THE IMPACT OF EASTERN LIBERALISATION ON EAST-WEST COUNTERTRADE

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Abstract

This paper considers the implications for countertrade (CT) of recent liberalisation of politico/economic structures in the former Eastern Bloc. Because CT is a response to market imperfections, more relaxed institutional restrictions with greater availability of information may remove the need for CT. However, orthodox trade requires mutual currency convertibility or reliable access to trade finance. Until these are established, CT is likely to feature strongly in trade with former CMEA countries. Meanwhile, lower institutional barriers will drive Western and Eastern partners toward more formal strategic alliances. The experiences of a small group of UK exporters illustrates these tendencies.

Introduction

British firms are often reluctant participants in economic relationships with Eastern European countries. Complicated protracted negotiations with governmental Foreign Trade Organisations, distaste for the political structures of the government and concern and suspicion of the quality of goods offered have resulted in a relatively low proportion of British trade conducted with the nations of the former Council for Mutual Economic Assistance (CMEA).

Firms from other European nations, for example, Germany and Holland, have been less reticent in their economic links with these countries, partly owing to geographical factors but largely due to their readiness to engage in countertrade (CT), an undesirable practice in the eyes of many Western executives and their governments.

The various forms of CT all have a common feature: reciprocity. In each case, a seller provides a buyer with goods (or services) and undertakes in return to purchase goods (or services) from the buyer. To many, this linkage of sales to purchases represents a throwback to a darker, moneyless age, when a hungry carpenter had to find a farmer whose barn-door needed repairs. The invention of money and the evolution of markets were direct responses to this "double coincidence of wants" problem. Therefore, reversion to CT often appears to be an inefficient alternative to trading via cash or credit.

During the post-war period, a major proportion of trade between former CMEA countries and a significant proportion of East-West trade was conducted in this way. As the Eastern Bloc economies expanded, albeit at rates slower than those experienced in Western Europe, their need for advanced technology inputs outstripped their capacity to finance the required imports by conventional means. As a result, Western suppliers increasingly faced demands to deal via CT, with the implied threat that the sales would otherwise be lost to a competitor more receptive to CT.

Several official reports have recorded the growing incidence of CT (UN 1979, Ford 1986) often in less than enthusiastic terms. Some Western nations have been "flatly opposed" to CT, while others, although clearly regretting the necessity to deal in this way, gave it qualified approval.

However, not all Eastern Bloc nations were CT enthusiasts. According to an official source, "The Hungarian government has never in the past, (and obviously not in the present), advocated the idea of trading with any country, and specifically with the West, on a countertrade basis. In Hungary, we never had any compulsory, legislatory directive or incentive to countertrade with the West".

This paper continues by considering the likely future prospects for CT activity, examines the motives for CT from both an "Eastern" and a "Western" perspective and suggests that, in view of these, CT may be supplanted by more formal trading relationships. The penultimate section briefly describes fundings based on a small sample of UK exporters, in the light of which, an assessment of likely future developments in the former Eastern Bloc is offered.

Prospects for Countertrade

Recent developments in Eastern Europe have led to suggestions that demands for CT will decline (eg Van Hoof 1991). There are several reasons for this.

At a general level, the sheer freedom from the bureaucratic interference required by a centrally-planned regime, will probably promote more enterprising attitudes and require speedier and more efficient business transactions, whereas CT is slow and cumbersome (Jasch 1989).

More specifically, recognition at official as well as business levels of the development gap between Western and Eastern Europe will lead to greater demands for technology-based imports from the West. Freedom from controls over the pattern of import and export trade may lead to greater ability by Eastern exporters to supply goods which Western firms really require, and for which they are prepared to offer hard currency. The arrival of Western banking, accountancy and consultancy resources in Eastern Europe will sharpen local expertise, and enhance the likelihood of additional loan facilities being granted to finance such imports. Finally, the very fact that tied trade was associated with the old regimes may lead local entrepreneurs to seek alternative trading media.

CT with the former GDR has already virtually ceased since the reunification with the FRG while recent events threaten the continuation of CT in several other states. As with Hungary, Rumanian CT is now insignificant since the country now "acts for free trade, (we offer) no encouragement for CT, and we press for hard currency". CT is no longer mandatory in any Eastern country and conventional modes of trade financing are increasingly available. In general, the historical motives for CT in the region are disappearing.

Although many of these former CMEA countries remain highly indebted and suffer chronic domestic and foreign currency shortages, this financial stringency is likely to ease in the long term through internal development and injections of Western aid, possibly including substantial debt remissions.

It is easy to see from the following examples why Western firms would welcome the demise of CT. ICL provided components to Poland for building portable televisions to Western European standards and then acted as sales agent for the TVs in the West. The Poles then purchased ICL personal computers in kit form with the hard currency received for the TV sets. These machines were customised for the Polish market and sold locally for Zlotys, which were then used to subsidise production of yet more televisions which ICL sold in the West.

The US 3M Corporation set up a Swiss subsidiary to negotiate deals with Eastern Bloc countries. The proceeds from selling $1m of Polish nails were deposited in a European bank and the Polish government drew on the account to buy 3M health-care products.

Perhaps the biggest CT transaction with E.Europe was the complex Soviet pipeline deal, involving German pipe producers, a separate firm of gas suppliers and the Soviet Union as supplier of natural gas and initiator of the deal. Essentially, the Western firms were to be paid for their respective construction and distribution services in the form of natural gas throughout (Schuster 1978).

Motives for Countertrade

Whether demands by E.European importers to deal via CT really will decline depends on what impact recent liberalisations may have on the motives for CT. It is useful to distinguish "Eastern motives" from "Western motives".

The Eastern Perspective

From the Eastern perspective, incentives to CT can be grouped into economic, political and developmental, although these categories inevitably overlap.

<u>Economic Motives</u>.

Eastern European countries often used CT to by-pass hard currency shortages and debt crises and to augment import volumes. (Roosa 1985) Moreover, CT may enable both Western firms and Eastern countries to predetermine the terms of trade by setting the implied values of goods thus reducing foreign currency risk. CT enables countries to concede, or even initiate, secret price cuts to stimulate exports during periods of flat demand without causing long-term damage to world prices. Similarly, Eastern European countries have imposed CT terms on Western exporters beset by excess capacity during recession (Nykryn 1985), in order to overcome Western import barriers, such as anti-dumping restrictions, and to redress trade balances. (Gonzalez 1985)

<u>Political Motives</u>.

Under the former tight state control of trade and industry, CT was used to promote political ideals. The Foreign Trade Organisations (FTOs) which formerly administered CT in ex-CMEA countries, used their powers to deter low priority imports by imposing strict obligations on importers and to surmount Western import barriers.

The clandestine nature of CT enabled it to be used as a veil to regulate the types and volumes of imports and to administer internally unpopular austerity regimes. Moreover, the FTOs used CT to mask imports of strategically important products at the expense of possibly more socially desirable, and certainly more popular and urgently-needed, consumer goods.

<u>Developmental Motives</u>.

This group of CT motivators is linked with internal industrial development ambitions, although these are not exclusively associated with Eastern Europe (Jones 1990). Common incentives for demanding buy-back or offset terms are to enhance a country's technology stock, its infrastructure, labour skills and employment levels (Griffin and Rouse 1986). By allocating additional CT credits to exporters in favoured industries, it is possible to stimulate the diversification of a nation's industrial base. This is further facilitated when CT is used to penetrate new markets by accessing the marketing channels of Western firms to overcome adverse country-of-origin stereotypes and to save on distribution costs (Zurawicki 1988).

The Western Perspective

Western exporters generally prefer hard currency or Letters of Credits to payment in goods since currency is more liquid, more certain and less troublesome, despite greater exchange rate volatility in recent times. If, however, Western exporters face problems like general spare capacity and strongly competitive rivals, they may accept customer demands for CT to meet their own volume objectives and achieve contributions to fixed costs. CT is often regarded as a "second-best" alternative, reluctantly adopted only when orthodox approaches appear unworkable. However, experience breeds expertise, (Palia 1990) and many firms now operate specialist units to manage their CT operations. Why do they use CT rather than orthodox trading channels?

The needs of "inefficient" Eastern marketers can be exploited by the Western exporter to enter and develop a new market. CT may be more efficient than orthodox trade if access to a "ready-made" customer reduces search and transactions costs, such as agents' commission. It may avoid the bureaucratic delays in a currency rationing process operated by an importer's government. By advancing the receipt of traded goods and hence, income from selling them, CT resembles factoring (Mirus and Yeung 1986). CT may also be an 'internalising' device whereby large diversified multinationals can source new materials, components and supplies offered on terms superior to those of current vendors (Kogut 1986). This form of "company-oriented" CT satisfies the needs of the counterdelivery recipient and can reduce distribution costs, thus achieving better exchange terms than by paying market prices.

CT is a response to imperfections in those centrally-planned and other less developed economies, with only embryonic market systems, unreliable legal systems and poor information flows (Mirus and Yeung 1991). In some transactions, the quality of goods and services is only fully observable to suppliers, encouraging sellers to under-supply the unobservable characteristics. Conversely, property rights over information-based goods and services are difficult to protect. CT may be a useful device for dealing with these principal-agent and property rights problems. The exporter finds that the value of the contract depends on his efforts to identify and sell exportable local goods, while his own property rights are not easily appropriated. CT "packages", despite serious drafting and implementation costs, may thus be preferable, under certain conditions, to sets of independent contracts.

CT thus occurs in response to market imperfections and, in the case of trade with "command" economies, official restrictions on conventional trade and currency dealings.

From the Western perspective, involvement in CT may be interpreted in two ways. On the one hand, it may be merely "opportunistic", representing an ad hoc and essentially short-term means of boosting sales and achieving a contribution to fixed costs at a time of particularly harsh trading conditions. On the other hand, it can be seen as a way of obtaining an initial "toe-hold" involvement in a market, serving as a forerunner to a longer term presence when conditions permit.

Recent liberalisation programmes introduced in a number of Eastern European countries have a number of possible implications for East-West CT. The establishment of more conventional trading relationships could well obviate the need for some forms of CT or reduce reliance on them. This would apply particularly to "opportunistic" CT.

Greater access to hitherto restricted markets and more positive official attitudes towards conventional trade deals and inward investment can be expected to both encourage established traders to increase their involvement in these markets and to prompt new traders and investors to participate in various types of strategic alliance.

Strategic Alliances

Strategic alliances are cooperative arrangements between businesses (each of which continues to retain its own individual identity), enabling them to obtain access to technologies, know-how, capital and markets to augment their own resources and capabilities. Pairing resources and capabilities in this way allows strategic partners to achieve synergistic effects otherwise unobtainable on an individual basis, while allowing each partner to focus and concentrate on its core business strengths. Strategic alliances are seen as a particularly effective way of expanding internationally as an alternative to solo exporting and foreign direct investment. Partners can contribute established marketing and distribution systems, production and R & D facilities and local knowledge of the markets they serve. They can ensure that products get to market more quickly and more effectively, particularly where products need to be modified to meet local regulations covering product standards and packaging, and the preferences of local customers.

Strategic alliances can take a variety of forms including:

* ***joint production agreements***, in which partners cooperate to make components or complete products. These agreements enable partners to optimise the use of their own resources, to share complementary resources and to take advantage of economies of scale by, for example, each specialising in the production of particular components or finished products.

* ***co-marketing agreements*** in which partners cooperate to market or promote each other's products. Again, these agreements enable partners to maximise their marketing efforts by obtaining wider sales coverage through wholesale and retail outlets and the benefit of partners' local marketing expertise.

* ***cross-licensing agreements*** may be used to enhance the effectiveness of production and marketing alliances by exchanging the rights to use their products or services.

* ***joint R & D agreements*** in which partners cooperate in basic Research and Development of products. Such agreements facilitate the input of different mixes of technical expertise and know-how in solving problems and in progressing projects, allow partners to reduce the expense and risks involved in R & D work.

* ***joint ventures*** involve the formation of independent businesses through the cooperation of two or more parent firms. The central characteristic of a joint venture is that it is an equity-based relationship, with ownership split in a variety of ways. Forming a joint venture is usually undertaken if the nature of the business or project requires partners to forge a deeper commitment to the business or project than can be allowed for within the confines of a contractual agreement. One implication of the equity arrangements is that it is usually more difficult to terminate than other types of strategic alliance.This factor does not appear to have prevented increasing numbers of Western firms from concluding joint venture deals in Eastern Europe.

Joint Ventures: A Flurry of Activity

Recent joint venture initiatives include Fiat's purchase of a 51% stake in its long-standing associate FSM in the first-stage of the privatisation of Poland's car industry. Fiat also plans to buy into Russia's VAZ motor manufacturing company which produces Ladas, with a mixture of cash, technology transfer, and licence deals. Fiat is likely to export existing designs for production at

VAZ's Togliatti plant, which it helped set up over 20 years ago. It plans to build up its presence in Russia as a "second leg" within E. Europe to complement the much larger car interest in Poland, eventually producing 300,000 cars p.a. To date, this is the largest expansion by a Western company anywhere in E. Europe.

Fiat will not be alone in Russia. British Aerospace, is planning to invest "tens of millions of pounds" in building 150,000 units of its Montego model in order to capitalise on low Russian labour costs and to get into position for building up market share in Eastern Europe. Finance will be provided via an equity stake in its partner, NAMI, the state-controlled organisation responsible for motor vehicle technology and design in Russia and the other states of the former USSR.

In air transport, Air France is leading a consortium to buy 40% of Czechoslovakian Airlines (CSA) in a deal which values the group at $150m. The state government and local financial institutions will retain the remainder of the shares. Meanwhile, British Airways intends to set up a Moscow-based airline in partnership with Aeroflot by forming Air Russia as a legally-established company. BA will take a 30% holding with Aeroflot splitting the rest of the majority stake with Moscow's domestic airport. The new airline will use Russian airspace to shorten trans-Asian flights, slicing hours off long-haul services.

In tobacco, BAT has purchased a majority shareholding in Pecsi Tobacco Factory, Hungary's largest cigarette manufacturer with 45% of the local market. Philip Morris has acquired the Egri Tobacco Factory also in Hungary, and RJR Reynolds Tobacco, (part of RJR Nabisco) is to build a cigarette factory in Poland. The Reynolds plant, expected to cost around £18m, should come on-stream in 1993, initially producing 'Camel', but eventually making other brands.

Involvement by UK Firms in Eastern Europe

To gain some insights into economic transactions with E. European nations, the authors recently contacted twenty leading exporters, all from the 'Financial Times Top 100 Exporters'. Executives were asked whether they had engaged in CT in E. Europe and if so, whether this form of trade had increased/remained constant/decreased in recent years as a proportion of their exports to this area. They were also asked about the extent of their involvement in strategic alliances in E. Europe. Companies occupied a wide range of consumer and capital goods industries.

Four companies reported increased CT, one company no change and five reported either a sharp decrease or total cessation in CT. Ten companies with no past or current involvement in CT with E. Europe were currently exporters to, or investors in E. Europe.

Of the firms reporting an increase in CT, all were involved in barter and three in counterpurchase, <u>all</u> had joint venture involvement, three to a "significant" degree. Of the five firms with reduced CT, four had ceased CT totally, although the remaining one still conducted over 10% of its exports to E. Europe in this way. Only one of these firms was significantly involved in joint ventures, while two had no form of strategic alliance at all. Of the firms with no CT involvement, two had significant joint venture involvement and two were involved in a minor way. One further firm was planning a joint venture.

Clearly, firm conclusions cannot be drawn from such a small sample but the results indicate:-

* Evidence of increased as well as falling CT suggests that many E.European customers continue to expect Western firms to deal in this way.
* Firms with increased CT tend to have rather greater involvement in strategic alliances, especially in joint ventures. This suggests that for these firms, CT may have been a way of obtaining a strategic foothold in E. Europe and now that conditions are more liberal, there is scope for more formal and more extensive involvement.
* Firms with reduced CT, tend to have fewer strategic alliances which points to only opportunistic and perhaps reluctant involvement in CT and in E. Europe in general.
* Some firms with no CT involvement are involved in strategic alliances, having 'leapfrogged' the CT stage in their relationships with E. Europe.

Assessment

Like Mark Twain's death, reports of the imminent demise of CT appear exaggerated. There is little question that Western firms, eager to avoid the often substantial transactions costs of CT, would <u>prefer</u> to receive hard currency for their exports. But until presently "soft" currencies become fully convertible and Western Banks and aid agencies significantly expand their lending to Eastern European <u>enterprises</u>, as distinct from governments, it is difficult to see how East-West trade can expand without CT. Insistence on hard currency by Eastern agencies may often be counterproductive and contribute to local industrial dislocation.

In this respect, a significant development is the establishment of Western-backed banking agencies within Eastern European countries to provide small-scale venture capital to assist industrial reconstruction. At issue is not simply the rise and possible fall of East-West CT, but whether it will give way to more permanent forms of industrial cooperation and on what scale. While currency problems continue, CT will persist but it is likely to be augmented by an acceleration of more formal types of strategic alliance like joint ventures.

It is tempting to suggest that CT is merely a staging post en route to such alliances, which are "a natural progression from CT". For a firm with a market bridgehead established via CT involvement, the dismantling of many of the legal and institutional impediments, thus alleviating property rights and agency problems, will encourage the consolidation of a more secure presence in markets deemed to be of strategic importance.

Among our small sample of exporters, there is evidence of this gradual progression, evidenced most strikingly by the case of the pharmaceutical company ceasing to CT, having set up a joint venture in Poland (ie) it does not CT, because "it now has no need to".

However, this gradualistic argument should not be overstressed. Some companies have set up joint ventures without having prior experience of CT, or indeed any other contact, with the host country. These companies have clearly "jumped" the CT phase of building up trading relationships.

The future for CT largely hinges on the future availability of Western funding to lubricate trade. Without this, CT is likely to persist, at least in the medium term, as existing countertraders continue or possibly increase their activities, and as other companies, newly aware of the strategic importance of the more open Eastern markets, "test the water," initially via CT involvement. Other companies will "leap frog" this stage and take full or partial equity stakes in local enterprises.

Many observers argue that the economic centre of gravity of Europe is swiftly moving eastwards. Firms which fail to consider the strategic potential of E. Europe risk being left behind in the wake of the likely concentration of European economic activity into the London - Berlin - Milan triangle. There are undoubtedly severe problems in the evaluation of investment and related activities in E. Europe but firms should ask whether they can afford not to become involved in such ventures.

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