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**NEW CHANNELS FOR FINANCING INDUSTRY
FROM COMMERCIAL SOURCES***

(compensation and buy-back arrangements)

prepared by
the secretariat of UNIDO

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BACKGROUND PAPER 4(b)

Introduction

1. The past few decades have witnessed increased complexity and diversification of contractual relationships. On the one hand, contracts dealing with one machine or simple equipment have tended to become a thing of the past; on the other hand, there has been a considerable increase in the sales of complex aggregates of machinery and equipment or of comprehensive industrial units. Today, it rarely happens that the supply of a complete industrial unit is not organized around the sale of a licence: a licence whose exploitation requires the supplying of documentation and know-how which may be prolonged by a technical assistance component. It has also become normal for a contract to provide for the training of the customer's personnel in accordance with a precise organizational structure. Organization and management affecting all the channels of the future unit (from supplies to the marketing of the products) is extremely important. In short, it can be said that we have passed from turn-key contracts^{1/} to the so-called "products in hand"^{2/} or "market in hand" types with a whole series of intermediate formulae combining these various components with different degrees of emphasis.

Financial Aspects

2. The mobilization of financial resources for carrying out a project has become a complex art, passing through many stages from the original outline of the project to the signing of the contract and its implementation; in

1/ This is "the supplying of a complete industrial unit, comprising the design, study, construction and delivery in working order of all the works and equipment for an over-all lump sum price and under the prescribed conditions of production".

2/ In the "product in hand" contract, the buyer entrusts a contractor with responsibility for designing a product as well as for building and equipping the plant needed for its production. The contractor must design the product, determine the process of manufacture, select the equipment, build and equip the factory, select and train the local personnel. Contrary to what happens in "turn-key" contracts, the contractor assumes the technical responsibility up to the time when the local technicians consider themselves able to take over all the operations of production.

* See P. Judet: "Industrial co-operation: trends and prospects" ICIS/73.

fact, the financing of a project can be broken down into some twenty-five successive stages, from the attempts to define financing strategies to the final approval of loan contracts. Some very big engineering firms have set up a specialized section ^{1/} to take care of what might be called the financial engineering of a project: an engineering component whose purpose becomes increasingly important along with the dimensions and cost of very many projects.

Evolution of Contractual Forms and the Planning of Exchanges: Compensation

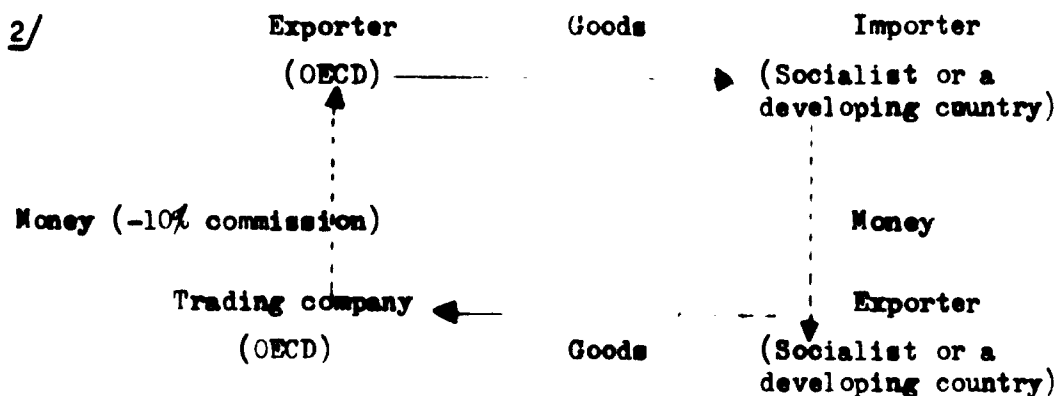
3. The recent development of compensation has introduced a new element of great importance into contractual relations, in so far as the sale of industrial complexes not only gives rise to a financial flow but also to the new unit which has been built. This new procedure marks the transition from the sale of industrial units to complex relationships involving the planning of exchanges and potentially leading on to the question of harmonizing productions, or of industrial collaboration arrangements.

4. There are different modalities of compensation: (i) to (iv) are examples of traditional forms, whereas (v) and (vii) represent new trends:

(i) Barter is the extreme form of compensation; it does not involve any monetary transaction or any other counterpart; usually it gives way to subtler types of arrangement.

(ii) Compensation contracts: ^{2/} the exporter of industrial complexes accepts payment in kind for all or part of the contract. One hundred percent compensation is closely akin to barter, but with two differences: the possible appearance of a third party and the possibility of monetary settlements. Partial compensation affects only a part of the market, the balance being settled in currency.

^{1/} See Business International Money Report, 10 and 17 February 1978, "Project financing now to construct the optimum package".

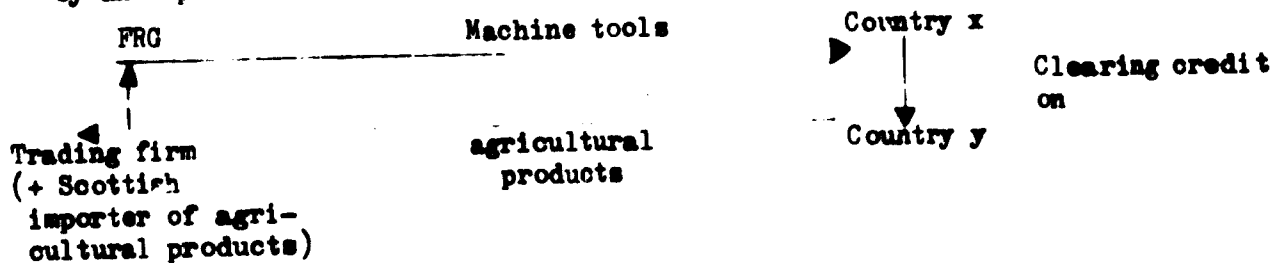


(iii) "Switch" contracts play on the bilateral trade agreements concluded between the socialist countries and many developing countries, known as clearing agreements; these contracts use the clearing credits available in one country to obtain desired products from another country. ^{1/}

The circuit is closed thanks to the intervention of a trading company which finds a buyer for the agricultural products and pays the monetary equivalent to the exporter of machine tools.

(iv) Reciprocal purchase contracts by which the exporter undertakes to purchase (or to have purchased) products of the (socialist or developing) countries for a certain percentage of the amount of the contract and during a specific period of time. Unlike in the case of the preceding type of contract, there is an exchange of currency; additionally, the exporter or a third party can choose - within certain limits - the products to be bought. In this case, two contracts are signed, a sales contract and a purchasing contract; this favours the exporters in so far as the export insurance covers the whole and not the balance.

^{1/} A country x uses a clearing credit which it has in a country y to pay, in agricultural products produced by country y, for machine tools sold by an exporter in the Federal Republic of Germany.



- (v) Agreements of the "buy-back" type. At the present time, compensation agreements are developing fastest in this form. The exporter accepts a payment (whether partial or not) in products manufactured by means of the equipment sold (ammonia in return for an ammonia plant, methanol in return for a methanol plant).

The granting of licences against payment in kind also comes under this heading. Payments in the form of the delivery of products often constitute a preliminary stage in a movement towards more complex relations between the partners.

- (vi) "Self-supporting" or subcontracting agreements. When, in connection with a buy-back agreement, the supplier (of equipment) or the grantor (of a licence) acquires the whole production and continues to buy the products thus manufactured even after the price has been fully paid, one is moving towards a subcontracting agreement. This becomes clear if the products purchased in return are incorporated as parts or subassemblies in a product (or complex) manufactured by the supplier (licenser). We are now in the field of industrial co-operation.

5. In short, the link which is being created between compensation and co-operation may be clear or not depending on the type of compensation used:

- (i) The relationship is distant and vague when purchases of footwear or tomato concentrate partially compensate sales of medical equipment.
- (ii) The link is much more apparent in the case of "buy-back" agreements: the sale of an ammonia plant compensated by the buying back of ammonia over a period of several years, or the sale of a methanol plant compensated by the buying back of methanol, etc.
- (iii) The relationship is, on the other hand, quite obvious when the product bought back is incorporated in a product or set of products being manufactured by the seller (electronics or engineering products). Here we pass from individual transactions (which may be of large size), entered into one

by one, to long-term operations which fall under the heading of "sub-contracting" or "co-production" and, in any case, of industrial co-operation.

Some Considerations on Compensation Arrangements

6. The phenomenon of compensation has certain contradictory aspects: while some administrations show great reluctance to resort to it, other countries are pushing actively in that direction; it may be considered as a necessary evil which is tending to become permanent and in any case is spreading rapidly. Many administrations refuse to have an official position on compensation since they consider it a return to the "barbarism" of barter, undermining the Havana Charter and all the GATT principles which were the driving force behind the improvement in international trade since the end of the Second World War.

7. For example, COFACE in France is extremely reluctant to cover export operations which are explicitly tied to forms of compensation; the same thing appears to be true of Exim in the United States.^{1/} The more open-minded attitude of other insurance organizations, such as ECGD, shows that reservations in principle are in the long run undermined by the sheer force of circumstances. The United States Government for example, estimates that nearly 30 percent of trade between the OECD countries and the socialist countries is transacted on the basis of compensation agreements in various forms.^{2/}

8. Compensation agreements are going beyond the field of East-West trade: relations between oil countries and industrialized countries and to a greater extent between developing countries and industrialized countries, for example:

1/ See Business International Money Report.

2/ In this connection, see Business Eastern Europe, 17 December 1976, 5 August 1977, 3 February 1978, 17 February 1978, etc.

- (i) Iran is concluding or negotiating contracts exchanging oil against industrial equipment or complexes:
- With Italy: 6,000 barrels of oil per day against steel plants valued at US \$1 billion;
 - With the United Kingdom: oil against various types of armaments ^{1/} and equipment;
 - With Greece: oil against services and work by Greek enterprises. ^{2/}
- (ii) Algeria has also placed several contracts on the basis of compensation. The specialized press points out that the readiness to accept and propose compensation is an advantage for firms which want to win markets in this country.
- (iii) Brazil is trying to negotiate contracts which will enable it to exchange its agricultural products (sugar, rice, soya) against the oil which it mostly has to import.

9. Compensation agreements are also increasing between industrialized countries, as in the case of Finland, which asks the United Kingdom for a counterpart of 100 percent to compensate for the purchase of training aircraft. In the case of Canada, which asks for industrial compensation for purchases of equipment from Europe; or in the case of France, which tends to make purchases of foreign aircraft dependent on orders for subassemblies for those aircraft.

^{1/} It is well known that compensation has been readily accepted for a long time when it comes to armament contracts; it is often a condition, for example, in contracts placed between Belgium, the Netherlands, Denmark and the United States for arms purchases.

^{2/} See Business Europe, 5 August 1977.

Compensation as a Phenomenon which is Tending to Become Permanent

10. It is estimated that in the next five years compensation agreements might involve up to 40 percent of East-West trade and up to 6 to 10 percent of world trade as a whole; in these conditions it is understandable that many authorities are beginning - although still unofficially - to evaluate and analyse a reality with which they have to live and from which they ought, if possible, to derive the maximum profit.

11. The socialist countries have been the first to make systematic use of the advantage which they have when they appear as buyers in markets which are on the point of stagnation; they have learned to use the buyer's advantage with full effect; they are using it as a means for restoring their balance of trade. Developing countries, followed by industrialized countries, are also proceeding in the direction of more systematically organized trade relations. Today, it would seem that the time is nearly past when foreign trade services could merely evaluate their possible exports without worrying about what they would buy in return in the various markets they had explored. Such a conception of foreign trade in simple terms of maintaining and expanding shares of the market is tending to disappear before the increasing pressure to tie purchases to sales and sales to purchases, i.e. to plan trade relations.

12. Even if the official authorities of the OECD countries still systematically denounce or are reluctant to apply the compensation method, the same is not true of a large number of industrial, commercial or financial firms. Some of the biggest industrial firms, as well as some smaller ones, are willing to enter into compensation agreements; they even take the initiative in that respect. For example, one big Western firm has set up a commercial subsidiary which specializes in prospecting for products (agricultural or other) in developing countries which lack convertible foreign currency, so that it can find a counterpart for the cars sold by it. This type of agreement encourages the rise of international trading corporations:

corporations affiliated with big industrial groups like the Japanese (or Korean) shoshas, independent corporations or corporations affiliated with banks based in Vienna, Hamburg, London or Amsterdam: the Centro Bank^{1/} in Vienna, for example, whose business turnover rose from \$2 to 55 million between 1975 and 1976.

13. The banks themselves are welcoming the increase in compensation agreements: at least for certain kinds of loans in the case of certain categories of banks. Compensation agreements and especially buy-back agreements are creating a medium-term and long-term flow of goods. A flow of this kind offers the real guarantee which every banker looks for to justify his loans, especially in the case of loans (in Euro-currency) which are not covered or are only partially covered by official insurance of the Hermes, ECGD or Exim type.

There is every reason to conclude, therefore, that compensation agreements are tending to become a contractual arrangement of the greatest importance and that an inventory should be made of their beneficial implications and the possible openings towards more intensive co-operation.

From Compensation to Co-operation

14. To begin with, compensation agreements are to be found in terrain which is unfamiliar to the firms and Governments of developed market-economy countries; they have to enter this terrain willy-nilly, first responding to the initiation of partners and then seizing the initiative themselves. In this context, compensation agreements sometimes have the style of instruments on which a powerrelationship is based; for example:

- On the part of purchasing agencies of the socialist countries, the demand for compensation may be a means of pressure to lower the price agreed to by the seller;
- On the other hand, some big Western firms consider to have made good use of the compensation method to delay the granting of a licence until such time as it became profitable.

^{1/} A subsidiary of Italian, Spanish, British, German, Austrian, French Japanese and Polish banks and corporations. Business Eastern Europe, 18 March 1977.

15. From another point of view, compensation may give socialist countries a marketing network for their products in the West without having spent any resources on the construction of that network; on the other hand, when Western firms take over the marketing of these products in the West that may make it possible to set up a screen between production in the East and marketing in the West and so remain master of the process.

16. The relationships established on the basis of compensation are medium-term or long-term relationships, extending over ten years rather than over five years. They establish, for partners from different environments, a long period of close collaboration. It is found that these co-production and co-operation relationships sometimes tend to lead on to joint ventures for the development of processes and products, and, eventually, research (R and D). These relationships are based on mutual advantage: the expansion of a market and the lowering of certain costs, on one side; access to larger series, or the acquisition and assimilation of new techniques, on the other. In practice, compensation agreements in the sense of co-production and co-operation agreements are today becoming an effective instrument for the transfer of technology where the buying back of the product manufactured under licence is a strong incentive ensuring the effectiveness of the transfer.

From Compensation to Expanded Agreements

17. In some quarters, compensation contracts seem to be regarded not as a makeshift expedient which is better than nothing but as an initial stage which may lead inter alia to two directions: the development of bilateral relations and the expansion of triangular and multilateral arrangements.

- (i) The development of bilateral relations. Buy-back contracts are, after all, limited by the importing capacity of developed market economy countries and also by the exporting possibilities of the developing countries. It is a matter then of adjusting production launched in the developing countries to bring it in line with the needs of the markets of the developing countries so that these operations become equally attractive for both parties.^{1/} We pass then from individual long-term agreements to harmonization based on the adjustment of real flows in industrial development

^{1/} Business Eastern Europe, 9 December 1977.

strategies; this is at the very centre of industrial co-operation.

- (ii) Triangular and multilateral expansion. Compensation agreements do not lock the partners up in a narrow, closed bilateralism. The agencies of the socialist countries are actively seeking to enter into co-operation with Western firms in order to penetrate third markets....Moreover, new industrial partners in developing countries sometimes provide a way into new third markets (in the Third World) for large Western firms of consulting engineers and suppliers of plants. Western firms also take the initiative in proposing to the USSR and other socialist countries co-operation on industrial projects directed towards third countries

18. Compensation agreements generally constitute one element in these complex systems, where the transfer of technology is linked to an expansion of markets, and where quite original edifices are being built in place of the undermined edifice of free trade - the efficiency of which must in any case be examined in the light of the very modest results obtained by the developing countries under a generalized system of preferences. Before trying to identify the implications of this evolution in contractual forms from the viewpoint of industrial co-operation and inquiring into the role of the firms, States and multilateral organizations involved, a more refined approach is once again needed as we analyse the problem areas which arise in any co-operation effort.

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