected developing countries most. Judging from the risks already inherent in the current trading system, countries that experience rising cost of capital (especially developing countries) will move further ahead in the widening divide between the able and the less able, the developed and the developing. Hence, the system is generally regarded as suboptimal (Mohammad, 2002).

These undesirable consequences of the current trading system makes thinking people look around for alternatives to the conventional trading medium. These very weakness of the current trading system also became the underlying reasons and motivations of the growth of countertrade practices, despite its complex nature and various drawbacks. Countertrade is known to be effective in neutralizing some of these liberalization and globalization effects. It provide short terms solutions, complimenting conventional methods that are inappropriate or unavailable to certain countries. As it is a reciprocating arrangement, government or private enterprises can, in its various procurements require the seller to benefit its own industries or interest. It is able to create opportunities to multiply, direct or bring additional benefits from one originating transaction. Many countries have already stimulated by the benefits of this trade arrangement. Malaysia for example, in the bidding for the construction of hydroelectric dam project, Chinese contractors reactively offered to commit, among others, to a long-term purchase of Malaysian palm oil if they get the construction job for the main dam. Another bidder offered to bring in Middle East investors to set up by way of a foreign direct investment an aluminium smelting plant near the dam site if they get the job for the main dam.