Barter world:

Professor Dalia Marin and Pratik Dattani cast an economist's glance

Gorbachov´s Perestrioka, Yeltsin´s reforms and Putin´s new beginning were all supposed to be the first steps to recovery, to restore the sick Old Man of Communism to his feet. This Old Man has been through a lot. He has had his freedom confined by the intellectual limitations of pre-Revolutionary Russia. After 1917 an additional constraint on his freedom was imposed, this time the allegedly rational ideology of Marxism-Leninism. The double bondage of these totalitarian heritages has left him tired and weary. But Dame History remembers both times with fond memory, almost romantic in nature. One life event she will probably not remember in the biography of the sick Old Man is the crisis that began post-privatisation in the 1990s. In Russia in 1994, just five percent of GDP was made up by non-cash transactions. In 1998, this demonetisation trade accounted for a staggering 60 percent of GDP. In Ukraine, barter accounted for 51 percent of sales in 1997. Barter in itself is no bad thing: indeed it makes Old Man Russia feel nostalgic of the days of nomads, when cattle used to be the standard of exchange in Rome and freedom was not a chore. The one recent incidence of barter that most people remember, however, is during the German hyperinflation of 1923, which showed how dreadful such an economy could be.

Barter started to rise after macroeconomic stabilisation and has started to decline since macro instability set in after the August 1998 crisis, accounting for 43 percent of receipts of industrial firms in 1999 and 30 percent a year later. How can this time pattern of demonetisation in the Russian economy be explained?

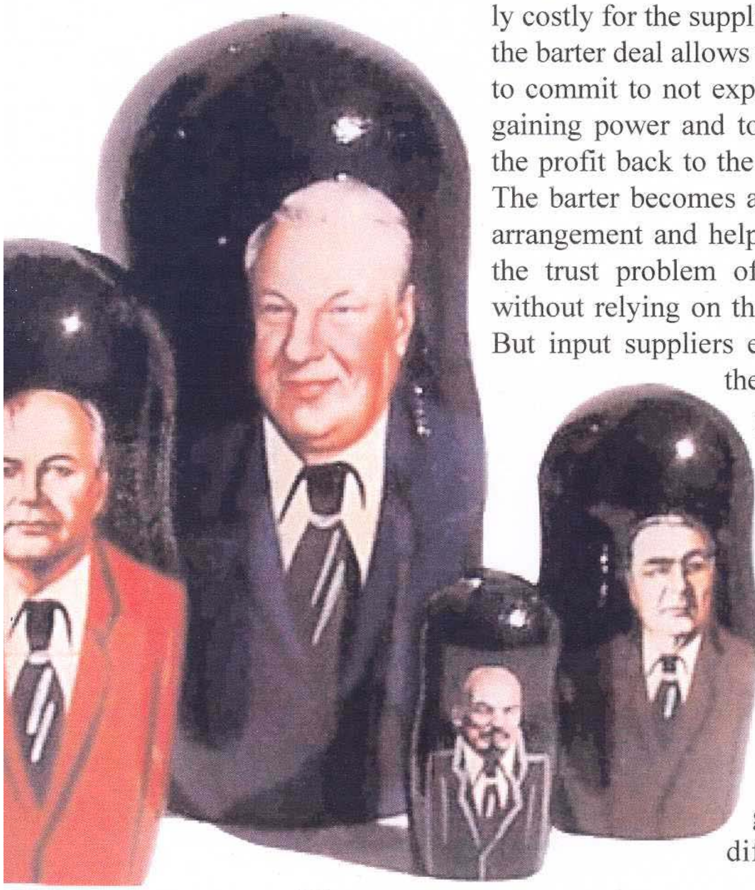
Several arguments have peen put forward to explain the surge of barter: soft budget constraints, delay in restructuring, tax avoidance, and the virtual economy. Delays in privatization and inefficient governance structures are seen to lead to quantity targeting rather than profit maximization, while the absence of hard budget constraints gives firms no incentive to minimise costs. Barter is seen to help conceal the true market value of output while payment in goods allows firms to circumvent paying taxes. The tax argument, however, cannot explain why barter exploded so dramatically within four years.

One of the most influential arguments is the "virtual economy" argument. It claims that by allowing firms to change the prices of the goods exchanged in a hidden way, barter helps different groups in the economy to keep in the illusion that the manufacturing sector is producing a valuable output while, in fact, it is not.

The alternative, altogether more empirically robust argument is one of trust. Disorganization and trust problems arise in a 'no future environment' when old business relationships break down before new ones can be established.

Input suppliers stop delivering inputs out of the fear of being 'held up' by their input buyers. Under central planning, the main instrument to enforce production and delivery of goods was the coercive power of the state. With the vicarious village economy, it was the threat of trial by community. From the 11th century Maghribi traders to modern day, trust has formed the crux of credible busi ness relationships. Transition eliminated the central planner and thus the instrument with which to limit the adverse effects of the lack of trust in the economy, without having first created the institutions to deal with it.

Inter-firm arrears can help to prevent firms reneging upon contracts. Suppose intermediate producers have no cash to pay for their inputs and thus require a trade credit from their input suppliers. They can repay this credit only when they sell the input (after refinement) to the next buying firm. The input suppliers would only



Ready or not

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provide the credit if they could credibly threaten against the buyer reneging on the contract. These non-trivial costs would typically involve either the legal channel or the Mafia. When such credit enforcement costs become too large, however, the input supplier will refuse to participate in the deal, since he cannot expect a positive profit.

But say our law-abiding input supplier turns to the courts, too immature and underdeveloped to help, and finds himself severely out of pocket once he has delivered the goods. Post-delivery, the buyer commands all the bargaining power and has no incentive to pay. Anticipating this, the supplier does not deliver in the first place and output production grinds to a halt in a suspicious world.

Under these circumstances barter can help to maintain production. Barter introduces a hostage, a commitment device, that prevents the buyer from fully exploiting his initial bargaining power. More specifically, when credit enforcement becomes prohibitively costly for the supplier, introducing the barter deal allows the input buyer to commit to not exploiting his bargaining power and to shift some of the profit back to the input supplier. The barter becomes a self-enforcing arrangement and helps to cope with the trust problem of the economy without relying on the legal system. But input suppliers exploit the fact there are few suppliers around and switching supplier is costly. They therefore charge higher prices for these inputs under barter compared to cash deals, giving rise to a different trust problem.

Barter is in many ways a natural evolutionary consequence of the failure of the banking system. The arrears crisis in Russia evolved in 1992, while barter started to rise in 1994, when arrears reached a critical level (around 30 to 40 percent of firm's sales) at which production was unsustainable. Bank loans were not easily available and, where they were, only at horrendous interest rates. At this point firms refused to extend further credit to each other. Barter then stepped in as the only way to maintain production.

However, if the 'illusion view' of the barter economy is correct, barter is a bad thing because it allows the manufacturing sector to avoid the bitter pill of restructuring and so distortions in the real sector remain. If the 'truth view' is right, the problem lies in the financial sector and barter is in fact a good thing. It allows the real sector to finance production when the banking sector fails in its role of intermediation to help facilitate investment. Either way, barter helps maintain production.

The paradox is, when the state declared itself officially bankrupt and succeeded in emasculating the other banks with one clean sweep of its blade, non-cash transactions fell rapidly. The banking sector started caring about surplus liquidity and Russia experienced a positive growth rate for a long time. The Old Man was rising from the grave he had earlier buried himself in.

History can be fickle mistress. But only she knows how well he will respond, and whether this is just another war wound or the beginnings of something deeper and altogether more frightening and terminal for his welfare. The policy implications of the barter episode are simple: reform banking goes further than partial reforms that are more tokenistic than effective; and employ a careful expansionary monetary policy that does not have perverse effects on the trust issue. This hefty discussion is a tale for another day from the annals of Dame History.

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For more information, read *Trust vs Illusion: What is driving Demonetization in Russia?* (2000) and *Monetary Policy does not work in Russia's Barter Economy - German Banking as a Solution?* (1999) by Marin; and *Disorganization and Financial Collapse* (1999), CEPR Discussion Paper No. 2245 by Marin and Schnitzer