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‘SPECIAL PURPOSE MONEY’: EXPLAINING THE RESURGENCE OF INTERNATIONAL BARTER

We tend to think of paying in cash as a far more efficient way of doing business than paying in goods. Yet barter and countertrade - the exchange of commodities, consumer goods and/or investment goods without the use of money – have grown dramatically over the last two decades and now make up between 10-20% of world trade. Why?

Writing in the latest issue of the *Economic Journal*, Professors **Dalia Marin** and **Monika Schnitzer** show that barter is, in fact, an efficient economic institution that makes international trade possible where it would otherwise not happen. The anonymity of money as a medium of exchange can be a disadvantage in trade with highly indebted countries with questionable creditworthiness, since the debtor can use it for purposes other than repaying debt. Goods, in contrast, can be earmarked as the property of the creditor, making contract enforcement more effective.

The challenge is to find goods as a means of payment that are relatively liquid and have a low degree of anonymity. High liquidity means that there is little uncertainty about their quality, as is typically the case for goods traded on an exchange, such as coffee or metals. Low anonymity means that the creditor gets valuable collateral since she can successfully label the collateral goods as belonging to her.

These two properties influence which goods tend to feature most commonly as means of payment in international barter in different parts of the world. The less creditworthy a country, the more likely it is to use goods that are high liquidity and low anonymity.

International barter started to increase in response to the international debt crisis in the mid-1980s when private lending to developing and transition countries declined dramatically. As highly indebted countries found it increasingly difficult to finance their imports, there was a resurgence in unconventional forms of trade and trade financing. More recently, domestic barter has grown enormously in the economies of the former Soviet Union, particularly Russia and Ukraine. Estimates suggest that in some of the transition economies, domestic barter accounts for up to 60% of GDP.

So why do parties prefer to pay in goods rather than cash? Many observers argue that barter is inefficient because it does not overcome the problem of a ‘double coincidence of wants’ as money does – a seller may need to accept goods for which he has no use himself. Moreover, payments in goods can be a problem as it is difficult to judge the quality of goods offered as a means of payment. Most observers therefore conclude that this form of exchange occurs because many developing countries lack foreign exchange or foreign loans to pay for their imports.

But these researchers argue that parties might want to pay in goods rather than cash to solve incentive problems that would otherwise prevent any trade from taking place. Barter has important advantages over traditional credit arrangements in terms of contract enforcement. As an anonymous medium of exchange, money can be a disadvantage in trade with countries that lack creditworthiness. But goods can be earmarked as the property of the creditor so that the debtor is less free to use them for purposes other than repaying debt. Since goods are less anonymous and property rights on goods are easier to define and enforce than property rights on future cash flows of a country's export returns, goods are better collateral than cash.

The challenge is to find goods as a means of payment that are relatively liquid and exhibit a low degree of anonymity. Homogenous goods tend to be liquid but also anonymous whereas differentiated goods tend to be less liquid but also less anonymous.

Professors Marin and Schnitzer use these incentive properties to rank goods with respect to their liquidity and anonymity and predict the pattern of specialisation in barter trade. Among barter exports from developing countries and Eastern Europe, consumer goods (32%) and investment goods (36%) dominate. The analysis has two predictions:

- ?? First, countries that differ in their creditworthiness will also have a different pattern of specialisation in barter. Countries with low creditworthiness - like some of the Latin American countries, which had debt-to-GDP ratios of over 100% at the end of the 1980s - will use higher value collateral goods like basic goods as a means of payment in barter. A comparison between Latin America and Eastern Europe's export pattern in barter confirms that in the former region, commodity exports dominate.
- ?? Second, because of their low liquidity, investment goods will be used as means of payment only when a country's creditworthiness is not too low. The former Soviet Union and the former Czech Republic with debt-to-GDP ratios of between 6-20% respectively at the end of the 1980s could 'afford' to use predominantly investment goods as means of payment. Investment goods provided collateral of sufficient value compared to the gains from defaulting. Consumer goods turn out to be 'good money' because of their high liquidity and low anonymity.

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Notes for Editors: 'The Economic Institution of International Barter' by Dalia Marin and Monika Schnitzer is published in the April 2002 issue of the *Economic Journal*.

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