BEYOND VODKA--RECIPROCITY IN INTERNATIONAL BUSINESS

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A short newspaper article in the Frankfurter Allgemeine Zeitung tells us that swapping goods--horse trading, Americans might call it--is doing well in Eastern Europe. The story, and it may be no more than that, says that four Soviet soldiers on maneuvers in Czechoslovakia recently traded their armed tank to a tavern keeper for 24 bottles of vodka. The tavern owner was so elated at the deal that he gave the soldiers some herring and pickles to show comradeship with the young men. He is said to have dismantled the tank and sold the scrap to a recycling center. The soldiers spent most of the two days after the trade drinking and sleeping off the effects of the transaction; it is not known how they will spend the rest of their lives, but the Soviet army is not generally known as a forgiving institution.

There is nothing apocryphal about the arrangement between Pepsico and Soyuzplodoimport, a Foreign Trade Organization of the Soviet Union. A contract between the two initially called for Pepsico to export soft drink syrup from its British subsidiary to a plant in Novorossiysk on the Black Sea. With guidance from Pepsico's technical staff, Pepsi Cola would be bottled and sold in the area around the sea side resort. Pepsico would not be paid in hard currency such as English pounds or American dollars, but would take its pay in Stolichnaya vodka. Of course, Pepsico could have been compensated in ball bearings, textiles, or any of dozens of products that the U.S.S.R. would like to export. But Stolichnaya was a particularly good choice. The vodka could comfortably be added to the product line of Monsieur Henri, a Pepsico subsidiary that markets alcoholic and soft beverages in the United States. In short, the fit between the new product and Pepsico's already existing marketing channels was nearly perfect. Since that early arrangement, Pepsico and the Soviets have expanded their agreement. Western tourists need not fear that they will ever be very far from their cola "fix," even when in Tallinn, Leningrad, Moscow, and other Soviet cities.

This article is about transnational countertrade, a seemingly generic term that focusses on international transactions in which some sort of reciprocity is either expected or demanded by one of the parties. Some of the following vignettes¹ will suggest both the magnitude as well as the diversity of such arrangements:

- * Syria wants light crude oil to mix with its own heavier sulphur oil, so it imports what it needs from Iran. But rather than pay hard currency, it plays host to about two thousand tourists a week from Iran. Each Iranian tourist's hotel room, meals, and ground transportation are already paid for by the Syrian government. The tourists, of course, pay their own government a fee for the trip which in turn pays for the petroleum. But there's more to the story than the government to government agreement. Observers say that nearly all of the individual travellers carry along huge bags of pistachios to trade away for whatever they want in Syria's well stocked bazaars.

- * Boeing Company won a contract in Saudi Arabia to build a huge communication and command system that will help operate that country's AWAC radar aircraft. But when requesting bids, the Saudis made it clear that preference would be given to those bidders who had plans to use at least part of the sales revenue in the country. Taking it all back to America--or Germany or anywhere else, for that matter--would not be tolerated. So Boeing agreed to build a medical products factory, a digital telecommunications plant, and several other operations. Thus, much of the money that Boeing will earn will stay in Saudi Arabia.
- * When Brazil wanted a communications satellite but lacked the huge amount of hard currency to make the purchase, it told its would-be suppliers that they must be good customers. So both France and Canada offered to purchase coffee, shoes, iron ore, and soy beans to help Brazil finance the transaction, even though most of these products are amply available all over the world. The Canadians even agreed to purchase a quarter billion dollars worth of wood pulp, something that may have shocked its own huge wood pulp industry.
- * Rank Xerox knows that Eastern Europe is a largely untapped market for its reproducing equipment. State-managed economies usually generate far more paperwork than do free market economies. Furthermore, the various Eastern bureaucracies lag the West in sheer numbers of machines. Rank Xerox has fitted out tractor-trailers to demonstrate their equipment, travelling like a road show from bureau to bureau and capital to capital. But the English company knows about foreign exchange shortages and has willingly taken back all sorts of products as payment. Like Rank Xerox, companies that do business in the East must know what to do with raspberry jam, sugar beets, wrist watches, television sets, fresh ham, red wine, and countless other products that the Eastern trading organizations cannot easily sell for hard cash.

This article focusses on the various types of bilateral and sometimes triangular arrangements that are currently in use, some of the commercial problems that they elicit, and some of the legal issues that participants must confront if they are to stay on the right side of both American and foreign law. The subject merits much attention, far more than can be given in this short article, because the practice is wide spread, probably growing and complex. Estimates of its significance vary, but few would dispute that perhaps one-quarter of today's international trade is bilateral in some way. And for some trading relationships--those with the Socialist states, the less developed countries, and debtor nations--the figure is assuredly higher.

Variations On A Theme

The ways that reciprocal international arrangements can be manifested is limited only by the creator's imagination. Furthermore, the terminology is not well established, so readers shouldn't be surprised that the terms and

their definitions used here may be used somewhat differently elsewhere. Let's take five expressions and give a definition and an example of each.

Barter

Barter almost certainly preceeded money trade, perhaps by thousands of years. It occurs when one trader trades away a good or service that is considered in excess supply to another trader who has a different good or service that is considered by the second trader to be in excess supply. For such barter transactions to take place, some unlikely events must happen: The perceived value of each set of goods or services must be identical, the timing of each party's needs must coincide, and each side must hold at least a modicum of trust for the other side. Today, we occasionally read about a barter arrangement, but the conditions mentioned above are seldom fully present. We read far more often about a more sophisticated form of barter.

Counterpurchases

A counterpurchase, often called parallel purchasing, takes place when a seller of goods or services agrees to become a buyer of unrelated goods or services offered by the seller's customer. For example, Nigeria has entered into several arrangements with companies all over the world, selling its petroleum and taking back a variety of products.

Counterpurchasing differs substantially from pure barter, largely because the mechanics differ. The participants sign two sales and purchase contracts. Thus, Nigeria may contract to sell a specific amount of petroleum to a purchaser. And the other party contracts to sell a specific amount of some other good or service to Nigeria. The amounts may be specified in dollars or some other currency, and they may or may not be exactly the same. Each side will ship the contracted goods and will take payment from the customer through the same financial system as any other sales and purchase agreement. So it does not matter if one side's sales were for 1,250,000 Marks while the other sides sales were for 1,110,000 Marks. Nor does the timing of the transactions matter. One contract may be completed in April, while the other is completed in July. The two contracts often are accompanied by a Protocol that points to the link that exists and describes the penalty if either side should not perform. Since many Western companies would prefer not to be involved in counterpurchases, the penalty for nonperformance can be substantial. Penalties as much as fifty percent of the value of a contract may be written into a Protocol, clearly large enough to prevent most companies from walking away from their obligations.

Compensation Arrangements

Compensation deals, sometimes called Buy-backs, occur when one party contracts to help another party with a venture, agreeing to be paid with the output of the venture. For example, Volkswagenwerk negotiated with East Germany to build a factory capable of producing almost 300,000 automobile

engines a year. About two-thirds of the engines would be used in the East but the rest would be exported to West Germany. If the quality standards can be achieved, they will become an integral part of Volkswagen's European cars, much the same as if they had been produced in Wolfsburg.

Countries on the receiving end of such deals, in the above example, East Germany, are delighted. They acquire advanced technology far faster than if it were developed at home, generate jobs that require a higher level of productivity, and produce output that is likely to generate foreign exchange. Companies on the selling end may also be satisfied. They sell technology that is otherwise underutilized, they have gained entry into a market that might otherwise be closed to them, they may have found a low cost source of goods, and their own product may be improved if a grant-back provision is written into the contract that gives them the right to use their partner's discoveries.

The major worry held by the usually Western partner about such deals is that a new and potentially powerful rival is being created. The Westerner has no assurance except a handshake that the partner will limit its exports to only enough to pay for the factory. In its hurry to earn foreign exchange, the compensation partner may ignore the home market. Everything may go to export, part to pay for the factory and part to bring in dollars, marks, pounds, or anything else that can be spent.

Clearing Arrangements

Countries sometimes enter into agreements in which they contract to purchase specified and often equal amounts of goods or services from each other. Such contracts assure that trade will be balanced between the countries during a particular period, usually at least a year. When the volume of trade gets too imbalanced--known as the swing--the country that has been buying too lavishly stops purchasing until the difference is reduced. But if a cessation of purchases is too burdensome, the country that is obliged to buy more may turn to a Switch House who helps it fulfill its obligations. The Switch House finds customers who will buy enough to bring the relationship back to normal; trading can then resume.

For example, Finland and the Soviet Union have a long history of balancing their trade vis a vis each other. The Soviets regularly sell petroleum to Finland, while the Finns mostly sell industrial goods to the U.S.S.R. When the price of petroleum was high, Finland's exports soared, but when the world price for petroleum declined Finland was able to export fewer products to the Soviets.

Or for another example, when France recently imposed on its citizens a temporary limit on foreign tourist travel, those former colonies that maintain a clearing arrangement with France were exempted. Thus, a French family could visit Senegal or the Ivory Coast, spending a nearly unlimited amount. It was a way to balance the payments between the parties. But a trip to the United States was virtually unthinkable because the amount of francs that could be converted to dollars was too small to allow survival.

Offsets

The last approach that will be mentioned here are offset agreements, those in which a supplier agrees to produce or service part of a product in the purchaser's home country. It is a demand on the part of the host country for local participation. The major reasons are to minimize the cost of foreign exchange and to create local jobs.

Defense equipment is so costly that contracts often are accompanied by offset arrangements. For example, when McDonnell Douglas wanted to sell Hornet jet fighters to the Spanish air force, it barely bothered talking about straight cash. Rather, it put together several proposals for the Spanish to explore. One of the suggestions was that McDonnell Douglas employees would vacation in Spain, using otherwise unoccupied hotel space, and thus helping to pay for the \$2.5 billion worth of airplanes. But particularly important to Spain was that the aircrafts' horizontal stabilizers, brakes, and control rudders would be built in Spain. All together, the package may have offset about \$1.8 billion of the total cost of the 72 airplanes that the air force would get.

The McDonnell Douglas contract is difficult to classify since it involved several of the approaches suggested here. The American company also agreed to find customers for Spanish shoes, transfer vital technology, and even try to attract foreign investment to Spain.

Making the Perfect Match

Marriages that involve bilateral agreements are seldom perfect, but some are much better than others. Virtually no Western company would ordinarily prefer to engage in reciprocal transactions; they occur at the insistence of the other party and are agreed to by the Westerners with varying degrees of reluctance. The major objections are that the Western company must take back goods or services that is already abundant in the developed countries; is too poorly made to meet the demanding tastes in Europe, the United States, or Japan; or is likely to compete with the company's own product line. These are three compelling marketing reasons why international managers must review such arrangements very carefully before making a commitment. In short, knowing the way out of a deal is more important than knowing the way into it.

There are three ways that companies use the goods that they agree to take back.² First, the product may be used quite comfortably in-house. In those happy circumstances, one aspect of a sourcing problem is solved. The company's purchasing department need not look around for suitable suppliers and choose among the candidates. One supplier is already known--the reciprocity partner--and it has been imposed on Purchasing by either the International Marketing Department or someone even higher. The integrity of the Purchasing Department, its freedom to make unencumbered decisions, has been violated which can lead to morale problems. But if the drive for sales volume is greater, morale must suffer unless management can explain why the decision is necessary.

The purchasing department's tasks may actually be greater in reciprocal agreements than in those contracts with companies operating in the free market place. Three major problems are that the bureaucratic work will be greater, particularly when dealing with the Socialist States; quality control will probably be more difficult to maintain; and on-time delivery may be riskier both because of geographic differences in distance and cultural values.

Second, the Western company may send the goods received in trade down through its own marketing channels. This solution is most likely to work well for the company that sells a wide range of products to a variety of industries. Conversely, companies that market highly specialized products to a narrow market will have trouble finding anything in their partner's offer that will mesh with their own customers' needs. The partner's list of products that are available for counterpurchase is likely to be small. This is because the best products will have already found their way through hard currency marketing channels. Furthermore, each trading organization is only interested in trading away those products for which it is responsible. Thus an American company might persuade Prodtorg, a Soviet trading organization to purchase, say, frozen chickens, but it would be obliged to take back fish or dairy products which fall within Prodtorg's export responsibilities. It would not be free to choose, say, chemicals which fall in Sojuzchimexport's trading domain.³ Indeed, the list can be a skinny one that is incompatible with the Western firm's existing product line.

Finally, the Western partner may elect to wash its hands of the problem by selling to customers that are unrelated to established markets. The fastest and easiest method is to turn to a barter house, a company that does little else than manage various elements of reciprocal arrangements. Western companies that are unsophisticated in such trading are wise to turn to such companies very early in the negotiations; early advice reduces the likelihood of costly mistakes. Such barter houses seek out and find customers who will purchase almost anything taken in trade if the price is right. Those products that are too poor quality for Western markets may be acceptable and welcome in some of the world's poorest countries. But the discounts at which the goods must be sold may be substantial and must be built into the selling price of the Western company's product if a profit is to be made. Discounts of 20 percent are common, even though neither the Western company nor the barter house ever take possession of the product; the discount is solely for making the match.

Some companies are so large and so deeply involved in international business--General Motors, General Electric, Control Data are good examples--that they have established their own in-house barter units. In many instances these in-house organizations engage in trading arrangements not only for the parent company but also seek out other companies for whom they attempt to arrange international deals.

Staying Within the Law

There is no legislation that applies solely to these kinds of arrangements, but practitioners must be wary of several applicable statutes. Indeed, countertrade deals probably encounter more potential legal hazards than routine export sales or import transactions, partly because the legality is not yet well charted by situations that have been contested in the courts. Some of the legal issues have been written about elsewhere,⁴ so this brief section is limited to describing some of the pitfalls that confront an unwary trader.

Perhaps the most serious problem concerns the potential allegations that the firm receiving countertraded goods is selling them at unfair prices in the American market. The receiving firm is understandably anxious to rid itself of the goods taken in trade and may resolve its problem by selling at substantially discounted prices. This quick fix may come to the attention of the Federal Trade Commission, the Justice Department, or the International Trade Commission either because it is perceived as an unfair business practice, an attempt to monopolize, or dumping. The American firm is on safest legal ground when it can be shown that the products have been sold at a widely accepted market price and are not marketed in such a quantity as to disrupt or affect domestic markets. But sellers often are in a hurry and the quantities often are large, so federal law enforcement agencies may pay close attention.

The second most serious problem is that countertrade has potential anti-trust implications because low prices and coercion may be seen as leading to restraint of trade and monopoly. American's legal system has dealt with domestic reciprocity since the early 1930s, but has devoted much more attention to the issue in the last twenty years.⁵ The large, multi-product firm is far more capable of practicing reciprocal trade than a smaller firm. Therefore it has a greater capacity to enhance its market size, often at the expense of smaller firms. Although legal speculation is rampant here, it appears that the greatest danger is that a firm receiving goods in countertrade may strongly encourage its suppliers to accept a portion of the foreign goods received in filling its obligations. This action forecloses to the larger firm's smaller rivals the opportunity to supply goods to the larger firm's suppliers. Viewed in this way, the reciprocal arrangement involves three parties: the foreign supplier, the large domestic purchaser, and the purchaser's suppliers. The party that is omitted--and this is why there are antitrust implication--is the smaller company that would like to sell to its large rival's suppliers.

American companies often resolve this matter by selling the countertraded merchandise outside the United States, thus reducing their legal exposure. However, it is well established that the jurisdiction of America's anti-trust laws reach beyond our borders and can affect business transactions that take place in foreign countries, if made by American controlled companies. Furthermore, foreign countries may have their own legislation that can apply to countertraded merchandise. Although foreign antitrust laws often are less rigorous than American, they are not harmless and must be given attention.

A major limit to America's claim for jurisdiction over its corporations' foreign operations is the country's efforts to achieve a comity of nations. A useful defense that is available to any American company or its foreign subsidiaries is that they were compelled to act in a particular way--a way that might be illegal if the action took place within the United States--by the laws of a foreign state in which it was operating. In short, America's claim for legal extraterritoriality is limited by a foreign country's right to legislate and police the laws within its own boundaries. This "foreign compulsion doctrine" means that if an American company is obliged by a foreign country to engage in counterpurchases, it may have a defense to allegations that it has transgressed American law. But like so many legal questions, the issues and answers are not clear cut, so legal advice should be copiously sought.

Other problems that counterpurchased products confront include satisfying American health and safety rules, payment of higher than usual tariffs because the products may come from Socialist states that do not enjoy Most Favored Nation status, quota limits on certain products and perhaps even laws that forbid imports made with slave labor. However, these problems confront any product imported into the United States, not just those that come in via the counterpurchase route.

Moving to Maturity

Monsieur Henri Wines recently ran full page advertisements in major newspapers in the United States to explain that Stolichnaya vodka is not always available in the country's liquor stores. It explained that unprecedented demand caused the problems. Stolichnaya, you may recall is imported by Monsieur Henri to pay for the Pepsi Cola syrup and technology that Pepsico exports to the Soviet Union.

Those who look for more sinister explanations may speculate that Stolichnaya is gradually finding its own way to market, quite independent of the marketing efforts of its American partner. Bilateral commerce grows out of a weakness. The weaknesses may be because a country manufactures products whose quality is so poor that they cannot find acceptance in the richer Western markets, the country's planners do not understand or have access to international marketing channels, or the country may be so lacking in foreign exchange or borrowing capacity that it must immediately export its own products if it is to import foreign goods. Once these weaknesses have been corrected, there are major advantages to terminating the reciprocal arrangement. Perhaps Stolichnaya is approaching a modicum of maturity so that it can soon make its own way to market without the help of its American partner.

End Notes

1. These Examples have been widely reported in such publications as The New York Times, The Economist, The Chicago Tribune, and other media and from the author's interviews in Europe, Japan, and the United States.

2. Robert E. Weigand, "International Business Via Barter. . .," Marketing Managers Handbook, Stewart H. Britt and Norman F. Guess, Editors, (Chicago: Dartnell Corporation, 1983), pp. 1225, or Robert E. Weigand, "International Trade Without Money," Harvard Business Review, (November, December, 1977), pp. 28.
3. For a listing of Soviet Trading Organizations and their trade responsibilities, see Who's Who in Soviet Foreign Trade, U.S.-U.S.S.R. Trade and Economic Council, 1983.
4. For more comprehensive analysis of reciprocity and the law see Thomas B. McVey, "Countertrade: Commercial Practices. . .," Law and Policy in International Business, 16:1, (1984), pp. 1-69 or Philip H. Potter, "East-West Countertrade. . .," Law and Policy in International Business, 16:413 (1981), pp. 413-464.
5. Robert E. Weigand, "The Problems of Managing Reciprocity," California Management Review, (Fall, 1973), pp. 40.