

COUNTERTRADE REQUIREMENTS IN EAST–WEST TRANSACTIONS *

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1. Introduction

Trading nations seek to sell their goods to other nations; nations purchasing such goods seek in turn to sell their goods to others. The sale of goods by nations to others from which they are currently buying goods “balances” trade between nations. This has been the pattern of world trade for centuries.

In recent years, countries within the Council for Mutual Economic Aid (the “CMEA”) have introduced requirements that, before agreeing to purchase goods from Western sellers, such sellers must agree to purchase goods from the buying country concerned. The need for this requirement has been emphasized by recent shortages (to varying extents) of freely convertible currencies, but it is no more than a “formalizing” of the general principles of trade mentioned above and is a perfectly correct and proper way of carrying on business. Those Western sellers who hold views to the contrary should seek to sell their goods elsewhere.

These countertrade requirements do, however, create certain problems. These problems are analyzed and some suggestions are made as to how such problems can be overcome.

A major source of problems is the differing economic philosophies pursued (to varying extents) by East and West. Generally, throughout the CMEA countries, planned economies are organized which anticipate fixed order quantities and fixed deliveries. This tends to assist continued supply at constant qualities and at fixed prices, but it does reduce the ability of the Foreign Trade Organizations (the “FTOs”) to react to changed market conditions. Western companies find some difficulties in ordering goods of a fixed specification for long deliveries in fixed numbers and at fixed prices. The more sophisticated the product, the more difficult this problem becomes. In order to conclude and execute countertrade arrangements, it is necessary for each side

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to see and understand the point of view of the other side and for compromises to be made to allow for these different points of view.

Countertrade arrangements between East and West have given rise to a certain amount of jargon and it is necessary to understand the meaning of certain words used in countertrade arrangements. Lack of understanding of these terms, both by principals and by interpreters, can hinder trade discussions. The more important of these are:

- “Countertrade” means the purchase of goods or services by those Western suppliers who are themselves selling goods or services to CMEA countries. It is a general word often used to describe all such arrangements including more specialized forms of countertrade such as “buyback”.
- “Buyback” means an arrangement whereby a Western supplier agrees to purchase goods which are to be produced using the equipment, plant, or machinery (and in some cases even specialized raw materials) which he has supplied. Often the goods to be produced will be to designs of the Western supplier and may be intended to be incorporated into products which the Western supplier himself produces.
- “Refinancing” means the arrangements (buyback or countertrade) by which a Western supplier proposes to produce freely convertible currency in the hands of the FTO, or the Foreign Trade Bank of the country concerned, to repay loans which a Western supplier has arranged to enable the FTO to purchase goods in the first place.
- “Disagio” (also called discount, premium, or subsidy) means the amount by which a Western supplier will need to reduce the price which he has paid for countertrade goods before selling them to third parties. Alternatively, the supplier may elect to pay this disagio to a trading house which will then sell the goods to third parties on his behalf.

The amount of disagio which a Western supplier will have to budget to spend will depend on the type of goods which he agrees to buy. It will also be influenced by restrictions which an FTP may impose on the sale of the goods, such as territorial restrictions on market areas. This amount can be as low as 2% or as high as 30%.

A number of practical problems arise in preparing a countertrade agreement. The main problems are set out in the following sections.

2. Definitions of the goods to be purchased and sold

Western suppliers usually seek access to a wide range of goods, *e.g.* “all products of the metal working industries” of the country concerned. FTOs generally prefer a more restricted range: the more restricted the range, the easier it will be for the country concerned to plan its production.

3. Quality

In some cases, with specified goods, it is possible to define quality in very precise terms. This is particularly true with buyback agreements where the goods to be purchased, including their quality, are precisely specified by a Western supplier. In other cases it is necessary to revert to more general descriptions, *e.g.* “such quality as will render the goods competitive with goods of a similar nature produced in other countries”. Such descriptions, from a legal point of view, are not very satisfactory.

4. Quantity

Similar considerations arise as with the description of quality. If detailed specifications can be given, it is possible, within some limits, for a Western supplier to agree to specified annual quantities. For planning purposes the FTO concerned will wish to specify quantities in monthly, quarterly, or annual lots. Both parties concerned, however, will realize that if it is not possible to define the goods except in the most general terms, then it is pointless to try to define annual quantities of such goods. One possible compromise is to agree to purchase goods up to a total value in any one year. Again, for planning purposes, it is convenient for an FTO to define both annual quantities and the value to be paid for such quantities per annum, but it is very difficult for Western suppliers to agree to such close definition.

5. Unit prices

Except in the case of buyback agreements, it is virtually impossible to define unit prices, especially in view of the periods during which goods are to be purchased. These periods can be as long as ten years and are seldom less than five. The possibility of fixing prices accurately over such periods is remote. Attempts have been made to establish prices for goods and to apply escalation formulae, based on various published indices, to these base prices. The danger of this arrangement from both parties' point of view is that it can present a totally distorted price, especially over a long period. This distortion in turn can lead to goods being unrealistically priced to an extent that would not enable a Western supplier to sell the goods except by making an increase in his disagio for which he has not budgeted. A compromise which is commonly adopted is to include wording such as “prices must be such as will enable the goods to be sold competitively against goods of a similar nature made by other manufacturers selling into the areas concerned”.

6. Total prices

The total value of goods which a Western supplier will be required to purchase depends mainly on three factors, as outlined in the following subsections.

6.1. The attitude toward countertrade of the country concerned

Attitudes vary throughout the CMEA countries: some countries generally require Western suppliers to purchase goods to 100% of the value of goods supplied by a Western supplier plus interest which a foreign trade bank will have to pay on loans arranged by a Western supplier. Other countries require a lesser commitment (perhaps as low as 25%) of the value of goods supplied by a Western supplier. It is understandable that the decision about the level of countertrade required will be influenced by the freely convertible currency reserves of the country concerned and also by the availability of goods for export. The attitudes of the different CMEA countries will vary from time to time.

6.2. The nature of the goods sold by a Western supplier

If these goods are essential to the industry of the CMEA country concerned, their purchase may be accompanied by a lower demand for countertrade than would be the case for nonessential supplies.

6.3. The current plan for the country concerned

Major projects are included in five-year and annual plans and the freely convertible currency to enable payment to be made is allocated in advance. If imports have not been included in the current plan, it is almost certain that countertrade to the total value of the goods plus interest on loans will be required in order to ensure that the currency required will be available.

7. Sanctions for nonperformance

Most countertrade agreements specify what is to happen if a Western supplier fails to purchase goods as agreed. Typically, a penalty is provided which can be as low as 5% of the total value. Alternatively, some agreements specify that a Western supplier must take the goods and must make payment. There is often a relationship between the total value of countertrade required and the amount of penalties. If, for example, an FTO has agreed a level of 25% of the value of imports, it is more likely to insist on specific performance by a

Western supplier and to provide that if a penalty is payable, it should be paid as a true penalty, the payment of which will not relieve the Western supplier from his obligation to purchase the goods. Occasionally FTOs will request bank guarantees which can be called in the event of failure by a Western supplier to purchase goods, but in view of the cost to the Western supplier of long-term bank guarantees (both in terms of bank charges and in terms of reduction of borrowing power) these requests are seldom met.

Except in rare cases, where goods, quantities, and prices can be closely defined, it is unrealistic for a Western supplier to ask for penalties in the event of failure of supply by the FTO concerned. Various attempts have been made to draft clauses which provide relief for a Western supplier if goods of the required type cannot be provided at the required times. These clauses are resisted by FTOs for the understandable reason that to relieve a Western supplier of his obligations in this way leaves the foreign trade bank of the country concerned with the problem of finding the freely convertible currency required from another source.

8. Separate agreements

Some FTOs request that a countertrade agreement should be included in and form part of an agreement for the sale by a Western supplier to the FTO. An alternative request is that although the documents may be separate documents, each should contain a reference to the other. Western suppliers resist these requests and prefer that each document should constitute a completely separate agreement to be interpreted according to its own provisions. Although the transactions are “linked” in that one usually arises from the other, it is considered unwise to have provisions whereby performance of one agreement can be influenced by the other.

There are certain arrangements which have to be carried out during the performance of a countertrade agreement. The following are the more important.

(1) When goods are purchased by a Western supplier under a countertrade agreement, he should obtain a “letter of release” from the FTO concerned. The form of such letters varies from one country to another, but the form is not important. What is important is that the letter should refer to the countertrade agreement and should state that part of it which has been performed by the purchase of goods of stated volumes or values.

(2) Where a Western supplier deals with more than one FTO, or where a series of transactions is being carried out, it is sometimes possible to arrange for an official “evidence account” to be maintained by the foreign trade bank of the country concerned. Such an evidence account lists all sales by a Western supplier to the country concerned and all purchases by him of goods or

services. One is then offset against the other and, provided an overall balance at some agreed level is maintained, the Western supplier is considered as having discharged his countertrade obligations.

(3) Where a Western supplier has entered into a countertrade agreement with a particular FTO, and finds during the performance of that countertrade agreement opportunities to purchase goods other than those listed in such countertrade agreement, it is possible to arrange for a “linkage” of such alternative goods. Such linkage, which should be recorded in a letter of release from the FTO with which the agreement has been made, will state that the goods purchased will be considered as having been purchased pursuant to the original countertrade agreement.

9. Conclusion

As would be expected with almost any long-term agreement, problems will arise during implementation. Depending on the governing law which has been selected (and which is almost always stated in the countertrade agreement), the question may arise whether a countertrade agreement is enforceable. If goods have been vaguely described and if quality, quantity, and prices have been similarly vaguely described, it may be that the agreement could be judged to be no more than an “agreement to agree” or to be so vague as not to be enforceable. Western suppliers should, however, be cautioned against taking this approach. If an agreement has been entered into, in good faith by both parties, then irrespective of what some laws (usually foreign) may have to say, the FTO concerned will regard a commitment as having been made and will expect a Western supplier to find a way to make the agreement work.

If a Western supplier has made honest attempts to make the agreement work but has, for various reasons, been unable to purchase goods to agreed amounts, or to agreed values, then most FTOs will be prepared to discuss an extension of the period of the agreement or other variation in its terms. A resort to the law of the agreement is less likely to bring about a solution than a frank approach and an open discussion of problems.