Authors
Tarek Ghani
Washington University in Saint Louis

Tristan Reed
World Bank

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Relationships on the Rocks: Contract Evolution in a Market for Ice[†]

By Tarek Ghani and Tristan Reed*

Firms use relational contracts to support repeated trade. Do these informal agreements evolve in response to market conditions? In a market for ice, firms reestablish relationships on new terms when a prior agreement breaks down. Using transaction data, we show that ice retailers prioritize deliveries to loyal buyers—fishing firms—when supply from the monopolistic manufacturer is scarce. After an upstream shock to competition increases supply, repeated trade lapses, threatening retailers' positions. Incumbent retailers establish a new agreement expanding trade credit to loyal buyers, which impedes new retailer entry. Upstream competition also increases downstream firms' productivity and lowers consumer fish prices. (*JEL* D24, D86, L12, L14, L81, O14, Q22)

Economic relationships are observed as repeated trade between agents. Starting with Coase (1937), the literature on relationships has focused on the so-called "make or buy decision"—the choice to procure inputs either through spot markets or through vertical integration. Baker, Gibbons, and Murphy (2002) argue that relational contracts—informal, reciprocal agreements sustained by the value of future repeated trade—are a third organizational form that may provide more flexibility than vertical integration and more stability than spot market transactions. A broad lesson of this literature is that as markets develop, relational contracts become difficult to sustain. For example, when outside options improve on the spot market, making a particular reciprocal agreement less attractive to one party, the standard model predicts that the agreement will lapse (cf. Kranton 1996).

*Ghani: Olin School of Business, Washington University in St Louis [illegible]

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The paper proceeds as follows: in Section I, we describe Sierra Leone's ice industry and the shift in market structure that we exploit for variation. This section describes the basic effect of entry into ice manufacturing on ice and fish quantities and prices. Section II describes the data used in the analysis of relational contracting. Section III presents our core results, quantifying the effect of ice manufacturer entry on outcomes in the ice retail market including supply assurance, trade credit, and loyalty. Section IV concludes.
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