

**INTERNATIONAL BIDDING AND THE IMPLEMENTATION OF
COUNTERTRADE TO DEVELOP LOCAL ENTERPRISES: A
CASE STUDY OF THE SOUTH AFRICAN ARMS DEAL**

by

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ABSTRACT

INTERNATIONAL BIDDING AND THE IMPLEMENTATION OF COUNTERTRADE TO DEVELOP LOCAL ENTERPRISES: A CASE STUDY OF THE SOUTH AFRICAN ARMS DEAL

One of the biggest problems facing the South African economy is unemployment. It is estimated that 33,9 percent of the population between the ages of 15 and 65 are unemployed. The South African government is however aiming to utilise the instrument of international government procurement to leverage economic benefits and develop local enterprises. Through the use of countertrade the South African government is hoping to create sustainable economic growth, increase foreign investment, create job opportunities and develop South Africa's human resources.

Recently the South African government announced that it had signed a R30 billion deal to purchase defence equipment. In return South Africa hopes to gain countertrade benefits worth more than R104 billion over the next eleven years. Similar countertrade deals, however, reached between smaller countries and the major arms producing nations have more often than not failed to produce the promised benefits.

The purpose of this research was thus to determine whether countertrade – and specifically countertrade related to these arms procurement contracts - can aid in the development and growth of enterprises in South Africa. In doing so this would help create sustainable jobs in the South African economy.

The research started of with an evaluation to determine whether South Africa has a proper countertrade policy. It was found that both Armscor and the Department of Trade and Industry have countertrade policies. These policies were then evaluated against policy guidelines identified in a literature study. These policy guidelines included for example:

- A countertrade policy should contain clear and unambiguous objectives.

- The policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase.
- Performance penalties should be given for non-performance with the agreed countertrade obligations.

These policy guidelines were then tested for their relevance through an opinion poll conducted amongst countertrade practitioners worldwide. Evaluated against these policy guidelines it was determined that South Africa has got two properly formulated countertrade policies for the successful application and implementation of countertrade.

Secondly the research set out to determine whether proper procedures are in place to ensure the success of the countertrade obligations. It was found that South Africa has created three bodies namely the Industrial Participation Secretariat, the Industrial Participation Control Committee and the Defence Industrial Participation Committee to monitor the implementation of countertrade. In addition performance penalties are also being used to ensure the attainment of countertrade obligations by the suppliers.

Lastly the research identified the countertrade obligations that were negotiated for this arms procurement deal in order to be able to determine whether enterprises are in fact being established and grown. Countertrade obligations such as the following were negotiated:

- The establishment of a fish processing plant in the Western Cape by Saab and Swedefish.
- The proposed transfer of technology by the German Frigate Consortium to a local supplier of crankshafts to help boost its production for export purposes to 500 000 units a year.

It was thus found that: South Africa has got two proper countertrade policies aiding in the application and implementation of countertrade; that ample provision has been made for the monitoring of the implementation of the countertrade obligations; and that the countertrade obligations negotiated would indeed help create and develop local enterprises.

OPSOMMING

INTERNASIONALE AANKOPE EN DIE IMPLEMENTERING VAN TEENHANDEL OM PLAASLIKE ONDERNEMINGS TE ONTWIKKEL: N GEVALLESTUDIE VAN DIE SUID-AFRIKAANSE WAPEN TRANSAKSIE

Een van die grootste probleme wat die Suid-Afrikaanse ekonomie in die gesig staar is werkloosheid. Daar word beraam dat nagenoeg 33,9 persent van Suid Afrika se bevolking tussen die ouderdom van 15 en 65 werkloos is. In 'n poging om die probleem te oorkom, poog die Suid Afrikaanse regering om deur middel van internasionale regeringsaankope nie alleen ekonomiese voordeel te trek nie, maar ook om plaaslike ondernemings te help ontwikkel. Deur gebruik te maak van teenhandel poog die regering om ekonomiese groei aan te moedig, buitelandse beleggings te lok, werksgeleenthede te skep en Suid Afrika se menslike hulpbronne te help ontwikkel.

Die regering het onlangs aangekondig dat hulle 'n R30 biljoen kontrak onderteken het vir die aankoop van wapentuig, en as teenprestasie verwag hulle teenhandel ter waarde van sowat R104 biljoen oor die volgende elf jaar. Soortgelyke teenhandelsooreenkomste in die verlede tussen kleiner lande en die groot wapen verskaffende lande het egter nie gerealiseer nie.

Die doel van die studie was dus om te bepaal of teenhandel – en spesifiek die teenhandel verwant aan die wapenkontrakte – daarin kan slaag om ondernemings in Suid Afrika te help ontwikkel en groei, en in die proses werksgeleenthede te help skep.

Die navorsing het begin deur te bepaal of Suid Afrika 'n behoorlike teenhandelsbeleid het. Daar is bevind dat beide Krygkor en die Departement van Handel en Nywerheid teenhandelsbeleidsdokumente het. Die beleidsdokumente is toe geëvalueer teen beleidsriglyne wat gedurende 'n literatuurstudie geïdentifiseer is ten einde die volledigheid van die beleidsdokumente te bepaal. Die beleidsriglyne het onder meer die volgende ingesluit:

- 'n Teenhandelsbeleid moet duidelike en ondubbelsinnige doelwitte bevat.

- Die beleid moet die grootte van die verlangde teenhandelsprestasie as 'n persentasie van die waarde van die oorspronklike aankope spesifiseer.
- Boetes vir die versuim om aan die beloofde teenhandelsprestasies te voldoen moet gespesifiseer word.

Na die identifisering van die beleidsriglyne is 'n meningsopname gedoen onder teenhandelpraktisyns ten einde die relevansie van die teenhandelsbeleidsriglyne te bepaal. Gemeet teen die beleidsriglyne is daar bevind dat Suid-Afrika twee goed geformuleerde teenhandelsbeleidsdokumente het ten einde teenhandel suksesvol te kan toepas en implementeer.

Tweedens het die navorsing gepoog om te bepaal of daar behoorlike prosedures in plek is om te verseker dat die beloofde teenhandelsprestasie werklik gelewer word. Daar is bevind dat Suid Afrika nie alleen drie liggame naamlik die “Industrial Participation Secretariat”, die “Industrial Participation Control Committee” en die “Defence Industrial Participation Committee” gestig het om die implementering van die teenhandel te monitor nie, maar dat prestasie boetes ook gebruik word om die lewering van die teenhandelsprestasies te verseker.

Laastens is die teenhandelsprestasies wat tydens die wapenaankope beding is geïdentifiseer teneinde te bepaal of ondernemings wel gestig en gegroei gaan word deur gebruik te maak van teenhandel. Teenhandelsverpligtinge soos die volgende was beding:

- Saab en Swedfish gaan 'n visverwerkingsfabriek in die Wes Kaap oprig.
- Die “German Frigate Consortium” gaan deur middel van die oordrag van tegnologie 'n plaaslike vervaardiger van krukasie help om sy produksie tot 500 000 eenhede per jaar op te stoot met die oog op uitvoere.

Daar is dus bepaal dat: Suid Afrika twee behoorlike teenhandelsbeleidsdokumente het ten einde die toepassing en implementering van teenhandel te bevorder; dat daar behoorlik voorsiening gemaak is vir die monitering van die implementering van die

teenhandelsprestasies; en dat die teenhandelsprestasies wat beding is wel sal lei tot die oprigting en ontwikkeling van ondernemings in Suid Afrika.

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CHAPTER 1

INTRODUCTION AND PURPOSE OF STUDY

1.1 INTRODUCTION AND PROBLEM STATEMENT

One of the biggest problems facing the South African economy is unemployment. Each day, some 1000 people enter the labour market and the formal sector of the economy sheds 200 jobs. The South African Reserve Bank estimates that total unemployment is rising by one or two percentage points each year. Unless the economy can grow much faster than its current plod of one to two percent a year, South Africa will find that its starkest divide is no longer between black and white, but between those in work and those who despair of ever legally making a living (The Economist, 1998:45). In the eighties, South Africa's official unemployment was still relatively manageable at 12,4 percent. In 1991 it rose to 19 percent but since the ANC took over the reins of government in 1994, it has ballooned more than 30 percent, although new methods of measurement try to put the rate lower (Mittner, 1998:49). According to the last Census in 1996 the total population of South Africa was 40 583 573 (Statistics South Africa, 2000:8). A total of 33,9 percent of the population between the ages 15 and 65 are unemployed. This figure includes the informal sector (Statistics South Africa, 2000:41).

Furthermore compared with other countries at a similar stage of development, South Africa's education budget is generous, but much is squandered. Over 90 percent of the spending goes to teacher's salaries, leaving little for books or buildings. A rowdy atmosphere dating back to the 1970s (when disrupting classes was a form of political protest), persist to this day. South Africa came bottom out of 41 countries in a resent assessment of proficiency in science and math. About 30 percent of adults are functionally illiterate (The Economist, 1998:46).

With this in mind the South Africa government is aiming to utilise the instrument of international government procurement to leverage economic benefits and develop South African industry (Department of Trade and Industry, 1997: 2). Through the use of

countertrade the South African government is hoping to create sustainable economic growth, increase foreign investment, create job opportunities and develop South Africa's human resources (Department of Trade and Industry, 1997: 2). Countertrade being an umbrella term that encompasses a variety of methods to conduct trade where, in varying degrees, purchases are required to offset sales (Coetzer, 1995: 82). In South Africa however the term Industrial Participation is used instead of the term countertrade (Van Dyk, 2000).

According to Fletcher (1998: 519) countertrade isn't something new. Between 1987 and 1996 there were 2581 cases of countertrade reported worldwide. In South Africa all government and parastatal purchases or lease contracts with an imported content equal to or exceeding US\$10 million (or the equivalent thereof) have been subject to countertrade since 1 September 1996 (Department of Trade and Industry, 1997: 2) and Armscor who is responsible for defence procurement, acquisitions and related services in South Africa also has been using countertrade for the past 10 years (Armscor, 1999: 14).

South Africa's national carrier (South African Airways) for example used countertrade in 1999 when they purchased two Boeing 747-200s worth R1, 3 billion, as well as with the purchase of a new short haul fleet worth R4, 9 billion. The negotiations are however still under way to determine the type of offsets required from Boeing, but South African Airways are pushing for offsets relating to training in particular. The Department of Trade and Industry's main focus is however on trading economic projects that would provide jobs for people once they were trained (Bailey, 2000: 6).

However, recently the South African Government announced that it had signed a R30 billion deal to purchase defence equipment. In return, South Africa hopes to gain industrial participation benefits worth more than R104 billion over the next eleven years (Campbell, 2000:16). According to Trade and Industry Minister, Alec Erwin the countertrade deal would help focus people's minds on what South Africa had to offer, and would contribute very considerably to the country's skill capacity. He described the programme as "an important injection which will strengthen South Africa's

manufacturing capacity”, creating viable and sustainable projects within the country. In addition to the jobs created directly - an estimated 65 000 sustainable jobs- the programme will also have an indirect impact on the labour market. The demand for raw material, the spending of incomes earned from employees and spending by government from its tax revenue will all contribute to economic growth and job creation (Stuart and Looock, 1999: 4). According to Kamm (2000) due to the size of the countertrade – R104 billion in countertrade for purchases of R30 billion – this South African arms deal is the benchmark setting countertrade deal for the rest of the world.

It is however widely agreed that successful countertrade programmes depend on careful monitoring and the enforcement of the various conditions attached to them to ensure that they achieve specific aims. In similar offset (countertrade) programmes elsewhere, the benefits that have eventually accrued to equipment purchasing countries have been closely related to their government’s capacity to successfully manage the implementation of these offset (countertrade) programmes (Loxton, 1999: 3). Adding to this Barrell and Streek (1999: 4) writes that similar offset deals reached between smaller countries and the major arms producing nations have more often than not failed to produce the benefits promised. The question now arising is whether South Africa can successfully implement and carry out this benchmark setting countertrade arms deal? If not the promised jobs, new enterprises and growth in existing enterprises won’t materialise.

As this can be seen as one of the benchmark setting countertrade agreements in the world this study will thus answer the following question: Was the countertrade portion of the arms deal successfully implemented, in order to ensure the success of the countertrade deal and in doing so, creating and growing enterprises in South Africa?

1.2 RESEARCH OBJECTIVES

As stated in the previous section the purpose of this study is to determine if the countertrade portion of the South African arms deal was successfully implemented in

order to create and grow enterprises in South Africa? This question can however be broken down into more specific research questions, namely:

- Was proper policies developed for the implementation of countertrade?
- Were procedures put in place to ensure the attainment of the countertrade obligations from the suppliers?
- Which countertrade obligations were negotiated with the suppliers that will ensure the creation and growth of enterprises in South Africa?

1.3 LITERATURE REVIEW

The majority of research on countertrade focuses on research into the different types of countertrade such as the research by Anyane-Ntow and Harvey (1995: 48 – 50) who identifies ten different types of countertrade namely:

- Barter
- Counterpurchase
- Offsets
- Buy-backs
- Swap transactions
- Switch trading
- Evidence Accounts
- Blocked Currencies
- Bilateral Clearing
- Cooperative ventures

This study will also as part of the literature study focus on the different types of countertrade but it is not the main aim of this study to classify countertrade into different types.

Other research into countertrade have focussed on the main points to be included in a countertrade policy such as the research conducted by Okoroafo (1994: 230 – 233) and Korth (1987: 95) but this research has focussed on the development of countertrade

policies from the perspective of private enterprises or the selling enterprise, and this research was looking more specifically at the implementation of countertrade by the South African government. An author that has however looked at the development of a countertrade policy from the perspective of the buying government was Schaffer (1989:38 – 107). As a result his research can contribute greatly to the identification of guidelines for the formulation and evaluation of a South African countertrade policy.

Other authors such as Coetzer (1995) have researched the legal aspects of the use of countertrade especially the contractual aspects of countertrade agreements, however he has also researched the influence of the World Trade Organisation (WTO) on the use of countertrade. This aspect of Coetzer's research is of particular importance as the WTO Agreement on Government Procurement (GPA) can have a significant effect on the arms procurement deal. Other authors whose research also contributes to this area of the study is Hoekman and Mavroidis (1990) who researched the law and policies of public procurement, and especially important to this study also looked at the influence of the WTO's GPA on the use of countertrade.

One of the most comprehensive pieces of research on countertrade has come from Fletcher (1998: 511 – 528), who evaluated all the reported cases of countertrade between 1987 and 1996. Each transaction was analysed in terms of those aspects that reflected the pattern of the countertrade:

- Regions in which the countries are based – developed; low-income developing countries; middle income developing countries; organisation of petroleum-exporting countries; and former centrally planned economies.
- The value involved – less than US\$ 500 000; US\$ 500 000 to US\$1000 000; US\$1000 000 to US\$10 000 000; US\$10 000 000 to US\$100 000 000 and above US\$100 000 000.
- The type of countertrade deal – barter, counterpurchase, offsets, buy-back, and debt.

- The group of products countertraded – food products and raw materials; fuels and petroleum products; simple transformed manufactured products; sophisticated manufactures; and services/other items.

1.4 RESEARCH DESIGN

The following research design was used:

- **Degree of problem crystallisation.** This is an exploratory study, as this study attempts to determine how countertrade is applied in South Africa, as well as determine what role countertrade plays in the current arms procurement deal and how it will help with the development and growth of enterprises in South Africa. The study aims to determine hypotheses and questions for further research as most of the current arms procurement deals countertrade is still in the infant stages and will only materialise in the long-term.
- **Method of data collection.** The study was conducted using both monitoring and survey processes. The study began with a literature study to identify and crystallise the field of countertrade as well as determine how countertrade is implemented in South Africa. A literature study was also undertaken to identify policy guidelines against which the South African countertrade policies could be evaluated. A survey was then conducted to support the literature study as well as identify the importance of the policy guidelines identified in the literature study (the methodology of this survey will be discussed in chapter 7).
- **Control of variables.** This is an ex post facto study as there was no control over the variables and the study only attempts to report the current countertrade situation in South Africa.
- **The purpose of the study.** This is both a descriptive as well as a causal study, as the study firstly focused on determining how countertrade is applied in South

Africa and what countertrade has been negotiated as part of the arms deal, and secondly the study is causal because it attempted to determine if countertrade could lead to the development and growth of enterprises in South Africa.

- **Time dimension.** This is a cross-sectional study as it looks at how countertrade is currently being applied as well as which countertrade obligations have been negotiated. It will not attempt to track countertrade or the arms procurement deal over time to see how it develops.
- **The topical scope.** This was both a statistical study and a case study. The arms deal and the use of countertrade in the arms deal was written up as a case study, while a statistical study was undertaken to evaluate the thoroughness of the current South African countertrade policy.

1.5 LIMITATIONS OF THE STUDY

The South African arms procurement deal consists of two sections (contracts), the procurement of the arms and the allocation of the arms procurement contracts on the one hand and the determination and implementation of the countertrade obligations on the other hand. This study will make mention of the procurement of the arms and the allocation of the arms procurement contract, but will focus on the implementation of countertrade in the arms procurement deal. The research is however hampered by the fact that the allocation of contracts in the arms procurement deal and to a lesser extent the countertrade obligations is being investigated by the government for charges of nepotism as well as material deviations from acceptable practice in the awarding of contracts. These procedures were however constantly monitored to determine any influences that the findings might have on the study.

A further limitation of the study is that not all the countertrade obligations have been determined yet, and that the negotiations that are currently under way in order to

determine the countertrade obligations are treated as confidential as the negotiations are at a sensitive stage.

Lastly a lot of the countertrade practitioners – both countries and enterprises – do not freely admit to using countertrade and as such it is difficult to determine the size and location of the population for the survey. Most of this population are situated internationally and as such it was difficult to collect information from them.

1.6 STRUCTURE OF THE STUDY

This study consists of eight chapters. Chapters two to five is a literature study looking at the background for the research, while chapter six is a case study that shows how countertrade is applied in South Africa and shows what has happened with the South African arms procurement deal. Chapter seven shown the survey findings, while the last chapter consists of a summary, conclusion and recommendations of the research. The following gives a brief overview of the chapters in this study.

- **Chapter two.** This chapter looks at the historic development of countertrade, the different types of countertrade being used throughout the world and the advantages and disadvantages of using countertrade.
- **Chapter three.** This research deals with the South African arms deal and countertrade, and as South Africa is seen as a developing nation this chapter looks at the role that countertrade plays in developing nations and especially the amount of countertrade taking place in and with developing nations.
- **Chapter four.** The WTO's main aim is the encouragement of free international trade and globalisation. One of the WTO's agreements, the GPA especially prohibits the use of offsets – a type of countertrade – so this chapter takes a look at the influence of the WTO and its agreements on the use of countertrade.

- **Chapter five.** This chapter determines what the literature recommends should be included in a successful countertrade policy, as well as gives guidelines for the formulation of a countertrade strategy. With the aid of these policy guidelines the South African countertrade policies can be evaluated to determine their thoroughness, potential success or failure.
- **Chapter six.** This chapter is a case study that looks at which policies are in place in South Africa to ensure the successful implementation of countertrade. It also looks at the South African arms deal and the countertrade (Industrial Participation) that was negotiated with the successful suppliers. Finally this chapter looks at the criticism against and advantages of the South African arms deal and countertrade.
- **Chapter seven.** Before the South African countertrade policies in chapter six were evaluated against the policy guidelines identified in chapter five, these guidelines were evaluated to determine their relevance for inclusion in a countertrade policy. This chapter presents the finding of the survey conducted amongst countertrade practitioners to determine the relevance of those policy guidelines.
- **Chapter eight.** The last chapter consists of a summary and conclusion of the research and finally makes recommendations for potential further research identified during the course of this research.

1.7 ABBREVIATIONS

The following abbreviations will be used in the text:

- Communist economy (Comecon)
- Centrally Planned Economies (CPE)
- Defence Industrial Participation (DIP)

- Department of Defence (DoD)
- Department of Trade and Industry (DTI)
- General Agreement on Tariffs and Trade (GATT)
- Gross National Product (GNP)
- Agreement on Government Procurement (GPA)
- Health and Usage Management Systems (Hums)
- International Monetary Fund (IMF)
- Industrial Participation (IP)
- Industrial Participation Control Committee (IPCC)
- Industrial Participation Secretariat (IPS)
- International Trade Organisation (ITO)
- Less Developed Countries (LDC)
- Low Income Developing Countries (LID)
- Most Favourite Nation (MFN)
- Middle Income Developing Countries (MID)
- Ministry of Defence (MoD)
- National Industrial Participation (NIP)
- National Industrial Participation Programme (NIPP)
- Organisation of Petroleum Exporting Countries (OPEC)
- Request for Information (RFI)
- Request for Proposals (RFP)
- South African National Defence Force (SANDF)
- United States (US)
- World Trade Organisation (WTO)

1.8 REFERENCE TECHNIQUE

The Harvard reference technique was used in this study.

CHAPTER 2

COUNTERTRADE THEORY

2.1 INTRODUCTION

According to Coetzer (1995:80-82) there is such an abundance of definitions of countertrade, but no universally agreed upon definition. Many authors on the subject are, therefore, in agreement that it is quite difficult to give a clear and concise definition of countertrade. In order to get an overall idea of the general traits and characteristics of countertrade, reference could in a somewhat tedious manner be made to some typical examples of attempts at defining countertrade:

- Countertrade is an international sale, which is conditional on a sale in the opposite direction.
- A technique by which one can obtain goods or services without necessarily having to use money.
- It is also seen as an innovative financing technique.
- International trading transactions in which purchases are made to offset sales as a means of reducing the flow of hard currency.
- Countertrade as traditionally understood is the exchange of goods – a kind of international barter.
- Countertrade is an umbrella term for various forms of international transactions in which the seller is obligated by the buyer to accept full or partial payment in goods.

- Countertrade is an umbrella term that encompasses a variety of methods to conduct trade where, in varying degrees, purchases are required to offset sales.

Alexandrides and Bowers (1987: 5) add that there is a great deal of confusion over the definition of countertrade and its various forms in the government and business communities. Governments of developed countries that have practiced countertrade for many years call it by some euphemism such as “industrial benefits programs” and reserve the term “countertrade” for the practices of developing countries and centrally planned economies. The segment of the business community that is new to countertrade does not know what to think. The business press persists in describing countertrade as “trade without money” which understandably frightens many companies; however, in most forms of countertrade, there is at least a partial payment of hard currency. Moreover, in countertrade between developed countries, full payment is usually made in cash, with the countertrade or offset obligation satisfied under a separate contract.

Elderkin and Norquist (1987: 1-2) write that countertrade is an umbrella term referring to any transaction where payment is made, at least partially with goods instead of money. In all its forms, countertrade links two transactions – normally independent under a free trade system – into one agreement. These transactions are the sale of a product by the multinational corporation into a country, and the sale of goods out of the country.

As can be seen from the numerous different definitions it is very difficult to define countertrade especially as it is used as an umbrella term for different types of countertrade. These different types of countertrade as well as the reasons for using countertrade will be discussed in the next sections. It should however be noted that throughout the study whenever the dollar sign is used it refers to US dollars unless stated otherwise.

2.2 THE MODERN DEVELOPMENT OF COUNTERTRADE

It is a fair assumption that trading practices founded on barter or variants of barter have existed since time immemorial. However, due to the appearance of monetary systems, pure barter dwindled and gradually made way for conventional trade. Notwithstanding the gradual advent of conventional trade, barter based trading practices have all along shown a temporary increase whenever international trade channels have been disrupted by economic upheaval and a decline when trade liberalisation has been in the ascent. In time of trade liberalisation barter or barter related practices give way to multilateral trading where settlement is normally effected in money.

Countertrade, it appears, was utilised by several governments since the 1920s. In the 1920s and 1930s United States corporations were largely responsible for the development of the Middle Eastern oil industry, mainly because these corporations offered technology and know-how in exchange for oil. Between the First and Second World Wars, Germany used countertrade in the expansion of its heavy industries. After the Second World War countertrade once again assisted Germany, but this time to overcome its post war recession.

Countertrade, however, only became a real influence in international trade after the Second World War, chiefly because the former Soviet Union and its allies in the Eastern bloc used countertrade mainly to bypass economic and political restrictions on East-West trade at the time. At that stage countertrade was also used in the West as an informal arrangement based on the rendering of mutual assistance between friendly nations in the West because Western bank credit was generally hard to obtain (Coetzer, 1995: 84-86). According to Osmanczyk (1990: 246) East – West is an age-old international term, which after World War Two became a synonym of world division. Shafritz, Williams and Calinger (1993: 237) add to this when writing that the East - West term is used to symbolize the Cold War-era division of Europe. The East consisted of the Soviet Union and its Eastern European satellites; the West consisted of the United States and its Western European allies plus Japan.

As far as the United States was concerned, The Department of Agriculture started a barter programme in 1950 with the aid of a government-financing organisation for United States agricultural exports, called the Commodity Credit Corporation. The objective of this barter programme was to trade agricultural surpluses held by the Commodity Credit Corporation for so-called strategic and critical materials needed for the American National Defence Stockpile. At that stage the United States Government also had a domestic price-support programme through which the Commodity Credit Corporation acquired agricultural commodities, which were then made available for purposes of the international barter transactions. This American programme lasted for a period of seventeen years, thus until 1967.

In the mean time, from the late 1940s to the late 1950s, more than 70% of trade amongst the Latin American countries consisted of countertrade, where extensive use was made of clearing account agreements.

With the advent of the 1960s, countertrade became important for Eastern block governments, as they started to promote countertrade as a reaction to limited foreign exchange, alternatively, as a way of disposing of surplus commodities in order to finance imports. Moreover, since the late 1960s some governments, not only Eastern European governments, required industrial countertrade arrangements which involved joint venture production sharing.

The next boost for countertrade came during the 1970s with the sharp rise in oil prices by the Organisation of Petroleum Export Countries (OPEC), an event that had a profound effect on the world trading system. Furthermore due to the sharp rise in oil prices, the terms of trade in non-oil exporting Third World countries deteriorated and had to be compensated for and the method used for this compensation was countertrade. In addition, during the 1970s there was a significant growth in industrial production in the former Soviet Union and in the East bloc countries. However, notwithstanding this growth, these countries could not achieve positive trade balances by capturing a meaningful market share in the West. With a view to reducing these imbalances and also to preserve their hard currency reserves and, furthermore, to promote their exports,

these countries increasingly required the purchase of Eastern European goods in return for their Western purchases.

These occurrences resulted in an expansion of countertrade activities by United States firms during the 1970s, which coincided with an increase in trade between the United States on the one hand and the Third World and the East bloc on the other hand.

The 1970s was also a period, which Eastern Europe and the Third World became increasingly indebted to the West and during which their currencies were to a relatively large extent overvalued. Sequential there upon, Third World and East bloc countries groped at countertrade in an effort to bring their economies into equilibrium.

As regards the employment of countertrade during the 1980s, it seems that countertrade is coming out of the closet. Today a growing number of countries formally demand countertrade.

This statement is especially true for developing countries, as countertrade plays a new role for these countries in that since the 1980s they have increasingly turned to countertrade as an emergency measure (Coetzer, 1995: 86-88). The term developing nation that was mentioned previously is seen as an anomaly, for there is an implication that a developing nation is not developing, but decaying. But there is also an implication that this decay is not necessarily permanent; it may be a stage through which a nation is passing, a temporary setback. We are defining a developing nation here in terms of its effects on individuals or, more exactly, families. Those effects have to do with a stable personal environment; to experience this, an individual's housing, cultural setting, job, and education must all be in balance. Good education and poor job, low income and expensive house, affordable house but hostile neighbourhood, good job with insecure future – all result in imbalances. A stable personal environment requires enough food to eat, housing that is affordable and satisfying to live in; neighbours and cultural facilities with which he or she feels comfortable; a job offering a modicum of satisfaction, continuity, and above-subsistence income; and an educational system which can promise children the same advantages. A person with no monetary income can have this

as well as one with high income; the key lies in the balance of the parts. Modernisation creates imbalances in these parts and also provides means to correct those imbalances. Some nations, which we term developed nations, have already achieved such environmental balance for a majority, or at least increasing percentage of, their citizens. Other nations once (usually before the advent of nationhood) had such balances for a majority of their people; today, a decreasing minority of their total populations experience such stable personal environments, though this trend may be reversed in the future. These are the developing nations; specifically, those in Latin America, the South Pacific Islands, Southeast Asia including Australia and New Zealand, South Asia, the Middle East excluding Israel, and Africa. All the other nations on the globe are classified as developed (Gamer, 1976: 8-9). The emergency situation in which these developing countries found themselves since the early 1980s related to the long-term structural changes in the international economy which includes matters such as the debt overhang, the sluggish growth of international trade, the decline of multilateralism and growing protectionism.

This concise contemporary history of countertrade leaves one with the distinct impression that the countertrade agreement, which in some quarters is looked down upon, has time and again been the lifeline that enabled even developed countries to haul themselves to safer international trade positions (Coetzer, 1995: 88).

2.3 FORMS OF COUNTERTRADE

So far the term countertrade has been used as an umbrella term for different types of international trade. It however represents a number of different types of possible international trade techniques that is available to enterprises and governments. The most well known and frequently used types of countertrade is:

- Barter
- Counterpurchase
- Compensation/Buy-back agreements
- Offset agreements

- Clearing account agreements
- Switch trading

2.3.1 Barter

Barter takes many forms. However, the essence of any type of barter transaction is simply the exchange of one product (whether a good or a service) for another (e.g., one antelope hide for so many ears of maize, or a shipload of oil in exchange for fertiliser). This type of exchange is what is known as simple barter (or straight barter, or pure barter).

- *Deferred payment*: Traditionally, barter transactions occurred simultaneously. However, even in primitive markets, deferred-payment arrangements could be made (e.g., one sheep a month in exchange for 100 bushels of wheat after the harvest). This type of agreement created a type of barter credit.
- *Multiproduct trade*: The barter transaction could involve not simply the exchange of one item or service by each seller but several, or many on either side (e.g., beaver skins and deer pelts in exchange for grain, coffee, blankets, and tobacco). Since many products are not readily divisible (e.g., a dairy cow) and the seller's demand for the other's principal product may be limited (e.g., eggs), the expansion of the trading to include a variety of products greatly increases the flexibility of barter. When combined with the afore mentioned barter credit, multiproduct trade becomes even more flexible.
- *Multilateral barter*: Another method in addition to multiproduct barter for circumventing some of the inherent limitations of barter caused by the restricted need each party commonly has for the other's goods or services is multilateral barter: several parties exchange goods. For example, company A's wheat could be shipped to Company B, whose corn goes to Company C in exchange for fruit that is, in turn, shipped to company A.

With simple barter, there is a direct exchange of goods between two parties. Only a single contract is signed (in many of the informal deals, no contract is signed). The agreement (whether written or oral) will specify both the specific type and the quantity of the goods or services to be traded. No middlemen are typically required. The goods or services will not be transferred to third parties. No money is involved (except indirectly, since in monetary economies both parties will tend to bear in mind some approximate monetary value for both products offered and products received)(Korth, 1987:2-3).

Anyane-Ntow *et al* (1995:48) support this view when they write, “Barter is the simplest form of countertrade. It is a one-time, direct exchange of goods of equal value. The exchange is executed under a single contract between two parties and is consummated simultaneously or over a period of up to one year”.

Examples of pure barter agreements are the following (Coetzer, 1995:100-101):

- After the fall of the Shah of Iran that country was unable to sell its crude oil in the international market, it therefore entered into pure barter agreements with various countries. In 1982 New Zealand delivered to Iran \$200 million worth of frozen lamb in exchange for crude oil. Iran, furthermore, entered into a pure barter agreement with Romania in 1981 for locomotives, tractors, oil, equipment, spare parts and consultancy services, with China in 1983 for meat and with Thailand in 1982 for rice.
- The bizarre is also sometimes present in this type of agreement. For instance, the Swedish rock and roll music group, ABBA, performed in the Soviet Union at one stage and was paid in various kinds of Russian products including chemicals.

2.3.2 Counterpurchase

A counterpurchase or parallel barter agreement could be defined as, a contract whereby an exporter undertakes to:

- sell to an importer, goods or services for cash or on credit, or partly for cash and partly for goods or services;
- to counterpurchase goods or services from that importer to the value of a stipulated amount; or
- to market such goods or services on behalf of that particular importer,

and which obligation to counterpurchase could be assigned by the exporter (Coetzer, 1995:105).

According to Hammond (1990:9), this is an agreement whereby the initial exporter buys or undertakes to find a buyer for a specified amount or value of unrelated goods from the initial importer during a specified time period. Where the arrangement involves goods only it is often referred to as “parallel barter”. Such transactions often involve cash plus products under separate contracts for each item and hard currency.

Examples of counterpurchase agreements are (Coetzer, 1995:113-115):

- In 1984 Pakistan bought six aircraft from the American Boeing Company. For its part Boeing undertook to purchase Pakistani products at a countertrade ratio of 20%.
- In 1977 Volkswagen of West Germany sold 10,000 Volkswagen motorcars to East Germany and in return undertook to buy selected East German goods such as coal oil and machinery, over the ensuing two years for an equivalent value.
- In 1982 the government of Indonesia established an extensive counterpurchase scheme, which required all foreign exporter selling to the Indonesian Government to purchase Indonesian goods at a counterpurchase ratio of 100%.

The first transaction under the scheme was concluded in August 1982 with the purchase of \$128 million worth of fertiliser by the Indonesian government.

2.3.3 Compensation/Buy-back agreements

The next type of countertrade is a very special form that has evolved primarily in response to the reluctance of Communist countries to permit ownership of productive resources by the private sector-especially by foreigners. The typical buy-back arrangement involves a company from abroad building a manufacturing or processing facility in a Communist country. The local government would own the factory. The assistance that the private-sector company provides may take forms such as the inflow of equipment, financial capital, patents, technical and managerial assistance, or distribution assistance. In exchange, the contract provides that the company will “buy-back” some of the output from the new facility at a reduced price (or even free) as its compensation.

From the viewpoint of the Eastern European host government, this arrangement provides valuable Western assistance without sacrificing control and sometimes with little or no commitment of local capital. Also, continued Western assistance in quality control, technical training, and so on is frequently required.

From the viewpoint of the Western company, this “buy-back” arrangement could provide access to untapped market in the former Communist world (e.g., many of the contracts involve the company receiving a share of the gross revenues from all sales by the local government as well as from what the company itself sells) and could provide an alternative source of low-cost production for Western markets (Korth, 1987:4-5).

Anyane-Ntow *et al* (1995:49) supports this description of buy-back when they write, “Buy-back is the fastest growing form of countertrade in terms of dollar value. Under this deal, the seller (usually an industrial firm) exports equipment and technology and agrees to buy back, over a period of time, a quantity of the products manufactured. The value of a buy-back is equal to or greater than the value of the original contract.

Although the original purchase may be made in cash, settlement is always the product. Buy-backs is transacted under two contracts and may involve a third party such as a trading house”.

Some examples of compensation/buy-back agreements are (Coetzer, 1995:127-128):

- During the 1970s, a United Kingdom company, Guinness and Peat, contracted with Bulgaria in regard to the building of a furfural alcohol plant in Bulgaria. In respect of the relevant secondary contract, the UK company apparently still takes delivery of alcohol produced at that facility.
- In the early 1970s, an American company sold technology and equipment to Romania, which enabled Romania to build a tyre plant, and at the same time undertook to purchase a certain portion of the production of the particular plant.

2.3.4 Offset agreements

According to Coetzer (1995:130) an offset agreement could be defined as a medium term transaction under a protocol whereby an exporter sells goods to an importer under a principle contract, subject to the condition that the initial exporter undertakes, in terms of a secondary contract to:

- purchase from the importing country any components necessary for the manufacture of the particular goods;
- manufacture components of the imported goods in the importing country;
- allow the importing country to co-produce some of the components of the goods concerned;
- assemble the specific goods in the importing country;
- transfer technology to the importing country; or
- market a commodity of the importing country.

According to Hammond (1990:7) offset agreements are contemporary, reciprocal trade agreements for industrial goods and services mostly used in military-related export sales and services. It is in effect, countertrade in the defence sector. It is also used in the purchase of civilian aircraft and has grown to be the norm in the aerospace/defence sector. The purpose is to compensate the buyer for the consequence, economic or political, of acquiring a foreign good or service. There are two principle kinds of offset:

- *Direct offsets*: Involve compensation in related goods and usually involve some form of co-production, licensing or joint venture.
- *Indirect offsets*: Involve goods and services unrelated to the defence material being sold. These may involve raw materials, investments, technology transfers or tourism.

Coetzer (1995:131–133) adds that an important factor is that importers under offset agreements usually are foreign governments in those cases where governments buy from foreign companies on a large scale and where such governments insist that the seller offset the prices concerned in some way or another. Thus, these agreements are mainly used in connection with some form of government procurement contracts where the importing country considers it a priority to purchase the relevant goods. Offsets are primarily used in sales relating to military equipment and commercial aircraft. Virtually without exception countries want to build their defence systems, maintain those systems, build their own aircraft or ships, or their own high tech equipment. Offset agreements are also used by governments for the purchase of items other than military equipment and commercial aircraft.

An offset agreement operates in a manner similar to that of a counterpurchase agreement, but with the difference that the goods acquired by the exporter could always be used by it in his business.

Some important practical implications are that the conclusion of offset agreements certainly:

- enhances industrial development and domestic employment,

- facilitates technology transfer, and
- attracts foreign investment.

Consequently these agreements are particularly attractive to those developing countries which are more advanced and which are in a position to undertake technology intensive production.

It is important that whether the exporter markets the product of the sovereign country, or whether the firm manufactures part of its output in that country, both contribute to the hard currency supplies of the country concerned.

Some examples of offset agreements are (Coetzer, 1995:134):

- A United States aircraft manufacturer, McDonnell Douglas, agreed in 1982 to an offset transaction with Canada whereby Canada's 15 year obligation to purchase jet aircraft to the value of \$2,4 million was offset by McDonnell Douglas agreeing to buy airframe components from Canadian suppliers as well as to find buyers for other Canadian products.
- During the 1980s, New Zealand called for tenders in connection with a major railway electrification project. Offers were made by many of the bidding consortia to purchase certain design, engineering and construction services locally, including the substitution of locally produced components for those items, which they would have imported into New Zealand.
- In 1987 the American aircraft manufacturer, Boeing, sold to the French government a number of AWAC (airborne early warning systems) aircraft with the offset condition that such aircraft should be fitted with Snecma engines built in France.

2.3.5 Clearing account agreements

A clearing account agreement is defined by Coetzer (1995:141-142) as a bilateral agreement between two governments, which is contained in a single document, concluded for a definite or indefinite period and in terms of which the parties agree to:

- open a common bank account
- extend to one another a line of credit
- purchase from one another, goods to a specified value or quantity within a specified period, which goods are valued in terms of a particular clearing currency or valued in terms of any other internationally acceptable unit, and
- balance the said account at the termination of the agreement or at certain intervals, as the case may be.

Korth (1987:4) describes clearing account barter as a more flexible format than either straight or parallel barter. With clearing account barter, each party agrees in a single contract to purchase a specified value of goods or services from the other country over a specified, often lengthy, period. Thus trade may be out of balance at the end of the first or even several years but will balance over the term of the contract.

Furthermore this clearing currency credit can often be used only within one country (although it can often be sold or transferred or switched to a third party). It is, in effect, a line of credit of a fixed amount, which is matched by a compensating line of credit in the other country. No money is actually involved in the trade in such barter. Each company or government thus provides the other with barter credit.

Frequently, clearing dollars can be used to purchase any of a variety of products. In other cases they can buy only a specified product. Nevertheless, clearing account barter generally allows greater flexibility to either or both parties in terms of both time of drawdown on the “lines of credit” and types of products available. This form of barter occurred mostly between former Communist countries or between former Communist and a less developed country (LDC). It is, however, becoming more common between LDCs. However there is nothing in the nature of clearing account barter that would

logically prevent it from being used by two private sector companies in industrialized countries.

Information in regards to examples of clearing account agreements on a global basis is not easy to obtain, but in 1989 it was estimated by the Institute on Switch and Barter trade, New York, that approximately 83 countries had entered into at least one clearing account agreement each.

It further gauged that quite a number of those countries are engaged in numerous clearing account agreements. For instance at that stage the former Soviet Union was engaged in 30, Mexico 19, Brazil 17, and France in 12 such agreements. At the time of the assessment, 1989, the following agreements were, amongst others current:

- Morocco oranges for capital equipment from Soviet Russia;
- Egyptian cotton for Hungarian electrical equipment;
- In 1983, the Peoples Republic of China concluded a clearing account agreement with East Germany in order to exchange rice, canned fruit, vegetables and textiles for German scientific instruments, printing machines, trucks and chemical fertilizer (Coetzer, 1995:147-148).

2.3.6 Switch trading

Switch trading refers to the use of specialised third-party trading house in a countertrade agreement. When a firm enters into a counterpurchase or offset agreement with a country, it often ends up with what are called counterpurchase credit, which can be used to purchase goods from that country. Switch trading occurs when a third-party trading house buys the firm's counterpurchase credit and sells them to another firm that can make better use of them. For example, a United States (US) firm concluded a counterpurchase agreement with Poland for which it receives some number of counterpurchase credit for purchasing Polish goods. The US firm cannot use and does not want any Polish goods, however, so it sells the credit to a third-party trading house at a discount. The trading house finds a firm that can use the credit and sells them at a profit.

In one example of switch trading, Poland and Greece had a counterpurchase agreement that called for Poland to buy the same US-dollar value of goods from Greece than it sold to Greece. However, Poland could not find enough Greek goods that it required, so it ended up with a dollar-denominated counterpurchase balance in Greece that it was unwilling to use. A switch trader bought the right to 250 000 counterpurchase dollars from Poland for \$225 000 and soled them to a European sultana (grape) merchant for \$235 000, who used them to purchase sultanas from Greece (Hill, 1997:456-457).

Iran and Poland entered into a clearing account agreement to buy from one another \$1 million worth of goods per annum. Iran had to deliver oil and Poland shoes. At the end of the first year Iran had in fact delivered \$1 million worth of oil but Poland had only delivered shoes to the value of \$800 000. Trade between the two countries stopped at that stage, because the swing had reached its limit in terms of the bilateral contract. A switch trader then came into the picture. The switch house offered Iran \$160 000 in hard currency, which Iran accepted for its “purchasing position”. Before making the offer, however, the switch house found a buyer in Africa who was willing to pay \$165 000 in hard currency for Polish shoes, which was allegedly worth \$200 000. As a consequence all parties were satisfied. Poland received oil, Iran received shoes and hard currency and the Africans acquired shoes for only \$165 000 (Coetzer, 1995:156–157).

2.3.7 The use of the different types of countertrade

In a recent study, which would be elaborated more upon in the next chapter Fletcher (1998: 517-519) gives us a break down of the use of the different types of countertrade between 1987 and 1996 in table 2.1 and figure 2.1.

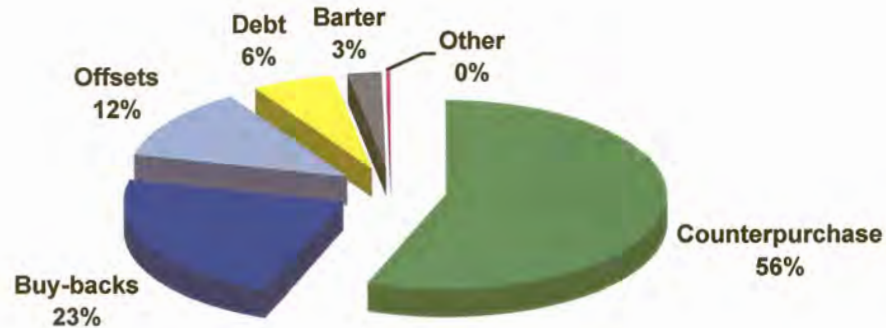
Table 2.1 Countertrade usage by type 1987-1996

	1987-90	1990-93	1993-96	1987-96
	(n=963)	(n=1114)	(n=503)	(n=2580)
Type	(%)	(%)	(%)	(%)
Counterpurchase	63,3	55,6	42,3	55,9
Buy-back	21,4	28,0	14,5	22,9
Offsets	7,2	10,4	25,8	12,2
Debt	6,9	4,1	9,6	6,2
Barter	0,4	1,9	7,8	2,5
Other	0,8	—	—	0,3
Total	100,0	100,0	100,0	100,0

Source: Fletcher (1998: 519)

From the information in table 2.1 it can be seen that world wide between 1987 and 1996 2580 cases of countertrade had been reported. Off these reported cases the majority namely 55,9 percent was through the use of counter purchase agreements followed by buy-back agreements with 22,9 percent. Third was offset agreements with 12,2 percent of the transactions, fourth was debt with 6,2 percent, barter with 2,5 percent and the other forms of countertrade with 0,3 percent of the reported countertrade transactions. Fletcher (1998: 519) also identified a form of countertrade which is not normally mentioned in studies on countertrade as a type of countertrade namely debt. Debt is of interest if a firm is owed or has frozen assets it wants to liquefy. So a country would exchanges goods or services in return for debt reduction.

Figure 2.1 Countertrade usage by type 1987-1996



Source: Fletcher (1998: 519)

Figure 2.1 gives a graphic presentation of the information discussed in table 2.1. It can be seen that counter purchase was the most popular form of countertrade worldwide between 1987 and 1996, followed by buy-backs.

2.4 ARGUMENTS FOR AND AGAINST COUNTERTRADE

2.4.1 Positive aspects

The arguments for countertrade may be summed up as follows (Townsend, 1986:21):

- For the Western exporter the prime advantage of countertrade is the possibility of gaining access to markets otherwise closed to him by virtue of a dearth of foreign currency. The problem of absence of credit facilities for the finance of this trade is also overcome. This is clearly an advantage for the importing country as well, since it gives access to goods sometimes highly essential to its economic progress, which would normally be beyond its reach.

- It is sometimes possible for the exporter to obtain a permanent foothold in the markets as a result of the initial delivery, obtaining repeat orders or supplementary orders for extensions or spare parts. These subsequent orders, especially spare parts, will not necessarily be subject to countertrade deals.
- Not all countertrade goods are difficult to dispose of and it may be possible for the Western exporter either to make use of them himself or sell them profitably to another Western user. In some cases it occurs that the countertrade merchandise delivered enjoys a demand in excess of the contractual value with the result that, more Western goods can be sold against further countertrade deliveries and a regular trade can be developed.
- Countertrade has given some developing countries the opportunity to increase exports and also to develop exports of products, previously little known, but nevertheless acceptable in Western markets. At the same time, particularly in the case of co-operation deals, countertrade has provided the means for developing countries to make significant strides forward in their domestic economies.
- Less scrupulous countertrade advocates see it as a means of enforcing Western investment in third world countries and overcoming trade barriers set up to protect Western markets.

Hill (1997:457) sees the main attraction of countertrade in that it can give a firm a way to finance an export deal when other means are not available. Given the problems that may develop and Third World nations have in raising the foreign exchange necessary to pay for imports, countertrade may be the only option available when doing business in these countries. He adds that even when countertrade is not the only option for structuring an export transaction, many countries prefer countertrade to cash deals. Thus if a firm is unwilling to enter into a countertrade agreement, it may lose an export opportunity to a competitor that is willing to make a countertrade agreement. Countertrade allows US firms to remain competitive with large Japanese and European trading companies, which for historic reasons are the masters of countertrade.

2.4.2 Negative aspects

The arguments against countertrade may be summed up as follows (Townsend, 1986:20-21):

- The system of countertrade promotes a departure from conventional commercial dealings, payment terms, and pricing, undermining the progress made in the field over decades while simultaneously the free market economy is sabotaged by a practice which inhibit free trade.
- Uncertainty and risk are increased particularly in view of the limited number of experienced and /or suitable personnel available and the rarity of experts with knowledge of the various techniques, which may be employed in a market, which has grown so rapidly.
- The practice is criticized on the grounds that it often leads to the dumping of countertrade products on Third World markets to the detriment of newly developed industry. The same could be alleged in respect of developed countries, but in their cases anti-dumping legislation and control tend to be more sophisticated.
- Countertrade is sometimes seen as a means by which those countries with foreign currency problems avoid facing up to their basic economic problems. Equally it is alleged that over the long term the system does not help developing countries as much as, for example, Comecon (communist economy) countries because the Third World lacks experience in this field.
- Somewhat unjustly the system is accused of, primitive, inefficient and even sinister dealing techniques. Although it is fair to argue that it has the effect of increasing costs and prices and thus distorting markets, nobody with practical experience of the modern countertrade market can seriously suggest that it has not achieved a high degree of professionalism and sophistication. Allegations of

sinister or semi-illegal practices tend to relate back to post 1945 days when even conventional methods of trading were often suspect.

- The lack of international control and supervision of countertrade movements has led to suspicion and confusion regarding the actual volume of trade being transacted along these lines and its effect on the world economic system. There is undoubtedly some justification for this charge. Large multi-national companies are not required to divulge such information to any international authority and are most unlikely to volunteer such statistics even in the unlikely event that they could produce really accurate information.
- Seen from the point of view of the supplier of the countertrade merchandise there are not purely advantages but also problems, notably:
 - The normal pattern has been for such countertrade deals to be of a non-recurring nature; hence no long-term trade pattern is established. This is an important consideration, bearing in mind that the first countertrade is usually the most difficult to negotiate and that subsequently deals between the same partners for similar merchandise are much less complicated.
 - The rarity of voluntary repeat orders from the western recipient of the countertrade goods does not encourage a countertrade merchandise supplier to improve the quality of the range of goods offered, but instead results in lethargy.
 - The increasing tendency for Western recipients to resell the countertrade goods into third markets at low prices subsidised by the original exporter may ruin previously acceptable markets for the countertrade goods supplier. This occurs especially when the countertrade goods supplier has been inefficient or lacked experience when drawing up the countertrade contract, i.e. failing to adequately restrict resale of the goods in third markets.

According to Hill (1997:457) the drawbacks of countertrade agreements are fairly substantial. Other things being equal, all firms would prefer to be paid in hard currency. Countertrade contracts may involve the exchange of unusable or poor quality goods that the firm cannot dispose of profitably. For example, a few years ago a US firm lost money when 50 percent of the television sets it received in a countertrade agreement with Hungary were defective and could not be sold. In addition, even if the goods it received are of high quality, the firm still needs to dispose of them profitably. To do this countertrade requires the firm to invest in an in-house trading department dedicated to arranging and managing countertrade deals. This in itself can be expensive and time consuming.

According to Hammond (1990:47), an American George Schultz, once supposedly remarked that countertrade is “a communist way of doing business and the US government won’t get into it”. Hammond (1990:48-53) lists the following as possible arguments against countertrade:

- **Unlikely natural occurrence of “double coincidence of wants”:** Countertrade rests on the concept of barter. Barter is an inferior method of exchange because it relies on the unlikely “double coincidence of wants”. It is highly unlikely that two enterprises or nations will stumble on each other to exchange efficiently the things each has that the other desires. Hence money as a medium of exchange offers greater flexibility, for with it one can purchase nearly anything and exactly what one wishes, without intermediate barter to finally get what you want. An example of this is the Swedish rock group, which gave a concert in Poland and was paid in coal. They presumably sold the coal for cash rather than lugging it home to burn for heat.
- **Creates monopsony:** In that countertrade is essentially bilateral and restricts sales of a commodity, output of a plant or the exchange of specified goods and services to one purchaser, it is anti-market and promotive of monopsony. A monopsony is an economic system where there is only one buyer. From the seller’s perspective, there can be no competition, no market; the seller has no control over the purchaser. How can a monopsonic arrangement increase trade

and improve economic performance? Rarely is the entire output of a single product consigned to any one purchaser, but within the confines of a particular transaction, monopsony certainly exists.

- **Trade restrictive, not expansive:** There are many claims that it creates more trade than otherwise would have been. Such claims are impossible to verify and rests on the notion that the two-way trade that would have occurred if one of the items involved in countertrade had been bought for cash. But if the purpose of the transaction was to export something and import something else, both of which were needed, then it is merely another way of doing what would have occurred through the use of cash anyway. There is the possibility that one or the other of the items in a countertrade deal was neither desirable nor usable by one of the purchasing parties. If that is the case, then the inefficiency is obvious, for the purchase of unwanted or unneeded goods or services is unnecessary and uneconomical. If this is so, then additional trade may be created in unwanted or unneeded items.
- **Increase inherent transaction costs:** Though hidden, the cost of financing countertrade is higher than if access to regular credit markets was available. Telephone and travel, hotel and meal expenses during prolonged negotiations, translation fees, insurance – are all likely to be higher because of the time it takes to negotiate a countertrade deal. The lags and leads in the exchange process, increased marketing expenses, the duration of the contract or side agreements and the unforeseen costs that may be entailed in the transaction all means the cost of conducting countertrade are higher than a cash sale.

2.5 REASONS FOR USING/CONSIDERING COUNTERTRADE

The reason why nations and enterprises make use of countertrade can be classified into two categories. These are negative reasons, constraints and imperatives, which force nations and enterprises into considering or using countertrade whether they wish to or

not. Then, there are positive incentives, opportunities and profitable initiatives available to enterprises and countries, which make countertrade an attractive option. According to Hammond (1990:28-33) the reasons why enterprises and countries become involved with countertrade are:

2.5.1 Negative incentives for countertrade

- **Large debt:** The number of basically insolvent nations who have had their debt “rescheduled”, normally a euphemism for being in default of interest payments, alone grows annually. Given a lack of ready cash, countertrade becomes an increasingly attractive way of attempting to obtain needed imports without aggravating an already bad situation.
- **Trade imbalances:** If a country’s trade is heavily skewed towards only a few trading partners and there are large trade imbalances, countertrade may be used to insure that the trade deficit does not grow any larger. In requiring exchanges of goods and services that can be arranged in advance, the deficit may be frozen. While not an answer to the basic dilemma, it allows some breathing space in order to attempt to get ones finances back in order. It also serves as a signal of determination to insure that things will not get worse and may, thus, be a spur for further debt restructuring. Alternatively it may be reduced by specifying certain joint ventures, licensing or co-production in the host country and thereby producing what may have been imported from abroad before.

2.5.2 Positive incentives for countertrade

- **Expanding markets and export promotion:** For countries of whatever circumstances confronted with difficulties in expanding markets and promoting exports, using countertrade as a vehicle whereby others must undertake to penetrate and create new markets may be a desirable strategy. Exports may be targeted into new markets or seek expanded market share through such devices as offset requirements, or long-term raw material supply via countertrade.

- **Effective management techniques in an increasing competitive environment:** In that countertrade has a follow-on impact, an element of additionality, business creation that would not have occurred in a purely cash transaction, then it becomes an effective marketing tool and management device to compete in an international environment. If one firm offers cash and another countertrade with a longer time commitment and “extra” opportunities in the same purchase, the latter may well be favoured over the former. Countertrade is good management in so far as it compels diversification, both in products, services and financial arrangements that would likely not exist in a cash sale environment.
- **Securing market expertise:** In effect, one is using another nation, company or countertrade broker as a marketing consultant and gaining marketing expertise and expansion in the process. This will work well only if the supplier country has its own personnel take advantage of the marketing training in conjunction with the host nation’s efforts. Otherwise, no expertise is gained and no net marketing capability accrues. Seeing countertrade as a vehicle to enhance one’s human capital is a critical requirement for it to work well.
- **Creative development strategies:** As has occurred with numerous countertrade and offset deals in countries as diverse as Belgium and South Korea, the national government may target the location of a particular joint venture plant to create development in a certain region, promote employment in a distressed area, encourage investment of a particular type, etc. the way in which this can be done requires some political and economic sophistication on the part of the country receiving the investment in plant and equipment as part of an overall internal development strategy.
- **Clearing out surplus goods:** Getting rid of an oversupply of a particular product or commodity is a business strategy which can be assisted through countertrade. Obviously, where the product may be inferior or non-competitive, as is often alleged in countertrade deals, this may be only delaying the

inevitable. Much of what is offered for countertrade is an inferior quality of goods in large supply. Avoiding this is necessary for both the buyer and the seller if the strategy is to be mutually advantageous in the long run.

- **Less costly sources of supply:** If one is engaged in consummating a long-term deal for commodities, one may get a fixed price over a set period of deliveries. This price may be high or it may be low, but there is at least the possibility of locking in a particular volume at a fixed price. This simplifies pricing in what may be a volatile market. It may or may not redound to the advantage of both parties. For instance, a depressed agricultural commodity or mineral resource may be overvalued in the near term and undervalued in the long. The length of one's planning horizons the time for amortizing the investment is critical.
- **Upgrading manufacturing capabilities:** It may be technology transfer, training or obtaining necessary machinery that is most important in boosting exports and earning foreign exchange. Modest deals and marginal assistance in manufacturing processes, machine tools, quality control, packing or transport may make a major difference in one's ability to compete in certain markets or product sectors. Expansion of existing plant and equipment in a given area may be possible because of a long-term or high-volume contract as part of a countertrade deal.
- **Guaranteeing raw materials or component supply:** Guaranteeing sources of scarce or expensive commodities and components are an important concern in an increasingly competitive international environment. Long-term arrangements for components can be made an effective part of countertrade deals.
- **Taking advantage of political or military, rather than economic, incentives:** The rationale for states to deal with each other may have nothing to do with short-term initial profitability or economic rationale. They may be politically inspired as desirable for a number of reasons in pursuit of some large-scale purpose, or for tangential access, influence or control of some kind. We frequently forget

that countertrade is as much politically inspired as economically necessary for many.

2.6 CONCLUSION

This chapter showed that countertrade is an umbrella term used to describe different types of reciprocal trade agreements. The six most common types of countertrade were shown to be: barter, counterpurchase, compensation/buy-back agreements, offsets, clearing account agreements, and switch trading. It was also shown that of the different types of countertrade used throughout the world, counterpurchase is being used the most followed by buy-back agreements. It was also shown that countries don't always have a choice in whether they want to use countertrade or not. Negative incentives like large debt and trade imbalances some times leave a country no choice other than to use countertrade if they want to trade internationally. On the other hand countries aren't always forced into using countertrade. Positive incentives such as expanding markets and securing market expertise make a country want to use countertrade when trading internationally.

The term developing nation was also defined in this chapter. In the next chapter it would be shown why South Africa is seen as a developing nation, and as South Africa is the focus of this study it is important to determine the role of developing nations in worldwide countertrade transactions.

CHAPTER 3

DEVELOPING COUNTRIES AND COUNTERTRADE

3.1 INTRODUCTION

In chapter two numerous reasons were given why enterprises and countries would want to make use of countertrade, for example large debt, expanding markets and export promotion, securing market expertise (Hammond, 1990:28-33), to mention but a few. This study however deals with countertrade in South Africa, and as a developing nation it is important to focus on the situation in the developing nations and why and to what extent they are using and are involved in countertrade.

South Africa can be classified as a developing nation according to Brink (1991: 100-101) who compared South Africa to the characteristics normally associated with developed and developing nations and found that South Africa compares most favourably with the characteristics of a developing nation. In the previous chapter Gamer's (1976: 8-9) definition of developing nations was mentioned and the entire African continent was listed as developing including South Africa.

According to Osmanczyk (1990:223) "developing countries are those in which large segments of the economy are still comparatively underdeveloped and the majority of the population very poor, although there are wide variations of gross national products (GNP) and per capita income".

3.2 THE PROBLEMS OF DEVELOPING NATIONS

According to Elderkin & Norquist (1987:32) the growth of countertrade is the result of three major trends at work since the Second World War:

- production overcapacity,
- international debt and
- the long-term impact of technology.

But the one that seems to have had the greatest impact on the growth of countertrade in Third World Nations is international debt.

The international debt of the Third World and especially that of Latin America is closely tied to the recent history of oil prices. Until 1973 low oil prices permitted the world economy to grow rapidly. But in 1973 the world experienced not only an oil embargo, but also a fourfold increase in the price of oil, which caused a recession in the West and an imbalance in the flow of oil payments.

In the years that followed the OPEC countries began receiving massive payments for their oil. Some countries used the money for public works projects and military hardware. But the money simply came in too fast. Not wishing to lose interest on the funds these nations deposited their money in Western banks, which then reused it to finance loans to the Third World. The banks looked upon Third World countries as an acceptable risk promising a high return.

Looking back, it is hard to believe that levelheaded bankers would have made many of these loans. At the time, however, the picture looked different. The growth rate of many Third World nations had been strong for a number of years, interest rates were high, and the loans were backed by "Sovereign" guarantees. Sovereign entities could not go broke, or so the bankers thought. If the growth rate of these countries had continued as projected and the money was used well, there would have been no debt crises. Net foreign exchange and the growth of the GNP would have been enough to offset the size of the debt in percentage terms. Furthermore, the projected increase in foreign exchange would have been enough to cover the interest and pay down the principle, thus avoiding a turnover of loans.

The Third World and Eastern bloc countries experienced a boom in economic growth in the mid-1970s. However, that growth was financed by borrowed funds. Meanwhile, in the Developed World the recession wore off, industry adjusted, and the entire economic system began to grow at an unprecedented rate.

In 1979 OPEC raised the price of oil by a factor of three, thus making the price of oil twelve times what it had been at the beginning of 1973. Even more money began to flow into OPEC coffers, money that OPEC nations again could not absorb. The money went back to Western banks, which in turn reinvested it in further loans to Third World countries. Only this time, the world never recovered from the oil price rise. Inflation in the Developed World was exacerbated by increased oil prices. When the economy of the Developed World slowed, demand for exports of Third World commodities slackened and prices plunged. Inflation forced up prices on many products and services, especially petroleum products. High inflation led to high interest rates, and high interest rates slowed the economy.

At the same time as oil prices rose, consumers conserved to a far greater extent than exporters had thought possible. Also, non-OPEC countries produced more oil. Thus, the rate of flow of dollars into OPEC accounts began to diminish. This reduced flow, coupled with the fact that OPEC countries were now spending more money on their own needs, slowed investment from these countries into Western banks. Suddenly the flow of new loan money into Third World countries was reduced to a trickle. At the same time, the recession in the developed world sharply decreased exports from the Third World. Increasing amounts of foreign exchange from Third World countries were needed to pay off oil imports. But Western banks no longer were willing to extend loans beyond rolling over outstanding debts. A number of Third World countries found themselves in dire straits. Growth rates had dropped to zero. In some instances growth rates even reversed themselves and descended into negative percentages. Against this backdrop, interest payments became so large that often there was no foreign exchange to import the goods and services needed to invest in industry and expand exports. Additionally, instability caused massive flights of capital and decreased internal investment.

In early 1986, the price of oil slid to below \$15 per barrel. If it remained in this area, countertrade for some countries like Brazil might decrease as cash formerly used for petroleum is freed for other items. However, countertrade by oil producing countries may well continue due to competition. The irony is that countries, such as Iran and

Nigeria that once required those who sold to them to take overpriced oil as payment, may now be asked by their customers to be paid in goods rather than cash.

Not all the crises are attributed to oil prices. Good portions of Third World countries' problems are of their own making. Investments and loans made to the Third World in the 1970s were in many cases not effectively used. Stories abound about billions of dollars in investment and foreign aid being squandered on luxury items or siphoned back to personal bank accounts in the Developed World by social and military elite. Mr. Marcos of the Philippines and Baby Doc Duvalier of Haiti are but the most recent examples of this kind of activity.

European and Japanese society emerged from the Second World War with the educational and organisational talents of its people fairly intact. Third World people, on the other hand, begin with handicaps. These are:

- lack the pre-existing industrial base,
- advanced education,
- disciplined work force,
- technological skill,
- cohesive culture, and
- work and business ethics that made rapid rebuilding in Western Europe and Japan a reality.

Cultural constraints and ideology, likewise, have restricted economic growth in many parts of the Third World. This is especially true in Latin America, an area strongly influenced by socialism, centrality of the state, and mercantilism. Given Latin America's resources, these nations should be amongst the richest on earth. Other Third World countries run by elitist governments obsessed with large industrialisation projects, state controls of enterprises and oligopolistic industries have fared similarly. In fact, for the most part, only in those countries where the ruling classes highly supportive of business-as in the Pacific Rim-have the prospects dramatically improved. This has put the Third World in the position of being susceptible to financial distress in hard

times and thus more likely to have to use countertrade (Elderkin & Norquist, 1987:33-36).

Hill (1997:310) supports this when writing, Third World economic growth was slowed and even stopped in the early 1980s by a combination of factors, including:

- Rising short-term interest rates worldwide (which increased the cost of debt).
- Poor microeconomic management in a number of Third World countries, in particular, inflationary growth policies.
- Poor use of funds borrowed by Third World governments (to finance consumption rather than investment).
- A slowdown in growth rate of the industrialised West, the main markets for Third World products.

The consequence was a Third World debt crisis of massive proportions. At one point it was calculated that commercial banks had over \$1 trillion of bad debt on their books, debt that the debtor nations had no hope of repaying. If any major country had defaulted at this time, the shock waves would have shaken the world financial system. Many feared that if this were to occur, the resulting bank failures in the advanced nations would turn the widespread recession of the 1980s into a deep depression.

Against this background, Mexico, long thought to be the most creditworthy of the major Third World debtor countries, announced in 1982 that it could no longer service its \$80 billion in international debt without an immediate new loan of \$3 billion. Brazil quickly followed, revealing it could not meet the required payments on its borrowed \$87 billion. Then Argentina and several dozen other countries of lesser credit standing followed suit. The international monetary system was facing a crisis of enormous dimensions.

Into the breach stepped the International Monetary Fund (IMF). Together with several Western governments particularly that of the United States, the IMF emerged as the key player in resolving the debt crises. The deal with Mexico involved three elements:

- Rescheduling of Mexico's old debt
- New loans to Mexico from the IMF, the World Bank, and commercial banks.

- The Mexican government's agreement to abide by a set of IMF-dictated macroeconomic prescriptions for its economy, including tight control over the growth of the money supply and major cuts in government spending.

Orchestrating this agreement required the IMF to persuade approximately 1600 commercial banks that had already lent money to Mexico to increase the amount of their loans by 8 percent. The IMF's success in pulling this off, first for Mexico and later for other debt ridden Third World countries was no small achievement. However the IMF's solution to the debt crisis contained a major weakness: It depended on the rapid resumption of growth in the debtor nations. If this occurred, their capacity to repay debt would grow faster than their debt itself, and the crisis would be resolved. By the mid 1980s, it was clear this was not going to happen. The IMF-imposed macroeconomic policies did bring the trade deficit and inflation rates of many debtor nations under control, but it was at the price of sharp contractions in their economic growth rate.

By 1989 it was obvious that the debt problem was not going to be solved merely by rescheduling debt. In April of that year, the IMF endorsed a new approach that had first been proposed by Nicholas Brady, the U.S. Treasury secretary. The Brady Plan as it became known, stated that debt reduction-as distinguished from debt rescheduling-was a necessary part of the solution and the IMF and World Bank would assume roles in financing it. The essence of the plan was that the IMF, the World Bank and the Japanese government would each contribute \$10 billion to the task of debt reduction. To gain access to these funds, a debtor nation would once again have to submit to a set of imposed conditions for macroeconomic policy management and debt repayment. The first application of the Brady plan was the Mexican debt reduction of 1989. The deal, which reduced Mexico's debt of \$107 billion by about \$15 billion, has been widely regarded as a success.

Thus when taking the debt crisis of most of the Third World countries into consideration with Hammonds (1990:28) view that given a lack of ready cash, countertrade becomes an increasingly attractive way of attempting to obtain imports without aggravating an

already bad situation. It seems that countertrade is a very attractive procurement tool for Third World Nations.

3.3 PROTECTING LOCAL ENTERPRISES

In a Developing Country, it is sometimes necessary for a government to regulate the economy to a certain extent. Whilst government regulatory policy should aim to achieve its goals in the international trade context and environment, it must also take into consideration:

- the support and development of local industry;
- the creation of employment; and
- other key issues of national priority such as the upliftment of previously disadvantaged sections of the community.

Therefore governments need to consider ways to protect local enterprises in the process of internationalisation. According to Bennett (1996:105-108) the following techniques for protection exist:

- **Imposition of restrictive tariffs.** The most common form of protection is the import tariff, namely a tax or customs duty imposed on goods crossing international frontiers. A tariff can be calculated as a specific amount of money per item imported or as a percentage of the value of the imported goods (ad valorem tariff). Tariff systems in general may be “single column” or “double column”. The former apply the same duty to imports of a particular product no matter where the goods come from, the latter allow for the imposition of different tariff rates on imports of the same item from different countries.
- **Quantitative restrictions.** Import quotas impose definite limits on the number or total value of a certain item imported into a country. A quota system may operate on a “first-come first-serve” basis whereby any goods arriving after the

quota limit is exceeded, are refused entry, or through the issue of licenses to certain companies and only allowing these businesses to import relevant products up to a specified amount.

- **Other non-tariff barriers.** These might include complex customs procedures and deliberate delays in processing documentation by customs officers, or customs authorities deliberately classifying products into inappropriate high-tariff categories so that the exporter has to initiate a time consuming and expansive appeal.

- **Other “hidden” barriers.** Other “hidden” barriers to the importation of goods can take any of the following forms:
 - insistence by the customs authorities that imported products undergo several safety checks, each one having to be conducted by an official from a different government department;
 - complex rules on packing and labelling;
 - restrictive specifications of technical product standards;
 - local content rules, namely requirements that in order to avoid import duties certain proportions of a product’s inputs have to be sourced locally rather than being imported; and
 - state subsidies to domestic companies to help them compete with imported products.

- **Exchange controls.** Exchange controls can also be used to restrict or discourage imports. Exchange control can be done in different ways:
 - allocation of foreign exchange to selected importing firms;
 - the issue of foreign exchange licenses;
 - imposing queues and waiting lists for foreign currency distribution.

- **Countertrade.** Countertrade is an alternative to the aforementioned methods and can be used to great effect by governments to develop “infant” industries

and to save domestic jobs. It was however already discussed in great depth in chapter two.

3.4 THE ROLE OF DEVELOPING NATIONS IN WORLD COUNTERTRADE

Using the research done by Fletcher (1998:519) it is possible to identify the Developing Nations role in international countertrade for the time period 1987 to 1996. Fletcher analysed the worldwide reported countertrade transactions between 1987 and 1996 (nine hundred and sixty-three (963) countertrade transactions from September 1987 to August 1990, one thousand one hundred and fifteen (1115) from September 1990 to August 1993, and five hundred and three (503) from September 1993 to August 1996).

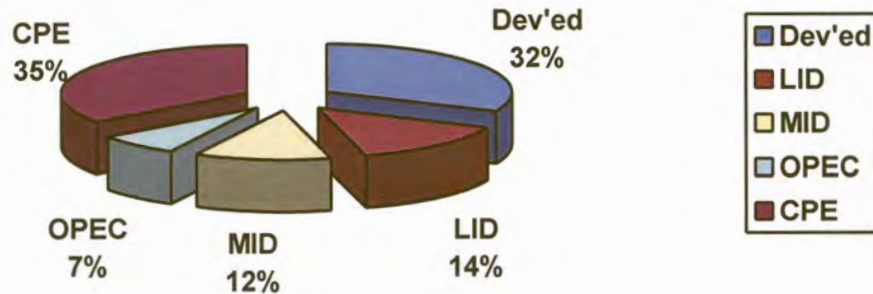
Table 3.1 and Figure 3.1 shows the regions in which the countries involved in countertrade between 1987 and 1996 are based - developed (Dev'ed); low-income developing countries (LID); middle-income developing countries (MID); Organisation of Petroleum-exporting Countries (OPEC); and formerly Centrally Planned Economies (CPE).

Table 3.1 Global Pattern of Countertrade Transactions

	1987-90	1990-93	1993-96	1987-96
	(n=1926)	(n=2264)	(n=1027)	(n=5217)
	(%)	(%)	(%)	(%)
Developed	32,9	29,8	33,0	31,6
LID	20,5	13,1	5,3	14,3
MID	10,5	12,0	13,5	11,8
OPEC	7,6	6,7	8,3	7,4
CPE	28,4	38,3	39,9	34,9
Total	100,0	100,0	100,0	100,0

Source: Fletcher, 1998:519

Figure 3.1 Global Pattern of Countertrade Transactions 1987-1996



Source: Fletcher, 1998:519

This gives us an indication of the amount of countertrade that the Developing Nations account for. With a combined total of 26,1 percent for all Developing Nations (both low income and middle income Developing Nations) of all the reported international countertrade transactions from 1987 to 1996.

Table 3.2 (Fletcher, 1998:522) shows the extent to which countries in one group countertrade with countries in another group.

Table 3.2 Comparison of Countertrade between groupings of countries

Table 3.2(a) Between Groupings of Countries 1987-1990

	Dev'ed	LID	MID	OPEC	CPE	Avg
	<i>n</i> =531	<i>n</i> =174	<i>n</i> =123	<i>n</i> =69	<i>n</i> =90	<i>n</i> =987
	(%)	(%)	(%)	(%)	(%)	(%)
Dev'ed	7,9	16,7	19,5	30,4	18,9	13,5
LID	15,1	26,4	23,6	31,9	48,9	22,4
MID	7,7	9,8	13,0	8,7	5,6	8,6
OPEC	4,9	13,2	14,6	—	15,6	8,2
CPE	64,4	33,9	29,3	29,0	11,1	47,3
Total	100,0	100,0	100,0	100,0	100,0	100,0

Source: Fletcher, 1998: 522

Table 3.2(a) indicates that out of their 174 reported countertrade transactions the LID countries had 16,7 percent of their transactions with developing countries, 26,4 percent with other LID countries, 9,8 with MID countries, 13,2 with OPEC countries and 33,9 with CPE countries for the period 1987-90. It seems that the bulk of the LID countries countertrade transactions between 1987 and 1990 was with the CPE countries.

The table also shows that the MID countries in the same period out of a total of 123 reported transactions had, 19,5 percent of their transactions with developed countries, 23,6 with LID countries, 13 percent with other MID countries, 14, 6 percent with OPEC countries and 29,3 percent with the CPE countries. Also in their case the majority of countertrade transactions were with the CPE countries.

Table 3.2(b) Between Groupings of Countries 1990-1993

	Dev'ed	LID	MID	OPEC	CPE	Avg
	<i>n</i> =582	<i>n</i> =112	<i>n</i> =177	<i>n</i> =63	<i>n</i> =181	<i>n</i> =1115
	(%)	(%)	(%)	(%)	(%)	(%)
Dev'ed	8,2	14,3	6,2	11,1	6,6	8,4
LID	14,4	22,3	18,1	20,6	17,1	16,6
MID	8,4	10,7	5,1	15,9	8,3	8,5
OPEC	5,7	8,9	12,1	6,3	10,5	7,9
CPE	65,3	43,8	58,5	46,0	57,5	58,6
Total	100,0	100,0	100,0	100,0	100,0	100,0

Source: Fletcher, 1998: 522

Table 3.2(b) shows the comparison of countertrade between groupings of countries between 1990 and 1993. In the table it can be seen that in this period the LID countries reported 112 countertrade transactions, of which 14,3 percent was with developed countries, 22,3 with other LID countries, 10, 7 percent with MID countries, 8,9 with OPEC countries and 43,8 percent with CPE countries. So for this time period as well, the majority of the LID countries countertrade transactions were with the CPE countries.

The MID countries had 177 reported countertrade transactions. Of these 6,2 percent was with developed countries, 18,1 percent was with LID countries, 5,1 percent with other MID countries, 12,1 percent with OPEC countries and 58,5 percent with CPE countries. So for the MID countries as well in this time period the majority of their countertrade transactions was with the CPE countries.

Table 3.2(c) Between Groupings of Countries 1993-1996

	Dev'ed	LID	MID	OPEC	CPE	Avg
	<i>n</i> =233	<i>n</i> =21	<i>n</i> =67	<i>n</i> =24	<i>n</i> =158	<i>n</i> =503
	(%)	(%)	(%)	(%)	(%)	(%)
Dev'ed	20,3	42,9	20,9	37,5	12,7	19,7
LID	6,0	4,8	10,4	8,3	4,4	6,2
MID	9,1	4,8	29,9	16,7	11,4	12,7
OPEC	14,3	19,0	3,0	—	13,3	11,9
CPE	50,3	28,6	35,8	37,5	58,2	49,3
Total	100,0	100,0	100,0	100,0	100,0	100,0

Source: Fletcher 1998: 522

Table 3.2(c) shows the comparison of countertrade between groupings of countries between 1993 and 1996. Here it can be seen that the amount of countertrade transactions have decreased from the previous two periods. The LID countries had only reported 21 transactions. Off these transactions 42,9 percent was with developed countries, 4,8 percent was with other LID countries, 4,8 percent was with MID countries, 19 percent was with OPEC countries and 28,6 percent was with CPE countries. Thus in this time period the LID countries had the most countertrade transactions with the developed countries.

The MID countries reported 67 countertrade transactions, which also show a decline from the previous two periods. Off these transactions 20,9 percent was with developed countries, 10,4 percent was with LID countries, 29,9 percent was with

other MID countries, 3 percent was with OPEC countries and 35,8 percent was with CPE countries. Again the majority of transactions were with the CPE countries.

Table 3.2(d) Between Groupings of Countries 1987-1996

	Dev'ed	LID	MID	OPEC	CPE	Avg
	<i>n</i> =1355	<i>n</i> =307	<i>n</i> =367	<i>n</i> =156	<i>n</i> =429	<i>n</i> =2614
	(%)	(%)	(%)	(%)	(%)	(%)
Dev'ed	10,1	17,6	13,4	23,7	11,4	12,5
LID	13,1	23,5	18,5	23,7	19,1	16,8
MID	8,2	9,8	12,3	12,8	8,9	9,4
OPEC	6,6	12,0	11,4	2,6	12,6	8,8
CPE	61,9	37,1	44,4	37,2	48,0	52,5
Total	100,0	100,0	100,0	100,0	100,0	100,0

Source: Fletcher, 1998: 522

Table 3.2(d) gives a summary of countertrade between groupings of countries between 1987 and 1996. In this table it can be seen that the LID countries had a total of 307 reported countertrade transactions in this time period. Off these 17,6 percent was with developed countries, 23,5 percent was with other LID countries, 9,8 percent was with MID countries, 12 percent was with OPEC countries, and the majority of transactions between 1987 and 1996 was with CPE countries with 37,1 percent of the transactions.

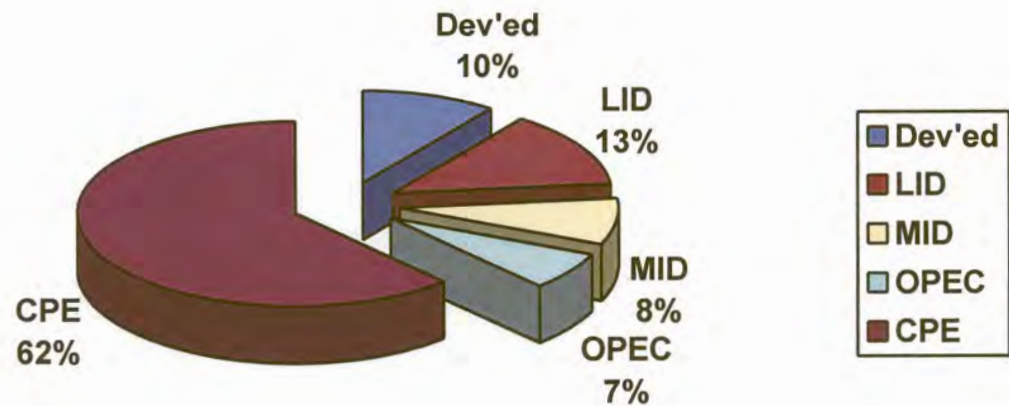
The MID countries reported a total of 367 countertrade transactions in this time period. Off which 13,4 percent was with developed countries, 18,5 percent was with LID countries, 12,3 percent was with other MID countries, 11,4 percent was with OPEC countries and the majority of transactions was with CPE countries.

Thus both the LID and the MID countries conducted the majority of their countertrade transactions between 1987 and 1996 with the CPE countries with the

exception of the 1993-96 period in which the LID countries traded more with the developed countries.

Figure 3.2: Comparison of countertrade between groups of countries 1987-96

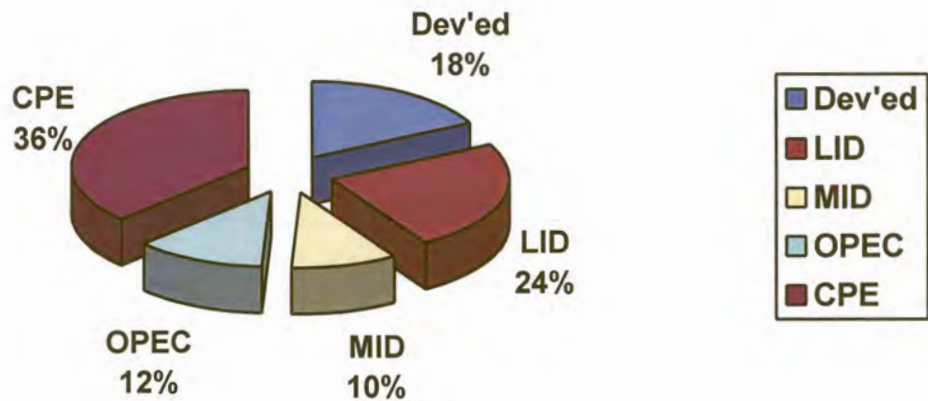
(a) Developed Nations



Source: Fletcher, 1998: 522

Figure 3.2(a) – (e) gives a representation of the findings in table 3.2(d). According to figure 3.2(a) the developed countries had the majority of their countertrade transactions with the CPE countries 62 percent while their trade with the LID accounted for 13 percent and with the MID only 8 percent.

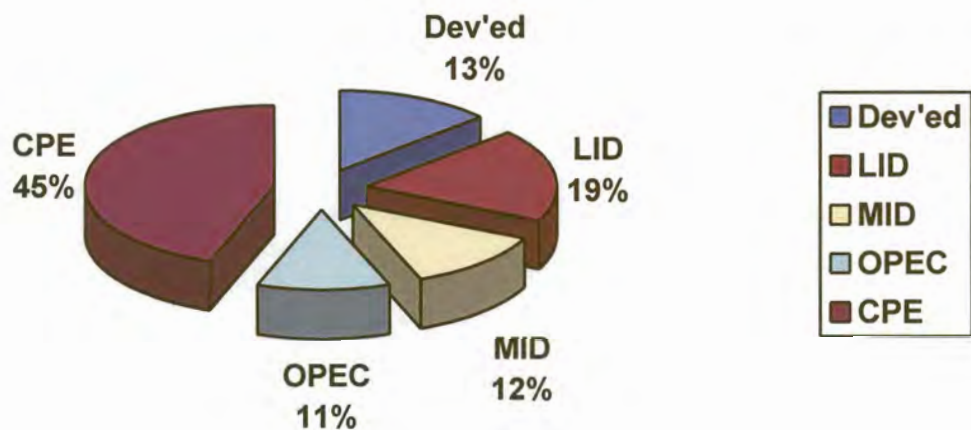
(b) LID



Source: Fletcher, 1998: 522

Figure 3.2(b) represents the earlier findings that indicated that the LID countries had the majority of their countertrade transactions with the CPE countries namely 36 percent and second most with other LID countries.

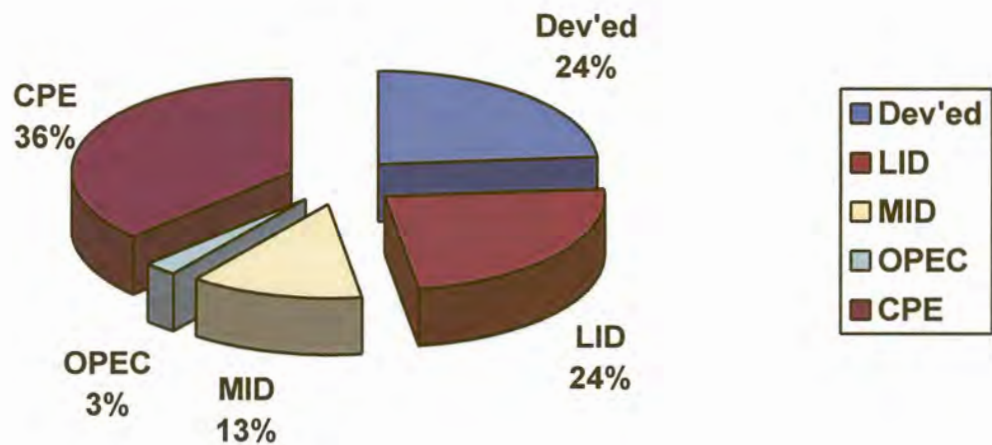
(c) MID



Source: Fletcher, 1998: 522

Figure 3.2(c) shows with the aid of an illustration that the MID countries conducted the majority of their countertrade transactions with the CPE countries namely 45 percent, just as the LID countries did, and that the second most transactions was with LID countries namely 19 percent.

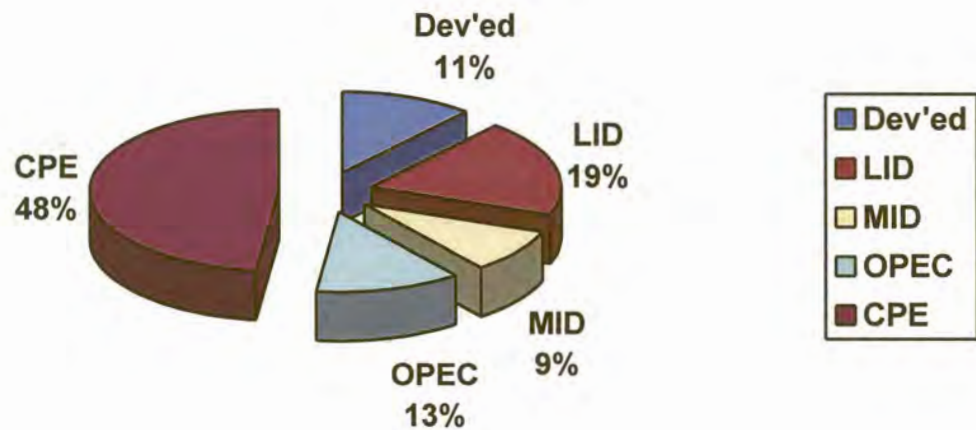
(d) OPEC



Source: Fletcher, 1998:522

In figure 3.2(d) the OPEC countries countertrade transactions are broken up into different groups indicating that they also had the majority of their countertrade transactions with the CPE countries namely 36 percent followed by the developed and LID countries in joint second place on 24 percent each.

(e) CPE



Source: Fletcher, 1998: 522

Figure 3.2(e) gives a graphic representation of the CPE countries countertrade transactions. In the figure it is clear that the CPE countries conducted the majority of their transactions with other CPE countries namely 48 percent while the transactions with the LID countries came in second with 19 percent. It seems from this information that the LID and MID countries do use countertrade extensively, but that the majority of countertrade is conducted by the CPE countries.

In conclusion Fletcher (1998:527) is of the opinion that the LID countries are more likely to use countertrade to:

- dispose of surplus, obsolete or perishable products;
- secure government contracts;
- gain entry into new or difficult markets;
- circumvent an overvalued or blocked currency.

Whereas the MID countries are more likely to use countertrade to:

- line up sources of supply;
- increase sales volumes;

- increase profit;
- generate goodwill for the firm/country.

3.5 CONCLUSION

Countertrade is used by Developing Nations throughout the world as can be seen in the reported cases of countertrade between 1987 and 1996. However it seems that the majority of countertrade with the Developing Nations has come from the former Centrally Planned Economy countries or former East bloc countries, as they are also known. The use of countertrade can be attributed to three major trends since the Second World War namely: production overcapacity, international debt and the long-term impact of technology. Especially the impact of international debt after the international oil crisis has led to the increased use of countertrade by developing countries. Developing countries make use of countertrade extensively as can be seen from the reported cases of countertrade between 1987 and 1996 where developing countries accounted for 26,1 percent of the reported 5217 cases of countertrade worldwide. It however seems that the amount of countertrade used has been declining in the last couple of years from 1993 to 1996. One of the reasons for this can be the implementation of the WTO's GPA, which came into effect on the 1st of January 1996. The object of the GPA is to subject government procurement to international competition by extending the General Agreement on Tariffs and Trade (GATT) principles of non-discrimination and transparency to the tendering procedure of government entities. It applies however only to WTO members who have signed the agreement (Hoekman & Mavroidis, 1997:13). This agreement as well as the influence of the WTO on countertrade will be discussed in the next chapter.

CHAPTER 4

THE REGULATORY ENVIRONMENT OF COUNTERTRADE

4.1 INTRODUCTION

Chapter three dealt with Developing Nations and their role in countertrade. It was mentioned that there are certain techniques that the Developing Nations can use in order to protect its local economy. These techniques are however being phased out by the World Trade Organisation (WTO) and are not as available to countries for economic protection. Established in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT), the WTO is an international organisation that is “writing the constitution of a single global economy”, according to the former WTO Director Renato Ruggiero. The WTO aims to increase global trade by reducing restrictions on cross-border commerce, such as tariffs (taxes on imports)(Alpert, 1999). One of the WTO agreements in particular was mentioned in the previous chapter as a possible reason for the declining use of countertrade in the last couple of years, namely the Agreement on Government Procurement (GPA). This chapter will deal with the WTO and the GPA and consider their influence on countertrade in particular.

4.2 THE HISTORY OF THE WORLD TRADE ORGANISATION

During the early 1930's, the world's leading trading nations were deep in recession. They reacted to the situation by introducing a series of highly protectionist measures. These measures, far from resolving the situation, merely served to undermine international trade.

Near the end of the Second World War, the United States and the United Kingdom, mindful of the negative consequence of uncontrolled trade protectionism, and seeking to

avoid the economic events of the 1930's, began to discuss plans for a post-war system of regulating world trade.

These bilateral discussions were broadened in 1946 when a Preparatory Committee was set up, under the auspices of the United Nations Economic and Social Council, to produce a draft constitution for the International Trade Organisation (ITO). The ITO was intended, in conjunction with the World Bank and the International Monetary Fund (IMF), to form part of a trio of multinational organisations pledged to furthering economic development. More specifically, it was intended to put into place rules designed to discipline world trade whilst, in addition implementing regulations relating to such diverse areas as employment, commodity agreements, restrictive business practices, international investment and services.

Whilst discussions about the ITO were taking place, a group of 23 participating countries began to negotiate a series of tariff concessions and certain free trade principles designed to prevent the introduction of restrictive measures amongst themselves. During a six-month period in 1947, significant tariff reduction negotiations were held which resulted in 45 000 binding tariff concessions from the participant countries affecting about \$10 billion in trade. Pending the establishment of the ITO, these binding tariff concessions and certain trade liberalisation principles became an integral part of the GATT signed in Geneva on October 1947 by these 23 countries.

GATT was not intended to be a fully independent legal body. Its function was to act as an interim measure to put into effect the commercial policy provisions of the ITO. However, although 53 countries finally signed the ITO Charter in March 1948, the decision of the US Congress to vote against its ratification left GATT as the sole (interim) framework for regulating and liberalising world trade.

The GATT mandate was to oversee international trade in goods and to gradually liberalise that trade by means of progressive reductions in tariff barriers. The furthering of trade liberalisation was to be achieved by negotiation "Rounds" held between various GATT contracting parties on a regular basis. The establishment of the WTO could bring

the need for GATT “Rounds” to an end. In the future, discussions about the liberalisation of trade will be ongoing, under the day-to-day direction of the General Council of the WTO. Major policy decisions will then be adopted at the Ministerial Conference - the top tier of the WTO structure - every two years. A new negotiations round may however be necessary if the broadening of the WTO to cover such areas as labour, standards, environment and competition is deemed desirable.

The setting-up of the WTO should, in time, permit a greater degree of liberalisation of trade than under the GATT “Round” system of negotiations and with less of the accompanying trauma. The General Councils and Committees will be permanently engaged in monitoring and rendering effective the Uruguay Round Trade Agreements. As part of their function, they will discuss ways of further improving world trade. Although the General Council cannot itself take major policy decisions, it can discuss and instigate discussion about them. The advantage of this continuous negotiating forum is that by the time the Ministerial Conference take place (every two years), many ideas for liberalising trade will already have been thoroughly debated and a consensus agreed. These strengthened WTO structures will make it easier for final decisions to be made at the Ministerial Conference itself. It was precisely this lack of advance planning and consensus that caused the later GATT rounds to become increasingly tied down and contentious (Adamantopoulos, 1997:1-4).

Not everyone is however completely satisfied with what the WTO is doing. The Economist (2000:91) writes that diversity is generally a good thing, not least in international trade. It is precisely because countries are different that free trade makes all of them richer, since each benefit from what others do better. So it is odd that, in one important respect, the WTO is trying to make its member countries more alike. It enforces minimum intellectual property standards, not only in rich countries, but also, since 1st January 2000, in many developing ones. If Thailand, say, fails to stamp out counterfeit Louis Vuitton handbags and pirated Viagra, France and the United States can seek WTO approval to retaliate by imposing trade sanctions. This sets an unfortunate precedent. After all, outlawing products made in ways that are copyrighted by others is not very different from banning goods made by children or shrimp caught in

ways that harm endangered sea turtles. So if intellectual-property standards are applied, why should the WTO not also enforce minimum labour and environmental standards too?

So it seems that the WTO is not without controversy, according to Alpert (1999) in general, the WTO has adopted rules, which are in the interest of trans-national businesses and rejected rules opposed by business. Representatives of “civil society”, such as unions, consumer activists, environmentalists, indigenous people, and women’s groups, have protested WTO policies. In Mexico, where a currency crisis threw the nation into depression shortly after implementation of NAFTA, small business owners were in the streets too, opposing “free trade”. Poor countries of the global south, which disagree with northern unions over labour protection, agree the WTO is not working in the interest of most people. Since the 1996 Singapore summit, which concluded the “Uruguay Round” of negotiations, the WTO has ruled against provisions of the US Clean Air Act, which would have blocked the use of dirty imported gasoline. The WTO ruled against European laws, which banned the sale of beef raised (in the US) with artificial growth hormones. Laws that ban the import of products made by child labour could be ruled illegal as well.

Bradley (2000:11) adds to this when he writes that the 135-member WTO is intended to ensure that member nations trade with one another fairly, and its rules are supposedly designed for that purpose. But fairness, like beauty is in the eye of the beholder. Many opponents of the organisation believe the rules are skewed in favour of big business and against workers and environmental protection. Conservative critics contend that the WTO infringes on national sovereignty, and unions argue that the rules make it easy for businesses to export good jobs.

4.3 THE WTO AND COUNTERTRADE

Multilateral trade - trade between more than two parties -, which is enforced by the WTO, is crucial for the enhancement of international trade. It seems, therefore, that to

continue with lucrative international trade, the international trading community has no option other than to uphold the multilateral trading system. The crucial question that now has to be examined is whether or not countertrade agreements which is normally a form of bilateral trade, or trade between two parties, undermine the multilateral trading system?

At the outset it should be mentioned that countertrade agreements are, in principle acceptable in terms of GATT rules, provided that such agreements are not entered into on a discriminatory basis for non-economic reasons and in response to governmental policies and programmes. The conclusion of international countertrade agreements could, under particular circumstances, have disruptive and detrimental effects on international trade (Coetzer, 1995:384-386). In the next section the acceptability of countertrade will be examined against the Articles of the General Agreement on Tariffs and Trade.

4.3.1 The Most-Favoured Nation treatment

This rule is what is called the Most-Favoured-Nation clause or MFN clause, which is Article I of the Agreement. The term Most-Favoured-Nation (MFN) means that all GATT Members are bound to grant each other MFN treatment. The result is that no country could grant privileged trading advantages to another Member or discriminate against another such party. In practice this means that should country A, for example, cut its import tariffs on electrical appliances manufactured in country B by 10%, the resultant tariff will apply to the like electrical manufactured goods of all other Members. Thus, as far as tariffs are concerned, the general rule regarding MFN treatment means that the same tariff rate is charged with respect to a given product, notwithstanding the country of origin of the product.

When the language of Article I is examined closely, it is evident that nothing prevents a government from imposing any conditions falling within the provisions of Article 1 to the conclusion of international countertrade agreements. What is important, however, is

that such conditions should be applied equally to all other Members, making them all subject to the same conditions. This could be illustrated in the following way.

Assume, for instance, that country X is a developing country with extensive tin reserves and that it purchases large amounts of grain from country Y. Country Y, on the other hand, is a developed Western country with a vast amount of marketing technology. As a condition for purchasing grain from country Y, country X requires that country Y must market some of its tin. Country A also sells grain to country X, but because country A has no marketing technology, country X does not require that country A should market any of country X's tin. The countertrade requirement imposed by country X against country Y is discriminatory, as it does not apply to country A as well. This conduct by country X constitutes preferential treatment of country A.

It is also quite possible, for example, for a government in regard to a particular countertrade agreement, to allow the entry into its territory of the countertraded goods concerned at a lower customs tariff than would have been the case under the conventional trade agreement. Should other Members be allowed to export like products into that country at the reduced customs tariff there would be no contravention of the provisions of Article I. However where the lower tariff only apply in regards to that specific countertrade agreement, in other words, where such tariffs are discriminatory against the other Members, such action would technically be in contravention of the GATT (Coetzer, 1995:386-388).

4.3.2 Tariff protection

Article II of the General Agreement pertains to the Schedules of Tariff concessions annexed to the General Agreement which set out the tariff concessions each of the Members make with respect to the products imported into their territories. The Schedule of Concessions comprises a Part I and Part II. Part I contains those concessions made with respect to the commerce of other Members who do not receive any preferential treatment. Part II contains the concessions made to countries eligible for preferential treatment, such as Developing Countries under the Enabling Clause. These concessions

are the result of tariff negotiations in terms of Article XXVIII or renegotiations under Article XXVIII.

Paragraph 1 of Article II, which contains the crux of the Article, stipulate that:

- each Member shall accord to the commerce of all other Member treatment not less favourable than that which has been set out in the said Schedule of Concessions;
- the product imported into the territory of a Member shall “...subject to the terms, conditions or qualifications set forth” in Part I of the Schedule of Concessions of the importing country, be exempted from ordinary customs duties in excess of that stipulated in the said Part I; and
- the products imported into the territory of a Member and originating in a country that qualifies for preferential treatment, shall likewise “...subject to the terms, conditions or qualifications set forth” in Part II of the Schedule of Concessions of the importing country, be exempted from ordinary customs duties in excess of that stipulated in the said Part II.

Paragraph 1 further stipulates in subparagraph (b) and (c) that the products involved are also exempt from any “other duties and charges” pertaining to importation, in excess of those duties and charges imposed on the date of the General Agreement, “...or those directly and mandatory required to be imposed thereafter by legislation in force in the importing territory on that date”.

The above stipulation entail that a Member is prohibited from affording protection to a particular domestic product other than the tariff which it had negotiated in regard to that product and which is contained in the Tariff Schedule of that Member.

Should a country therefore, provide protection to its domestic industries by the imposition of countertrade requirements, such measures would be inconsistent with the principle contained in paragraph 1 of Article II. On the other hand, should the country concerned include the relevant countertrade requirements as a condition in its GATT Schedule, such action would be acceptable. The apparent reason is that it would have

been negotiated on a multilateral basis. This situation is now influenced by the provisions of the GPA that will be dealt with later (Coetzer, 1995:389-391).

4.3.3 The general elimination of quantitative restrictions

The general elimination of quantitative restrictions is dealt with in Article XI of the General Agreement on Tariffs and Trade. A quantitative restriction refers to a limitation placed on the amount of products that are permitted to be imported into the country that imposes the quantitative restriction. Quotas are, therefore, the primary target of Article XI. This Article accordingly prohibits the imposition of such restrictions on imports as well as on exports, irrespective of the fact that these restrictions are made effective through quotas; imports licences or export licences or what is called “other measures”. The prohibition does not, however, pertain to taxes and what is called “Other charges”.

From the above it is clear that Article XI deals with restrictions other than tariffs. At this point it would be appropriate to make a distinction the practical effects of quantitative restrictions and that of tariffs. In the case of the latter, international trade could continue irrespective of the rate of tariffs concerned, while in the case of quotas trade in the product involved, could come to a standstill.

A mandated countertrade requirement could thus prevent a particular enterprise from exporting to another country unless that enterprise accepts the said countertrade requirement. Moreover, as was pointed out above, such a requirement is in effect no different from a conventional import quota and when it is adjusted to particular circumstances, it could limit imports, for example, a particular amount of hard currency export. Say, for instance, that a country has imposed an import quota on the importation of a particular product and thereafter adjusts the quota in order to bring it into line with its level of exports, that quota would then contravene the provisions of Article XI. Accordingly, when the conclusion of countertrade agreements under mandated countertrade requirements have similar effects on private enterprises as quotas, such requirements is in violation of Article XI. Hence, governmentally mandate countertrade is nothing other than a trade restriction. It should, therefore, be said that whether a quota

as mentioned above has been adjusted or not, is irrelevant, as any import quota is, in principle, contra the provisions of Article XI. To illustrate the point further, when government imposes a countertrade requirement, such a requirement inevitably has a detrimental effect upon international competition as prospective purchasers are forced to choose between a transaction based upon normal market factors and a transaction based upon the willingness of a seller to accept the mandated countertrade terms.

As far as the reference to import licensing in paragraph 1 of Article XI is concerned, it is quite clear from the wording of the paragraph that should the granting of an import license be conditional upon exports, for instance, by way of the conclusion of a countertrade agreement, such practice would be a restriction within the meaning of Article XI: 1 (Coetzer, 1995: 396 – 397).

These are however just some of the General Agreement on Trade and Tariff's Articles that the use of countertrade could be in contravention with. The other Articles that the use of countertrade could be in contravention of are (Coetzer, 1995: 392 – 407):

- Article III National treatment of internal taxation and regulation
- Article XIII Non-discriminatory administration of quantitative restrictions
- Article XV Exchange arrangements
- Article XVI Subsidies
- Article XVII State trading enterprises

It should be kept in mind that the rules of the General Agreement regulate the behaviour of governments and not that of private individuals or of private business enterprises. Consequently, should a private enterprise, for example, decide to import on a discriminatory basis, or, on the other hand, to impose one or other discriminatory condition to its international trade, such an action would fall outside the ambit of the provisions of the General Agreement (Coetzer, 1995: 408).

So GATT deals only with governments and their involvement in international trade and as was said previously, this research deals with countertrade or more specifically governmental countertrade. The involvement of governments in international

countertrade agreements can take a variety of forms in that governments can impose countertrade requirements either directly or indirectly. Governments can, for example, be on the lookout for countertrade opportunities in order to impose countertrade requirements for purposes of improving trade balances (Coetzer, 1995: 386). But according to Evans *et al* (1994: 61) government procurement policies were explicitly excluded from GATT jurisdiction by Article III (national treatment) provisions of the original treaty. The State Trading article contains a little on the control of government policy, but otherwise government favouritism in procurement was not constrained by the original GATT. Dodds (1995: 8) adds to this when writing that the GATT allows favouritism of local industries in government procurement by explicitly exempting government procurement contracts from the core GATT obligation of non-discrimination against imported goods.

We can thus see that even though the WTO and GATT is apposed to the use of countertrade as it is a technique to protect local enterprises restrictive to international trade, government procurement, and thus governmental use of countertrade is excluded from the GATT. The WTO is however attempting to fill this gap with the GPA and through the GPA is trying to limit tie use of countertrade.

4.4 THE AGREEMENT ON GOVERNMENT PROCUREMENT

The GPA - originally negotiated during the Tokyo Round - was renegotiated for the second time during the Uruguay Round (1986-94). The revised GPA, signed in Marrakech on 15 April 1994, entered into force on 1 January 1996. It is one of the WTO's so-called Annex IV or Plurilateral Agreements, signifying that it applies only to WTO Members that have signed it (Hoekman *et al*, 1997:13).

Evans *et al* (1994:60-61) adds to this when writing the plurilateral agreements contained within the GATT are separated from the rest of the agreements negotiated under the auspices of the GATT, yet are part of the overall results of the Uruguay Round. These agreements are unique because they operate under the principle of "conditional MFN",

rather than the principle of unconditional MFN in the rest of the GATT. This difference is essential to the operation of the agreement. Conditional MFN allows the negotiating parties to plurilateral agreements to operate separate “clubs” within the GATT. Under previous rounds no country could discriminate between other countries regarding access to its markets. Under the plurilateral codes a country is allowed to limit access to its markets to those countries, which have signed up to the code in question.

The objective of the GPA is to subject government procurement to international competition by extending the GATT principles of non-discrimination and transparency to the tendering procedure of government entities. The GPA only applies to those entities listed in schedules (Annexes) of each signatory nation. Over time, the entity coverage has been expanded through periodic negotiations, which are explicitly called for in Article IX: 6(b) of the Agreement.

These negotiations were relatively successful in expanding the reach of multilateral disciplines. The GPA initially exempted purchases of scheduled entities with a value of Special Drawing Rights (SDR) 150,000. According to Dodds (1995:10) SDRs are a basket of currencies used as an international unit of account. This threshold value was lowered to SDR 130,000 in 1988. At this time the Agreement was also extended to cover rental and leasing contracts, the time allowed for bid submissions was increased, and publication of information on winning bids became required. During the Uruguay Round the GPA was extended further to cover non-central government entities and the procurement of services, including construction. The enforcement provisions of the Agreement were also substantially strengthened. Despite these advances, membership of the GPA has largely remained limited to high-income countries (Hoekman *et al*, 1997:13).

4.4.1 Basic elements of the agreement

The objectives of the GPA are to contribute to greater liberalisation and expansion of world trade; eliminate discrimination among foreign products, services or supplies; and enhance the transparency of relevant laws and practices. The Agreement applies to any

law, regulation, procedure, or practice regarding any procurement by entities listed in Appendix 1 of the Agreement. Procurement covers all contractual options, including purchase, leasing, rental and hire purchase, with or without the option to buy. A so-called positive list determines the reach of the GPA; it applies only to entities that are listed in Appendix 1 of the Agreement. The Appendix contains five Annexes of each signatory. There are three entity Annexes: Annex 1 lists covered central government entities; Annex 2 lists sub-central government entities; and Annex 3 lists all other entities that procure in accordance with the provisions of the Agreement. Annex 3 is a catchall category that includes entities such as utilities. The term entity is nowhere defined, reflecting the absence of consensus on what constitutes a public undertaking or entity. The entities that are listed in the three Annexes are subject to the rules and disciplines of the GPA with respect to their procurement of goods and services if:

- the value of the procurement exceeds certain specified thresholds; and
- the goods or services being purchased are not exempted from the coverage of the Agreement.

Annex 4 lists covered services, and Annex 5 covered construction services. The GPA covers only services expressly indicated by the signatory. Table 4.1 sets out the various thresholds that apply to the procurement of goods and services for the three types of entities.

Table 4.1 presented on the next page

Table 4.1: Thresholds in Annexes 1, 2 and 3 of the GPA (SDR thousands)

Category	Canada	EU-15	Israel	Japan	Korea	Norway	Switzerland	US
Annex 1								
Goods	130	130	130	130	130	130	130	130
Services	130	130	130	130	130	130	130	130
Construction	5000	5000	8500	4500	5000	5000	5000	5000
Annex 2								
Goods	355	200	250	200	200	200	200	355
Services	355	200	250	200	200	200	200	355
Construction	5000	5000	8500	15000	15000	5000	5000	5000
Annex 3								
Goods	355	400	355	130	450	400	400	400
Services	355	400	355	130	450	400	400	400
Construction	5000	5000	8500	15000	15000	5000	5000	5000

Source: Hoekman *et al*, 1997: 15

As mentioned previously Annex 1 consists of central government entities; Annex 2 sub-central government entities; Annex 3 all other entities which are scheduled by Parties. In general Annex 3 comprises public enterprises or public authorities or public enterprises, including utilities.

There is some variance between signatories. For central government entities there is a common minimum threshold of SDR 130,000 for purchase of goods and non-construction services. Thresholds can be as high as SDR 15 million for construction services procured by non-central government entities. The product coverage of the Agreement is also determined by the Annexes. As far as goods are concerned, in principle all procurement is covered unless specified otherwise in an Annex. Thus, a negative list approach is used to determine the coverage of the GPA for procurement of non-defence related goods by scheduled entities. The procurement of goods by defence

Ministries or similar entities is often subject to a positive list: only items explicitly scheduled are covered. Procurement of services is also subject to a positive list: only the procurement by covered entities of services explicitly scheduled in Annexes 4 and 5 are subject to the GPA's rules, and then only insofar as no qualifications or limitations are maintained in the relevant Annexes.

Many parties have made explicit derogations to the commitments that are contained in their Annexes. These can be divided into two types. The first consists of a derogation from the non-discrimination requirement. Most signatories have made these. They generally specify that Party X will not apply the non-discrimination rule to the procurement by entities listed in Annex Y to firms originating in Party R, S or T until such time as X has accepted that the Parties concerned give comparable and effective access for X's undertakings to the relevant markets. This reflects a desire to achieve reciprocity on either a product and/or an entity basis. The second type of derogation pertains to commitments on services (Annexes 4 and 5) and specifies that listed services are covered only to the extent that other Parties to the GPA provide reciprocal access to their services. Canada, Finland, Korea, Switzerland and the United States have made such derogations. The mix of positive and negative list approaches for entities, products and services, varying thresholds, and the use of exceptions and derogations make it difficult to determine the effective scope of the GPA (Hoekman *et al*, 1997:14-16).

4.4.2 Non-discrimination

The two basic principles governing the GPA are MFN and national treatment (Article III). The former prohibits discrimination between foreign products; the latter prohibits discrimination between foreign and domestic suppliers. The non-discrimination obligation applies irrespective of the customs treatment of the product or services that affect the procurement contract. That is, they "shall not apply to customs duties and charges of any kind imposed on or in connection with importation, the method of levying such duties and charges, other import regulations and formalities, and measures affecting trade in services other than laws, regulations, procedures and practices regarding government procurement covered by this Agreement (Article III: 3).

Article III: 2 require Parties to ensure that covered entities do not discriminate between locally established suppliers “on the basis of degree of foreign affiliation or ownership” or “on the basis of the country of production of the goods or services being supplied”. This provision was introduced during the Uruguay Round renegotiation of the GPA. The Tokyo Round Agreement spoke only of traded goods, i.e. products originating within the customs territory (including free trade zones) of Parties. Under the 1996 GPA, the words “originating within...” were deleted from Article III: 1. Non-discrimination therefore applies to both trade and sale through establishment (Hoekman *et al*, 1997:16-17).

Another description of the term National Treatment comes from Coetzer (1995:363-364): The Members of GATT have agreed that internal taxes, other internal charges, laws, regulations and requirements which could have an effect on the “...sale, offering for sale, purchase, transportation, distribution or use of products” in a domestic market, should not be applicable to products that are imported or to products that are produced locally, so as to afford protection to products domestically. The Members have also agreed that the same principle applies to the use of quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions in such markets. The implication of this is that it would be in order should internal taxes be increased on imported products, provided that the tax on the domestic product is also increased to the extent that the relevant tax would be the same for the imported as well as for the domestic product.

4.4.3 Tendering procedures

Three methods of tendering may be used by covered entities (Article VII and XIV): open, selective, and limited. All three may be complemented by competitive negotiations. Open or selective tendering are the preferred methods. Under open tendering procedures any interested supplier may submit a bid in response to a call for tenders. Selective tendering procedures involve a pre-selection of potential suppliers. This pre-qualification is usually intended to speed up the tendering process by determining a set of suppliers that satisfy the technical criteria required by the procuring

entity. Entities that desire to have recourse to selective procedures are required to maintain lists of qualified suppliers. Signatories must publish such lists at least once a year in an agreed publication, specifying their validity and the conditions that need to be satisfied for inclusion of suppliers, including the methods used to verify that requirements are met (Article IX: 9). All suppliers that are qualified must be given the opportunity to bid.

Under limited tendering (previously known as single tendering), an entity contracts specific suppliers individually. This method is only permitted if there was no response to a call for tenders, in cases of urgency, for additional deliveries by an original supplier, or in case of additional construction services not intended to be included within the original contract. Limited tendering procedures may not be used “with a view of avoiding maximum possible competition or in a manner which would constitute a means of discriminating among suppliers of other Parties or protection to domestic producers or suppliers” (Article XV).

Negotiations may be used to complement the tendering process if entities have indicated their intent to do so in the call for tenders, or when it appears from the evaluation that no tender is obviously the most advantageous in terms of the specific evaluation criteria set forth in the notices or tender documentation. Elimination of participants in this context should be carried out in accordance with the criteria set forth in the tender document. In case of modification of the criteria, all remaining participants must be accorded an opportunity to submit new offers.

The GPA pays particular attention to fostering transparency. Article IX requires each entity to publish an invitation to participate for all intended procurement of goods and services covered by the GPA, except in the case of limited tendering. Summaries of procurement notices must be issued in one of the WTO’s official languages (English, French or Spanish). Notice of planned or proposed procurement must include information on a minimum set of variables to ensure transparency, including the mode of procurement, its nature and quality, date of delivery, economic and technical

requirements, amount and term of payment, etc. In publication of notices (call for tender), entities must specify that the procurement is covered by the GPA.

Article VI (Technical Specifications) require that specifications do not create “unnecessary” obstacles to international trade, “where appropriate” be expressed in terms of performance rather than design or descriptive characteristics and be based on international standards if these exist. The choice of specifications is entirely the responsibility of the procuring entity. The only limit to their discretion is the obligation not to create “unnecessary” obstacles to international trade (Article VI: 1). The question whether the choice of specifications is necessary or appropriate in order to achieve the desired outcome appears to escape judicial review, unless the obligation imposed by Article VI: 1 is interpreted in a wide manner. Similarly, the “appropriateness” test for the use of performance-based and international standards is a potential loophole.

For tenders to be considered for award, they must comply at the time of the opening with the notice and conditions of participation (Article XIII). Entities are legally obliged to award contracts to the tenderer who “has been determined to be fully capable of undertaking the contract” and who is:

- either the lowest tenderer; or
- the tender which in terms of the specific evaluation criteria set forth in the notice or tender document is determined to be the most advantageous (Article XIII: 4b).

Although determination of the lowest tender is clear-cut, procuring entities have substantial discretion in judging the capacity of the tenderer to fulfil the contract and determining who best meets the evaluation criteria. The main constraint on such discretion is what is specified in the notice or tender document. It would violate the Agreement were an entity to consider a tender as the most advantageous on the basis of evaluation criteria that were not specified in the notice tender documentation.

The foregoing requirements do not need to be followed if the procuring entity decides it is in the public interest not to issue the contract (Article XIII: 4B). This is potentially an

important loophole in the GPA since the public interest is nowhere defined. The public interest clause could allow industrial policy considerations to be pursued by simply delaying contracts or reformulating them to better suit domestic bidders. The public interest provision has never been interpreted in the GATT case law. In part this may reflect the fact that entities have absolute discretion to formulate notices with respect to technical specifications within the limits of Article VI.

In contrast to other WTO Agreements (e.g. on subsidies), there is no obligation in the GPA to motivate (provide a reasoned explanation for) decisions to award contracts. Two provisions address this issue in substantially different ways. Article XVIII: 2 states that: “Each entity shall, on request from a supplier of a Party, promptly provide: pertinent information concerning the reason why the supplier’s application to qualify was rejected, why its existing qualification was brought to an end and why it was not selected; and to an unsuccessful tenderer, pertinent information concerning the reasons why its tender was not selected and on the characteristics and relative advantages of the tender selected as well as the name of the winning tenderer”. Article XIX: 2 provides that: “The government of a Party to this Agreement may seek, without prejudice to the provisions under Article XXII, such additional information on the contract award as may be necessary to ensure that the procurement was made fairly and impartially. To this end, the procuring government shall provide information on both the characteristics and relative advantages of the winning tender and the contract price. Normally the government of the unsuccessful tenderer may disclose this latter information provided it exercises this right with discretion. In cases where release of this information would prejudice competition in future tenders, this information shall not be disclosed except after consultation with and agreement of the party which gave the information to the government of the unsuccessful tenderer.

The need to motivate decisions therefore becomes operative only upon the request of unsuccessful tenderers or the intervention of the government to this effect. As the publication of the award of contracts required under the GPA merely has to identify the successful tenderer (without any motivation), justification only needs to be elaborated *ex post facto* following a formal request to this effect. This approach is at odds with

other WTO Agreements (e.g. on subsidies and antidumping) and related case law, which require motivation of decision (Hoekman *et al*, 1997: 17-19).

4.4.4 Accession

Article XXIV: 2 GPA states that “ Any government which is a Member of the WTO but which is not a Party to this Agreement may accede to this Agreement on terms to be agreed between that government and the Parties”. Accession to the GPA therefore involves a negotiation between the interested government and existing members on the list of entities and services that will be scheduled. A Working Party to facilitate accession negotiations can be created upon request by the applicant country or by an existing member.

Article V GPA contains special provisions on special and differential treatment for Developing Countries, requiring that development objectives be taken into account during accession negotiations. Both during and after acceding to the GPA, Developing Countries may negotiate mutually acceptable exclusions from the rules on national treatment with respect to the entities, products or services that they schedule. Although Article V allows for deviation from the national treatment principle, the MFN rule is absolute. Developing Countries may also continue to use offsets as long as this is negotiated at the time of accession. Offsets may only be used as a criterion for qualification to participate in the procurement process and not as a criterion for the award of contracts Hoekman *et al*, (1997: 20).

4.4.5 Enforcement

There are various ways through which entities could avoid GPA obligations. Classic tactics in this regard include splitting of contracts to fall below the threshold value, abuse of technical specifications, short deadlines for submission of tenders, non-publication of calls for tenders, and the use of single or limited tendering. A number of these issues have been addressed in periodic re-negotiations of the Agreement. Thus, in 1996 GPA attempts to reduce the scope for circumventing by imposing deadlines,

prohibiting splitting (Article II: 3), and establishing detailed rules on the content of tender documentation and award of contracts. It also embodies a requirement to establish effective bid protest mechanisms to give greater bite to such rules. The introduction of a challenge procedure (Article XX) is arguably the most innovative aspect of the GPA. The nature of procurement is such that most of the time, unless rapid action can be taken, inconsistencies with the Agreement will de facto be tolerated because firms will not have an interest in bringing cases to the WTO dispute settlement body. Even if they do, they risk confronting a situation where less than effective remedies are recommended. The creation of a bid-protest mechanism had long been on the agenda of some GPA members.

According to Article XX: 7, challenge procedure must provide for:

- Rapid interim measures to correct breaches of the agreement and to preserve commercial opportunities. Such action may result in suspension of the procurement process. However, procedures may provide that overriding adverse consequences for the interests concerned, including the public interest may be taken into account in deciding whether such measures should be applied. In such circumstances, just cause for not acting shall be provided in writing.
- An assessment and a possibility for a decision on the justification of the challenge.
- Correction of the breach of the Agreement or compensation for the loss or damage suffered, which may be limited to costs for tender preparation or protest.

These provisions are note worthy in allowing private parties to invoke WTO law before domestic adjudication bodies (Hoekman *et al*, 1997:17-20).

4.4.6 Limitations

Dodds (1995:10) identified the following limitations to the Agreement:

- Although the Agreement strictly forbids offsets, it does not apply to all government contracts by parties. Only those government entities listed in a member's annex that the member has agreed to make subject to the Agreement

are covered. During the negotiations over the new Agreement, parties attempted to expand the coverage of the Agreement as far as possible. Some significant areas of government procurement however, remain uncovered. For example, because of the inability of the United States and the European Union to reach an agreement on the procurement of telecommunications equipment, this area is not covered by the Agreement and members have omitted the relevant procuring entities from their annexes.

- In other areas such as services and sub-central government procurement, the parties were able to negotiate coverage, but only on the basis of strict reciprocity. Departing from MFN treatment, parties did not extend equally favourable treatment to all other members. When they found that the offers of other parties were not as complete as their own, they reduced their offers accordingly, on a one-to-one basis.
- Another limit to the Agreement's coverage is that only those contracts above a minimum monetary value or threshold are subject to the Agreement. Thresholds vary slightly from country to country and range from approximately \$85 000, or 130 000 SDR for central government suppliers to roughly \$3 263 000 (5 000 000 SDRs) for construction services.
- The Agreement also provides some additional leeway for developing countries. Article V of the Agreement permits Developing Countries to negotiate "mutually acceptable exclusions from the rules on national treatment". Article XVI includes a narrow exception for offset use, allowing Developing Countries at the time of accession to the Agreement to negotiate conditions for the limited use of offsets. Offset requirements allowed under the exception may only be used for qualification to participate in the procurement process and not as criteria for awarding contracts. If China for example accede to the GATT/WTO as a Developing Country and, upon signing the Agreement, successfully negotiates conditions for the use of offsets, foreign suppliers could see only partial relief from offsets.

4.4.7 Concluding remarks on the GPA

Special provision has been made in Article XVI of this Agreement for countertrade transactions under the header “Offsets”. The fact that this term is used to denote countertrade reiterates the confusion pointed out previously regarding the use of countertrade terms. In chapter two dealing with the different types of countertrade agreements it was shown that the term offset is not a generic term, but it actually refers to a specific type of countertrade agreement namely, an Offset Agreement (Coetzer, 1995: 409).

4.5 CONCLUSION

Coetzer (1995: 411) writes that apart from the GPA under particular circumstances, the multilateral trading system does not prohibit the conclusion of countertrade agreements. Consequently, such contracts are indeed, largely permissible within the system. The advantage of concluding countertrade agreements are amongst others, that countertrade agreements, in many instances, ensure the international trade flow where conventional trade is not possible. Thus, from this point of view it could be said that although the conclusion of countertrade agreements could, as far as technical aspects of the multilateral trading system are concerned, contravene certain provisions of the various instruments in that system, international countertrade does not necessarily conflict with the overall goal of the system.

As far as the GPA is concerned, the South African government is not a signatory of this agreement and as this agreement is a plurilateral agreement that only affects the signatories it does not affect our government purchases. There are however expectations that the government will come under increasing pressure from its main trading partners to sign this agreement (South Africa, 1997: 99).

As the South African government is still allowed to use countertrade in their purchases it is important to determine what the best practices or procedures are in order to

successfully use countertrade as an economic development tool. These procedures will be discussed in the next chapter.

CHAPTER 5

COUNTERTRADE POLICY AND STRATEGY GUIDELINES

5.1 INTRODUCTION

Most of the literature on the development of a countertrade policy and strategy is written from the perspective of an enterprise looking to trade with a foreign government. This study is however looking at countertrade from the perspective of government procurement. This chapter will thus look at the guidelines for the development of a countertrade policy and strategy mainly from the perspective of private enterprises as most authors from this sector developed it. However, in conclusion, the different approaches will be combined in a single guideline for the development of a countertrade policy and strategy for government procurement.

5.2 COUNTERTRADE POLICIES AND STRATEGIES

The first step for a company - and for that matter a government - in developing a countertrade strategy is to define its policy clearly to its divisions. It should then make periodic reviews and evaluations to ensure that the strategy being used is consistent with the policy. However, the divisions should have the flexibility to use contingency strategies, as long as these strategies are within the framework of company policy. It is also important that the divisions coordinate their countertrade operations in order to minimize conflict and improve cost-effectiveness (Alexandrides and Bowers, 1987: 56-57). Even though the previous section was written from the perspective of an enterprise it is equally important for a government and its departments when using countertrade.

Okoroafo (1994: 230-233) developed a model to facilitate the implementation of countertrade. The model borrows from the industrial organisation and macroeconomic theory. It deals with the key countertrade participants: firms and countries. The model shows a common case in which participants to a countertrade transaction consists of a firm on the one hand and a country on the other. However, it can easily accommodate

countertrade participants consisting of the “firm-firm” and “country-country” types. His model can be broken down into six steps:

Step 1: Determine your firm’s motivation.

A company interested in countertrade must understand its motivations. This is because the success of the countertrade deal should be subsequently measured against these motivations and not sales, return-on-investment, or market share. In this respect, industrial firms have used countertrade to achieve the following objectives:

- Build goodwill with foreign partners.
- Market penetration.
- Discovery of low cost sources of production and raw materials.
- Maintain market presence.
- Recoup foreign debt.
- Gain competitive advantage.
- Release blocked funds.
- Get rid of surplus production.

These motivations may vary depending on the countertrade type contemplated.

Step 2: Analyse your partner’s motivation.

It appears that motivation for countertrade varies between Developing and Developed Countries. Many discussions address motivation for Developing Countries and the East bloc; however, some objectives are relevant for Developed Countries. Below is a list of some incentives for countries to engage in countertrade;

- Reduce foreign debt.
- Conserve foreign exchange.
- Circumvent international agreements.
- Unload poor quality goods.
- Support overvalued currency.
- Stabilize foreign trade.

Managers can systematically analyse a country's balance of payment statements, policy statements, and other sources to determine countries' economic goals and their ability to fulfil those goals without countertrade.

Step 3: Internal analysis.

Internal analysis involves a systematic assessment of the firm's characteristics. Factors such as experience in international operations, negotiations and countertrade, firm size, product line, management attitude and commitment are relevant to countertrade participation and success.

Step 4: Review the countries' countertrade policy.

Some countries have formal countertrade policies, whereas others do not. However, when countries do not have formal countertrade policies, this does not mean that they do not participate in countertrade. Some countries do not have countertrade policies but would demand it for transactions of significance. Therefore, a country's policy could be explicitly written, or unwritten. In dealing with countries without formal countertrade policies, it is necessary to understand their motives and actions.

For instance the debt service ratio, commodity terms of trade, balance of trade, and foreign exchange reserves of Developing Countries could serve as predictors of imposed countertrade. It is therefore critical for managers to understand the macroeconomic circumstances of countries and consequently predict their countertrade participation

Another relevant group whose position, view, and policies could facilitate or hinder countertrade practice are home governments and international institutions.

Step 5: Review countries' past countertrade practices.

A country's countertrade strategy can be determined by reviewing past countertrade practices. Specifically, the products used in past countertrade deals, countertrade types, and price range are relevant. Typically, these products are ones that do not meet the

highest world standard. Despite their relatively low quality, markets could be found to dispose them. Countries have a schedule of products, price range, and restrictions.

Step 6: Establish your firm's strategy.

The final step in the process is to develop your strategy. There are many facets of a strategy. Elements of a countertrade strategy include decisions about choice of:

- Countertrade type. One of the perplexing problems associated with countertrade, to users and nonusers alike is that it takes on various forms. As could be seen in chapter two, in fact, the numerous definitions are often contradictory.
- Countertrade partners and intermediaries. Countertrade transactions can involve multiple parties that could be buyers, facilitators, or inhibitors. Understanding the motives of the various participants can develop appropriate strategies for negotiation. Government, for instance, could be buyers, facilitators, or inhibitors. Managers have considerable choice of countertrade intermediaries: specialised countertrading companies, switch trades, or barter merchants. Switch traders, such as ContiTrade Services, Inc., facilitate countertrade transactions by identifying and bringing parties together.
- Countertrade information systems. An information system is necessary for firms that are active countertraders. This information system will provide a systematic means of gathering pertinent information to countertrade transactions. It is necessary to know what firms/countries have goods to sell or buy. Also the motives and policies of countertrade participants need to be continuously monitored.
- Negotiation style. The negotiation style is influenced by culture. A negotiation style characterized by Eastern block partners is the “double trap door” in which negotiations are done under cash terms. After the final price quote is obtained, countertrade demands are introduced. It is known that the Japanese will not do business with a partner until they know and trust you. Similarly, the Chinese art

of negotiation is characterised as “Guanxi” relationships or connections can result in success or failure of countertrade negotiations with Chinese partners.

- International marketing mix variables. Countertraders need to consider the product, promotion, pricing, and distribution tactics necessary to support the countertrade deal. For instance, what level of product quality is acceptable to your firm? That decision has to be made in consideration of the markets the goods received would be switched. This is of particular importance when goods from the Eastern bloc and Developing Countries are being received. If the quality of goods is too poor to be attractive in Western markets, the firm can modify the type of countertrade.

According to Korth (1987, 95) the development of a corporate countertrade strategy involves four basic steps:

- Defining the countertrade objectives of the company.
- Analysing market potential in foreign markets.
- Develop a market-specific countertrade approach.
- Implementing that strategy.

As can be seen, both Okoroafo and Korth are looking at the development of a countertrade strategy and policy from the perspective of a private enterprise. Schaffer however looked at the development of policies and strategies for a governmental perspective. **According to Schaffer the following aspects might be useful when formulating an offset policy:**

Formulate objectives.

Start with formulating the objectives namely what we want to achieve. The major objective of the Spanish offset policy for example is to develop a national defence capability. Clear objectives will help steer the proceedings during negotiations in the right direction. Apart from that objective they set themselves the following goals:

- Full Spanish defence industry participation in multinational projects and national projects.

- Improving the technological level of Spanish industry.
- Fostering national economic, commercial and labour interest (Schaffer, 1989: 74-75).

Exclude valuable commodities.

A country should exclude its more valuable commodities from countertrade transactions, in order to sell them directly for cash. This does not mean that a country should only include low value, low quality items in their countertrade deals. The emphasis should be towards a win-win situation to satisfy all parties involved (Schaffer, 1989: 107).

Specific details.

A countertrade policy should specify that:

- A detailed description of any countertrade should be given.
- Specific dates should be given for carrying out the program.
- Performance quantities or penalties for non-performance should be given.
- That the role players should be named for all transactions (Schaffer, 1989: 74).

Consider establishment of an import board.

An import board such as INCOMEX in Colombia can be considered to ensure that importees guarantee that a corresponding export takes place, and reimbursing the board if it does not (Schaffer, 1989: 106).

Specify the size of the offsets.

When formulating the policy, it should specify how big the offset should be as a percentage of the actual sales contract (Schaffer, 1989: 41).

State what should be direct and what indirect.

Lastly one should specify for every offset, what percentage should be direct and what percentage indirect (Schaffer, 1989: 38).

5.3 CONCLUSION

Most of the authors that write on countertrade policy and strategy formulation start the policy formulation process with the development of clear objectives. It thus seems logical that the first step in the formulation of a governmental countertrade policy should be the formulation of clear and unambiguous objectives. As was seen in Chapter two in most cases Developing Nations use countertrade to achieve objectives such as:

- To expand their markets and promote exports.
- To secure market expertise.
- To aid in regional development.
- To clear out surplus goods, etc.

Secondly it seems important to analyse the motives and policies of the potential partners or selling enterprises in the countertrade deal. Alexandrides *et al* (1987: 51-52) writes that there are two basic types of countertrade policies an enterprise can follow: company advantage and mutual advantage. Under a company advantage policy, countertrade/offset is used primarily for the company's benefit (to make a sale, to maintain market share, etc.), with the needs of the buyer country being met at the minimum possible level. Most companies follow this policy. The effectiveness of the company advantage policy varies. At best, it results in a satisfactory arrangement for both buyer and seller. At worst, it can be a disaster; companies may try to get out of their obligations once the sales contract is signed, on the theory that it will be easier to pay the penalty than carry out the offset, and then get into a lot of trouble with the buyer country. In contrast, companies with a mutual advantage policy give the need of the buyer country equal weight with their own. Under this policy, the company is concerned with the goal of the buyer country (i.e., modernization, industrialization, balancing trade, increasing living standards, etc.) and how the countertrade transaction will help achieve these goals. These companies are willing to meet the challenge of achieving mutual benefit through countertrade, and in most cases their efforts are successful. A government should thus investigate the countertrade history of potential countertrade enterprises and exclude enterprises that have proven to follow a company advantage policy.

The previous section indicated that a government should buy from an enterprise that follows a mutual advantage policy in which the enterprise is trying to achieve a mutually beneficial deal, thus work towards a win-win situation. In order to achieve this and in order to achieve the governmental objectives of expanding markets and increasing exports preferably over the long term, it should be policy not to only include low value low quality products in their countertrade deals. These low value low quality products won't create a sustainable long-term demand internationally. Countertrade will only create a temporary demand but as soon as the countertrade deal is completed the demand for these low value low quality products will go back to its previous level. High value product for which there is a cash market and that would have been exported in any case should also preferably be excluded from countertrade deals.

The policy should specify the size of the value of the countertrade requirements as a percentage of the total value of the original purchases, and in the case of the use of offsets the policy should state what percentage of the offsets should be direct, and what percentage should be indirect.

The countertrade policy should also specify that:

- a detailed description of any countertrade should be given,
- specific dates should be given for carrying out the program,
- performance quantities or penalties for non-performance should be given and
- that the role players be named for all transactions.

On the topic of performance penalties for non-performance Kamm (2000) says that internationally there is a move away from performance penalties, as both parties want to work towards a win-win situation. He suggests that other control methods be found like increasing the offset volume, extending the time allowed for performance or black listing suppliers for non-performance for future purchases.

Lastly the policy should require the establishment of a board or a body to evaluate compliance with the countertrade deals, and to ensure that the penalties are paid for non-performance according to the countertrade contract.

As far as the development of a countertrade strategy is concerned the following strategic process as adapted from Alexandrides *et al* (1987: 58-60) could be followed by a government. The first step is to analyse the countertrade/offset needs of both the buying government and the selling enterprise. The enterprise's needs may include entering a new market, maintaining market share, or releasing blocked funds. Some typical needs of buying governments are industrial development; export development, import substitution, employment, and the generation of foreign exchange.

The second step is the cost-benefit feasibility analysis. The government should establish the cost of:

- Human resources, which is the cost of doing the entire transaction in-house, versus giving it to a trading company or other service providers, or a combination approach.
- Other costs such as legal, insurance, shipping, and finance.

These costs must then be weighed against the anticipated benefits such as job creation, increased exports, technology transfers etc.

When the countertrade needs and cost-benefits have been analysed, the government is ready to request sale bids and accompanying countertrade proposals. After the proposals have been received the government enters into negotiations with the selling enterprises.

Areas covered in the countertrade/offset proposal negotiations may include the offset percentages, amount and type of technology to be transferred, amount of investment in joint ventures, degree of technical and management training to be provided, duration of the obligation, level of non-performance penalty, method of enforcement of the obligation and details about the counterpurchases (products available, quantities available, delivery dates etc.) In some countries, the countertrade regulations may specify such things as additionality (exports above the usual level), specific markets for exports, or prohibition of the use of third-party traders. These points must also be negotiated, if the company feels unable to carry out the proposed obligations under specific restrictions.

Two contracts will be signed when the negotiations are complete: one for the sale and one for the countertrade. This stage of signing contracts can sometimes be broken down even further, into the signing of three countertrade contracts. The first stage is the signing of the contract between the supplier and the buying country. The second stage is the signing of contracts between the suppliers and local enterprises in the buying country that are going to be involved in the countertrade. Lastly the local enterprises will sign contracts with local subcontractors also in the buying country (Campbell, 2000: 16).

In sales implementation, the enterprise should adhere to the promised delivery schedule. In the implementation of the countertrade/offset obligation (which may include counterpurchase, buyback, technology transfer, joint ventures, sourcing etc.), the enterprise should make periodic progress reports to the buying government. An authorised agency of the buying government will issue a certificate when the countertrade obligation has been fulfilled (Alexandrides, 1987: 60).

These are some rough guidelines that can be used by a government when developing a policy and strategy for the implementation of countertrade.

CHAPTER 6

THE SOUTH AFRICAN SITUATION AND ARMS DEAL

6.1 INTRODUCTION

According to Kamm (2000) – President of the Asian Pacific Countertrade Association - when looking at the South African arms procurement deal and the fact that we are expecting countertrade worth R104 billion for arms purchases of R30 billion this countertrade deal will be a benchmark countertrade transaction for everyone in the world when it comes to countertrade deals.

In the South African case however the term countertrade is not used, instead the term Industrial Participation (IP) is used. The reason for this name change according to Jogessar (2000) – an assistant director in the IPS in the DTI - is that countertrade is normally associated with barter or some form of counterpurchase. The South African government is however trying to encourage more than just counterpurchases or barter, they are trying to encourage direct foreign investment, training programmes and technology transfers in order to help with the economic development of South Africa through government purchases. Van Dyk (2000) – a senior manager for defence industrial participation at Armscor - adds that the term IP is used, as the term countertrade is not acceptable to most of the signatories of the WTO because the use of countertrade is in conflict with the most of the agreements of the WTO. He also states that the term IP is commonly used by most European countries making use of countertrade, so the term IP can be seen as a synonym for countertrade.

This chapter will take a look at how IP is implemented in South Africa as well as look at the South African arms deal, how it was structured, its advantages as well as its disadvantages.

6.2 THE NATIONAL INDUSTRIAL PARTICIPATION POLICY

IP became obligatory on 1 September 1996. Cabinet fully endorsed the IP policy and its operating guidelines on 30 April 1997. In effect this means that all government and parastatal purchases or lease contracts (goods, equipment or services) with an imported content equal to or exceeding \$10 million (or the equivalent thereof) are subject to an IP Obligation (Department of Trade and Industry, 1997: 2). The IP policy was however just endorsed by government and since IP is not yet required by legislation a lot of IP opportunities are still not utilised because not all parastatals and government departments report purchases falling within the IP parameters to the Department of Trade and Industry to negotiate IP obligations (Jogessar, 2000).

The seller/supplier who incurs an IP obligation will be required to participate in the South African economy as suggested by these guidelines and evaluation criteria. All IP Projects/ Business Proposals must be based on the principles of mutual benefits and business sense (Department of Trade and Industry, 1997: 1).

6.2.1 Mission

The mission statement of the National Industrial Participation Programme (NIPP) is:
To leverage economic benefits and support the development of South African industry by effectively utilising the instrument of Government Procurement.

6.2.2 Objectives

The objectives of the South African NIPP are (Department of Trade and Industry, 1997: 2):

- Sustainable economic growth
- Establishment of new trading partners
- Foreign investment into South Africa
- Exports of South African “value added” goods and services
- Research and development collaboration in South Africa

- Job creation
- Human resource development
- Technology transfer
- Economic advantages for previously disadvantaged communities

6.2.3 Characteristics

The characteristics of the NIPP are (Department of Trade and Industry, 1997: 3):

- **Value threshold - imported content.**
 - Any single contract exceeding \$10 million, or
 - multiple contracts for the same product or service each exceeding \$3 million awarded to one seller over a 2 year period which in total exceeds \$10 million, or
 - a contract with a renewable option clause, where should the option be exercised the total value will exceed \$10 million.
- **Thirty (30) percent obligation.** The sum total of all commercial/industrial activity (subject to crediting criteria) must equal or exceed 30 percent of the imported content (Department of Trade and Industry 1997: 3). This means that any government or parastatal that buys goods, services or leases an item where the imported content exceeds \$10 million have a countertrade obligation to the value of 30 percent of the purchased amount over a period of seven years. In the case of the arms purchases the countertrade obligation was increased to 100 percent Defence IP (DIP) and 100 percent National or non-defence IP (NIP) over eleven years. So for every R1 spent on purchases the successful suppliers have a R1 DIP obligation and a R1 NIP obligation. Which comes to a 200 percent IP obligation (Jogessar, 2000).
- **Mainly performance based evaluation.** In order to receive IP credits the suppliers performance with regards to their IP obligations will be evaluated against the IP performance projections stated in their business plans (Jogessar: 2000).

- **Fulfilment period.** Seven years from the effective date of the IP Agreement (Department of Trade and Industry, 1997: 3). As was said previously in the case of the arms procurement deal the fulfilment period was extended to between seven and eleven years (Jogessar, 2000).
- **Banking.** Excess credits can be banked for a period of four years after the obligation is discharged. Only 50 percent of a new obligation can be fulfilled by banking credits (Department of Trade and Industry, 1997: 3).
- **Five percent performance guarantee.** The supplier will be required to pay in cash to the buying government department or parastatal an amount equal to 5 percent of the outstanding IP obligation if the supplier did not meet his IP obligation after seven years (Jogessar, 2000).

6.2.4 Principles

The principles of the NIPP are (Department of Trade and Industry, 1997: 4):

- **No increase in price.** The IP Obligation must not result in an increase in the price of the purchase.
- **Mutual benefit.** IP Proposals must be profitable for the seller and beneficial for the South African economy (Government of National Unity Objectives).
- **Additionality.** All IP Proposals must reflect incremental or new business to be considered for IP Credits. This means that the IP obligation must be additional to any other investments or deals that the successful suppliers might already be involved in, in South Africa. Saab for example suggested the expansion of another Swedish firm Electolux's plant in Bronkhorstspuit to produce products for the export market expanding its existing operations. This investment would be additional to the existing investment, where the plant is only producing for the local; market. It should thus create something new not previously done by

the supplier in South Africa in order to be eligible for IP credits (Jogessar, 2000).

- **Sustainability.** IP Projects must be economically and operationally sustainable, even after the purchase period.
- **Causality.** IP Proposals must result directly from the purchase contract. The IP Proposal would not have been initiated had it not been a condition of the purchase contract and a possible component in the adjudication process. The exception is the Strategic Partnership Agreement (SPA). The supplier have to prove that his IP obligation was the cause of a transaction in order to be eligible for the IP credits, so transactions already under way before the IP negotiations got under way will not be eligible for IP credits as the supplier or IP was not the cause of the transaction. A transaction has to be the result of the suppliers IP obligation in order to get IP credits (Jogessar, 2000).
- **Responsibility.** The fulfilment of any IP Obligation lies solely with the seller.

6.2.5 IP agreements

IP Agreements can include any one or more of the following (Department of Trade and Industry, 1997: 4):

- Investments
- Joint ventures
- Sub-contracting works
- Licensee production
- Research and development collaboration
- Export promotion
- Supply partnerships with South African industry

6.2.6 IP contractual agreements

In the South African NIPP there exists three broad types of agreements namely:

- **Confidentiality agreements.** Commitment to participating within the parameters of the IP programme and to respect the confidentiality of the discussions and negotiations that transpires between parties (Department of Trade and Industry, 1997: 13).
- **IP causal agreements.** The characteristics of this agreement is (Department of Trade and Industry, 1997: 13):
 - Conditional upon winning the tender
 - Linked to a single tender
 - Surplus credits can be banked for discharging a future obligation as follows:
 - Valid for four years after the discharge date
 - Only 50 percent of the new obligation can be satisfied with banked credits.
 - Performance guarantee of 5 percent

This means that for a single tender a supplier is allowed to bank his excess IP credits form one year and use them to meet his obligation in another year. He is however not allowed to use his banked credits to meet more than 50 percent of a future years obligation, and these credits can only be banked for a period of four years. The supplier is not allowed to bank credits that were obtained in one purchase contract and use them to offset his obligation in another obligation (Jogessar, 2000).

- **Strategic Partnership Agreement (SPA).** The characteristics of this agreement is (Department of Trade and Industry, 1997: 13):
 - Long term agreement between government and supplier

- Not linked to a single tender – can accommodate multiple tenders over a ten year period
- IP obligation can be offset by SPA provided the SPA’s proposed projects exceed the IP obligation
- SPA must be export biased – at least 60 percent of revenue/turnover must be from export business
- Banked credits can be used to discharge future obligations without restrictions
- All other conditions remain the same.

This is a proactive agreement whereby a current supplier with a view on future sales to the government which might require IP, begins to build up IP credits that he can use any time in a ten year period to offset his IP obligation of the future sales (Jogessar, 2000).

6.2.7 Business concepts and business plans

When tendering for a purchasing contract that requires IP the prospective supplier should submit a business concept and a business plan. The business concept should be provided to the DTI first for evaluation, this should include (Department of Trade and Industry, 1997: 13):

- A brief description of products or services
- A broad marketing strategy
- Broad financial projections: sales, cost of sales, profit
- A brief description of the technology/process

In other words the business concept states what the supplier proposes for his IP obligation. After this concept was evaluated and found to meet all the requirements of the DTI the prospective supplier is required to submit a business plan, which is a more comprehensive document than the business concept provided earlier. This document should include the following (Department of Trade and Industry, 1997:13):

- An executive summary
- A description of the business proposal:
 - Legal structure
 - Ownership structure
 - Mission and objectives
 - Description of products and services to be produced
 - Description of industrial sector, markets and customers
 - Processes, systems, technologies and equipment
 - Detailed employment projections, local and foreign
 - Technology transfer
 - Training
 - Exit mechanisms
- Marketing
 - Marketing research and analysis
 - Marketing strategy
 - Marketing plan
- Financial
 - Pro-forma balance sheet, income statement, cash flow statement
 - IRR, NPV, and payback period
 - Financial details of the project
- References of recent successes

These document will first be evaluated be the IP Secretarial and after they approved it, they will go to the IP Control Committee for approval, if they meat the requirements the buyer department or parastatal will be informed that they have complied with the IP requirements and that the purchase can go ahead (Jogessar, 2000).

6.2.8 IP Secretariat and IP Control Committee

As part of the South African government and the DTI's commitment to IP the IP Secretariat (IPS) and the IP Control Committee (IPCC) was founded. These bodies are responsible for the following:

- **IPS responsibilities.**
 - Keeping track of all relevant transactions in South Africa, which have IP potential.
 - Assist, guide and advise sellers in the fulfilment of their obligations.
 - Negotiate and evaluate IP proposals.
 - Make recommendations regarding IP to the IPCC for its approval.
 - Conclude IP contracts.
 - Administer and audit the performance of all IP projects.
 - Prepare status/performance reports for the IPCC that support or do not support the allocation of credits or penalties.
 - Submit an annual report containing information concerning all the activities of the Secretariat and progress with all IP obligations/agreements to the IPCC.
 - Assist the IPCC with its functions and where possible disseminate all decisions of the latter to all relevant parties (Department of Trade and Industry, 1997: 9).

- **IPCC responsibilities.**
 - Provide strategic guidelines and approve guidelines for the National IP Programme.
 - Ensure, with the assistance of the IPS, that all relevant government officials and parastatals are aware and enforce their obligation related to the NIPP.
 - Review, comment and decide on recommendations made by the IPS regarding IP proposals of prospective sellers.

- Evaluate the performance reports, as supplied by the IPS and award credits or penalties where justified.
- Ensure that all relevant IP agreements are monitored and audited by the IPS on a regular basis.
- The IPCC will meet as often as circumstances require, but at least once every two months (Department of Trade and Industry, 1997: 9).

6.2.9 Evaluation/Crediting methodology

In order to evaluate whether the supplier has met his IP obligations, IP credits are awarded to the supplier. Business plans/proposals will be evaluated and possible credits will be indicated. Credits will only be awarded upon successful performance. The following are the methods used to award credits (Department of Trade and Industry, 1997: 10):

Table 6.1 is presented on the next page

Table 6.1: Evaluation/Crediting methodology

	Objectives	Methodology	Factor
1.	Sustainable economic growth	Revenue accumulated over the fulfilment period	1 Unit = 1 Credit
2.	Export promotion	Export revenue = Additional Credits	1 Unit = 1 + LC*
3.	Job creation	Salaries & wages costs accumulated over the fulfilment period	1 Unit = 1 Credit
4.	Training and development	Training and development costs accumulated over the fulfilment period	1 Unit = 1 Credit
5.	Small Medium and Micro enterprise (SMME) promotion	Outsourcing to SMME's	1 Unit = 1 Credit
6.	Previously disadvantaged individuals (PDI)	Outsourcing to PDI SMME's PDI ownership% x revenue	1 Unit= 2 Credits Units x % = Credits
7.	Investment	Capital outlay or capital injection	1 Unit = 2 Credits
8.	Research and development expenses	All costs	1 Unit = 2 Credits
9.	Technology transfer	On a case by case basis linked to revenue	1 Unit = 1 Credit

*LC = Local Content

Source: Department of Trade and Industry, 1997: 10

6.2.10 NIPP summary

According to the South African NIPP the procedure followed can be summarised as follows (Department of Trade and Industry, 1997: 7):

- Liaison between IPS and purchaser regarding IP and the request for proposals.
- Tender invitation to include IP guidelines.
- Conclusion of the Memorandum of understanding/Confidentiality agreement.
- Seller submits business concept to IPS.
- Discussion with IPS regarding the business concept.
- Seller submits business plan to IPS.
- Discussion with IPS regarding the business plan.
- Evaluation of the business plan by the IPS.
- The IPS makes a recommendation to the IPCC.
- Discussion by the IPCC with further discussions if the IPCC disapproves of the business proposal.
- A conditional IP agreement will be signed between the IPS and the seller.
- The IPS would now notify the purchaser that the prospective seller has complied with the IP obligation, so the purchaser would now be in a position to award the contract.
- The IP obligation becomes effective when the purchase contract is concluded.
- Bi-annual progress reports are now required of the seller.
- The DTI will initiate audits if and when required.
- The seller is also required to submit independent audit reports annually.
- IP credits will now be allocated upon performance.
- The decision regarding IP credits will be communicated to the seller together with reports on the status of the seller's IP obligation.
- Upon fulfilment of the IP obligation, the seller will be notified in writing and in so doing, be discharged of the obligation.

6.3 THE DEFENCE INDUSTRIAL PARTICIPATION POLICY, PROCESS AND PROCEDURE

Apart from the NIPP, developed and enforced by the DTI the Ministry of Defence (MoD) has developed a DIP policy, processes and procedures of their own based on the

statements in the NIPP. The following section will take an in-depth look at the DIP policy, processes and procedures.

6.3.1 Objectives

The main objective of all DIP programmes, in addition to those of the NIPP, address specific defence industry objectives, such as:

- The retention, and where possible, the creation of jobs, abilities and capabilities.
- The establishment of a sustainable defence industrial and economic base, with strategic logistic support capabilities.
- The promotion of defence exports of value-added goods.
- The promotion of like-for-like (equivalent types) technology transfer and joint ventures.
- The maintenance of skilled indigenous manufacturing capabilities.
- The provision of a sustainable local defence industry capacity.

The assessment of DIP proposals is based on the extent to which such proposals support the capabilities required by the Department of Defence (DoD) and the South African National Defence Force (SANDF) in the defence industry to provide a strategic, logical support and upgrade capacity for a technologically advanced and modern defence force, its doctrine and posture (Armcor, 1999:1-2).

6.3.2 Defence acquisition and DIP responsibility

All defence-related acquisition programmes abroad, which is subject to IP, shall be managed and administered by Armcor's DIP Division, as directed by the DoD. The

non-defence (NIP) portion of the IP programme, where applicable, is the full responsibility of the IPS of the DTI in accordance with the provisions of the national IP policy (Armcor, 1999: 2).

6.3.3 Principles

The principles of the DIP policy can be summarised as follows (Armcor, 1999: 3):

- **Price.** The DIP obligation may not result in an increase in the price of the purchase.
- **Mutual benefit situation.** DIP proposals must be profitable for the seller and beneficial for the SA economy and defence industry at large.
- **Additionality.** All DIP proposals must reflect incremental or new business in order to be considered for credits. Existing business or completed projects will also not be considered for credits.
- **Sustainability.** DIP projects must be economically and operationally sustainable and must support the main objectives of the DIP programme.
- **Causality.** Causality means that the seller shall demonstrate to the satisfaction of Armcor that DIP projects are/were effectively caused by the seller as a direct result of the DIP agreement (this also applies to a pro-active DIP agreement).
- **Responsibility.** Responsibility for the choice of DIP (and NIP) projects, the selection of local companies/suppliers and the subsequent fulfilment of any DIP obligation rest solely with the seller.

6.3.4 Terms and conditions

The terms and conditions of the DIP policy can be summarised as follows:

- **DIP programme**

DIP programmes are those that cover activities which are directly (by specification) related to the products, services, materiel and/or equipment which are the subject of the main agreement (purchase contract) and commonly referred to as direct DIP, as well as indirect DIP activities related to other products manufactured by or purchased from, or other services rendered by SA defence related manufacturers (industries) in accordance with acknowledged international industrial standards and/or military specifications. DIP programmes shall not include any non-defence related activities (Armcor, 1999: 3).

- **Value threshold**

An IP obligation (DIP or NIP) comes into effect when the value of a defence purchase contract abroad, is equal to or greater than \$10 million (or the equivalent thereof), and is managed separately on a proportional basis between the IPS and Armcor (this also applies to contracts locally and where the imported content equals or is more than \$10 million). The MoD also prescribes an in-house DIP programme, managed by Armcor, on all defence purchases abroad between \$2 and \$10 million (or the equivalent thereof) (Armcor, 1999: 3-4).

- **Obligation**

- For all defence purchases \$10 million or more the IP obligation will be a prescribed percentage of the value of such purchase contracts, which is split proportionally between national and defence industrial priorities and managed separately by the IPS and Armcor. The IPS will determine the NIP obligation, whereas defence will require an obligation of at least 50 percent (in most cases the combined requirement will be proportionally shared on the assumption that the total IP benefit will amount to 100 percent of the tender price) (Armcor, 1999: 4).
- The DIP obligation for defence contracts between \$2 and \$10 million can be up to 50 percent and is managed by Armcor (Armcor, 1999: 4).

- DIP shall be a firm commitment and not only a best effort and will in all cases be substantiated by a proper business plan (Arm Scor, 1999: 4).

According to Van Dyk (2000) in the past suppliers would have had to meet IP obligation or their best effort, so they didn't have to meet their entire IP obligation. It was however very difficult to determine what the supplier's best effort was as this is something subjective so the best effort has fallen away and suppliers have to meet their entire IP obligation.

- **Discharge period/fulfilment period**

A maximum of seven years (with agreed milestones within this period) is allowed for the seller to discharge his DIP obligation. For contracts with a value of less than \$10 million, a shorter period may be prescribed. Long-term acquisition programmes are subject to case-by-case negotiations (Arm Scor, 1999: 4). In the case of the current arms procurement deal however the discharge period ranges from seven to eleven years (Van Dyk, 2000).

- **Penalty**

- A penalty for non-performance will be levied or liquidated damages can be claimed, in terms of the DIP agreement.
- Penalties could be as low as 5 percent and could take the form of a non-performance penalty linked to specific milestones, or liquidated damages.
- The format and type of guarantee is normally specified in the Request for Proposals (RFP), and could refer to either a bank, corporate or sovereign type of guarantee. An acceptable guarantee will be required when the DIP agreement is signed, or prior to the signing thereof (Arm Scor, 1999: 4).

- **Evaluation**

- Proposals for defence projects of \$10 million or more are evaluated on the basis of prescribed business plans for both NIP and DIP.

- DIP proposals on defence projects between \$2 and \$10 million are likewise evaluated on the basis of prescribed business plans, in which the seller is to clearly state his proposed activities and milestones of how he intends discharging his commitment.
 - An evaluation model/value system, as devised and used for the total evaluation of the RFP, forms the basis for DIP evaluation in which the DIP (and NIP) portion forms but one of the factors/elements taken into consideration. The evaluation of DIP proposals will address aspects such as to what extent they support defence, industry, skills, product/services and DIP strategic imperatives. A value model will be devised for each RFP and approved by the DIP committee on a case-by-case basis.
 - DIP proposals and commitments in excess of stated expectations will attract a higher rating. Vague, dubious and non-committed proposals will be disregarded and may even result in the disqualification of a RFP.
 - The seller must apply sound business principles when contracting with defence related industries in South Africa. Armscor and the MoD will not except any responsibility for such contracts and can merely provide a mechanism through the DIP agreement; to advance and promote reciprocal defence related business.
 - The generic aspects taken into consideration when evaluating DIP proposals are based on defence strategic considerations (Armscor, 1999: 5).
- **Banking**

Credits in excess of the seller's indirect DIP obligation may be banked after the initial obligation has been discharged, subject however to a separate pro-active DIP agreement being entered into with Armscor. Excess indirect credits can be banked for a period of four years, after being awarded and may be used for

fulfilling any future possible indirect DIP obligation. In certain cases where direct DIP activities result in foreign exports such may, at the discretion of Armscor, also be considered for possible banking. Defence and non-defence credits are not interchangeable (Armscor, 1999: 6).

- **DIP credit assessment**

Depending on the circumstances pertaining to a DIP transaction, either an input or an output model, or a combination thereof, will be applied by Armscor.

- An output-based evaluation process may be used as this allows the encouragement of sustainable business. Output-based evaluation implies that DIP proposals are evaluated and linked to performance and the realisation of specific goals and benefits gained, at which time credit claims will be considered.
- It might also be necessary to use the input-based evaluation to allow the necessary flexibility for business decisions to be taken by the seller, which in term may be imperative to make such DIP programmes viable. The input-based model implies that credits realised at the time of placing of order by the seller with a local supplier in terms of the DIP agreement. Seller remains however under obligation till such time DIP contracts placed are fully executed/completed (Armscor, 1999: 6).

- **Investment**

Investment may manifest in the following manner (Armscor, 1999: 6):

- It can be the amount of foreign equity capital and/or value of capital equipment that the foreign seller invests, for purposes of performing his DIP obligation, by physical transfer from the seller's country to South Africa, for the benefit of the relevant industries. Investment should be for a period of at least five years in order to qualify for credits. No multiplier will be allowed for determining DIP commitment or subsequent credit.
- It can also mean the accrued interest differential advantage gained by the local supplier/entity for foreign loan capital granted by the seller as part

of his DIP obligation. Such loan repayments must be for a period of at least five years to be considered for granting of credits on the interest advantage portion gained or benefited from. Such credit will typically be considered in accordance with the output principle. Armscor will take the interest rate, method and manner of repayment and the possible direct effect of export credit guarantee and the rate of exchange into consideration.

- **Technology transfer**

Technology transfer for other defence purposes, and other than that to be paid for as covered by the main agreement (purchase contract), which increases the efficiency of defence related companies in South Africa or helps to develop goods not previously manufactured in South Africa, must have an inherent value to South Africa. Armscor, in co-operation with the MoD and where applicable the industry, will determine the value of such transfers for the purpose of granting credits. In the case of DIP programmes such determinations shall be made in accordance with military strategic consideration. As a rule no multipliers will be considered for the purpose of granting credits for technology transfers. Technology transfer proposals shall at all times be addressed on a case-by-case basis (Armscor, 1999: 7).

- **Strategic considerations**

Facilities, products and skills, which are regarded by the MoD as being of strategic value to South Africa, are very costly to establish, retain and maintain. Local industry and SANDF requirements cannot always provide for profitable sustainability in these areas. Foreign contractors are therefore encouraged to consider these areas in the drafting of business proposals. Special emphasis is placed on defence strategic facilities (Armscor, 1999: 7).

- **Main agreement (purchase contract)**

Main agreement shall mean the main agreement or purchase contract concluded between Armscor and the seller for the supply of goods/services which places

the seller under a DIP obligation and, where applicable, a NIP obligation (Armcor, 1999: 7).

- **Agreement**

Agreement could mean two separate agreements for separate NIP and DIP projects (for defence contracts of \$10 million or more), which contains the Seller's defence and non-defence IP obligation, resulting from the main agreement (purchase contract), and signed concurrently with or prior to the latter by all the parties concerned. These agreements set out the scope, definition, commitment, terms and conditions of the respective IP obligation, and contain details of project proposals, all of which shall be in accordance with the respective NIP and DIP policies (for defence contracts of between \$2 million and \$10 million only one DIP agreement shall apply) (Armcor, 1999: 7).

- **DIP contract(s)**

DIP contracts shall mean either orders or contracts placed with Armcor and/or defence related industries in South Africa by the seller and/or industries in the seller's country, for which the seller qualifies for credits in terms of the provisions of the respective DIP and, where applicable, NIP agreements (Armcor, 1999: 7).

- **Buyer/Purchaser**

Buyer/Purchaser shall mean that party defined as buyer/purchaser in the main agreement (purchase contract), and who signed the latter and is responsible for the foreign or local acquisitions/procurement project. In the case of all defence acquisition projects the buyer refers to Armcor, acting for and on behalf of the DoD/SANDF as directed (Armcor, 1999: 8).

- **DIP credits**

DIP credit shall mean the value granted by the DIP committee for the seller's agreed performance, which results in the subsequent reduction in the seller's obligation, and shall normally consist of and be subject to those elements and

conditions specifically or otherwise agreed to in terms of the DIP agreement (credits relating to the NIP agreement are managed separate by the IPS) (Armcor, 1999: 8).

- **DIP Committee**

The DIP Committee is responsible for assessing all DIP proposals in accordance with the procedures prescribed for the evaluation of RFP's. The DIP Committee is furthermore responsible for approving all DIP credit claims and the imposition of penalties. This Committee will be constituted by Armcor DIP Division (the Chair), Armcor's audit and legal experts, the Chief Acquisition of the Defence Secretariat (MoD acting as co-chair) as permanent members. Other members of the MoD, organized defence industry and the Armcor Programme Manager will be co-opted in certain cases (Armcor, 1999: 8).

- **Imported content**

This means that a portion of the tender price is determined by the main agreement (purchase contract) which represents the costs of service, component parts or materials which have been or are still to be imported (whether by the seller or its supplier or subcontractor), based on free-on-board (FOB)/free carrier (FCA) or cost-insurance-freight (CIF) calculation, plus any other foreign direct importation cost and cost relating to royalty or licensing fees (Armcor, 1999: 8).

- **Joint venture**

For the purpose of the main agreement (purchase contract) joint venture shall mean an agreement between the seller, or industries in the seller's country, and Armcor, or defence related industries in South Africa, in terms of which each party contributes for the purpose of achieving a common and mainly defence industrial interest by establishing a third company/business entity (Armcor, 1999: 8)

- **Cancellation**

Should a DIP contract be cancelled, in whole or in part, solely due to the fault of the supplier, no amount shall be deducted from the credit originally granted to the seller. Should such contract be cancelled in whole or in part for any other reason, however, the credit will be adjusted pro rata to the price paid for the goods delivered and/or services rendered (Armcor, 1999: 9).

- **Pro-active DIP agreements**

Armcor also engages in pro-active DIP agreements with foreign suppliers, through which the objectives of defence industrial participation are advanced and simultaneously providing the opportunity for such foreign supplier to accumulate and bank credits that might be used in future defence acquisition programmes where such foreign supplier becomes the successful seller (Armcor, 1999: 9).

6.3.5 DIP procedure

In the case of defence purchases the defence-related portion of the IP obligation is administered by Armcor and evaluated in accordance with the prescriptions governing the evaluation of RFP's and the adjudication of tenders. The non-defence industrial participation obligation portion is specified, administered and evaluated by the IPS in accordance with their procedures for such defence projects where the purchase value is \$10 million or more.

Armcor's DIP Division, in due consultation with the Chief of Acquisitions, DoD, will set up a meeting with the IPS and discuss the interactive action plan to be drawn up for the IP programme, before a request for information (RFI) or Request for Proposal (RFP) is released. The RFI shall at all times include defence and non-defence IP guidelines to enable prospective bidders to submit relevant IP proposals as prescribed in the respective IP and DIP guidelines. A formal business plan is however not required at the RFI stage. The RFI is dispatched by Armcor to all possible contenders. Response

within the prescribed period is mandatory, and late submission shall be excluded from the formal tender (RFP) process.

Each contender will be required, at the RFI stage already, to confirm compliance with the defence and non-defence industrial participation requirements. Armscor will evaluate RFI submissions in collaboration with the DoD, except for the non-defence IP obligation portion, which will be evaluated independently by the IPS. Given the results of the RFI evaluation, Armscor, incorporating the input from the IPS, will draw up a list of possible contenders (shortlist). A formal RFP is drawn up by Armscor in collaboration and with the approval of the Chief of Acquisitions, DoD and dispatched to all possible contenders. Contenders must respond within a specific period. Comprehensive details of the defence and non-defence IP requirements will also be included in the RFP.

Bidders conferences will be organised by Armscor where all prospective sellers will be able to ask questions relating to the RFP. Both Armscor and the MoD relevant line and technical functionaries will attend these conferences. The IPS will also be invited to these conferences in order to answer queries regarding the national IP policy and the non-defence IP obligation (it must be noted that such bidders conferences are not necessarily applicable to all defence projects and may take place separately, each addressing its specific domain interests).

Discussions surrounding defence and non-defence IP proposals will be held between Armscor, the DoD, IPS and the prospective seller. It must however be noted that Armscor and DoD will not be involved with any discussions between the prospective seller and the IPS on business concepts etc.

In response to the RFP the submission by the prospective seller of detailed business plans is mandatory, in accordance with the respective defence and, where applicable, non-defence IP guidelines. Evaluation of the final IP business proposal(s) will be done by the DIP Evaluation Team, consisting of Armscor and DoD officials as part of the prescribed RFP assessment and approval process, and by the IPS where applicable. The

IPCC (of DTI) makes decisions regarding NIP business proposals only. The IPS notifies Armscor of the IPCC's decision so as to enable it to award the tender and to finalise the main agreement (purchase contract) and DIP agreement. In certain cases the NIP and DIP results will be combined and consolidated into a single IP result.

The NIP agreement, preceded in most cases by a "SPA" – Strategic Partnership Agreement, is then concluded between the IPS and the seller, stipulating the terms and conditions of performance to discharge the NIP obligation. Neither Armscor nor the MoD shall be involved in the latter activity. The main agreement (defence purchase contract) will not be concluded by Armscor, unless the prospective contender has fully complied the respective DIP and NIP requirements and have signed the prescribed agreement. The seller is expected to furnish Armscor with six monthly reports on progress with the DIP obligation. Armscor may also demand or initiate audits, as and when deemed fit (Armscor, 1999: 9-12).

6.3.6 General

Companies which have already been accredited through the MoD (Armscor) prescribed Accreditation Programme need not furnish or duplicate information in the prescribed business plan that has already been covered by the accreditation questionnaire. In such cases proof of accreditation must however be furnished by the prospective bidder. Companies not yet accredited must furnish the required information as well as complete the prescribed Accreditation Application.

Prospective bidders are encouraged and advised to consult in advance with South Africa's Aerospace, Maritime and Defence Industry Association (AMD), the MoD or Armscor, to provide them with assistance on information on defence industrial capabilities in order to draft the required defence-related IP business plans. Prospective suppliers to South Africa are furthermore advised to discuss the South African Government's requirements and expectations regarding non-defence IP projects in advance, with the DTI's IPS.

Pro-forma DIP agreements (active and pro-active) are available on request from Armscor Countertrade Division. Prospective suppliers to the MoD are strongly advised to carefully study the contents of these aforementioned agreements and to discuss any uncertainties well in advance with Armscor's Countertrade Division. Usually a copy of the pro-forma active DIP agreement is furnished with the RFP and forms the basis for negotiations and eventual contracting for DIP. The DIP programme is also intended as an instrument for furthering the initiative of capacitating and empowering Black entrepreneurs and business into the defence related industry. Foreign companies participating in the programme with Armscor will be considered for granting additional DIP credits.

It must be noted that the responsibility for negotiations in respect of and eventual contracting for DIP are ultimately that of the Armscor DIP Division (Armscor, 1999: 15).

6.4 THE ARMS DEAL IN DETAIL

South Africa will be spending R30 billion on arms for the Defence Force but in the process is hoping to gain R104 billion in countertrade benefits in return over the next eleven years. The deal takes three forms (Barrell and Streek, 1999: 4):

- Defence related offsets, R14, 5 billion, with local defence firms earning over R4 billion through direct participation in the production of aircraft and ships. Suppliers will also transfer technology worth about R3 billion in royalties and licence agreements to South African firms and will direct export orders to South African firms for more than R7 billion.
- Counterpurchases by the defence equipment suppliers of South African goods, worth R31 billion, including automotive components, furniture, fabricated metal goods including railway wagons and electronic goods.

- Foreign investment in South Africa by companies associated with the equipment suppliers, estimated at R24 billion.

The South African arms deal and the related countertrade obligations of the successful supplies can be divided and discussed according to the different products being purchased, the countertrade obligation is also further divided into defence IP (DIP) and national or civilian IP (NIP). DIP is further subdivided into direct DIP – the production and/or assembly of components of the weapons systems ordered by the South African National Defence Force (SANDF) – and indirect DIP, which is not connected to the systems for the SANDF, and is intended to benefit other defence related companies. The specific information on a number of the countertrade obligations could however not be divulged at the time of the study, as the negotiations was still at a crucial and sensitive stage.

6.4.1 Aircraft

South Africa contracted SAAB of Sweden and BAE Systems of the United Kingdom (UK) for nine two seater and 19 single-seater Gripen International advanced light fighters, and BAE Systems for the supply of 24 Hawk 100 lead-in fighter-trainer aircraft with an option to cancel some of the aircraft in case of a severe economic recession, for a total value of R15, 77 billion (Campbell, 2000: 16). The first twelve Hawk aeroplanes will be delivered by 2005 and the next twelve by 2006 while nine Gripen aeroplanes will be delivered between 2006 and 2008 (van der Westhuizen, 1999: 4).

IP for the Gripen and Hawk form a combined programme. The IP programme started with DIP, with weapons pylons for the Gripen, which are being manufactured by Denel for installation on all Gripens for the export markets, not just those for the South African Air Force (SAAF). Denel is subcontracting the pylons to Camau, of Port Elizabeth. Saab has installed an aircraft design centre at Denel, using 3D computer modelling, which can be used for all aircraft.

In addition, Denel will assemble 23 of the 24 Hawks on order, or on option, for the SAAF, here. Denel will also manufacture 23 tailplane sets for the South African Hawks and another 48 for the Royal Air Force Hawks. In addition AMS is producing the health and usage management system (Hums) for South African, Australian and Canadian Hawks. AMS's Hums is now offered as standard on all Hawks and as an option on all other BAE aircraft. In future the Hums will be extended to cover the engine as well – it will be fitted to the Adour 951 power plant, to monitor its behaviour. At the moment this feature is just for the SAAF, but it will be available to any other customer who desires it. ATE is developing the avionics suite for the SAAF Hawks, and this suite will be offered as an export variant for other countries.

Indirect DIP is likely to include work on the Eurofighter Typhoon advanced fighter and the BAE Nimrod maritime patrol aircraft. Denel's tooling manufacturing capability is being looked at to make production jigs for the Eurofighter. Also part of DIP, BAE contracted Denel to supply rudders and ailerons for the Avro RJ regional jet airliner. This contract was for some 18 sets a year, for the duration of production of the RJ. But it has now been extended to include other structural components as well, and Denel will also produce these, as well as the rudders and ailerons, for the new Avro RJ-X, a new aircraft, which was launched in March 2000.

Grintek would supply the communications management systems for the Gripen International fighter aircraft. With regards to the NIP Saab commented that it is still early days and that they are talking to local industries (Campbell, 2000: 17). Saab suggested the expansion of the Swedish firm Electrolux's plants in Bronkhorstspuit and Cape Town to produce products for the world market. The Swedish producers of fish Swedfish will according to a proposal by Saab go into partnership with the South African fishing community for the development of a fish processing plant. Saab will supply the financing for the plant and also help with the training of the employees. In a proposal aimed at the disadvantaged sections of the South African community Saab and BAE will help with the development and manufacturing of sun heating systems and devices for determining electricity consumption. Finally Saab will help with the upgrading of existing sawmills, help market South African furniture in the international

market, and help with the development of new furniture manufacturers in South Africa. BAE will invest in the South African industry with the acquisition of a 20 percent stake in Denel Aviation for a sum of R6, 5 billion (Gibson, 1999: 21).

Small, medium and micro enterprises could expect up to R3, 8 billion worth of export orders over the next eleven years in the non-defence portion of the government's R15, 7 billion arms deal with BAE Systems and Saab. The programme was expected to result in nearly R350 million of export orders a year for manufacturers of non-defence products. These include basic manufactured goods such as bolts; industrial consumables, safety equipment and work wear through to automotive components, sophisticated hi-tech electronic goods and industrial equipment. The consortium had formed a partnership with DNA Sherwood, a South African group specialising in finding supply chains, industrial procurement and making export arrangements. An export promotion drive would be launched with the support of the DTI. DNA Sherwood would identify and match foreign customers with South African suppliers and partners. There would be particular emphasis on helping small, medium and micro businesses to enter the export market for the first time. This facility will unlock new business potential for many South African manufacturers with the ability to export who have been unable to find appropriate markets for their products (D'Angelo, 2000: 20).

6.4.2 Helicopters

Agusta of Italy was chosen to supply 30 Agusta A109 Power light utility helicopters with an option on another ten for R1, 949 billion (Campbell, 2000: 16). The first light Agusta helicopters will be delivered by 2003 (van der Westhuizen, 1999: 4).

In the area of NIP Agusta is planning to build a mini-steel mill which will be built by an Italian company Danieli. Agusta is also making progress on two other major NIP programmes, for the manufacture of high-value mohair products, and for the production of gold chains in conjunction with Filk Gold, the world's third-largest gold jewellery manufacturer. Denel is also involved with Agusta's NIP, through the manufacture of the commercial Koala helicopter, which Denel will market with them (Campbell, 2000: 17).

Finally Agusta proposed the establishment of an ostrich leather tannery on an ostrich farm in the Potgietersrus area (Gibson, 1999: 21).

6.4.3 Ships

The German Frigate Consortium will supply four Meko A-200SAN corvettes worth R6, 917 billion to South Africa (Campbell, 2000: 16). The German corvettes will be delivered between 2003 and 2005 while the battle equipment will be mounted in South Africa (van der Westhuizen, 1999: 4).

One of the local companies known to be a DIP beneficiary from the corvette programme is African Defence Systems, better known as ADS, which is 60 percent owned by Thomson-CSF of France. Thomson-CSF is responsible for the combat suits for the new corvettes, and prospects for securing exports of elements of the South African combat suit to other Meko customers are reported to be good. As with Agusta, an important part of the consortium's NIP programme is a mini-steel mill (Campbell, 2000: 17). The steel mill will focus on the manufacture of galvanised steel and more specifically plate steel for the motor industry. The steel mill is expected to help produce steel and motorcars and car components of export quality. It was proposed that an existing steel mill should be upgraded at one of South Africa's existing sites namely Yscor. In another proposal it was proposed that technology be transferred to a local producer of crankshafts helping to boost its production for export purposes to 500 000 units a year (Gibson, 1999: 21).

6.4.4 Submarines

The German Submarine Consortium will supply three Type 209/14000MOD submarines to South Africa for a total of R5, 354 billion (Campbell, 2000:16). The submarines will be delivered between 2005 and 2007 (van der Westhuizen, 1999: 4).

The NIP programme for the German Submarine Consortium is centred on a proposed stainless-steel plant, to be built in the Coega industrial development zone in the Eastern Cape (Campbell, 2000: 17). A further proposal is that the South African packaging of

cosmetics does not meet the tough world-class quality requirements and the Consortium proposed that the French company Pechiney transfer technology to South Africa to bring this industry up to international quality standards (Gibson, 1999: 21).

6.5 ADVANTAGES OF THE ARMS PROCUREMENT AND INDUSTRIAL PARTICIPATION DEALS

There is a great deal of time effort and cost associated with the implementation of a countertrade deal. So no enterprise or country would make use of countertrade if there weren't definite advantages associated with the implementation of a countertrade transaction. The following are some of the most common advantages associated with the South African arms procurement and IP deals:

- The demand for raw materials, the spending of incomes earned from employees and spending by government from its tax revenues will all contribute to economic growth and job creation (Stuart *et al*, 1999: 4). The deal will bring in new job opportunities into the South African economy. The countertrade deal is expected to create 65 000 sustainable jobs in an economy that has seen the loss of 1,6 million jobs in the last five years (Stuart *et al*, 1999: 4).
- The deal would focus people's minds on what South Africa has to offer (Stuart *et al*, 1999: 4).
- The deal would draw billions of fixed investment into the country from the successful arms suppliers (Barrell *et al*, 1999: 4), such as the proposed stainless-steel plant that the German Submarine Consortium is planning to build in the Coega industrial development zone in the Eastern Cape (Campbell, 2000: 17)
- Countertrade deals like the arms deal and the South African Airways countertrade deal for the purchase of new aircraft will be an aid in the training of

the South African workforce – through for example technology transfers - thereby increasing their productivity and capabilities (Bailey, 2000: 6).

- Countertrade is also expected to help increase South Africa exports through export promotion programmes. It is expected that the export promotion programme of BAE Systems and Saab will result in nearly R350 million of export orders a year for manufactures of non-defence products (D'Angelo, 2000: 20) It is also expected that some of the components being manufactured locally for inclusion in the defence equipment being purchased such as the tailplanes for the Hawks will be exported to foreign governments such as the 48 other tailplanes being manufactured for the Royal Air Force (Campbell, 2000: 17).

6.6 CRITICISM

There has been a lot of criticism against the arms deal coming from different sources. This criticism can, however, be divided into two separate sections, criticism against IP and the implementation and application of IP, and criticism against the arms deal itself and the way the contracts were allocated. The following criticism originated from the press. The author wishes to state that by including this he does not necessarily agree with it or acknowledge the correctness in any way.

- **Criticism against IP**
 - The Minister of Finance and other economic analysts doubt that much of the offset investment into South Africa promised by the successful bidders would materialise (Barrell *et al*, 1999: 4). In adding to this Sapa (2000:1) reports that international experience has shown that the only function which offsets performance for recipient countries is to provide political legitimisation for the large outlay required on modern defence systems by allowing policy makers to point to apparent, but ultimately non-existing economic benefits. In short offsets are a scam promoted by

the armaments industry, with connivance of politicians, to fleece the taxpayers of both supplier and recipient countries.

- Little has yet been revealed about what offset deals are actually in place, with government representatives claiming the commercial confidentiality agreements could be breached if the public were to be informed. Thus far government has only made public a wish list of possible offset commitments, which weapons sellers mooted (without being tied down to them) during the negotiations aimed at securing the supply contracts (Powell, 2000: 8).

- **Criticism against the arms deal**

- South Africa has lost 1,6 million jobs in the last five years, and could lose even more jobs in the gold mining industry. So the 65 000 sustainable jobs being created by the countertrade deal would hardly make an impact on unemployment in South Africa (Stuart *et al*, 1999: 4).
- There are questions being raised about the real cost of the arms deal and whether the R30 billion being spent on arms can be justified against the R500 million that was slashed of the Gauteng hospital budget in 1999 (Stuart *et al*, 1999: 4).
- There are feelings that the equipment could have been sourced cheaper (Loxton, 1999: 1). It is being said that the price being paid by South Africa for the Gripen fighters, namely \$65 million an aircraft, is wildly inflated, with the benchmark price standing at \$32 million, just under half of the amount (Powell, 2000:8).
- The Ministers of Education, Health, and Welfare want to reduce the size of the arms deal because they fear the deal could reduce their budgets substantially (Barrell *et al*, 1999: 4).

- There has been accusations that the South African Air Force (SAAF) has spent R3,3 billion on 28 Gripen fighter aircraft it is not in a position to fully utilise. The SAAF currently has fewer than 10 pilots qualified to fly the 30 perfectly serviceable Cheetah C aircraft it currently owns – and none is as yet capable of flying the Gripen. The Cheetah C's were bought, in a batch of 32, from Israel as recently as 1996. Due to a shortage of qualified pilots in the SAAF, more than half of the aircraft are virtually unused. Two of the aircraft have been decommissioned after crashes. The C-class Cheetahs were bought to replace, at the cutting edge of technology, an earlier generation of aircraft, the Cheetah D, which the SAAF still flies. As opposed to the still functioning Cheetah C, analysts noted that the Cheetah D was indeed at the point of obsolescence. The Cheetahs already in possession of the SAAF constituted a force more powerful than any air attack that neighbouring countries in Africa could assemble (Powell, 2000: 8).

- The money spent on arms procurement could have built a million homes (Powell, 2000:8).

- The acquisition of 40 Italian made Agusta utility helicopters as part of the weapons procurement programme was made against the wishes of the SAAF experts. Before the final deal was done, the SAAF had already selected the Bell 427 – the world market leader in the class – going so far as to signal the forthcoming deal by draping the Bell helicopter in South African colours at an exhibition of defence technologies. The deal however went sour after the American company failed to bring Futuristic Business Solutions, a company with close links to the South African military establishment, in on the deal.

However an analyst has questioned the usefulness of the Agustas in the conditions for which they were bought. The first purchase of Agustas

was made for maritime conditions, but the problem is it cannot take high altitudes, and this reduces its effectiveness (Powell, 2000: 8).

- o CCII Systems has written to the Auditor-General to formally request that a forensic audit be conducted into the removal of CCII as selected contractor to provide the information management system for South Africa’s new patrol corvettes. The information system is the vital “brain” of the ship, linking weapons, communications and vessel control systems. The CCII system, which is South African, had been developed in conjunction with Armscor and had been selected by the SA Navy. However, late in the process, the contract was granted instead to French company Detexis. The significance of this is that Detexis is owned by French defence company Thomson-CSF. Thomson also owns the South African company African Defence Systems (ADS) that was appointed to drive South African participation in the “fighting” components of the corvette programme (Sole, 2000:13).
- o Companies with close links to the head of the military weapons procurement committee have been awarded a big section of local contracts in South Africa’s R30 billion weapons deal. It has emerged that the head of the defence department’s arms procurement committee, Shamin “Chippy” Shaik, has close relations in a company mandated to provide South African partners for the arms deal. A close associate of former defence minister Joe Modise is also a director of the company. The way the weapons procurement programme was structured meant foreign suppliers were required to form partnerships with local players in the defence industry and to guarantee investment in the South African economy, thus creating what cabinet estimated at 65 000 new jobs. There are two companies at the centre of the controversy. Firstly there is African Defence Systems (ADS), which lists Shaik’s brother, Shabir, as one of its directors in a seemingly flagrant violation of conflict of interest provisions in legislation governing tender procedures. Chippy Shaik’s

wife Zarina works as a senior marketing executive in ADS, which will retain a substantial portion of the R2, 6 billion paid into its account. Also included in the ADS directors as from earlier this year, is another family team former Umkonto we Sizwe member, and retired lieutenant general in the South African National Defence Force (SANDF) Lambert Moloi, and his son-in-law engineer Tsepo Molai.

Moloi is a close associate of Modise (who oversaw the initial phases of the weapons deals before his retirement in 1999) and also a director of the arms manufacturer Denel. Meanwhile both Moloi and Molai are also directors of the other company implicated – Futuristic Business Solutions (FBS). FBS not only was given work on the arms package by ADS, but also subsequently became a shareholder itself. FBS had acquired a 20 percent stake in ADS, and had been associated with ADS since late 1998. The rest of ADS is owned by a French company, Thomson CSF, making a mockery of the company's pretensions to being a black empowering venture.

All in all FBS stood in line to secure around 70 separate contracts in the weapons procurement deal, many of which had been facilitated by ADS as officially designated integrator of various projects. This was despite the fact that FBS lacks any actual infrastructure or manufacturing capacity and merely functions as a logistics co-ordinator (Powell, 2000:4).

- o The Auditor-General submitted a report on the arms deal to the Minister of Defence in which it was found that there were problems with the technical evaluation of the bid for the fighter trainer. The fact that a non-cost option was used to determine the successful bidder was a material deviation from the originally adopted value system. This ultimately had the effect that a different bidder, at a significantly higher cost, was eventually chosen on the overall evaluation. The Auditor-General

recommended that a special forensic audit be conducted into the subcontractors which fell out of the original terms of reference of his probe, and which have been the subject of repeated corruption claims (Sapa, 2000: 2).

As can be seen from the criticism the majority of the criticism is against the arms deal itself and the way that the purchase contracts was allocated, while there isn't much criticism against the use and application of countertrade.

6.7 RESPONSE TO THE CRITICISM

For the purpose of completeness it is important to not only look at the criticism against IP and the arms deal, but also at some of the answers to the criticism. The answers to the criticism can also be divided into answers to criticism against IP and answers to criticism against the arms deal.

- **Criticism against IP**

In answer to the criticism that IP is used by the defence industry to silence criticism by politicians and tax payers in the buying country against the huge capital outlay of defence procurements and that the IP obligations always fail to materialise, Barrell *et al* (1999: 4) write that Australia – apparently because of its relatively sophisticated industrial base – managed to ensure that two American guided-missile frigates and ANZAC Class frigates were built in Australia, and that 21 Hawk Lead In Fighter trainers were assembled in Australia. In the course of a major international defence procurement programme in 1996/97, Australia managed to spend more than half of its R10 billion on major and minor capital equipment inside Australia. This proves that IP can work. It just has to be implemented and policed correctly.

In answer to the criticism that little has yet been revealed about what offset deals are actually in place and that the government has only made available a

wish list of possible offset commitments, Van Dyk (2000) says that +/- one third of the NIP are investment projects of approximately R24 billion. The suppliers have presented their business concepts on these investment projects and these concepts have been approved by the DTI, however it takes time – approximately six to nine months which includes the preparation of viability studies - to prepare the final business plan for these NIP obligations. In that time the situation in the market can change and what seemed a viable business concept might not be one any more where the return on investment might not be high enough any more and the process has to start over again determining another viable business concept and plan. It needs to be understood that the contracts are just now coming into operation with the submarine contract only coming into operation at the end of July 2000 and then the supplier has got between 7 and 11 years to make good his obligation. That is the reason why not all the NIP has been finalised yet.

- **Criticism against the arms deal**

One of the criticisms against the arms deal were that there were nepotism in allocating contracts to ADS as well as that ADS wasn't a local supplier and as such the local defence industry wasn't being used in the building of the corvettes. In answer to these allegations Van Dyk (2000) states that one of the criteria of the tender for the corvettes was that whoever won the contract to supply South Africa with the corvettes had to contract at least 60 percent of the value of the contract for the combat suite for the corvettes with the local industry, the local industry being ADS.

The reason for this was that the SANDF and ADS has spent millions of rands over the last ten years to develop technology specifically aimed at the needs of the South African Navy. Had the tender not specified that ADS and its technology be used for the corvette defence systems that portion of the contract might have gone to a German, French or English supplier and the time and money spent on the development of our local defence systems would have been wasted. The defence system makes up approximately two

thirds of the total cost of a corvette. He adds that ADS was originally a local supplier, but in the time that the tender process transpired 60 percent of ADS was sold to the French company Thomson-CSF. It is still however technology developed with South African taxpayers' money that will be fitted into the corvettes.

This was the only case in which there was prescribed to the suppliers with which local suppliers they had to contract, all the other arrangements between suppliers and subcontractors for example between Saab and the fishing community in the Western Cape are purely up to them to decide with whom they want to associate.

There had also been criticism that the price paid for the Gripen fighter namely \$65 million per aircraft was too high compared to the benchmark price of \$32 million an aircraft. Van Wyk (2000) states that when evaluating a supplier for a contract they looked at three aspects namely technical aspects including costs such as purchasing costs, and life sickle costs, secondly they look at the IP being offered namely NIP and DIP and thirdly they looked at the financing of the contract. So the decision was based on a broad range of aspect that jointly help determine which supplier was going to be awarded the contract.

In response to criticism and fears from the Ministers of Education, Health and Welfare that their budgets might be cut in order to finance the arms deal, the government has said that the arms deal would not cause the state to exceed its budget deficit targets in coming years or raise its interest burden. The government also stated, that it did not expect the deal to cut into the budget allocations of other departments excessively (Barrell *et al*, 1999:4).

Lastly in response to the Auditor-General's report on South Africa's arms deal and the recommendation that a forensic audit be conducted into the subcontracts which fell out of the original terms of reference of his probe.

the Minister of Defence said the government could not be held responsible for any problems at that level, as only the prime contract are their responsibility and that the subcontracts are not their responsibility (Sapa, 2000:).

6.8 CONCLUSION

This South African arms deal consists of two types of countertrade namely national and defence industrial participation. The NIP consists of non-defence IP such as the building of a stainless steel plant in the Coega industrial development zone in the Eastern Cape by the Germans Submarine Consortium and the building of a fish processing plant by Saab in the Western Cape. This NIP is being administered by the DTI.

The DIP or defence IP consists of direct and indirect IP, direct IP being IP projects stemming directly from the arms procurement deal such as the assembly of Hawk trainer aircraft by the local enterprise Denel on behalf of BAE, while indirect IP refers to DIP not directly related to the arms procurement deal such as work that local enterprises will be involved in on the Eurofighter and the BAE Nimrod maritime patrol aircraft. Armscor on behalf of the MoD administers the DIP.

Not all the IP obligations have however been finalise yet, all the business concepts have been approved for the proposed IP but the successful suppliers are still in the process of finalising some of the business plans for the IP obligations.

The arms procurement deal is however not without criticism as was shown, this criticism can be divided into two sections, criticism against IP (countertrade), such as that the IP obligations never materialises and that the IP and its advantages are only used to silence criticism from politicians and tax payers. Secondly there is criticism against the arms deal itself that ranges from the price that was paid for the Gripen fighter was to high, to questions being asked about whether South Africa really needs to

buy new fighters as our old fighters is still more powerful than any air attack that neighbouring countries in Africa could assemble.

But the arms procurement deal also has its advantages in that it is expected to encourage economic growth, create job opportunities, lead to technology transfers and cause an increase in foreign investment.

CHAPTER 7

AN EVALUATION OF THE SOUTH AFRICAN COUNTERTRADE POLICY GUIDELINES

7.1 INTRODUCTION AND EVALUATION METHOD

Chapter five consisted of a literature study in which secondary data was evaluated in order to determine which aspects should be included in a countertrade policy, as well as to determine what a good countertrade strategy should look like. Then in chapter six the current arms procurement deal was written up as a case study including the current South African countertrade policies. The aim of this was to be able to evaluate the current South African countertrade policies against the information collected and documented in chapter five in order to determine how thorough and potentially successful the South African countertrade policies are, and whether South Africa would be able to create and develop local enterprises through the use of countertrade. A survey was also conducted in order to determine the countertrade practitioners' perceptions of the importance of the policy guidelines identified in chapter five before evaluating the South African countertrade policies against these guidelines.

7.2 DETERMINATION OF COUNTERTRADE PRACTITIONERS' PERSPECTIVES

A survey questionnaire was developed to determine the countertrade practitioner's perceptions of the South African countertrade policy guidelines. Secondary data identified and documented in chapter five was used to formulate fourteen statements and one question contained in the questionnaire. The questionnaire consisted of fourteen statements that the respondents had to answer on a five point scale where 1 was not important and 5 very important. The fifteenth and last question was an open-ended

question with respondents being able to answer the question as they saw fit. The questionnaire is included as Appendix A.

Non-probability, judgement sampling was used to determine the respondents as the respondents had to conform to certain criteria namely they all had to be involved in countertrade, in order to be able to answer the countertrade related questionnaire. As a number of the countries and enterprises that use countertrade don't admit freely to doing so it is very difficult to determine the population size and location. To overcome the problem a group of twelve countertrade practitioners from all over the world was selected at the annual Asian Pacific Countertrade Association Conference held at Sun City in South Africa. The questionnaires were sent electronically via e-mail to the respondents and were also received back via e-mail. Twelve questionnaires were sent out and eight received back. **Due to the small size of the sample and the even smaller size of responses the findings were not statistically processed or presented, but only serves to support the literature study.**

7.3 PERSPECTIVES OF THE RESPONDENTS

Table 7.1 gives a breakdown of the responses received to the statements. In the table a rating of 1 is not important and a rating of 5 is very important.

Table 7.1 is presented on the next page.

Table 7.1: Analysis of responses

Statement/Variable	Rating 1.		Rating 2.		Rating 3.		Rating 4.		Rating 5.		Average	Standard Deviation
	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%		
1. A countertrade policy should contain clear and unambiguous objectives.	0	0	1	12,5	1	12,5	4	50	2	25	3,875	0,991031
2. It should be policy to analyse the motives and policies of potential suppliers.	0	0	1	12,5	2	25	4	50	1	12,5	3,625	0,916125
3. A countertrade policy should state that the country would only negotiate with an enterprise that follows a mutual advantage policy.	0	0	1	12,5	1	12,5	5	62,5	1	12,5	3,75	0,886405
4. A countertrade policy should state that the country would only negotiate with an enterprise that follows a company advantage policy.	2	25	2	25	3	37,5	1	12,5	0	0	2,375	1,06066
5. A countertrade policy should state that not only low value low quality products should be included in the countertrade deal.	1	12,5	2	25	3	37,5	2	25	0	0	2,75	1,035098
6. High value products for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals.	1	12,5	4	50	2	25	0	0	1	12,5	2,5	1,195229

Table 7.1 (continued)

7. The policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase.	0	0	0	0	2	25	2	25	4	50	4,25	0,886405
8. In the case of the use of offsets the policy should state what percentage of the offsets should be direct, and what percentage should be indirect.	0	0	1	12,5	0	0	5	62,5	2	25	4	0,92582
9. The countertrade policy should specify that a detailed description of any countertrade should be given.	0	0	3	37,5	1	12,5	2	25	2	25	3,375	1,30247
10. The policy should state that specific dates should be given for carrying out the programme.	0	0	1	12,5	1	12,5	6	75	0	0	3,625	0,744024
11. Performance penalties should be given for non-performance with the agreed obligations.	1	12,5	2	25	2	25	3	37,5	0	0	2,875	1,125992
12. A countertrade policy should avoid the use of penalties for non-performance and rather use other sanctions such as the increase of the offset volume or extending the time limit.	0	0	1	12,5	1	12,5	3	37,5	3	37,5	4	1,069045
13. The policy should specify that all role players be named for all transactions.	0	0	2	25	3	37,5	3	37,5	0	0	3,125	0,834523
14. The policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations, and to ensure that the penalties or other sanctions are enforced for non-compliance with the countertrade obligations.	0	0	1	12,5	1	12,5	5	62,5	1	12,5	3,75	0,886405

The following can be deduced from the information in table 7.1:

- On the statement that a countertrade policy should contain clear and unambiguous objectives two of the respondents said that clear and unambiguous objectives was very important by indication a five on the five point scale, four gave the statement a four also indicating that the objectives was important, one gave the statement a three and one gave the statement a rating of two thus indicating that objectives isn't that important for inclusion in a countertrade policy. With an average of 3,875 this policy guideline can be considered as important for inclusion in a countertrade policy.
- On the statement that it should be policy to analyse the motives and policies of potential suppliers one respondent gave the statement a rating of five indicating that it is very important to analyse the motives and policies of potential suppliers, four gave the statement a rating of four indicating it is important, two gave the statement a rating of three indicating it is average in importance while only one gave the statement a rating of two. With an average of 3,625 this policy guideline can be considered as important for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that the country would only negotiate with an enterprise that followed a mutual advantage policy, and not with enterprises that followed a company advantage policy (a win-lose policy) one respondent said it is very important giving the statement a five. The majority of respondents responded with a four, namely five respondents. One each marked three and two. With an average of 3,75 this policy guideline can also be considered as important for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that a country should only negotiate with an enterprise that follows a company advantage policy (win-lose), and not with an enterprise that follows a mutual advantage policy only one respondent indicated that this statement is important, three indicated that it was average in importance two that it was less that average in importance and two

said it wasn't important at all giving the statement a rating of one. With an average of 2,375 this policy guideline is less than average in importance for inclusion in a countertrade policy.

- On the statement that a countries countertrade policy should state that not only low value low quality products should be included in the countertrade deals two respondent said that the statement is important marking the four on the questionnaire, three said it was average in importance marking the three, two said it was less than average in importance marking the two and one said it was not important at all choosing the one. When looking at the average of 2,75 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that products for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals only one respondent felt that it is very important to include such a statement in a countertrade policy. Two respondents felt it was average in importance while four respondents felt the statement was less than average in importance and only one respondent felt the statement was not important at all. Thus with an average of 2,5 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that the countertrade policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase four of the eight respondents said that this statement is very important for inclusion in a countertrade policy. Two said it is important and two said it is average in importance. With an average of 4,25 this policy guideline is important for inclusion in a countertrade policy.
- The following responses were received on the statement that when offsets are used the policy should state what percentage of the offsets should be direct, and what percentage should be indirect. Two of the respondents felt that such a

statement is very important for inclusion in a countertrade policy while five of the eight respondents felt that the statement was important. Only one respondent rated the statement as being less than average in importance by choosing the two. With an average of 4 this is an important policy guideline.

- On the statement that the countertrade policy should state that a detailed description of any countertrade should be given two respondents said it was very important that this statement should be include in a countertrade policy, two respondents said it is important, one said it was average in importance while three said it was less than average in importance. When looking at the average rating of 3,375 this policy guideline is above average in importance for inclusion in a countertrade policy.
- On the statement that the policy should state that specific dates should be given for carrying out the program six of the eight respondents said that this is an important policy issue one said it was average in importance indicating the three while only one respondent said that the policy issue was less than average in importance. With an average of 3,625 this is an important policy guideline for inclusion in a countertrade policy.
- On the statement that performance penalties should be given for non-performance with the agreed obligation three of the respondents said this was an important policy issue while two said it is average in importance, two said it is less than average in importance and only one said it wasn't important. With an average of 2,875 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that the policy should try to avoid the use of penalties for non-performance and rather use other sanctions such as the increase of the offset volume, extending the time limit and black listing the enterprise for future sales to the government three of the respondents said the policy issue was very important, three said it was important one said it was average in importance and

only one said it was less than average in importance. Thus with an average of 4 this is an important policy guideline for inclusion in a countertrade policy.

- On the statement that the policy should state that all role players be named for all transactions three respondents said it was important three said it was average in importance and two said it was less than average in importance. Thus with an average of 3,125 this policy guideline is just above average in importance for inclusion in a countertrade policy.
- On the statement that the policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations, and to ensure that the penalties or other sanctions are enforced for non-compliance with the countertrade obligations one respondent said this was a very important policy issue five said it was important one said it was average in importance and one said it was less than average in importance. When looking at the average of 3,75 for this statement this policy guideline can be seen as important for inclusion in a countertrade policy.

The last question was an open-ended question that asked the respondents to state any other variable that they thought was important for inclusion in a countertrade policy.

The following responses were received:

- The objectives to be achieved should lead the policy
- Relatively easy procedures to adapt offset work and schedule should be included but the recipient of offset must be protected to avoid undue supplier switching
- Consistency rather than rules itself are more important
- The policy should maximise the conditions for an initial commitment to be established and then allow for “normal” business relations to be developed between the parties to foster sustainable relations over the long term.
- The faster the offset obligation can be removed as a punitive threat the more innovation and optimisation will occur.

- A visual aid, which geographically identifies where the best benefits can be, achieved e.g. Eastern Cape, Western Cape etc. Also a table which loosely shows where suppliers can easily identify what to do and where to do it.
- Rural development projects, which encompass training, education and job creation identifies opportunities for development in these areas.

7.4 CONCLUSION

In this chapter the policy issues identified in chapter five were evaluated against the opinions of eight countertrade practitioners worldwide. Based on the responses received from them it is now possible to determine which policy guidelines are important for inclusion in a countertrade policy. The South African national countertrade policy and Armscor's countertrade policy can now be evaluated against these policy issues in order to determine their thoroughness and whether they are able to ensure the successful implementation of countertrade in South Africa.

CHAPTER 8

SUMMARY, CONCLUSION AND RECOMMENDATIONS

8.1 SUMMARY

Countertrade can be seen as an umbrella term used to describe different types of reciprocal purchase agreements. The most common of these different types of countertrade are:

- Barter
- Counterpurchase
- Compensation/Buy-back agreements
- Offset agreements
- Clearing account agreements
- Switch trading

Countertrade isn't a new approach to purchasing as it was already used extensively since the 1920's and barter even before that. The use of countertrade can be attributed to both positive incentives such as the upgrading of manufacturing capacity and expanding markets to negative incentives such as using countertrade because of a lack of ready cash to buy goods and services internationally or using countertrade to rectifying trade imbalances.

The developing countries, of which South Africa is one, makes use of countertrade extensively as 26,1 percent of all reported countertrade between 1987 and 1996 involved the developing countries. Adding to this the majority of developing countries countertrade in this time period (1987 – 1996) was with the former Communist countries or East Block countries, as they are also known. One of the biggest reasons why developing countries make use of countertrade can be attributed to their huge

international debt, which was built up after the international oil crisis in the 1970's. Forcing developing countries to use countertrade to purchase internationally.

When looking at the reported cases of countertrade between 1987 and 1996 a decline in the number of countertrade transactions can be seen from 1993 to 1996. One reason for this can be the WTO's GPA. The WTO does not specifically prohibit the use of countertrade in its agreements but when looking at the meaning of the WTO agreements it can be seen that the use of countertrade is in contradiction with these agreements. So no signatory will be allowed to make the use of countertrade mandatory when trading with their country. However the WTO does not influence nor guide the actions of private enterprises so they are free to use countertrade as they see fit. Government procurement was however specifically excluded from the WTO so governments could use countertrade in their purchases. But since the introduction of the GPA negotiated at the Tokyo Round of the WTO and renegotiated at the Uruguay Round the signatories of this agreement (GPA) has undertaken not to make use of offsets in government procurement. Developing nations acceding to the GPA will however be allowed - if they negotiated it with the other signatories – to require offsets as prerequisite for tendering for government contracts but will not be allowed to use offsets in the determination of the successful suppliers.

It can thus be seen that the WTO prohibits the use of countertrade as they are attempting to free up international trade. Countertrade is therefore seen to restrict international trade, but ironically countertrade in many instances ensure the international trade flow where conventional trade is not possible.

Lastly this paper developed a framework from the literature for a countertrade policy. This framework is summarised below in figure 8.1.

Figure 8.1: Countertrade policy framework

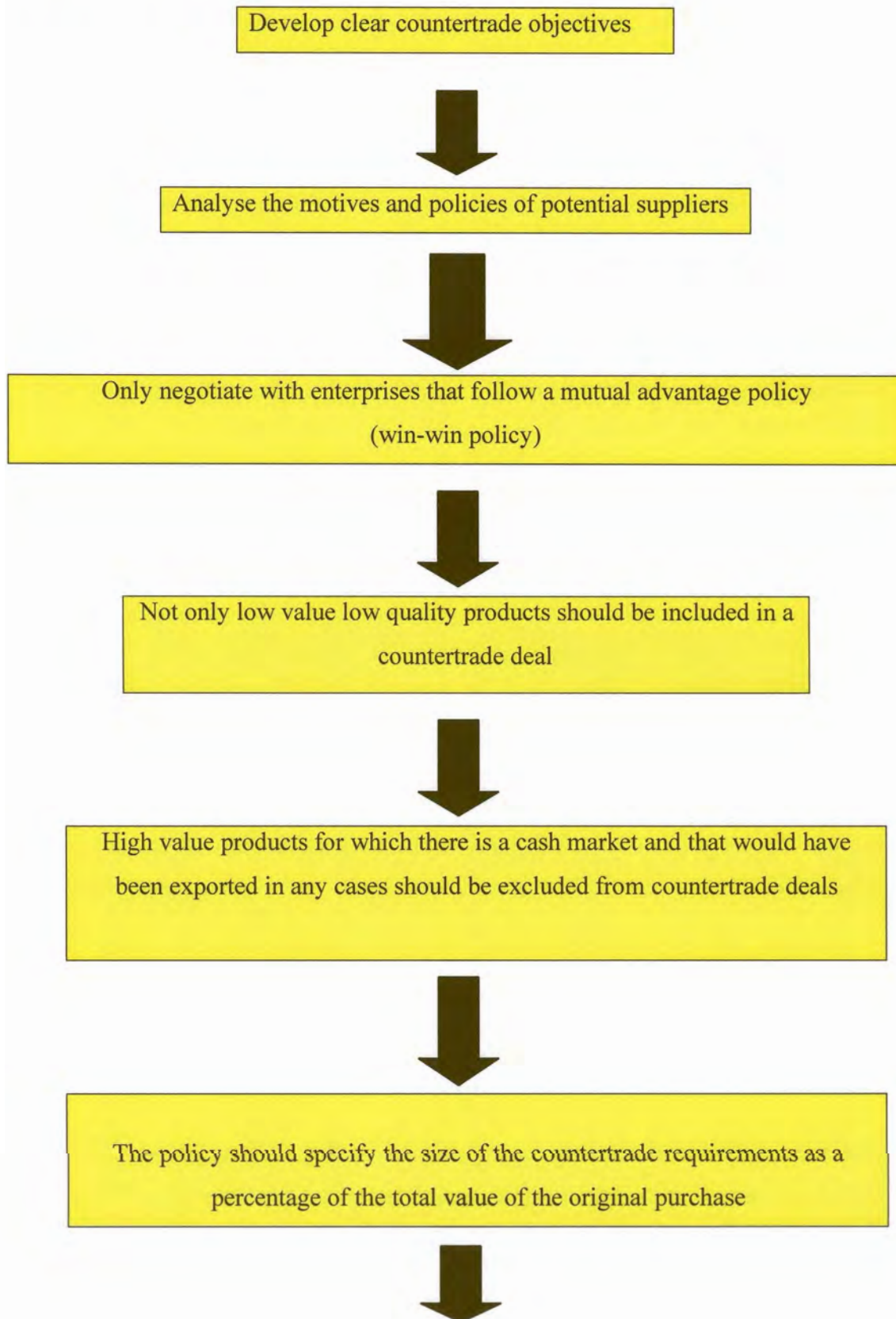
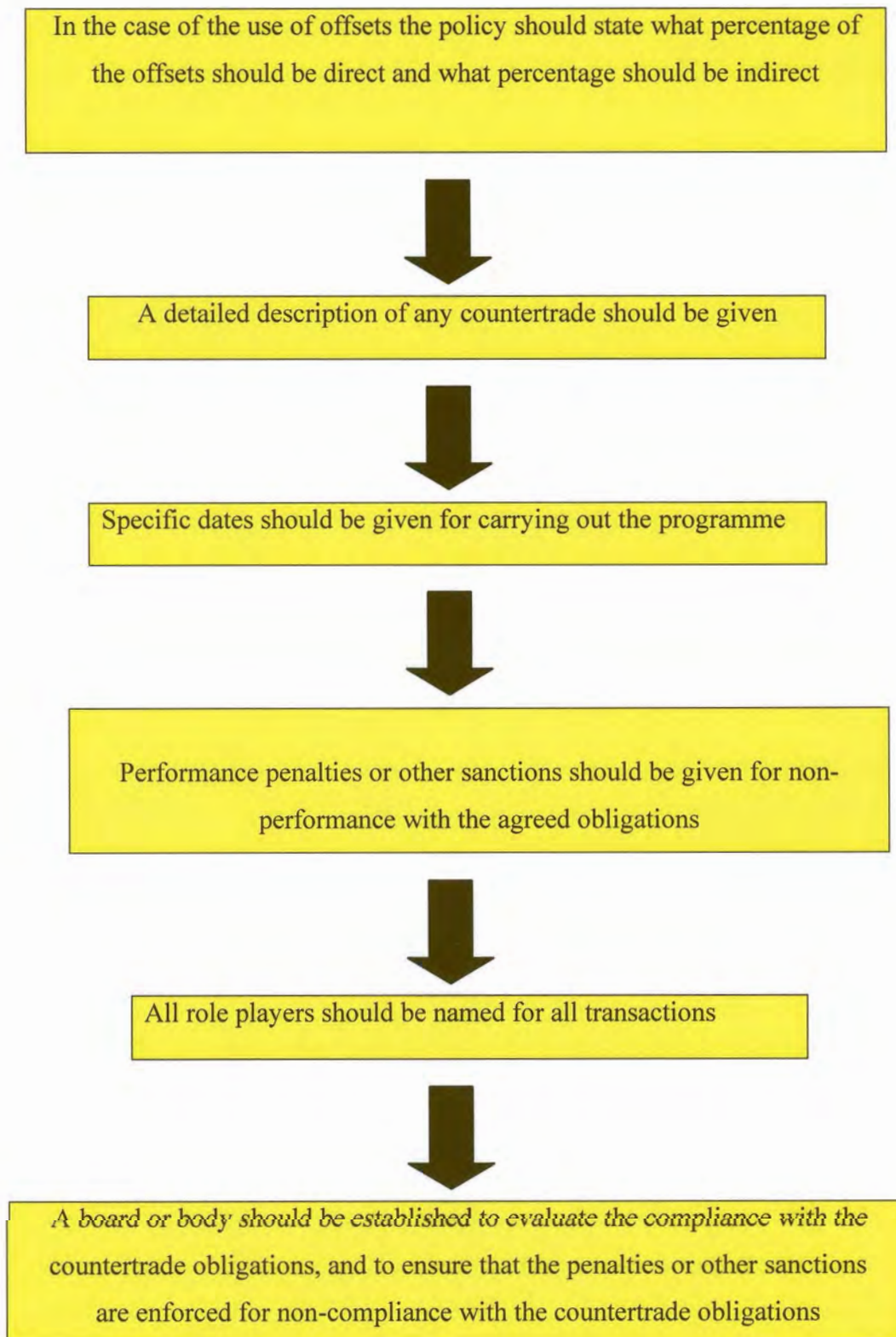


Figure 8.1 (continued)



8.2 CONCLUSION

When considering the application of countertrade in the arms procurement deal it can be seen that two parties are responsible for the formulation of policies and procedures as well as the negotiation and implementation of countertrade, namely, Armscor for the DIP and the DTI for the NIP. When evaluating their policies against the literature study and the responses from the survey the following was found:

- The first policy guideline identified in the literature stated that a countertrade policy should have clear and unambiguous objectives. The respondents in the survey indicated that this was an important issue for inclusion in a countertrade policy. Both the NIP policy and the DIP stated clear and unambiguous objectives as to what it intends to achieve with IP.
- The second policy guideline states that the motives and policies of potential suppliers should be analysed. The respondents in the survey indicated that they thought this was an important policy issue in developing a countertrade policy. When looking at the NIP and DIP policies it is implied through the fact that potential suppliers - as part of the tender process - should submit business concepts and business plans of what they intend doing as part of their IP obligation. Through the evaluation of these preliminary business concepts and final business plans the motives of the potential suppliers can be identified.
- Another policy guideline identified in the literature and viewed as important by the respondents in the survey stated that the policy should state that the country would only negotiate with an enterprise that follows a mutual advantage policy, as apposed to a company advantage policy (a win-lose policy). Both policies state that IP proposals should be profitable for the seller and beneficial for the South African economy. This issue is thus included in the countertrade policies.
- The policy guideline that a countertrade policy should state that not only low value low quality products should be included in the countertrade deal was less

than average in importance based on respondents responses in the survey. Taking this into consideration this issue is neither included in the NIP nor DIP policies. This is however implied by the statement that the IP proposal should be profitable for the seller and beneficial for the South African economy. The Armscor policy also states that the seller must apply sound business principles when contracting with defence related industries in South Africa and that Armscor and the MoD would not accept any responsibility for such contracts. The quality, value and profitability of products included in the IP obligation are thus the responsibility of the suppliers.

The Armscor policy further states that where technology transfer is offered as IP obligation such technology must have an inherent value to South Africa. This means that such technology should increase the efficiency of defence related companies in South Africa or help develop goods not previously manufactured in South Africa.

- A countertrade policy guideline that was identified in the literature but was seen as less than average in importance by the respondents in the survey was that the policy should state that high value items for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals. As was shown above the Armscor policy states that it is the seller's responsibility to contract with local suppliers and determine their IP obligation. The value of the IP is the responsibility of the supplier and even though the South African countertrade policies doesn't specify that high value items for which there is a cash market should be excluded from countertrade deals, the policies do provide other guidelines. The DIP policy for example state that the DTI and Armscor will evaluate the proposed IP obligations set out in the business concepts and final business plans, in order to ensure that the IP objectives are reached. So for example the government has steered clear of linking the IP deals to social development programmes, instead it has gone for a broad range of hard manufacturing industries focused on exports.

- Both the literature and the survey found that it is important that the policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase. On this policy guideline the NIP policy states that the sum total of all commercial/industrial activity (subject to crediting criteria) must equal or exceed 30 percent of the imported content. The DIP policy on the other hand states that DIP obligations for defence contracts between \$ 2 million and \$10 million can be up to 50 percent while DIP obligations for defence contracts of \$10 million and above will be at least 50 percent. For the current arms procurement deal there is a NIP obligation of 100 percent and a DIP obligation of 100 percent. So this policy guideline is covered in the two South African countertrade policies.
- A policy guideline that was also seen as being important by both the literature and the respondents in the survey was that a policy should state what percentage of offsets - if offset are going to be used – should be direct and what percentage should be indirect. Even though offset was used in the current arms procurement deal neither of the policies has stated what percentage of the offsets should be direct and what percentage indirect.
- The respondents in the survey perceived the policy guideline that the countertrade policy should specify that a detailed description of any countertrade should be given as being above average in importance. Both the NIP and DIP policies state that the potential suppliers must firstly supply a business concept – stating what IP they are proposing – to the IPS and the IPCC, after this concept is approved a final business plan - stating what the final IP obligations will be – must be submitted to the IPS and IPCC. These concepts and plans must be received and approved before any contract can be signed with the supplies. Thus through the business concepts and business plans the IP will be described.
- The next policy guideline stated that the policy should state that specific dates should be given for carrying out the programme. This guideline was rated by respondents as important for inclusion in a countertrade policy. According to the

NIP policy the suppliers have seven years from the effective date of the IP agreement to fulfil their IP obligation. The DIP policy also states that a maximum of seven years is allowed for the seller to discharge his DIP obligation. For contracts with a value of less than \$10 million, a shorter period may however be prescribed; the DIP policy further states that the potential suppliers have to indicate in their business plan what the agreed discharge milestones are within that seven-year period. For this arms procurement deal however the discharge period ranges between seven and eleven years.

- A policy guideline that was identified in the literature but was perceived by respondents, as less than average in importance is that the policy should give performance penalties for non-performance with the agreed IP obligations. Both the NIP as well as the DIP policies has included performance penalties. The NIP stated that a five percent performance guarantee will be required from suppliers, while the DIP policy states that:
 - A penalty for non-performance will be levied or liquidated damages can be claimed, in terms of the DIP agreement.
 - Penalties could be as low as five percent and could take the form of a non-performance penalty linked to specific milestones, or liquidated damages.
 - The format and type of guarantee is normally specified in the RFP, and could refer to either a bank, corporate or sovereign type of guarantee. An acceptable guarantee will be required when the DIP agreement is signed, or prior to the signing thereof.
- Another policy guideline identified in the literature that is related to the policy guideline above states that a countertrade policy should avoid the use of penalties for non-performance and rather use other sanctions such as the increase of offset volumes and black listing suppliers for future purchases. The respondents in the survey rated this policy guideline as important. As was seen above the NIP and DIP has given specific performance penalties for non-

performance with the agreed IP obligations. It is however being investigated for future inclusion in a countertrade policy by Armscor and is currently being applied as an unwritten policy to black list suppliers for future contracts if they don't honour their IP obligations.

- A policy guideline that was rated by respondents in the survey, as just above average in importance for inclusion in a countertrade policy, is that a policy should specify that all role players be named for all transactions. Both the NIP as well as the DIP policies state that the final business plans should be finalised and accepted before there can be contracted with a supplier, the parties to the different IP obligations must be set out in these business plans. So this policy guideline is included in both countertrade policies.
- The last policy guideline identified from the literature states that a countertrade policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations. The respondents rated this policy guideline as being important for inclusion in a countertrade policy during the survey. Both the NIP and DIP policies identify three bodies that have been formed for this purpose. For the compliance with the NIP obligations the IPS and IPCC was formed. The IPS administers and audits the performance of all NIP projects, prepares status/performance reports for the IPCC that support the allocation of credits or penalties and submits an annual report containing information concerning all the activities of the Secretariat and progress with all IP obligations/agreements to the IPCC. The IPCC on the other hand is responsible for evaluating the performance reports, as supplied by the IPS and award credits or penalties where justified and ensures that all relevant IP agreements are monitored and audited by the IPS on a regular basis. The DIP on the other hand is monitored by the DIP Committee. This DIP Committee will be constituted by the Armscor DIP Division (the chair), Armscor's audit and legal experts, the Chief Acquisition of the Defence Secretariat (MoD acting as co-chair) as permanent members. Other members of the MoD, the organised defence industry and the Armscor programme Manager will be co-opted in

certain cases. It is the DIP Committee's responsibility amongst other things to approve all DIP credit claims and the imposition of penalties.

It can thus be said that compared to the countertrade policy guidelines identified in a literature study and evaluated against the responses of countertrade practitioners worldwide that South Africa has got two very thorough countertrade policies. Both the NIP and the DIP policy and procedure manuals contain all the policy guidelines identified in the literature except for the fact that they don't specify what portion of offsets must be direct and what portion indirect. This can be seen as a shortcoming of the policies, and needs to be considered for inclusion in these policies in future. Except for this one omission from the policies, it can be said that South Africa has got clear policy guidelines for the implementation of countertrade (IP).

Adding to the above section on performance penalties and the monitoring of performance. It was written above that the IPS and IPCC was appointed to monitor the attainment of the NIP obligations while the DIP Committee was appointed to monitor the attainment of the DIP obligations. To ensure the attainment of the IP obligations for this arms procurement deal the performance guarantees was increased from five percent as stated in the NIP and DIP policies to ten percent. So every time a performance milestone was missed the suppliers will be penalised. On the DIP side there are also penalties for late delivery of equipment, meaning that if the supplier is late honouring his DIP obligation he is penalised but it will also mean that if he is late on his direct DIP obligation he will probably be late delivering his equipment as well and will thus be penalised there as well. Even though the South African countertrade policy sets specific penalty guidelines and do not officially use alternative sanctions such as black listing suppliers for future contracts for not honouring their IP obligations, Armscor will also unofficially black list these suppliers for future purchase contracts. Thus forcing suppliers to deliver on their IP obligations (Van Dyk, 2000). So far the deal has since April generated new business and exports for local companies worth some R248, 9 million with the remainder of the obligations being delivered on over the next twelve years (Swart, 2000: 10) Thus South Africa has put in place a comprehensive structure

consisting of three committees as well as official and unofficial penalties to ensure that the supplier honours their IP obligations.

The final research question requires that the study should determine which countertrade (IP) obligation was negotiated with the suppliers. In doing so it can be determined whether countertrade will be able to develop and grow local enterprises. When looking at the IP obligations that was negotiated the following should be kept in mind to understand the light in which these obligations were negotiated. The National Industrial Participation policy's mission statement makes it clear that the South African government wants to use countertrade as a technique to develop South African industry. Adding to this the DIP policy states that one of the DIP programme's intentions is to further the initiative of capacitating and empowerment of Black enterprises and business into the defence related industry. With this in mind the following IP obligations was negotiated:

- The weapons pylons for the Gripen's will be manufactured by Denel a South Africa enterprise, these pylons will not just be manufactured for the local market, but also for the export market. Denel has on its tern subcontracted the manufacturing to a Port Elizabeth based enterprise Camau.
- Saab has installed an aircraft design centre at Denel, using 3D computer modelling.
- Denel will be assembling 23 of the 24 Hawk aeroplanes for the SAAF here in South Africa.
- Denel will also manufacture 23 tailplane sets for the South African Hawks, as well as 48 for the Royal Air Force.
- The South African enterprise AMS has been appointed to produce the health and usage management system (Hums) for the South African, Australian and

Canadian Hawks. Further the AMS Hums is now offered as standard on all BAE Hawks and as an option on all other BAE aircraft.

- ATE is developing the avionics suite for the SAAF Hawks, and this suite will be offered as an export variant for other countries.
- Denel's tooling manufacturing capacity is being looked at to make production jigs for the Eurofighter.
- Denel will further supply rudders, ailerons and other structural components for the Avro RJ regional airliner manufactured by BAE. Denel will also manufacture structural components, rudders and ailerons for the new Avro RJ-X, a new aircraft launched in March 2000.
- Grintek will supply the communications management system for the Gripen fighter aircraft.
- Saab suggested the expansion of the Swedish firm Electrolux's plants in Bronkhorstspuit and Cape Town to produce products for the world market.
- The Swedish producer of fish Swedefish will according to a proposal by Saab go into partnership with the South African fishing community for the development of a fish processing plant. Saab will supply the financing for the plant and also help with the training of the employees.
- In a proposal aimed at the disadvantaged sections of the South African community Saab and BAE will help with the development and manufacturing of a sun heating system and devices for determining electricity consumption.
- Saab will also help with the upgrading of existing sawmills, help market South African furniture in the international market, and help with the development of new furniture manufacturers in South Africa.

- BAE will invest in the South African industry with the acquisition of a 20 percent stake in Denel Aviation for a sum of R 6,5 billion.
- Augusta is planning to build a mini steel mill as part of their NIP obligations.
- Augusta is also planning the manufacture of high value mohair products in South Africa.
- Augusta is planning to manufacture gold chains in conjunction with Filk Gold the world's third largest gold jewellery manufacturer.
- Denel will be involved with August through the manufacture of the commercial Koala helicopter, which Denel will market with them.
- Augusta also proposed the establishment of an ostrich leather tannery on an ostrich farm in the Potgietersrus area.
- The local enterprise ADS will be responsible for the manufacturing of the combat suits for the corvettes and prospects for securing exports of elements of the South African combat suit to other Meko customers are reported to be good.
- A mini-steel mill that will be manufacturing galvanised steel or more specifically plate steel for the motor industry, helping produce steel, motorcars and car components of export quality.
- Technology will be transferred by the German Frigate Consortium to a local supplier of crankshafts helping to boost its production for export purposes to 500 000 units a year.
- A stainless steel plant is proposed for the Coega industrial development zone.

- Lastly the German Submarine Consortium proposed the transfer of technology by Pechiney to South Africa to bring the cosmetics industry in South Africa as far as packaging of cosmetics goes up to international quality standards, enabling South African firms to export cosmetics internationally.

Not all the IP obligations are known yet as some of the suppliers are still busy finalising their business plans. This is however a departure from the NIP and DIP policies as these policies states that potential supplier's should submit business concepts to the IPS and IPCC. When this concept has been approved a final business plans - stating what IP they are going to be involved in – should be submitted to the IPS and IPCC and only after approving this final business plan can the purchase contracts be awarded.

In conclusion the research proved that South Africa has got proper policies in place to ensure the successful implementation of countertrade. It has also been shown that there are proper policies, procedures and committees in place to monitor the compliance with the agreed IP obligations, one of the biggest reasons for the failure of many foreign countertrade deals.

From the IP obligations already determined it can be seen that IP (countertrade) will increase the demand for South African products through production and exports, arms related and non-arms related, making these enterprises grow through increased production. There are also a couple of theses IP obligations focussed on the development of new enterprises such as the Saab project to develop new furniture manufacturers in South Africa. It is however still early days as a couple of IP obligations still has to be announced and the suppliers has got between seven and eleven years to honour their IP obligations. But as was stated above since April 2000 R248, 9 million worth of IP has already taken place. So countertrade relate to this arms procurement deal is capable of leading to the development and growth of South African enterprises.

8.3 RECOMMENDATIONS AND FUTURE RESEARCH

This research was finalised as the Auditor-Generals report on the arms procurement deal was released. In this report it was found amongst other things that there were problems with the technical evaluation of the bid for fighter trainers. The report also recommended that a special forensic audit be conducted into the subcontracts, which fell out of the original terms of reference of his probe (Sapa, 2000: 2). After this report was released the National Assembly's standing committee on public accounts found that the arms procurement deal could cost R14, 5 billion more than initially thought because of bank fees and other transaction costs not taken into account (Loxton and Bloomberg, 2000: 1). The procurement of arms and the allocation of contracts fell outside the scope of this study as it was just focussed on countertrade's ability to develop and grow South African enterprises. However the findings and results of the National Assembly's standing committee's probe as well as the Auditor Generals forensic investigation into the subcontracts creates room for additional research into the allocation of contracts for this arms procurement deal.

Lastly the arms deal and its countertrade obligations are only in its infancy stage as a result one will only be able to determine the success or failure of this deal over the medium to long-term, as the IP obligations will only materialise over the next seven to eleven years. The proof of the pudding is in its eating, and it will require ongoing research and monitoring as well as a situational analysis at certain predetermined check points to determine the success or failure of this deal. Future research can thus be conducted into whether the IP obligations actually materialised and to what extent.

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APPENDIX A

**THE FORMULATION OF A COUNTERTRADE POLICY FOR
GOVERNMENT PROCUREMENT**

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Aim: The aim of this survey is to determine which criteria should be included in a policy when formulating a policy on countertrade for government procurement.

Instructions: Listed in questions 1-14 are various factors identified in literature, which can be included in a countertrade policy. Please mark with an X on a scale of 1-5, the number, which best expresses the importance of the factor to you for inclusion in a countertrade policy for government procurement. **If a factor is not necessary for inclusion, please mark the number 1 (Not important) with an X. A rating of 5 (Very important) should be reserved for those factors, which is extremely important when formulating a countertrade policy.** Question 15 is an open-ended question, which you must please complete in the provided space.

Example:

Factors considered:

1. Develop clear countertrade objectives.

1.	2.	3.	4.	5.
			X	

Factors considered:

1. A countertrade policy should contain clear and un-ambiguous objectives.

1.	2.	3.	4.	5.

2. It should be policy to analyse the motives and policies of potential suppliers.

1.	2.	3.	4.	5.

3. A countertrade policy should state that the country would only negotiate with an enterprise that follows a mutual advantage policy, and not with enterprises that follow a company advantage policy (a win-lose policy).

1.	2.	3.	4.	5.

4. A countertrade policy should state that a country would only negotiate with an enterprise that follows a company advantage policy (win-lose), and not with an enterprise that follows a mutual advantage policy.

1.	2.	3.	4.	5.

5. A countertrade policy should state that not only low value low quality products should be included in the countertrade deal.

1.	2.	3.	4.	5.

6. High value products for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals.

1.	2.	3.	4.	5.

7. The policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase.

1.	2.	3.	4.	5.

8. In the case of the use of offsets the policy should state what percentage of the offsets should be direct, and what percentage should be indirect.

1.	2.	3.	4.	5.

9. The countertrade policy should specify that a detailed description of any countertrade should be given.

1.	2.	3.	4.	5.

10. The policy should state that specific dates should be given for carrying out the program.

1.	2.	3.	4.	5.

11. Performance penalties should be given for non-performance with the agreed obligations.

1.	2.	3.	4.	5.

12. A countertrade policy should try to avoid the use of penalties for non-performance and rather use other sanctions such as the increase of the offset volume, extending the time limit and black listing the enterprise for future sales to the government.

1.	2.	3.	4.	5.

13. The policy should specify that all role players be named for all transactions.

1.	2.	3.	4.	5.

14. The policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations, and to ensure that the penalties or other sanctions are enforced for non-compliance with the countertrade obligations.

1.	2.	3.	4.	5.

15. Which other variable should be included in a countertrade policy for government procurement and list these variables according to their importance on a five point scale where five is very important and one, not important?