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Emerging legal challenges for countertrade techniques in international trade

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Introduction

Countertrade might generally be said to be a form of trade that involves the exchanging of goods or services, between buyer and seller, which are paid for, in whole or part, with other goods or services. The United Nations Commission on International Trade Law (UNCITRAL) Legal Guide on International Countertrade Transactions provides in Ch.I that:

"Countertrade transactions covered by the Legal Guide are those transactions in which one party supplies goods, services, technology or other economic value to the second party, and, in return, the first party purchases from the second party an agreed amount of goods, services, technology or other economic value".[1]

Countertrade, in modern times, appears in several variants, namely: barter, counterpurchase, buy-back, switch-trading, bilateral agreements, offset and build-operate-transfer (BOT). Although the concept of trading without using liquid cash or cash equivalents might seem a little anachronistic, the regrowth in countertrade in international trade is now an acknowledged fact.[2] This is despite the falling away of the Eastern communist bloc. This raises the question as to what the impetuses are behind this continued renaissance. This article evaluates the emerging trends in countertrade and explores some of the new challenges faced by participants in countertrade.[3]

A brief history of countertrade

The past

Although it is fair to say that countertrade, at least in the form of barter, was practised as early as 2500BC,[4] it is only appropriate for this article to take up the story in the 20th century when modern countertrade practices might first be said to have taken hold. In modern times, countertrading arose as a means of conducting international trade when there was a lack of hard currency[5] available to finance trade, or when the currency in question was subject to unpredictable inflationary and deflationary swings in value. It is not unpredictable therefore that it was the serious economic crises of the 1920s and 1930s that led to the redeployment of barter and the creation of other newer countertrade techniques (such as counterpurchase) by states labouring under a weak or unpredictable currency. From 1930-33 almost all Western European countries set up substantive controls on foreign trade and exchange and concluded a great number of bilateral agreements with a barter character. During the later 1930s, international barter experienced a further boost given the very tightly controlled economic and monetary policies in Germany. Germany established an extensive network of countertrade arrangements in particular with Eastern Europe and Latin America to obtain necessary food and raw materials.6 In Germany, both between the two World Wars and after the Second World War, countertrading and barter became a conventional way of conducting international trade. The former socialist countries in Central and Eastern Europe followed Germany's lead and by the 1960s had employed countertrading, on a large scale, in trade between themselves as a way ***Int. T.L.R. 112** to overcome the problems of their own nonconvertible currencies.7 The scale was soon enlarged to encompass countertrade transactions with various developing countries.8 And during the oil crisis in the mid-1970s, countertrade provided the socialist economies with a fairly reliable hedge.

While it is clear that countertrade in the 1970s was spurred on by the rise of protectionism, the decline in confidence in the world trading system coupled with a growing debt crisis among less developed countries gave succour to a practice that was largely inured from currency problems.9 By the end of the 1980s, nearly 100 countries were using countertrade and over half of the Fortune 500 companies had a countertrade vision.10 In the United States military offsets were the most common form of countertrading, accounting for an estimated 80 per cent of all US countertrade in 1984. In 1985 it may have accounted for 10 per cent of all international trade.11 During the second half of that decade, interest in countertrading softened as oil prices fell and the international business conjecture improved. At that time oil was the most countertraded of all the commodities. The period between the end of the Second World War and the gradual break-up of the Eastern bloc might therefore be said to show the consolidation of countertrade's role in international trade.12

In the early 1990s, Eastern Europe and the countries of the former Soviet Union began countertrading with Western nations to overcome difficulties associated with their currencies.13 However, countertrade was seen very much as an integral part of the old politics. Thus, with the shift in Eastern and Central Europe towards the end of the 1990s to a more liberal economic system, countertrade, which was perceived as a relic of the old dispensation, was quickly dispensed with.14 For example, according to Ibrohim Namirov, after achieving independence in 1991, the Government of Uzbekistan published a list of goods that traders were allowed to countertrade. Every year the list was shortened.15

The emerging trends

The main question for the modern commercial enterprise is whether countertrade can be economically profitable. Companies can use their countertrade suppliers as reliable long-term sources of certain critical raw materials, component parts or finished goods. These supply sources may be essential to a company's operations and are often not overly expensive because of relatively low labour costs.16

The same rationale applies to state-linked or state-run entities seeking a stable supplier. China's thirst for oil and gas for example, has led to countertrade arrangements with oil and gas producing countries in Africa, such as Sudan, Nigeria and South Africa. According to official Chinese statistics, trade between China and Africa has grown in the past year by nearly 35 per cent to more than US $39 billion (and this rate nearly doubling every year).17 And, as the world's second-largest consumer of oil, China has become Africa's third most important trading partner, after France and the United States. In Nigeria, for example, China signed a US $2.3 billion deal in January 2006 for the exploitation of an oil field. Beijing also agreed to a US $2 billion loan; and a Chinese company is going to help rehabilitate Nigeria's ailing railways.18 These trade relations are nearly all conducted through countertrade techniques such as buy-back and related bilateral agreements.

There is a discernible move from pure, direct reciprocity. More and more developing countries insist on infrastructural support and/or technology transfer, instead of the mere purchase of ***Int. T.L.R. 113** compensation products by the suppliers. Certain countries demand technology transfer as a part of the offset or other countertrade agreements (South Korea, Indonesia) while others create whole new industries (such as Turkey in its F-16 deal with General Dynamics). Short of offset, there was no way Turkey could consider acquiring an aviation industry of its own.19 Of course, one should realise that these possibilities may or may not bear fruit, but the opportunity to create more business or utilise foreign trade for domestic political or economic purposes in development is an added attraction of countertrade that seldom exists in a cash transaction.20 These perspectives led to a number of Asian countries adopting national countertrade policies. This was especially so after the economic crisis in South-East Asia in the late 1990s, when there was a loss of faith in cash-based transactions and a concern over the sudden flight of capital. Although in some such countries countertrade is viewed only as a second-best alternative to be used only when “normal” trade cannot be conducted,21 there is a genuine regard that national policies should be in place to ensure that countertrade can be used either as a helpful alternative in times of economic trouble or as an effective complement to “normal” trade under normal circumstances. More than 88 countries now stipulate in their foreign trade policy that for all purchases some amount of countertrade or proportional purchase of value-added products must be part of each transaction.22

The resurgence in countertrade is seen especially in countries where countertrade was not seen as an objectionable part of a rejected economic system.23 In the United States, for example, the Department of Commerce reported in 2004 that roughly 30 per cent of all international trade involved countertrade.24 There is also growth in African25 and Asian26 states where there is no association between socialism and countertrade.27 Precise figures are, however, generally difficult to establish, but various estimates suggest that countertrade may account for anything between 5 and 35 per cent of total world trade.28 Figures are difficult to come by partly because many countertrade participants tend to keep their transactions private and data collecting in certain countries is not entirely effective. It might be added that participants prefer to keep their transactions confidential because of the stigma of lack of liquidity that has traditionally been associated with countertrade.

Moreover, there is disagreement between countries as to what constitutes countertrade. Although the US Government publicly criticises traditional forms of countertrade as being uneconomic, it is also one of the most significant participants in the offset form of countertrade. Perhaps somewhat conveniently, it does not regard offset as a form of countertrade, whereas most other countries do.29 This makes national comparisons difficult. It might also be noted that as countertrade involves reciprocal exchange, the value placed on the goods involved may not reflect world market prices. This means that if countertrade has been used to avoid anti-dumping legislation, the goods being sold may reflect domestic costs of production but those bought may only be at approximately 25 per cent above world market prices. In this regard, the inclusion of transaction prices in statistics can be misleading.30

Islamic countries, especially in the Middle East, are now also increasingly providing their own distinctive approach to countertrade structuring. Because of the proscription on interest and wagering in Islamic law, Islamic finance companies, banks and traders find in countertrade methods of great interest. This article will discuss later how the convergence between Islamic finance and countertrade is being achieved.

***Int. T.L.R. 114** After decades of unease, international organisations, too, are changing their views on countertrade. As might be appreciated, countertrade is not the form of free trade on which the GATT (and subsequently the WTO) was based, but its role was examined by the Organisation for Economic Co-operation and Development (OECD) which warned in its study of East-West trade in 1981 against a policy of "no policy" because countertrade was developing at a rapid rate and decisions of firms might be contrary to the interests of the member nations of the OECD and their relations with the countries engaged in East-West trade.31 It would not be wrong to suggest that the international organisations involved with international trade are increasingly concerned about the problems countertrade might cause to the world trade system as we know it. The biggest charge levelled against countertrade is that it is bilateral rather than multilateral in nature. As such, it distorts trade by limiting the number of market participants and potentially reducing competition.32 Another matter leading to some disquiet is the suspicion that countertrade can too easily lend itself to "covert dumping". A country may offer its goods at a discount so as to induce its supplying partner to participate; while the supplying partner may hastily and recklessly dump the goods it receives in order to receive cash.33

An emerging issue of some concern in relation to countertrade for international trade organisations is that of accountability. Accountability is a striking issue because of the nexus between countertrade and international development. Are the developing countries getting true value? It is generally accepted that there is over-pricing by exporter companies in most of the arrangements, namely the so called "hidden cost". Exporter companies add these extras to their prices as an "unofficial" fee against technological and know-how transfers to those countries. The very complex nature of the arrangements (the so-called "package deal") makes it easy to hide true proceeds and costs.34 However, importer countries do turn a blind eye, because of the incentives promised by countertrade--the dispensing of hard liquid currency of payment, the receipt of new technology, the creation of jobs, the development of an entirely new industry, etc. Although an effective government audit office (such as the UK National Audit Office, the US Governmental Accountability Office) or an agency charged with implementing appropriately made foreign investment laws would go some way to ensure that the receiving state's taxpayers get proper value, it goes without saying that these accountability arrangements are not always present or adopted in many developing countries.

Despite the misgivings that international trade organisations, such as the WTO, have regarding countertrade, there is no disputing the fact that some legal guidance is needed for the reemerging phenomenon. In this connection, UNCITRAL decided to produce guidance on how best to engage in international countertrade transactions. In May 1992, the Legal Guide on International Countertrade Transactions was adopted by UNCITRAL and became the main source of soft law in the area. Countertrade principles and terminology are extensively covered in this guide. The Legal Guide does not argue for or against the use of countertrade as an effective means of trading but simply provides guidelines on how contractual problems might be resolved. While there is no direct endorsement of the effectiveness of countertrade as a form of trading by UNCITRAL in the Legal Guide, the fact that countertrade mechanics and principles are now specifically referred to in other UNCITRAL Rules and Model Laws demonstrates its increasing importance in international trade.35

Another international measure worth noting is the publication of two Guides on countertrade by the United Nations Economic Commission for Europe. The first was on International Counterpurchase Contracts (1990), and the other on the International Buy-Back Contract (1991).36 These two guides aim to provide potential participants with a basis for understanding the nature of these methods and to give them guidance on drawing up the necessary contractual documents.

Int. T.L.R. 115 Thus far, we have considered the growth, decline and regrowth of countertrade as a general form of international trading. However, it should be noted that countertrade exists in several forms. Not all forms of countertrade share the same resurgence in interest. There is some evidence that the classical forms such as barter and counterpurchase are on the decline, but greater emphasis is being placed on long-term and development-oriented forms of countertrade such as offsets and buy-back.37 More and more mainly developing countries are requiring their foreign suppliers to purchase national products to a greater or lesser degree. Businesses in industrialised nations thus have to organise themselves to face this demand from their buyers, by creating or extending services specialising in the selection and redistribution of compensation products. In some OECD member countries, governments have set up public or semi-public agencies to brief national firms on these new practices.38 Some regional centres also exist and act as clearing houses for countertrade deals--for example, the Miami International Currency and Barter exchange in the United States, and the Association pour la Compensation des Exchanges Commerciaux (ACECO) in France.39

An appraisal of modern countertrade techniques

Barter

As the earliest form of trade, barter is simply an exchange of goods or services with other goods or services. From a classical and neoclassical economics perspective, it might be said that barter represents the origin of money in that it was the impetus for the introduction of money--money, it could be said, originates as a solution to the problems of barter.40 Despite the emphasis on the difficulties barter poses to the trader in classical and neo-classical economics, the reality is that barter has a significant role in modern international trade and should not be dismissed lightly.41 Contractually, barter is a one-time transaction and involves only one contract, covering the offsetting deliveries between the two parties. Schmitthoff points out that a main difference between barter and a reciprocal sales agreement (counterpurchase) is that the latter is always a two-contract arrangement.42

It might be said that there are two types of barter--true barter and valued barter. In true barter, there is a simple exchange and no value is placed on the goods exchanged. On the other hand, in the second type, some value is put on the exchanged goods.43 This distinction is important; because of the value involved, only the second type of barter can be subject-matter of a commercial transaction in the sense that the consideration for one set of goods is measured against the value of the corresponding set of goods.44 Parties value their goods, but the value placed on the goods by one does not generally match the value placed on them by the other. It is therefore unsurprising that the settlement of the trade balance is a knotted problem in valued barter. This problem is usually overcome by the use of a "settlement" or "evidence account", which is (preferably) expressed in a hard currency country. The value of the bartered goods is set off in the settlement account and on termination of the transaction; the credit balance (if any) is paid in cash to the party whoever is entitled for it.

Despite the impression from the simple form of barter that there are two parties to the transaction, in reality there are normally three parties involved. This is because it is exceedingly difficult for one trader to find another with exactly the goods that he or she wants. It is far more convenient to dispose of the goods to an intermediary who will pair or match up the many bartering participants out in the open market. Modern barter thus faces two critical impediments--the problem of matching up needs and wants, and the problem of finding an honest broker. That could very well explain the relatively small role barter plays in modern trade; it has been reported that barter ***Int. T.L.R. 116** now accounts for around 8 per cent of global countertrade.45 That said, barter has the distinct advantage of being able to minimise the ill effects of fluctuations in the market value of the goods being exchanged because it normally takes place not only over a relatively short period of time, but also, because despite a price-type value having been applied to the reciprocal goods, that value of the reciprocal goods is more than a simple market price of the goods being exchanged/sold. Such a value is generally more stable. It should also be added that with the growth of telecommunications and IT platforms, especially in the business-to-business sector, barter brokers and participants are better placed to find the right "buyers" for their goods.

Barter deals, like most trade transactions, can be structured to be as cost-efficient as possible. It would therefore not be appropriate to assume that barter will be more costly than other trade instruments simply because intermediaries are involved. The real issue is ensuring that the contract is actually performed. As with all trade transactions, if litigation can be avoided, that would be an asset. Guarantees, especially demand or performance guarantees, can be used to ensure performance.46 Documentary credits, on the other hand, would be difficult to use. Barter does not entail a price consideration, thus making it hard for banks to issue letters of credit in favour of one party to the barter.

Often such agreements are concluded on a government-to-government basis, and the motives for entering into them may be more political than economic or commercial. Take for instance Venezuela. It uses its oil production as a tool to support countries like Cuba, Bolivia or more recently, Panama (natural gas and fuel joint venture deal)47 as an act of solidarity and support of their governments.48 Barter is simply a means of trade--as an instrument, it is amoral. Indeed, developing countries can quite conveniently use barter to acquire arms and weaponry which they would otherwise have been unable to afford. These deals are clearly controversial but represent a reality in the current marketplace where there are arms-exporting countries seeing barter and other countertrade forms as an effective means for conducting the arms trade. An oft-cited but controversial example is Thailand, which, prior to the coup in 2006, had made a number of barter arrangements for armed helicopters, armoured vehicles and fighter jets with China and Russia, in exchange for agricultural produce.49

Barter is also seen increasingly as a device for regional development. In July 2007, the construction of a bartering complex will commence in East Malaysia in the Batu Sapi area.50 The terminal will house a grain warehouse, bunkering area, customs, immigration, quarantine complex and a commercial centre for trading. The site was chosen because of its proximity to the Philippines, Indonesia and Papua New Guinea where commodities and natural resources have been traded with the West for centuries. The expectation is for barter to be carried on at a one-stop shop for grains, timber, food products, livestock, palm oil, electrical products, beverages, tobacco, and chemicals. The local Malaysian company given the contract to manage the terminal, Windsor Trade Ltd, has made clear that the terminal will cater for 90 vessels of 150 gross tonnage each, per day. What is also interesting is the fact that the company will be managing the barter project without any financial assistance from the state.51 This is clearly different from the way barter was managed in the past--one might justifiably see this as the privatisation of barter. Barter in the past was clearly state dominated and controlled and was characterised as a bilateral transaction. The new structure provides for a marketplace for all who intend to exchange goods to operate. The structure is triangular with the two parties and the marketplace operator/facilitator.

The Malaysian example demonstrates how barter is used at a localised, regional level. This is international trade in a highly informal context. It is also very democratised--instead of state-run agencies dealing with the exchange of goods, the state's role is reduced to facilitating trading between small traders. That being the case, statistics on trade balances and volume of trade would be difficult to collate. There are also implications for tax authorities, and instead of taking taxes based on turnover or income, governments will need to concentrate on the effective collection of customs duties.

Barter is not just a historical institution or one peculiar to archaic or “primitive” economies: it is a contemporary phenomenon, which covers both large and small-scale transactions and occurs within and between many different types of economic and social environment.52

Int. T.L.R. 117 **Counterpurchase or reciprocal sales**

The ECFE's guide defines “International Counterpurchase Contracts” thus:

“the seller and buyer of a primary transaction agree that the seller will subsequently buy (or will cause third parties to buy) products from the buyer (or from third parties in the buyer's country). In this form, the two flows of products--that is, the products sold under the primary transaction, on the one hand, and those sold in countertrade, on the other are paid for in money. The value of products bought under the counterpurchase contract may be lower than, equal to, or higher than the value of the products sold under the primary transaction. A typical feature of a counterpurchase transaction is that, contrary to buy-back, there need not be any special relationship between the products sold under the primary transaction and those supplied in accordance with the counterpurchase contract."[53]

It is an arrangement which has at times been referred to as parallel barter--the exporter seller undertakes to buy goods from an importer buyer or a company nominated by the importer, or agrees to arrange for their purchase by a third party within a specified time period. Third parties are commonly involved because it is natural that not every seller actually wants the counterpurchase product or goods in question for itself. There is no requirement for adequacy of consideration--the goods bought under the counterpurchase arrangement may range from a mere 10 per cent to 150 per cent of the value of the goods in the main contract. If the value of products bought under the counterpurchase contract is lower than the value of the products sold under the first transaction, the exporter seller pays the rest of the value with hard currency to the importer buyer. Ultimately, it is a commercial transaction. The failure on the part of the exporter to carry out its counterpurchase obligations is thus usually sanctioned by a liquidated damages clause.

There are two parallel contracts of sale (for each product and hard currency) in counterpurchase arrangements--the export contract and countersale. The second agreement sets out the general agreement to buy and the time-scale for performance. It is common for the agreement not to specify or describe the goods to be bought. Counterpurchase agreements are often part of a package put together in the absence of traditional financing, and can be combined with aid, loans or part payment in cash.[54] This limits the liability of each party to the specific transaction rather than the whole chain of related transactions.[55]

According to Schmitthoff there are two types of counterpurchase arrangements.[56] The first type normally involves three agreements:

1. a framework agreement ormemorandum of understanding providing for the reciprocal sales;

2. a contract of export;

3. a contract of countersale.

This arrangement has the advantage of keeping all three contracts separate--this makes it easier for the exporter to obtain export credit guarantees because export credit insurers are generally not prepared to underwrite risks in unusual trade arrangements. The same goes for the banks from which the exporter or counter-seller might seek performance guarantees. It is commercial wisdom for banks actively to disassociate themselves from the actual contract of sale and its performance when giving performance guarantees.[57]

In the second variant, the export sale is conditional on the export seller entering into, or possibly performing, the countersale. Any third party financing the export for example is necessarily and inevitably exposed to the vicissitude of the exporter failing to enter into or discharge his countersale obligation.

The two contracts of sale and countersale must be linked given that they are the product of a counterpurchase arrangement. This linkage is normally facilitated by the framework agreement or memorandum of understanding.58 Indeed, it ***Int. T.L.R. 118** might be noted that the UNCITRAL Legal Guide on International Countertrade Transactions does not consider contractually unlinked transactions as countertrade transactions. The Legal Guide in Ch.I states:

"The countertrade agreement is the term used in the Legal Guide for the basic agreement which sets forth stipulations concerning the manner in which the countertrade transaction is to be implemented."

Although it is possible for the entire arrangement to be contained in just one contract, this mode of counterpurchasing is inflexible because all the terms of the export and countersale would have been pre-agreed in the all-in-one contract. Any problems affecting either the export or the countersale could potentially jeopardise the entire counterpurchase arrangement.

Counterpurchase is the most frequently used form of countertrade, although recently its popularity has seen a decline.59 At present about 45 per cent of global countertrade takes this form.60 This form of trading appeals to many importing countries as a means of assuring a more positive trade balance.

Buy-back

Rajski defined buy-back (also known as compensation) arrangements as follows:

"A buy-back transaction may be described as a long-term arrangement in which a party under an obligation to deliver equipment, licenses and know-how for the construction of an industrial installation and/or to render appropriate technical services undertakes to buy over a fixed period (usually several years) products resulting from those installations in total or in part payment."61

Such arrangements are therefore normally made in oil, mining or other major industries.

The main difficulty in buy-back arrangements is the lack of consensus as to what constitutes satisfactory performance of the arrangement. The arrangement must therefore be properly detailed in the contract and must prescribe quite clearly what is acceptable--from the precise specification of the product/s in question to the amount, delivery periods, terms of maintenance, etc.). These problems are more acute in the buy-back as compared with a conventional sale contract for several reasons. First, the exporter has a direct role in the infrastructure or plant which manufactures the goods for the buy-back, rendering it more difficult for the exporter/investor to claim that the fault in delivering the goods to specification was with the producer/importer. Secondly, the perception that the buy-back is less of a commercial relationship than an investment in the importer country could cause a conflict of expectations in that it might be arguable that the contract is an investment contract which is to discharged over a certain period of time and not in the single delivery of goods, unlike a commercial sale. Thirdly, there is a clear risk that the goods produced for the buy-back could well fall below the standards expected by the exporter. It might plausibly be suggested that the importer country (usually a developing country) has lower manufacturing standards and weaker management systems for controlling the manufacturing process and quality. This is not an insurmountable problem but for the exporter to fully prevent a problem with manufacturing standards, it would do well to take a greater interest in the entire process--from production to marketing. It is customary for buy-back agreements to extend beyond the simple exchange of capital goods or production facilities and their related output. In order to win the contract for a specific facility, the private corporation may agree to provide the developing nation with a variety of other types of assistance, including loans, technology transfer, personnel training, plant operation and joint ventures. Such arrangements can be attractive to corporations for a variety of strategic and marketing reasons.62 Those reasons are more or less the same as those for foreign investments. The availability of good quality raw material, cheap labour, possible advantages on tax and the possibility of becoming a local market player are all important. As regards the buy-back contract, companies would mainly want to secure supplies of goods of a high enough quality or to get remunerated in some other way for what they transferred to or built in that country.

These arrangements developed rapidly from the 1960s onwards, particularly in long- and medium-term projects. Buy-backs are now less common in practice than they used to be in the 1970s and 1980s.63 It is beyond the scope of this article to delve into how buy-back is used in the early years as a significant form of foreign investment. It suffices to say that buy-back is a frequently used form of investment (perhaps more so than being seen and used as a commercial transaction per se). Indeed, as is seen in the pervasive use of buy-back in the Gulf countries over the last ***Int. T.L.R. 119** few decades to develop a fully fledged oil and gas industry,64 there is little disputing that buy-back is very suitable for large infrastructural projects. Another region which has relied on the buy-back for economic growth is Eastern Europe, where buy-back, especially in the late 1990s after these countries converted into free market economies, was seen as a primary means to attract investment. The difference between the Gulf states and Eastern European countries is the fact that while in the former buy-back has been vital in the introduction of turnkey projects, in the latter it has been largely used to upgrade obsolete plants.

The nature of the relationship is usually medium to long term; the time taken to pay for the plant by way of accepting products produced in that plant, and the agreement will be for a considerable duration. Because of its long-term character, the buy-back contract generally also provides for some "adaptation" mechanisms, which allow adjustment of some of the stipulations to changing circumstances, if this appears necessary.65

When compared with counterpurchase, buy-back contracts tend to be more sophisticated and complex because they are more than a pure and simple one-off commercial transaction but are a longer-term relationship of mutual co-operation and benefit. In the Economic Commission for Europe's International Counterpurchase Contract Guide,66 the difference between buy-back and counterpurchase is seen in the definition of buy-back:

"In this form, the object of the primary transaction is machinery, equipment, patents, know-how, or technical assistance that will be used to set up production facilities for the buyer. The parties agree that the seller will subsequently buy from the buyer products produced in those production facilities. As in counterpurchase, both flows of products are paid for in money, and the value of the products bought back may be lower than, equal to, or higher than that of the products of the primary transaction"67

That said, like most counterpurchase deals, buy-back arrangements are generally composed of three contracts, two purchase contracts and one protocol (framework). The protocol will usually provide for the general obligation on the parties to enter into the two agreements. It is not always clear whether this protocol conveys legal force.68

Switch-trading

This technique involves at least three parties. It is really more of a special method of payment rather than a trading form.69 The best way to explain switch-trading is to give an example, as follows:

An exporter seller from Germany sells its machinery products to a Ukrainian importer buyer, but because of the lack of convertible foreign hard currency in Ukraine, the buyer cannot pay the price and the German seller does not want to get paid in hryvnia (Ukrainian currency). However, the buyer is the beneficiary of a credit from a Russian company in roubles (Russian currency), because of a separate transaction. The German seller considers buying some steel sheets in Russia; therefore it can agree to get paid in roubles and pay its purchase in local currency. In that way the Ukrainian company makes its international purchase without using hard currency, which does not exist anyway, and the German company sells its product securely and makes its purchase without paying the exchange rate.

That said, the reality is not that simple as matching demands are very difficult. Companies thus usually turn to professional help for switch-trading. The persons who arrange these clearing transactions are called "switch traders", and they obviously add an additional cost to the transaction.

Bilateral agreements

Bilateral agreements or trade protocols between two governments are designed to facilitate countertrade between the countries concerned. Occasionally two nations will agree to purchase goods from each other in a determined amount. These are so-called "clearing units"--they are namely an artificial use of a pre-set currency, usually the dollar. The trade is designed to remain in balance. If it becomes out of balance the clearing units may be sold, often at a discount and often using a switch trader.70

Frequently, bilateral agreements are drawn up in more general terms, without specifying particular goods or services. This is perhaps why ***Int. T.L.R. 120** bilateral agreements are seen more as diplomatic or political instruments, rather than technical legal agreements. For the lawyer, there is clearly a disadvantage in relying on a bilateral "agreement" for enforcing legal rights and remedies.

Offset

Offset is the one of the more popular forms of countertrade. It is defined in the Legal Guide on International Countertrade (UNCITRAL) as:

"normally involv[ing] the supply of goods of high value or technological sophistication and may include the transfer of technology and know-how, promotion of investments and facilitating access to a particular market".

There are two types of offset arrangements: direct and indirect. Direct offsets involve co-production arrangements based on transfer of production technology to the importing country. Such deals are used by the importing country as a tool for industrial development, domestic employment generation and the financing of payment balance. However, in indirect offset the exporter seller agrees to purchase unrelated products from the importer buyer. Such arrangements help the buying country, typically a third-world state, to earn back some of the cost of the imports. In spite of the decreasing popularity of direct offset, indirect offset arrangements, since the mid-1990s, have been experiencing a growth in popularity.[71] The economic benefits of a direct offset are clearly more narrowly focused and are thus more favoured by economies at a more advanced state of development seeking to enhance a particular high-tech industry. Indirect offsets are applied by economies seeking investment in more general and broadly based, lower-tech, industries.[72] It is this desire of the recipient country that has led to many a high-tech multinational corporation setting up low-tech industries in developing countries--such as Thompson-CSF being involved in textile and garment manufacturing; Giat Industries in air conditioning, a horse racetrack, a stainless steel service centre, vegetable production and the winding and overhaul of industrial electric motors; Raytheon in aluminium smelting; and McDonnell-Douglas Helicopter Company (now a part of Boeing) in oil-spill cleanups.[73] That said, for an aspiring developing country seeking to develop a niche industry, the direct offset arrangement is by far superior.[74] The exporting firm, however, must be aware that the such narrowly focused transfer of technology can do commercial harm to its own interests or its home employees--for example, the fact that in the late 1990s, having received the necessary investment and technology, Turkey was able to manufacture F-16 jets in its own right for sale to Egypt was deeply resented by Lockheed-Martin workers.

Allocating the appropriate percentage of the local production is the most important part of the offset deals for both parties. Generally exporter sellers are not too keen on keeping this higher, because of strategic economic reasons and their government's attitudes on the issue. Exporter countries, for example, can be very strict about technology and know-how transfer, especially in the defence sector. On the other hand importer parties normally try to make this rate as high as they can for obvious reasons. Negotiations can thus be protracted and complicated and various protective devices, such as first demand guarantees, bonds, etc. might have to be resorted to. All this can potentially make offset an expensive arrangement. However, the exporting and importing countries need to appreciate that the offset relationship is intended to be over a long term and for substantial mutual benefits. As such, although the initial costs might appear prohibitive, they could be well worth it.[75]

Offsets are perhaps best known in the arms trade. These so-called defence offsets began in the late 1950s within the Cold War atmosphere. The Member States of NATO initiated offsets in the military sector with their procurement of military equipment from the United States. Between 1960 and 1975, the demand for offsets from the United States spread rapidly and resulted in offset agreements between the United States and most other industrial countries (NATO countries, Australia, Japan and Switzerland) and several other countries, including Argentina, Brazil, Iran, India, Pakistan, the Philippines, South Korea, ***Int. T.L.R. 121** Taiwan and Thailand.[76] Today, offsets are part of almost all large international arms agreements, and more than 130 countries have adopted offset policies.77 Defence offsets have clearly benefited a significant number of growing economies, especially those economies with problems with hard currencies. Developing economies have recognised the need for them to put in place appropriate laws to deal with offset, especially the defence offset. It is not acceptable to leave the offset arrangement wholly in the hands of the contract and the laws (and guidelines) the exporting country subscribes to. As far as the importing state is concerned, domestic policy needs to be better articulated and decisions should not be taken without being subjected to properly devised legal or administrative guidelines. This development is to be welcome--it is important to recognise the offset as a relationship between peers, not one where the exporting country calls all the shots and take on a paternalistic (or, in the bad old days, an exploitative) role. In Turkey, for example, the Directive on Offset Implementations in Defence Procurement Transactions was implemented on May 12, 2000 to provide for a more effective infrastructure of the defence offset industry and to eliminate negative impacts on the balance of payments caused by poor valuation of offset credits. This directive was recently modified by a new directive issued on July 15, 2003.78 A special importance is given to offsets of the projects undertaken by the Undersecretariat for Defence Industries (UDI) and high rate offsets are demanded from the participants. As of December 31, 2003, the number of contracts signed by UDI has reached 41 and within the scope of these projects, a total of US $4.1 billion has been committed. To date, 10 of the offset contracts awarded by UDI have been successfully completed. The remaining 31 are still effective and continue to be performed. Outstanding offset obligations under the existing offset agreements will be fulfilled by the end of 2013, which is worth US $2,356 billion.79

That said, the state's role in defence offset has always been quite controversial, and perhaps even more so as regards indirect defence offset. It might be said that the issue is problematically one of characterisation. Is it a matter of commerce or defence? In the United States, for example, the Department of Defense has no authority to require disclosure of statistics by firms engaged in defence offset--the jurisdiction to require statistics falls to the Department of Commerce, and even then the authority is limited to defence offset arrangements exceeding US $5,000,000 in value.80 However, if the offset arrangement involved the transfer of sensitive technology, or the export of physical defence goods, formal approval would be required.81 As far as the United Kingdom and the European Union are concerned, there too are similar provisions for state intervention and control. On October 26, 2000 the UK Government announced the consolidation of the national and EU criteria into a new single set of criteria. The Consolidated EU and National Arms Export Licensing Criteria will be used for all applications for:

• licences to export goods on the Military List, which forms Pt III of Sch.I to the Export of Goods (Control) Order 1994;

• advance approvals for promotion prior to formal application for an export licence;

• licences for the export of dual-use goods as specified in Annex 1 of Council Decision 94/942/CFSP,

where there are grounds for believing that the end-user of such goods will be the armed forces or internal security forces or similar entities in the recipient countries or that the goods will be used to produce arms or other goods on the Military List for such end-users. The criteria to be applied are:

• respect for the United Kingdom's international commitments, in particular sanctions ***Int. T.L.R. 122** decreed by the UN Security Council and those decreed by the European Community, agreements on non-proliferation and other subjects, as well as other international obligations;

• the respect of human rights and the fundamental freedoms in the country of final destination;

• the internal situation in the country of final destination, as a function of the existence of tensions or armed conflicts;

• preservation of regional peace, security and stability;

• the national security of the United Kingdom, of territories whose external relations are the United Kingdom's responsibilities, and of allies, EU Member States and other friendly countries;

• the behaviour of the buyer country with regard to the international community, in particular its attitude to terrorism, the nature of its alliances and respect for international law;

• the existence of a risk that the equipment will be diverted within the buyer country or re-exported under undesirable conditions;

• the compatability of the arms exports with the technical and economic capacity of the recipient country, taking into account the desirability that states should achieve their legitimate needs of security and defence with the least diversion for armaments of human and economic resources.

These "principles" are by no means straightforward --by their exhortatory nature, it is not easy to see how across the wide span of the European Union they could be applied uniformly and consistently. Indeed, the UK Ministry of Defence has stated[82] that in addition to these criteria, it will also take into account the following factors:

• the potential effects on economic interests and long-term stable democratic trading partners;

• the potential effect on the United Kingdom's relations with the recipient country;

• the potential effect on any collaborative defence production or procurement project with allies or EU partners;

• the protection of the United Kingdom's essential strategic industrial base.

Although it might be argued that there is no direct conflict between these and the EU criteria, and the authors are not advocating complete uniformity,[83] this fact shows that there is much room for controversy as to how the different criteria are to be weighed against each other.

The question is whether these criteria will always apply to a defence offset. Do they apply to both direct and indirect defence offset? The firm seeking to engage in the defence offset needs clarity on the matter. This is further complicated by the fact that if it is a matter of commerce, a firm based in the European Union intending to enter into an offset arrangement must naturally contend with the EU's approach to open competition and free movement rules. It has generally been assumed that Art.296 EC exempted Member States from the internal market freedom rules in matters relating to defence procurement.84 In the light of disquiet over the over-generous way Member States have construed the exemption, the Commission has recently published an Interpretative Communication85 to provide guidance on how to apply the provision. In particular, as far as indirect offsets are concerned, the Communication states:

"The objective justifying the exemption is only the protection of a Member State's essential security interests. Other interests, in particular industrial and economic interests, although connected with the production of and trade in arms, munitions and war material, cannot justify by themselves an exemption on the basis of Article 296(1)(b) TEC. Indirect non-military offsets, for example, which do not serve specific security interests but general economic interests, are not covered by Article 296 TEC, even if they are related to a defence procurement contract exempted on the basis of that Article."86

This development would cast a shadow over those firms established in the European Union--although not quite a ban on indirect defence offset as some have reported,87 this interpretation of the ***Int. T.L.R. 123** law signifies that Member States must ensure that any tenders for indirect offset arrangements tied with defence goods must be subject to EU market liberalisation rules on open competition and free movement. If this interpretation is correct, there would be no more protectionism of this aspect of the defence industry for EU Member States.88 The proposed position seems to be this--for the purposes of free movement principles, the defence indirect offset is a matter of commerce and is subject to those principles, but for the purposes of export, it is likely to be treated as a matter of defence so that the arms export criteria listed above would apply.

Build-operate-transfer (BOT)

Build-operate-transfer arrangements are a variant of the offset; they might be defined as follows:

"BOT and similar expressions are used to donate projects under which private sector interests are granted a concession to build a public sector facilities and operate it on their own account for a number of years".89

It is not the intention of this article to examine in any great detail the BOT arrangement as it is more about foreign investment than international trade. That said, there are some interesting similarities in structure between the BOT and the trade offset. They both should therefore share similar contractual provisions--including detailed provisions on discharge of the contract (by breach, performance or *force majeure*), satisfactory performance of the contract and limitation of liability. Typically, the government of the country in which the project is located seeks to obtain a substantial degree of control over the development of the project and the operation of the completed facility. Moreover, given the long relationship to be forged, various clauses need to be drafted so as to take account of the impact of local laws and regulations on payments under the project and on the project's profitability: for example, the availability of tax exemptions; labour laws; insurance regulations; and local provisions as to the enforcement of interest on sums due. Furthermore, if the project documentation fixes the tariffs that are to be levied by the operator once the facility is working, the relevant documents should also include a formula for adjusting the tariffs if operating costs increase.90

Islamic finance and countertrade

Islamic finance is developing at a remarkable pace. Since its modern inception three decades ago, the number of Islamic financial institutions worldwide has grown from one in 1975 to over 300 today in more than 75 countries. This has been strongly driven by the pressure of funds looking for *halal* (lawful, or "clean") investments. Total assets worldwide are estimated to exceed US $250 billion (up from US $5 billion in 1985), and are growing at an estimated 15 per cent a year (although cross-border data remain scarce).91 Most of these funds are now handled in Europe, mainly in the London financial markets by Western banks (e.g. ABN/Amro, ANZ, BNP, Citibank, Dresdner, HBSC), which are offering competitive products meeting Islamic finance requirements. Thus this rising popularity of Islamic banking and finance has a positive effect on countertrade practices.

Islamic finance is based on the concept of sharing profits and risks rather than charging and paying interest.92 Although Islam recognises capital as a factor of production (which thus has a cost), it does not accept that this factor should make a prior or predetermined claim on a productive activity in the form of interest.93

Countertrade has traditionally been a key instrument of commerce in Islamic countries. In this context oil, gas, phosphate and other minerals are regularly traded with western buyers on a countertrade basis. Islamic law, *Shari'a,* provides various sophisticated sale schemes that are suited to the requirements of international countertrade. These include, in particular, *murabaha* sales and *salam* sales. For example, in a back-toback sales situation conducted under *murabaha* principles, an intermediary (often an Islamic bank) may purchase goods from a third party at the request of a client and then sell them to the client at its own price.94*Salam* sales (forward sales) can be particularly suitable for certain forms of countertrade where the various tiers of the operations involved are to be performed in successive stages. Under *salam* sales, an item is sold at a price to be paid when the contract of sale is concluded, but it is delivered to the purchaser later, at the end of an agreed period.95 It is obvious that although these forms of sale lend themselves conveniently to international countertrade, they ***Int. T.L.R. 124** must be properly structured to avoid not only problems of contractual performance but also, private international law. As regards contractual performance, the contract must provide for any religious supervision by a properly established and qualified religious supervisory board, and the incorporation of any relevant Islam compliant procedures. As far as private international law is concerned, it should be noted that *Shari'a* law clauses are not likely to be given legal effect in the United Kingdom96 and, probably, the EU.97 Thus appropriate choice of law and jurisdiction clauses must be inserted.

Conclusion

Several conclusions might be drawn about modern day countertrade. First, countertrade operates at various levels--from small regional barter type markets to international multilateral offsets. Secondly, there are concerns over the issue of accountability in countertrade. Countertrade is inevitably tied to development and investment--both areas of state activity which should properly be subject to scrutiny and monitoring. How the issue of accountability can be integrated into the contractual framework of a countertrade arrangement is difficult to work out, but it is now such an important matter that firms (and states) would do well to address it properly. As regards defence offset, for example, any failure to account for any export of defence goods or technology could well (and should) lead to legal repercussions. Thirdly, contractual devices to provide for the efficacious performance of the countertrade agreement can be very complex and must necessarily be so to take on board new challenges such as Islamic financial principles, over-pricing by the "exporter", anti-competitive practices, trade distortions, etc. Lastly, its resurgence is fuelled by pragmatism. Not all states have the levels of liquid hard currency to make cash transactions, despite the new international monetary system. Other states see countertrade as a valuable development tool. As long as these needs exist, countertrade will always be a good workable alternative or complementary trading form to the traditional cash based export-import.

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1. UNCITRAL, *Legal Guide on International Countertrade Transactions* (1992), Ch.I: Summary, para.1.

2. WTO estimates that 15% of international trade is conducted on a non-cash basis. (Source: International Reciprocal Trade Association IRTA website, 2004 Global Reciprocal Trade Statistics, *www.irta.com*).

3. See McVey, "Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas" (1984) 16 *Law and Policy in International Business* 1, for some of the more traditional legal problems and implications for international countertrade.

4. B. Seyoum, *Export-Import Theory, Practices and Procedures* (Haworth Press, 2000), p.1.

5. "Hard currency" being currency that is freely convertible in the world foreign exchange markets.

6. Outters-Jaeger and Ingelies, *The Development Impact of Barter in Developing Countries: Synthesis Report* (Paris: Development Centre of the Organisation for Economic Co-operation and Development, 1979) [Washington, D.C.: OECD Publications and Information Center, distributor], p.12.

7. "Until 1989, the countries of the Soviet bloc traded primarily in autarky from the world economy. The small volumes of East-West business were conduced on the basis of counter-trade negotiated with statetrade monopolies."Klaus E. Meyer, "International Business Research on Transition Economies" in Tom Brewer and Alan Rugman (eds), *The Oxford Handbook of International Business* (2001) at p.2.

8. Organisation for Economic Co-operation and Development, *Countertrade: Developing Country Practices* (Paris: 1985) [Washington D.C.: OECD Publications and Information Center, distributor], p.8.

9. G. Cho, *Trade, Aid and Global Interdependence* (Routledge, 1995), p.90.

10. R. Berrios and J.E.Olson, "Countertrade as A Form of Debt Payment: Peru's Experience with The Soviet Union and Commercial Banks", University of Pittsburgh, for CIED (January 4, 1995).

11. D.P. Bianco, Reference for Business website, *www.referenceforbusiness.com.*

12. H.R. Falsom and W.M. Gordan, *International Business Transactions* (Hornbook Series, West Pub Co, 1995), Ch.2 at p.29.

13. Above fn.12.

14. "[S]ome of the Eastern European nations have stated that they will reduce countertrade as part of their market economy oriented reforms…": Falsom and Gordan, above fn.12 at p.54.

15. Interview with Ibrohim Namirov, trade and economic affairs adviser to the Uzbekistan Ambassador to the United Kingdom.

16. P.N. Agarwala, *Countertrade: a Global Perspective* (New Delhi: Vikas Pub, 1991), pp.10-11.

17. African trade with China has been growing strongly with exports rising by 72% in 2005, dwarfing the 30% increase in African exports to its traditional corridors to Europe, according to statistics of the Standard Chartered Bank. In 2005, total trade between China and Africa reached US $40 billion compared with US $4 billion in 1995. Source: *People's Daily Online,* August 3, 2006, *english.people.com.cn.*

18. "Economic Interests Drive China's Africa Policy", *China Confidential,* February 23, 2006, *chinaconfidential. blogspot.com.*

19. In the beginning of the F-16 project (1987-1995) 25% of an aircraft's main structure would be produced in Turkey, but this rose to 80% at the end of the project. These days, Turkey has an aircraft industry that can be globally competitive, managing to sell its products to Egypt, South Korea and United States. According to the Undersecretariat for Defence Industries this picture is the same for the rest of the defence sector in Turkey (*www.ssm.gov.tr*).

20. T.G. Hammond, *Countertrade, Offsets and Barter in International Political Economy* (Palgrave Macmillan, 1990), pp.32, 147-148.

21. "Potential Applications of Structured Commodity Financing Techniques for Banks in Developing Countries" (August 29, 2001) study prepared by the UNCTAD secretariat (UNCTAD/ITCD/COM/31), p.11.

22. Above fn.21.

23. Reciprocal Trade by Geographic Region Annual Statistics, IRTA, 2004 Global Reciprocal Trade Statistics (*www.irta.com*).

24. L.J. Gitman and C. McDaniel, *The Future of Business with Infotrac* (South-Western Pub, 2004), pp.132-133.

25. P. Mitchell, "Explore Finance Techniques for Projects in Africa" (2002) 3(4) *Export America* 10.

26. D. Hew, "What is Offset Countertrade and Structured Finance?" (2004) Asia Pacific Countertrade Association Pte Ltd, *www.apca.net.*

27. Above fn.23.

28. M. Rowe, *Countertrade,* 3rd edn (Euromoney Pub, 1997), p.1.

29. S. De Burca, L. Brown and R. Fletcher, *International Marketing: An SME Perspective,* 1st edn (FT Prentice Hall, 2004), Ch.21, p.6.

30. Above fn.29. One possible way to estimate the quantitative significance of countertrade would be to look at the total value of countertraded goods. Goods that form the subject-matter of countertrade transactions are, however, over- or under-priced most of the time. Therefore taking goods price as a measure to calculate countertrade percentages in overall world trade could be misleading. This is one of the reasons which make it so difficult to come up with a certain percentage for countertrade in world trade. Any estimates of countertrade are thus no better than mere guesswork.

31. Falsom and Gordan, above fn.12 at p.54.

32. Hammond, above fn.20 at p.52.

33. S. Onkvisit and J. Shaw, *International Marketing Analysis and Strategy,* 4th edn (Routledge, 2004), pp.500-502.

34. "One motive for price-hiding arose in the case of OPEC countries, who have frequently used payment in kind in order to hide sales below the posted cartel price. If the contract does mention a value, that contractual oil price can easily be inflated to meet the OPEC floor; the Western exporter then builds in the discount into his own price, or, equivalently, inflates the price of his goods by the same factor. On occasions, OPEC countries have also treated countertrade exports as not being part of normal trade, and therefore irrelevant w.r.t. their export quota for crude; in this last instance, not only the price but even the very existence of trade is more or less camouflaged".P. Sercu, "Pros and Cons of Countertrade" (1990) 25(3) *Tijdschrift voor Economie en Management* 265.

35. See the UNCITRAL's Model Legislative Provisions on Privately Financed Infrastructure Project (2003): UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects (2000). UNCITRAL Model Law on Procurement of Goods, Construction and Services (1994). UNCITRAL Model Law on Procurement of Goods and Construction (1993). UNCITRAL Legal Guide on Drawing up International Contracts for the Construction of Industrial Works (1987).

36. UNECE (United Nations Economic Commission for Europe, Geneva), *International Counterpurchase Contracts* (1990); UNECE, *International Buy-Back Contract* (1991).

37. De Burca, Brown and Fletcher, above fn.29, p.5.

38. Offset policy is administered by Armasuisse in Switzerland (an agency within the Department of Defence, Civil Protection and Sports (DDPS)). Incidentally, the Undersecretariat for Defence Industries (SSM) in Turkey is modelled after the Armasuisse.

39. Above fn.21. For information on ACECO see H. Martini, "La compensation, une source de financement des exportations à la portée des PME", *www.geoscopie.com.*

40. C. Humphrey and S. Hugh-Jones, "Introduction: Barter, exchange and value" in C. Humphrey and S. Hugh-Jones (eds), *Barter, Exchange and Value: An Anthropological Approach* (Cambridge: Cambridge University Press, 1992), p.2.

41. The World Trade Organization estimates that 15% or $8.43 billion of the $5.62 trillion in international trade is conducted on a non-cash basis in 2004. Source: IRTA website, *www.irta.com.*

42. Clive M. Schmitthoff, *Clive M. Schmitthoff's Select Essays on International Trade Law* (Chia-Jui Cheng ed., Martinus Nijhoff Publishers/Graham & Trotman, 1988), p.427.

43. Above fn.42 at p.428.

44. One measure of value is price in monetary terms. Where the valuation of the goods (on either side) is achievable in such a manner, say in a valued barter, there is thus a proper commercial transaction. The value, namely the price, is that which characterises the commercial transaction as a sale. For example, s.2(1) of the English Sale of Goods Act 1979 clearly provides that:"a contract of sale of goods is a contract by which the seller transfer the property in goods to the buyer for a money consideration, called the price".

45. De Burca, Brown and Fletcher, above fn.29 at p.7.

46. Agarwala, above fn.16 at p.16.

47. "Venezuela and Panama Sign Energy Agreements", June 23, 2006, Venezuelanalysis.com, *www.venezuelanalysis.com.*

48. Adam Thomson, "Chavez Outlines Package of Aid for Nicaragua", *Financial Times,* January 12, 2007, *search.ft.com* and also Gregory Wilpert, "Venezuela Offers China Greater Access to Oil to Reduce Dependency on US Market", *Energy Bulletin,* December 27, 2004 by Venezuelanalysis.com, *www.energybulletin.net.*

49. *Bangkok Post,* November 24, 2006; also January 21, 2006, *archives.mybangkokpost.com.*

50. *tyo.ca.*

51. Above fn.50.

52. Humphrey and Hugh-Jones, above fn.40 at p.5.

53. Above fn.36.

54. J. Holmes, *Countertrade for Australian Exporters* (Sydney: Australian Countertrade Association, 1995).

55. Hammond, above fn.20 at p.9.

56. L. D'Arcy, C. Murray and B. Cleave, *Schmitthoff's Export Trade: The Law and Practice of International Trade,* 10th edn (London: Sweet & Maxwell, 2000), pp.242-243.

57. In an English decision, *Edward Owen Engineering v Barclays Bank International Ltd* [1978] Q.B. 159, Lord Denning noted:"[A]ll this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank, which gives a performance guarantee, must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer: nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not".

58. In English law, this contractual matrix can create legal difficulties. For example, as Koh in "Countertrade: the Problem of Linkage in International Counterpurchase Agreement [1990] I.C.C.L.R. 97 observed:"Can the doctrine of collateral contract be extended to recognise a counterpurchase contract outside the primary contract if the exporter has made a promise or commitment that, as a result of the importer entering into a primary contract whereby the exporter is to supply goods to the importer, it (exporter) will enter into a counterpurchase contract to buy goods from the importer but no details of the contract have been settled? Under the doctrine of collateral contract a statement not forming part of the contract under consideration may be promissory and be part of a collateral contract, with the consideration necessary to support that promise coming from the principal or primary contract. The collateral contract may be between the same parties as the main contract or it may be between one of the parties to the main contract and a third party. Courts have displayed uneasiness in applying this doctrine although they have done so in a number of situations (*Heilbut Symons & Co v Buckleton* [1913] AC 30)".

59. De Burca, Brown and Fletcher, above fn.29 at p.8.

60. Above fn.59.

61. J. Rajski, "Some Legal Aspects of International Compensation Trade" [1989] I.C.L.Q. 133.

62. Above fn.10.

63. Rowe, above fn.28, 8.

64. See the following statement made by Petroleumiran, an entity offering information about the oil and gas industry in Iran and elsewhere: "Beginning in 1989, the buy-back method of transaction has become a feature of the national [Iran] economy, especially in gas and oil Industries. It is being supported by the [Iranian] Government as an efficient means of attracting foreign capital, services and technical know-how, while reducing foreign exchange expenditures, and expanding exports. A number of buy-back arrangements have been implemented with various foreign companies, and efforts for more such deals continue"; *www.petroleumiran.com.*

65. Rajski, above fn.61 at p.134.

66. UN publication (New York, 1990) accessible at *www.gfptt.org.*

67. Above fn.66, §2.

68. T. Milenković-Kerković, "Drafting an International Buy-Back Agreement" (2004) 2(2) *Facta Universitatis* (Series Economics and Organisation) 165, 171 (*facta.junis.ni.ac.yu*).

69. Rowe, above fn.28 at p.10.

70. Falsom and Gordan, above fn.12 at p.36.

71. Rowe, above fn.28 at pp.8-9, 110; see also Welt and Wilson, "Offsets in the Middle East" (1998) 6(2) *Middle East Policy Council Journal,www.mepc.org.*

72. Elisabeth Sköns, "The Economic Aspects of Defence Offsets: Experience from Sweden and Finland" (September 18, 2002), Project on Military Expenditure and Arms Production, Stockholm International Peace Research Institute, SIPRI, First Draft.

73. General Accounting Office, "Military Exports: Offset Demands Continue to Grow", GAO/NSIAD-96-65, April 1996, p.10.

74. Turkish government officials, in contrast, believe that they have gained more from direct offsets rather than indirect ones. "A Review of Turkey's Offset Successes … & their Families" (1998) 16(2) *Countertrade & Offset* 4.

75. For example, the mutually beneficial aspect of the offset was clearly recognised in the award by the Royal Australian Air Force to British Aerospace of a contract to supply Hawk jet aircraft worth US $800 million. 80% of that contract, a very high rate, will take the form of coproduction and industrial co-operation between British Aerospace and its Australian subcontractor. The initial 12 Hawks will be manufactured in the United Kingdom and the remaining 28 assembled at Williamstown, Victoria, Australia. Parts for the engines will be manufactured in Australia under licence and another 18 Australian firms will supply components (*Countertrade Review,* March 1997, Australian Countertrade Association).

76. For more recent statistics of defence offset involving US and EU "exporters", see US Department of Commerce, Bureau of Industry and Security's Eleventh Report on Offsets in Defense Trade to the US Congress (January 2007) at *www.bis.doc.gov.*

77. Hew, "What is Countertrade and Structured Finance?" *Asia Pacific Countertrade Association Bulletin* at *www.apca.net.*

78. Republic of Turkey, Ministry of Defence, Ankara, Directive on Offset Implementations in Defence Procurement Transactions, May 12, 2000 and July 15, 2003. Source: *www.ssm.gov.tr.*

79. Source: Undersecretariat for Defence Industries (UDI) Turkey at*www.ssm.gov.tr.*

80. US Department of Defense, "Report on Contractual Offset Arrangements, Memoranda of Understanding, and Procurement Waivers" (February 2005), para.2.1, *www.globaloffset.org.*

81. The most sensitive technologies from a national security point of view are included on either the US Munitions List (for military items) or the Commerce Control List (for dual-use items). Contractual offset arrangements and related agreements are clearly not exempt from compliance with the Arms Export Control Act, the Foreign Assistance Act, and the Export Administration Regulations (EAR). There are five criteria that the authorities would consider (above fn.80, para.2.2):1. Retain US technological edge while narrowing the gap with allies (if possible).2. Increase interoperability with allies so as to:a. improve military effectiveness; andb. increase the pool of countries that can fight with the United States;3. increase the scrutiny of exports that contribute to terrorism and weapons of mass destruction;4. facilitate defence exploitation of commercial technology;5. maintain a healthy defence industrial base.

82. See *www.deso.mod.uk.*

83. The provision of additional criteria is permitted under the EU Code of Conduct--Operative Provision 10 of the EU Code of Conduct specifies that Member States may where appropriate also take into account the effect of proposed exports on their economic, social, commercial and industrial interests, but that these factors will not affect the application of the criteria in the Code.

84. ##"The provisions of this Treaty shall not preclude the application of the following rules:(a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;(b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes."

85. COM (2006) 779 Final--Interpretative Communication on the application of Art.296 of the Treaty in the field of defence procurement.

86. Above fn.85, para.4.

87. (2006) 26(18) *Countertrade and Offset Bulletin* 1.

88. The contra argument might be that indirect offset, although it promotes non-defence related investment in the receiving country, is nonetheless executed only because of the agreement by the receiving country to buy defence goods. Thus, as far as the exporting country is concerned, this is an arrangement for the export of defence goods and is therefore a matter relating to defence and should benefit from the exemption in the EU Treaty.

89. Rowe, above fn 28 at p.121.

90. Rowe, above fn.28 at pp.125-126.

91. M. El Qorchi, "Islamic Finance Gears Up", (2005) 42(4) *Finance and Development, IMF.*

92. See generally information given by the Institute of Islamic Banking and Insurance at *www.islamicbanking.com* ; see also Rowe, above fn.28 at p.51.

93. Above fn.21 at p.24.

94. Above fn.92.

95. See Al-Baraka Banking Group, Syariah Opinion (Fatwa) on Istina, Contracting and Salam (compiled by A.M. Ahmed) (2007) at *www.abg.bh* ; also Rowe, above fn.28, 51-53.

96. *Bank Shamil of Bahrain v Beximco* [2004] 4 All E.R. 1072.

97. Above fn.96; see also Chuah, "International Trade Financing Instruments expressed to be governed by Islamic principles--A Study of the Morabaha in English Law" (2006) 27 *Northwestern Journal of International Law and Business* 137.