A Report on Countertrade

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A REPORT ON COUNTERTRADE

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I. INTRODUCTION

A report to the United Nations Commission on International Trade Law (UNCITRAL) defines countertrade as follows:

A countertrade transaction, as it is normally understood, is an economic transaction in which one party supplies, or procures the supply of, goods or other economic value to the second party and in return, the first party agrees to purchase, or procures to be purchased from the second party, goods or other economic

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value, so as to achieve an agreed ratio between the reciprocal performances.

Countertrade might be more concisely defined as "trading goods for goods, not money." By omitting many of the typical components of countertrade, however, this definition fails to convey the complexity and diversity of such transactions. Nevertheless, it serves as a general description, and as a common starting point for a more comprehensive discussion of the different forms of countertrade.

A. Current Situation

Estimates as to the significance of countertrade vary widely. Some economists believe that as much as twenty-five percent, or even thirty percent, of the world's international trade volume is in the form of countertrade. The Organization for Economic Cooperation and Development (OECD) estimates, however, that countertrade does not exceed more than five percent of the world's international trading volume. Opinions also vary as to whether countertrade is increasing or decreasing.

Countertrade is not a new phenomenon. Shortly after World War II, countertrade was quite common, due to a lack of ready capital in war-torn Europe. Traditionally, almost all trade amongst Latin American countries has been conducted via "clearing arrangements," a form of countertrade. Communist countries, with their limited supply of hard currency, had guarded their capital in order to service international debts and to purchase essential imports. As a result, trade between East European countries and the industrialized Western countries has typically taken the form of countertrade. The drastic political changes that have occurred in Eastern Europe may well have an influence on the predominant use of countertrade in the region, although this is far from certain.

The Communist countries and the lesser-developed countries of the Third World have represented the two most important areas for countertrade. Both East-West trade and North-South trade rely heavily on its use. Even in trade amongst the lesser-developed countries, particularly in South America, countertrade has proven to be the dominant trading strategy. Despite the astounding political developments of the past year, countertrade will continue to play a very significant role in world trade.

B. Reasons for Countertrade

There are a number of reasons why the government of an importing

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country engages in countertrade. Countertrade may be used as a financing tool in cases where proceeds realized from the export of countertrade goods are used to finance an import. This is particularly the case in the developing world when goods have to be paid for in convertible currencies and the importing country is short of foreign exchange that can be used for these purposes. But, even where there is no shortage of foreign exchange, exports of countertrade goods may also be used as a means of facilitating the marketing of goods for which the importing country is seeking to develop its own export markets. In other cases, countertrade may also be used as an instrument of industrial development, for example, when countertrade is made part of an industrial cooperation arrangement, or when it is used to attract foreign investment or technology into areas where the importing country is concerned with developing its own technological capabilities. In some arrangements, however, countertrade is simply used to sell the low quality products of an underdeveloped industry which otherwise could not be exported or used within the domestic market at all.

An exporter's principal objectives in entering into any business agreement are commercial. His main goal is to earn a profit on the transaction and to open new markets for his products. Due to the disadvantageous (and often unprofitable) conditions imposed on private firms in a typical countertrade deal, the motives of most firms for getting involved in such transactions are usually more complex than in a traditional business deal. A firm may need a secondary market in which to sell off a surplus of a product so as not to undermine the price structure of its primary market. It may conclude an otherwise unprofitable deal in a particular nation in order to assure the company a guaranteed supply of some crucial component or raw material. Whatever the reason is for concluding a countertrade agreement, a firm's principal goal is still to make a profit, no matter how complicated and difficult it may be.

II. FORMS OF COUNTERTRADE

Countertrade exists in a variety of forms. The two most common types of countertrade are known as counter-purchase and compensation. Barter has also been growing in prominence in Latin America following the recent liquidity crises in the region. A number of other variations on countertrade have also developed in response to specific conditions surrounding individual transactions and the particular needs of the parties involved.

A. Counter-Purchase

In a counter-purchase agreement, a private firm agrees to sell products to a nation, and to purchase from that nation, products which are unrelated to the item which it is selling. In a series of transactions between a major United States manufacturer of commercial aircraft and the government of Yugoslavia, the United States firm sold jet aircraft to Yugoslavia and in return agreed to purchase substantial quantities of Yugoslavian crystal glassware, cutting tools, leather coats, and canned hams.
In a counter-purchase transaction, each party is paid in currency upon delivery of its products to the other party. It is common in such transactions for the private firm to be allowed a period of time, following the sale of its goods, in which to fulfill its purchase obligations. Periods from three to five years are not uncommon in counter-purchase obligations imposed by the Soviet Union and East European nations.

Commonly, the parties agree upon a list of goods from which the private firms will later select the items which it will purchase. The good offered for the counter-purchase will often be of low quality or in excess supply. Companies resort to a variety of methods to dispose of the goods which they are forced to purchase. Most frequently, they resell the goods to trading companies or directly to end users, often at a discount. In certain instances, the firm will resell the countertraded goods at a price below that which it paid for them, seeking to offset this loss by larger profits generated by the sale of its own products to the other nation. Finally, except in rare instances, the nation imposing the countertrade requirements will insist that its private trading partner agree to pay a penalty, backed by security acceptable to the nation, in the event the firm defaults on its purchase obligation. Counter-purchase is most commonly used in transactions involving the Soviet Union, Eastern Europe, the People's Republic of China, and Indonesia.

B. Compensation

The most common form of countertrade is known as compensation, or buy-back. In a compensation transaction, a private firm will sell equipment, technology, and/or an entire turnkey plant to a nation, and agree to purchase a portion of the output produced for the use of the equipment or technology. An example is the US $20-billion Occidental Petroleum ammonia transaction with the Soviet Union, whereby Occidental assisted the Soviets in financing and constructing ammonia plants and agreed to purchase quantities of ammonia produced by these plants over a twenty-year period.

Compensation transactions usually allow the private firm significantly longer periods of time in which to fulfill its purchase obligation, often ten years or more. Compensation transactions are generally of larger dollar value than counter-purchase transactions. As with counter-purchases, the private firm is paid in currency when it takes possession of its portion of the output. An agreement providing for the payment of a penalty by the firm in the event of a default is common as well. Unlike counter-purchase transactions, however, the products that the firm purchases are of marketable quality and in demand in the international marketplace. In addition, companies can usually negotiate a purchase price for the output that is below the world market price, so that they can earn a higher profit in reselling the product.
C. Barter

Barter, swap, and other types of non-currency transactions are commonly viewed as forms of countertrade. Many non-currency transactions are entered into for reasons of convenience or transportation efficiency, and, as such, lack the coercive overtones characteristic of typical countertrade transactions. A nation may, however, impose a barter requirement in a coercive fashion for the purpose of disposing of a surplus of low quality goods that it otherwise cannot sell. In such instances, barter, swap, and other non-currency transactions are correctly characterized as countertrade transactions.

Barter is often used for crude oil transfers in order to convey crude below official prices of the Organization of Petroleum Exporting Countries (OPEC). Similarly, barter can be used to "liberate" blocked currencies or otherwise circumvent foreign exchange controls. Barter is increasing in prominence in trade with Latin American and Southeast Asian nations, this due to recent restrictions on international lending. Unlike classic East-West and Indonesian counter-purchase transactions, however, barter is often not required by the purchasing nation. Rather, barter is used by the private firm to "finance" an otherwise non-financiable transaction.

D. Import Entitlement Programs

An import entitlement program is a government-imposed mechanism under which a party is afforded preferential treatment in obtaining an import license if it arranges an export transaction of equivalent value. In many partially industrialized and Third World nations, hard currency shortages have forced national governments to impose import-licensing programs under which only essential goods are allowed to be imported. Under such programs, exceptions will be made for non-essential items if the importer also arranges an export from that country of equivalent value. While it may not be necessary for the foreign private firm itself to export goods from the host nation, a private firm capable of undertaking such exports will be more successful in selling its products in that nation.

E. Off-Sets

The term off-sets is used to describe the practice whereby foreign firms agree to hire subcontractors located within the purchasing nation, or to use components or raw material originating from within the nation. In a railway electrification project recently under bid in New Zealand, bidding consortia offered to purchase certain design, engineering, and construction services locally, and to substitute locally produced components for items which they would normally import into New Zealand.
F. Clearing Agreements

While countertrade is usually conducted between a nation and a private firm, such arrangements also exist between nations. Nations have entered into bilateral or multilateral clearing agreements under which they agree to purchase each other’s products in equal values over a specific period of time. This form of reciprocal trading is not unlike the relationships between private firms and nations discussed above. In clearing agreements, the participants typically open reciprocal lines of credit and exchange quantities of goods during a predetermined "clearing period". Clearing accounts are established at international banks, and balances are kept of quantities sold or exchanged. At the end of the clearing period, the accounts are balanced. When an imbalance develops in an account which a nation cannot rectify, private firms, known as switch trading firms, step in to assist the nation in disposing of the goods which it is required to purchase, usually for a fee.

G. Switch Trading

A switch trade is a device used to balance a bilateral clearing agreement. In a hypothetical clearing agreement between Romania and Brazil, for example, Romania may have taken more products from Brazil than Brazil has taken from Romania at the end of the clearing period. In this instance, Brazil will have "credit" in its "clearing dollars". A problem will arise when there are no available products that Brazil is interested in taking. In a switch trade, Brazil will locate a third party interested in purchasing Romanian goods and will substitute this third party’s purchase of Romanian goods for its own. Technically, Brazil sells its clearing dollars to the third party, and the third party uses these credits to pay for exports from Romania. Brazil sells the credits at a discount (discounts of up to thirty percent are not uncommon) and receives hard currency from the third party. It is common for a trading intermediary to assist nations in locating such third-party purchasers.

H. Progressive or Proactive Countertrade

In progressive or proactive countertrade, a firm purchases goods from a nation prior to the point in time at which it sells its products to the nation. This is done for the specific purpose of developing the right or opportunity to sell products to that nation in the future. This practice differs from the traditional types of countertrade discussed above, in that the private firm generates hard currency for the purchasing nation, subsequent to the sale of its products to the nation. In addition to inducing future sales or otherwise generating goodwill with that nation, the private firm will be in a position to sell its products without the delay and inconvenience of negotiating post hoc countertrade requirements. Under variations of this type of arrangement, the firm may obtain the right to utilize its credits as an agent, sell the products of other firms to the nation, or if the nation approves, the firm may transfer these
credits to other private firms for a fee. Indonesia, for example, has announced that it will allow the crediting of Indonesian exports generated by one firm against the countertrade commitments of another firm selling to Indonesia. In cases where the private firm is unable to locate desirable locally produced goods for export to develop countertrade credits, firms have been known to transfer technology and/or establish plants in the nation in an effort to assist the nation in producing items for which the private firm has an established overseas market.

I. Framework Agreements

In a framework agreement, a private firm establishes a formal, long-term crediting mechanism with the host nation, under which exports generated by the firm are routinely credited to the countertrade commitments of numerous third party firms on an ongoing basis. Under a variation of this type of arrangement, foreign exchange profits, earned from exports generated by the firm, are automatically placed in an escrow account and earmarked for payments to private third parties selling to the nation. In these instances, the private party generating the exports is generally paid a fee (typically from three to ten percent) by the third party seller for the use of its credits. The key to a framework agreement is that the crediting is undertaken on a routine and ongoing basis under a prearranged agreement, rather than on the more common case-by-case basis.

J. Positive or Reverse Countertrade

In certain instances, private firms prefer countertrade arrangements over conventional transactions. In so-called positive or reverse countertrade, the private firm views the goods which it will be required to purchase as more valuable than hard currency. This is most often the case when a firm in anticipation of future shortages of a necessary commodity or crucial components, seeks to establish a guaranteed supply of these items. An example is a proposed East-West "gas-for-pipes" transaction, known as the North Star Project, in which a group of private firms negotiated with the Soviet Union to provide gas transportation and production technology in return for guarantees of quantities of natural gas produced through the use of this technology. In a similar transaction, a United States oil firm was reported to have assisted in the development of a US $300-million export refinery and a separate US $300-million petrochemical complex in Saudi Arabia in exchange for the right to purchase 1.4 billion barrels of Saudi Arabian crude oil over a fifteen-year period.
K. Develop-for-Import Transactions

A develop-for-import transaction is a specialized type of positive countertrade between an industrialized nation and a developing or Communist nation for the specific purpose of guaranteeing the industrialized nation sufficient future supplies of strategic minerals or other scarce resources. Under such arrangements, nations such as Germany, France, and Japan provide the capital, equipment, and technology to develop mining and energy products in nations rich in natural resources which lack the economic and technological capability to exploit them. In exchange, the transferring nation will be guaranteed a long-term supply of the mineral or hydrocarbon produced by the mine or well it assisted in developing. Develop-for-import transactions differ from compensation transactions in that the primary motive for undertaking these projects is to establish guaranteed future supplies of strategic commodity rather than to effectuate the sale of equipment or technology.

L. Performance Requirements

A performance requirement is a condition, imposed by a nation, requiring foreign parties who wish to undertake an investment in that country to agree to take certain steps to increase exports from the country. Such steps could include an agreement by foreign investors to export a certain percentage of the output from an investment project, to employ a certain number of local inhabitants in the project, to use a predetermined amount of locally produced components in the manufactured product, and to transfer certain technology to the host nation. Performance requirements are distinguishable from countertrade requirements in that they involve the private firm's investment in the imposing nation, rather than the purchase of goods from that nation. In light of their similarity, however, they are frequently treated as one and the same phenomenon. One of the most frequently cited performance requirements is the "Mexican Automotive Decree", pursuant to which foreign-owned automobile assembly enterprises operating in Mexico are required to generate sufficient exports to cover the value of all Mexican imports which occur as part of their respective assembly operations.

LL. Collection-through-Export Transactions

A major problem currently experienced by United States firms doing business overseas has been the collection of overseas funds which have been restricted from repatriation by foreign exchange controls. A private firm may have earnings in local currency, but due to foreign exchange shortages will be unable to convert this currency into dollars. In a collection through-export transaction, the firm will use the local currency to purchase locally produced goods from the host nation, and sell the goods overseas for dollars or another convertible currency. The number of these transactions is quite limited due to restrictions on such activities by many host nations. A few have, nonetheless, been successfully concluded.
III. LEGAL ISSUES ARISING FROM COUNTERTRADE

The complexity of countertrade is reflected in its legal aspects. The UNCITRAL report observes:

The conduct of countertrade often requires the ability to resolve difficult problems of a commercial nation, and to coordinate the undertaking and performance of obligations that are disparate in nature and time, and that must often be undertaken by parties who are not parties to the countertrade agreement itself. This calls, first of all, for commercial skills in conducting these transactions. It also calls for skill in drafting the contractual agreements that structure the transactions, whether or not those contractual agreements are fully enforceable through the use of legal means.

A. Contracts

The simplest form of a countertrade agreement is a barter contract. Normally, in such a contract, only two parties are involved, trading goods for goods which are specified in terms of quantity and quality when the agreement is signed. More complex are counter-purchase contracts, which usually consist of two separate purchase agreements, with a third agreement, the protocol, linking the two together. The primary contract is a standard purchase contract, and, as such, introduces no new concepts unique to countertrade transactions. The interesting clauses from a legal perspective are found in the secondary, or counter-purchase contract, which requires that the private firm purchase certain goods within a certain period of time.

The counter-purchase contract usually reflects the "involuntary" nature of the transaction. The contract will specify the amount of money the importer is required to spend purchasing goods, will list in detail which goods are available under the counter-purchase agreement, and what price the importer has to pay for them. The first problem for the importer are the restrictions on his choice of goods for purchase. Many Eastern European countries limit the products available for export in order to prevent the export of products needed in the domestic market. These countries have issued "export lists" containing all the goods free for export. Such lists are changed frequently according to the demands of the domestic market. This practice, thus far, has not been discontinued as a result of the political changes in Eastern Europe in the past months. Hungary, for example, recently stopped the export of certain agricultural products in order to supply the domestic market.

The importer's second problem concerns the method used to arrive at the prices for the counter-purchased goods. In a centralized economy, prices set by the government usually differ substantially from the fair market value of the
goods. Special attention must be drawn, therefore, to drafting a fair pricing
formula, common examples of which are, "the acceptable international price at
the time of purchase," and "ten percent below the fair market value for the
goods in the buyer's home country." In long-running contracts, it is a good idea
for the private firm to seek a most-favored-customer clause. Otherwise, it may
be forced to sell its counter-purchased goods at a loss on a market flooded by
lower priced exports from the very same country.

The protocol is a very short contract which connects the primary and
counter-purchase contract. In such a protocol, an optional cancellation clause
is often occasion for intense negotiations. Western importers usually try to
include a clause giving them the option to cancel the counter-purchase contract
if the primary contract has not been fulfilled. Most East European countries will
oppose such a clause, preferring instead a clause that provides for re-negotiation.
Existing arguments have expressed the view that, if the primary agreement has
not been executed or fulfilled, the counter-purchase agreement does not have to
be fulfilled either. The reasoning of the working group was that the import
contract is the *raison d'être* for the export contract; a private firm only agrees
to counter-purchase obligations in return for sales of its own products. Failing
a clause explicitly stating that both contracts are completely separate, courts in
certain jurisdictions, may consider the contracts interdependent, regardless of
whether the protocol contains a cancellation clause.

B. Third Parties

A countertrade arrangement naturally becomes more complicated when
third parties are involved. As mentioned above, a company may contract with
a switch trading firm for help in disposing of otherwise undesirable goods that
the company was required to purchase from the host nation. In many cases a
bank or bank-affiliated company will play this role. The services of such agents
range from simple one-time sales contracts to long-term brokering of import
credits. The switch trade firm may have contractual relations with either one
or both of the parties to the original countertrade agreement.

Banks play a significant role in countertrade. Bank guarantees are
formulated in many cases to secure the obligations of the parties to the
countertrade agreement. A bank will also be involved in any agreement in
which a transfer of money takes place. In trade with Eastern Europe, a Western
bank, as the source of hard currency, will conduct the financial end of the
arrangement, while a local Eastern European bank will be engaged to maintain
an evidence account for the transaction.

In dealing with Eastern European countries, it has been necessary to
involve a foreign trade organization (FTO) in the negotiations. In order to
balance and control their international trade, Eastern European countries have
required the approval of an FTO for all imports into their country. Negotiations
with developing countries can also be simplified when conducted with a foreign
trade organization. Such FTO’s typically have close links to government agencies, are thoroughly familiar with import-export regulations, and can often intercede on behalf of foreign interests if the regulations change.

Other parties to a countertrade deal could include an export financing bank to subsidize the transaction, various insurance companies or agencies, and transportation or maintenance companies. Sometimes, the counter-purchase agreement can even be transferred in its entirety to a third party. A typical countertrade deal may involve multiple contracting parties, who have various, often indirectly related, obligations to one another. This naturally demands a great deal of skill from lawyers drafting such agreements.

C. Unfair Trade Practices

Some Western governments regard countertrade agreements as an unfair trade practice. They point out that companies might be forced to purchase goods that they would not normally choose to buy, or that companies might decide to purchase certain items only from a particular country in order to ensure sales of their own products in that country. Countertrade is regarded by some economists as running counter to free market principles, as the artificial prices of counter-purchase goods will tend to disorder foreign markets. Various Western industrialized countries, including the United States, have strict laws regarding unfair trade practices and dumping. Thus, countertrade agreements that set artificially low prices for export goods may actually be prohibited by certain countries.

An example of this is a compensation agreement between Occidental Petroleum Corporation and the Soviet Union, signed in the late 1970s. According to this agreement, Occidental Petroleum would help the Soviet Union to build a US $900-million ammonia plant and sell the Soviets phosphoric acid. In return, the Soviet Union would sell Occidental ammonia, urea, and potash. An anonymous competitor filed a plan with the United States International Trade Commission (ITC) to initiate a Section 46 proceeding. In this proceeding, the Commission found that Occidental Petroleum would receive products specified in the agreement at an artificially low price, indirectly financed by export profits. The Commission regarded this practice as unfair competition which would threaten the United States domestic market for a substantial period of time. The Commission calculated that up to five percent of the domestic demand for these products could be affected. The Commission accordingly recommended that the agreement be annulled, but President Carter declined to follow the recommendation, as he believed that the agreement posed no threat.

D. Antitrust Law

A similar obstacle to countertrade agreements may arise out of antitrust legislation. Many Western countries prohibit tying contracts or reciprocal
exclusive dealing arrangements, as they are regarded as monopolistic and a threat to a functioning free market. Under European Community (EC) law, tying arrangements are permitted, if the additional goods or services are, by their nature or by custom of the trade, usually furnished along with tying products. In the United States, the Sherman Act and the Clayton Act prohibit tying arrangements and other anti-competitive practices. Although the Clayton Act, in general, is applied only to United States parties, the Sherman Act applies to any party whose acts adversely affect competition in the United States market. This legislation prevents an unfair concentration of market control in the hands of a small number of companies. Countertrade agreements which may lead to an increase in market share by a company already dominant in a particular market, or more generally to significant decrease in competition in that market, will most likely run afoul of antitrust laws.

E. Tariffs and Quotas

Developing countries use various means to protect their own indigenous economies. The most common are tariffs and quotas. High tariffs discourage foreign companies from trying to import their goods into the host nation. Quotas limit the amount of goods being traded by simply fixing the quantity of goods permitted to be imported into or exported from the nation. Countertrade agreements are not, by nature, exempted from tariffs and quotas. Nevertheless, if a countertrade agreement is directly negotiated with a governmental agency, special exceptions may be made for the primary contract. A cautious lawyer may also seek a most-favored-company clause for a long-term countertrade agreement in order to take advantage of any better conditions offered to other companies in the future.

F. Taxes

Naturally, a countertrade agreement will be taxed according to national tax laws. Both sales and exchanges of goods and services are considered taxable events under almost any tax code. With countertrade agreements, the question often arises as to the real value of the goods being purchased to satisfy countertrade obligations. Usually, the tax authorities estimate the value of the goods purchased according to the real market value. There is usually a strong difference of opinion as to which market should be used to evaluate the market price. Therefore, even in a pure barter agreement, it is advisable to specify the value of the traded goods in order to clearly identify the taxable base for tax authorities. The other problem in this connection is determining when tax payment is due. In direct barter transactions, it is relatively easy to determine when the taxpayer receives "payment" in goods. In more complicated countertrade agreements, however, determining the moment in time when the taxpayer has received taxable income may become more complicated.
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IV. CONCLUSION

Many international organizations believe that, through countertrade, protectionism is accelerated. But for Third World countries, countertrade represents an essential component of their trade policies. Thus, countertrade could turn out to be a major source of contention between developed countries and the Third World. As the use of countertrade continues to expand, resistance against it is building up in the developed world. The United States, the countries of Western Europe, the International Monetary Fund (IMF), the General Agreement on Trade and Tariffs (GATT), and the World Bank unanimously claim that countertrade will eventually reduce world trade. Even the United Nations Conference on Trade and Development (UNCTAD) predicts that the balance of payment situation in the Third World will not improve through the use of countertrade, and that bi-lateralism will grow. An OECD report on East-West countertrade concluded that countertrade causes serious trade distorting effects, introduces unnecessary complications into the transaction process, and presents additional risks for Western firms which are not accompanied by any significant advantages.

The dangers of countertrade are fairly clear. The overriding concern is a reduction of world trade. Statistics from various international organizations have shown that world trade is reduced by countertrade agreements. A free exchange of goods and capital in an open market still seems to be the best guarantee for growth in international trade and for a healthy economy. Countertrade agreements often exclude other competitive exports. They force unwanted goods onto an otherwise free market. Industries protected by the unequal conditions of a countertrade agreement do not have to compete in a free economy, and without this competition, the protected industry has little incentive to improve the quality of its goods and the efficiency of their production. Countertrade tends to remove the flow of goods from normal financial channels, and by doing so, it inhibits the growth of world trade. Nevertheless, for developing countries, which lack sufficient quantities of hard currency and are burdened with enormous debts, no countertrade often means no trade at all. A greater amount of capital investment and hard currency in the Third World could reduce the need for countertrade agreements, and thereby assist in promoting international trade.