Limiting Factors in the Operation of Commercial Trade Exchanges
[Excerpted from Chapter 15, Commercial Trade Exchanges—Their Present Limitations and Potential Future, in *The End of Money and the Future of Civilization*]

These are the limiting factors that pertain to current commercial trade exchange operations, which will be addressed in order.

1. Limited scale and scope of membership
    a. Inadequate number and diversity of member businesses.
    b. Limited geographic coverage.
    c. Failure to penetrate all levels of the supply chain (almost exclusive focus on recruiting members who operate at the retail level).
2. Failure to perceive and promote credit clearing as their most valuable service.
3. Certain clauses that are commonly included in their membership agreements that result in conflicts of interest with their members and debasement of the value of their internal trade credits (currencies).

Limited Scope and Scale

The vast majority of commercial trade exchanges are small local operations that average between a few hundred to a little over one thousand members. In most cases, the bulk of the member businesses offer services or "soft goods" rather than "hard goods" like manufactures and commodities that are in everyday demand. Media, advertising, hospitality, tourism, and entertainment comprise a large portion of the offerings in many trade exchanges. These and other business lines that have prices that are "fuzzy" and negotiable, rather than fixed and advertised, are usually well represented, making the value of the internal trade credits harder to pin down.

Further, trade exchanges have been limited by their almost exclusive focus on the retail level of business-to-business trading. While retailers and service providers are the most readily available client prospects, the greatest potential lies in connecting suppliers and customers throughout all levels of the supply chain, including wholesalers and manufacturers, etc. (more about this later).

The Value Proposition

Trade exchange operators generally recognize that the main value propositions which they offer to their members consist of:

1. the competitive advantage of having privileged access to an existing membership base, providing a group of potential new customers,
2. the active brokering of trades, by which exchanges help their members to find customers for their offerings and suppliers of their needs and wants, and,
3. the ability to pay for purchases using internal trade credits instead of cash.

However, their emphasis has been too much upon the marketing advantages of membership inherent in the first two of these items and not enough on the financial advantages of the third. It is the credit clearing service which is the most distinctive feature of trade exchange operations. The dysfunctions and flaws in the political money system result in most businesses having excess capacity, i.e., the ability to provide more value than they actually sell. Excess capacity is not so much a matter of overexpansion as it is a lack of money on the part of potential buyers. The greatest value proposition is the credit clearing service that provides additional exchange media—a cashless payment alternative and an interest-free line of credit—that enables business to sell more of what they are able to produce.

Many exchanges intentionally limit the number of members in a particular line of business that they will accept in order to assure them a competitive advantage. If one sees the marketing advantages as the main value proposition provided to exchange members, then it makes sense to accept only a few restaurants, for example, in a particular neighborhood. But if the main value proposition of exchange membership is the cashless "clearing" or offset of purchases against sales, then "the more the merrier." The value and usefulness of a credit clearing network, just as any other network, grows geometrically as the size of the network increases. Grounds for exclusion and offers of exclusivity to prospective members need to be seriously reconsidered. The fact is that credit clearing can work for everyone who provides desired goods or services to the market, and the larger the number of participants in the trade exchange, the more useful membership will be.

Operations and Agreements

Certain clauses that are commonly included in their membership agreements have jeopardized the viability of trade exchanges and retarded their growth. Specifically, these are clauses related to the trade exchange's own trading account and its ability to participate as a member as well as a service provider. But, such a dual role can easily, and often does, lead to serious conflicts of interest. As third-party record keepers, and managers of their members' collective credit, trade exchanges have a professional responsibility to put their members' interests first. They must earn the trust of their clients, and must assure the continued value of their internal trade credits.

There are two major conflict-of-interest issues that have arisen in the management of trade exchanges. The first is called "cherry picking," which is the ability of a trade exchange operator, based on its insider information and prior knowledge, to acquire the best offerings of its members before the other members even get to know about them. This has become less prevalent amongst established exchange, but may still be an issue in some newer, smaller exchanges.

The second and more serious issue derives from the "borrow and spend" clause that is typically contained in trade exchange membership agreements. This clause grants to the exchange account a virtually unlimited credit line that allows the exchange management to (1) to spend beyond its means, and (2) out-compete other potential buyers (members) in the system. The resultant ballooning of debt in the system account results in the debasement of the value of the internal trade credits and the loss of confidence in the trade exchange management. Members are usually denied access to definitive information about the extent of these practices, but their effects are "felt" in the internal marketplace as trade credits become harder to spend and therefore less valued. As a result, members may seek ways to differentiate their cash prices from their trade credit prices, or may require a blend of cash with trade credits when they sell something within the trade exchange. Both of these practices diminish the usefulness and credibility of the trade exchange system.

Proposed Remedies

How might these problems be remedied? I suggest that the problem of 'cherry picking" can be handled by limiting both WHAT the system account can buy and WHEN it can buy. The system should NOT be allowed to buy anything from its members for the purpose of resale, but should be restricted to buying only those goods and services that it commonly needs to conduct its business operations, i.e., to provide services to its members. Further, it should not make any purchase until the offering has been made generally available to the entire membership for some reasonable period of time.

With regard to the line of credit allocated to the system trading account, it should be determined on the basis of the same qualifying criteria as for any other account, i.e., it should have no special privileged access to trade credit. Ideally, the credit allocation process should involve broader participation by the members and be based on objective criteria, primarily, the internal trade credit earning history of each account averaged over some reasonable period of time.

In regard to these practices, some trade exchanges are better managed than others, but the remedies and restrictions proposed above need to become industry standards and formally specified in their membership agreements. (A generalized draft of such a proposed membership agreement is provided in the Appendix A.) If exchange operators do not voluntarily discipline themselves, they will eventually see that discipline imposed on them from outside, either by government regulation or by the requirements for participation in an eventual wide-area network of exchanges. But, more importantly, by adopting these measures and making prospective members aware of them, a trade exchange will gain a big competitive advantage over other trade exchange operators that are more closed and inclined to exploit their members. Exchange owners that subject themselves to such restrictions can still be active traders, and by the quality and volume of trading they do, become living examples to their members of the advantages of cashless trading without risking debasement of their internal currency (trade credits). Industry trade associations, like the IRTA (International Reciprocal Trade Association), have done much to foster the adoption of such standards of practice through their own certification and branding programs.

The Real Deal—Credit Clearing Services

I firmly believe that the most important value proposition that trade exchanges can offer to their members is the cashless clearing of their transactions, that is, the operation of mechanisms that enable the members to use their sales to pay for their purchases. In accounting terms this means the use of their accounts receivable (A/R) to offset their accounts payable (A/P). The market for such clearing services is virtually unlimited and worldwide, but to tap that market it will be necessary for exchange operators to think outside of the conventional “box.” What are the necessary actions required to realize that potential?

Tapping the Vast Potential Market

The short answer to that is that credit clearing exchanges need to attract a much larger, more diverse membership base. As pointed out above, the value and usefulness of a credit clearing network, grows geometrically as the size of the network increases. The obvious way of achieving that is by making it easy and inexpensive to join an exchange. Existing pricing schedules for trade exchange services needs to be completely reviewed and revised. Trade exchange operators need to find ways of reducing the costs of participation in order to make membership more attractive. It costs nothing to open a bank account. Any alternative payment system must justify it membership fees in comparison to that.

It is said that “nothing succeeds like success,” and the challenge is to find the right combination of services and implementation strategies to get the success spiral started. During the early stages, it has been appropriate for trade exchanges to emphasize the “competitive advantage” and brokering services that it provides for its members, but as the size and diversity of the network is increased, the financial advantages of membership become much more significant and obvious.

Another aspect of member diversity has to do with the supply chain. If geometric growth in both membership and trading volume is to be realized, a trade exchange must include members, products, and services from *all levels of the supply chain*—not only retailers, but also wholesalers, manufacturers, basic commodity producers, independent professional service providers, and ultimately, employees. Trade exchange operators must actively solicit membership down through those other levels. If a trade exchange has a retail member, it should try to recruit the wholesale companies that supply that retail member, then try to recruit the manufacturing companies that supply those wholesalers, then try to recruit the basic commodity producers that supply those manufacturers, and so on, until the loop is eventually closed by recruiting the employees/customers who are supplied by the retailers. In this way, each participant will be able to pay their suppliers by means of credit clearing, as depicted in Figure 15.1, below on page 167.

Achieving this may take a trade exchange far afield from its local base of operations, since many suppliers will not be located within the local area in which the trade exchange operates. That implies the need for exchanges to either operate over a wider geographical area, or perhaps more importantly, to have effective reciprocity agreements with other trade exchanges in other regions. The vision of a global network of independent trade exchanges that could result from such agreements is an attractive one that the industry should work toward establishing. At the present time, this broader reach is being achieved by a process of acquisition of small local exchanges by a few larger companies leading to consolidation within the industry.

Finally, each member of a trade exchange should be allocated an internal line of credit, which, I strongly recommend, should be interest-free. If it is not, the credit clearing alternative could end up replicating the dysfunctional political money system. It is these lines of credit that constitute the “money supply” within a credit clearing circle. As described in previous chapters, it is necessary, at any given time, for some members’ balances to be negative (in debit) in order for other members’ balances to be positive (in credit). The total of all account debits should always equal the total of all account credits, making the overall system balance equal to zero. The interest-free feature follows the usual and long-standing business practice of trading on “open account” by which a supplier ships goods to a customer and allows that customer as certain period of time in which to pay the invoice. A commercial trade exchange is a credit clearing association in which that practice of “selling on credit” is organized on a multi-lateral basis. If the industry is to tap the huge potential market for cashless credit clearing services, the provision of no-interest credit will be crucial. Unlike banks, then, trade exchange system revenues will be obtained on a fee-for-service basis, deriving mainly from transaction fees, brokerage fees, advertising revenues, and risk premiums.

The issues that are raised in regard to lines of credit are (1) how to determine an appropriate debit limit for each account, (2) how to assure performance of contract on each account, and (3) how to cover the inevitable “bad debt” losses. Conventional business, especially banking, has developed answers to all of these questions, but improved approaches can be worked out along the lines that have already been covered in Chapter 12, in the sections “Balance Limits and Settlement” on page 134, “Providing Surety of Contract” on page 135, and “An Insurance Fund” on page 136.

On the question of an insurance fund for bad debts, let me add some further thoughts to those above. We've already discussed above the possible revenue sources and proposed that the bulk of trade exchange revenues should derive from those members who obtain the greatest benefit from their membership, which are those who are able to clear more of their transactions through the system. That implies fees according to the volume of transactions cleared. To cover "bad debts," there can be an "insurance fund" against which defaults can be written off. This fee should be only as large as needed to cover prospective bad debt losses, and should not be allowed to morph into an interest charge. Any resulting buildup in the amount of the insurance fund beyond the amount of reasonably expected losses, should be periodically returned to the members.

A further important feature is transparency in the operation of the exchange. Full and timely disclosure is necessary to enable the participants to evaluate the soundness of the operation and the value of their trade credits at any point in time.