Countertrade as a technique for state mining enterprises

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In my paper I shall briefly define *countertrade* (CT) in general terms. I shall then analyse the role of countertrade as a marketing technique and as a financing technique based on actual examples.

1. Countertrade

Since the beginning of this decade, exporters have been increasingly asked to accept payment in kind for their products or services, or to arrange for trade transactions usually in order to compensate for the use of the foreign exchange associated with the import. Such compensation programs are not only requested by developing countries, but also increasingly from industrialized countries including Switzerland. Beyond that even exporters are more frequently offering countertrade in order to enhance their competitiveness in the international market.

Countertrade can take many different forms, but in its broadest sense it is a set of additional demands made by an importer on an exporter of goods and services. The result is a linkage of two originally legally separate transactions.

There are five major types of countertrade:

- Counterpurchase
- Buyback
- Offset
- Barter
- Clearing/Switch.

1.1 Counterpurchase

Counterpurchase is the most common form of countertrade. A supplier is committed to compensate for his sale by purchasing certain goods or certain services for a certain amount over a certain period of time. Import contract and export contract are to be fulfilled separately. Therefore, exports are not directly financing imports.

Let me give you an example. A Canadian company (here referred to as an MG Services Client) was awarded a contract by an Indonesian Ministry to supply a plant. Import value of the contract was 100 MUSD. According to Indonesian Law, instituted January 1, 1982 and titled "Guidelines for the Implementation of Linking Government Import Procurements with Indonesian Non-Petroleum Exports", each foreign supplier to the Indonesian government-owned companies introducing an import with a value exceeding 500 kUSD has to commit to compensate the full import value of its contract by incremental purchases of certain Indonesian goods, such as plywood, rubber, paper, textiles and cocoa. This obligation is specified in the letter of undertaking by the Canadian supplier to the Indonesian Department of Trade and contains a 50% penalty clause for non-fulfillment; in this case 50 MUSD. MG Services has agreed with the Canadian supplier in the "Countertrade Services Agreement" to assume this export obligation including the 50% penalty against the payment of a — modest — fee. From the viewpoint of the Indonesian Central Bank, the supplier's commitment to generate incremental exports of whatever nature within the regulations is sufficient to generate foreign exchange for the debt service on the financing of the imported project.

1.2 Buyback

A supplier of a plant or equipment is committed to compensate for his sale by purchasing goods that are produced by, or derived from the equipment in the original sale.

An engineering company, here referred to as an MG Services Client, has delivered a turn-key chemical plant to the Ministry of Chemical Industry in a certain country. Although the captive demand for the plant production in this country was only 250 kt annually, econ-

omies of scale required a plant with an annual capacity of at least 700 kt. Therefore, the engineering company was requested to purchase 450 kt of the product annually over a long period of time as compensation; this obligation was assigned to MGS.

1.3 Barter

The supplier is not paid in money but in kind. A Company, here referred to as an MG Services Client, delivers a plant to the Plant Buyer, who is paying with LCs to be payable by a supplier located in the country of the plant. The foreign exchange for this account is guaranteed by the sale of certain products. For this purpose, a memorandum of understanding is concluded between the plant supplier, here referred to as MG Services Client, the Plant Buyer and the FTO as product seller and Metallgesellschaft as product purchaser. Metallgesellschaft takes delivery of the product and pays the purchase price into the trust account from which the LCs in favour of the plant supplier are drawn.

1.4 Offset

A supplier of aircraft or other high-tech equipment is committed to promoting the economy of the purchasing country by co-production, licensing, subcontracting, investments, technology transfer, counterpurchase or export promotion in third countries. An example is the sale of aircraft engines and electronic equipment by GE to Canada with an offset obligation of 878 MCAD.

This type of countertrade is irrelevant for today's topic.

1.5 Clearing/Switch

Two governments, or in rare cases private companies, purchase specific amounts of each other's products over a specified period of time, using a so-called clearing currency, usually US dollars, for payment. The final imbalance is settled in cash.

Imbalances arising in clearing agreements are transferred or can be sold to third parties to be used for the purchase of products from the country in deficit. Such transfer is commonly known as "switch trading". Let me cite three brief examples:

(a) Clearing Agreement between Rumania and Brazil.

(b) An example of a Clearing Agreement which is not government-to-government is the one between the state-owned Trading Corporation of Pakistan and MG Services.

(c) Finally Clearing Agreements are used to promote exports in third countries.

During the last few years, CT expanded fairly rapidly in terms of dollar volume. The use of CT has spread from purely East-West trade to many transactions in North-South trade and increasingly to South-South trade. Therefore, it is safe to say that the methods of countertrade are of importance in global trade.

Estimates of the share of CT in international trade vary significantly from 1.0% (by the IMF), 4.8% (by GATT), 8.0% (by OECD) and up to 40% by press reports.

These variations occur because:

(a) different definitions of CT are used. For example, some definitions include while others exclude bilateral clearing accounts between governments;

(b) reliable data is not available as CT is usually not identifiable in official trade statistics;

(c) involved parties usually do not disclose CT transactions.

This occurs for many reasons ranging from the political ramifications related to, for example, the rejection of CT by the IMF to competitive confidentiality.

Excluding trade between governments and trade under bilateral clearing agreements, one may consider OECDs estimate to be the most realistic, although 8% in my opinion, is a little low. Whatever the correct percentage may be, it definitely can be claimed that countertrade constitutes a substantial portion of world trade.

Still, I do not think that this represents a threat to free trade. World trade is indeed threatened by many powerful forces including the rising tide of protectionism, massive subsidies to many sectors of industry and agriculture, and many other non-tariff barriers. Countertrade can be seen rather as an — at least presently — unavoidable outgrowth of strains in the system resulting from deeper forces and, in the final analysis, as reaction caused by free market forces. In a buyer's market, the buyer demands an additional performance from the seller; and he is able to obtain it.

The most frequently practiced forms of countertrade are counterpurchase, buyback and offset. Each of these comprises two separate, but more or less closely linked contracts, both of which are fulfilled by payment of hard currencies. The linkage results from the importer's demand: "I buy from you and, therefore, you must buy from me". In fact, countertrade is "trade without money" only in cases of barter and clearing agreements.

Nevertheless, the prices of exchanged goods in such transactions are indirectly reflected in the barter ratio. Therefore, it is a misconception that countertrade results in a demonetarization of international trade.

2. Countertrade as a marketing technique

What is the importance of countertrade to state mining enterprises? State mining enterprises can use countertrade as a technique to enhance marketing of production as well as to create additional financing possibilities.

Since the beginning of the current decade commodity markets changed from seller's markets into buyer's markets. Contrary to many projections, for example from the Club of Rome, worldwide

capacities grew much faster than raw materials consumption and commodity prices declined. Retrospectively it has been a basic judgmental error to have gone "short" in USD, that is to borrow respective funds, and to have gone "long" in commodities, that is future production of raw materials.

In this environment of structural oversupply of raw materials, countertrade may be used to enhance marketing of raw materials. This can be either achieved by forcing suppliers of goods and services to state mining enterprises into commitments to buy products from them or, the other way round, by offering to buyers of raw materials to accept counterpurchase, that is a commitment to buy goods and services from this buyer. I provide an example for each alternative of counterpurchase transaction.

First alternative

The Ministry of Nuclear Energy of the People's Republic of China had requested from a potential supplier of a nuclear power plant a counterpurchase obligation with a volume of at least 4G DM of non-ferrous metals over a long period of time. Metallgesellschaft on behalf of the potential supplier and China National Non-Ferrous Metals Industry Corporation (CNNC) on behalf of the Chinese government consequently entered into a sales contract after detailed studies and market analysis and both worked out a detailed long-term marketing programme. Unfortunately, this sales contract did not come into effect because finally the nuclear power plant project was cancelled.

Second alternative

Every iron ore producer desiring to supply iron ore to Rumania has no other choice than to either sell through a clearing agreement, e.g., the Romanian-Brazilian Clearing, or to commit to counterpurchase Romanian goods. The additional cost to the iron ore producer to fulfil this counterpurchase obligation exceeds 10%. This is therefore only a viable export promotion technique in the case and to the extent that the iron ore producer can absorb the additional cost.

To employ countertrade as a marketing technique has pros and cons. The pro is obvious: you are able to sell — hopefully — additional quantities in a buyer's market. However, there are serious cons.

Quantities sold under countertrade transactions may conflict with traditional effective marketing. For example, such exports may not be incremental, meaning that such sales are not additional but rather replace traditional exports. Or the pricing of traditional quantities may be disturbed as countertrade quantities are often offered at a discount. Both concerns are certainly of less or no importance in highly liquid markets and smaller spot transactions. Finally, as a general rule, the request for countertrade results in additional cost to the supplier. The amount of such additional cost is a direct function of the risks the supplier has to assume in the counterpurchase obligation. Such additional cost may reduce the profit margin, if any, of the supplier or may be partially or totally passed on to the purchaser of the equipment.

In my opinion countertrade can be a very effective marketing tool, provided it is handled right. A key element in this connection is to have the countertrade obligation handled by a reliable and financially strong professional entity experienced in marketing.

3. Countertrade as a financing technique

Generally speaking, countertrade involves a kind of payment, while financing refers to the timing of payment. In this sense, countertrade has been used traditionally as a financing technique in its forms of counterpurchase, buyback and barter. In a more recent development, specific financing techniques have been created by transforming credit risks into performance risks.

Countertrade in the form of counterpurchase is seen by the Central Bank of the importing country as a foreign exchange generator. The reason why countertrade is required in such cases is the that the importing country intends to balance capital outflows with specific capital inflows. An example is the mentioned counterpurchase requested from the Ministry of Nuclear Industry of the People's Republic of China. The foreign exchange guaranteed through the sale of the non-ferrous metals was earmarked for the nuclear power plant project.

Countertrade in the form of Buyback is used as a foreign exchange generator, whereby there may or may not be a direct link to the project finance. An example is the buyback of products from a chemical plant as outlined in my previous example.

Such a project can be financed, at least partially, on the basis of a firm buyback commitment for the product from the plant. Such a commitment has to be "bankable", that is, for example, a long-term take or pay contract. A take-or-pay contract is a contract to make periodic payments over the life of the contract, ideally from the point of view of the bank as lender, in certain minimum amounts as payments for a product to sufficiently service the debt needed to finance the project and to pay operating expenses. The obligation to make payments is unconditional and payments must be made whether or not the product is actually delivered.

The obligation to take-or-pay may be structured in a variety of forms. For example, minimum payments may be granted by guaranteeing a minimum price in a way that in the case when market price is below the minimum price the difference between minimum price and market price is granted as a subordinated loan to the project.

If leasing is involved, leasing rates may be paid in kind; that is, in goods

produced by the plant, which was partially or totally financed by a lease agreement.

Countertrade in the form of Barter may be used to back project finance. In case of an unacceptable sovereign risk to the lender funds are collected in a trust account outside the country step by step.

In order to avoid delays in the project caused by a shortage of funds in the trust account due to delays in the delivery of the barter products, a bridge financing has to be arranged. Although this all sounds rather simple barter financing tends to be rather complicated in real life. However, it is doable — even for large projects.

Countertrade in the form of a clearing agreement may generate a financing. For example, the mining enterprise E and Metallgesellschaft establish a clearing agreement. Therefore E can purchase goods from Metallgesellschaft which will be paid for by the delivery of mining products. This clearing agreement may be heavily "swing" oriented, whereby Metallgesellschaft grants a swing facility, that is a financing, of let us say 100 MUSD over a period of 3 years. Therefore E can purchase goods from Metallgesellschaft which will be paid by delivery of mining products.

Countertrade also may be used to transform a credit risk into a performance risk. It is a statistical fact that whereas loan agreements have not always been fully honoured in the past, the contrary is true with respect to delivery contracts. Therefore, if financing is structured in such a way that repayment can be secured outright or optionally by shipment of commodities, financial institutions may be more inclined to take this performance risk. Furthermore, political risk insurance premiums for non-performance under a loan agreement are — if a coverage is available at all — much more expensive than those under a purchase agreement. Let me provide three brief examples:

Commodity linked financing

In this example, the following basic parameters had to be observed:

(a) The supplier, i.e., the exporter had to grant payment terms under his supply contract.

(b) The importer himself was a supplier of raw materials.

(c) Country A had a record of payment problems and, therefore, promissory notes originating there were not acceptable.

However, contractual obligations with regard to commodity shipments had always been fulfilled.

We structured the transaction in such a way that conditional on the unavailability of foreign exchange, the importer, ie, raw materials exporter, would supply certain commodities equivalent to the foreign exchange obligation. The nature of the commodities allowed us to agree on a specific price formula at the outset.

Export financing with securitized funding

The foreign buyer issued promissory notes for his import. These notes were insured by an export credit insurance policy from a private underwriter. In order to obtain such political risk insurance the underwriter requires in many cases that the notes be backed by a delivery contract of commodities as outlined in the previous example. We bought the notes with limited recourse to the exporter. These notes served as a backing for separately issued securities. These securities in turn were sold to investors in a private placement. The detailed technical procedure is very similar to the placement of mortgage-backed securities in the US In order to obtain an attractive rating on the securities, the insurance company issued a pool insurance policy (which is essentially equivalent to a financial guarantee). At maturity of the original promissory notes, the debtor will pay to a trustee who in turn would hold the funds for payment of the separately issued securities at their maturity.

Off balance sheet financing.

This is a large field of various different alternatives. Again we basically utilize the group's abilities to enter and execute commodity contracts by combining a spot purchase with a forward sale on a roll-over basis. By allowing our client to continue to use the raw material, we create a financing effect without a financial liability on his books.

Finally I would like briefly to draw attention to an instrument which is only very loosely connected with the topic of my paper and which allows mining enterprises to raise new financing or to refinance old debt at more attractive rates than otherwise possible by linking expenses, i.e., payment of interest and principal, to revenues, i.e., commodity prices.

Such instrument is the commodity linked bond. This is a straight bond whose return is linked to the price of its underlying commodity.

Whereas conventional bonds pay stated nominal interest rate and a stated nominal amount upon maturity, commodity linked bonds incorporate a warrant feature allowing the holder to receive in addition a benefit based on the value of a stated quantity of a specific commodity. There are many different types of commodity linked bonds, all of them incorporating a commodity price linked return structure.

For example, a straight bond with a relatively low interest rate is enriched with a warrant granting the option to the bondholder to purchase a specific quantity of a commodity at a specific price formula. This means for the investor that he will receive an extra profit in the case, and to the extent that the commodity price has moved upwards. The borrower who on the other hand gives away the upside potential of a higher price to the bondholder, is compensated by a lower interest rate.

During the last year more than 30 commodity linked bonds have been issued, mostly for highly liquid commodities such as oil and precious metals. Certainly the mechanics are the same for all other commodities actively traded on exchanges. Recently, for example, there has been an issue involving zinc and copper.

Conclusion

Countertrade is no longer the exclusive preserve of the supplier. Instead it may be used as a very effective marketing tool and as a technique to secure financing of projects.