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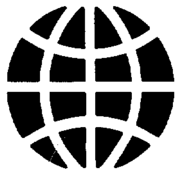

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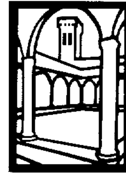

European University
Institute, Florence

July, 1989

Financial Reform in Socialist Economies

Report No. 9371

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Editors

Christine Kessides
Timothy King
Mario Nuti
Catherine Sokil

EDI SEMINAR SERIES

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Financial Reform in Socialist Economies

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Christine Kessides
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The World Bank
Washington, D.C.

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Foreword

This collection contains the revised and edited papers presented at a workshop on Financial Reform in Socialist Economies held at the European University Institute (EUI), Florence, in October 1987, together with an overview of the papers and the ensuing discussion. The origins of the workshop lay in discussions between Timothy King, then a World Bank country economist working on Hungary and Poland, and Mario Nuti of the Economics Department of EUI, then a consultant to the Bank in its work on Poland, about the parallel movements toward financial reform taking place in the Bank's socialist member countries and the great interest of the international financial institutions in this process. We felt that the countries had much to learn from each other as well as from some of Yugoslavia's experiences with its decentralized financial system. Christine Kessides, a Bank country economist on Hungary, joined these discussions, and from them emerged a proposal for the workshop.

The implementation of the proposal was accomplished by Mrs. Kessides, on behalf of the Bank, and Professor Nuti, with the major administrative work carried out by Jessica Spataro of EUI. With the help of grants from the Commission of the European Community and the European Policy Unit, EUI also financed the travel and subsistence for the socialist country participants. The organizers are most grateful for all this assistance and for the support of Marcello de Cecco of EUI and Eugenio Lari, director of the World Bank's Country Department for Europe, which enormously facilitated the smooth organization of the workshop.

By the time the workshop took place, Timothy King had moved to the Economic Development Institute (EDI), a department of the Bank whose central object is to disseminate the lessons of development research and experience to policymakers and practitioners. EDI was anxious that the value of the workshop not be confined to its participants. It therefore asked Catherine Sokil, assistant professor of economics at Middlebury College in Vermont, to serve as rapporteur. She also took on major responsibility for the overview and for editing the papers, in which she was assisted by Emmanuel D'Silva of EDI. Preparation of the papers for desktop publishing was done by Lydia Martinos.

The Editors

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Glossary and Acronyms

CD	-	certificate of deposit
CMEA	-	Council for Mutual Economic Assistance (also COMECON)
CPE	-	centrally planned economy
dinar	-	the Yugoslav currency
forint	-	the Hungarian currency
FYP	-	Five Year Plan
HUF	-	Hungarian forint
lev	-	the Bulgarian currency
LSE	-	Law on the State-owned Enterprise (USSR)
NBH	-	National Bank of Hungary
NBP	-	National Bank of Poland
NBY	-	National Bank of Yugoslavia
NEM	-	New Economic Mechanism
OECD	-	Organisation for Economic Cooperation and Development
OPEC	-	Organization of Petroleum Exporting Countries
renminbi	-	the Chinese currency denominated in yuan
ruble	-	the Soviet currency
SEI	-	socialist economic integration
TR	-	transferable ruble
yuan	-	the Chinese unit of account
zloty	-	the Polish currency

Conference Program

Monday, October 12

Session 1. Current Developments

Chair: Mario Nuti (EUI).
Marcello Buzzonetti (Secretary-General, EUI):
Welcome to participants.

Gregory Grossman (Berkeley):
"Monetary and financial aspects of Gorbachev's reform."

Andrzej Olechowski (National Bank of Poland):
"Monetary reform in Poland."

Renzo Daviddi (EUI):
"Monetary reforms in Bulgaria."

Discussants: Tom Wolf (IMF), and Ortwin Klapper (Creditanstalt, Vienna).

Tuesday, October 13

Session 2. Current Developments (continued)

Chair: Timothy King (World Bank).

Tamás Bácskai (Karl Marx University, Budapest):
"The reorganization of the banking system in Hungary."

Cuilan Wu (Ministry of Finance, Beijing):
"China's reform of the financial and tax systems."

Jozef M. van Brabant (United Nations):
"Economic reform and monetary cooperation in the CMEA."

Discussants: Christine Kessides (World Bank), and Klaus Schneider (EEC).

Session 3. Monetary Policy Issues

Chair: Christine Kessides (World Bank).

Mitja Gašpari (Narodna banka Slovenija):
"Balance of payments adjustments and crisis of financial system and policy in Yugoslavia since the early 1970s."

Cezary Józefiak (Lódź):
"Financial aspects of the Polish economic reform"

Ren Junyin (People's Bank of China):
"The basic thinking of the monetary reform."

Discussants: Marcello de Cecco (EUI), and Michael Lav (World Bank).

Wednesday, October 14

Session 4. Systemic Issues

Chair: Wlodzimierz Brus (Oxford).

Planinko Kapetanović (Belgrade):
"The role of small-scale industry in economic development in Yugoslavia."

Meizheng Xu (System Reform Commission, Beijing):
"Economic structural reform and financial reform in China."

Lászlo Antal* (Institute for Financial Research, Budapest):
"The beginnings of the development of a capital market in Hungary."

Milica Uvalić (EUI):
" 'Shareholding' in Yugoslav theory and practice."

Discussants: Timothy King (World Bank), and Christine Wallich (World Bank).

Thursday, October 15

Session 5. Alternative Models

Chair: Mario Draghi (World Bank).

Marcello de Cecco (EUI):
"Alternative models of financial organization: Anglo-American versus Continental-European."

Ales Vahčić and Tea Petrin (Ljubljana):
"Financial system for restructuring of the Yugoslav economy."

Discussants: Andrzej Olechowski (National Bank of Poland), and Ortwin Klapper (Creditanstalt, Vienna).

* Mr. Zsigmund Jarai gave an oral presentation, filling in for Mr. Antal, who was unable to attend.

Session 6. Future Prospects

Chair: Gregory Grossman (Berkeley).

Maciej Iwanek and Marcin Święcicki (Warsaw):
"Socialist stock company: The missing link in eonomic reform."

D. M. Nuti (EUI):
"Feasible financial innovation under market socialism."

Discussant: Wlodzimierz Brus (Oxford).

Friday, October 16

General discussion.

Financial Reform in Socialist Economies: Workshop Overview

Catherine Sokil
Middlebury College
Timothy King
The World Bank

Most of the socialist countries of Eastern Europe and Asia are undertaking economic reforms to correct perceived deficiencies in the traditional centrally planned economy (CPE) model. These deficiencies include overcentralization of decisionmaking, disregard for market forces, and the lack of individual initiative. The reforms take many forms in different countries; most involve the decentralization of decisionmaking from ministries to enterprises, selective expansion of the role of markets in guiding this decentralized behavior, and increased scope for individual initiative. These reforms have begun with markets for goods and services, but have almost universally advanced to include markets for factors of production, which is essential if the price mechanism is to lead to a more efficient use of resources. Financial sector reform is considered to be a fundamental component of economic reform in general, and necessary for the more efficient use of capital in the socialist system.

Financial reform entails the development of institutions and instruments for the more efficient allocation of financial resources, and for the effective use of indirect macroeconomic policies to replace administrative directives by central authorities. The use of instruments of indirect monetary control would enable authorities to manage macroeconomic aggregates more efficiently and with less need for intervention in micro-level economic decisionmaking. Banking reform would enable the banking system to become the focus of financial intermediation, allocating a larger share of investment according to profitability criteria, with a corresponding reduction in the role of the state budget. The appropriate nature of the financial system, however, including capital markets, banks, interest rates, and fiscal and monetary policy under socialism is a subject of debate among policymakers and economists.

In this spirit of debate, the World Bank and the European University Institute (EUI) organized a workshop in Florence, Italy, in October 1987 entitled, "Financial Reform in Socialist Economies." The purpose of the workshop was to explore the issues surrounding financial reform, especially using the experience of socialist countries that are members of the World Bank and the International Monetary Fund (IMF)—China, Hungary, Poland, and Yugoslavia. The reform wave has also touched other socialist countries, and increasingly the Union of Soviet Socialist Republics (USSR). The workshop included papers on the progress of financial reform in the USSR and Bulgaria as well as in each of these four countries, and these are summarized in the first part of this overview.

The workshop papers and the ensuing discussions centered on several sets of common issues. First, what are systemic changes (i.e., changes in the relationships among economic agents) to be foreseen under financial reforms,

and what is the nature of systemic constraints which cannot be changed, at least for the time being. Among the questions raised are:

- What is the model for the fully reformed financial system for these countries?
- What are the systemic limits, or constraints, to financial reform?
- What characteristics of financial reforms are necessary for their success? Included here are methods to ensure the financial soundness and discipline of the reformed institutions, both banks and enterprises. Among the issues are portfolio strength, regulation and supervision of activities, auditing procedures, and accounting standards—all herein referred to as "financial fundamentals."
- What constraints does membership of the Council for Mutual Economic Assistance (CMEA) impose on financial reform in individual CMEA member countries, and what role could the CMEA take in promoting reform?

The second broad set of issues concerns how these countries could proceed to the desired model of the financial system, and therefore the appropriate speed, sequencing, timing, and force of reforms, which have both microeconomic and macroeconomic aspects. Among the issues discussed at the workshop were the following: What other economic reforms are simultaneously needed as conditions for creating a meaningful capital market? Need they be implemented in a comprehensive package, or will a sequence of selected reforms do? Is the present an appropriate time for these countries to be reforming their financial systems?

The relationship between financial reform and macroeconomic stabilization is of current importance to all four countries belonging to the IMF and World Bank—China, Hungary, Poland, and Yugoslavia. The major macroeconomic variables, it may be argued, are directly—though imperfectly—controlled under strict central planning, whereas following economic reform the available policy instruments are more indirect and the outcome is influenced by impersonal market forces. Should financial reform therefore be delayed until a reasonable degree of macroeconomic stabilization is achieved through central control? Indeed, is financial reform possible in an unstable macroeconomic environment, or will the authorities be eventually forced to revert to more direct, administrative controls over macroeconomic variables? Alternatively, can other market mechanisms function as they are expected to in a reformed economy, if the necessary instruments for controlling credit, inflation, and interest rates are not available to allow the authorities to achieve macroeconomic stabilization without resorting to central control over resource allocation?

The final part of this overview deals with more specific monetary policy issues for socialist countries undergoing financial reform. Among these are "monetary overhangs" (i.e., undesired or unintended liquid balances) of households and/or enterprises due to market shortages, repressed inflation, and inappropriate interest rates. Some problems of macroeconomic control are shared by all socialist countries, regardless of progress in financial reform, while each stage of reform is also characterized by its own particular macroeconomic problems. The experiences of countries which have undertaken significant financial decentralization seem to underscore the need for consistent implementation of comprehensive reforms of the economic system, and

introduction of new reforms as experience is gained. Failing this, countries may find themselves on a treadmill of economic reform, during which time further decentralization may exacerbate monetary control problems. Such inconsistencies may explain why Yugoslavia—the country with the longest reform experience—faces the most acute financial sector crisis. One may even go so far as to argue that true financial reforms have yet to be given a fair try in any of the countries under review here, due to the absence of the necessary simultaneous reform measures. The particular problems of Hungary, an economy in the "transition stage" of reform with two decades of reform experience, and Yugoslavia, with almost 40 years of reform experience, conclude this overview.

The experience of financial reform

The Soviet economic system under Stalin provided other socialist economies with a blueprint (at least for their urban industrial sectors) often described as the "traditional" centrally planned economy (CPE). The financial system of a CPE is characterized by the administrative accommodation of financing to the physical plan. The central bank monopolizes commercial banking, and since it has close links to the state budget, monetary and fiscal policy are inseparable. There are separate money circuits for enterprise and household sectors. There is strict central control over the disposition of enterprises' funds; financial instruments, as alternatives to bank accounts, are absent. Interest rates are administratively fixed in an environment where credit is allocated centrally by administrative rather than financial means and is made readily available to ailing enterprises. Household savings must be held in cash, savings bank accounts, insurance and, in some cases, house purchase. These characteristics severely restrict the interpretation of such monetary concepts as the "money supply" and "monetary policy." In his paper Nuti maintains that, with rare exceptions, "monetary policy" in the traditional CPE has involved the use of money, but only for controlling plan implementation and accompanying plan orders, rather than as an active instrument for economic management. The paper by Bácskai includes a description of the accommodation of the banking system to the needs of the CPE control system.

All countries discussed at the workshop have expressed at least an official intention to reform significantly this traditional model. Some have gone so far as to express the intention to proceed toward some form of "market socialism," a system whose theoretical model is not clear but which would involve considerable reliance on market forces along with social ownership of the means of production. Specific discussions and provisions can be grouped into three broad categories, namely: reform of institutions, of behavior of economic agents, and of interest rate structures. Reform of institutions includes the development of a "two-tier" banking system with both a central bank and competing commercial banks, as well as the introduction of some sort of a market for the issue and trading of bonds and other financial instruments. Reform of behavior includes giving financial autonomy and responsibility to enterprises (including banks) in order that they should be able, indeed compelled, to respond to financial signals. Necessary components of this are to grant enterprises responsibility and autonomy over their accounts, the establishment of bankruptcy proceedings, and the reduction of financial intermediation through the budget so that enterprises depend less on government subsidies and grants and more on bank and self-

generated funds. Reform of the interest rate mechanism seeks to make this a significant influence on the allocation of financial resources and an important indirect target and/or instrument of central control.

Nuti's paper summarizes the progress of the socialist economies in introducing financial reforms involving bank decentralization, bond market development, limited use of interest rates, and other features of monetary policy and fiscal reform. He ranks socialist countries on the basis of the length of their experiences with decentralization, in the following order, from shortest to longest: the USSR, Bulgaria, Poland, China, Hungary, and Yugoslavia. Individual workshop papers deal with each country in more detail.

USSR. The paper by Gregory Grossman discusses the financial aspects of the economic reform blueprint for the USSR under General Secretary Mikhail Gorbachev. An important contributor to the reforms has been the realization that "money matters," which is in part a result of the "second economy."[1] The financial reform so far centers on the establishment of six new sectoral banks, which would function as monopolies in their areas of specialization—not a significant development in itself, as it is reminiscent of the situation during the Stalinist period, when central planning was first introduced in the USSR, and many specialized banks were in effect monitoring and clearing institutions for specific sectors. Households have been promised a wider selection of financial services, such as checking accounts. Enterprises have been told that their performance will be judged much more on the basis of indicators of financial success than in the past. Direct subsidies are to be replaced by bank financing, which will require repayment. Enterprises will have to rely more on their own funds and on convincing banks to lend to them for projects. Because of the many issues as yet left unresolved, Grossman is skeptical that the reforms, whose implementation is scheduled to begin in 1990, will result in anything more than a "halfway house" between the traditional CPE and some form of reformed market socialism.

Bulgaria. The reform blueprint is quite well developed in Bulgaria, as described in the paper by Daviddi. Among the measures in the blueprint are the separation of commercial and central banking as of June 1987; the establishment of eight banks (all but two of which would be located in Sofia); and, perhaps most significant, the ability of banks to confiscate borrowers' assets in the event of default. However, the blueprint remains somewhat vague, and possibly inconsistent. It is unclear who will own and control the commercial banks. These are to bear joint responsibility for the success of projects they finance, which might lead to direct bank interference in enterprise affairs. The suggestion that commercial banks will deal in foreign exchange may weaken foreign exchange control. Interest rate policy is to be a main instrument of indirect control, but how it will be determined is a mystery.

Poland. Financial reform in Poland is described in the paper by Józefiak. In spite of significant decentralization in several areas since 1982, until very recently the financial system conformed closely to the traditional CPE model, with a few relatively insignificant exceptions. Enterprises were permitted some

1. A "second economy" exists in most socialist economies. Its characteristics vary, but generally it provides a source of earnings, often on a part-time basis, outside regular state employment. Very often this entails the provision of services, such as repairs, construction, or transport. But it may include privately organized cooperatives working with state-owned equipment.

discretion in the use of their funds—for example, they could invest out of retained profits and bank loans. Contractual relations between enterprises and banks were to depend in principle on creditworthiness. However, the monopoly of the National Bank was unbroken. Provisions for bankruptcy existed, but were seldom applied.

The 1982 Banking Law envisaged autonomous commercial banks which would compete for enterprise deposits and grant credits to enterprises based on their assessments of creditworthiness. New banks could be set up in the form of joint-stock companies with domestic as well as foreign capital. In practice, however, banks are few and specialized, and they are dominated by the National Bank of Poland (NBP). In 1985, bank credits accounted for only 16 percent of finance for enterprise investments. Bonds are issued by the NBP, and reportedly an incipient secondary market for bonds recently started to develop, but was discouraged by the NBP on the grounds that it might reduce demand for primary issues. Interest rates of all kinds are still strongly negative in real terms.[2]

While a wide gap remains between the blueprint and the implementation of financial reform in many countries, even the blueprints are often somewhat vague, probably for political purposes. As participants argued, vagueness may make it easier to convince divergent political interests of the need for and benefits of reform. However, it also may impede implementation, because not all political constituencies stand to gain from reform, and backtracking may result as the political establishment attempts to ease the resulting economic hardships. Implementation has progressed much further in China and Hungary, where financial reforms have many similarities. But even here, experience has been mixed.

China. The paper by Wu describes developments in China's fiscal system and complements the discussion of the financial system by Ren. In another paper, Xu puts the financial reforms into their broader context. Budget financing of state sector investment has fallen from 65 percent in 1975 to 22 percent in 1983, and this trend will continue, as investment financing will increasingly depend on development-type banks, including the new Construction Bank and investment companies. The latter may issue loans or shares to enterprises, or issue securities to the public to raise capital. Four huge, specialized banks have sectoral monopolies which are proving difficult to abolish. These banks are heavily taxed and subject to other state intervention. New nonbank financial institutions include trust, leasing, insurance, and finance companies, as well as cooperatives and joint ventures. These are designed to provide financial services of a longer term and riskier nature than is acceptable for deposit-taking commercial banks. Their number is growing, while still accounting for a small fraction of financial intermediation in an environment of investment growth. New instruments have also emerged. Government entities, enterprises, and financial institutions have been allowed to issue bonds on a trial basis. The state has issued a significant volume of treasury bonds which could aid in the development of open market operations as an indirect control mechanism over liquidity. Although some interest rate flexibility has been introduced, real rates still are not unambiguously positive.

2. For more on developments in Poland up to the time of the conference, see World Bank (1987). Since the conference, attempts to make real interest rates positive have yet to be successful, despite substantial raising of nominal interest rates in 1988.

Hungary. Of the socialist economies which retain a centrally planned economic system, Hungary is furthest along in financial reforms. Both positive and negative aspects of its experience are discussed in the papers by Bácskai and Antal. The monopoly of the National Bank of Hungary was abolished in January 1987. Five full service commercial banks currently operate, and are regulated by the central bank primarily via refinancing limits, but also via reserve requirements and other instruments. Limited open market operations are planned for the near future. Commercial banks are free in principle to determine their interest rates on deposits and loans, but in practice they closely follow the structure of interest rates in their transactions with the central bank. In addition, many new, small financial institutions typically provide finance to enterprises on a profit-sharing basis, but they may not take deposits. A second insurance company has been established to compete in the mobilization of savings.

Since the first issue of bonds in 1983, the bond market had grown in volume by 1987 to 20 billion forints (approximately US$500 million). Of this amount, 70 percent had been issued by enterprises and 30 percent by local councils; 80 percent had been purchased by private individuals and 20 percent by institutional investors. State guarantees on bonds purchased by households were discontinued in 1988. A secondary market for bonds was created before any legal framework had been established. Turnover on the secondary bond market amounts to about 10 percent of the total value of outstanding bonds, or two billion forints annually. A limited share market exists, comprised of 40 different shares, in the value of 30 billion forints. These shares may be purchased only by state or cooperative (i.e., socialist) enterprises, and as yet there is no secondary market for shares. Foreign ownership of bonds and shares, however, is prohibited.[3]

Yugoslavia. Under its system of workers' self-management, Yugoslavia has a financial system that is unique, but with elements characteristic of all socialist countries. In principle, enterprises practice significant autonomy, as they are managed by their own workers, entering into social compacts and self-management agreements with other entities on economic and social issues. This decentralization is paralleled in the banking sector as, since 1977, banks can be founded by organizations of associated labor and self-managed communities of interest. Banks, then, which are established and owned by enterprises and other "self-managed communities of interest" who pool their resources, act as "service agencies" of these enterprises. Moreover, founders do not necessarily have to contribute capital—therefore founders may be either providers or utilizers (or both) of resources. Providers and users of capital both receive profit.[4] Individuals' resources may be mobilized by contractual associations of associated labor (COALs). Socialist enterprises may mobilize resources directly from individuals, and they may receive interest or other benefits (employment, housing, services). Enterprises in Yugoslavia may "pool labor and resources" by investing in each other. However, the legal provisions of such investment are biased against the investing enterprise in favor of the receiving enterprise.

This particular form of decentralization, involving bank ownership by enterprises, coupled with a weak central bank and absence of sound "financial fundamentals," has resulted in a host of problems for the Yugoslav economy

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3. The lifting of this limitation is currently under consideration.
4. This was changed under the new banking law—now only contributors receive profit from the venture.

which are discussed in the contributions by Gašpari, Kapetanović, Uvalić, and Vahčić and Petrin. Gašpari discusses problems of macroeconomic control by the central bank. Kapetanović and Vahčić and Petrin document the lack of effective competition in the industrial sector which limits the effectiveness of financial reform. Uvalić discusses theoretical and ideological issues of financial reform under the unique Yugoslav workers' self-management system.

Systemic issues

What is the model for the fully reformed financial system?

Clearly, by financial reform, socialist countries want to improve the allocation of resources by developing an efficient financial system; how to do so is less clear. No clear model exists of the eventual financial system goal of these reforming socialist economies. Official pronouncements and reform experience to date suggest that by financial reform these countries appear to desire some sort of a decentralized banking system composed of banks competing for clients. These banks would be indirectly controlled by an independent central bank. Financial instruments, such as bonds and equity capital, would aid in the mobilization and allocation of financial resources.

Yugoslavia has the most decentralized financial system of all the socialist countries. Yugoslavia's role as a model for financial reform in other socialist countries may be limited, however, by ideological considerations of ownership and management in its unique self-management system. As Uvalić shows, ideology prevents financial market developments which interfere with the concept of workers' self-management. Whereas reforms in Yugoslavia envisage that banks will be transformed into profit-making institutions, currently they operate expressly as "service agencies" of enterprises. Banks are bound by their commitment to their owners, and do not have the freedom to pursue their own goals. This nullifies the potential role of the financial system in improving the allocation of resources. Yugoslavia's role as a model is also seriously questioned by the practical results of the changes—which might not even appropriately be referred to as reforms—in its financial system. Yugoslavia's decentralization of banking without concurrent resolution of other, notably monetary control, issues of financial reform, has made it more difficult for the country to come to grips with its severe balance of payments and macroeconomic adjustment problems. Both issues—ideology and practical results—make Yugoslavia an unattractive model for other countries.

In financial system reform, the East European reforming CPEs might look toward their own presocialist heritages of universal banking. The paper by de Cecco raises the issue of the possible eventual choice between American-style and continental European-style banking systems. He suggests that the appropriate model of banking system development is not the American model, but rather the continental European model of concentrated, universal banks. Other participants, however, warned against following the continental model for various reasons, including its use of borrowed money (i.e., deposits) to buy shares.

Nuti argues that in striving to introduce some form of market socialism through economic reform, socialist countries have indeed become more "monetized," in that a greater role for money is allowed, but that financial markets have not been sufficiently developed. Rather than devise monetary and financial institutions appropriate to a functioning financial system under

market socialism, reforming socialist economies have "grafted" onto their economic systems some elements of the market economy, notably instruments such as bonds, while avoiding other elements due to economic or ideological constraints—consequently limiting these countries' success at achieving increased financial efficiency. Nuti suggests that socialist countries might develop their own distinct model of the financial system, and imagines, in an "intellectual experiment," uniquely socialist institutions for doing so. Iwanek and Święcicki, on the other hand, argue for the creation of a full-fledged capital market in the reformed socialist economies, the only difference with that in capitalist countries being in the proportion of institutional (public) versus private investors.

What are the systemic limits, or constraints, to financial reform?

Ownership. The Marxist theoretical basis of modern-day socialist economies presents obvious ideological obstacles to financial market development, particularly when the discussion turns, as it has in many of these countries, to the question of share ownership. Private ownership of shares allows individuals who own capital to derive income from the labor of other individuals, and this may be considered contrary to Marxist, socialist, and self-management philosophy. The issue of ownership has direct relevance to the equality of income distribution in socialist economies, as under private ownership, a "rentier" class might emerge. Bond issues to individuals in countries such as Hungary have been acceptable, as they do not represent an ownership share; they carry a fixed return; they carry no entitlement to participation in management; and they have been risk-free to the bearer, under state guarantees of interest and principal.

The workshop participants seemed to agree that private ownership is not necessary for financial system reform. They did believe, however, that some form of share market is needed for the proper valuation and allocation of capital, and that this share market could be based on some form of institutional ownership. Yugoslav thinking on this issue is surveyed in Uvalić. Schemes for such ownership are devised in the papers by Iwanek and Święcicki and by Nuti.

The paper by Uvalic discusses the theoretical basis of property rights under the workers' self-management system, as well as how ownership issues have been dealt with in legal practice in the development of the Yugoslav financial system. In 1953, state property in Yugoslavia was converted to social property. Enterprises have since been granted not property rights, but only the right to use social property. Capital market development has proceeded in Yugoslavia within the realization, in several Yugoslav laws, of the need to remunerate workers' "past (embodied) labor." Schemes were introduced in the 1970s in Yugoslavia to remunerate past labor of individuals as an incentive for efficient management of social capital. However, the legal provisions were vague and general. A 1982 law provides some further details, but remuneration is linked to seniority, not in the particular enterprise, but according to the number of years of service in the socialist sector.

None of these schemes, however, deals sufficiently with the issue of how to compensate individuals adequately for the sacrifice of present consumption entailed in investment decisions and thus motivates them to invest. Moreover, the view was expressed that it is difficult to use the concept of past labor as a foundation for the limited issue of shares, since this would imply that income is entirely the result of the contribution of labor. In Yugoslavia, for example, there is

effectively no capital charge by the government on the capital endowment of a firm. These endowments differ widely from one firm to another, putting firms on very unequal footing and so limiting the operation of a capital market. The schemes also reward these "past labor" contributions only according to their duration, and not to the performance of the investments in which they are embodied.

As Uvalić discusses, the self-management theoretician Kardelj has argued that workers should be rewarded, through past labor, also for their managerial decisions. Workers would receive these awards for past labor not as proprietors, but as managers of capital. Kardelj elaborated a scheme on a form of workers' shareholding which would have at best established a form of nonmarketable, nontransferable instruments.

Equity shares have yet to be introduced in Yugoslavia, although some existing schemes resemble equity shareholding. There is an ideological debate as to whether shareholding, by whatever scheme, is compatible with workers' self-management. Shareholding by workers of the enterprise appears to be more compatible with self-management ideology than other private shareholding. Uvalić maintains that Western producers' cooperatives confirm that shareholding is consistent with self-management; she also presents the results of a survey of Yugoslav workers' opinions on shareholding, finding mixed opinions on the part of workers toward share market schemes.

Recent criticism of social property has resulted in a revival of interest in shares and many suggested schemes for a form of shareholding in Yugoslavia, according to Uvalić. For example, Milovanović suggests a system of socialist shareholding in which the state would issue initial shares in proportion to the value of social capital and would distribute these to the population. The trading of shares on an organized market would follow, resulting in an unequal distribution of shares due to unequal time preferences of individuals. Shareholders would receive dividends based on performance of the firm whose shares they own, but would have no say in the decisions of the firm—this would remain the dominion of the workers of the firm. This would eliminate the major reason for opposition to shareholding in a self-managed system, but would also deny the possibility of takeovers and their potentially favorable impact on enterprise efficiency.

The ideology of self-management poses particularly acute problems for banking. Under Yugoslav socialism, financial services are not considered productive activities. Because BOALS can exist only for productive activities, and therefore not for banks, self-management cannot apply directly to banks and financial institutions. For this reason, in order to comply with self-management principles, banks must be dependent upon enterprises, and serve only to provide for these enterprises, which own them. The practical result is that banks have no protection from heavy borrowing by enterprises.

Participants commented that, on balance, ideological opposition to shareholding seems stronger in Yugoslavia than in Hungary and Poland, which seem—at least from the discussions at this workshop—more pragmatic at this stage in their capital market development. Besides ideological questioning over whether shareholding can be consistent with self-management, practical political obstacles to the development of shareholding in Yugoslavia were raised. These included the vested interests of state authorities, who might resist loss of their influence over enterprises should enterprises come under the direct control of private shareholders. Several participants commented that individual share

ownership presents not an ideological issue but only a technical issue of financial system development in socialist economies. It should be noted, however, that the diversity of views on this issue and of differences among socialist countries is probably much greater than represented at this workshop, whose participants seemed exceptionally pragmatic on the ownership issue.

Individual ownership would lead to competition for private funds between the legal private sector and the socialist sector. For example, could private investment compete with foreign exchange accounts in Yugoslavia where these are risk-free, liquid accounts? (Yugoslav households keep virtually all nontransaction balances in these foreign exchange accounts.) Is it appropriate to experiment with financial system reforms which involve transfer of ownership under current conditions, when many state enterprises need to be restructured? Can individuals be persuaded to buy shares that are currently unprofitable? It is one thing to allow private ownership of new ventures; but how would ownership of existing firms be transferred from state to private hands? How would the initial value of the existing capital of state enterprises be determined?

Ownership and management. Both the desirability and the feasibility of separating ownership and management of firms in socialist economies was discussed. In capitalist economies, private owners of firms not only derive income from the firm, but also exercise indirect control over the management of the firm by casting votes for the board of directors and on some major issues on the principle of "one share, one vote." Some capitalist firms also allow workers' representation on the boards of enterprises. Under state ownership, managers may be considered agents of the state, as principal, whose interests are also represented by officials in the state bureaucracy. This is used to justify these officials' interference in the firm's operations, including the selection and remuneration of managers. Arguably for this reason, the surplus product of the firm accrues to the state budget. In the reforming CPEs, the question of what are the functions of ownership and who should exercise them are unclear. Ownership functions include bearing the privileges—possibly including voting rights as well as income—and the risks of socialist firms.

The Chinese delegation repeatedly stressed the desirability of retaining state ownership in most cases, while achieving a separation of ownership and management. In China, measures have been taken to make enterprise management more independent of state authorities. The issue of how to represent the interests of the state, as owner of enterprise assets, is under discussion. Xu summarizes the different viewpoints. One view is to develop a special government institution to oversee ownership—a "state asset management bureau." This institution would send delegates to sit on enterprise boards of directors, not to interfere in the day-to-day management of the firm, but to represent the state's interest in preserving and perhaps increasing the value of its assets. A second view is that shareholding companies should be established by all levels of government which would send representatives to be members of the boards of directors of firms. An enterprise which uses its own assets could issue additional shares and could invite other enterprises, banks and other institutions, and even households to become shareholders with seats on the board of directors and to share in the profit of the firm. To prevent the emergence of a rentier class, share ownership by individuals could be limited, or individuals could participate by holding shares in investment associations or unit trusts, which would exercise ownership rights. Another scheme under consideration would involve leasing state property to managers under contract.

Voting vs. nonvoting shares. A way of separating ownership and management may be to issue nonvoting shares. Some participants argued, however, that voting needs be attached to shares not only to protect against excess distribution of product in the form of wages, but also to permit the possible takeover of the firm by investors who think they can use the capital more efficiently—that is, to protect owners from poor management. Effective outside voting shareholders enable capital mobility and ensure the most efficient use of capital by existing management. Shareholders in Hungary have voting rights, but so far only institutions own shares; the state represents its ownership share via the Ministry of Finance.[5] The management boards of banks, for example, are chosen by shareholders.

Suggested share market arrangements. Iwanek and Święcicki survey the problems of the traditional CPE financial system and elaborate on the design of a system of public holding companies which in their estimation would operate in the interest of long-term efficiency of social capital. In their scheme, holding companies are additional institutions intended solely to correct the weaknesses of existing financial institutions and possible ideological constraints. Some participants expressed concern, however, that devising a system of holding companies might involve the creation of an entirely new bureaucracy, and questioned the incentives of these new institutions.

The paper by Nuti presents an alternative scheme for socialist financial market development which would perform the functions played by private ownership of voting equity shares and full-fledged stock markets in market economies, namely to give assets liquidity and to value the opportunity cost of capital assets. This could be accomplished, he argues, without relaxing the systemic restrictions of the market socialist system—namely, that social ownership dominate.

Currently, systemic constraints prevent the exercise of three important functions of a stock exchange, namely, to provide:

- liquidity of investment in equity shares, needed as an incentive to save;
- current, up-to-date valuation of enterprises, needed to assess the opportunity cost of capital assets; and
- a mechanism for redeployment of productive assets via mergers and takeovers.

The market socialist system is, nonetheless, capable of fulfilling these three functions, using existing and/or new, innovative institutions. Nuti presents a three-stage scheme by which these functions are fulfilled, but within a uniquely market socialist context.

1. Under the "challengeable (contestable) self-assessment principle," an enterprise would announce the value of its assets and be forced to release or revalue its assets if outsiders' valuations exceed the valuation by the enterprise's own managers.

2. Under an "intermittent stock exchange," state agencies, including possibly enterprises and institutional investors, would trade shares, equal in total face value to the value of assets determined in 1.

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5. A new Law of Associations to be enacted by January 1989 has been approved recently by the Hungarian Parliament. This law will permit individuals to own negotiable and transferable shares in joint-stock companies.

3. In spite of lack of private ownership and control, individuals could participate in valuation, risk-taking, and the consequent potential financial gains thereof, via ingenious schemes involving options-type trading, or loans and deposits indexed to share performance, or possibly other schemes.

The rewards of such an undertaking are potential efficiency gains. Government's pursuit of monetary and industrial policies is not precluded by these schemes; nonetheless, the proposed simulated stock market would potentially expose the economy to instability, unemployment, insider trading, and unequal income distribution, which ideally would also be given system-specific remedies, some of which Nuti also suggests. These combined institutional changes would make a socialist stock exchange potentially equal to a capitalist one in achieving the goals of efficiency of the financial system within its own institutional context.

What characteristics of financial reforms are necessary for their success?

As the Chinese put it, a major challenge of financial reform is to convert bankers in socialist countries from bureaucrats into independent businessmen, or turning banks into "self-responsible enterprises." Traditionally, banks in socialist countries have not been expected to perform as profit-maximizing banks as such, but rather to simply manage enterprises' financial resources to accommodate the central plan. Even under economic decentralization, at least of the Yugoslav type, banks have been seen more as service agencies of enterprises than as profit-maximizing entities in their own right, given that enterprises and other self-managed organizations establish and own banks.

Among the conclusions of the workshop was that a central place in financial sector reform needs to be given to "financial fundamentals" of the newly created banking institutions, and of the enterprises they serve. In order for financial considerations to guide economic decisions, financial conditions need to be made transparent to decisionmakers. The collection and provision of timely and accurate financial information on enterprises and banks is critical.

Among the "financial fundamentals" are issues such as the quality of the enterprises' and banks' portfolios, the methods of approving loans, the regulatory and supervisory framework for financial deals, and the accounting and auditing procedures fundamental for financial discipline. Lack of attention to these aspects of financial sector reform seriously reduces the ability of a reformed banking system to play an appropriate micro- or macroeconomic role. For example, in Hungary, banks are tempted to bail out the weak enterprises in their portfolios, rather than to finance dynamic new activities. Yugoslav banks are owned by enterprises which seek to bail themselves out of financial difficulties. Serious losses emerge, destabilizing the financial sector and undercutting fiscal and monetary policies.

The legacy of past lending under traditional CPE conditions is reflected in the present portfolios of the banks. It has been estimated in China, for example, that in some bank branches over 60 percent of loans are in arrears and 50 percent of loans would be classified as nonperforming by Western accounting standards, and that a large number of bank branches would have a negative net worth if their portfolios were marketed. Given these precarious portfolios, banks are seriously hindered in the attainment of their goals of earning a profit.

The development of a market-based financial system in reforming socialist economies, if it is to occur, also will require grappling with issues of bank supervision as well as accounting and auditing reforms of enterprises and banks. Valuation and trading of capital market securities requires an adequate flow of financial information, which depends on a transparent accounting system, required independent audits, and requirements for financial disclosure. Enterprises' financial accounts will need to be made more transparent, if banks are to successfully judge enterprises' creditworthiness. At the same time, the regulation of banks would have to be resolved, including such issues as minimum capital requirements, guidelines on portfolio composition, acceptable activities, standardized accounting, disclosure norms, and deposit insurance.

Training the necessary staff will be a major undertaking, required for enterprise financial managers, bankers, bank supervisors and regulators, and macroeconomic planners and policymakers. Bankers will need to be trained in financial management, credit evaluation, foreign exchange management, asset-liability management, maturity gap management, hedging strategies, underwriting, and a host of other skills. Moreover, financial specialists will be needed to evaluate firms' financial performance and to provide independent opinion on the financial status of a firm. Although this issue may appear a "technical detail," the experience of countries such as Hungary shows it to be a vital practicality in banking reform.

Hungary has implemented a major reform of financial institutions, policies, and instruments since 1986, to supplement and accommodate the economic reforms in goods and labor markets. In doing so, the Hungarian authorities had to confront many difficult issues, with mixed success, and their experience can provide other countries with insights into the financial reform process and its prerequisites, necessary characteristics, and timing. The issues Hungary has been forced to confront include: ensuring competition among banks; providing adequate capitalization of banks; ensuring independence of central banks vis-à-vis state treasuries; developing tools of monetary policy; assessing the role of foreign joint ventures in banking; and integrating the household and enterprise monetary circuits.

1. What are the desirable conditions of competition among banks? For example, should banks be restricted to certain geographic regions? In retrospect, among the shortcomings of the present stage of the Hungarian financial reform is the imbalance in the size and strength of banks, with consequences for competition among banks. Banks continue to vary widely in the strengths of their balance sheets. Moreover, the balance sheets of some banks are dominated by the deposits of at most a few firms, making banks very vulnerable in the event of bankruptcy of a major client, now theoretically possible, given the new bankruptcy law.

2. Under banking reform, the central banking and commercial banking functions of the central bank were separated, and the commercial functions passed on to several new, competing commercial banks. The question naturally arises: how should the portfolios of these new banks be apportioned? In Hungary, some of the individuals with responsibilities for allocating past credits of the National Bank of Hungary into the portfolios of the new banks knew that they were to become managers of these banks, and thus had a vested interest in the outcome of their portfolio allocations. The resulting uneven allocations at least initially may have seriously inhibited competition in banking.

3. How can the necessary independence of the central bank be assured in a decentralized banking system? In Hungary, the precise relationship between the state budget and the National Bank is not completely transparent, and the fiscal/financial separation is as yet incomplete. True, investment financing through the budget has decreased relative to that performed by banks. However, further progress is needed to permit enterprises with the greatest potential profitability to generate and retain more of their savings, while curbing the fiscal transfer of these savings to unprofitable firms. The State Development Institute, created from the State Development Bank, has continued to administer interest-free state grants under refinancing for priority investments and assistance in reflotation. Bargaining by enterprises for these preferential appropriations is inefficient; an "auction market" on which firms would bid on interest rates they can pay would be a more efficient means of allocating investment credit.

4. What tools of monetary policy could be made available in the absence of open market operations, and how could a tight monetary policy be enforced? In Hungary, the task of economic reform is to develop monetary policy as an instrument for achieving macroeconomic balances, as opposed to its traditional role of accommodating the resource requirements of government and enterprises. Ironically, an especially lax monetary outcome in 1986 reflected the Government's effort to provide financial assistance to a group of large loss-making enterprises prior to the liquidation law, and to permit the transfer of a "clean" loan portfolio to the newly formed commercial banks. Since 1988, a tighter monetary policy is being pursued under an IMF Standby.

The NBH intends to control credit expansion within the new banking system primarily via indirect instruments; namely, refinancing, open market operations, interest rates, and reserve requirements. Because the commercial banks are not yet free to mobilize deposits from households, they rely heavily on refinancing, which is currently the major instrument of bank regulation. Eventually, open market operations might be used as instruments of monetary policy. The treasury has only in 1988 begun to issue transferable securities, whose use could eventually expand to allow open market operations. Reserve requirements are high by international standards and partially offset high refinancing volumes.

5. Were foreign joint ventures in banking desirable to introduce additional competition? Hungary has allowed banking joint ventures on its soil, as well as in an off-shore bank, to inspire competition. Foreign banks can now lend to domestic enterprises, in forints. Of Hungary's three banks with foreign participation, two deal both in foreign and domestic currency. The third is an offshore bank which is setting up a subsidiary to deal in forints.

6. How can the typical separation of household and enterprise finance be eliminated to achieve a more efficient mobilization and allocation of financial resources? In Hungary, the separation was due in part to legacies of different pricing, taxation, and interest rate structures between households and enterprises, as well as the legacy of reliance on budget intermediation. The introduction of a personal income tax in 1988 was cited as a necessary step toward the unification of household and enterprise finance, inasmuch as it made the tax treatment of households and enterprises more consistent. However, clearly this process will require resolution of the issue of housing subsidies, which have existed in the form of highly negative real interest rates on mortgages. As households have used an increasing share of their savings on housing investment, net financial savings—which would be available for intermediation through the financial

system to the productive sector—have remained small by international standards. The integration of the household and enterprise banking systems requires an increase in the interest rates on housing loans and household deposits. This, in turn, requires special treatment of the present portfolio of the National Savings Bank and a new policy of financial assistance to families for housing.[6] Integration of the two money circuits, integration of the banking system and bond markets, and reforms to ease the constraints on equity ownership and to develop the role of institutional investors would diversify enterprises' sources of debt financing and risk capital. At the same time, a wider variety of financial assets for households might raise financial savings.

What is the appropriate role for the CMEA in financial reform?

The paper by Brabant deals explicitly with the issues surrounding CMEA membership and financial reform in CMEA member countries. All members of the CMEA conduct at least half of their trade within the CMEA, at prices which often depart markedly from world market prices. This and other systemic aspects of the CMEA monetary-financial mechanism, including bilateralism and inconvertibility of currencies, put a severe constraint on how far economic, and particularly financial, reforms can proceed in reforming countries. Brabant elaborates on these, and suggests how CMEA policies, behavioral rules, and institutions could be changed to give greater support to domestic financial reform within member countries as well as socialist economic integration (SEI) among member countries. He argues that the recent wave of reform in individual CPEs, as well as their greater integration into the international financial market, is largely unsynchronized. If the appropriate CMEA institutions were established, the CMEA organization could conceivably play a much greater role as a coordinating regional economic institution.

Speed, sequencing, timing, and force of reforms

The appropriate speed, sequencing, timing, and force of reforms in general, and of financial reforms in particular, constitute major issues for the socialist countries. Not enough experience has been amassed to be able to generalize about the appropriate sequencing of socialist economic reform, especially because it is not a question of completing first one reform and then another, but rather of advancing on several fronts at the same time.

Reform needs careful and well-planned implementation. On the other hand, the insecurity and uncertainty of the internal and external situations of the socialist countries may not allow them the time to be gradual in financial reform, as they may make it easier for opponents of reforms to mobilize and bring the process to a halt. The timing issue has a microeconomic side, concerning the question of what reforms in other areas of the microeconomy may be needed prior to financial reform, and also a macroeconomic side, concerning

6. All of these measures are being introduced in 1989, as the present system of financing the purchase and construction of housing is scheduled to be changed rather dramatically. A Housing Mortgage Fund will be established to deal with the existing stock of housing loans, while subsidies to eligible recipients for new housing loans will be administered through the budget rather than through the banking system, thus removing a source of distortion in bank interest rates and making the total subsidy more transparent.

whether some degree of macroeconomic stabilization is a prerequisite to financial reform.

What conditions are needed to create a meaningful capital market?

A market-based financial system requires many prerequisites, arguably more than a system of central planning. The discussion sought to enumerate the conditions, or simultaneous reform measures, whose absence would condemn reforming CPEs to, at best, some form of "halfway house" between the market and plan. In this halfway house, the financial system cannot play more than a passive role and is still subservient to central decisions. Financial instruments, which are supposed to constitute the means of indirect control, cannot be effective, not because they are not developed, but because legacies of the CPE system leave these instruments little scope. Taxes, subsidies, and the like are used to favor individual enterprises, and are intended to substitute for market competition. As they are used to adjust both the level and structure of demand, especially of enterprises, to accommodate its actual supply, they are intended to substitute for price flexibility. Because overregulation is still present—instruments are criticized as being too numerous, contradictory, and so forth—authorities revert back to nonfinancial instruments. The "vicious circle" is complete (Józefiak).

What seems often to be left out of discussions of financial reform in socialist countries is the need to develop simultaneously the real capital sector of the economy, along with the financial system. As households are encouraged to invest in financial instruments, and firms to invest in one another, and increased intermediation occurs, what is to ensure the modernization and expansion of the real capital stock? The answer seems to rely on the proper channeling of incentives to producers of capital goods, which can only be assured by an enterprise management structure which is motivated by the desires of its customers, and a system of foreign trade that provides competition to domestic manufacturers and permits the import of foreign technology. In this scheme, the price system needs to act as a signal of consumers' final demands, which in turn is a necessary ingredient in the assessment of the efficiency of investment projects.

Price reform. The discussion (Wolf) raised some complicated issues surrounding reform of pricing systems in socialist economies. Efficient reform requires the simultaneous fulfillment of three objectives:

- the linking of domestic producer prices to world market prices (converted into domestic currency), or the "transactions price rule";
- the need to eliminate subsidies on domestic production; and
- the need for the domestic markets to clear.

The linking of domestic and world market prices also raises the issue of the appropriate exchange rate to use, and whether the reference price is the convertible currency or ruble trade price.

The key to the solution of all these objectives is price reform. Financial reforms and the use of monetary policy are meaningless without "equilibrium" in commodity markets, achieved by microeconomic reforms, in particular reform of the price system. Price reform implies freeing the prices of producer goods, final products, and real capital to ensure flexibility of prices and the elimination of price distortions. Conversely, if authorities continue to control enterprises by direct means, and make central, quantitative decisions—although

claimed to be temporary and unavoidable—price reform by itself has little meaning.

Of course, what is needed is not simply a "decontrol" of prices in an oligopolistic economy or a recalibration of administered prices. Rather, what is needed is the introduction of real competition in product and factor markets. Developing effective competition in turn requires reform in a number of areas at more or less the same time.

Most discussions of price reform, however, concern only price revision, not price reform; but unless excess demand is eliminated, planners will be forced to revert to allocation by administrative means. Socialist reformers seem to argue that prices must be revised to eliminate shortages before introducing the market mechanism, which will in turn introduce true price flexibility. Economists trained in the market tradition, however, would argue that this reasoning is circular: only the introduction of the market mechanism will eliminate shortages at the microeconomic level. Price reform and reform of the industrial structure are therefore necessary simultaneous measures needed to ensure that financial reforms will be meaningful.

Financial discipline. Price reform is only meaningful if firms are sensitive to costs (including interest rates), or a "hard budget constraint" is achieved. A "hard budget constraint," participants argued, does not necessarily imply profit maximization by firms. However, Nuti argues that it does necessarily introduce insecurity for managers, or their susceptibility to dismissal if they are challenged by potentially better users of their enterprise's assets. The reluctance of enterprises to invest in each other when allowed to do so may act as a measure of the soft budget constraint on enterprises, as well as an indication of their mistrust and uncertainty in an environment of only partial reforms. In Poland, for example, enterprises had been allowed to issue bonds to each other since May 1986, but in at least the first six months no enterprises had done so.

Without these reforms in the pricing and enterprise management systems, financial reform by itself involves an inconsistency in the objectives of economic agents. On the one hand, bank managers are explicitly expected to maximize profits, as they are for example in the Soviet reform blueprints. On the other hand, other economic agents, notably managers of state enterprises involved in production, are not explicitly assigned the goal of profit maximization. Or, if assigned, productive enterprise managers may share this goal with many other, possibly competing, goals.

Competition and entry. Profit maximization will not necessarily have desirable allocative effects unless there is effective competition. Many socialist countries, especially the small ones, are characterized by highly monopolistic industrial structures. In these circumstances, it is necessary that imports be permitted to compete with domestic production. By reinforcing the link between domestic and world prices, the export competitiveness of the economy is also strengthened.

Virtually all reforming socialist economies have given recent attention to bankruptcy laws and the "exit" of firms. Entry is just as important, however, especially in innovation and risk-bearing, as the experience of the Western countries has shown. Enterprises must be free to exploit new opportunities, which means lifting "profile" restrictions (i.e., on the permissible range of activities) and other constraints on their entry into new product lines. Establishment of new small- and medium-sized firms also must be encouraged. The importance of small firms, entry, and entrepreneurship are underscored in the paper by

Kapetanovic. Vahcic and Petrin document the virtual absence of small firms in the nonprivate sectors in socialist countries, including Yugoslavia, and suggest how institutions might be designed to trigger the creation of small firms to create competition. The nonstate sector (second economy) plays an important role in creating direct and potential competition to the state sector.

Elimination of political pressures. Financial reform has inevitable political aspects, since the operation of the financial system is subject to state intervention in most economies, and the traditional CPE financial system is one of the instruments of central control. State authorities may be tempted to try to continue this intervention, at the expense of financial decentralization and reform.

In Yugoslavia, for example, it may be argued that banks are inefficient partly because of the traditional dominance of political over economic considerations in banking. Although since 1967, political intervention has decreased, and local sociopolitical communities of interest no longer participate in the founding of banks, they nonetheless remain major players in concluding social compacts with banks. It may be important to decentralize the financial system; to introduce bankruptcy laws, to transfer financing from state to banks, and to introduce Western financial concepts. However, none of these changes will be significant if political intervention precludes the economic basis of decisionmaking.

Need for Concurrent Actions. In sum, reforms which should be implemented concurrently with financial system reform include autonomy of enterprise decisionmaking and financial responsibility of firms as well as a greater scope for prices and competitive pressures. Among the "financial fundamentals," or necessary characteristics of the financial reforms themselves, are: greater transparency of enterprises' financial accounts, to enable banks to judge creditworthiness, and thus make banks' goal of profit maximization meaningful; reduced scope of budget intermediation; and restructuring or closure of loss-making enterprises. Reforms need to advance on all these fronts simultaneously.

In the USSR, for example, a price and financial reform is acknowledged to be needed to make effective the new Law on Enterprises. The absence of price reform and a reformed financial system arguably will severely limit the significance of enterprises' newfound autonomy and financial responsibility. The impediment to price reform, however, is the absence of real competition. Many countries share these problems, given the concentration of industry characteristic of centrally planned socialist economies.

For example, Bulgaria has introduced a financial reform blueprint before price reform. Although Hungary established a link between domestic prices and world market prices in 1980 when the "competitive pricing system" was introduced, central authorities are still thought to exercise considerable authority over prices, limiting their movement, despite much progress on financial reform. Antal refers to the shortcomings of the Hungarian reform in these other areas as the "contradictory nature of the reform process." By this he means that, generally, prices have not been freed in Hungary, because competitive pressures have not been created; insolvent enterprises are supported by the authorities or, if liquidated, are done so only upon the decision of the authorities; and the central control apparatus continues to intervene in the affairs of enterprises.

Insofar as rationality of pricing is concerned, China may be the furthest along, which may put that country in a favorable position for financial reform

(Granick, 1987).[7] China has also allowed many small-scale enterprises to flourish; rural industrial and informal (household and cooperative) sectors now account for 40 percent of the gross value of industrial output, up from 22 percent in 1975 and less than 10 percent before the reforms in agriculture began in 1979.

Which comes first: institutional change or macroeconomic stabilization?

The recent imbalance of payments of Hungary and other countries in the "transition stage" raises another question of financing. Is it necessary to develop more effective monetary control within the existing institutional framework before attempting institutional change? In other words, does financial reform, which is desirable on other grounds, make it easier or more difficult to control interest rates, credit, inflation, and monetary aggregates, and does instability in these variables prevent effective financial reform?

Participants were in agreement that some degree of macroeconomic stability is a prerequisite for financial reform in socialist economies. Yet, under the unreformed financial system, substantial impediments to macroeconomic stability exist. These include budget deficits which are automatically financed by the central bank, "soft budget constraints" of enterprises, influence of pressure groups on credit allocation, and other systemic shortcomings, not to mention the poor microeconomic decisions leading to an inefficient real sector. The absence of macroeconomic stability in the unreformed system is manifested in repressed inflation, monetary overhangs, etc.

Financial sector weaknesses are usually a key part of the macroeconomic instability problem, and so financial reforms logically should be part of the solution. There appears to be a growing recognition that in the complex issue of macroeconomic stabilization vs. financial sector reform sequencing, there is indeed a need for a large number of concurrent actions on the part of reformers and macroeconomic policymakers. The limited experience amassed in reforming economies so far, and with mixed results, seems to signal a need for a pragmatic policymaking approach, involving doing what one can when one can. This approach, of course, can lead to inconsistencies, but these are resolved by further reform in a continuous progression.

Barring this continuity, active monetary policy is precluded in the transition stage by the legacies of CPE central banking. The Chinese participants, for example, repeatedly referred to the need to strengthen the People's Bank as a result of the reform. The difficulties are very clear when one examines the balance sheet of the central bank. Of its three major components, net lending to government has been determined by the government's budget deficit; net lending to banks has been determined by past investment plans of the Planning Commission; and net foreign assets have been determined by trade and external borrowing over which the Bank has had less than full control. In sum, the monetary aggregates are largely outside the control of the monetary authorities. Moreover, in the traditional CPE, planners tend to be overly optimistic in appraising growth potential, and enterprises exert considerable pressure for central funds for investment, reflecting systemic rewards for expansion, and few penalties for losses. Thus monetary expansion tends to be excessive. In contrast, given the intimate relationship between the central bank and the state budget, the

7. However, recentralization of pricing in China during 1988 makes this less likely.

traditional CPE has no dearth of strong, potentially effective instruments for macroeconomic control, in the form of administrative orders—only a hesitation to use them. Some participants argued that while financial reform was desirable, countries with severe macroeconomic imbalances should postpone it until these problems were reasonably under control. However, since the financial system is a large contributor to the macroeconomic problem, its reform should logically be part of the solution.

Other participants argued that institutional reform was essential to macroeconomic stabilization. Institutional reform by itself, however, can lead to further macroeconomic instability. Thus, it is not narrow institutional reform that is required for both stabilization and financial reform, but more generally systemic reform, which would entail behavioral changes, for example, in the nature of enterprise response to incentives, including responsiveness to financial signals without regard to political and other pressures. Several countries appeared to be placing too much emphasis on institutional measures, such as the creation of banks and financial instruments, and too little on systemic change. However, it was noted that the process of creating institutions of the decentralized banking system may itself provoke other necessary changes in the economy. In Hungary, for example, a reform of taxation and a significant reduction of budgetary subsidies were recognized as necessary to shift financial intermediation from the budget to the banking system and tighten enterprise financial discipline; to the extent that these measures are being taken, they permit efficient operation of the reformed banking system.

Nonetheless, reforms in nonfinancial sectors do not automatically cure the weakness of traditional CPEs in the financial areas. For example, Antal's paper explains that in Hungary, even after the comprehensive reforms of 1968, the loss of monetary control continued due to the absence of factor market reforms, and particularly financial ones. As direct administrative controls were eliminated, these were replaced by fiscal controls and regulations which were frequently changed and so greatly contributed to uncertainty on the part of enterprises. Recent problems with the control of credit in Hungary have created skepticism that further institutional changes in the banking system can improve macroeconomic performance without measures to correct fundamental shortcomings in the conduct of aggregate demand management policies.

Even in China, where stabilization policy measures have preceded institutional reforms to a significant extent, problems remain because of institutional rigidities. In China, the exchange rate and the interest rate have been used extensively as instruments of restrictive macroeconomic policy in the 1980s. Three devaluations in two years have led to a 35 percent cumulative devaluation in local currency terms. Yet, producers feel neither the effects of higher import prices, nor that of more favorable export prices, as 70 percent of foreign trade still operates via foreign trade institutions which are both directly and indirectly subsidized by the state. Interest rates have doubled and are now positive in real terms. Still, investment hunger of enterprises has not been curtailed—the share of investment in GDP has increased from 30 percent to 38 percent in recent years.

The argument over the sequencing of macroeconomic stabilization and financial reform raises the broader issue of the goals of economic reform itself. Descriptions of reform in CPEs often speak of the "market" as something which planners should "control," "guide," or "manipulate"—that is, as an instrument of planning. The question was raised as to whether, essentially, operation of the

market is consistent with its manipulation by central authorities. Other participants argued that reliance on markets does not preclude the active use of economic policy; the aim is not to abstain from influencing financial and fiscal parameters, but to avoid making these enterprise-specific. In this sense, the reforms are in danger of inconsistency.

A major principle of the reforms is to apportion rewards according to performance. Yet, performance must not be based on irrational prices, capital subsidies, and other legacies of the past which put enterprises on unequal footing. During the "transition period," in which these performance parameters are used but these legacies remain, performance indicators are inevitably discriminatory to account for these initial inequalities. Neither can true markets operate, nor can "market-type" instruments be used nondiscriminatingly. Participants who followed this line of argument plead a strong case for financial reforms being the leader in reform in general, because capital market reform is necessary for the revaluation of capital and appropriate and smooth reallocation of resources. Financial institutions need to be developed precisely for this purpose.

And so the original question stands, reworded: Do financial reforms achieve this revaluation and reshuffling of capital, as a prerequisite to the use of indirect and nondiscriminatory instruments of economic control? In practice, it would appear that financial reform has been moderately successful at allocating new financial resources on efficiency grounds, but has done little to reallocate existing financial resources. The experience of reforming CPEs in establishing joint-stock companies and new financial institutions, but not in establishing a stock market to value existing capital, such as that suggested by Nuti, shows that the issue of allocation of new investment is more easily solved than reallocation of the existing capital to potentially more efficient managers. This situation has led to the development of parallel socialist sector (or first economy) and private (second economy) capital markets and explains the recent growth and successes of the latter in many socialist countries. It also helps explain why the socialist sector is so difficult to reform. To the extent that the second economy provides potential and real competition to the first, free entry is permitted, and liquidation occurs whenever necessary, the problem is largely resolved. If, however, discriminatory support to the socialist sector precludes effective competition, financial and other reforms are flawed from the start. Although financial reform is a positive step, it will not solve all problems of the socialist system; massive restructuring will still be needed to solve the existing structural problems in the state sector of these economies.

Issues of monetary policy

The discussion of the problem of macroeconomic policies and controls which have to be worked out simultaneously with reforms of the financial system raised many issues which, to varying degrees, plague socialist economies at all stages of reform. They include "monetary overhangs," inflation, and interest rate determination. After discussing these, we turn to particular issues of policy in the "transition stage," using Hungary and Yugoslavia as examples.

Monetary overhangs

The lack of attention to macroeconomic policy concerns in the discussion and documents of reform in Bulgaria and the USSR is an indication that their

financial reform is as yet in a very early stage. Traditional CPE countries embarking on economic reform programs, of which financial reform is but one component, face a common issue of monetary policy at a rather early stage—namely, the macroeconomic "monetary overhang," "forced savings," or "repressed inflation," characteristic of supply-constrained economies with chronic shortages at the microeconomic level.[8] The phenomenon is exhibited in the hoarding of cash or its spending on goods not currently desired, but feared to be in short supply in the future ("forced spending"). The monetary overhang problem has historically been solved by harsh, administrative means in the traditional CPE, including currency reform and/or confiscations of funds of enterprises (in accounts at the bank) and/or of households (in savings accounts), made possible by the centralized, subordinate banking system. A solution more consistent with the increasing "marketization" of the economy, but resisted for political reasons, would be to replace "repressed" inflation with open inflation. Indeed, some countries have found it necessary to resort to this solution.

Grossman discusses the issue of monetary overhang in the USSR. General Secretary Gorbachev, since assuming power in 1985, is embarking on a reform program in the midst of a large monetary overhang in the household and enterprise sectors, a legacy of the strict CPE system. The result of excessive printing of money, this situation imposes a constraint on the development of a rational pricing system. But price reform is essential, because the present pricing system is characterized by enormous subsidies and relative prices which are totally unrelated to world market prices. At the same time, the second economy has, for better or worse, forced people to think in market and monetary terms, while it has resulted in a very unequal distribution of income, and particularly holdings of cash. This inequality, in turn, imposes a political constraint on policymakers on the further development of the second economy.

Thus, reform of the financial/monetary mechanism has an important political dimension at this early stage of reform. This is particularly true for a country, such as Poland, which is implementing a macroeconomic stabilization program concurrently with reform. The problem of the overhang, moreover, is much more serious for an open economy, such as Poland's, than for that of the USSR, because with liberalization this liquidity may flow abroad.

A question was raised as to why Poland did not impose drastic measures, such as currency conversion or confiscations of savings under the martial law regime in 1981-82, as it did in the early 1950s. By soaking up excess liquidity, it is argued, authorities could have paved the way for price and other structural reforms. Legitimacy problems and other political constraints of the government at the time precluded currency reform. Instead, authorities relied on two- to three-fold price increases to battle excess demand. Still, price increases did not solve (and currency reform would not have solved) the systemic cause of the monetary instability: namely, the large increase in wages and nominal incomes and, thus, money supply. A first step is recognition of the problem, but the very existence of a monetary overhang is itself a point of controversy: some economists have attempted to measure the extent of the overhang empirically, while others contend that the second economy with its higher prices allows markets to clear and thus has eliminated "forced savings."

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8. Recent work by Nuti (1986) makes a distinction between a monetary overhang and excess demand for the products of the socialized sector at prevailing socialist sector prices.

The Polish example shows the importance of discussing and resolving issues of monetary policy before embarking on reform of the banking system. The Polish monetary system is unique in that it is estimated that approximately US$3 billion is deposited in foreign exchange accounts, a figure which would represent about 80 percent of all household savings. The inability to control the growth of credit and nominal wages in Poland during 1985-87, combined with skepticism that decentralization of banking would increase the authorities' ability to control the growth of credit and wages sufficiently to offset the lobbying of industrial groups of workers, led some participants to conclude that decentralization of banking would create additional problems for the Polish economy. Such reasoning serves to provide political ammunition against economic reform.

The monetary overhang and excess demand are also recognized as the major problems in Chinese financial reform. Chinese authorities hope to correct the problem in the next two to three years, by a combination of monetary policy measures. The role of the central bank in macroeconomic control is to be strengthened to allow the money supply to increase within limits to accommodate economic growth. Enterprises' traditional attitude of reliance on specialized banks is to be changed, as is the attitude of reliance on the central bank by the specialized banks. Fiscal authorities are to rely increasingly on the issuance of bills rather than money (over)drawn from the central bank to finance the budget. The relationship between the central bank and state planning commission is to change, to allow the central bank to refuse to finance automatically the investments mandated by the state planning commission. Finally, enterprises are to become more efficient. The need for change in these behaviors is crucial; but how, concretely, they are to be modified, is a more difficult challenge.

Inflation

Inflation presents a difficult issue for economic reform in general. The political acceptability of reform will be strongly affected by the rate of inflation. Yet it can be argued that economic reform inevitably tends to be inflationary, because it requires relative price adjustments, which in practice means that average prices are certain to rise. Moreover, economic reform improves and multiplies financial resource transfers in a system which is already characterized by excess demand. If reform is going to promote efficiency, there has to be some room for resource reallocation, which is very difficult in an overheated economy. In that case, a deflationary environment needs to be created to compensate for the inflationary tendencies under reform. Economic reform also may be inflationary because it may require some costly concessions to be made to those who would lose under the reform, and this higher cost must be reflected in higher prices at all levels. For example, enterprises which are forced to rely more on short-term bank credits instead of budget subsidies may attempt to pass these higher costs on to consumers via higher prices. Another source of inflation may be found in the resolution of the monetary overhang problem.

Experience confirms the inflationary tendencies of economic reform. Not surprisingly, then, consumers in the USSR have been forewarned that economic reform may result in higher prices for some consumer goods. Experience in other countries suggests that excess liquidity is most easily eliminated by increasing consumer prices at the same time that nominal incomes are raised, but more rapidly, so that real wages are reduced slightly.

In contrast, in the longer run economic reform may alleviate inflationary pressures by eliminating serious distortions in the economy and by introducing competition, and consequently increasing efficiency. Some characteristics of financial reform in particular may also alleviate inflationary pressure. Introduction of marketable government debt, for example, means that government deficits will no longer be instantly monetized, as is the case in traditional CPEs. In Hungary, for example, authorities intend to finance the government deficit increasingly through bonds, which are less inflationary than bank financing in the short term.

Underlying the issue of deficit financing is a more fundamental one: namely, the mere existence of a large and persistent government deficit, whether financed by bond issues or central bank credit, tends to aggravate excess demand pressures and absorb resources needed for productive investment. The need for a serious effort to reduce government expenditures is rather acutely felt in Hungary at the present time, given the need for stabilization. However, the problem is characteristic of many of the socialist countries.

Authorities are likely to have to sacrifice some macroeconomic stability in the name of reform. One issue for planners is how much inflation society is willing to accept in the name of reform. A second, related question concerns how to control inflation without subverting reform. A way to restate this question is to ask how much of inflation should remain repressed, and how much should be open.

Poland provides a good example of a country in which repressed and open inflation coexist. Poland's modern history is colored by the strong popular opposition to price increases, which were protested in 1970, 1976, and 1980, and triggered political leadership changes in 1970 and 1980. The failure of the recent Polish referendum, which made explicit the costs of economic reform in terms of inflation, indicates that the population continues to have a relatively low acceptance of inflation.

In Hungary, with memories of postwar hyperinflation, the tolerance for inflation is even lower. But the effect of imposing a personal income tax and value added tax in Hungary in 1988 has been inflation on the order of 15 percent, which has affected financial developments. In anticipation of price increases, consumers spent their savings freely in 1987, which led to a drastic decline in personal savings. To stabilize the bond market, interest rates on outstanding bonds were raised recently, and some new issues have variable interest rates.

With regard to inflation, China has a clear advantage over Eastern Europe, in that its reform can take place in a period of rapid expansion, rather than debt-induced austerity. Nonetheless, the Chinese economy has been subject to swings in performance since 1979, particularly in the monetary aggregates, in investment, and in the external position, because the tools of indirect economic management have been imperfect, and the underlying structure of the economy largely unreformed. China has had difficulties since 1984 in controlling the money supply due in part to lack of experience in managing the new banking system, but also to wage formation. In China, as arguably in other socialist countries, tighter money tends to affect production more than it affects incomes, because poorly performing enterprises maintain wage bills and even bonuses rather than repay loans. Monetary policy, therefore, cannot be effective without more comprehensive reform of incomes and consumption policies and without supply-side policies to overcome China's many structural problems.

Interest rates

Another legacy of the traditional CPE system is the unimportance of the interest rate mechanism in allocating financial resources. Investment is decided by the center, and then financed automatically from the state budget free of charge to investing enterprises, which are subject to straight-line amortization charges on the historical cost of their investments, and which transfer their surpluses back to the state budget. Credit is granted at an almost symbolic rate of interest designed to cover administrative costs. Interest rates are typically negative in real terms. Efficient allocation of financial resources requires positive real interest rates; yet positive real rates are absent from reform discussions in many of these countries. Of course, real positive interest rates presuppose positive returns and yields on investments.

An obstacle to developing an effective interest rate mechanism in reforming socialist economies is the "soft budget constraint" of borrowers—that is, their lack of sensitivity to costs. For example, in China, enterprises pay an interest rate on their fixed assets under the "hardening" of sources of finance, but if they cannot repay, they are subsidized.

The interest rate question is also critical for the household sector, as households typically borrow for housing at significantly negative real interest rates in these countries. As discussed earlier, in Hungary, continued lending of 35-year housing loans at 3 percent interest has precluded the effective integration of the household and enterprise money circuits. Currently in Hungary, commercial banks are free to determine the interest rates they pay on deposits and charge on loans to enterprises, although in the present stage of limited competition these rates closely follow the structure of interest rates on transactions between the commercial banks and the NBH. A desirable development is that a positive level of lending rates to enterprises has been maintained.

Institutional changes by themselves may be unsustainable in an unstable macroeconomic environment. Decentralized banks cannot enforce positive real interest rates in an environment of lax monetary policy and lack of financial discipline. A more rational interest rate structure would be conducive to industrial restructuring (after industrial failures) and would help alleviate the liquidity overhang problem by increasing the willingness of enterprises and households to hold money. While the microeconomic case for positive real interest rates was not disputed, it was observed that none of the reformed CPEs appears to have made the interest rate the primary mechanism for the allocation of financial resources in the economy.

Monetary policy in the "transition stage"

Hungary provides an example of an economy in the "transition stage" from central planning to market socialism. Economists and policymakers admittedly know very little about the implementation of monetary policy in the "transition stage," and yet such policy is a critical issue in the political acceptance of further reform. As the Polish example also shows, macroeconomic instability can be used as political as well as economic ammunition against reform, with the result that policymakers may be forced to undertake strong measures which counteract the reforms. Bácskai argues this to have been the case also in Hungary in the 1970s.

The Hungarian case sheds light on the issue of whether reforms need be comprehensive, or whether piecemeal reforms are sufficient. Workshop

participants were in agreement that some "critical minimum" set of reforms is needed as a precondition to financial reform. The adoption of this "critical minimum" package would result in a low probability of retrenchment. Financial reform was largely left out of the 1968 new economic mechanism (NEM), but has been a major thrust of the reforms in the 1980s. Bácskai attributes recentralization in Hungary during 1972-79 to the step-by-step approach to reform, which would have been precluded by a more comprehensive reform package. Institutional change, including bank decentralization, was precluded by political factors, such as a failure to confront political opponents of reform with vested interests in the traditional management system.

The most recent set of reforms, implemented beginning in 1979, has sought to fill in the gaps left by the NEM, and in particular to reform the institutional structure of the economy, including, especially, the financial system and regulatory environment of enterprises. The banking reform encountered political opposition from those who argued that bank decentralization would be inflationary, as the money supply would be less controllable by the central bank. Ironically, the financial reform facilitated some rather strong, administrative monetary control measures by central authorities. Antal gives examples of such measures, including the establishment of the small financial institutions out of the confiscated funds of enterprises, which were justified as austerity measures. Other institutions of the reformed financial system were similarly administratively created and justified by austerity, with the result that the financial reform was both a response to and an integral part of the stabilization program. (For example, the bond market arose out of the tightening of state sources of finance.)

Antal also describes the role of political factors in financial reform. Banking reform in Hungary was in part a political move to break up the monopoly of the central bank, which had grown increasingly influential in the formulation of planning policy since the beginning of the stabilization program in 1978-79. The growing power of the National Bank was in part a result of its control over external finances in a period of external illiquidity. It may thus have been furthered by membership into the IMF and the World Bank, as Antal argues, but ironically, then, was effectively curtailed in the name of financial reform which was strongly encouraged and assisted by these institutions. The monopoly of the central bank was broken up by the establishment of a two-level banking system.

These and other institutional reforms, however significant, are not so far along that they could not still be manipulated to retain the previous system of political and economic control by central, administrative directives. All in all, financial reform in the "transition stage," while significant, is manipulable by central authorities and is not irreversible, and therefore its significance should not be exaggerated. Continued further measures are necessary, in order to implement the reforms effectively.

Monetary policy under Yugoslav market socialism

Yugoslavia provides a case study of the problems of macroeconomic control where significant decentralization of economic decisionmaking has occurred under a system of workers' self-management and has been accompanied by very decentralized banking. The decentralization, however, has not been accompanied by either restrictive monetary policy at the macro-level or financial discipline at the micro-level, with the result that inflation is endemic. The Yugoslav case

illustrates that financial decentralization, without far-reaching and comprehensive reform, is not a panacea for macroeconomic stabilization problems, and indeed may exacerbate them.

Some Yugoslav problems are discussed in the paper by Gašpari. The National Bank of Yugoslavia covered the foreign exchange risk of the substantial foreign exchange deposits of households with commercial banks, providing the banks with large subsidized resources lent to enterprises at negative real interest rates, often for dubious purposes. This policy led to large uncovered losses to the banking system when the dinar value of the foreign exchange deposits rose rapidly as the dinar was devalued. The monetization of these losses reveals the true expansive nature of monetary policy, which according to conventional measures appeared restrictive during this period.

Postscript

In Yugoslavia, as in Hungary and Poland, financial reforms have continued into 1988-89, since the time of this workshop. As noted above, the method of dealing with housing finance is being revised in Hungary. In Poland, significant changes in financial sector legislation and monetary policies have come about since 1987. In Yugoslavia, 1988 has seen the drafting of major new legislation related to the financial sector, including a new banking law, a law on the National Bank of Yugoslavia, a joint venture law, and a new accounting law. In addition, a new interest rate policy has been implemented since May 1988. The new policy is designed to restore real interest rates on dinar time deposits and dinar credits to positive levels by indexation to the current consumer price index. The success of these measures will depend on the precise contents of the final legislation and how it is implemented.

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Monetary and Financial Aspects of Gorbachev's Reform

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Prefatory

The main positive features of Mr. Gorbachev's economic reform began to emerge during the second half of 1986 in the form of specific laws and decrees, such as those pertaining to "individual labor activity," cooperatives, and foreign trade. By June/July 1987, the reform took comprehensive—if not final—shape with the formal adoption of a number of key resolutions or measures, particularly the "Basic Principles of Radical Restructuring of Managing the Economy," adopted by the plenum of the Central Committee (CC) of the CPSU (Pravda, June 27, 1987); the "Law on the State-owned Enterprise (or Association)" (hereafter, LSE), passed by the Supreme Soviet of the USSR (Pravda, July 1, 1987); and the ten published joint resolutions by the Central Committee of the CPSU and the Council of Ministers of the USSR, all dated July 17, 1987, on a series of overarching themes of prime import. Among the latter are the reorganization and reform of planning, technological progress, supply, price policy and price formation, statistics, the changed role of production ministries, wages and social questions, and—of particular concern here—financial and fiscal matters, and banking.[1] Other high-level legislative and administrative documents—further defining, implementing, specifying, and interpreting the particular aspects of the economic reform—have followed, and very many others doubtless will. What is more, the innumerable lower-level legislative, administrative, planning, and monitoring bodies have been and will be issuing countless relevant documents, which, in the aggregate, may go far in applying, modifying, or undercutting the

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1. *O korennoi...* (1987); Resolutions (*postanovlennia*) of the Central Committee of the CPSU and of the Council of Ministers of the USSR, respectively, No. 819, "On restructuring the financial mechanism and enhancing the role of the Ministry of Finance under new conditions of economic management," pp. 132-149; and No. 821, "On improving the system of banks and strengthening their effects on enhancing the efficiency of the economy;" both dated July 17, 1988, both reprinted in *O korennoi...* (1988), pp. 132-149 and 165-189, respectively.

reform. Finally, "life itself" (as the Russians say)—including the second economy, reshaped by the sum of these measures but also inevitably adapting to them—will exert its inevitable impact on the reform's course (Grossman, 1987).

The reform measures are being phased in over several years. Some went into effect on various dates in 1987, while the LSE began to apply to a large part of the economy on January 1, 1988. Although it is too soon to pass definitive judgment on Gorbachev's economic reform, at this writing (beginning of 1988) the evidence strongly suggests that, in terms of its schedule and with reference to its authors' intent, the reform is proceeding slowly or partially in most respects and is all but stalled in others. It is making notably little progress in altering the operation of the state sector of the economy.

On paper at least, the 1987 reform measures aim to go some distance toward introducing market-like relations, institutions, and behavior into the state sector; that is to say, to at least partly marketize what has been a strikingly overcentralized, overbureaucratized, rigid, wasteful, and inefficient command economy in a "precrisis" condition, if we can believe no less an authority than Gorbachev himself. In any event, however, the first attempts to translate the formal reform measures into reality have so far proved to be rather modest in almost all regards, falling short of the laws and resolutions adopted at high levels, let alone the official reformist rhetoric.

The measures antedating June/July 1987—such as those dealing with individual (private) activity, formation of autonomous, nonagricultural cooperatives, other innovative decentralized forms of economic activity, and limited devolution of foreign trade to ministries and enterprises—have been slow to take off. But the most important setback became evident when the LSE went (partially) into effect at the turn of the year. Taking advantage of loopholes in the law, especially that pertaining to so-called "state orders," the production ministries and other administrative authorities have succeeded in preserving nearly all of the "command" setting of production targets. Together with the almost undiminished systems of materials allocation, price control, and centralized investments, the effect is to leave the old command economy virtually intact. (More on the implementation and realization of the reform measures enacted to the end of 1987 will be found in the Postscript to this chapter, which carries the record to mid-1988.)

Thus, leaving aside the question of whether Gorbachev's ultimate goal is indeed a full-fledged socialist *market* economy, the now-emerging system seems to amount to only quite limited—and not always consistent or properly timed—introduction of a market mechanism, and only partial dismantling of the command structure and principle. If so, the new system is likely to suffer from inadequate coordination, continued micro- and macro-disequilibria, poor amenability to control from above by either direct or indirect means, continuance of a large second economy and of widespread corruption, and other serious problems. Its systemic stability is likely to be low. By past experience, it will be prone to creeping administrative recentralization, unless, of course, it is at some point subjected to a round of more "radical" and decisive reform measures sufficient to carry the market system to a more viable institutional plateau.

With these prefatory considerations in mind we proceed as follows. In the second section we take note of certain features of the Soviet economy on the eve of Gorbachev's accession to the general secretaryship, which at once heighten the need and urgency for a marketizing reform and impede or restrain its advance

at this stage (and may continue to do so at later stages as well). Next, we sketch out the essential features of the reform as of this time. In the fourth section, we describe and assess its financial and monetary aspects. A Postscript brings the facts and discussion to mid-1988.

The difficult legacy

In its sixty years of existence, the Stalinist economy has succeeded in erecting a variety of formidable obstacles for anyone so bold as to dare to radically change it. A large part of this difficult legacy matured, if not originated, during the Brezhnev-Chernenko era (1964-1984), or what is now officially known as the "period of stagnation." We now briefly survey some of the more formidable obstacles, emphasizing the monetary and financial ones.

Money

The Gorbachev era inherited a supply of money [M], and particularly a supply of currency [C], seriously in excess of that required to maintain the average official price-wage level without the help of administrative controls. In other words, it inherited a considerable monetary overhang [M-O], of which an important component is a currency overhang [C-O].

In the usual Soviet-type economy, M flows through two distinct but interconnected circuits and, at any moment, may be said to consist of two stock magnitudes. The first is private money holdings [MP] for both personal (household) and private-business uses (largely underground), comprising currency [CP] and private savings-bank deposits [SD].[2] The second is, in the socialist/state sector (outside of banks), money balances [MS] held by firms and other state or socialist entities in the form of bank balances [BB] and currency [CS], some of the latter held unlawfully, stemming from and/or destined for illegal (underground) uses. To sum up, C = CP + CS, while M = C + SD + BB; or, alternatively, by type of holder, M = MP + MS, where MP = CP + SD and MS = BB + CS.[3]

The monetary overhang, M-O, is then that part of M which is in excess of the voluntary demand for money by socialist and private entities at the *officially controlled or sanctioned price/wage level*, given all other pertinent conditions and, *nota bene*, the *risks* attaching to holdings of *particular* forms of money (C,

2. Bank balances other than savings deposits held by private entities have been negligible, and probably still are despite the formation of the new, private cooperatives since 1986, while a very small part of the savings deposits may be held by various socialist ("social") entities—a minor fuzziness that need not concern us here. Numerical data on total savings deposits and on the portion of MS held by state-owned business firms (but not other state/socialist entities) are published in official sources. As mentioned, absolute figures on currency circulation have not been revealed for over half a century, though this may now change in line with *glasnost*.

3. For description and discussion of the standard Soviet (and Soviet-type) monetary and banking system, and in some cases on their relation to past reforms, see Garvy, 1977, Grossman, 1966 and 1968; Hartwign, 1987; contributions in Lavigne, 1981. Podolski, 1973; and Zwass, 1972 and 1979. A comprehensive, incisive, analytical survey of inflation in the Soviet-type economy is to be found in Nuti (1986). A concise, poignant statement on the State Bank's powerlessness to staunch the outflow of credit is in a brief piece by Alkhimov (1985), its chairman at that time.

SD) of legally or ideologically dubious origins or in amounts inviting official suspicion or private blackmail (which is not uncommon). However, two major reasons to hold substantial amounts of money, especially currency, should be borne in mind:

- speculative, to take advantage of opportunities to buy in a setting of pervasive shortages; and
- precautionary, to be ready to bribe as needs or emergencies arise.

Bribery is an important lubricant and solvent in a Soviet-type economy. Ironically, owing to the precautionary reason, a rise in excess money supply helps to augment its own demand, for the more money the public holds, the more it is in need of cash to maintain a degree of security via bribes and pay-offs.

We should also take note of an additional, *latent* monetary overhang implicit in the well-known readiness by the Soviet banking system to lend to state firms and collective farms virtually on demand—or even without demand, automatically in the normal course of payments clearing—thereby adding equivalently to bank-deposit money, and then to private currency holdings (CP) as wages are paid out.

Automatic bank credit induces large hoarding of producers' inventories (a normal response to materials shortages), or camouflaging cost overruns, waste, and sales in the black market. Consequently, by the beginning of the Gorbachev era, Soviet firms were at once heavily in debt to the banks, a large part of it overdue (especially in agriculture), while simultaneously carrying very large materials inventories on the books, of which an unknown portion was (and still is) "phantom." All this, of course, adds to the difficulty of setting financial matters in order.

Most of the presently existing currency supply appears to have been created during the late 1970s and early 1980s, in a manner that has been lately much discussed in Soviet sources, while the creation of large savings-deposit holdings has understandably followed the large currency issue (see Grossman, 1986). Breaking a long spell of official secrecy on currency data, though still not in absolute terms, Gorbachev revealed in his speech at the June 1987 CC Plenum (*Pravda*, June 27, 1987) that the amount of currency in circulation had increased 3.1 times during 1971-85—that is, at an average annual rate of 7.8 percent. The nominal value of personal money incomes derived from official sources increased 2.1 times over the same 15 years (or 14 years from mid-year to mid-year)—that is, 5.4 percent on average (Barkovskii, 1987, p. 78). In other words, currency in circulation grew almost one-half again as fast as nominal personal incomes, thus considerably augmenting such currency overhang as may have already existed in 1970. Savings deposits increased even faster over the 15 years: 4.7 times, or 10.9 percent per year.

Money supply seems to have continued to rise appreciably since Gorbachev took over, as may be inferred from the apparent lag of the value of official sales of consumer goods (including a very sharp drop in the official sales of alcoholic beverages) behind the growth in nominal incomes (Lokshin, 1988, pp. 39-42; Schroeder, 1988). Savings deposits increased by 10 percent during 1986 and by 9.9 percent during 1987, or almost as fast as in 1971-85.

Furthermore, the fact that large private currency hoards derive primarily from underground activity and bribe-taking, the size distribution of currency holdings among households can be expected to be quite unequal. They are also apparently very unequally distributed among regions, paralleling the uneven spatial

incidence of the second economy. Some of the southern minority nationality areas, in Transcaucasia and Central Asia, appear to be especially currency-heavy.[4] Savings deposits are presumably more equally distributed than currency, both among regions and among households, partly because very large deposits are generally eschewed since they carry presumption of illegal origin.

Prices

Soviet prices are centrally set and controlled, determined with little regard for demand and dubious fidelity to supply conditions, lastingly rigid, multiple in fact, often containing large government subsidies[5] as well as large indirect taxes, and widely divorced from either world-market or CMEA price structures. Therefore, Soviet prices require a *substantial and early decontrol*, if a major marketizing economic reform is to succeed. Yet, even under Soviet socialism, such an upheaval cannot but have massive effects on personal careers, incomes, and fortunes (both below and above "ground"). Hence, no wonder that the prospect of a thoroughgoing price reform, including (as it must) the elimination of a good part of the subsidies to consumer goods, elicits passionate public reaction and strong conservative opposition.

The underground economy and corruption

The Brezhnev era witnessed considerable expansion of underground economic activity and of its unfailing concomitants—corruption, extortion, graft, and even violent organized crime. Informal and illegal private incomes waxed and multiplied, abetted by the sociopolitical climate and spurred by a combination of shortages and currency inflation. So did private wealth—illicitly acquired, covertly held, some of it in very large hoards (of cash and valuables) and at times in very high places. Thanks to considerable interlocking of the economic underground with formal (aboveground) power through patron-client ties, its net overall effect is probably to reinforce the opposition to perestroika (see Millar, 1985; Grossman, 1986).

The underground economy and corruption do not seem to be withering away since the launching of the economic reform, despite the harsh campaign launched against them by Gorbachev in May 1986. (The ongoing currency

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4. A questionnaire survey among recent Soviet emigrants residing in the United States has found the following average cash (currency) holdings (in rubles *per capita*, urban dwellers only, relating approximately to 1977, unreweighted): residents of European USSR 478 (N=524 families); Armenians residing in the Armenian Republic 4,469 (N=175 families). In other words, Armenians in Armenia held almost ten times as much cash as did residents of the European USSR, although on average the former enjoyed a lower *official* income than the latter. The survey was conducted by the Berkeley-Duke Project on the Soviet Economy pursued by Grossman jointly with Professors V.G. Treml (Duke University) and Michael Alexeev (George Mason University). (Please note: The Soviet Union has not published absolute data on currency circulation since 1937.)

5. For 1988, total subsidies are *budgeted* at 66 billion rubles (BR) for agricultural products alone, and at about 90 BR for all goods and services, or about 15 and 20 percent of total budgeted expenditures, respectively. The 90 BR figure is about 26 percent of the value of total retail sales of goods and services through official outlets in 1987 (Kagalovskii, 1988, p. 69). By 1990, total subsidies from the budget are expected to reach 104 BR (V. I. Shprygin in *Pravda*, April 9, 1988).

inflation, worsening goods shortages, and the anti-alcohol drive, if nothing else, ensure their continued thriving.) Instead, they can be expected to adapt to any new conditions—which is what they do best—and to continue to pose a danger to *perestroika*. The danger lies not only in the impact of economic crime and corruption on the integrity of the state and on efficiency and incentives in the first economy, but also in the very real chance that the leaders' reactions to the "negative phenomena" will be such as to seriously restrain the advance of decentralization, decontrol, and privatization.

The physical legacy

To a large degree, the economy's fixed capital stock is old and aging, technologically backward, undermaintained, physically decrepit, technically obsolete, unsafe and accident prone, environmentally predacious, mislocated, bottleneck ridden, and—not the least—structurally unbalanced, especially for a product mix responding to the call of *perestroika* and needs of the "human factor." Environmental disruption and the wanton depletion of natural resources have become a vast national scandal, thanks to *glasnost*. Merely stopping the deterioration and obsolescence of the country's potentially usable endowment will be expensive enough; the long-run cost of its "radical restructuring" and modernization boggles the mind. And yet, remedial and modernizing measures cannot be ignored, and their high cost cannot be deferred, lest the economy slide downhill, to the reform's discredit and discomfiture. (However, the optimal level of investment at this point has been under intense discussion lately.)

Moreover, the Soviet "rust belt," long accustomed to almost complete shelter from every kind of economic fluctuation and risk, is probably yet another source of opposition to *perestroika*, by dint of a variety of economic and political vested interests in the status quo.

The four just-cited aspects of Gorbachev's difficult legacy are typically less noted in the West as serious obstacles to the economic reform than are such more purely "subjective" ones as opposition by powerful elements in the leadership, bureaucracy, and the party apparat; ideological and dogmatic objections; or the quite justified fears and doubts of the rank and file. Certainly, the importance of this latter ("subjective") group of obstacles to reform can hardly be overstated. But neither should the importance of the other group of factors be minimized. What is more, they are not easily amenable to management by persuasion, politics, and purge. Thus, even if Gorbachev could convince every Soviet soul of the correctness of his way, his reform would still face most formidable difficulties on account of the monetary overhang, the distorted price structure, the rampant underworld, and the parlous physical condition of the economy.

Overview of the reform: The halfway house

Gorbachev intends the reform to be a long process that will pass through three main stages (here described in our own words). The near term, the implementation stage, is defined by the enacting and introducing of a series of institutional and related changes, culminating with (rather than starting with) a general reform of the price system. This stage is to last to 1990-91 (if not longer)—that is, to the end of the current (12th) or lapping over into the 13th Five-Year Plan (1991-95).

In the medium term—say, for a decade or more—the current reform measures would be essentially in place and the new, but still interim, system will be functioning as an integral and presumably viable whole.

In the distant term—some time after the turn of the century—another round of measures will presumably complete the reform of the economy, bringing into being a system considerably more decentralized and self-managed than the interim one, but whose specific features can be only vaguely discerned at this point, if at all.

For the sake of this discussion, we leave the distant term aside and restrict our attention to the near and medium terms (without necessarily presuming that they will be completed). And, while keeping an eye on monetary and financial aspects of the reform, for reasons of space we omit in this paper any but incidental references to some important parts of the economy, themselves objects of *perestroika*, such as agriculture, foreign trade, wage and incomes policy, and social measures.

In brief, this is the present state of the reform's principal provisions as of the beginning of 1988, at least as they appear on paper:[6]

- The reform proceeds from the fundamental premise that only a "radical restructuring" (*korennaia perestroika)* of economic institutions can bring the Soviet economy out of its drawn-out stagnation and current "precrisis" condition (Gorbachev, at the June 1987 CC Plenum). This is to be accomplished simultaneously with a historic program launched earlier by Gorbachev (starting with 1986, the first year of the 12th FYP), the program of rapid and decisive "acceleration" (*uskorenie*) of economic, technological, and "social" growth and development, in order to halt the downslide of the economy, and to turn it decisively upward. All this is to take place under less than favorable domestic and external economic conditions, as already in part discussed, making Gorbachev's dual program a most ambitious one. Since a radical reform in itself demands considerable resources and generates inflationary tendencies, its coupling with "acceleration" may well place an excessive burden on the economy, to the likely detriment of both.

- An important premise that breaks sharply with previous philosophical orthodoxy (if not with reality) is that socialist society need not be limited to one official set of interests but to a multiplicity of interests, whose interplay can and must be harnessed for overall economic benefit. Accordingly, there is to be much wider scope to "money-commodity relations"—that is, greater role for money and finance and for market forces—as well as a more tolerant attitude toward individual self-enrichment in pursuit of socially useful activity.

- In particular, demand—both domestic and foreign—is to play a much greater role than heretofore in determining the bill of goods produced, the allocation of resources, technical choice and progress, and the distribution of earnings and other benefits. Competition among enterprises is encouraged, while monopolistic behavior is condemned and is to be thwarted by the superior ministry (itself typically a monopolist).

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6. For analytical discussions of the overall reform, though with relatively little emphasis on money and finance, the reader is referred to works by Ericson (1988), Hanson (1987), and Hewett (1988).

- A certain amount of decisionmaking authority is to be devolved to state-owned enterprises and superenterprises ("associations"), in regard to such crucial matters as the determination of a part of the bill of goods, a part of the material inputs, some capital investment, foreign trade in some cases, and some labor decisions in regard to numbers, firing, and discipline.

- A limited measure of intrafirm employee self-management is provided, including the election of directors (top managers) and other managerial and supervisory personnel. However, the hierarchical superior (ministry) must approve a director's election, while the party is expressly mandated to "guide" the exercise of self-management.

- Profit maximization as such is not mandated for the firm, but "profit or income is the overall indicator of [its] activity" (LSE, article 2.2), "financially, [it] must...ensure growth of profits..." (article 17.1), and "[it] must avoid financial loss" (article 17.4). In any case, larger profits will make possible higher wages and bonuses, and augment funds for "self-financing" (spending from internal resources for investment, research, and welfare measures for the workforce). Emphasis is placed on firms (and indeed everybody) earning their own way, on not being a burden on the treasury. Thus, presumably, firms will seek greater profits and thereby become more cost-sensitive, less wasteful, and generally more attentive to financial aspects of their operation. If this happens, they will be more controllable by financial means and institutions, especially by the banks, whose role is to be greatly enhanced.

- A firm in financial difficulty may borrow from its administrative superior, which in turn may borrow from the bank for the purpose. (This could become a loophole for preserving some measure of the traditional soft budget constraint.) A firm may be declared insolvent and eventually liquidated. Laid-off workers or employees are to retain their seniority and to continue to receive their average pay for up to three months. After that period, they may have to be requalified and retrained.

- Inequality of earnings from lawful labor is to be not only tolerated but positively encouraged for incentive purposes. The stake is on the productive and the enterprising. Use is to be made of worker "collectives" and family groups to maximize both incentives and intragroup social control for the sake of productivity.

- At the same time, "nonlabor income" and partiality toward alcohol are now subjected to severe official condemnation and harsher penalties. In the first three years of the Gorbachev era, hundreds of thousands of people have been subjected to criminal and administrative punishment, up to execution, for diverse "economic crimes" and corruption.

- The enterprise's relationship with various government authorities is to rest on stability, predictability, and the stimulation of pecuniary incentives. Payments to the treasury, local budgets, and the superordinate ministry are to be in the form of pre-fixed, long-term, stable "normatives" (coefficients, rates, "regulators" in East European parlance) which in effect assure the retention of a certain share of profit or value-added by the enterprise, an important incentive provision. The wage bill is either fixed or subject to a normative in relation to value-added, but a portion of economized wages from dismissal of redundant labor can be passed on to the workforce in higher pay. Yet other normatives pertain to the allocation of retained profit among permitted purposive funds.

- In addition to taxes on enterprise profit—incidentally, at individually set rates—the treasury will also collect charges for the firm's use of resources, namely, on fixed capital, labor (payroll tax), diverse natural resources, and so forth. Thus, fiscal and efficiency purposes will tend to be mingled in this set of instruments, while bureaucratic decision will still play an important role in the setting of individual rates and charges.

- Each enterprise will now compile its own plan rather than receive from above a plan in the form of mandatory targets and directives. Instead, it will now receive from above a set of "control figures" which will cover much of the ground of the traditional plan, but will not be mandatory. However, "the distinction between directive and nondirective control figures is a fine one, and fine distinctions have generally been lost in the rough-and-tumble of Soviet administration" (Hanson, 1987, p.4).

- The various normatives—many of the prices, specific exchange rates, the tax-like charges on resources, and other parameters—are, however, to be set for longer periods (usually five years) for individual enterprises or groups of them. "Limits" will be set for each enterprise for investment capital from the state budget and for such equipment and supplies as will be still allocated from central (state) resources. It is not clear how the "limits" will differ from the traditional allocations. The now important "state orders" for goods (see below) are to be issued to individual producers. Hence, bargaining and other phenomena typical of the old system will continue, though now related to these variables rather than the notorious plan. (Since at this stage many of the old directive indicators will be retained, they continue to be objects of bargaining as well.)

- While production in response to buyer demand rather than "for the plan" is the stated desideratum, a major role in determining the bill of goods will be played by so-called state orders (*gosudarstvennye zakazy*). Although the word *zakaz* connotes more a commercial order than an administrative directive, it seems that these will in fact be administrative directives for the production and delivery of goods and for investment in production capacity. Transmitted, like the traditional plan directives, from highest planning levels through the ministries down to the enterprise, such "orders" will refer to the more important and/or more "deficit" goods, will be compulsory to the enterprise, will carry relatively low prices, and will carry high priority rating. However, they will benefit from the administrative allocation of the requisite supplies. The state orders' relation to demand-determined commercial orders is unclear at the moment.

- Despite a good deal of rhetorical praise of price flexibility and price responsiveness to demand (and to CMEA and world markets), in the foreseeable period, prices charged by state enterprises to one another, to the government, and to the public, will still be primarily either fixed or at least closely regulated.

- The transfer of material goods from one enterprise to another, traditionally (and still) largely accomplished on the basis of administrative allocation and disposition (but not without informal retrading, however), is to be gradually replaced by so-called wholesale trade (*optovaia torgovlia*), a term going back into the history of Soviet reform attempts to at least 1965. Though it evokes an image of freely conducted market transactions, in fact it has been applied often to certain relatively more stable, administratively controlled

interenterprise relations. Thus, at this point, it is not clear how unregulated—or how regulated—"wholesale trade" will in fact be.

- Most important, the economic-administrative hierarchy has not been abolished, as it largely would be with full marketization. But with enterprises—and, we might add, local governments—slated to play a substantially greater autonomous role in economic decisions and actions, the functions of the central planning bodies and higher administrative organs are to be accordingly curtailed in some respects and transformed in others.[7]

In the new conception, these bodies are to shed many of their directive functions (but not all, as the case of state orders indicates) and are to emphasize functions such as long-term and medium-term development planning, policy formulation, technology projection, and overall guidance and regulation in their respective spheres of reponsibility. Fifteen- and five-year plans are to be stressed, normatives and prices are to be set for five-year spans, and one-year plans—heretofore the real substance of Soviet central planning—are to disappear as such. Particularly the ministries, allegedly among the most implacable foes of *perestroika,* are to cease exerting detailed command and control over enterprises, requisitioning their funds and resources at will, or changing the rules for enterprises in midstream. More than that, they are to bear responsibility for harm done by transgressing their authority, a revolutionary principle in Soviet experience.

- Finally, as already mentioned, financial and fiscal variables, monetary/credit institutions and the treasury, and therefore macroeconomic planning and policy, are to play considerably more important functional and regulatory roles in the new demand-guided and efficiency-seeking schema than heretofore. This will be considered in the next section.

Imaginative, bold, and indeed "radical" as the reform is, are its provisions adequate to the task of bringing about a decisive breakthrough to a better and bigger economy? Are they sufficiently coherent and properly sequenced? Can they, and will they, be realized in practice? What, then, will the Soviet economic system be like in the early 1990s as the implementation stage ends and (what we called) the "interim system" takes over?

First, will the market mechanism have taken over sufficiently to establish a systemically stable and viable market economy, open to institutional adaptation and evolution, more efficient in operation and more effective in outcomes than its predecessor, while enjoying legitimacy in the public's eyes? (And, of course, will it also be a "normal" advanced market economy in the sense of suffering from the usual ills and pains of one.) Or, second, will the Soviet economy still remain in the grip of the command principle? Or, third, will it institutionally muddle through the 1990s as a kind of a "halfway house"—neither command nor market economy, or rather *both* command and market, with the two principles of coordination blocking one another?[8] Gorbachev's economic *perestroika* rides on

7. See Resolutions of the CC CPSU and CM USSR numbered 816, 817, 818, 819, 823, 824, and 825, all dated July 17, 1987, reprinted in *O korennoi...*1987.

8. A situation characterized as "neither command nor market" may well contain more of the market than meets the eye; namely, the underground market, which may be richly nourished by the poor internal coherence of the economy in this case.

these broad alternatives; and so, of course, do the substance, prospects, and meaning of its financial and monetary aspects.

Of the three, the first alternative is unlikely, at least well into the 1990s, owing to the grave obstacles to marketization discussed above, not only in our view but also in Gorbachev's own assertions. The second alternative appears to be precluded by Gorbachev's determination to proceed with *perestroika*, so long as he is where he is. (But, in any case, it is not interesting for the present purpose inasmuch as the domestic financial consequences of a reversion to a command economy can be easily imagined from past experience, minor variations apart.) This leaves us with the third alternative—halfway house for the near and medium term. (It may be banal to note at this point that the Hungarian halfway house has been standing for 20 years.)

More specifically, the case for a halfway-house outcome rests on a variety of considerations, drawn both from the content of the reform measures (at this stage) and from its domestic sociopolitical setting. We have already mentioned the aboveground vested interests and the underground informal property rights opposing the reforms and likely to do so at every future step, while the broad public seems to be both skeptical of and hostile to *perestroika*. Also as mentioned, the totality of Gorbachev's program appears to be exceedingly ambitious in terms of both physical possibilities and psychological demands. But, for the present purpose, of central importance in blocking the progress of the economic reform, threatening to keep it the halfway-house position, are the twin and closely interrelated problems of the MP (currency-plus-savings-deposits) overhang in public hands and the soft budget constraint in the socialist production sector, both generated and perpetuated by the traditional behavior of the banks and the budget. (A still more fundamental cause is the traditional paramountcy of the command principle, that is to say, the administrator's ultimate insistence that no monetary or financial constraints be allowed to block the execution of his will.)

The soft budget constraint blocks most moves toward efficiency in the official production sector, pumps excess purchasing power into the system, and perpetuates the MP overhang. The overhang militates against decontrolling consumer prices lest open inflation take off (or, rather, accelerate), labor conflicts explode, interregional and internationality tensions aggravate, and, in a word, political caution be thrown to the winds. Continued control of consumer prices, reinforcing the direct effect of the soft budget constraint, helps perpetuate the continued control of nearly all producer prices, wages, exchange rates, and so forth. The MP overhang also stands in the way of granting greater scope to individual business, for fear of drawing too many resources into this lucrative sphere at the expense of the first economy.

We shall return to this problem in the setting of reform policy.

The reform: Money and finance

Money matters

Much is written these days in the Soviet Union about the underappreciation of finance and money in the past and the consequent dire effects on the economy. Now, with the swing of the political pendulum, "finance" has turned from the cinderella of the economic system into a princess of the *perestroika*.

Money *does* matter, of course, even in a Stalinist economy; suffice it to point to the unhappy experience with repressed inflation and soft budget constraints in all Soviet-type economies. It should matter more—in a different way—as the system is decentralized and liberalized, and particularly as it is expected to turn from a resource-constrained to a market-oriented and demand-led one.

But what of the twin monetary impediments: the soft budget constraint and the MP overhang? Turning to the latter first, cutting this Gordian knot in the Stalinist manner by confiscating the overhang seems, so far, to have been unacceptable to the authorities, presumably on grounds of social equity and for fear of shaking public faith in the reform and inviting political risk.[9] While a few individual (but inspired?) voices in favor of confiscation have appeared in the central press,[10] the official stance, not surprisingly, has been to deny any impending confiscation of private money holdings.[11] An interesting alternative solution of placing a hard ruble into parallel circulation with the existing soft one has been forcefully advocated by the well-known economist V.D. Belkin;[12] we forgo comment for lack of space.

True, if—or rather when—the general level of the *controlled* retail prices is significantly raised to reduce the subsidies (a process already partially begun), and wages are compensatorily increased as proposed, and a few likely turns of an inflationary spiral follow, the overhang of currency and savings deposits would shrink relative to the new price-wage level—though depending on how fast the money supply grows in the meantime.

In short, the newly proclaimed emphasis on finance and money seems to be still largely at the rhetorical stage. The laws and resolutions passed so far give only vague promise of betterment on this score and provide little indication of the policy problems looming down the road.[13]

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9. The interregional and internationality complexity of the confiscation of the MP overhang is illustrated by the following. In the Berkeley-Duke sample of Soviet emigrants (see footnote 4), relating mostly to the later 1970s, currency holdings averaged 13 percent of total household wealth for residents of the European USSR, and 29 percent of (much larger) household wealth in Armenia. Interestingly, in both regions, there was very little variation of this ratio between poorer, middle, and richer households (in terms of per capita wealth). (Here wealth is gross, before deduction of household liabilities.)

It is worth noting that faced with Poland's large monetary overhang, the Jaruzelski regime did not adopt the confiscation solution even at a historically opportune moment—i.e., directly after the imposition of martial law, when the population was stunned and immobilized.

10. For example, letters by Volkov and others and by Ivensen in *Pravda*, February 1, 1986.

11. For instance, the statement by Deputy Minister of Finance S. Borisov, as reported in an Agence France Press dispatch, October 20, 1987.

12. The joint authors of this plan are V. Belkin, P. Medvedev, and I. Nit. See Belkin (1987), and ensuing discussion; Medvedev and Nit in *Sotsialisticheskaia industriia*, April 28, 1988.

In the meantime, certain measures have been announced which, among other purposes, may have the effect of mopping up some MP in the short run—e.g., a voluntary supplemental pension scheme for individuals to buy into. But the main instrument for holding down currency issue seems to be a system of administrative limits on the amount of currency that local banks can obtain from the center (see Garetovskii, 1988a). In some localities this has caused difficulty in meeting payrolls.

13. See Resolutions 819 and 821, cited in footnote 1.

To sum up, the halfway-house alternative is the most likely prospect for the medium term—with profound implications not only for the role of money and finance, but also for the economic reform as a whole, and more than just the economic reform.

The reorganization of banking

Though banking reorganization is perhaps the financial innovation of recent months most noticed in the West, organizationally the measure is of minor import. There are now six banks, about the same in number and name as in the late Stalin period. All are of national scope and monopolies in their respective areas. They are the State Bank (Gosbank); the Foreign Economic Bank (successor to the Foreign Trade Bank, or Vneshtorbank); the Bank for Industry and Construction; the Agro-Industrial Bank; the Bank for Housing, Local Economy, and Social Development; and the Savings Bank (successor to the system of savings banks lately under Gosbank, but a separate entity before 1961). The Savings Bank differs from the rest in that it serves mostly the public at large rather than the socialist sector. However, the Bank of Housing, Local Economy, and Social Development is the only one authorized to deal with the newly liberalized private individual and (private) cooperative businesses. All banks but Gosbank are sectoral; each is responsible for a slice of the economy. Gosbank is now to be a central bank of sorts (although, in addition to being that, it is also a sectoral bank under the new scheme, having been charged with financing the "nonproductive"—i.e., the service—sector). Neither the two CMEA banks nor the Soviet-owned banks abroad are named in the resolution.

As mentioned, Gosbank remains the central bank. As such it is charged (in Resolution 821, article 4) with the "centralized, planful management of the money and credit system of the country, and the conduct of a uniform national credit policy, coordination of the [other] banks...,[being] in charge of money supply ('circulation') and of "strengthening."

What is new in Soviet banking is not the reorganization itself but the intended mode of operation and behavior. Banks are now charged to deal with the business sector in a banker-like way: evaluating risks and enforcing efficiency and financial responsibility. Their goal is explicitly stated to be profit. At the same time, the new banks are sectoral monopolies in the traditional Soviet way.

It is said that automatic extension of credit, especially in connection with payment for supplies, is being curtailed or phased out. Increasingly, lending is made with reference to the firm's overall financial position. Moreover, greater pressure is being brought on firms to reduce excessive inventories.[14]

On the other hand, we are also told (by the head of the Lithuanian Bank—i.e., branch—of the State Bank) that the reorganization of banks has changed nothing but the signs, that their charters are still unavailable, that the style and methods of the whole credit and monetary "mechanism" has remained unchanged, and that coordination by the USSR State Bank is "incredibly weak."[15]

And why not? How can the banks meaningfully and effectively have businesslike relations with firms when the latter still largely operate in the old environment of price control, materials allocation, state orders, and other

14. See Garetovskii, the new Chairman of the Board of Gosbank (1987, 1988a, 1988b).

15. Z. Zhilevichus in *Sots. industriia*, January 1, 1988 and June 22, 1988.

quantitative constraints—and will continue to do so in the near term, as we expect? And what meaningful new role can Gosbank, as the nominal central bank, have in a halfway-house reform? Nor is there much indication yet of serious concern with macroeconomics, either as theory or as policy.

Postscript

The foregoing sections of this chapter, originally written in late summer 1987, were updated and revised toward the end of the year, when there was still little factual information regarding the implementation and realization of the 1986-87 reform measures, the most important of which were not due to go into effect until January 1, 1988. This was especially true of the reforms in the area of finance and banking, which—as we have seen—had been delineated only broadly and vaguely in the official and semiofficial statements and documents of June-July 1987. Fortunately, thanks to the genial indulgence of the editors, this postscript is added to take account of information and developments which came to light in the first half of 1988.

Of special note in this connection are:

- the performance of the economy during 1987 and the first half of 1988, and the closely related question of the urgently needed improvement in the quantity and quality of Soviet economic statistics;[16]
- the implementation and realization of the reform measures, especially the key ones of mid-1987, and, for the present purpose, particularly those in the area of finance and banking; and
- the additional reform steps promulgated or announced at this writing.

As to the economy's performance, no decisive improvement is yet visible, whether in regard to the production or the productivity of labor and capital (see PlanEcon, 1988), or in regard to the aforementioned program of "acceleration" and modernization, particularly in the key sector of machine-building, or in international economic relations, or—perhaps especially—in regard to consumer welfare (see Schroeder, 1988). It may be properly observed that any truly fundamental economic reform, such as Gorbachev's, cannot be expected to show decisive positive results for at least several years—as indeed has been repeatedly stressed by the General Secretary from the reform's outset—and that economic indicators will turn up with time.[17] Fair enough, but the outside observer's cautious prognosis is supported by considerations such as the following:

1. In the monetary sphere (cf. *supra*), continuing and growing difficulties in 1987 and the first half of 1988, including a seeming upturn of price-wage levels combined with likely growth in the currency overhang (with reference to the "first" economy)—i.e., increases in both open and repressed inflation. At the same time, in a sharp reversal of past practice, annual budget deficits, past and current, are now not only openly admitted (though no numbers yet revealed), but also blamed for the inflationary trend, especially since the beginning of the

16. Regarding the slow "restructuring" of Soviet statistics, in both quantity and quality, see Treml (1988).

17. This pattern is formally modeled and traced to the year 2000 by Kellogg (1988).

1980s.[18] This trend further reduces the chances of a substantial freeing of prices in the foreseeable future (except in the still very small private/cooperative sector) and, hence, of a viable marketizing reform of the "first" economy. It also strongly militates against the implementation of a meaningful reform in finance and banking.

2. The emergence or amplification of a number of major social and economic problems, such as serious unrest (or at least restiveness) in minority republics; spreading shortages and rising prices of consumer goods, particularly

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18. Cf. PlanEcon (1988), pp. 8ff., where *inter alia*, the deficit of the (consolidated) Soviet state budget is estimated to have been as follows: 1980-1985 - fluctuating annually between 16.4 BR and 24.2 BR with no clear trend, then sharply rising to 55.5 BR in 1986 and 95 BR in 1987. The latter two figures represent about 6.9 and 11.5 percent of current GDP [op.cit, Table 5]. (Using the PlanEcon method we estimate the "deficit" to have been about 17 BR in 1970—i.e., within their range for 1980-85). Since domestic bond sales are quite small, in the main the deficit would have to be covered by domestic bank loans, occasioning an equal expansion in the total money supply, probably chiefly in the form of currency and savings deposits. However, as pointed out later in this note, the deficit figures may require some qualification. The same PlanEcon report points to "abundant signs of inflationary pressures in the second quarter of 1988" (Ibid, p. 1ff).

Almost simultaneously, the authoritative political journal *Kommunist* published an article (Kagalovskii, 1988) which sets an important precedent by openly rejecting the official claim of no deficit financing of budget expenditures (not counting curt allusions to a budget deficit in recent speeches by Gorbachev and other leaders). Kagalovskii points to the budget category called "other income" and states that it consists in the main of two items: budget receipts from foreign trade (long known to be a large figure, especially in recent years), arising from the disparity in internal and external price structures of tradables and the official overvaluation of the ruble; and funds supplied by the State Bank (Gosbank), which, the author points out, include "the current increment in households' savings and *money issue*" (our emphasis). He adds that the line-items "other income" has been categorized as part of "receipts from the socialist sector," though the bank-supplied portion thereof cannot be properly so denoted, and adds that "this has been fictitious income, giving the appearance of a deficitless budget."

Kagalovskii stresses that the share of bank funds in "other income" rose sharply in 1986 owing to the need to cover the decline in that year of both receipts from foreign trade and the inflow of turnover tax from alcohol (owing to the anti-alcohol campaign launched in 1985). He gives the total of "other income" in 1986 as 136 BR, though he does not give its breakdown between the two major components. His 136 BR is almost identical with the PlanEcon estimate (*op.cit.,* Table 4) of 132.5 BR as the sum of their estimate of "net foreign trade taxes" (77 BR) and the residual category identified by PlanEcon as "estimated budget deficit" (55.5 BR). (It is unlikely that the Kagalovskii article was already available to the PlanEcon authors.)

Both, however, overlook the important fact that the amount of bank loans outstanding to the business sector of the economy (excluding the government as such) declined by 68.7 BR, or 13.2 percent, during 1986 (Narkhoz 1986, p. 635). This is the first time in many decades that this category has registered a decline, let alone of this magnitude. From a monetary standpoint, the decline in bank loans to the business sector not only fully or partially offsets the increase in bank loans to the treasury in the same year, but may be functionally related to it. Indeed, some of the decline in business loans may have been occasioned by a diminution of inventories of alcoholic beverages. Also, some of it seems to be explainable by a sift in the source of financing of other inventories, especially in construction, directly or indirectly at the expense of the state budget and of its deficit (ibid., pp. 627, 535). On the other hand, the reduction in business loans may also be partly occasioned by the sheer writing-off of bad loans as part of *perestroika*; again, at the expense of the state budget.

The even much larger PlanEcon estimate of the budget deficit in 1987—95 BR—cannot yet be related to the operation of the banking system for lack of 1987 bank statistics at this writing. Nonetheless, and despite the qualifications and uncertainties, the overall impression is indeed one of a continuing rise in prices and wages and in the monetary overhang.

of food; public concern with expected sharp food-price increases; tension in labor relations; environmental and health problems, lately highly publicized; the continuing aging of the capital stock; and the widely perceived and now virtually admitted ineffectiveness of the campaigns against alcohol consumption, corruption, and "economic crime." These and other politically charged problems and issues are occasioning additional socioeconomic programs or expenditures just when resources for the institutional reform and for economic "acceleration" are already under great strain.

3. Internationally, the tapering off of several military conflicts with Soviet involvement or intense concern presents an economically mixed outlook. Withdrawal from Afghanistan should release resources for other uses. The end of the Iran-Iraq war brings the unwelcome prospect of significantly lower energy prices and corresponding decline in Soviet hard currency earnings. Nor is Eastern Europe proving to be the significant source of additional machinery and consumer goods for the USSR, as seems to have been hoped at the start of the Gorbachev era.

4. And, not the least, the halting progress of the already promulgated reform measures—to which we now turn—does not bode well for the reform.

As mentioned, on January 1, 1988, a number of major reform measures went into effect, notably the law on the state-owned enterprise (also the banking reform, as per the resolution of July 17, 1987). While it would take some time before the law on the state-owned enterprise (LSE) could begin to bear tangible fruit, results of the initial test of strength between the reformers and the planning/administrative hierarchy had become manifest immediately. It will be recalled that the LSE provides not only for a number of features of a new, partly market-oriented, economic mechanism (as well as of limited self-management by workers), but also for the (ostensibly provisional) retention of certain key features of the old command mechanism. Among the latter, the so-called state orders, differing more in name than in essence from the old mandatory plan targets, had to be issued to the enterprises by their administrative superiors at the very beginning of the year. In the reform's design, the state orders would apply only to a part of the total bill of goods, a regrettable exception to the reform's decentralizing principles, needed to tide the economy over the transitional period before the market could take over.

As the year dawned it became obvious that what was to be now an exception remained the rule. State orders were issued to cover all or the bulk of individual firms' production capacities,[19] and, of course, with the wonted lack of consistency or regard for demand for the respective goods and services. Other key features of the traditional system also stayed largely in place: price control, material and equipment allocation (now called "limits"), a production plan passed down the hierachy ("control figures"), as well as the traditional

19. Thus, in 1988, according to L. B. Vid, a deputy chairman of the State Planning Commission, state orders accounted for the following percentage shares of output of individual "complexes" (clusters of branches of industry) and ministries: machine-building 86, fuel and energy 95, metals 86, chemical and forest industries 87, Ministry of Light Industry 96, and Ministry of Building Materials 66 (*Ekonomicheskaia gazeta,* 1988, 36, p. 1). After considerable outcry from the reform wing, these percentages are said to have been reduced for 1989 as follows: 25, 59, 4, 42, 34, 30, 51 (respectively). For the text of the provisional regulation (*vremennoe polozhenie*) regarding the setting of state orders for 1989 and 1990 (though not the figures just cited), see *idem*, 1988, 31, pp. 18-20.

organizational structure of planning bodies, ministries and departments, and the party apparat itself. At the same time, the fledgling features of the new order—profit orientation, cost sensitivity, financial autonomy and self-reliance, and so forth—have had little chance to constitute any new resource allocating mechanism at all, let alone an effective one.

As this postscript is being written in the summer of 1988 the reformist forces, alert to the fiasco of the turn of the year, have gone on the counterattack to significantly relax the stranglehold of the traditional system by 1989.[20] Even if they succeed, the question remains whether, given the legacies and problems discussed in this paper, the reform can move beyond the halfway-house stage, so that a viable market mechanism begins to develop. In addition, all aspects of the reform are currently seriously held back by a lag in legislative implementation.[21]

Among the more creative innovations at this juncture are the provision in the Law on Cooperatives for the establishment of cooperative banks, plans for "venture" funds or firms, and the founding of a small number of local "share" (*aktsionernye*) banks for independent, bolder financing of innovative projects .[22] Too little is known of them at this point to say more, and though the ambience remains unpropitious, they bear watching. Individual state-owned (nonbank) firms have started selling "shares" to their personnel and/or to other firms and organizations, which typically seem to be fixed-interest, nonvoting, unsecured instruments with unclear retrading possibilities and uncertain seniority among potential claims against the firm. On the whole, though occasionally mentioned by leading-edge reformers, a capital market does not seem to be in the offing yet.

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20. See the preceding note regarding 1989.

21. On the restraining effect of the lag in legislative implementation, see ibid., 1988, 34, pp.1-2.

22. Regarding cooperative banks (to be established by associations of cooperatives) see Zakon...,1988, article 23.5. An example of plans for nontraditional banks, though owned by shareholding official entities, see *Ekon. gazeta*, 1988, 34, p. 5.

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2

Monetary Reforms in Bulgaria

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A decree of June 1987 attempts to reorganize the Bulgarian banking system. The system envisaged is in many respects similar to a market-type one, with separation between lending and clearing activities, typical of commercial banks, and note-issuing and monitoring activities of the State Bank. The attempt is in no sense new; not only have other East European countries reorganized their banking systems along these lines, but already at the end of the 1960s similar measures were introduced in Bulgaria and withdrawn a few months later. What appears to be different this time is the environment into which the new measures are supposed to fit. A major reorganization of the whole mechanism of direction of the centrally planned economy is under way, and the reorganization of the banking system is supposed to play a key role in implementing the economic reform.

This paper describes the main features of the banking system which is being developed and assesses its feasibility. In the next section, the historical evolution of the Bulgarian banking system is presented briefly. The more recent measures follow. An attempt is made to relate them to the more general framework of the so-called New Economic Mechanism (NEM) in the fourth section ("The reorganization of planning and management"). A few concluding remarks sum up the main findings.

The evolution of the Bulgarian financial system

The Bulgarian banking system has followed a development pattern similar to that of the other East European countries. Private banks were nationalized in 1947 and were merged into two institutions: the National Bank (*Balgarskata NarodnaBanka, BNB*) and the Investment Bank. The National Bank simultaneously took over all the functions of commercial banks in addition to those of the central and issuing bank.

During the 1960s, a series of monetary measures introduced important changes. First, all domestic currency was exchanged on a 10 to 1 basis for the newly created *heavy leva*—with more favorable rates for the conversion of prices, wages, and savings—to mop up excess purchasing power in the hands of the population. Second, in 1964, a bank specializing in foreign transactions (*Balgarskata Vneshnetargoveta Banka, BVB*) was established with 40 million leva in capital. The change of the monetary base led to a *de facto* 40 percent devaluation of the leva in hard currency terms because the BNB set the gold price at 2.88 leva per gram, rather than 1.32 as first announced (Lampe, 1986). *De facto*, however, the insulation of the domestic economy made the devaluation scarcely effective.

Like other socialist countries, Bulgaria attempted a reorganization of the centralized system of planning and management in the second half of the 1960s. At least on paper, the reform was quite advanced. Market-type instruments were introduced, and the role and functions of central planning were redefined. This reorganization included a substantial transformation of the banking system. For nearly two years after April 1, 1969, the BNB functioned purely as a central bank—that is, as a bankers' bank—and left all business operations to two newly established commercial banks: the Bulgarian Industrial Bank and the Bulgarian Agriculture and Trade Bank.

The new banking system was to be closely integrated with planned management through a set of appropriate refinancing procedures and a policy of differentiated interest rates. Bank credit, until then representing an insignificant share of investment funds (a mere 6 percent versus 58 percent provided directly from the state budget in 1964), was supposed to play a more active role in financing enterprises' activity in order to exercise selective control over projects and thus favor a more efficient use of resources. Market-type instruments—such as minimum reserve/deposit ratios and the regulation of interest rates—were used by the State Bank for influencing commercial banks' activities (see Uzunova, 1968). Banks were held responsible for all aspects of financial control over the activities of enterprises, but the reform was not so far-reaching as to include credit between enterprises. The process, however, did not go far: a governmental decree in December 1972 put an end to the experiment and resumed the traditional system. The Investment and Agricultural Banks, founded in 1969, were merged with the BNB, which had already quietly absorbed their activity. A conclusion may be drawn that perhaps too much was expected of the financial reform, without a parallel decentralization of planning activity.

At the end of the 1970s, enterprise investment was made more dependent upon contractual obligations and credit from the BNB, which was responsible also for monitoring the enterprise's cash balance (Lampe, 1986; Kaiser 1981). Prior to this period, enterprise investment was based on limits set by the State Planning Commission. The change resulted in an increase in the share of investment credits allocated through the banking system at the expense of the State budget. Finally, as part of the economic reshuffling of the early 1980s, the Mineral Bank - Bank for Economic Initiative was established to finance small- and medium-sized enterprises.

Main characteristics of the 1987 banking reform

The basic features of the Bulgarian banking reform are based mainly on the decree proclaiming a new set of rules (*Darzhaven Vestnik*, June 16, 1987) and on information received from bankers during a recent visit to Sofia. However, many details have yet to be disclosed, and, more crucially, the practical realization of the new system is yet to follow.

The new rules mean a movement toward a more active role of monetary management in the economy. The establishment of a mixed, sectoral banking system is envisaged, with the creation of a few (seven so far) specialized banks and the redefinition of the role and functions of the existing Foreign Trade Bank, the State Saving Bank, the Mineral Bank - Bank for Economic Initiative, as well as the Bulgarian National Bank. The decree and the accompanying document, *Regulations on Banks,* determine also the criteria for the relationship between

banks and self-managed economic organizations (SEOs). The new system includes:

- the Bulgarian National Bank;
- the commercial banks, subdivided into specialized commercial banks and the Bulgarian Foreign Trade Bank; and
- the Bulgarian Saving Bank.

The Bulgarian National Bank

The core of the system remains the Bulgarian National Bank (BNB), whose structure and functions have been redefined. It is still directly subordinated to the Council of Ministers,[1] but its Management Board is now composed of the President of BNB (who is President of the Management Board), the vice presidents, the chief secretary, and the general directors of BNB. Article 22 of the *Regulations* states ambiguously that "the managers of other banks, of self-managing organizations, of BNB branches, as well as representatives of the state and public bodies and organizations, can also be invited to participate in the work of the Management Board," without specifying whether they are allowed to vote.

The BNB has maintained the role of the central bank, with the exclusive right to emit and circulate bank notes and coins. It participates in the definition of monetary policy, regulates the turnover of money, coordinates and controls the activity of banks, drafts the credit and cash plans, and takes part in drawing up the financial plan. It also holds in deposit the free assets of other banks. The new main tasks of BNB include fixing maximum and minimum levels of the interest rate and determining the foreign exchange rate of the lev, subject to the approval of the Council of Ministers. The BNB also determines the maximum amount of credit to be extended to the SEOs by commercial banks and the level of indebtedness in foreign currency, both hard and soft.

The regulation of credit relies on two main instruments:

- the refinancing of commercial banks on a contractual basis, expanding or limiting the use of short- and medium-term credit; and
- interest rate policy.

The law authorized the Bank to decree a reserve ratio[2] and a liquidity ratio.[3]

The BNB exercises control over the activity of commercial banks by monitoring monthly reports, annual balance sheets, and end-of-year accounts presented by commercial banks. The BNB has the power to decree sanctions against commercial banks deviating from norms and, in the case of systematic breach of rules, it can recommend to the Council of Ministers the reorganization or dissolution of a commercial bank (Article 7 of the *Regulations*).

Besides the central management, the BNB maintains district banks and branches. Articles 16 through 19 of the *Regulations* describe (quite confusingly)

1. The National Bank was subordinated to the Ministry of Finance before the 1970s.

2. "The minimum admissible ratio between a commercial bank's resources and the risk balance assets and other nonbalance commitments of the commercial banks" (Article 5 - *Regulations on Banks*).

3. "The minimum admissible ratio between the commercial bank's liquidity and financial solvency" (Ibid).

the activity of district banks, which "in the respective district should perform the functions of the BNB." Here, the principle of control by the lev (*kontrol chrez lev)* is reintroduced: the district bank must exercise control over the productive activity of the SEOs, including the fulfillment of contractual obligations. District banks are also given the power to discount bills against temporary bank credit.[4]

The BNB maintains the functions of a commercial bank in providing current banking services to the SEOs of the nonproductive sphere. Finally, the coordination of cooperation with CMEA banks remains the prerogative of the BNB.

The commercial banks

The new commercial banks are joint-stock companies in which self-financing organizations, banks, and other organizations participate. The statutory fund is distributed into shares of equal value, each of which carries one vote. The fund cannot be less than 20 million leva, and at least half of it must be deposited with the central bank before the commercial bank is registered. Formation of new banks is, however, subject to the approval of the Management Board of BNB. In most cases, commercial banks operate in specific sectors, although they may assist enterprises in different branches of the economy; conversely, an enterprise belonging to a particular branch may use a bank which is not in its sector of activity. Article 2 of the decree recognizes the following:

- the Electronics Bank (*Banka Elektronika*);
- the Biochemical Bank (*Banka Biokhim*);
- the Autotechnical Bank (*Banka Avtotekhnika*);
- the Agricultural and Cooperative Bank (*Zemedelskata i kooperativna banka*);
- the Construction Bank (*Stroiteliata banka)*;
- the Transport Bank (*Transportnata banka)*;
- the Bank for Economic Projects (*Bankata za stopanski iniziativi*) dealing in particular with the Industry for Man Association;
- the Economic Bank (*Stopanskata banka*) for the remaining self-financing organizations; and
- the Mineral Bank - Bank for Economic Initiative, which is to restructure itself into a commercial bank.

All banks are based in Sofia except the Agricultural Bank (in Plovdid) and the Transport Bank (in Varna).

The management organs of a commercial bank are: the general assembly of shareholders, the council of shareholders, the management board, the president of the bank, and the audit commission. The general assembly, which makes decisions on the basis of a two-thirds majority of its members, is the government

4. "The district bank can discount bills of exchange and other documents in leva for separate supplies made, on the conditions of company (commercial) credit with up to a three-month term...the bill of exchange is accepted against temporary bank credit..." (Article 19 of the *Regulations*).

body of the bank. It elects and discharges the president (although he is actually appointed and eventually dismissed by the Prime Minister), his deputy and the members of the council of shareholders, the vice president of the bank, and the members of the audit commission. The executive body is the management board which implements the decisions of the general assembly and decides on issues of operation of the bank.

Commercial banks are juridical persons, carrying out their activity on a cost-accounting (*khozrachet*) basis, and bearing the responsibility, jointly with SEOs, for the economic results achieved in the process of crediting and utilizing funds. The bank is obliged to set aside a part of its income for a "reserve fund" which can be used to cover losses. If the yearly loss cannot be covered by the reserve or other sources, the BNB can propose to the Council of Ministers the reorganization or the closure of the bank and, consequently, call its management to account for the bank's performance. The bank's management and specialists are rewarded on the basis of the bank's performance.

The main role of commercial banks is to provide SEOs with short-, medium-, and long-term credits in local and foreign currencies, to accept their deposits, to provide other banking services, and to monitor their economic and financial accounts. In particular, the bank should exercise control over the investment activity of SEOs, using the interest rate to influence the behavior of economic units and to promote a more efficient use of resources. Economic units are obliged to submit information on their economic activity, and the bank may carry out an independent investigation of a particular enterprise before granting new credit. Article 52 of the *Regulations* establishes that if more than 30 percent of the credit granted has not been repaid in time, the bank has the right to impound and dispose of buildings, equipment, and material after a written warning to secure its credit.

Under the law, commercial banks can set up:

- an "equalizing fund" (*uravnitelen fond*) to cover the differences arising out of transactions in leva and foreign currencies; and
- a "fund for financing innovations" (*fond finansirane na novovuvedeniya*) that can be used by the commercial bank to take part in joint ventures or to finance the introduction of new machinery and processes.

The Bulgarian Foreign Trade Bank

The Bulgarian Foreign Trade Bank (BFTB) is a particular kind of commercial bank that has a monopoly over foreign trade transactions. The new measures envisage a change in that the BFTB would continue to coordinate foreign trade activity, but other commercial banks would be allowed to act on the international market, to open accounts, and to deal in foreign currency. This particular role would be rather limited at the beginning but may expand in the future. In any case, this has to be considered a channel to attract foreign loans, because all activities will be under the control of the BFTB and the BNB. The principle of self-financing should also be applied to foreign markets and to foreign currency. For enterprises producing only for the domestic market, state

support within the framework of planning is envisaged, even though the bulk of enterprises are in a position to earn hard currency.[5]

The reorganization of planning and management

The restructuring of banking is part of a more general reorganization of the economy, considered the most far-reaching attempt in Bulgarian economic history. Economic reform has been on the agenda since 1956, when the Communist Party proposed the famous "April line," which marked the appearance of T.K. Zhivkov as party leader. Major restructuring was introduced in the mid-1960s (the New System of Planning and Management) and in 1981 (the New Economic Mechanism). However, minor adjustments and experiments were introduced throughout the 30 years of Zhivkov's leadership, sometimes in a contradictory way.

The comprehensive set of measures announced at the end of 1986 were summarized in a document called "Regulations on Economic Activity" and further elaborated within the Central Committee of the Bulgarian Communist Party on July 28, 1987. These came into force on January 1, 1987 (Zhivkov, 1987; see Price Waterhouse, 1987; and Deliiski,1987). These regulations are supposed to remain in force at least until the end of 1990 to guarantee a sufficient trial period.

The basic principles of the reform allow increased independence in enterprise management in an attempt to speed up the introduction of new technologies and to revive economic development. Emphasis is placed on *economic levers* in the management of the economy, as opposed to the *administrative approach* that characterized previous attempts. The aim of the reform is to introduce competition at several levels. The most important innovation introduced under the reform concerns economic planning. Enterprise-level planning, which used to be based on directives from higher authorities, is now to be done by using the national plan as a general guideline. A draft central plan is presented to the economic units, but it no longer contains detailed targets and compulsory indicators. The plan is submitted mainly to provide basic information on the basis of which an enterprise can draw up its own plan; it does not carry any administrative power. The plan, ultimately drawn up after discussions with business partners, is approved by the enterprise's economic council and *does not require any further approval.* However, the state retains considerable indirect influence over current business activities and long-term development.

The economic policy of the country is shaped by using wage policies, taxes, interest rates, credits, exchange rates, and so forth. A system of governmental purchase orders has been introduced to produce certain basic industrial goods, to meet export commitments to other CMEA countries, and to provide other goods essential for the normal functioning of the economy. The Council of Ministers places orders to enterprises on the basis of competitive bidding.

The economic system is reorganized according to a pyramidal structure. At the bottom is the enterprise, the basic economic unit. In the middle are economic corporations, or combines formed by enterprises, which have close horizontal or vertical links. At the top are associations formed *voluntarily* by large

5. At the beginning of 1987, Bulgaria had 74 trading companies, each of which specialized in a particular sector. The monopoly of the Foreign Trade Organizations was abolished under the reform. However, it will still be necessary to have licenses from the Foreign Trade Ministry, restructured as the Ministry of Foreign Economic Relations.

intersectoral complexes. However, the pyramidal structure is not intended to be hierarchical, and both corporations and associations should mainly coordinate the activity of the enterprises and provide services and expertise. The general principle of the reform is that no superior body should have the right to perform functions that can be adequately taken up by lower economic units. The economic corporations are primarily concerned with market support, planning, research and development, advice on capital investment projects, and staff training; they are specifically barred from exercising any management authority over the enterprise. The associations essentially perform the role of a coordinating body; they draft a unified technological, investment, and marketing policy for basic economic units that accept membership.[6] They are not intended to replicate or substitute for ministries. For this reason, associations can employ only a limited staff (less than 70 employees).

The enterprise is to be the basic economic unit working on the basis of self-financing under the responsibility of a managing director and an economic council elected by the employees. The enterprise can freely choose its trade partners on a contractual basis, negotiating the most favorable terms it can. Manufacturers are no longer "attached" to a source of supply and are able to choose suppliers of raw materials, fuels, machinery, and equipment, theoretically both in the internal market and abroad. The principle of economic responsibility of the enterprise has been introduced: the consequences of the enterprise's behavior have to be borne by the enterprise itself and by the banks. The principle of bankruptcy also has been introduced; this involves penal responsibility (judgment in court) and workers' unemployment.

The reform of the tax and pricing systems is still under discussion. Only the main lines of the reform have been anticipated. The classic cost-plus principle of price determination will be replaced by contractual prices. The *maximum* wholesale price is to be based on the price at which a specific product is sold on representative foreign markets. After an adjustment for quality differences and other factors (international price fluctuation, market conditions, etc.) the price is converted into leva at a centrally determined exchange rate. Actual prices, negotiated between the seller and the purchaser, cannot exceed this maximum, while downward adjustments depend exclusively on contracts. With the consent of the Committee on Prices, the price of a product can be temporarily revised if a customer wants the product modified. Some prices, such as those of energy supply, basic foodstuffs, and other essential goods, remain under the direct administrative control of the Committee on Prices. The establishment of a closer link between domestic and foreign prices is considered a necessary condition for the enterprise to compete internationally. As a trade official noted recently, "We want prices based on what we earn abroad, on how the international market appreciates our performance. It is the only way for a small country to compete."[7] But the long-term aim of the reform, as repeatedly stated by Zhivkov and other officials, is to arrive at an exchange rate based on the purchasing power of the lev. This objective is very ambitious.

The reform of the tax system is expected at the beginning of next year. The traditional system based on turnover taxes is to be replaced by the so-called

6. Membership in the associations is not compulsory. An enterprise may also join more than one association.

7. *Wall Street Journal,* August 18, 1987.

realization tax, based on value added and similar to the VAT system of many West European countries.[8]

Conclusion

It is too early to draw more than highly tentative conclusions from the reform proposals presented here. However, it is clear that the Bulgarian leadership is aiming at introducing a comprehensive set of market-oriented reforms which will affect almost all sectors of the economy—a "radical reform" rather than the recurring piecemeal and partial improvements of earlier experiments.

The introduction of principles of decentralization in the decisionmaking process, the encouragement of competition, the splitting of large economic organizations into component units, the linkage of employee remuneration with the overall profitability of the enterprise, and the introduction of new concepts of bankruptcy and creditworthiness make the present reform one of the more advanced experiments attempted by a socialist country. It remains to be seen whether the usual resistance to reform (from subsidized industries, the military, powerful bureaucrats, and less enlightened party officials) will be stronger than the leadership's determination to change.

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3

Financial Aspects of the Economic Reform in Poland

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The reform and its implementation

Poland's 1981 reform program contained in "Directions of the Economic Reform" advocated changes in the functioning of the economy that spill over to other spheres of social life.

On state-owned enterprises, the program assumes:

- the relations within a firm will be based on the principle of self-management;
- the firm's external relations with other firms and banks will be based on commercial principles;
- the firm will have autonomy in decisionmaking; and
- the firm's financial situation will depend on economic performance verified by the market.

On central planning, the document provides procedures of planning to the functioning of enterprises. The tools of economic policy used by the central administration and the government banking system are meant to ensure:

- the attainment of the objectives of the central plan; and
- the maintenance of market equilibria.

Such a change in the economic system calls for the democratization of social relations not only at an enterprise level, but also at other levels (professional association, local government, etc.). The next element of the program is "to restore the Polish economy to health and to improve social relations which requires serious transformations in the institutional system. This concerns, above all, the organs of the government and the state administration."

For the first time in Poland the reform program was comprehensive. In the past, it had touched only the economic sphere. This time the government recognized that the new principles for the functioning of the economy required changes in the social and political system. The lesson drawn from experience was that if the reform was not comprehensive by including democratization of social relations and changes in the institutional system, it might fail. These latter provisions were dubbed the "institutional guarantee of the consistent reforming of the economy."

The program outlined only the guidelines of the reform; implementation needed to be specific. The substantiation of the program and the introduction of

detailed changes initially took place at open meetings in which official institutions, formal and informal groups, and interested individuals participated. Meetings were on the Acts on State Enterprises and on Workers' Self-Management, which were enacted in 1981. Subsequent changes, however, took place under seriously altered conditions brought about, first, by the introduction of martial law and, second, by the Act on "special legal regulations for overcoming the socioeconomic crisis." (The latter initiated a series of amendments to the Acts passed in 1982.) The concrete solutions introduced into the economic system could no longer be the outcome of a dialogue. They resulted instead from authoritative resolutions; even though they were frequently submitted to social and professional consultations, they were rarely revised under their influence. This meant that with the extinction of social reforms from below, the central institutions had full powers on reform matters, which caused the reform to be shallow and frequently revised.

Deviations of the systemic changes from the program relate, first of all, to its socioeconomic provisions.[1] This, in turn, hindered the transformation of traditional central planning. The tools of economic policy could not achieve desired goals since they could not reconcile central planning with market self-regulation. Of course, without the latter, enterprises can self-finance their expenses only in appearance, not in actuality.

The quantitative central plan and its "financial side"

In official documents as well as in the colloquial language, the term "central plan" is understood to mean the central quantitative plan. The central quantitative plan determines the allocation of "basic" inputs; the output targets for different product groups and some individual products; the distribution of national net material product among consumption, exports, and investment for different sectors and branches; and the allocation of investment inputs necessary to achieve these outputs.

Under the reform program, the central planning of quantitative targets and the allocation for particular branches were to be replaced by planning with macroeconomic aims, like investment activity in the economy, competitiveness on international markets, balance of payments position, and other global economic indicators. Such a central plan may be called the macroeconomic aims plan.

The transition from the quantitative plan to the macroeconomic aims plan required a new approach to the central financial plan. Under the traditional centrally planned system, the quantitative plan was subordinated to the financial plan and included the balance of the population's incomes and expenditures as well as the variables affecting this balance, such as prices of consumer goods and wages. This was known as the "rule of priority of quantitative planning." This rule did not allow prices to be determined by the market, which is necessary for evaluating the efficiency of the planned and actual production structure.

The reform program promised to discard the rule of priority of quantitative plans, but did not reject quantitative planning. It said the central plan would not

1. See my paper "The Structural Changes in the Power Center and Economic Reform in Poland," *Forschungsberichte* 125, The Vienna Institute for Comparative Economic Studies, March 1987.

be a detailed plan (barring some specified exceptions) and that quantitative targets would no longer be imposed on enterprises (except in cases of national emergency and government export contracts). These statements seemed to suggest that the main aim of the reform was to change the management system, while the reform of central planning was to be reduced to simply improving the old system. The same intention was indicated by stressing that the central coordination of financial and quantitative planning would be an indispensable condition for economic equilibrium.

However, this condition was regarded as too weak. Therefore, the National Bank was granted more autonomy in its relations with the government. It was not meant to be fully independent, of course, but sufficient autonomy was granted to protect the economy from the government's decisions, especially on investments.

When the reform program was being prepared, the future of the branch ministries was hotly debated. These ministries had been the mainstay of the traditional economic system. The government decided that one or two such ministries would continue to operate; however, they were deprived of the legal basis to interfere with the independent decisions of enterprises.

The functional ministries, in contrast, were regarded as being compatible with the new system. Their role in the economy was to be increased. However, the general concept of this role was phrased in a way that unfortunately left the door open for interpretations that excluded market self-regulation. According to the new rules, the functional ministries "apply economic instruments in directing the economic units' activities and consult on these instruments with the branch ministries."

Under market self-regulation, the functional ministries would influence economic processes, but they would not direct enterprises' activities. Any such "direction" would permit the application of specific financial instruments in individual branches of industry or even in individual enterprises. This would turn the reformed system into an indirectly centralized economic system. This element of the reform program is inconsistent with the concept of central planning. It is more compatible with the quasi-market mechanism, which is perceived as a financial instrument in the hands of the government to achieve the targets of the traditionally constructed central plan.

The five-year plan for 1986-1990, worked out in the fifth year of the economic reform, is evidence that the traditional approach to central planning continues. At first, the priority targets were determined. The determination of the remaining targets restricted even more the possibility of achieving internal balance of the plan. For instance, metallurgy received priority, as it had before. The long-run development program of this sector was approved by the government in May 1984. Next, the long-run development programs of the fuel and energy sectors were settled. Parliament approved these programs in March 1985. Only after this approval did the Planning Commission put forward the five-year plan for the whole economy for discussion and consultation. Predetermined priorities were found to be the additional constraint on the choice of input-output structures. No doubt pressure groups from the branch ministries were behind this mode of central planning. It is not easy to identity these pressure groups, their mechanisms of operations, and their internal and external interdependencies. Suffice it to say that they have been strengthened by the reforms.

Traditionally worked out, the central quantitative plan for 1986-90 generates the usual imbalances and strains. They are transparent in the so-called "critical

indicators." This name has been given to the cost-saving requirements on which the execution of the plan is dependent. The "critical indicators" show the share of inputs of materials, energy, and labor that "must" decrease per unit of output and what rates of export and import growth "must" be. The cost-saving targets are high, and even the authors of the plan call them unprecedented. This is caused by the fact that the planning and implementation of quantitative tasks are separated from one another—stemming from the fact that, in the past, plans were meant to "mobilize" resources.

The financial side of the plan, in contrast to the detailed quantitative plan, is general and vague. All variables, except those related to foreign trade and agricultural production, are expressed in constant 1984 prices. Thus, attempts at achieving quantitative targets completely ignore the criterion of economic efficiency: the quantitative targets are assumed to be pursued with no regard to changes in the relationship between prices and costs.

Consumers' planned incomes are estimated, but there are no forecasts of price movements since nothing can be said about the future situation of the market which is far from equilibrium. Nevertheless, in the descriptive part of the plan it is hoped that the consumer market will be in equilibrium. The plan does not reveal the government's intentions on budgetary and monetary policies. There are only general statements that subsidies will be decreased and the budget deficit eliminated. All features of the 1986-90 plan, including the secondary role of its "financial side," prove that the system of central planning has not been touched by reform.

The financial and nonfinancial instruments of central regulation

The financial system of a planned economy consists of rules regulating money flows, or the administrative adjustment of enterprises' payment ability to their quantitative output targets. Adjustments are made on the basis of actual prices and technological conditions. Passive financial adjustments, however, would ensure neither the fulfillment of quantitative goals, nor the efficient operation of enterprises. The financial system is used to press enterprises to meet superior organs' expectations. Results will depend to some extent on managers' and workers' willingness to meet these expectations. Therefore, the financial system should serve as an incentive mechanism to comply with these expectations.

These characteristics of the financial system refer to vertical regulation—that is, between superior administrative organs (and banks cooperating with them) and enterprises. These rules make enterprises generally insensitive to prices and deprive them, as well as other financial instruments, of their effectiveness. The instruments, flexible in the market economy, are relatively rigid here. Other instruments (such as taxes), which are generally stable and uniform in the market economy, are unstable here and differ among products and producers.

Because of enterprises' weak responsiveness to prices, the burden of equilibrating the intermediate and investment goods markets is left to nonprice instruments, both financial and nonfinancial. As far as financial nonprice instruments are concerned, the authorities try to reduce enterprises' demand by siphoning off major parts of profits by taxation. (This is called "fiscalism" in Poland.) They regulate the structure of demand by means of "special purpose funds" established at the national, branch, and enterprise levels. However, these financial instruments are not sufficiently effective for achieving microeconomic

equilibria. Thus, there is a need for nonfinancial instruments as well. As a result, the rationing of many inputs continues.

There is confusion about the role of instruments of government regulation. Under the reform program, enterprises are to make their own decisions. Three groups of information are to be taken into account in the decisions: internal (technical, organizational, and so forth); market (prices and demand); and government regulations. However, there have been tendencies to:

1. limit market information in favor of instruments of government regulation;
2. enlarge the role of nonfinancial instruments; and
3. establish a complicated system of financial instruments.

The effect of Tendency 1 is visible in price performance. There are no market-determined prices (except for fruits, vegetables, and some other foods in the private market). The intention was to allow prices of some consumer goods and industrial inputs to be determined by demand and supply. The number of these commodities was to be gradually increased. In practice, the new category of prices, called "contract prices," have not achieved market-clearing levels. They are determined on the basis of costs of production. Profits on various outputs must not be "too high." The authorities have the right to freeze prices, to set maximum rates on price increases, and to reduce any "excessive price."

Distribution of different prices by types of goods, 1982-86

	Distribution of prices (%)				
Type of goods	*1982*	*1983*	*1984*	*1985*	*1986*
Consumer goods					
State-fixed	37	40	47	47	46
Regulated	15	15	3	3	2
Contracted	48	45	50	50	52
Industrial inputs					
State-fixed	19	20	34	34	34
Regulated	5	5	3	3	3
Contracted	76	75	63	53	63
Agricultural procurement					
State-fixed	72		72	72	72
Regulated	0		–	–	–
Contracted	28		28	28	28

Source: Government reports on implementation of the economic reform (1982-87).

Nevertheless, contract prices are controlled by the government less than "state-fixed prices" (for food, energy, and essential raw materials) and

"regulated prices" (for construction services). Regulated prices equal costs of production, while the basis of determining state-fixed prices is unclear. The prices of imported raw materials and those produced at home, which are "exportable," are to be set at world market levels, while the prices for other raw materials are to be set at market-clearing levels. These recommendations reflect the government's intentions. In reality, many state-fixed prices are less than costs. The costs, in turn, are usually underestimated. The table above presents the percentage share of each by sales of different types of goods.

Tendency 2 is inconsistent with the reform program because it creates instruments of government regulations that are at odds with the typical financial instruments. The obligatory instructions on accounting rules for inputs and outputs are included in the instruments of government regulation. These include rules specifying methods for calculating the so-called justified costs, for determining the variable which the enterprise is to maximize, and for determining a formula for optimization.

Moreover, organizational rules make it possible for the central administration to combine or split enterprises, create their associations, and appoint their supervisory boards. The central administration has the right to appoint and dismiss an enterprise's directors and to set their salaries. Directors who are dependent on the state administration for their salaries are susceptible to informal instructions in decisions that are officially left to enterprises.

Tendency 3 creates a complicated system of financial instruments which are numerous, discretionary, and unstable. The tax system consists of a turnover tax on gross output, several taxes on inputs (which are included in the costs of production), a direct tax on profit, and a tax on any increase in the wage bill above a set "norm" (paid from profits net of direct taxes). The basic rates of turnover tax are 10 percent for goods and 5 percent for services. Actual rates differ—from more than 100 percent for "luxury" goods (fur coats, woollen carpets, etc.) to negative taxation (e.g., subsidized foodstuffs).

Taxes on inputs (which are included in the costs of production) include the wage fund tax of 63 percent, the tax on land (zl. 10/m2), and three taxes on fixed capital.[2] Of the three, one takes the specific form of the government budget's participation in the amortization funds of enterprises. The budget's shares are branch differentiated. Another is the taxation of buildings at a rate of 2 percent of their value. The third is a tax on fixed capital at 2 percent "for the Foreign Debt Servicing Fund." (This tax cannot exceed 20 percent of the firm's profits net of direct taxes.)

Apart from the wage fund tax, the enterprise must pay a tax on a wage bill in excess of the "norm." The base of this tax, the threshold at which it begins to operate, and the tax rates differ among individual branches and enterprises. There are many allowances and exemptions as well. In 1986, this tax took 38 percent of the profits of the industrial sector, net of direct taxes. The direct profit tax took 52 percent of the pretax profits in industry. The basic rate amounts to 65 percent, but the actual rate is lower because of allowances.

The wide differentiation in tax rates and other financial regulators is widely criticized in Poland. The differentiation serves the central organs in implementing the planned production and investment structure whose efficiency may not be reliably tested in advance. The attempt to achieve this structure leads

2. Of the 63 percent, 43 constitutes a payment for the centralized social insurance fund.

to reproduction of disproportions, disequilibria, and other undesirable results. For instance, it is frequently argued that giving financial preferences to some centrally approved investment projects will eliminate shortages of certain intermediate goods. However, this claim is based on an unreliable evaluation of input-output balances which does not take into account all feedback. Only direct technological interdependencies are taken into account. Moreover, these balances are based on a doubtful assumption that the future production structure is known. This approach cannot eliminate the possibility that expansion of the preferred supplies would increase rather than decrease imbalances.

The central organs, while focusing on the quantitative input balances, usually assume that the demand structure will not change. They do not take into account the fact that tax allowances, subsidies, and other financial incentives, which are meant to encourage output expansion, can affect demand. Financial incentives cause income redistribution and, therefore, they do not concern only the producers in question. An economic system deprived of the market self-regulation mechanism does not adapt the structure of supply to the new structure of demand.

To control the demand for inputs, under conditions of weak price responsiveness of enterprises, the authorities regulate enterprises' expenditures from after-tax profits by creating a number of "central purpose funds." After-tax profit is divided among several "enterprise funds." One of them—the reserve fund—is obligatory; two others—development and innovation funds—are recommended by the central authorities. There is also a profit-sharing fund. All these funds take about 10 percent of the pretax profit (i.e., the part which remains in the enterprise).

Enterprises which need additional money for financing any undertaking can seek participation in the central purpose funds. About 70 central funds exist for such things as environmental protection; technical and economic progress; development of the domestic market; foreign debt servicing; conserving fuel, energy, and raw materials; reprocessing waste, and so forth.

Subsidies continue to play an important role in regulating incomes and demand. They have reached 40 percent of the government budget expenditures (which have exceeded revenues in the past few years). Since budget expenditures equal almost half of the net material product, the share of subsidies in national income (net material product) amounts to about 20 percent. About 60 percent of the subsidies are paid to producers of consumer goods.

In spite of these massive subsidies, central priorities continue to be protected by the government and the National Bank. Last year, 85 percent of the annual outlays on central investment projects were financed by credits. In general, the credit policy is subordinated to the quantitative "central programs."

The financial system and financial policy generate strong pressure by enterprises on the government agencies that set the financial instruments. Enterprises' weak response to market signals is related to this problem. Neither the needs of customers nor the structure of total demand exert much influence on enterprises' activity. Enterprises' quick response to signals from the government administration also existed in the command economy. The difference between the old and the reformed system lies in the bargaining between enterprises and the government on financial targets.

The reform program for the late 1980s

The so-called "second stage of the reform" does not offer any prospects for rejecting the "indirectly centralized" character of the system. The second stage of the program can be summarized by the following:

- The central quantitative plans are to be less detailed and better correlated with the central financial plans.
- The ministries, whose number has been reduced from 26 to 18, will continue to influence enterprises' activities by means of organizational and financial instruments to ensure that the activities dovetail the "quantitative and qualitative goals and targets" of the central plans.
- The set of financial instruments is to be: (i) simplified (e.g., the number of central purpose funds will be limited); (ii) modified (e.g., a new two-grade system of interbranch and intrabranch "norms" for wage bills above which the enterprises pay a special tax); and (iii) made more adequate (by "reshaping the price-income relations").
- Administrative restrictions imposed on cooperative and private sectors are to be lifted.

These "crucial changes" in the economic system are expected to encourage an "enterpreneurial behavior" among managers of state-owned firms and a tendency toward market equilibrium. However, prices will continue to be government instruments, not market variables. It means that market interactions among demands, supplies, and prices will continue to be restricted. There is a kind of vicious circle: on the one hand, as long as central quantitative targets are established, there will not be reliable (i.e., market-clearing) prices. On the other hand, as long as there are no reliable prices on the market, there are still strong arguments for continuing quantitative central planning. Because of inadequate price data, enterprises do not find the right condition to meet market demands. Thus, the enterprises are encouraged to act according to government financial instruments. Unfortunately, in this case, the enterprises have soft budget constraints. Neither entrepreneurial behavior by firms' managers, nor a tendency toward market equilibria results from the "second stage" of the reform.

4

China's Reform of the Financial and Tax Systems

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Since socialist countries were established only in the 20th century, no experience has been available anywhere which could be readily applied in building these countries. As a result, each socialist country has had to pursue its own path of development based on its own experiences and in conformity with its own particular circumstances. However, research and discussion of the experiences of China, Hungary, Poland, and Yugoslavia in restructuring their economic systems will be mutually beneficial.

Since the founding of the People's Republic of China, the state has pooled human, material, and financial resources to achieve rapid development. This has laid a material basis for building a prosperous, powerful, democratic, and modern socialist country. However, the Chinese failed to realize the importance of a commodity economy for a long time. As a result, material production replaced commodity production in the state-owned economy; state control over enterprises was overemphasized; administrative measures were preferred to economic ones in management; and material gains were negated. These actions resulted in the formation of an economic model that is incompatible with the requirements for the development of social productive forces. This model is characterized by the fact that enterprises eat in the "big bowl" of the state, employees eat in the "big bowl" of their units, and local governments eat in the "big bowl" of the central government.[1] This situation has suppressed the enthusiasm, initiative, and creativity of enterprises and workers, and prevented a full use of the potential of the socialist system.

After 30 years of experience with socialism, China began in 1979 to search for a road that would keep her a socialist country with Chinese characteristics. The Communist Party of China made a series of important decisions, which focused on two aspects. First, the party upheld four basic principles as the foundation for building and ruling the country. These were: socialism; people's democratic dictatorship; leadership of the Communist Party; and Marxism, Leninism, and Mao Zedong Thought. Second, the party accepted economic reform and opening-up of the economy to the outside world as the policy for bringing about socialist modernization.

1. This Chinese expression is taken to mean that regardless of their performance, individuals can eat from the communal pot.

In the restructuring of the economic system, special attention has been paid to the following points:

- The economic reform is meant to promote a planned commodity economy.
- While maintaining a leading role for public ownership, other forms of ownership (such as collective, private, foreign-owned, and joint ventures) would be encouraged to invigorate the economy.
- More autonomy would be given to big and medium-sized enterprises in decisionmaking, profit disposal, and company management.

The restructuring of the economic system covers a large area, of which the reform of financial and tax systems is an important part. The latter has a direct bearing on the distribution of profits between the state and enterprises, among enterprises themselves, between the central and local governments, and among local governments themselves. The rationale in the distribution of profits will decide whether the control over enterprises will be loosened or tightened, and whether the development of a commodity economy will be promoted or hindered. An irrational disposal of profits will dampen public enthusiasm and consequently produce a negative effect on the economy, while a rational disposal will arouse public enthusiasm and help the development of the national economy. The main features of the financial and tax reforms are discussed in the sections that follow.

Distribution of profits between the state and enterprises

Between 1949 and 1978, the state took full responsibility for the incomes and expenditures of enterprises, except for a brief period when enterprises were allowed to retain their profits in fixed proportions. Profits of enterprises, after a small deduction for distribution to staff as bonuses, were turned over to the state. Losses were absorbed completely by the state. The funds needed by enterprises for production expansion were also allocated by the state.

These practices played a positive role at the time of founding the republic and during the first Five-Year Plan period, when the state had to pool the limited financial resources to restore the economy and to launch massive economic development programs. But as the scale of these programs expanded, the weakness of the centralized system—too much and too tight control over enterprises—became clear. Although some readjustments were made later in the division of management power between the central and local governments and between government departments and localities, no major changes were made in the relationship between the state and enterprises, or in granting additional financial power to enterprises. Since 1979, however, more financial power has been gradually delegated to enterprises in deciding on the distribution of profits and in closely linking rewards with achievements. Two major reforms were launched during this period.

First, between 1979 and 1982, a system was introduced for profit sharing and for full responsibility by enterprises over their profits and losses. Profit sharing meant that enterprises could retain some of their profits, in prescribed proportions, and hand in the rest to the state. The profits retained by enterprises included fees for the trial production of new products, fees for scientific research and technical training of workers, welfare funds for workers, bonuses, and enterprise funds. After four years of reforms, the proportion of the profits retained

by state-owned industrial enterprises expanded from 8 percent in 1979 to 22 percent in 1982.

For enterprises that made only small profits, the system of delivering profits to the state in a fixed amount was adopted. If their profits surpassed the amount set by the state, the difference was shared between the state and enterprises according to a predetermined proportion. Enterprises that operated with a deficit were subsidized according to a fixed amount. Enterprises that exceeded this loss amount were not subsidized. Losses that were smaller than the fixed amount were, however, divided between enterprises and the state according to a certain formula.

Second, since 1983, tax payments were substituted for profit delivery, which meant that enterprises had to hand in their profits to the state in the form of income taxes. This reform was implemented in two phases. In the first phase, both profits and taxes were paid to the state. The mechanics worked as follows: enterprises first paid income taxes; they then retained part of their after-tax profits and delivered the rest to the state. The delivery was made in four forms:

- prescribed progressive rates;
- according to fixed proportions;
- as adjustment taxes (at different rates for different enterprises, which in actuality was the same as delivery according to fixed proportions); and
- at a contracted amount.

Less than two years after the first phase, the second phase of the reform was started. Profit delivery was replaced by tax payment to mitigate the contradictions caused by distorted prices and to handle more rationally different economic relations. The state introduced some new categories of taxes, readjusted tax rates, and prescribed that enterprises should deliver profits in the form of adjustment taxes. (Different tax rates were still fixed for different enterprises, which was the same as levying taxes on enterprises according to prescribed proportions.) The after-tax profits were left with enterprises; most of these were used to expand production, though a small part was used for welfare funds and bonuses.

As part of the reform, several policies and measures were adopted to strengthen enterprises. These included a loosening of previous restrictions on the financial sources which enterprises could draw upon to repay loans taken for launching technical renovations, and new regulations which allowed enterprises to repay loans from their pretax profits. In other words, the profits used to repay loans were exempted from income and adjustment taxes.

This policy greatly enhanced the repayment capacity of enterprises, though it also gave rise to some negative practices. Enterprises gained considerably from the two-phase reform. The share of profits retained by state-owned industrial enterprises increased to 39 percent. Their financial strength grew substantially, as did their capacity to launch technical renovation. The reform played a positive role in mobilizing the initiative of enterprises, improving their management, and raising their output and income. However, there were some problems during the second phase in replacing profit delivery with tax payment.

First, adjustment taxes had to be imposed to narrow the income gaps among enterprises caused by differences in their profit rates. Efforts to rationalize prices by readjusting tax rates were not successful because of price distortions and income gaps among enterprises caused by differences in the technology used, history of development, location, and economic conditions.

Adjustment taxes were levied to prevent enterprises in underdeveloped areas from going bankrupt and to keep enterprises in developed areas from gaining too much. This practice suited China's circumstances. But because the rate of adjustment taxes differed from one enterprise to another, unjust tax burdens were inevitable.

Second, the growth rates of both loans and repayments by enterprises for upgrading technology were too high on account of a loose policy on pre-tax loan repayments and an even looser implementation of the policy. In 1982, enterprises used 5.7 percent of their total profits to repay loans; by 1985 it had increased to 12.5 percent, and was expected to increase further in the future. Such a large increase not only made it difficult for the state to exercise control over capital investment, but also gravely affected its revenues.

To further mobilize the initiative of enterprises and to help them realize their internal potential fully, the state plans to introduce an economic responsibility system in large- and medium-sized state-owned enterprises. The system will be characterized by setting, in the form of contracts, quotas on profits that must be delivered by enterprises to the state. Competitive bidding can be used for choosing contractors and for setting contracting quotas so that state revenues are guaranteed. Meanwhile, relevant departments are working on another plan to deepen reforms in enterprises. The tentative proposal is to eliminate adjustment taxes, lower income tax rates, and abolish tax exemption on the profits used for loan repayments. The previous practice of pretax loan repayments will be changed into one of after-tax loan repayments.

Moreover, the state intends to introduce a contracting system for disposal of after-tax profits of enterprises, or a system of sharing dividends between the state and enterprises. This reform has three advantages:

- tax burdens will be fairly well distributed among enterprises, thus facilitating competition;
- enterprises will assume major responsibility for investment, which will improve investment returns because enterprises will not only assume responsibility for borrowing and repaying loans, but will also have the right to use loans and enjoy benefits from using them; and
- the state, as an investor, will be able to share profits with enterprises on the basis of its investment shares, just like any other investor.

Collection and distribution of depreciation funds

Before the 1970s, enterprises selected their depreciation rates for fixed assets and implemented the rates after approval by relevant departments. Under this method, an enterprise could contribute to depreciation funds according to either classified or comprehensive rates. Before 1966, all enterprises handed over their depreciation funds to the state. The state then distributed the funds uniformly among enterprises for renovating their fixed assets. After 1967, enterprises handed over some of the funds to the state, some to local governments or supervising departments, and the rest was retained.

The usual practice of enterprises was to make deductions for the depreciation fund on the basis of their comprehensive depreciation rate; this resulted in low comprehensive rates. In 1983, the average depreciation rate for state-owned industrial and transport enterprises was 4.3 percent spread over 23 years.

To facilitate the renovation of equipment and technical processes and to strengthen the capacity of enterprises to renovate on their own, a method of classified depreciation was introduced in 1983 in some enterprises. The depreciation period for most equipment was lowered to 10 to 20 years, and for factory buildings to 10 to 55 years. By 1987, all state-owned industrial and transport enterprises were expected to adopt this method. The officially prescribed depreciation period for the major equipment of some key machinery industries was also shortened by 30 percent. By the end of 1987, the average depreciation rate of state-owned industrial and transport enterprises are to be raised to 5.3 percent from 4.3 percent in 1983, while the average depreciation period is to be shortened to 19 years from 23 years. The average depreciation rate for equipment will be 7.2 percent spread over 14 years, and that for factory buildings will be 2.5 percent over 40 years.

The raising of the depreciation rate is important for speeding up the technical renovation of fixed assets. In China, the funds accumulated from the higher depreciation rate are not the only funds available to enterprises for renovating their fixed assets. Enterprises have also been granted, gradually, greater power to dispose of their depreciation funds. Moreover, the fact that enterprises can repay loans before taxes means in reality that the state shoulders a certain amount of the interest and loans of enterprises for launching renovation. (Since 1985, the state has stopped collecting depreciation funds, and enterprises have been able to use at least 80 percent of their funds on their own. In some areas and departments, all these funds are now left with enterprises for free disposal.)

Reforming the tax system

Tax revenues are a major source of state revenue and an important means to implement economic policies. Since the late 1950s, two major reforms have been introduced to simplify and amalgamate taxes. As a result, only one tax—the industrial and commercial tax—was levied on state-owned enterprises; two others—the industrial and commercial tax and income tax—were levied on collective enterprises. However, this simplified tax system greatly weakened the role of taxes in implementing economic reforms. Since 1978, when the Communist Party of China held its third plenary session of the 11th Congress, a series of tax reforms was launched in line with the party's policy of invigorating and opening up the economy to the outside world. The two main features of these reforms are:

1. *Reform of the domestic tax system.* The aim of this reform is to use taxes as an economic lever to help adjust the economy; to balance the profit levels of enterprises; and to encourage enterprises to follow independent accounting procedures, operate independently, and assume full responsibility for their profits and losses. The main items of the reform include the setting up of:

- An income tax for state-owned enterprises. The 1983 reform discarded the long tradition of requiring state-owned enterprises to deliver profits to the state. Income taxes replaced profit delivery.
- Product, value-added, business, and sales taxes in place of industrial and commercial taxes. These taxes are not imposed simultaneously. An enterprise which pays product taxes, for example, will not have to pay value-added taxes. Since 1984, product taxes have been levied on the products of most industrial enterprises in proportion to their sales volume.

For those industrial products that are manufactured through continuous processing, value-added taxes are levied in proportion to the value of additional factory sales. Units and individuals involved in commerce, transport, construction, finance, insurance, publication, and service trade have to pay business taxes in proportion to their business volume. Units engaged in the production and management of salt have to pay salt taxes in fixed proportion to sales.

- A resource tax on units and individuals engaged in the production of crude oil, natural gas, coal, metal, and nonferrous metal products. The tax is meant to narrow income gaps caused by differences in the price of natural resources. Price distortions keep prices of most mineral products low. At present, the resource tax is levied only on the production of crude oil, natural gas, and coal.
- Local taxes on urban construction and maintenance, real estate, and the use of vehicles and ships.
- A special tax to restrict certain activities of enterprises.

2. *Promulgation of laws on taxing foreign-owned ventures.* To safeguard interests of the state and foreign investors, several laws and regulations were promulgated in 1980. These included the laws on income taxes of joint ventures and of foreign enterprises. These laws were promulgated to meet the demand for foreign capital, for importing advanced technology, for introducing advanced management practices, and for handling issues related to foreign economic interests.

All of these reforms have changed the nature of China's legal system: a single turnover tax has been replaced by a combination of turnover and income taxes. Turnover tax accounted for 57 percent and income tax 35 percent of the country's total tax income. The new system has played a bigger role than the old one in expanding state revenues and in adjusting the economy. However, more needs to be done. Some taxes should be unified or readjusted, and the method of levying some taxes needs to be improved. For example, for historical reasons different income tax laws are applied for enterprises of different ownerships. This practice creates unfavorable conditions for enterprises seeking to compete under similar circumstances.

In the future, the rates of product and value-added taxes and the pricing system should be rationalized in accordance with the objectives of state economic policies. Further studies are needed on standardizing the methods of collecting value-added taxes. Resource taxes should be imposed on more trades as the process of price readjustment continues. Adjustment taxes on bonuses and wages, which can help to curb the growth of consumption funds, should be gradually unified.

Replacing state allocation with investment loan

Before the 1970s, investment in new projects came from state allocations to guarantee the launching of key projects. But the economic responsibility for new project units was not always clear; good investment returns were therefore not always achieved. In the late 1970s, an attempt was made to replace state allocations with loans for capital investment. The aim was to improve the efficiency of fund use by cultivating in enterprises a sense for investment

returns. This practice was then tried on a wider scale; by 1985, it was introduced throughout the country. The reform played some role in encouraging new investment units to save on investment, lower project costs, shorten construction time, improve returns, and pay attention to the recovery of investment.

However, replacing state allocations with loans still poses some problems. First, some projects may be beneficial to society, but may not yield any economic returns. As a result, recovering the investment cost from enterprises launching these projects may be difficult. These projects include scientific research, educational and administrative undertakings, and flood-control programs. Second, planning departments still approve capital investment projects, which means that neither new project units that borrow nor construction banks that lend have much choice. Third, both the principal and interest of loans are repaid with pretax profits, which minimizes the importance of loans. However, some preliminary adjustments have been made on the coverage of the reform. Projects that do not yield economic returns but are a benefit to society will continue to receive state funds. In addition, new regulations are being proposed to extend loans and their repayment period for projects still covered by the reform.

Local government power on financial matters

China's financial management system has undergone many reforms in keeping with changes in the country's political and economic situation. The past few years have seen two major ones:

1. *Establishment of a financial management system to specify revenues and expenditures and to set specific quotas at various levels.* This system, established between 1980 and 1984, had three main features.

First, revenues and expenditures of the central and local governments were specified. State revenues were divided into three categories and shared between the central and local governments. The first category was regular revenues, the second was revenues to be divided in fixed proportions, and the third was "regulating revenues."

Regular revenues were further divided into regular revenues of the central government and regular revenues of local governments. Those of the central government included customs duties and incomes of enterprises and institutions directly under the central government; those of local governments included incomes of subordinate enterprises and institutions, salt taxes, agricultural and animal husbandry taxes, incomes of collective enterprises, and local taxes.

The revenues to be divided in fixed proportions were the incomes of enterprises whose jurisdiction was transferred from local governments to the central government. The central government's share of the revenues was to be 80 percent; the remainder was to go to the local governments.

"Regulating revenues" were industrial and commercial taxes to be regulated by the central and local governments. The State Treasury paid for the expenditures of administrative organizations and enterprises directly under the central government. They included capital investment, working capital needed by enterprises, funds for technical and equipment renovation, fees for experimenting with and manufacturing new products and for geological exploration, and spending on foreign affairs. The treasuries of local governments paid for the spending of their subordinate administrative organizations and enterprises. Moreover, the State Treasury was responsible for

special allocations, such as relief funds for serious natural disasters, subsidies for fighting droughts and controlling floods, and aid to underdeveloped areas.

Second, specific quotas were established on the revenues and expenditures of local governments on the basis of the actual 1979 budget: the expenditures of local governments were met from their regular revenues and the revenues shared with the central government in fixed proportions. If these revenues exceeded expenditures, the surplus would be handed over to the central government in fixed proportions; if they were insufficient, the central government would provide local government its share of the regulating revenues in a fixed proportion to make up the shortfall. If the regular, shared, and regulating revenues were still not enough to compensate local government, the central government would subsidize the shortfall. Minority areas got an additional 10 percent subsidy each year.

Third, a financial relationship was established between the central and local governments. The relationship had three features:

- local governments had to hand over their revenues to the central government in fixed proportions;
- regulating revenues were to be divided between the central and local governments according to prescribed proportions; and
- the central government was to provide subsidies to local governments on the basis of fixed quotas. Under this system, local governments could spend revenues as they received them and were held responsible for balancing their revenues and expenditures.

2. *Introduction of a financial management system consisting of different tax categories, specified revenues and expenditures, and specific quotas at various levels.* This system was introduced in 1985 to fit the reform of the industrial and commercial tax system launched in 1984. The major difference between this system and the 1980 system lay in the fact that revenues were divided, according to new tax categories, into regular revenues of the central government, regular revenues of local governments, revenues to be shared between local governments, and revenues to be shared between the central and local governments.

- The regular revenues of the central government included the income and adjustment taxes paid by state-owned enterprises; the business taxes paid by the railway, civil aviation and post and telecommunications departments; the general offices of various banks and insurance companies; customs duties; treasury bonds; and incomes from state investments in key energy and transport projects.
- The regular revenues of local governments included the income and adjustment taxes paid by locally administered state enterprises, income taxes paid by collective enterprises, and local taxes.
- The revenues shared between the central and local governments included product taxes, value-added taxes, business taxes, salt taxes, resource taxes, individual income taxes, bonus taxes, construction taxes, and the unified industrial and commercial and income taxes paid by foreign-owned firms and joint ventures between Chinese and foreign companies.

Under the 1985 system, local governments had to hand over their surplus revenues to the central government, in fixed proportions, after deducting expenditures. If local government revenues were not enough to balance

expenditures, the central government was to channel, also in fixed proportion, the revenues it shared with the local government. If the regular and shared revenues were still not enough to compensate local expenditures, the central government was to provide subsidies at fixed quotas. The proportions and quotas were to last five years. This system sought to encourage local governments to balance their revenues and expenditures. The more they gained, the more they were able to spend.

Because of the many changes emerging from the restructuring of the country's economic system during the past two years, the regular and shared revenues of local governments were temporarily grouped into one category. If this combined figure was bigger than the expenditures of local governments, the surplus was either shared between the central government and local governments, or handed over by local governments to the central government, both in fixed proportions.

5

The Reorganization of the Banking System in Hungary

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The presocialist banking system

From the first third of the 19th century the Hungarian banking system developed along the continental line of banking, which led to predominantly universal banks, the department stores of finance. The system consisted of a large number of small banks and branches—a sizable part of them at county and town levels—controlled by a handful of big banks tightly intertwined with large foreign banks.

This situation created a large number of well-trained and many-skilled banking personnel, where especially in the provincial banks and branches with a limited staff, bank employees had to be "jacks of all trades," mastering all banking and stock exchange operations. The Association of Banking Employees, a trade union-like organization, had a strong left-wing audience, and the latter had a considerable influence on banking personnel. The majority of bankers in the higher echelons were pro-Allied liberals and not associated with Nazism. Because of these factors, the new regime was able to draw its cadres from among professionally well-trained, politically loyal or neutral people. Even after filling the controlling posts with cadres of the labor movement from 1949 on, the lion's share of the former banking staff remained in lower posts, as deputies of the new upper-level managerial staff or in influential advisory jobs.

Thus, banking operations, accounting, calculation, compilation of balance sheets, and correspondence (both domestic and foreign) were maintained at very high standards. Nevertheless, there was and is a shortage of bankers able to optimize the safety and profitability of financial resources because many of the former top-level managers had been fired. This shortage did not become obvious until the current decentralization of the 1980s, when many legal and informal limitations on the autonomy of banks were lifted. From 1951, university training for banking and the employment of a lot of university graduates in banks have provided hope that the shortage will be eased. Another factor facilitating the emergence of bankers is the country's strong involvement in foreign trade, in handling of World Bank loans, and in setting up and running joint ventures with foreign equity. All of these have acquainted hundreds of Hungarian banking staff with foreign banking.

Hungary established her own central bank, the National Bank of Hungary, rather late in 1942. This bank was preceded by the Budapest Main Office of the former Austro-Hungarian Bank, the central bank of the Austro-Hungarian monarchy. The newly emerged central bank operated between 1924-31 under the strong influence of the Bank of England and personally of Montague Norman

(later Lord Cobbold). The central bank excelled in keeping the money supply tightly linked to changes in the base metal through its rediscounting operations. With the suspension of convertibility in 1931, the National Bank of Hungary (NBH) assumed the function of managing and rationing foreign currency for imports and ran scores of bilateral clearing accounts. With the advent of the 1938 armament program, the indirect financing of the budget and direct controls over commercial banks came into the fore, and, banking operations got bureaucratized. At the same time, NBH became the skeleton for the new banking system because it had branches in every district and county, with personnel trained in keeping bank accounts, making payments, and so forth.

The banking system under directive planning

The new government made industrialization based on full employment and the establishment of collective farming the principal aim of its economic policy; government/state management became the means. A number of factors contributed to the relative underdevelopment of the economy, which required that funds be redistributed from consumption to capital formation and from agriculture to industry. The middle class (especially the intelligentsia) was disillusioned with market mechanisms. The apparatus, instrumentarium, cadres, and legal stipulations were inherited from the war economy of 1938-45. Foreign currency was in short supply from 1934 and had to be rationed. The nationalization laws of 1948 and 1949 concentrated practically all industry in the hands of central and municipal governments. The bulk of the land was cultivated by collectives or state-owned farms. Firms were guided by a central plan.

The idea of a national plan was not new in Hungary. In March 1938, the Daranyi government launched a "billion pengoe plan" with support from the budget and bond issues. The plan sought an annual expenditure of 200 million pengoes (£8 million at the then prevailing exchange rate) for five years, in investment subsidies to heavy industry, transport, and agriculture. As a result of capital formation under this plan, factory employment rose from 289,000 workers in 1938 to 392,000 in 1943. In 1941, Hungary launched a ten-year investment plan for agriculture, which was disrupted by the war. Thus, civil servants had experience in planning and implementation. In addition, returning Marxist exiles from the Soviet Union and the West brought with them theoretical and practical experience in planning and implementation.

The postwar plans were novel because they intended to guide productive and distributive activity as an integrated entity and thereby deeply influence consumption. Another novelty was the detailed planning of production and distribution in physical units. Some of those units were aggregated in money terms, either as a convenient form of representing quantities or where the specification of items in their own physical measures was considered a scrupulosity. The technique for preparing plans was based on material balances, with a process of bargaining whereby ministers or other political authorities negotiated for supplies. Statistics and public administration reflected the delineation of plan targets in physical terms. Industrial enterprises were grouped by product and subordinated to intermediate-level central administrations which were components of an industrial ministry.

In this hierarchical system, decisionmaking lay very close to the top of the pyramid. Targets were formulated in kind and industrial enterprises were

directed through administrative orders. Lateral (or horizontal) contacts among enterprises were made only through superiors. The means of production were rationed in kind, that is, the enterprise had a quota on current inputs and capital equipment and could recruit workers only within a specified wage bill. Lack of choices for enterprises in technologies, markets, and so forth resulted in no choice in bank allocations, and no active role for money and credit. Money had, instead, a passive role, one of mirroring plan fulfillment under the above constraints by financial control carried out by banks or one bank.

If every planned movement of goods and services has to be "controlled by the forint," it has to be checked by a corresponding bank entry. To facilitate double checking, accounts were concentrated in a single bank. Indeed, NBH became the obligatory center of accounts for state-owned enterprises and the cooperative sector. In its capacity as a central bank, NBH managed first all government and municipal accounts, later only those of central government agencies. The maximum lapse of time between the movement of goods and their payment was one month—a means of avoiding and outlasting interenterprise credit and establishing the monopoly of bank credit. Control meant not only assessing the flow of goods and services, but also that companies remain within the tight restraints of their working capital, wage bill, allotted capital, manpower and inventories. Hence, to finance current production, banks audited and reaudited balances of the companies, carried out on-the-spot checks of inventories, compared planned and actual wage bills, sanctioned excedents of the latter if not substantiated by an adequate increase in productivity, and so forth. In scrutinizing credit applications, an inquiry into the solvency and creditworthiness of the enterprise was not important, as the political guideline—"money, or the absence of it cannot hinder planned economic activity"—exempted the banks from such obligations. Bankers had to determine whether the activity to be backed by a loan was planned, whether it had material covering (by inventories, buildings, machines), and whether the companies' own funds and constant passive balances (wages accounted for but not yet paid, debts to suppliers, etc.) were sufficient to finance the planned activity without recourse to a loan.

Division of labor within one bank or among banks was based upon specialization. The administrative reason for this practice was that a bank, or a directorate or a department of the bank, had to have a valid counterpart in the hierarchically construed agencies of control (branch ministries or departments of the latter, county and district councils, etc.). The more correct reason was that supervision of the implementation of company plans formulated in kind required the bank inspector to specialize in certain branches and not compare branches with an eye toward opportunity cost and the building up of a portfolio. Finally, there was specialization—formerly completely alien from the universal banks of Hungary—separating current financing from working capital financing and the collection of deposits from investment financing. As long-term investment outlays were nonreimbursable and bore no interest, there was no need for banking expertise (except in accounting). However, there was a need for an inspectorate composed chiefly of technicians. All the banks were large hierarchical entities, with little regard for small ventures. The lack of choice in allocation and the absence of a material interest in the outcome of operations gave rise to bureaucratic tendencies.

Last but not least, NBH remained a bank of issue as well. Being an amalgamate of a bank of issue, a commercial bank, an investment bank for agriculture, the foreign trade bank of the country (the Hungarian Foreign Trade

Bank fulfilling only auxiliary lines of business), the central bank, and a foreign currency management agency, it grew into a mammoth institution with monopolistic authority, manageable only through detailed instructions. Its decisions on loan applications were decisions of public administration with few traces of business behavior. The different functions could only be realized at each others' expense within the bank, without open clashes and compromises of interests. Thereby, NBH ceased to function as a real bank of issue; it financed planned targets regardless of the deviation of their costs from planned costs.

The bank operated until the mid-1980s without any target figure on money supply and without regard to the size and maturity of its deposits. Until the early 1960s, it tried to control only notes and coins in circulation, without controlling its roots and without regard for other monetary aggregates. Commercial banks did not face liquidity constraints, did not calculate risks, did not hedge against risk (except in term operations in the international money market), nor did they build up a portfolio. The narrow specialization by branches and subbranches of the national economy limited the horizon of the collaborators to one company, or a small group, and led to an unsound identification of the banking employee with the sector he or she financed. The banking needs of the population were restricted to the National Savings Bank, which faced the unnoticeable competition of isolated, mostly rural savings cooperatives. Until the late 1950s, this bank hardly served its depositors: the population.

The reform process

The reform process began with revisions in economic policy in 1957. The policy of rapid capital formation at the expense of living standards and investment mainly in heavy industry at the expense of other sectors (particularly agriculture), was changed in light of political, social, and economic realities. The steady improvement in living standards as well as a balanced development of the national economy with a view to increasing foreign trade became important goals. An important means to achieve these goals was to enhance the participation of producers in industry and agriculture, based on their self-interest and material stimulation.

In agriculture, compulsory deliveries of produce were replaced by a system of contractual production and procurement. Industrial wages were to a certain extent linked to enterprise profits under a profit-sharing system introduced in 1957. However, the artificial price and cost system made judgment about profits difficult, despite price reform in 1959. Pricing remained autarchic—that is, it reflected domestic cost levels in the interest of maintaining solvency of enterprise activities.

Between 1963 and 1965, enterprise-level economic decisionmaking was extended by a constant reduction of obligatory target figures, the elimination of medium-level administrative agencies in industry, and by granting some major industrial enterprises autonomy in exports (and in extreme cases in imports as well). The cooperative movement in agriculture, industry, and services acquired a number of new efficiency-raising features. The taxation of gross income (wages plus profits), increased interest in production, the expansion of production of household plots owned by cooperative members, all were given both central and cooperative-level financial impetus. The development of cooperative democracy led to the election of better-prepared, experienced managers with a market

orientation. In fact, the economic reform in agriculture served as the experimental ground for the reform in industry which followed a decade later.

By the mid-1960s, the reserves of extensive development, mainly manpower, were exhausted, and a switch to intensive economic development became necessary. This change demanded a creative, and—as we only later realized—an entrepreneurial attitude from economic actors at every level, but especially at the managerial level. But, as it is very difficult to dance in chains, it was paramount to grant more competencies to decisionmakers. In the early 1980s, we introduced tender-based elections of managers by the whole staff in medium-sized firms and the election of a board by indirect ballot in big companies.

In 1968, the comprehensive reform of the economic control and management system included industry. The reform was preceded by a debate on the nature of the socialist economic mechanism in Hungary, based upon empirical studies and economic policy analysis. The reform was influenced by the debate among von Mises, Oscar Lange, Abba Lerner, and Professor Dickinson on rational decisionmaking in a socialist economy and Soviet discussions prior to the ascent of Stalin. Hungarian contributions were made by Gy. Péter, S. Balázsy, P. Erdös, J. Kornai, I. Varga, Gy. Varga, O. Gadó, A. Hegedüs, T. Liska, R. Nyers, R. Hoch, K. Szabó, N. Mandel, B. Csikós-Nagy, F. Jánossy, and many others.

The government created the Economic Commission in February 1957 to elaborate a comprehensive government program. It was chaired by Prof. István Varga. More than 200 experts from different spheres of economic and social life participated in the deliberations. The preparation of the blueprint and the participation by the members in its preparation left an indelible mark on the 1968 document which helped prepare for the 1968 reform.

Raising efficiency became a focal point for the further development of the national economy, particularly the raising of productivity of labor and capital. Qualitative rather than quantitative considerations came to the fore: the return on investments, the modernization of products and of technology through the implementation of research and development, and the international competitiveness of output. These aims required marked development of socialist production and ownership relations and their actual manifestation: the economic mechanism.

The reformers reinterpreted the concept of central planning and control in the context of an open and sophisticated economy of the late 1960s and came to the conclusion that the national economic plans had to concentrate on the major trends of economic development and be open to changes based on differences between assumed and real conditions of the external and domestic environment during the (usually five-year) planning period.

As the plan is not in the form of obligatory target figures for the enterprises, the system of economic regulatory tools (instruments)—i.e., influencing enterprise decisions on the basis of collective and individual interests—is a bridge between central planners and enterprise managers. The regulatory system envisaged consisted of a small and diminishing number of direct instructions or administrative regulations and a major and growing sphere of indirect instruments partly transmitting information and impulses of foreign markets (exchange rates and international interest-rate levels, loan maturities, etc.), of the state of equilibrium of the different domestic markets, and of the intentions of economic policy, in particular the ratio of individual, enterprise and central incomes (taxation, budgetary grants, etc.). Thus, the plan, economic policy, and the instrumentarium were meant to reckon with and react to the market.

An important tenet of the reform was the new interpretation of the system and order of interests in the bargaining processes aimed at compromise among different interests in the socialist society in Hungary. The former rigid concept drew up a strict hierarchy of national, collective, and personal interests. The new interpretation acknowledged a much more variegated pattern of interests embracing market competition, and other market and non-market (bargaining, etc.) forms of interest harmonization, in place of rigid subordination.

With the expansion of decisionmaking based on material or rather pecuniary interest, the activity and initiative of enterprises and their staff were to be encouraged and to lead to a rapid improvement of performance. Unfortunately, it was also assumed that energies released by the reform would lead to unemployment, inflation, or shortages, or would deflect commodity flows stipulated in bilateral trade agreements with COMECON to other markets. There were thus too many constraints on economic rationality. No changes were made in Hungarian policy on capital imports—loan capital or joint ventures with foreign equity. Last but not least, institutional changes followed the reform with a big delay (Tardos, 1985).

The absence of a banking reform can be attributed mostly to the tight constraints imposed upon economic rationality, which de facto excluded the application of a monetary policy and a businesslike allocation of loans for both working and fixed capital formation. Manipulated prices and, thereby, costs are not the best guides for allocation decisions based on business considerations. By maintaining unsuccessful enterprises, a number of credit applications get rejected, thereby, affecting both credit allocation and the money supply. Foreign trade quotas limit choices between inputs of different origins and outputs with different destinations. Those who did not support, or only reluctantly supported, the reform process considered the untouched monobank system a safeguard for predominantly centralized investment decisions through centrally managed long-term investment loans. NBH did not easily surrender its monopolistic powers and argued that "more banks only cost more but do not increase capital formation"; that a "multibank system does not lead to competition when credit will be scarce"; that a "multibank system with money creation by commercial banks is more inflation-sensitive than a monobank with the exclusive rights of money creation"; and that the "compartmentalizing of banking will be an obstacle to the full comprehensive view of the economy by a monobank."

Tardos (1985) writes:

> "After 1968, the National Bank of Hungary...has received an increased role in financial management, besides the National Planning Office, the National Office for Materials and Prices, and the Ministry of Finance. This role has remained, however, much more that of a central institution of control and management than that of commercial bank. It is characteristic of this situation that it cannot deny loans for development projects supported by government authorities and cannot stop granting working capital credit to enterprises whose solvency it no longer trusts....The Bank issues a quantity of money corresponding to the planned rate of inflation and reconciles it, not with a safe return of the money placed, but with the financing of economic aspect....It does not raise the rate of interest to insure against a demand for credit jeopardizing the stability of currency but applies credit quotas."

Nevertheless, meaningful changes occurred within the banks:

- Nonreimbursable investment grants were replaced by loans.

- Banks were required to filter credit applications, both passing a judgment on the project and on the creditworthiness of the applicant (even for the future lifetime of the loan-backed project).
- The same had to be done for loans on working capital, though without an immediate effect.
- Interest was paid on medium-term deposits of companies.
- More market-conforming, though not equilibrium interest rates were introduced (based on the costs of the resources of the bank).

Similarly, significant changes occurred in legalizing interenterprise credit and equity relations, and a small but rapidly growing bond market emerged. These measures made the work of the banks more businesslike and offered more choices to enterprises among sources of finance.

Debates on banking reform

While drafting legislation on economic reform the question of banking reform was an object of heated discussions. It was pointed out that in a socialist country either a single- or a two-level banking system may exist. A single-level banking system exists if the central bank is not solely a bank of banks, a lender of last resort, but one that maintains direct credit ties with economic units, handles their accounts, and fulfils their payment orders. In a two-level system, the central bank indirectly influences enterprise behavior through commercial and other banks.

The monobank system was not embodied in a single bank either in Hungary or in the other socialist countries. Only in Albania, Cuba, and Mongolia does a single bank carry out all banking functions. In the typical single-level banking system—in addition to the central bank, which grants working capital and investment loans and manages foreign currency operations—one usually finds one or more investment development banks, with or without short-term lending operations, deeply involved in investment activities; a foreign trade bank sharing external operations with the central bank; and one or more savings banks. Yet, each of these aforementioned banks is in a monopolistic position toward either a certain group of customers or a certain type of operations.

In the discussions of the future banking system, four models were put forward. Prof. Sándor Ligeti (1986), an eminent scholar of banking, summarizes the four types in the following manner:

> "In principle, the interrelationship of commercial banks in a two- or double-level banking system may be set up in the following ways. 1. There exists only a single commercial bank besides the central bank. 2. Commercial banks are specialized according to branches/subbranches of the national economy. 3. Commercial banks cover certain geographic regions. 4. There is no division of labor among commercial banks. Customers may utilize the services of any commercial bank; there is competition among the banks."

This latter type is featured in the same issue of *Külgazdaság* in an article written by the outstanding research fellow of the Institute for Financial Research, Lajos Bokros (1986).

> "...in order to arrive at all to a situation of competition it is necessary to have at least an overlapping of the spheres of customers and types of transactions of the credit banks."

Solution 1 is only a technical, I may venture to say, technocratic solution—technocratic, in the sense that there would not be control by competition over the single commercial bank. According to Ligeti, it would artificially create a monetary policy impact between the central and the sole commercial bank and a technical buffer-bank facilitating the rejection of "exaggerated" credit demand at an "outpost" of the central bank. Solutions 2 and 3 are purely continuations of monopolistic positions in new forms. An additional counterargument is given by Ligeti (1984): "these banks may easily become the representatives of particular interests." I think this is true, as branch ministries in the past and countries in the present are enviously representing the interest of economic units under their supervision to each others' detriment.

My view was to give interested state-owned and cooperative enterprises, savings banks, and savers (in the form of cooperatives), freedom to fund banks, provided they have the necessary capital and are able to "buy" banking expertise.[1] In this case, one could exclude the possibility of banks being established on a branch, subbranch, or territorial basis, but they would compete with banks with mixed clientele and transactions created "from above" in the reorganization process.

From the point of view of monetary policy, banks based on a branch or a territory would require individual monetary regulations because of differences in their deposit-collecting and loan-placing possibilities. These differences would be an obstacle to a general, normative monetary policy. For a short period, the German Democratic Republic and Bulgaria made use of branchwise commercial banking, abandoning it out of disappointment. I believe a similar type of banking was introduced in China in 1984. A radical change can come about only by adopting Solution 4, a system of competing commercial banks, which prevails in market economies and in Yugoslavia.

In this discussion, attention was given to the reorganization of the banking system. (The minor changes in 1970 didn't alter the essentials; they only regrouped certain activities among banks.) It was agreed that a further development of the economic control and management system and of the institutional framework would be required for a meaningful banking reform.

More than compromise blunted the reform and delayed the implementation of institutional changes (Ministry of Finance, 1984):

> "Initially the consistent practical enforcement of the principles of the economic reform was greatly hindered by the fact that central control could not always meet the functions efficiently enough, and a part of enterprises failed to meet new and higher requirements. Later the consistent enforcement of the principles of economic reform was hindered by unfavorable changes in the world economy, i.e. the readjustment of relative prices, the world economy recession, the recession of the capitalist economies, and their strengthening protectionism."

I might add to this the slowing of growth in the socialist economies, the unwillingness to change economic policy in our country by a restructuring of output in view of new cost and demand structures in the world, our investment structure in light of the latter, and the newly emerging competition by the so-called "threshold countries" in Hungarian markets. This led to a growing state subsidy to outdated branches and enterprises, and to a growing supremacy of

1. My opinion coincides with that of Mr. Miklós Pulai, the Deputy President of the Planning Office and a former First Deputy President of the National Bank of Hungary.

fiscal policy at the expense of monetary policy and sound credit allocation. Instead of taking into account these shortcomings of central economic policy, blame was placed on enterprise management (Ministry of Finance, 1984). A wide gap emerged, "between the reform rhetoric of the government and the conditions and process which took place" (Laki, 1985).

The resolution of the Central Committee of the Hungarian Socialist Workers Party on December 6, 1978, correctly determined that:

> "Enterprises and plants which are not profitable, the activities of which are not in harmony with the interests of the national economy, and which—among the given investment possibilities—cannot be profitable by the means of rationalization, might not be maintained, their losses might not be covered by state subsidies. In such case the state organs, helped by party and social organizations—as a last solution—have to determine and use their means for partial or total liquidation."

Central intentions were frustrated by ill-interpreted social considerations, and this delayed the adjustment process which should have taken place in utilization of capacities, capital and labor flows, and so forth. Instead, state subsidies weakened the norms of the regulatory system. The scope of authority of directive, administrative bodies (e.g., of branch ministries) increased at the expense of enterprise decisions—both unfavorable developments for businesslike decisionmaking by banks. A high degree of volatility of the regulatory system, especially of taxes, developed. The stability of the regulatory system "is especially important, so that economic organizations be in a position to adjust their business policies with the necessary foresight and be able to undertake obligations related to developments or to the raising of personal incomes" (Ministry of Finance, 1984). This development didn't tally with businesslike banking. Even in enterprises with the best loan-backed investment, changes in taxes or the exchange rate may have had a disproportionately bigger impact on their profits after taxation than any change in the market situation.[2]

Only in the late 1970s were substantial efforts made at modernizing the institutional system of economic control of enterprises and at correcting responses to the world economy in 1979 and 1982, giving rise again to direct interference by government agencies into short-term economic processes. Yet, with all the relapses, there was and is a process of development of the system of economic management and control. To a great extent, producer prices of industrial goods are adjusted to prices in international markets. At the same time, the range of prices determined administratively has narrowed. This was a major achievement of 1980, completed with the introduction of a uniform convertible currency exchange rate on October 1, 1981. Though the tax burden of enterprises increased, the autonomy of enterprises in the utilization of after-tax profits grew. In the financing of investments, the share of state grants not subject to repayment decreased considerably. These now affect only investment projects in infrastructure and a small number of particularly large investment projects. Channels for interenterprise capital flows as well as population-enterprise flows were opened.

Changes in the institutional and organizational system were of equal importance. In the late 1970s, large enterprises with monopolistic positions were split up. Corporations called trusts were not trusted any more, but eradicated, and enterprises earlier controlled by them received autonomy. In order to promote a

2. There was a monotonous revaluation of the Hungarian forint in the years 1968-81.

more flexible adjustment to market requirements, more than 200 producing and domestic trading enterprises were given foreign trade rights—especially for export—without the interposing of a socialized foreign trading company, dissolving the monopoly of the latter. New legal stipulations permitted the formation of various forms of small-scale ventures to encourage individual initiative and to adjust ownership forms to the scale of activity.

An important step was the amalgamation of three former branch ministries into a single Ministry of Industry dealing with industrial policy and not with the exercise of ownership rights. This has developed into a new division of powers between the authorities and enterprise managements concerning ownership rights and the exercise of the rights of the employer. Two new forms of management have emanated: enterprise councils and management by an elected management.

In banking, two joint ventures with foreign equity emerged: an off-shore bank (CIE) and a bank functioning under Hungarian regulations in forint (Citibank). A score of so-called developmental financial institutions has been founded, financing primarily innovative investment projects with a quick return by taking a stake in the capital and by granting credits.

Generally, and from the viewpoint of banking decentralization, the greatest event was Law-Decree No. 11 of 1986 on bankruptcy (euphemistically called "winding up") of enterprises. It also regulates the economic rehabilitation procedure and the creation of an Economic Rehabilitation Fund. These developments created the necessary conditions for the reorganization of the banking system.

The banking system after January 1, 1987

On January 1, 1987, the National Bank of Hungary was transformed into a classic bank of issue (a bank of banks and the lender of last resort) and a central bank (the bank of the government) retaining temporarily the management in addition to the regulation of foreign currency operations. Five commercial banks will be fully authorized for all operations (accounts, deposit, credit, etc.), except—temporarily—foreign currency operations and serving the population, which remain the domain of the National Savings Bank and the 260 savings cooperatives with more than one thousand branches, and perhaps a postal bank network. Initially, the five banks "bring" their original clientele. Within a year, clients may switch over to another bank with their account (house-bank) and/or may make use of the services of more than one commercial bank. The banks may also "pick" their customers and reject credit applications; they are only obliged to open an account for the client.

There is a major problem with the initial clientele (Bokros, 1986):

> "The five commercial banks bear branch features with their initial clientele. The Hungarian Credit Bank (*Magyar Hitelbank*) initially had a heavy machine and building industry bias; the Countrywide Commercial and Credit Bank (*Országos Kereskedelmi és Hitelbank*), an agricultural, food industrial, light industrial, and domestic trade one; the Budapest Development and Credit Bank (*Budapesti Fejlesztési és Hitelbank*), a broadly defined infrastructural one; the Foreign Trade Bank of Hungary (*Magyar Külkereskedelmi Bank*) carries, true to its name, a clientele with a marked foreign trading feature. The General Bank for Securities (*Altalános Értékforgalmi Bank*) didn't get an initial clientele."

Though this statement is relevant only to the headquarters of the banks and not to a significant degree to their branches in the provinces, nevertheless, there is more than a grain of truth in Mr. Bokros' anxiety. The biggest companies are financed at present by the headquarters. There is the danger of habit—habitual clients do not move. And the industrial or agricultural credit inspector will, perhaps, remain without a broader lending horizon and knowledge of opportunity cost. In any case, the initial "mix" does not foster competition. On the other hand,[3] enormous administrative difficulties were thereby avoided. The initial mix may not prove counterproductive if differences in size, network of branches, the composition of resources, and so forth, which give insuperable advantages, are minimized. Two banks—the Hungarian Credit Bank and the National ("Countrywide") Commercial and Credit Bank—have comparable assets, but the other three are lower by one or two orders of magnitude, and may take up major ventures only in syndication. Big assets go hand in hand with a big number of branches, though unevenly. The second biggest bank in assets has twice as many branches as the first one, the third one significantly less (46, 23, and 18, respectively) and the two others have none at all. The administratively determined mix brings major differences among banks also in deposit-coverage and the degree of central bank refinancing under its favorable terms.

There will be problems with the regulatory role because of the constraints put by NBH on money creation by commercial banks. Because of the big difference between credit/deposit ratios, a high and differentiated cash reserve ratio may be necessary—contrary to international experience. A major task will be the determination of the upper limit of refinancing, which probably will be determined as a multiplier of the banks' own capital, perpetuating initial differences. A big burden will lie on these instruments and rediscounting policy in the absence of open market operations due to a virtual absence of gilt-edged government bonds. Both company and local bonds are in circulation but are unsuitable for the task of monetary policy.

Last but not least, there is the standing of the central bank versus the government. In a planned economy, the validation of monetary aspects in the planning process is of utmost importance. There were proposals to raise the standing of the President of the central bank to the level of a member of government (a Central Committee membership would be desirable, too), or to subordinate the central bank directly to Parliament to have in the Bank a valid counterpart of, in the first case, ministers, and in the second, of the government.

Earlier, the small financial institutions mainly competed with each other with their expertise in different fields (innovations, patent and license protection procedures, etc.) as well as in their readiness to take risk through participation in capital. Nowadays, they have entered major ventures through syndication. There is a tendency to establish joint services for all the banks and financial institutions by joining forces as well as to set up an interest-representing organ.

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6

Feasible Financial Innovation under Market Socialism

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Over the last 30 years centrally planned economies, also known as Soviet-type or socialist economies or as instances of realized socialism, have often undertaken and to some extent implemented reform projects for the progressive expansion of the scope of markets at the expense of direct central allocation. From Yugoslavia to China, from Hungary to Poland and the Soviet Union, none of these economies with the possible exception of Albania has escaped this process; the very frequency of reform attempts indicates both the necessity and difficulty of changing the principles of operation of socialist planning, rather than simply introducing marginal improvements. Reform projects have included varying degrees of enterprise decisional autonomy, contractual relations instead of central allocation of materials and foreign exchange, direct access to foreign trade, workers' self-management, and reprivatization.

Economic reform in each case has implied also, sooner or later, a certain remonetization of the socialist economy. This paper reviews monetary reform, its latest developments and its systemic limits, and then considers the following questions. Take an imaginary closed economy where socialist central planning has been successfully reformed and converted to market socialism, but where the system's economic or ideological premises still preclude financial institutions such as private ownership of voting equity shares or a full-fledged stock exchange. Are there important functions in such an economy that might have been performed by the missing financial institutions? Could these functions be performed by already existing, permitted financial and other institutions? What kind of financial innovation might replace or simulate the functioning of the missing institutions? I will argue that the customary restrictions do not affect the possibility but hinder the efficiency of financial intermediation, and that secondary equity markets

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importance also under market socialism; that, nevertheless, market socialism could, in principle, replicate or simulate those functions without relaxing systemic restrictions. A three-stage proposal is put forward for financial innovation which ought to replace the missing institutions; here financial innovation is understood not only in the general sense of new markets, instruments, and institutions, but also in the technical sense in which it is used in current debates on capitalist financial developments, that is, of "banks' disintermediation" and of the economy's "securitization." The final section of the paper summarizes the arguments for and against the proposal.

It should be stressed that this is a purely intellectual speculation about the feasibility of potentially useful institutions, not a firm statement about desirable change. No market socialist model, however, can be deemed complete unless it considers and settles one way or another the questions raised by the missing financial institutions.

Reform and remonetization

A moneyless socialist economy, outside a distant full communism, was rarely suggested or practiced; Neurath's Naturalwirtschaft (1919), Soviet War Communism (1918-21) at its peak, or Cambodia in the early 1970s were exceptions. Lenin had understood the importance of banks as an administrative structure; his intuition and the necessary implications of central planning are reflected in the role of money in the traditional socialist model, which took shape in the USSR at the turn of the 1930s and was fully imitated in the other Eastern European countries (see Garvy, 1966).

In the traditional centrally planned model money is primarily an accounting instrument of aggregation and control; financial flows are compartmentalized between enterprises and households, with a bank money circuit for interenterprise transactions and cash for transactions involving households as buyers or sellers. These financial flows are adjusted passively to planned physical flows and to the degree of their implementation by a single bank monopolizing the functions of commercial as well as central banking (therefore dubbed "monobank"). Households are free to convert cash into available consumption goods, a small range of durables including some production goods, or save it as cash or a limited range of financial instruments (deposits, bonds, insurance, lottery tickets, etc.); the balance of revenues and expenditures of the population is closely monitored and ideally balanced ex ante through price and incomes policy; it forms the basis of cash issues. Enterprises can only use finance for purposes specified in plan documents; in this sense Berliner (1976) talks of "documonetary" economy. Investment is centrally decided and allocated in real terms while finance is provided automatically and interest-free from the state budget to investors, who are subject to straight-line amortization charges on the historical cost of their investments and transfer back to the state budget any surplus which they may realize (or rely on further transfers from the budget to cover their planned losses). Credit is mostly short term and is also automatically available to enterprises to finance their working capital requirements necessary to fulfill their planned tasks; it is granted by the Central Bank at an almost symbolic interest rate designed to cover banks' administrative costs. Trade credit between enterprises is forbidden. Thus money in the traditional system is a unit of account, two-tier medium of exchange conditionally to plan conformity, a store of value in competition with inventories of goods rather than with alternative

financial or productive assets. It is an instrument for economic management, except when planners lose control over financial balances, in which case monetary policy can be an important instrument for restoring that balance.

In the reformed socialist model (which still is not fully realized in any actual socialist economy) money recovers an important role (see Brus, 1964, for a pioneering detection and analysis of the early stages of this process in the 1960s; and Grossman, 1968). Financial flows become fully connected. Commercial banking is separated from central banking (as it was done in Britain with Sir Robert Peel's Act of 1844, which abandoned the principles of the banking school in favor of those of the currency school) and exercised by competing banks (as had been the case already in the USSR in the early stages of NEP; see Arnold, 1937; Carr and Davies, 1969). Investment grants are replaced by bank credits, interenterprise loans, and self-finance. Credit is provided not automatically but at the discretion of banks on a contractual basis and at an interest rate which is supposed to balance the market. Enterprises which are not deemed creditworthy can be forced into liquidation and bankruptcy. There is a wide range of financial instruments available to households and enterprises. Money becomes an unconditional and therefore more liquid means of payment, and a less attractive store of value because of a wider range of alternatives. The way is paved for active monetary policy, using standard instruments such as reserve and liquidity ratios, rediscounting scale and rates, open market operations, etc.

The role of financial markets and their possible features in a socialist system have been conspicuously neglected both in the classical literature on market socialism and in the blueprints for economic reform in Eastern Europe. Pareto (1902, 1903) stressed the imminence of economic categories such as capital and interest regardless of economic system (Vol. I, Ch. 6; a point made also by Bohm-Bawerk, 1909, Vol. I); criticized socialist thinkers for confusing the capitalist and the entrepreneur (Vol. II, Ch. 10) and Proudhon's monetary and banking scheme (Vol. II, Ch. 11) which, providing money automatically for productive undertakings at virtually no interest, closely resembles the monetary system of a traditional centrally planned economy. Barone (1908) expected the Minister of Production of his Collectivistic State to finance investment exclusively through loans at an equilibrium interest rate that matched the marginal return on investment. None of the proponents of "Marktsozialismus" worked out any system-specific arrangement for money and finance. The list includes, besides Heimann (1922 and 1934), who coined this term, Taylor (1928), Landauer (1931), Dickinson (1933), and Lange (1938; for a comprehensive survey of pre-War literature see Landauer, 1959). The same is true of more recent literature on socialist blueprints, except perhaps Brus' stress on the importance of money in the decentralized model of socialism (Brus, 1964). Nove's "feasible socialism" (1984) only mentions money to say that it must be there and never mentions financial markets. In the latest volume on "Rethinking socialist economies" (Nolan and Paine, 1986) financial innovation only goes as far as a new State Investment Bank. The development of monetary and financial institutions in the "reformed" socialist economies has simply imitated without change a few capitalist institutions.

Recent developments in socialist economies

Monetary and financial institutions perhaps are most developed in Yugoslavia where for a long time, especially since 1971, banking and credit have

been major instruments of macroeconomic management; there is a plurality of commercial banks, investment banks, and other financial institutions; and enterprises can lend to or have a share in other enterprises or even found new banks, or sell bonds to the public including individuals (see Dimitrievic and Macesich, 1973, 1983). However, in Yugoslavia these developments may be due to its specific systemic features, since income-sharing by self-managed enterprises is expected to favor financial intermediation at the expense of direct reinvestment of enterprise income (self-financed assets, unlike distributed income, cannot be appropriated by workers; see for instance Pejovich, 1976, and Furobotn, 1980). Moreover, an enterprise in which another enterprise has a direct share investment can pay it back at historical cost, so that what appears as equity is effectively a loan (see the Associated Labor Act, and Uvalić, 1987).

Leaving aside Yugoslavia, the most developed monetary and financial institutions can be found in Hungary, especially since the inauguration of the new banking system on January 1, 1987. The National Bank of Hungary has hived off its credit activities by transforming its lending directorates and some local branches into associated but separate banks, such as Innofinance, the National Commercial and Credit Bank, and the Credit Bank of Budapest (Budapesti Itelbank). These and other commercial banks are or soon will be operating, including the Hungarian Foreign Trade Bank, the General Banking and Trust Company, and three banks with substantial foreign participation (the older Central-European International Bank and Citibank Budapest as well as the new 45-percent foreign-owned Unicbank). There is an obligatory reserve ratio of 20 percent for demand deposits and 10 percent for time deposits. "To avoid multiple creation of outstanding reserves, deposits taken over from other financial institutions are exempt from the obligatory reserve requirement" (NBH, 1986). The discount rate, which until the end of 1984 was decided by the government, is now decided by the President of the Central Bank.

Bonds were first issued experimentally in Hungary in October 1981 for local authorities and are now regulated by a decree of the Minister of Finance of 1984, no. 28. Government, local authorities, financial institutions and enterprises (state, cooperative, and joint) can issue bonds subject to the approval of the Ministry of Finance. The State Development Bank is playing a major role in financial intermediation and operates a primary and secondary market for bonds issued by public utilities and other state enterprises.

There are two types of Hungarian bonds: those for sale to the population and those to state agencies. The first are guaranteed by the state (which defeats one of the purposes of financial intermediation, that is, the discrimination between different classes of borrowers with respect to risk), and are tax-free—the latter are not guaranteed and are taxed. The State Development Bank does about one-half of the underwriting. Prospectuses are available to investors and advertised. Bonds for the population are sold for cash over the counter, have bearer form, and can be retraded; most of them are listed daily by the State Development Bank to whom they can be resold. Dealings take place in a trading room in the Budapest headquarters of the State Development Bank, but there are facilities also in the provinces. The range of maturities at issue is 1-15 years, with yields of 7-15 percent, and an average of 11 percent on an average maturity of 7 years. There has been at least one case of performance-linked bonds, with interest of 9 percent increasing to 13 percent subject to the borrower's profit performance. These bonds are traded at various premia or discounts with respect to the price of issue. Average yield is presently 10-10.8 percent, compared with an interest rate of 11

percent paid by enterprises and of 9 percent paid on time deposits of comparable length. The typical investor (accounting for 80 percent of investment) is 50-60 years old. Bonds represent under 1 percent of the population's stock of savings; yearly turnover is about 10 percent the stock of bonds.

After Hungary, the socialist economy most advanced in its monetary and financial reform is perhaps China, where commercial banking has developed and the first experiments with financial markets are taking place (see Naughton, 1986). Most of the enterprises issuing shares are collectives or private enterprises whose employees buy the stock, but a few state enterprises are also experimenting with stock. Joint-stock companies are regarded as a mixture of the other three forms of ownership (state, private, and collective; see Sensenbrenner, 1987). A first stock exchange is reported to have been opened on September 1, 1986, in Shanghai. The official press has published regulations for bond and share trading in the southern province of Guangdong, where more than 1,000 companies have issued such securities. According to the official *Economic Daily*: "Buyers of shares will be the working public."[1] However this is still no more than a small-scale local experiment; in any case, shares are still illiquid (having to be held for substantial minimum periods) and do not carry a vote. It is significant that the Shanghai Stock Exchange had to be closed for weeks after its opening because all the bonds and shares had been "sold out";[2] if that market had been functioning properly, oversubscription should have led to intensive retrading.

The Polish reform project of 1981, which is still the official blueprint endorsed by the Party Congresses in 1981 and 1986, envisaged the creation of new, specialized, and fully independent credit institutions. Enterprises are to enter contractual relations with any one bank of their choosing, while the Central Bank is to acquire a new major role as institution of refinancing for other banks (KPZdsRG, 1981). Implementation to date in principle does away with automatic credit and relies on contractual relations between banks and enterprises. However, the National Bank of Poland still combines central and commercial banking functions and has virtual monopoly of credit, in spite of the birth (again on the fated date of January 1, 1987) of an Export Development Bank for the state sector. Legislation on state enterprises (September 1981) simply refers to "the bank." However, recently the chief Polish government spokesman, Mr. Jerzy Urban, is reported to have announced that Poland will soon offer shares to private citizens in several state companies: "Plans to start a classic stock market like London's have not been included in existing projects, but if there is a demand for it and if it proves necessary or suitable for the good of the Polish economy, we would not refrain from it."[3]

Recently it has been announced that Bulgaria is to follow the Hungarian monetary and financial reform by mid-1987.[4] If Gorbachev's economic reforms get off the ground in the Soviet Union, similar monetary and financial changes

1. *Financial Times*, October 15, 1986.
2. *Handelsblatt*, November 27, 1986.
3. *Financial Times*, April 7, 1987.
4. *Financial Times*, February 10, 1987, and *East European Markets*, February 20, 1987.

would have to be introduced, but so far there have only been unofficial intimations of such a possibility.[5]

Restrictions on equity ownership, control, and exchange

The introduction of monetary and financial institutions, instruments, and markets in the socialist model so far has not developed anything new, or system-specific. Well-tried capitalist practices simply have been grafted onto the socialist model, only on a smaller scale and subject to three important systemic limitations:

- the exclusion of national individual ownership of equity stakes in state enterprises, with the possible exception of China;
- in any case, the even stricter lack of provisions for shareholders' voting rights to influence managerial appointments, dismissals, and policies; and
- the lack of a developed secondary market even for the equity shares owned by state agencies.

It might be argued that these three restrictions on individual ownership, voting, and secondary exchange do not derive from the system's economic features but are purely ideological. From a purely economic viewpoint, the big divides are:

- whether or not individuals are allowed to save;[6]
- the payment of an interest on savings;
- the opportunity to take risk and the reward or loss associated with it; and
- whether or not private individuals or agencies are allowed to own means of production and to hire labor.

All extant models of socialist economy encourage individual savings, pay more than symbolic interest, hold lotteries, and pay profit-linked premia. Private enterprises—including joint enterprises also with foreign capital and even with a majority interest—are allowed in many socialist economies, such as Hungary and Poland. Once these systemic limits are exceeded, restrictions on individual ownership and control and the lack of secondary retrading of equities appear to be rooted in the ideological rather than economic principles of the socialist system. Nevertheless, regardless of their causes these restrictions are an integral part of "realized socialism" everywhere; they are hardly dented by the Chinese experimental reform, and given the usual implementation lags they can be expected to continue to apply for the foreseeable future.

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5. Witness an interview with Leonid Abalkin in *East European Markets,* February 20, 1987, where specific reference to the Hungarian and Bulgarian model is made, and an interview with Abel Aganbegyan on Italian TV on March 15, 1987. See also Petrakov, 1987, who specifically indicates the replacement of automatic credit with enterprise creditworthiness, a time structure of interest rates, and profit-oriented and competing "special purpose" banks, though still subject to the "leading role" of Gosbank.

6. Joan Robinson used to say that the reward of abstinence is first of all the ability to keep what one abstains from consuming.

The rest of this paper considers:

- the implications of these three restrictions on equity ownership, control, and exchange for the efficiency of market socialism; and
- the possibility of performing or simulating, in that model, the functions which in a capitalist economy are performed, or at any rate should be performed, by capital markets with unrestricted ownership, control, and trading of equity shares.

Financial intermediation and secondary markets

It is useful to distinguish between the functions of direct (that is, primary) financial intermediation and of secondary trading in securities (which is thin or partly missing for shares under market socialism). Financial intermediaries basically match lenders and borrowers, the short- and long-term ends of the market, and pool or share risks. The issue of new bonds and shares pertains to these functions and can be performed regardless of the existence of a stock exchange as a secondary market, though of course the anticipation of after-issue prices in such a market when it exists is an important determinant of issue prices. In the absence of secondary retrading, financial intermediation would consist exclusively of the issue of new bonds and shares which, as Keynes once advocated out of concern for speculatory instability and the liquidity trap, would be tied to their purchasers in an indissoluble marriage-like contract. Financial intermediation could still be performed, but with two major disabilities. First, over time on average, the resulting illiquidity of financial assets would make them less attractive to potential lenders/investors so that intermediation would take place presumably on a smaller scale and at higher cost to borrowers/issuers—that is, less efficiently than if a secondary market were allowed. Second, speculatory instability would be replaced by yields instability in a thinner market where old stocks are not substitutes for new issues. Borrowing on the security of nontransferable bonds and shares, or small-scale retrading as in the case of unlisted securities, reduces but does not eliminate completely these disabilities and the ensuing inefficiency.

Thus, the first function of secondary markets is that of continuously "liquidizing" both bonds and the real assets embodied in shares, which would otherwise remain illiquid, introducing the possibility of divorcing investors from their long-term investment. This represents a considerable financial inducement to save and to place savings in bonds and shares rather than in inventories and cash, which would be otherwise a more liquid alternative in spite of their actual (storage) or opportunity (forsaken interest) cost. This is an important function in present-day socialist economies, reported to be in a semipermanent state of excess demand (Kornai, 1980; see also Nuti, 1986), not only for individuals if shares were to be made available to them, but for enterprises which could be cured at least partly of their hoarding habits and of their "soft budget" syndrome (diagnosed by Kornai, 1980). An enterprise with access to liquid investment in other enterprises, in fact, would find hoarding of both materials and cash more costly than without such an access.

Another function of secondary markets for shares and bonds is that of providing a current valuation of enterprise financial liabilities and above all a valuation of sorts of any listed company as a going concern—that is, a current valuation of enterprises' net physical and financial assets in their current use

and under the existing management and the actual policies pursued. Together with the dividend record of a company, this valuation and its trend give an indication of past performance and prospects. A corollary, which could be viewed as a separate function, is that of bringing the current valuation of an enterprise as a going concern close to the maximum value, net of liabilities, that the enterprise's productive assets could have if redeployed elsewhere in the economy or employed in the same activity under a different management and/or policy. If this were not the case, an incentive would appear for another company or group to acquire a controlling interest and gain from a change of management and/or policy or even the liquidation of the company regardless of the wishes of the existing management. This function, which the stock exchange in capitalist economies often does not perform sufficiently or performs only too well (as witnessed by factory closures, asset stripping, and insider trading as well as turbulence in financial markets) is very important for bringing managerial capitalism somewhat closer to the traditional capitalist model in spite of the separation of ownership and control (Marris, 1964; see however the reservations expressed by Stiglitz, 1985).

There can be no doubt that these functions, whether or not they are well performed in a capitalist economy, if at all, are extremely important in a "market socialist" economy where production and trade are decentralized to enterprises, and "monetization" has been introduced successfully. A continuous evaluation of assets is needed to assess performance by adding to (deducting from) current distributed profits the increase (decrease) in the value of capital assets used by enterprises; this is preferable to arbitrary and debatable (especially if there is inflation) accounting conventions for the determination of an appropriate capital amortization allowance to be subtracted from gross profits. Such valuation is also necessary in order to assess the prospective profitability of enterprise activity, as opposed to profitability calculated on the historical cost (even if properly corrected for amortization) of the enterprise's capital assets. If the ratio of prospective profitability to the current value of assets is lower than interest rates applicable over the period, there is a case for considering enterprise liquidation and redeployment of assets even if prospective profits are sufficiently high with respect to the historical cost of the enterprise's capital assets. These functions are particularly important at times when a productive structure that has become inappropriate to current conditions is being "restructured" in order to indicate the desirability of continued operation versus redeployment and to put all enterprises on an equal footing when performance indicators are used to determine managerial and staff bonuses, profit retentions, and creditworthiness. Polish planners, for instance, have expressed a preoccupation for giving all enterprises "equal chances" with the introduction of economic reform, whereas historical valuations of enterprise assets normally are a biased basis for calculating profitability as an indicator of current and prospective performance, except in the unlikely case that ex post profit rates happen to be uniform and equal to their planned levels throughout the economy.

Suppose an enterprise expects to be able to use the assets of another more productively if it could take them over and use them in a different sector or simply change its policies or pursue the same policies with greater efficiency. Suppose also that the first enterprise has the financial means to acquire the second, or it can persuade other enterprises or credit institutions to lend the means to acquire it. The ability of the first enterprise to take over the second simply descends from competitive entrepreneurship and not from capitalism as a

system of ownership. Once state enterprises are transformed—as reform projects state to be the intent—from administrative agencies into competing profit-minded and decentralized agencies, it makes no sense to give them a de facto monopoly in the use of the productive assets which they happen to possess. That monopoly is already broken when a loss-making enterprise is liquidated or goes bankrupt (for instance in current Polish legislation), as in that case its assets and liabilities can be taken over by another enterprise or be dispersed among a number of enterprises. At present, however, managers of state enterprises—both in capitalist and socialist systems—are protected from "unfriendly" takeovers by groups acquiring a controlling share interest. Yet without this potential threat managers can afford to be inefficient and monopolistic, and there is no competitive mechanism which might redeploy efficiently existing assets, in view of the rarity and at any rate the imperfection of markets for used productive assets.

The question is, therefore, how can these functions be performed in economies which, rightly or wrongly, do not allow individual shareholders to have a vote or possibly even to exist, and which do not, in any case, wish to recreate the large-scale logistic apparatus of a stock exchange.

Existing instruments and institutions

The valuation of capital assets could be undertaken as a centralized task or market service within the framework of the respective model. We could imagine a State Committee of Experts for the Current Valuation of Capital, enlisting accountants, economists, and engineers, sitting in the capital city and issuing an official valuation of all plants, buildings, and land in the whole country, officially applicable from January 1 of the base year, revised periodically or on request. Information costs and "moral hazard" make this impracticable; we can presume that if central planning were capable of performing this kind of task speedily and accurately, it would not need reforming, since the information required for such task is the same as that required for the efficient management of the planned economy—that is, data about current and future resource allocation and prices.

Alternatively, we could imagine a private or state brokerage agency (as suggested by Manuel Hinds) which, for a fee, would seek better uses for existing capital equipment and locate redundant equipment to fill existing needs. Such an agency, or a number of them in competition, however, would be limited to consensual redeployment of existing assets, and would not perform any disciplinary role on enterprise management.

Starting from a Hungarian-type environment—that is, public shareholders and commercial bank competition—perhaps the most promising development which could be imitated from Western experience is that of German bank involvement in the management of enterprises. The special feature considered here is not the mixed nature of German banks, operating both at the short and long end of the market, but their intimate involvement in the management of industrial companies: through the appointment of representatives to the Boards of borrowing firms, through direct shareholding (found to be 9 percent of share capital in a study of 74 representative quoted companies by Eckstein, 1980) and above all through proxy voting on behalf of those shareholders (by and large the majority) who have lodged their shares with their banks (see for instance Cable, 1985a and 1985b). This institutional pattern was introduced as a consequence of the underdevelopment of capital markets in Germany in the late 19th century and

is naturally suited to the rudimentary capital market of a country like Hungary. Public shareholders, possibly also private shareholders without voting rights, could entrust competing commercial banks with the task of overviewing their companies and monitoring and promoting their profitability.

However, the merits of German-type supervision of industry by banks are controversial. The system has come under strong criticism recently, especially in Germany (Gessler Kommission, 1979; Eckstein, 1983; Vittas, 1983). The system is widely regarded as a second-best option; the dominating role of banks in the stock exchange is resented, especially in view of conflicting interests vested in different functions of banks as lenders, shareholders, and advisors to investors; their emphasis on short-term performance; and the dangers of monopolistic practices (which have attracted the attention of the Monopolkommission, see Cable, 1985a). It is no accident that German bank legislation explicitly prohibits any transmission of inside information by bank representatives on company boards to their own bank or primary employer, or to any other party.[7] Werner (1981) suggests that bank officials are well aware of their sensitive position and comply with these prescriptions; Lutter (1981) emphasizes that bank appointees on company boards are subject to the mandate to exclusively promote the interests of the company supervised. Thus the kind of board behavior that is supposed to give banks direct control over their borrowers is actually illegal; control must rely on banks' shareholding and proxy-voting. (Fitzroy and Kraft point out that the main role of bank representatives in the supervisory board, or Aufsichtsrat, is to approve annual financial statements and to appoint members of the management board (Vorstand); only at times of crisis, such as the recent near-collapse of AEG, is there any direct involvement by bank representatives, while a strong bank presence in the Aufsichtsrat of AEG did not help reveal the build-up of the crisis until it was almost too late.) Moreover, the German system generates a certain insulation between the real world of production and the world of financial values, which prevents the fulfilment of the function discussed above, of stimulating efficient redeployment of assets.

For these reasons, and as an end in itself, let us explore further the range of permissible financial institutions under market socialism. What follows is an intellectual experiment understood as an exercise in consistency between the premises and existing models of market socialism, not a statement about the relative merits of markets versus plans, private versus state ownership, or of alternative models of socialism.

Stage I: Capital evaluation and interfirm mobility

Imagine a successfully reformed and remonetized socialist economy where enterprises are engaged in production and trade through contractual relations with other state agencies, while planning is confined to macroeconomic policies and truly parametric (that is, non enterprise-specific) instruments for the central manipulation of market signals. Sectoral policies can be undertaken by the

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7. See Articles 93 and 116 of the Aktiengesetz. Article 404 treats any break of confidentiality by bank representatives as liable to prosecution as a criminal offence. I am grateful to Felix RitzRoy for drawing my attention to these norms and for providing the next references quoted from an unpublished paper by FitzRoy and Kornelius Kraft.

government, but sector-specific subsidy or tax differentials must be applied by the government consistently and predictably. Suppose the following steps are implemented:

1. Enterprise managers are asked to assess the current value of their productive assets, as a whole and for specific components (such as individual plants) exceeding a certain ceiling, and to register it with a central public record office. If managers do not provide such a valuation by a given date, the central record office automatically enters the book value of enterprise assets. (Yearly book values are already publicly available in Poland for the top 500 manufacturing enterprises and the top 300 state farms.)
2. At any subsequent time any other state enterprise can bid for the enterprise's productive assets, as a whole or for a specifically listed plant or other large item. When this happens, either the challenged enterprise revises upward the valuation of its assets to the point that the request to purchase is withdrawn, or has to sell at the highest valuation offered. If the bid is for a section of the enterprise assets, the enterprise can link it to other sections but has to prove that there is a technological connection between the two sections. If there is a sale, sale revenue is first used to satisfy creditors; any remainder is retained by the enterprise unless it has sold all its assets, in which case any net residual value is transferred to the enterprise's shareholders. (In their absence, Branch Ministries, defined as "founders" in Polish law, could take this role.)
3. At any time the enterprise can alter its capital valuation registered with the public records office, raising it as new capacity comes on stream or as the profitability of its products increases, or lowering it in consideration of wear and tear, obsolescence, or falls in the profitability of its products.
4. Any increase in the valuation of the enterprise's productive assets recorded spontaneously by the enterprise, or as a result of a bid for its assets (whether failed or successful) in any fiscal year, net of any change in its financial assets and liabilities, is regarded as part of net profit (and any fall as a loss) to be added to (or deducted from) the enterprise's distributed profits. (Any deduction for amortization becomes a purely internal reallocation of funds in compliance with accounting conventions, but no deduction for amortization is needed to calculate net profit once the change in the current value of enterprise assets has been estimated and added to dividends. Whether profits distributed to workers should or should not be included in this notion of profit depends on whether the workers' profit share is or is not regarded as part of workers' basic income.)
5. Unsuccessful bidders are paid by the enterprise a small commission on their raise over the last previous bid (or over the initial value for the first bidder).
6. A tax is charged on any increase in the value of the enterprise's net assets due exclusively to a revaluation of existing assets, at a tax rate higher than the tax on operating profit. Alternatively, or at the same time, any profit-rate-linked bonus for managers and staff is calculated at a lower rate for that part of the enterprise profit which is due to the revaluation of existing assets.

Enterprise managers have an incentive to understate the value of their assets to avoid paying tax on capital gains or to obtain in the future higher profit-rate-linked bonuses; but a limit to their wish to understate is set by the positive though weaker impact of capital gains on current bonuses and, above all, by the danger of encouraging other enterprises to consider taking them over. The two opposite incentives do not necessarily cancel out, inducing mangers to reveal their true assessment of capital values, but their deliberate distortions will be contained

within a range which can be narrowed by manipulating bonuses and tax parameters.

The arrangements outlined under Stage I have the advantage of providing:

- a continuous, nonbureaucratic, decentralized, and automatic evaluation of enterprise capital, necessary to assess past performance and guide current allocation;
- a mechanism for intersectoral and interfirm mobility of physical capital, necessary to ensure its efficient use; and
- an incentive for enterprises to use their capital equipment in the way that maximizes their valuation and a disincentive to invest in ventures which might reduce the net value of their assets.

Thus some of the tasks usually expected of a capital market are performed here without a bureaucracy and with a minimum of financial innovation without touching at all the systemic constraints of "realized socialism."

Stage I is similar to a proposal by the Hungarian economist Tibor Liska (see Liska 1963, 1986a and 1986b; MacRae, 1983; and Barsony 1982). In Liska's "entrepreneurial socialism," however, individuals use the guaranteed income out of their share of social capital to bid for the rental of production goods, renting them if successful or encashing from successful bidders the amount of their unsuccessful raises, surrendering at death their original capital stake and its accretion. Here state and private enterprises bid for the purchase of larger chunks of productive assets, if unsuccessful keeping nothing or at most a small percentage on their raises. The differences between the two schemes are substantial; ultimately they only have in common the permanent state of insecurity of enterprise managers, continuously exposed to the challenge of potentially better users of their enterprise's assets. Kornai criticizes Liska for exposing managers to this kind of insecurity (Kornai, 1982) but no competitive behavior and profit-mindedness—and therefore no hardening of Kornai's alleged "soft-budget constraints" (Kornai, 1980)—can be expected of managers without introducing precisely this kind of insecurity.

A limitation of Stage I is that it forces managers to utilize their assets as profitably as they could be used in their best alternative use outside their firm and not up to the maximum profitability that could be obtained in the firm, and which only they are likely to know. Stage I can, at most, bring the valuation of an enterprise's capital up to its maximum value obtainable outside the enterprise. If enterprise capital is not easily redeployable elsewhere, that is, if it is highly specific or immobile, the possibility remains of its management using it inefficiently undisturbed or exploiting monopolistic power. The same snag would apply to Liska's proposals. Stage II is designed to overcome these difficulties by introducing voting shares but maintaining the systemic constraints of excluding private individuals from share ownership and voting control and of avoiding a large-scale secondary market.

Stage II: Share capital evaluation, exchange, and control

Stage II is composed of the following steps, preferably but not necessarily taken after Stage I is completed:

1. State enterprises are requested to declare and record in a public register the current market value of their physical assets (hence the desirability of Stage I

to ensure a realistic assessment of current value), financial assets, and liabilities (which could be audited and evaluated at the time of the declaration, subject to the same external bidding in case of divergent views about interest rate trends), and thereby their estimated net worth.

2. The enterprise founders (branch ministries if there are no others) are then issued a number of shares, each of a nominal value of, say, (for Poland) 100,000 zlotys with a total capitalization equal to the enterprise's estimated net worth.

3. Thereafter the enterprise can, at any time on its own initiative, raise or lower the valuation of its net worth, thereby altering the current value of its shares. In practice the enterprise simply announces publicly a revised value of its shares, without reference to its founders as initial shareholders or to subsequent shareholders.

4. As long as they are shareholders, founders can *ex officio* raise or lower the valuation of the enterprise shares. However, founders must sell the shares in their possession to any state agency (productive enterprises, banks including the central bank and financial institutions, pension funds, insurance companies, etc.) wishing to buy them at the price decreed by enterprises or revised by themselves. The shares so acquired by state agencies are managed by them as owners and not by their own founders; the government can repurchase those shares if they are offered for sale but it can only do this via the central bank or through a special State Holding Company, not through the original branch ministries as founders. In this way share transfers implement automatically a decentralization process which progressively divests ownership and control away from central sectoral bodies, however without violating the principles of public ownership since the transfers do not involve the private sector or private individuals. Founders transfer the proceeds of their share sales to the state budget; government policy can affect share prices in such a way as to reduce or raise the liquidity of state enterprises, as it happens in capitalist economies as a result of open market operations.

5. State agencies wishing to purchase or to sell the shares of an enterprise at the price published by enterprises or revised by shareholding founders address their request to the enterprise itself (hence the avoidance of a large-scale centralized market). If a net excess demand or supply of shares arises at those prices, if it is small relative to turnover—say, 20 percent—it is handled through proportional rationing (as in the case of oversubscribed issues of capitalist companies). If it is large relative to turnover but small relative to the total stock of the enterprise—say, 1 to 5 percent—a waiting list is used. Otherwise, alternative procedures are followed for excess demand or supply.

6. If, once the enterprise founders hold no more shares, a net excess demand appears, the enterprise must either accept the surplus bids and issue additional shares at the published price, or raise the valuation of its shares upward by small predetermined discrete steps until the excess demand disappears. (If at some point excess demand turns into excess supply, the price last quoted is regarded as an equilibrium price though bidders are rationed, regardless of the size of the latest excess demand relative to either turnover or total stock.)

7. If at the self-assessed share price of an enterprise there is a net excess supply of shares, beyond the tolerance limits indicated above, the enterprise may choose to reimburse the excess shares at that price but is highly unlikely to do so unless it is particularly liquid and the management is far more confident of the enterprise's profit prospects than existing shareholders. Alternatively the enterprise can and, more probably, will lower the value of its stock until the

excess supply of its shares disappears or turns into a small excess demand, at which point as in the previous case bidders either are in equilibrium or are rationed at a price treated as the equilibrium price.

8. Each share carries a voting right, exercised at yearly meetings of shareholders, or more frequently at special meetings if they are called by a substantial fraction of total shareholders. At those meetings the performance of existing managers is discussed; current policies and future plans can be revised and limits imposed on management or distribution to shareholders; and managers can be dismissed and appointed. If shares are sufficiently dispersed, a controlling interest can be acquired with a fraction substantially lower than the majority of shares. The potential threat of hostile bidders taking over a controlling interest will exercise some restraining influence on managers otherwise tempted to stray from the straight and narrow development path of efficiency and concern for shareholders' interests. In general, there can be no effective market or quasimarket for shares without the attachment of voting rights to shares, because otherwise there is no shareholders' protection against managerial inefficiency or simply lack of initiative or imagination; at a time of transition from centralized commands to decentralized enterprises the voting provision is even more necessary.

9. As in Stage I, the change in the market valuation of the enterprise is an element to be added to distributed profits for the assessment of managerial performance. In Stage II, however, the possibility of managers deliberately overstating the value of their assets is ruled out by market discipline (that is, by the appearance of excess supply of shares at artificially inflated asset values) so that there is no longer a need for a tougher tax treatment of the appreciation of enterprise assets.

10. The operation of this kind of secondary market for shares is not only fragmented and decentralized to each enterprise, but is also intermittent to a greater extent than the capitalist stock exchange as we know it. The secondary market envisaged here is best thought of as opening and shutting once a day, or a week, or even a month, to handle the bids received since the previous closure. To iron out the effect of this type of discontinuity (qualitatively no different from the closure of capitalist stock markets outside opening hours and working days), it is best to conceive buying and selling bids not as single-valued quantities at the previously announced price, but as indications of alternative quantities bought or sold at alternative prices in the neighborhood of that price; or more simply as indications of reserve prices below or above which the bid is revoked.

The combined outcome of all these arrangements is a kind of "slow motion" stock market, however, with all the features necessary for its vitality, namely: competitive bidding, negligible indivisibilities, and restraint of managerial discretion. Stage II can be introduced gradually. It does not violate the principles of public ownership. It does, however, dissolve the sectoral centralization built into branch ministries, thus preparing the ground for their abolition, but it preserves instruments of central government policy, both macroeconomic (through open market operations of the central bank) and sectoral (through the activities of a new State Holding Company). In principle, it cannot be said to be potentially better or worse than the capitalist stock exchange as we know it, except for the exclusion of private individuals. This matters not only because of individual exclusion from a range of enrichment opportunities, which is bound to have a discouraging effect on personal savings, but because the exclusion makes the secondary market described unresponsive to information, beliefs, and

expectations diffused throughout society at large. The additional provisions introduced in Stage III are designed to remove this limitation.

Stage III: Individual indirect participation without ownership or control

The exclusion of private individuals from direct ownership of shares in productive and financial state enterprises (investment trusts, common funds, and so forth) is not an insurmountable obstacle to individual participation in either risk-bearing or control. Risk-bearing without ownership is already present in capitalist financial markets through options trading as well as "bets" on the movements of major financial indices; with appropriate modifications these institutions could be grafted onto market socialism. One could also add a new institution, namely the indexation of deposits and loans to the cumulative performance of a share inclusive of the reinvestment of dividends, which would produce the same results without the leverage effect and therefore speculative dangers of options and "bets." The idea is that one or more state agencies should buy and sell options, take bets, make loans or take deposits, at prices/odds/rates such that individuals could gain from spotting above average and below average performing enterprises or lose from their failure to do so, if they wish and on the scale they wish to expose themselves to risk. If, in addition, a mechanism was introduced to ensure that individual "investment" choices had an impact on share prices, individuals would be exercising, indirectly, some influence both on managers (threatened by takeover if policies unwanted by the public depress share prices) and on investment allocation (since enterprises popular with the public will register higher share prices, thus facilitating their raising of capital through share issues). Let us consider first the three alternative modes of risk-sharing without ownership and the pricing formulas associated with each, then the question of indirect control.

1. An option is the right to buy (call option) or sell (put option) shares (or anything else) at a specific price (the striking price) before a specific date at which the option expires. Normally, however, when an option is exercised by its buyer/owner it leads to a payment by its seller of an amount corresponding to the difference between the striking and the spot price of the amount of shares involved, rather than to the actual purchase/sale of that amount of shares at the striking price (especially if a share purchase had to be followed by an actual sale for the realization of profit from the operation). The option transactor thus incurs risk and is exposed to uncertain benefits or losses without acquiring ownership (see Cox and Rubinstein, 1985).

However, a share option market is not enough for a market socialist economy where Stage II of financial innovation has been realized: options trading in capitalist markets is not purely speculative but plays a major hedging role for share owners, so that nonshare-owning individuals would not be present in large numbers on that market. But suppose that a state agency, possibly the State Holding Company that actually owns shares on behalf of the government, is given the statutory obligation of issuing or buying call or put options. Let us say that call options are traded for a striking share price equal to the current share price and are sold at a price equal to the market rate of interest which would mature over the period on the current value of the shares involved, while dividends, if any, paid before the option expires accrue to the buyer of the call option. In this way the individual "investor" buying the option, in spite of having

no access to the secondary market for shares, breaks even if the rate of return (including distributed and reinvested profits plus capital appreciation) is equal to the interest rate, gains exactly to the extent that the enterprise shares perform better, and conversely loses up to 100 percent of his investment, if the enterprise shares perform worse than the going interest rate. Or, for example, let us say that the price of put options is set at the same level as for a call option, but the striking price is made equal to the current value of shares plus twice the market rate of interest over the period. Here the option buyer will lose up to 100 percent of his investment, if the selected enterprise performs better than normal, but will gain to the full extent that the enterprise performs worse than the market rate of interest. (Discipline of individual transactors might require that any option price paid by the State Holding Company for options sold by the public should be deposited into a special account as a guarantee to cover the investor's possible losses.) Thus, from the point of view of individuals, access to options trading is as good as access to share trade and ownership.

2. An alternative or additional provision enabling nonowner individuals to participate in stock value gains and losses is the ability to bet fixed amounts of money on a share, or an index of share prices, moving in a specified (upward or downward) direction within a prearranged time. In the simplest version of this game, the stake would be either lost or doubled, according to whether or not the share or the index moves in the predicted direction; more interestingly, losses and gains could be made proportional to actual price changes. For instance, someone betting 1,000 forints that a given share will rise would lose his stake if the share does not move (within small bounds), will gain 1,000 forints for every percentage point increase, or lose 1,000 forints for every percentage point fall registered (outside the same small bounds) at the time the position is closed by the betting individual within the stipulated time. This type of opportunity is available to investors in capitalist economies, and is indeed favored by tax treatment being more lenient for betting wins than for capital gains on share trading. For instance, one can bet on the Financial Times index of London share prices, or on the rate of exchange between dollar and sterling. The extension of this facility to enterprise shares would, as in the case of options trading, give individuals the opportunity to benefit fully from their ability to predict movements in share prices in spite of their lack of access to share trading.

3. The only disadvantage of options and bets on enterprise shares, from the viewpoint of the socialist economy, might be the leverage involved in both institutions, which enables individuals to notionally move masses of shares at a fraction of their market value. To discourage the speculative implications of options trade, which very often rightly or wrongly come under strong criticism also in capitalist economies, it might be necessary to stipulate that individual traders should, simultaneously with their options transaction, deposit with the Central Bank or with a specialized bank an amount corresponding to the total value of the shares on which they are trading options. The combination of compulsory deposits with either options trading or share bets, however, is equivalent to lending and borrowing operations indexed to the price of shares, with reinvested dividends computed into the index. If, as is likely in socialist economies, speculative opportunities are not encouraged, this type of indexation is the simplest financial innovation necessary to expose individuals to the effects of a stock exchange in which they are not allowed to trade shares. Taking a loan indexed to the price of a share and depositing the amount at the normal rate of return; betting that the share price will fall; purchasing a put option or selling a

call option—all are equivalent strategies, given the pricing criteria selected above for these alternatives for individuals believing that the share of a particular enterprise will perform below the going rate of return. Conversely, a deposit indexed to the price of a share; a bet that its price will increase; the purchase of a call option or the sale of a put option—again are equivalent strategies for individuals convinced of the above-average performance prospects of a particular enterprise share.

All three systems, which could even coexist, presume the existence of one or more specialized state agencies respectively issuing or buying options, or taking bets, or taking or making loans indexed to share performance. If these agencies acted passively they would only undertake those transactions requested by individuals and suffer or gain from the accidents of the aggregate good or bad judgment of individual investors; the obstacle of no individual ownership of shares would be overcome but individuals would have no influence on share market values. The share trade of state agencies would be totally insulated from individual beliefs, information, and preferences. This confirms that the envisaged financial innovation is compatible with total retention of state control—through state enterprises and specialized agencies—over the economy. At the same time, if the public at large disagreed with the government about the relative merits of specific sectors and enterprises, and the public were right, as long as compensatory subsidies and tax changes were prevented the government would be specifically penalized—through the net losses of its agencies transacting options, bets, or indexed loans with individuals—for having disregarded the indications coming from the household sector. What is more, the government would be penalized precisely in proportion to the intensity of disagreement between its agencies and the public, measured by the volume of transactions in share options, bets on share price trends, and loans indexed to enterprise performance. Therefore, even a passive position on the part of the state agencies transacting with the public would produce information, penalties, and rewards and therefore an incentive to respond to the public's convictions.

At the other extreme of possible responses, the new specialized agencies could respond instantly and fully to the individuals' choices as investors, offsetting their net exposure in transactions with individuals through balancing purchases and sales of shares, which they, unlike individuals, are allowed to undertake. In this way, the specialized agencies would make neither profits nor losses from share movements, covering their running costs on average out of commissions on their transactions, but would transmit speedily and fully to the exclusively public trade of shares the wishes, beliefs, and convictions of the public at large.

Summary and conclusion

The recurring attempts at reforming central planning in socialist countries have been accompanied by measures of remonetization of their economies. This process has gone furthest in Hungary, with the separation of commercial from central banking functions of the National Bank, the establishment of competition in commercial banking, primary and secondary trading in bonds issued by state agencies and enterprises and available to the public, and equity shares tradable among state agencies. However, the development of financial institutions has found everywhere, in practice, three systemic constraints, namely the lack of private ownership of equity shares or, in any case, of voting rights associated to them, and the inadmissibility of a large-scale secondary market for the retrading

of equity shares. This paper considers the implications of these constraints for the efficiency of market socialism and the possibility of producing the same effects with existing instruments and institutions.

Restricted ownership, control, and retrading do not impede completely financial intermediation under market socialism: lenders and borrowers, short and long ends of the markets can still be matched, and risks can be pooled or shared. The systemic constraints, however, prevent the exercise of three important functions of a stock exchange: the liquidity of investment in equity shares, the lack of which is a disincentive to save; the valuation of enterprises as going concerns, which is needed to assess past performance and to plan future allocation; and the ensuing mechanism for redeployment of productive assets via mergers and takeovers, which in a capitalist economy does not even require the consensus of the managerial groups involved (for instance, in the case of hostile takeovers).

These functions, which are important also for market socialism, could be performed by existing types of institutions: a centralized State Committee, which however would reproduce the drawbacks of central planning; a brokerage agency, which could only operate if there were consensus among different managerial groups; a German-type banking involvement in the management of firms (through membership of boards, direct shareholding, and proxy-voting), which however is subject to criticisms for its internal conflict of interests and monopolistic tendencies. For these reasons, and for its own sake, the possibility is explored of alternative and innovative financial instruments and institutions.

A three-stage scheme is outlined. In Stage I, state and private enterprises are allowed to bid up the valuation of existing productive assets—a challenged enterprise having to either release or revalue its assets—thus ensuring the potential mobility of resources toward their most productive uses outside the enterprises that possess them. Tax and bonus provisions would encourage truthful reporting of asset values; indivisibilities are dealt with by introducing joint bidding for technically joint productive assets.

At Stage II, an intermittent stock exchange is suggested, decentralized to individual enterprises and with share ownership reserved to state agencies, also on the basis of the "challengeable self-assessment" principle. The valuation of underlying assets and liabilities associated with Stage I provides a practical underpinning of market valuation of shares, but Stage II could also function on its own, with enterprises and institutional investors (insurance companies, pension funds, etc.) as shareholders.

At Stage III, individuals are allowed to benefit from their ability to identify above- or below-average performing enterprises in spite of being excluded from ownership and control. This is done by means of loans (equivalent to a "bear" stance) and deposits (equivalent to a "bull" stance) indexed to the cumulative performance of any enterprise share, on any scale; it could also be done by a system of options and/or bets, though these would have the disadvantage of speculative leverage. Stage III is compatible with any degree of government interference with the economy, as long as this is consistent and predictable. That is, the government could pursue its own industrial policy regardless of the indications of individuals' positions in the market for options/bets/indexed loans—and be penalized if individuals are proved right in the aggregate—or transmit fully individual positions to the limited stock exchange of Stage II, thereby simulating much more fully the operation of a conventional capital market.

The simulation of a stock exchange in a "market socialist" economy of course would expose that economy not only to potential efficiency gains but also to potential drawbacks such as instability, unemployment of labor, insider trading, and adverse distribution of income and wealth. If these illnesses appeared, antidotes would have to be found. Apart from the insulation between individual behavior and real allocation, potentially still open in Stage III, other system-specific remedies could be suggested. For instance, if there is unemployment the pricing of assets and the principles of bidding could be altered, any unused asset being compulsorily released by enterprises to whoever can provide the highest employment at whatever price is offered, unless the enterprise possessing the asset undertakes to match the additional employment offered. Workers' self-management organs could be given or take a lead in the proper valuation of assets (that is, stamp on insider trading by diffusing relevant information) and in their redeployment. Undesirable distributional effects could be handled by means of taxation.

If the scheme proposed here is deemed unworkable or unsuitable, some other scheme will have to be devised. Once traditional central planning is replaced by competitive entrepreneurship, it is necessary that monetary and financial institutions also be altered to match. Unless socialist reformers intend to reproduce a capitalist economy without or with fewer capitalists, it is imperative that they invent and introduce financial innovations suitable to the systemic premises of their brand of market socialism.

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7

Shareholding Schemes in the Yugoslav Economy

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In spite of a variety of new mechanisms introduced into the Yugoslav financial system in the past 35 years, there is one financial instrument—equity shares—that has never been considered a possible form of financial innovation.[1] The reasons clearly emerge from the existing system of property rights. After the official abolition of state property in 1953, all capital assets became social property. Enterprises were not granted property rights, but only the right to use socially owned resources. These regulations have remained intact since then. The 1976 Associated Labor Act (ALA) clearly states that "no one may acquire the right of ownership over social resources" (Article 12).

Nevertheless, the economic reform implemented during the 1970s resulted in the adoption of several arrangements that resemble shareholding schemes. The main purpose of this paper is to discuss some of these arrangements. Discussions about shareholding in Yugoslavia are reviewed; these include the writings of Edvard Kardelj and recent proposals of Yugoslav economists. A survey on workers' opinion about shareholding is also presented.

Existing arrangements and their implementation

Among the various problems that emerged after the 1965 economic reform were also the ones of growing concentration of economic power in banks, large trade organizations, and monopolistic groupings, and the related problems associated with "group-ownership" tendencies and of "autonomous" financial capital. These problems were evaluated by Yugoslav authorities as being directly

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in conflict with self-management because they implied rental income for privileged classes, and the deprivation of workers of a part of income produced. The economic reform implemented in the 1970s was supposed to:

- enable enterprises to appropriate a larger part of income; and
- decrease the role of banks by introducing new forms of mobilizing savings that would not necessarily require their intermediation.

The pursuit of these objectives resulted in arrangements that resemble, or could have resembled, shareholding.

Workers' "shareholdings"

At the enterprise level, a solution was sought in introducing a system of workers' remuneration based on the contribution of not only their "live" (current) labor, but also "past" (embodied) labor. "Past labor" is a synonym for capital. Since workers directly contribute to the increase of capital through their investment decisions, they ought to be rewarded. The scheme was thus intended as an incentive for stimulating workers' willingness to invest.

In all the major documents adopted during the 1970s—the 1971 Amendments, the 1974 Constitution, and the 1976 Associated Labor Act—workers' past labor is explicitly recognized as a criterion that determines the level of personal incomes. However, legal provisions on past labor are very general.[2] They state only that past labor should be rewarded without indicating the criteria by which an individual's contribution to capital increase should be measured, and the form in which it should be rewarded. Details concerning past labor rewards ought to be specified in self-management acts of the enterprise, which are firm-specific, the only restriction being that these acts may not be contrary to social compacts concluded by the enterprise (ALA, Art. 128). And without precisely defined methods on rewarding past labor, it is not surprising that in everyday practice the scheme has been implemented in a rather simplistic way.

The common feature is that past labor rewards are usually determined in proportion to seniority. For each year of employment, starting with the second year, a worker is given an additional percentage (around 0.5 percent) of his personal income.[3] However, such a reward is usually linked to the years of employment of a worker in the social sector. Hence, the scheme does not guarantee to provide stimulus to a worker for efficient management of capital (and investment) of the enterprise in which he is employed.

Besides the described mechanisms, in some enterprises workers about to retire get indemnity in cash. However, since the amount usually does not represent more than a month or two months of a worker's personal income,

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2. A worker's personal income should depend on the contribution "he has made by his live and past labor to the increase in the income of his basic organization" (Constitution, 1974, Art. 20). "A worker's personal income shall be determined in accordance with the ...contribution he has personally made with his current labor and the management of and doing business with social resources, as his own and social past labor, to a rise in the income of his basic organization..." (ALA, Art. 126; see also Art. 129).

3. A worker employed, for example for ten years, would receive an additional 4.5 percent of his personal income for past labor.

neither can this form of reward represent an adequate compensation for workers' investment decisions.

Several Yugoslav economists have criticized the implementation of the scheme. They claim that it represents a misinterpretation of the original idea advanced by Kardelj. In fact, Kardelj himself complained that the scheme did not have a positive impact on workers' motivation to invest, since bonuses based on seniority are considered more as an instrument of social policy—a part of the distribution system—than as an economic right of workers linked to their investment decisions (1971a).

Since the implementation of the past labor scheme did not result in its further elaboration in practice, the need was felt to regulate the issue further. After long discussions and seven versions of a law on past labor, the "Law on Enlarged Reproduction and Past Labor" (LERPL) was finally adopted in 1982.[4] However, in spite of 24 articles devoted specifically to past labor, the law does not clarify some of the crucial issues.

The procedure for determining the amount of income to be devoted to past labor rewards is rather complicated (see Art. 60-69). This part of income is determined on the basis of not only eight obligatory indicators for evaluating business results obtained, as prescribed in Art. 141 of the ALA, but also of another three criteria (Art. 65). The indicators are not only numerous, but are not mutually consistent: the ones contained in the ALA have been demonstrated to be conflicting (see Babic, 1982). What is surprising is that these resources need not necessarily be used in the enterprise that has realized them (Art. 67, 68), and need not be devoted exclusively to rewarding past labor (Art. 69).

Furthermore, LERPL does not ensure that an individual worker will be rewarded on the basis of the quantity and quality of past labor contributed (see Art. 70-83). Two out of three elements that determine a worker's contribution are based on his contribution together with those of other workers; thus, the incentive is more of a collective than of an individual nature. Moreover, the law does not offer concrete instructions on how to measure past labor contribution. The only significant innovation of ALA is the possibility of realizing the right to past labor after a worker's termination of employment (Art. 78), probably to legalize what is effectively being done in practice.

A new system of rewarding past labor is presently being elaborated. An attempt has been made to define the part of income to be devoted to past labor rewards more accurately, by linking it to the "rentability" of an enterprise. "Rentability" is defined as a ratio between accumulation (net savings) and average utilized business assets (capital).[5] However, the rentability rate—instead of being calculated as a ratio between accumulation and *total* business assets of an enterprise—ought to take into account only returns from *own* capital (Dumezic, 1986). It has finally been recognized that the seniority criterion is not satisfactory,[6] but past labor rewards are simply the positive difference between gross personal incomes and personal incomes for current labor, to be distributed in every enterprise that allocates a part of net income to accumulation. Since all enterprises face a legal minimum requirement to be allocated to accumulation,

4. On the different versions and discussions of the new law on past labor, see Burić (1983).

5. See draft on the "Law on Revenue and Income" in Dumezić (1986).

6. See draft of the "Social Compact on Income" in Bogetić (1987).

this implies that even if an enterprise allocates the bare minimum to accumulation, and incurs losses from investing these resources, it will reward its workers, instead of penalizing them.

In conclusion, while the past labor scheme might have contributed to the appropriation by the enterprise of a larger part of income produced, it has done little to motivate a worker to invest. Even if it had been introduced in a more operational way, by directly linking the amount of income to be devoted to past labor rewards to the efficiency of invested resources, it would still not have motivated workers, because of a specific obligation linked to the use of socially-owned resources. Yugoslav firms are obliged to maintain the value of their fixed assets, in the sense that all reductions caused by the sale of assets, or diminished in the course of operation, have to be replenished. This restriction has a negative impact on workers' willingness to invest: it implies that the collective will not be able to recover the principal of an investment in their enterprise, as such resources, once invested, become part of socially-owned capital stock that subsequently cannot be decreased.[7]

Had Kardelj's scheme been implemented in such a way as to link more directly past labor rewards to capital returns, it could effectively have had certain characteristics of shareholding. Workers would be rewarded for investing retained earnings in capital stock (instead of distributing them in the form of personal incomes), by participating in the firm's profits in proportion to investment yields. Like a shareholder, a worker would be able to count on a personal return on the equity of the enterprise, while the firm would be able to obtain additional capital as with the issuing of shares.

However, an important limitation would be the conversion of shares into liquid assets. The collective would not be able to cash in past labor rights, as workers are not permitted to liquidate the enterprise voluntarily and distribute the proceeds. The individual worker too would not be able to cash in these rights, as he cannot transfer them to other individuals. Therefore, under existing institutional arrangements in Yugoslavia, past labor rewards could at best have taken the form of nontransferable, nonmarketable dividends.

Other forms of shareholding

The economic reform of the 1970s introduced several other instruments that were meant to mobilize savings externally, thus allowing a form of shareholding by outsiders.

At the enterprise level, one form of "pooling of labor and resources" is for one enterprise to invest in another. What is effectively being pooled is the investing enterprise's financial resources with labor and resources of the enterprise receiving the investment. Once the pooling is established through the signing of a self-management agreement, the participants are supposed to jointly share income and risk, and influence the business and development policy of the firm (ALA, Art. 64-65).

7. First suggested by the theories of Vanek (1971) and Pejović and Furubotn (1969-80). See Uvalić (1986).

However, legal provisions of the ALA do not seem very stimulative for the investing enterprise.[8] First, although the investing enterprise is supposed to receive both a refund of invested capital and some compensation (Art. 84), the enterprise receiving the investment is given priority in income distribution (Art. 82).[9] Second, the possibility of a permanent share in the income of the receiving enterprise is clearly excluded (Art. 83, 85).[10] Third, contrary to what is envisaged under "joint bearing of risk," it is the investing enterprise that bears all the risk: once the time limit of the contract has expired, it has no further rights in recovering invested capital, while the receiving enterprise is ensured, in advance, even a part of income for accumulation (Art. 82). Finally, it is even envisaged that the investing enterprise may renounce its right to the restitution of pooled resources (Art. 85).

Therefore, it is not surprising that this form of pooling resources has not had a significant role in stimulating investment in other firms. In 1984, only 13.2 percent of the total long-term investment of firms had been invested in other enterprises (SZS, 1986). In 1981, long-term bank credits to enterprises were 11 times higher than long-term pooled resources among enterprises, while the ratio among short-term obligations of enterprises on the basis of pooled resources, and different kinds of bonds, bank credits, and direct credits, was 1:1.5:10:20 (Mramor, 1984).

The 1982 LERPL merely elaborates the legal provisions already contained in the ALA. It confirms the temporary character of a contract concluded by two enterprises, and provides an additional element to protect the receiving enterprise. The only exception to the rule that the partnership ends when the time limit of the agreement has expired, is "in cases that the time limit has been overpassed by the fault of the enterprise invested in" (Art. 39). Therefore, if the receiving enterprise encounters difficulties in realizing a joint project, it can prolong the duration of the contract, and hence effectively postpone its obligations toward the investing enterprise (instead of being in some way penalized). Had the scheme of investing in other enterprises allowed a permanent sharing of income by the two enterprises, and had the "joint bearing of risk" been ensured, the instrument could have represented a form of shareholding by one socially owned enterprise of another.

Another form of pooling resources is the type that occurs when a bank is formed. During the 1970s banks were transformed into "service agencies" of enterprises, operating under direct control of their founding members. A bank can be founded by enterprises and self-managed communities of interest (prior to 1977, also by sociopolitical communities), which sign a self-management

8. Our observations have been inspired and are in part based on an excellent critique of these issues by S. Babić (1983).

9. "Shares in joint income on account of past labor shall be realized from the part of such income left after the allocation of resources for personal incomes and for collective consumption of workers in the basic organizations which have in their business made use of pooled resources" (ALA, 1976, Art. 82).

10. "The right to this share (in joint income) shall expire upon the refund of the value of pooled resources and compensation, or upon the expiration of the time limit determined by the self-management agreement, irrespective of the amount of the value of pooled resources that has been refunded....Any self-management agreement that does not provide for the termination of the right to a share in joint income when...pooled resources have been returned together with appropriate compensation shall be illegal" (ALA, 1976, Art. 85).

agreement on the bank's foundation (ALA, Art. 16). The founders of a bank may contribute an initial amount of capital, but this is no longer obligatory since 1977. Founding members guarantee all obligations of a bank with their own resources, and thus jointly carry the liability for the bank's operations. All decisions are made not by workers of a bank, but by the bank's members, which all have equal say at the general assembly, irrespective of invested capital.[11] After operating costs have been covered and resources set aside for personal incomes of the bank's workers, all new income is distributed among founding members, both depositors and borrowers, because both borrowing and lending contribute to the bank's income. Income is distributed in proportion to the "contribution" made by these organizations, to be determined in a self-management agreement (ALA, Art. 89).

For the different forms of pooling of resources, the 1971 "Law on Securities" envisages the use of certificates of pooled resources, which entitle the bearer to participate in both profits and management. These certificates have a minimum redemption period of ten years; can be issued by an enterprise, a bank, or an insurance company; and are transferable to other enterprises, banks, and sociopolitical communities. Certificates issued by an enterprise can be subscribed only by another enterprise or a foreign firm; those issued by a bank, by enterprises, communities of interest, and sociopolitical communities; and by an insurance company, in addition to the above categories, also by banks (Art. 16-23, 46, 52-55, Law on Securities).

Pooling of financial resources in a bank resembles shareholding insofar as it ensures founding members' participation in profits, management, and the joint bearing of risk. However, it differs fundamentally from shareholding because it gives such a right to all members—depositors and borrowers—irrespective of invested capital.

The certificate of pooled resources comes closest to shares. However, in spite of being a long-term security, this certificate is also redeemable (as are all other types of securities in Yugoslavia), and it cannot be subscribed by households.

At the level of the individual, existing laws envisage different ways of mobilizing private savings of individuals in intermediate forms of enterprises, based on a mixture of private capital and the self-management system. The first of these forms is a "contractual organization of associated labor" (COAL), in which an individual pools his labor and privately owned resources with the labor of other workers on a self-management basis. The individual receives compensation for the resources he has invested, participates in profits, and has the right to run, as manager, the business of a COAL, for which he receives personal income. Private capital in a COAL can be contributed by more than one individual.

Although the ALA envisages the participation by different organizations with their socially owned assets in the establishment of a COAL (Art. 306), in practice existing COALs are often composed of solely private capital.[12] Two features

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11. Prior to the 1977 Law on Banking, the number of votes of each founder was supposed to be linked to the amount of capital contributed, but in practice, each founder usually had only one vote (see Mramor, 1984). The law was changed in 1986, and is being revised again.

12. Commentators have observed that this is in effect a private enterprise acting under certain legal constraints. Workers sign a contract with the owner, who in turn agrees to conform to self-management rules (Singleton, 1982).

distinguish a COAL from small firms of the private sector. First, in a COAL there is no limit on the number of workers that can be employed; hence, COALs are often larger enterprises than those of the private sector. Second, COALs must respect certain rules which apply to normal social sector enterprises, which may be regarded as unstimulative for the individual investor. Thus workers in a COAL are ensured self-management rights; their personal incomes are given priority in income distribution;[13] and the capital maintenance requirement is respected (Art. 311-312). Furthermore, the manager's ownership rights are not clearly defined, as they are determined by the contract establishing COAL (Art. 312). Finally, COALs are regarded a transitional form of enterprise to be gradually transformed into socially owned firms: workers have the right to buy the owner out over time by paying the historical cost of capital invested.[14]

The individual investing his capital in a COAL can be compared to a shareholder, as he does receive a part of profits on account of property rights. Nevertheless, since such participation is only temporary and effectively puts the individual in the position of a lender, this instrument does not provide a permanent basis for income on account of ownership. Evidence on COALs reveals that their number has risen: 23 in 1976, 59 in 1978, 156 in 1982, and 225 in 1984 (SZS, 1986). The latest figure represents 0.01 percent of the total number of all forms of organizations in Yugoslavia.

The second instrument for mobilizing private savings envisages that firms may collect financial resources from citizens (ALA, Art. 91). A citizen that invests his savings in a socially owned enterprise has the right to recover invested capital, and to receive a compensation in the form of interest or other benefits. If these resources are used for creating new work places, a labor relationship with the citizen may be established.

The scarce information on this instrument contained in the ALA effectively puts the citizen in the position of a shareholder. However, the 1982 LERPL took care of excluding such a possibility. Besides specifying what is intended by "other benefits" (employment, housing and training, using services of the enterprise), the law clearly states what such a benefit may not include: that an individual enjoys the benefit for an unlimited amount of time; that he participates in management; and that he participates in income distribution other than receiving interest (Art. 46).[15]

A special law adopted in 1986 regulates private investment by citizens.[16] The law contains both stimulative and unstimulative elements. On the one hand, it envisages that in place of the investor, a member of his family may be employed.

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13. The part paid to the manager on account of ownership, other than his personal income, is a residual.

14. "If the value of the resources which the manager has pooled in the COAL has been paid out to the manager within the framework of his share in the organization's income...the manager's right to a share in income on account of his ownership right shall be terminated" (ALA, 1976, Art. 315).

15. This would seem to imply that even if the benefit takes the form of employing the citizen, such an individual is automatically put in a position of a "second class" worker; not only must his employment be of a fixed duration, but he will be excluded from participating in management and income. This could not have been the intention of the law.

16. "Zakon o pribavljanju sredstava od gradjana za prosirivanje materijalne osnove organizacija udruzenog rada" Službeni List SFRJ no. 24, 1986, as reported by Labus (1987).

On the other hand, it specifies that the investor has the right to start recovering invested capital only after a period of three years, thus limiting the liquidity of his investment.

In conclusion, all financial instruments discussed above bear some similarities with shareholding, as they play the role that primary distribution of shares usually plays in a capitalist economy: of raising additional financial capital. However, in the absence of a secondary stock market, these schemes do not play one of the essential roles equity shares play or ought to play in the capitalist economy: of providing a pricing mechanism by which enterprises may be valued.

Theoretical discussions on shareholding

Kardelj's views on past labor

In the early 1970s, Edvard Kardelj introduced the concept of "past labor." Kardelj preferred using the term "past labor" to "social capital," "accumulation," or "means of enlarged reproduction" to emphasize that such a remuneration scheme would not be linked to capital, but to labor (Kardelj, 1978).

Kardelj's proposal at first provoked severe opposition. Dogmatic ideologists identified the notion of "past labor" with the concept of private shareholding, a capitalist category in conflict with marxism, socialism, and self-management (see Buric, 1983). Their argument was that since, in line with the Marxist theory of value, it is only labor that produces new value, labor should be the exclusive basis for rewarding workers. A remuneration scheme that includes the contribution of past labor (capital) would imply earning income on the basis of investing capital and not on the basis of labor, and hence remuneration on the basis of property.

Kardelj regarded such views as a misinterpretation of Marx. Although labor is the only creator of value, a part of surplus value created by labor (profit on capital, bank profit, and rent), in spite of not producing new value, does represent value, and has a specific use value, as more efficient management of social capital creates more favorable conditions for improving labor's productivity (Kardelj, 1978). Rewarding past labor cannot be interpreted as a scheme independent of workers' labor, but on the contrary, because "it is clear that you need to open the tap of a cask in order to enable the flow of wine" (1971). The essential point is to prevent workers' filling the cask of social property with their work, while someone else opens the tap. Hence, "it is not a question of whether past labor produces value or not, but a question of who disposes of income" (1971).

Criticizing "state-ownership conservatism," Kardelj recalled that Marx did not identify state ownership with social ownership, but considered social property as a form of individual property. "Social property is common property of all working men, and therefore also personal property of each individual worker in the scope and form in which it ensures him the right to work with social means" (1978). Workers collectively dispose of means of production, but individually enjoy the fruits of their labor. However, social property is not a monopolistic right of any individual subject (the state, the working collective, or the individual worker), but of everybody and nobody—that is, common and personal. This is the only way that social property would really "belong" to all members of society (1972, 1978). Nevertheless, it must not be considered as a no-property category, since "as long as appropriation exists, property will continue to exist" (1972).

The post-1965 alienation of past labor related to "group ownership" tendencies had, according to Kardelj, represented a form of managerial capitalism. Awarding workers' past labor would be a way to avoid the negative effects of both state ownership and "group" ownership, but the scheme would be fundamentally different from private shareholding. Kardelj firmly rejected proposals for citizens' shares in socially owned enterprises.[17] Private shares imply a permanent right to exploit someone else's labor, while the proposed system would be based on the right of workers to derive income from their own work. This right ought to eliminate the old relationship between the worker as hired labor and the owner or manager of capital (1978). Personal income of workers would not be linked to the amount or cost of invested capital to avoid the division of social capital into shares, but would depend on results—returns of an investment—to make the worker aware that his material position depends on accumulation. Workers would not receive this part of income as proprietors, but as managers of social capital, and thus would be encouraged to manage it rationally.

Concerning the concrete form of rewarding past labor, Kardelj mentions shares and bonds, "a secondary problem" for which "concrete solutions must be found" (1971). Since his ideas on issuing workers' bonds had "provoked a real affair" (to use his own words), Kardelj insisted that the worker's receipt on this basis would be a minimum incentive. Hence, "it is absurd to identify a worker that consumes these means in the form of personal income with a capitalist that appropriates them on the basis of a share due to private capital" (1978).

The main merit of Kardelj's writings on past labor is his emphasis that reward for investment decisions is not only compatible with socialism, but is a necessary requirement for the rational use of capital. Nevertheless, Kardelj's writings are not always consistent. One point of confusion is the relationship between "social" and "individual," whether referring to property, income, past labor, and so forth. He speaks of property "of the whole society"; of social property as a form of personal property; and occasionally, in spite of all his criticism of "group ownership," he considers the enterprise the main subject of property rights.[18] Similarly, Kardelj emphasizes the social character of income. Income from social property belongs to all workers and to each of them individually, since it is the result of labor of the whole society, the result of social productivity (1978). The same type of ambiguity is also present in reference to past labor. He does not make a clear distinction between "social past labor" and "individual past labor"; his definitions are often imprecise, ambiguous, even contradictory.[19]

Kardelj fails to distinguish between initial capital endowment given to enterprises by the state when social property was introduced—that could be

17. Among the proposals for introducing shares in Yugoslavia advanced in the late 1960s in the proposal by S. Kavičić, who believed it would be an adequate way for mobilizing citizens' savings; and the proposal of a Working Group of the Federal Assembly (see Korać, 1986).

18. Thus we encounter sentences such as: "We have transferred social capital to basic organisations of associated labor (BOALs)" (1978); or "Self-managed associated labor today disposes of the entire social capital, but this social capital is distributed, i.e., decentralized to BOALs" (1978).

19. For example: "Past labor in the wider sense represents that part of value that workers have produced with their current labor, which the society in various ways allocates for accumulation" (1978). "Pooling of income is not investment in another organisation, but investment in common social labor" (1978). "From the results of total social labor a worker ought to have a material benefit on the basis of his own past labor" (1978).

considered the result of "social past labor," and thus ensure a part of income that is "social"—and successive increments to capital arising from "individual past labor," for which workers ought to be rewarded. In this sense, Kardelj is not explicit enough in emphasizing the individual basis of the scheme. For the scheme to be functional, property cannot belong to the whole society. The basis for determining workers' past labor must be the income of the individual enterprise. And, past labor rewards ought to be linked to the individual worker's contribution.

Kardelj is also ambiguous on the relationship between the proposed scheme and socialist objectives. Tendencies toward private property relations are to be avoided by implementing simultaneously the principle of distribution according to work (both current and past) and the principle of workers' solidarity (1978). To incorporate his scheme into a planning mechanism of coordination, Kardelj proposes that rewarding workers' past labor "would every year be stabilized by the social plan" (1978), and that "a worker does not have the right to, through his personal income, appropriate a part of social capital...since self-management agreements and social compacts should regulate distribution relations" (1978). In conclusion, it seems that Kardelj encountered difficulties in incorporating the individually based system of workers' remuneration of past labor into a more general framework that takes into account social interests, socialist objectives, and a planning mechanism of coordination.

Recent proposals on shareholding

Several Yugoslav scholars have recently proposed the introduction of a form of shareholding, following Kardelj's ideas on rewarding past labor. S. Babić (1983) is one economist who openly advocates "shareholding of past labor." In line with Furubotn-Pejovich's theory on investment of the labor-managed firm, Babić argues that a self-managed collective entrepreneur will be less willing to invest with respect to a situation in which he would be able to recover the principal, and could acquire a permanent right on investment returns. He points to a contradiction of the 1976 ALA which explicitly prohibits shareholding by producers, but not by citizens. Such norms that deliberately prevent shareholding entrepreneurship raise barriers to investing income, and stimulate the outflow of capital from accumulation into consumption.

To motivate an entrepreneur to invest, both in his own, and in another, enterprise, and to increase the mobility of capital, Babić advances two proposals:

- introduce a parametric price for the use of social capital to ensure the social character of property; and
- allow shareholding entrepreneurship.

If shareholding were introduced, resources obtained through the parametric price of capital could be left at the disposal of the enterprise. The entrepreneur would be permanently excluded from consuming this part of income, but would be indifferent whether he invested it in his own, or in another, enterprise, as long as he could recover the principal.

Whereas Babić's proposal would probably resolve the problem of capital mobility, it would not eliminate the problem of underinvestment. Babić proposes that resources obtained through the tax on capital would have to be used for investment. If this is imposed on the firm, the decision to invest hardly reflects a voluntary choice of the collective (contrary to Furubotn-Pejovich's assumption that

workers decide on the use of income on a fully voluntary basis). Babić's solution would ensure higher levels of investment—but through administrative norms, not by influencing an entrepreneur's "motivation to invest." Furthermore, Babić does not discuss problems related to social property and, in particular, the capital maintenance requirement, which is the main factor impeding the recovery of the principal of an investment in a Yugoslav-type labor-managed firm (Uvalić, 1986). If regulations on social property are not redefined, Babić's "shareholding entrepreneurship" would not ensure recovery of the principal.

Another proposal is advanced by Milovanović (1986), who has developed a theoretical model of rewarding workers' past labor.[20] His model assumes that the requirements for equilibrium are the existence of a capital market and compensation for the use of social capital. He shows that under free capital market conditions, optimal remuneration of past labor is possible; without a capital market, an economy is inferior because it will have lower consumption per employed person in all time periods.

Milovanović offers a concrete proposal on how to introduce workers' shares in a socialist economy. He proposes that the state issue initial shares in proportion to the value of social capital, and distribute them to the population. These shares could be traded on an organized market. Workers would in general own shares of their own firm, but could also buy shares of other firms. Such ownership would not give the worker any right in management, which remains a self-management right of those employed, but would only guarantee a dividend depending on the firm's business results. When retiring, a shareholder would not abandon his share; only after a worker's death do his rights cease. Shares would not be transferable to heirs, but would go into a state fund from which each 18-year-old citizen would be given a minimal allocation of shares. In this way, social resources would in a real sense become "social," while workers would become permanently interested in investing.[21]

Milovanović's proposal is appealing, but fails to clarify several issues. How are shares valued on the market? Would they reflect the net worth of an enterprise? What would be the incentive for outside shareholders to buy nonvoting shares?How would a possible divergence of interests between workers and outside shareholders be resolved? On which principles are initial shares distributed to the population?Would new shares, corresponding to the increment in social capital, be equally accessible to all? Or would workers employed in the enterprise issuing new shares be given priority to ensure that the majority of shareholders remain workers employed? Otherwise, the underinvestment problem would not be resolved: workers could vote for consumption rather than investment, while the nonvoting outside shareholder would be powerless to press for more investment.

T. Nikolić (1987) argues that workers' shareholding has advantages over credit relations that have resulted in the present high indebtedness of the economy. Workers as coowners of social capital would be interested in its increase, because dividends on the basis of past labor would be linked directly to

20. As a theoretical framework under conditions of certainty, Milovanović uses the Austrian theory of capital (in a simple Fisher-Hayek form), and under conditions of uncertainty, Hishleifer's theory of probabilistic decisionmaking.

21. Milovanović's proposal bears some similarities with the proposal on "entrepreneurial socialism" of Hungarian economist T. Liska, first advanced in the mid-1960s (see Barsony, 1982).

realized profits, and because their personal property (value of shares) would depend on the efficiency of its use. Workers' shareholding would not only prevent inefficient investment by political bureaucracy, but would resolve the "enigma" regarding the imprecise definition of social property, as each individual subject would need to bear risk and responsibility. Social capital would increase depending directly on the creation of domestic accumulation, and further indebtedness would be prevented. (This is doubtful, however; several economies with share capital, such as Brazil and Mexico, have not avoided the problem of high external debt.)

According to Nikolić, workers' shareholding would not represent the negation of social property, since it is directly based on Marxism. When describing cooperative factories, Marx spoke of a worker having two functions: as the proprietor of his own means of production, he is a capitalist and receives a profit, and as a worker, he is hired labor and receives a wage. However, Nikolić does not discuss the problem of how to reconcile social property with the concretization of property rights and workers' share capital. In fact, he finds a compromise by using an ambiguous term: "workers' shareholding social property."

A concrete solution to this problem is offered by Labus (1987). Labus considers that "the crisis will not be overcome without change in effective property relations," and thus proposes to clearly distinguish between macro and micro interests and competences regarding property, to be divided between working collectives and state organs. To prevent tendencies toward "group ownership," a price for the use of capital should be introduced.

On the other extreme, several economists have attacked such proposals, mainly on ideological grounds, regarding shareholding as a step backward, leading to reprivatization of socialism. M. Korać (1986) has calculated what the introduction of workers' shareholding could cause in terms of capital losses: social capital, instead of increasing six times in the next 40 years, would only increase 1.8 times. Korać's calculations are based on the simplified assumption that workers would distribute the larger part (two-thirds) of accumulation in the form of dividends, that would thereafter go into their personal consumption, thus considerably decreasing the average accumulation rate of the economy. However, he offers no arguments as to why this assumption should hold.[22]

Current discussions on shareholding

Current discussions among Yugoslav scholars concerning the economic reform in course include a lively debate on shareholding. The debate reveals a revival of interest in traditional financial instruments, and a generally favorable attitude toward the diversification of property rights. The concept of social property, that has for years been accepted as one of the fundamental features of the Yugoslav economy, is for the first time being openly criticized.[23] Nevertheless, most of these proposals seek solutions for introducing shareholding

22. If workers are coowners of capital, this would not be in their long-term interest. Even if a large part of profits is distributed in the form of dividends, mechanisms meant to mobilize workers' savings for productive purposes could prevent the lowering of the accumulation rate.

23. Nevertheless, endless discussions about the real meaning of social property have been going on for years, as disagreement among Yugoslav scholars exists on practically all issues. On these earlier discussions, see B. Horvat (1970).

without affecting the socialist features of the economy, for example, by introducing shareholding on a limited scale, either in specific sectors, or in a mixed property sector.

Some economists regard shareholding fully in line with the present economic reform (Round Table Discussion, 1986). B. Kovač proposes the division of the economy into three sectors: social, private, and mixed. The social sector could be given a transition period of five to six years, during which conditions for the survival of firms would be tightened, and enterprises not surviving would be liquidated. The establishment of a mixed sector with diversified property forms would stimulate competition.

Other participants of the discussion were more skeptical because of ideological reasons (Mencinger); negative consequences shareholding may have on socially owned enterprises by increasing competition (Inic); absence of citizens' confidence in the state without which a shareholding system cannot function properly (Jerovsek); incompatibility between a stock market and the present system in which the government "freezes" and "unfreezes" the entire economy every three months (Labus); and eventual loss of control of the government, which can easily give orders to 200 enterprise managers, but not to two million shareholders (Labus).

Labus (in RTD, 1986) argues that since shares imply private property and owners' risk, no one would be willing to invest in a firm unless he can retain some form of control in management. Without this control, shareholding capital would remain at a minimum. But such control would be in conflict with self-management. Instead of shareholding, Labus believes a system of bonds—which does not imply participation in management—has a better chance of successful implementation, as in Mondragon cooperatives.[24]

Others, however, consider the conflict between shareholding and self-management resolvable. Božović suggests parallel participation in management of both workers and capital providers (in Lakićević, 1987a). Nikolić and Raić (in Nikolić, 1986) propose the establishment of an assembly of shareholders in workers' councils of enterprises, which would have certain rights concerning the election of managerial bodies and the economic policy of the firm.

However, much of the present discussion is characterized by a confusion on different proposals (workers' shareholding, shareholding by outsiders on a limited scale, shareholding by both workers and capital providers, alternative forms based on existing mechanisms, etc.), which would have very different implications for self-management. Workers's shareholding is fully compatible with self-management (this is clearly confirmed by the experience of workers' producer cooperatives in Western countries), and so is external shareholding on a limited scale. If shareholding was introduced only in the mixed property sector, there is no reason why this (smaller) part of the economy should be organized along self-management principles. But even if shareholding was considered on a larger scale, there are ways of reconciling shareholding with self-management.

Shareholding does not imply the direct involvement of investors in the management policy of the firm, in spite of the fact that the stock exchange, in an

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24. In Mondragon cooperatives, 85 percent of capital is contributed by individual workers, whereas the remaining 15 percent is collective property. However, these are not shares since a worker cannot sell the claim on his individual account, nor convert the whole amount into cash before retiring.

indirect way, disciplines managers who diverge too much from shareholders' interests. Occasional participation of shareholders in decisionmaking need not imply the usurpation of workers' managerial rights. A solution could be sought in two classes of shares, with disproportionate voting rights.[25] An alternative to parallel decisionmaking would be not to give external shareholders voting rights, so that management would remain the exclusive competence of workers. A solution could be sought in having a market for workers' voting shares, parallel with a market for risk-sharing, nonvoting shares.[26] Alternatively, having a secondary market only for nonvoting shares would still be better than having no market whatsoever; however imperfect, the going price of a nonvoting share would still serve as an indicator of an enterprise's net worth. A remaining problem concerns incentives for investing in nonvoting shares.[27] Judging from the Yugoslav experience, however, a worker who already realizes his self-management rights in his own enterprise, where he is involved daily in time-consuming meetings, may be happy enough to invest in nonvoting, profit-related shares of other enterprises that do not require his participation in additional decisionmaking, yet could ensure higher returns than savings deposited in a bank.

At the official level, although the 1982 Stabilization Program, the main document of the present reform, does not specifically treat the issue of property, problems related to property have lately been discussed officially by the Communist Party, the government, and other political bodies.[28] At a February 1987 meeting of the top party organ (CCLCY), it was proposed that individuals (even foreigners) be permitted to own means of production (other than those in the small-scale private sector), while at a March meeting it was suggested that "the economic and social situation requires that, in the framework of our socioeconomic system, besides social, other forms of property are developed" (Lakićević, 1987a). This resulted in a document on property prepared for the Presidency of the CCLCY, which considers how to stimulate private investment on a wider scale, especially of Yugoslavs employed abroad, and how to encourage existing mixed property forms. Another document prepared for the Federal

25. Workers employed would buy "Class A" shares, ensuring more voting rights but lower dividends than "Class B" shares sold to external shareholders, with inferior voting rights and higher dividends. Some American stock exchanges (e.g., AMEX) permit this type of dual class capitalization, while others (e.g., NYSE) want to introduce it. However, the present "one share, one vote" controversy among American securities exchanges suggests there might be a return to the standard uniform voting rule (see Seligman, 1986).

26. In a system that combines workers' shareholding with external shareholding, each worker would be a holder of a voting share of his enterprise, but could also buy nonvoting shares of his, or another enterprise. A worker leaving the enterprise could either abandon his share in return for appropriate compensation, or he could sell it to another individual, if the firm wants to employ a new worker of a profile corresponding to the potential buyer of such a share; or he could remain an outside holder of a nonvoting share, or cash it on a secondary market for nonvoting shares.

27. The theoretical literature on the labor-managed firm offers solutions that are supposed to ensure the coincidence of interests between outside providers of capital and workers. See Barlett, Uvalić (1986).

28. Discussions organized by the Central Committee of the League of Communists of both Macedonia (Skoplje, 1985) and Serbia (Belgrade, 1986), by the Presidency of the League of Communists of Yugoslavia (Kumrovec, 1986), and by the Changer of Commerce (Belgrade, 1986). See Korać (1986).

Executive Council proposes to ensure more rights to an enterprise investing in another (Lakićević, 1987b).

Nevertheless, there is still a lot of resistence toward these changes. For example, the draft of the law on enterprises with foreign capital (a type of mixed property enterprise primarily meant to attract the capital of Yugoslavs employed abroad) has for the moment not been accepted, on the grounds that Yugoslav emigrants, having the exclusive right to invest in such enterprises, would be more privileged than workers employed in Yugoslavia. The history of economic reforms in socialist countries teaches us, indeed, that it is a long way from proposals to elaboration and implementation.

Table 1. Criteria for rewarding past labor

Criteria	*Percent of positive answers*		*Rank*	
	Croatia	*Slovenia*	*Croatia*	*Slovenia*
Investment of own capital (workers' savings; personal loans)	18.9	22.8	5	4
Rewards for innovation	28.4	21.1	4	5
Total personal income	70.5	69.5	1	1
Years of employment in firm	40.7	42.5	3	3
Total years of employment	61.4	52.2	2	2

Source: Županov et al (1977).

Workers' views

To seek workers' views on the notion of past labor, a sociological study was made based on a questionnaire to some 3,500 workers from Croatia and Slovenia on four specific issues: criteria for rewarding past labor, its concrete forms, the character of such a right, and its time dimension (Županov, 1977).

Table 1 reveals that workers prefer less precise criteria for rewarding past labor, such as personal income and total years of employment. To explain this attitude, additional questions were posed on the criterion of individual investment of capital by workers. A majority of those surveyed regarded this criterion as not in conformity with the law, which may be the reason why they did not consider it.

Sixteen forms of realizing the right to past labor were grouped into three subcategories depending on the role past labor rewards should have. These were entrepreneurial (compensating postponed consumption); self-managed (managing social capital in general); and security (securing workers' socioeconomic welfare). Table 2 reveals that the most favored forms of rewarding past labor were those linked to: seniority in a specific firm (E), the firm's productivity (J), housing problems (O), and job protection (P).

The third group of questions concerned the character of the right to past labor rewards: whether it is a worker's subjective right, or a moral right based on

solidarity; and whether it is a property right. Responding to the first question, the majority considered it a subjective right of each individual. Concerning the second question, workers thought that past labor rights should not be linked to current membership in an enterprise. A worker who was fired for economic reasons should continue to enjoy such a right, but if he is dismissed because of his own fault, the right to past labor should cease. Only 15 percent of the workers thought that the right to past labor should be transferable, although the majority (60 percent in both republics) thought it should be inheritable by family members.

Table 2. Forms of rewarding workers' past labor

		Percent of positive answers	
Orientation	*Form*	*Croatia*	*Slovenia*
Entrepreneurial	A. Worker invests in the firm, receives personal income and a part of income, depending on profit.	68.2	75.3
	B. Worker puts his savings at firm's disposal, receives interest in advance.	51.4	58.6
	F. Worker receives a special reward depending on contribution to past labor while employed in that firm.	58.7	55.3
	J. Worker's personal income depends on productivity in the firm.	80.3	89.0
Self-managed	K. Worker's personal income depends on average productivity in the industry of that republic.	48.3	40.6
	L. Worker's personal income depends on average productivity in the commune.	37.7	29.4
	M. Worker's personal income depends on average productivity in the republic.	40.0	32.0
	N. Worker's personal income depends on average productivity in Yugoslavia.	38.2	23.4
Security	C. All workers receive equal rewards depending on firm's business results.	49.8	47.5
	D. Worker receives a special reward depending on total seniority.	72.8	68.0
	E. Worker receives a special reward depending on seniority in that firm.	72.8	76.5
	G. Worker receives a pension depending on seniority in that firm.	51.4	52.6
	H. All workers receive same pension.	23.3	18.9
	I. Workers performing similar jobs receive equal pensions.	61.5	62.1
	O. Workers helped with housing problems.	88.4	88.5
	P. Workers provided job protection.	72.8	81.3

Source: Županov et al (1977).

Finally, workers were asked what should be the minimum length of employment required for acquiring the right to past labor. In Croatia, 51 percent,

and in Slovenia, 45 percent of workers thought five years was sufficient. They were also asked whether the right to past labor ought to be recognized retroactively; 50 percent of Croats, and 39 percent of Slovenes were in favor.

The survey revealed that there might be social constraints to introducing workers' shareholding. On the one hand, it seems that the Yugoslav worker is risk-averse and is not willing to fully accept the role of an entrepreneur, but he prefers the present "implicit" contract with the state which assures benefits irrespective of personal contribution. This is confirmed by workers preferring less precise criteria of rewarding past labor; by their negative attitude toward investing personal savings; by answers on forms of past labor rewards, as three out of the four most preferred forms of rewarding past labor belong to the security-oriented group (and not the entrepreneurial one); and by their attitude toward the right to past labor, which ought to be nontransferable, not linked to membership, but inheritable. On the other hand, workers may be happy the way things are. The solutions adopted do not diverge much from the desires of this group of workers, considering that the most preferred criteria—personal incomes and total seniority—are precisely those effectively applied in practice; while three out of the four most preferred forms of rewarding past labor—personal income depending on collective productivity, job protection, and social help for housing problems—can be said to be present in practice.

Conclusion

The strongest argument against shareholding in Yugoslavia remains ideology, and not self-management. A permanent right to an income from ownership seems to pose insurmountable ideological barriers even in a reformed, highly decentralized, socialist economy. Therefore, it is necessary to seek solutions within the existing institutional framework—in the context of social property—without officially introducing shareholding or private property rights.

In the case of workers' shareholding, if we accept the view that there is no major distinction between the right to use and the right to own (Prout, 1985; Bajt, 1968; Horvat, 1970), or proposals to specify concrete holders of property rights, social property would be maintained but could effectively be treated as collective property. Each organization's part of social property would be determined by its capital stock; an adequate system of taxation could prevent "group ownership. "This flexible interpretation of social property would be more acceptable not only because it would respond more to the requirements of self-management, but because it would specify that it is the individual organization that ought to bear full responsibility for the use of its part of social capital.

Allowing individual workers' shares would be a further step in solidifying responsibility, but its plausibility under socialism depends on the interpretation of social ownership. Some regard workers' shares as being fully compatible with social property and socialism under an egalitarian system that permits everyone access to capital (Milovanović, 1986; and Liska, in Barsony, 1982). Alternatively, instead of shares, workers could be issued profit-related, risk-sharing bonds, equivalent to reinvested income per head. Since individuals in Yugoslavia are already permitted rental income (savings deposited in a bank), why shouldn't they be allowed to invest in profit-related securities of their own enterprise?

In the case of outside shareholding, as long as the socially-owned enterprise continues to represent the dominant form of enterprise, and shareholding is kept within "acceptable" limits, it should represent no "threat" to the socialist features

of the economy. Nevertheless, mechanisms already existing in Yugoslavia clearly demonstrate the need for instruments similar to shares that could be applicable on a wider scale. As existing arrangements are all characterized by temporary participation in profits of the individual or institution contributing capital, a solution could be found that allows a continuous renewal of contracts with external providers of capital, thus allowing a "hidden" form of shareholding. Such schemes would represent a temporary (although renewable) right to income from using socially owned resources (and not a "permanent right to income from ownership"). Indirect forms of shareholding through banks could also be encouraged.

What would be achieved through such schemes is a longer-term interest in invested capital, which would have a positive impact on the efficiency of investment. A more adequate mechanism of mobilizing savings (especially of individuals) would be provided, as well as freer flow of financial capital and greater financial intermediation—mechanisms the Yugoslav economy needs at present. This issue is not one of returning to capitalism, but of using its financial instruments by adapting them to socialism, and thus enabling the functioning of capital markets in socialist economics. The crucial issue is not that of introducing private property rights, but defining alternative incentive mechanisms that could play the role they play in capitalist economies.

Postscript

The proposal on workers' shares in socially owned enterprises has in the meantime been accepted at the official level, after being advanced by both the Serbian Commission for the reform of the economic system, and Mikulić's Commission. The proposal will form part of the new government measures, to be enacted by January 1, 1989.

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8

Structural Reform and Financial Reform in China

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China's structural reform, first initiated in the rural areas and gradually extended to the cities, entered an all-embracing stage in 1982. Financial reform has become more important in the ever-deepening process of structural reform. I present a brief review of China's economic structural reform and its reform efforts in the financial sector.

Present state of China's structural reform

China initiated its reform program by breakthroughs in the rural areas, where we established the responsibility system on the basis of the household, readjusted prices for agricultural produce, and abolished the system of sole state purchase and marketing of farm products. All these efforts greatly improved rural productivity and paved the way for urban reforms.

Urban reforms have centered around invigorating China's enterprises. In 1979, Chinese enterprises were allowed to retain a part of their profits. In 1983, a tax scheme was enforced under which enterprises could freely dispose of their profits after paying their income tax and regulatory tax to the state. At present, enterprises retain about 50 percent of their total profits. However, after making contributions to state funds for energy and communication development and after paying administrative fees to their supervisory bodies, the actual rate of after-tax profit is less than 30 percent. We also reformed the depreciation regime by returning the depreciation funds originally turned over to the state budget back to enterprises. As a result, enterprises' financial powers have been greatly enhanced.

To further stimulate enterprises, we have introduced a responsibility system in various forms among many state-owned large- and medium-sized enterprises. A minimal profit level is set for each enterprise. Profit gained beyond that level is incrementally retained by the enterprise. Over one-half of all enterprises operate under this new system. Leasing, contracting, and transfer of ownership are used for small state enterprises. In addition, we are carrying out pilot tests in a few enterprises on equity sharing schemes and asset trusteeship regimes (to set value-added targets for the operator). All these steps are aimed at finding an optimal way to separate management from ownership.

Who should represent the owner of state enterprises? Some people are in favor of setting up a state agency to manage the property of state enterprises. This agency would not be involved in the daily business of enterprises, but would be represented in the management board or board of directors. However, another group of people believe that the ownership of state enterprises should be represented

by equity schemes. Holding companies should be established to manage state property, so that a firm can have several public holding companies, together with financial institutions, other enterprise groupings, and individuals as its equity holders. To ensure the socialist nature of our enterprises, limitations can be imposed on individual equity participation. Moreover, individual investment may be managed through pension funds, insurance companies, or other cooperative savings organizations to diversify direct private risk and to avoid the formation of rentiers from the concentration of shares.

China's investment pattern is also changing. The single system of largely governmental investment is evolving into a mix of government, enterprise, and individual investment. The vertical investment channel of budgetary allocations is being combined with horizontal capital flow among various social entities. Investment projects are being decentralized. The relative share of budgetary investment is on the decline: it now amounts to less than 20 percent of total infrastructure investment by society, compared with about 80 percent in 1980. The remainder consists of investments from enterprises, local governments, line ministries, banks, and individuals. However, the traditional way of managing investment remains unchanged. Administrative means continue to be the sole mode for controlling the scale of investment and for examining and approving projects—an anachronism urgently calling for remedy by reform of the investment system and use of financial levers to regulate and guide investment.

Reforms in the financial sector

China's financial reforms have concentrated in five areas:

- Establishment of the central bank.
- Reform of the specialized banks.
- Reform and development of urban and rural cooperatives.
- Nonbank financial institutions and the financial market.
- Reform of the interest rate structure.

The central bank

In September 1983, the State Council decided that the People's Bank of China should assume the function of the central bank, and that its original crediting operations be transferred to the newly established Industrial and Commercial Bank. The Council of the People's Bank of China is composed of the bank's president and vice presidents; vice ministers from the Ministry of Finance, the State Planning Commission, the State Economic Commission, and the State Systems Reform Commission; and governors of all the specialized banks. The People's Bank of China has branch offices in all provinces, prefectures, cities, and some counties.

In 1984, the newborn central bank suffered a lack of indirect regulatory means caused by the fact that no resources delimitation had been made between itself and the specialized banks at a time of overzealous economic expansion and an inflation of demand. Consequently, credit was out of control by the end of that year. To counter this situation, the central bank adopted a tight policy in 1985 and went on to control the credit quota directly. The hasty expansion was checked, but the direct hand also dampened the enthusiasm of banks and had a negative

impact on economic operations. Since 1986, the central bank has tried to combine direct control with indirect control measures, setting quotas for fixed asset loans while allowing ordinary loans to grow with deposits. Now, the central bank indirectly controls credit, mainly by its credits to the various specialized banks.

Because the central bank presently lacks regulatory means and a full-fledged financial market, and because of rigid interest rates, industrial and commercial entities and banks are rather irresponsive to indirect control measures. Governmental intervention at all levels also precludes the central bank from exercising macroeconomic control effectively.

The specialized banks

China now has four major specialized banks: the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Construction Bank of China, and the Bank of China. The main function of the Industrial and Commercial Bank is to provide credit to industrial and commercial enterprises and to accept deposits in urban areas. It is the largest bank in the country, with deposits accounting for 45 percent of the total of all banks and credit coops combined; it also provides 40 percent of the country's loans. The second largest is the Agricultural Bank whose main function is to handle rural credits. The Construction Bank is mainly responsible for state budgetary investment. It also uses deposits mobilized by itself (mainly enterprises' compulsory basic construction deposits) to provide credits. The Bank of China is a state monopoly dealing with foreign exchange and balance of payments operations.

Each of the four major specialized banks is a state monopoly bank in its own domain of operations. To break this monopoly and to create conditions for competition, overlapping of operations is now being encouraged. The Industrial and Commercial Bank can extend its operations into rural areas while the Agricultural Bank is allowed to operate in cities. They are allowed to deal with foreign exchange, while the Bank of China accepts savings in renminbi.[1] These banks are gigantic. The Industrial and Commercial Bank and the Agricultural Bank have over 300,000 staff members and several thousand branches, while there are only a few banks in the whole of China. It would be rather difficult therefore to break the monopolies of specialized banks under China's present banking system.

Reform measures allow specialized banks to retain part of profits, according to a certain ratio, to use in expanding their networks or as collective welfare and award funds. They can also retain a certain amount for supplementary credit funds. The remainder is to be surrendered to the state budget in the form of income tax, regulatory tax, and energy and communication development fees.

The traditional monopolistic control by the head office of all its branches, both in terms of deposit and lending of credit funds, and in terms of financial receipt and outlay, is also changing. Resources are being delimited between the head office and its branches. Capital flows are no longer free allocations but head office loans that bear interest. The head office also allows its branches to retain part of their profits according to certain proportions.

The specialized banks enjoy some autonomy over liquid capital credits. But due to excessive government intervention, they are still not in a position to refuse

1. The Chinese currency is called renminbi (RMB) and is denominated in yuan.

loans to inefficient, even failing enterprises. Credits on fixed assets are mainly determined by the planning authorities both in terms of how much and where to lend.

While restructuring the existing banks, we have recently set up several joint-stock banks, such as the Bank of Communications, CITIC's Industrial Bank of China, and the China Merchant Group's Bank. We have also set up savings banks for housing to coordinate with the housing system restructuring program.

Urban and rural credit cooperatives

Rural credit cooperatives have existed in China for a long time. More than 50,000 such coops operate under the leadership of the Agricultural Bank. They are managed like the state banks, an arrangement that has greatly hampered their operations. We have begun restructuring their management system, mainly by allowing them autonomy in mobilizing deposits and providing loans. Except for reserve deposits, they are no longer obligated to hand over their deposits to the Agricultural Bank. Their interest rates are permitted to fluctuate within margins. These measures have not only invigorated rural financing and stimulated the growth of the commodity economy, but they have also helped to keep down the rate of interest.

In recent years, urban credit coops have been on the rise. Presently over 1,500 strong, they are all autonomous entities responsible for their own losses and profits. They have played a positive role in the development of urban collective and individual sectors of the economy.

Nonbank financial institutions and the financial market

The reform has changed the pattern of national income. Centralized state budgetary funds are decreasing, whereas extra-budgetary funds are on the increase. To organize and use extra-budgetary funds, a number of trust and investment corporations have come into being to act as investment agencies in various regions. There are several hundred such trust and investment corporations of varying sizes, as well as some leasing companies and finance companies. These nonbank financial institutions play an important financing role in some regions. Some of the provincial and municipal international trust and investment corporations have helped build local infrastructure by issuing bonds in the domestic as well as in the international market. But most such corporations are run by specialized banks, so their operational management system is basically the same as that of national banks. Other corporations run by local governments suffer from too much administrative interference.

In the past year or two, horizontal borrowing among financial institutions has developed rapidly. Several financing networks exist at various levels in central cities. The interest rate is allowed to float freely within the range of the price of loans, which is somewhat fixed. At present, horizontal borrowing is mainly conducted within the specialized banking system, but there have also been cases of interregional horizontal flows (e.g., the financial resources of the Northwest flowing to the coastal areas). Commercial bill acceptance and discount operations have also made some headway, with Shanghai, Shenyang, Chongqing, Wuhan, and Guangzhou setting the pace.

Currently, the evolution of the capital market is mainly marked by developments in the bond market. Nearly 30 billion yuan in corporate bonds,

financial bonds, and enterprise-mobilized funds, and tens of billions of state treasury bonds have been issued. In Shanghai, Shengyang, Chongqing, Wuhan, and a few other cities, transfer business in corporation bonds has been initiated. This year has seen the issuance of key construction project bonds, a part of which has taken the form of bonds in kind (e.g., the subscriber of a certain amount of bonds may get a certain amount of electricity supplied in return, at a favorable price determined by the state). As regards equity capital financing, up to now, there are experiments in a few enterprises (e.g., the Shanghai Yanzhong Corporation and two other large corporations).

Interest rate structure

The regulatory role of interest rates has expanded with preliminary reforms in the interest rate structure. We have repeatedly raised the interest rate on savings deposits of individuals, from 3.36 percent in 1979 to 7.2 percent at present. We have differentiated interest rates according to maturity, and raised the fixed asset loan rate which is no longer lower than that on working capital loans as was the case in the past. The annual interest rate on fixed asset loans for one to three years has been raised from 5.76 percent to 8.6 percent, which is higher than the interest rate of 7.92 percent on working capital loans. We have also adjusted the interest rate management system, by leaving completely open the interest rate on the horizontal borrowing market, and allowing an interest rate floating range of 20 percent for working capital loans and 50 percent for credit cooperative loans.

Problems in interest rate structure remain. Interest rates are low in real terms: the annual interest rate on savings deposits is sometimes slightly higher but sometimes lower than inflation of commodity prices. Interest rates are unfair: on enterprise deposits they are too low, while those on bonds are too high. The interest rate on state-appropriated loans is too low. The interest rate structure lacks flexibility; in a word, it needs further reform.

Further financial reforms

Banking system

The Construction Bank of China should be transformed from a fiscal investment agency into a development bank, and some investment companies should be set up to undertake policy-guided investments, support industrial restructuring, and execute economic development strategies. The investment fund which used to be directly distributed by the State Planning Committee should be given to these institutions as part of their financial resources; another part should come from the bond markets.

After the separation of policy-guided credit and loan operations from the existing specialized banks, these banks need to be gradually commercialized to become more business-oriented. They should be granted autonomy in lending to enable them to take risks in investment. It is also necessary to explore the separation of the rights of ownership from that of operational management, as well as ways and means to reform the present organizational structure of banks. Apart from reforming the existing banking system, it is also important to secure successful operation of the newly established banks, such as the Bank of Communications, CITIC's Industrial Bank, the China Merchant Group's Bank,

the new housing savings banks, and others, so that the present sectoral monopoly by the specialized banks can be broken up.

The reform of the credit cooperative system must continue to allow the credit cooperatives to gain greater operational autonomy, and to facilitate healthy management, sound settlement, and financing operations of combined credit cooperatives on a countrywide basis. We shall continue to support the development of urban credit cooperatives and the experimental cooperative banks based on credit cooperatives. However, no individual is allowed to operate a private financial business.

Orderly development of financial markets

Efforts should be made to develop an interbank market, and to break the barriers between areas of specialization of banks' businesses and local government jurisdiction, so that financial resources may flow more freely and widely. At the same time, management of the horizontal borrowing market should be strengthened. Efforts should be made to establish, develop, and improve the markets for commercial bill acceptance, discount, and transfer; to promote the bill system in commercial credit transactions; and to develop bill acceptance, discount, and rediscount services. The banks should recognize bills as the basis for granting loans, and the central bank should use rediscount as a means of monetary control. Short-term bonds of various kinds should be issued, and a secondary market should develop gradually.

Steps should be taken to develop a long-term capital market, which at present mainly consists of bonds. Because of a reduction in government investment, it is necessary to raise funds for infrastructure and other construction projects through the bond market. At the same time, we should also encourage ordinary enterprises to raise funds in the bond market. We should gradually establish a secondary bond market. For example, next year will see the opening of secondary markets for treasury bonds. Corporate bonds should gradually be channeled into the bond market; the circulation of such bonds should in turn stimulate their issuance. Interest rates on bonds would be determined by risk. With respect to the financing of equity capital, we will continue our experiment. The stock market will be developed as equity financing develops and enterprise reform deepens.

We should also aim at full-scale development of contractual savings agencies, long-term financial resources, and diversified insurance operations. In tandem with the reform of the retirement system, pension funds will be established. In the rural areas, emphasis will be placed on the establishment of life insurance and funds for old-age care. All these measures are aimed at tapping the savings potential and opening up long-term resources.

We shall formulate and improve financial legislation, such as the law of negotiable instruments, rules and regulations governing bonds, rules on financial market management and competition among banking enterprises, and rules for setting up special financial institutions and training specialists. The foreign exchange adjustment market will be tried out first in selected cities, then expanded in line with the reform of the foreign trade and foreign exchange control systems.

Reform of the interest rate and exchange rate

At present, our interest rates are so low that they have become negative in real terms. As such, they have played a role in the excess demand and in the

inefficient use of funds. Reform is needed. At the same time, the Chinese economy has shown a certain degree of interest rate elasticity; interest rates do adjust. Since the precondition for an across-the-board price reform, which is about to start in China, is control over aggregate demand, steps to bring about positive interest rates are all the more important.

Adjustment of the interest rate structure will continue. Discrimination among enterprises in interest rates will be gradually eliminated, so that interest rates for the deposits and bonds of corporations will gradually approach those for individuals. It is imperative to do thorough research and adjust the interest rates on deposits, bank loans, and different kinds of bonds. More attention will be paid to the flexibility of interest rates (e.g., setting a ceiling for interest rates on deposits and a floor for interest rates on loans), and allowing fluctuation in between. Exchange rates should be brought in line with the reform of the foreign trade system.

Monetary policy and macroeconomic regulation

In recent years, when aggregate demand became excessive, the central bank tightened its credit policy. But this could not dampen demand, especially consumption. On the contrary, supply was affected—production was the first to suffer. Consequently, the central bank was forced to loosen its credit policy, which only resulted in more excess demand. The central bank needs to improve its regulatory mechanism so it can do a good job in controlling the base money, reducing credit loans, and increasing rediscount operations. While the aggregrates are under control, the capital structure needs to be adjusted; the central bank should also use the bond market for monetary regulation. Something should be done on the demand side as well (e.g., increase interest rates to control the demand for money).

To be effective, monetary policy needs to be accompanied by other policies. First, a good fiscal policy is required to keep a balanced budget. Budget deficits should be offset by issuing treasury bonds, not through financial transfers from the central bank. Second, a sound incomes policy is needed, for it is difficult to regulate demand for consumption by monetary policy alone. Increases in interest rates can help mobilize more savings, but to control consumption, an incomes policy is needed because of its control over aggregate personal incomes. In addition, investment policy and reforms at the enterprise can help monetary policy, but I will not elaborate on these in this paper.

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The Beginnings of a Capital Market in Hungary

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Since the end of the 1970s a series of changes has taken place in Hungary, aimed at reviving the long-forgotten institution of the capital market. The Law of Association and the regulations pertaining to the foundation of international joint ventures were liberalized, securities (bonds, promissory notes, and shares) reappeared, and the first steps for the development of a secondary securities market were taken. More than ten small financial institutions had been founded; these, in the meantime, all obtained the status of banks. The Law of Liquidation (bankruptcy) was passed. In 1987, the banking system was reformed into a two-tier system. Five fully licensed commercial banks were established.

Although the changes in the functioning of the economy were by no means as far reaching as one could expect, the demolition of the legal obstacles to the organization of a capital market, however, could not be classified as cosmetic changes. Based on the Hungarian experience, I shall attempt to demonstrate what role is played (or could be played) by the capital market in various phases of the centrally planned economy (CPE) as well as the reasons for the momentum gained by the establishment of the institutions of the capital market in the 1980s. I shall also discuss a question that is highly uncertain today, namely, how the new opportunities change the investment behavior of enterprises and cooperatives.

A modern economy is characterized by growth and by constant, never accurately foreseeable changes in the structure of demand and in the technology of production. Under such conditions, a significant part of the generated savings has to be reallocated. A part of the income is used for purposes other than the expansion of the activity whereby it was generated, and frequently it is not utilized within that same enterprise.

In a traditional CPE (command economy) the direction of the reallocations is determined by the central plan, while in the market economy the expectations of entrepreneurs (which are also influenced by the economic policy of the state) are predominant. The reallocation of capital based on the profit expectations of entrepreneurs is realized through the capital market.

In both cases, the reallocation of savings is based on ex ante judgments. In the traditional CPE, however, the autonomous central plan tries to deduce present day investment requirements from an imagined *future* structure, in contrast to the profit motive of the market. In the CPE, a capital market would be not only superfluous, but also disturbing. The theoreticians of the CPE believe in the superiority of plan-based reallocations over market-determined movements; or, that every single investment need not be profitable. The reallocation of resources should be carried out as conceived by the planning apparatus (which is how heavy

industry developed so quickly in all socialist countries). A capital market as such *cannot be interpreted* under conditions of the traditional CPE despite the fact that the factors of production are reallocated here as well, and within a very short time.

The situation changed somewhat in Hungary with the introduction of the economic reform of 1968. The fundamental principle of the reformed socialist economy was that the *commodity market* should function. Enterprises should have a high degree of independence in using their existing resources, in selecting sources for obtaining necessary inputs, in the product they could produce using existing capacities, in determining the extent to which existing capacities would be exploited, and in selecting partners (including foreign partners) to whom they could sell their products. In contrast, major structural changes, or decisions on which these were based, continued to be the authority of the central planning apparatus. That is to say, the reform concept affirmed the commodity market but not the capital market.[1]

The 1968 reform concept contained a number of compromises, mainly for tactical reasons.[2] For the successful introduction of reform, an agreement between the two wings of the political leadership was crucial. Some of the leaders hoped that the limited reform aimed strictly at making economic decisions more rational would gradually transform the society and political institutions. Others expected the economic changes to cause major sociopolitical changes that could, perhaps, get out of hand from the point of view of the controlling apparatus. The temporary compromise of the two contradictory perspectives was, perhaps, the most important precondition of the successful introduction of this reform program initiated by the top political leadership. This also explains, however, the compromising nature of the reforms and the fact that these compromises were temporary and unstable: the upswings of the reform were mostly followed by counteroffensives to reverse the process.

The rejection of the capital market, however, was not a tactical compromise which the directors of the reform intended to resolve sooner or later. Three weighty counterarguments were advanced:

- The existence of the capital market would thwart central investment policy regarded also by the adherents of the reform as the fundamental guarantee of planned economic management (see Brus, 1967).

- An advanced capital market creates income movements and income reallocations which, in the case of enterprises and individual employees, depend not on effort and on the utility of such effort but on the use made of capital. If a significant part of enterprise and personal incomes would stem not from work but from property, then this—according to the view still

1. "Although the 1966 directives did not state the separation of simple and extended reproduction explicitly, this is revealed from the fact that since the individual big investments were *ab ovo* directed to the budgetary sphere..." (Szamuely, 1986).

2. Thus, for instance, the review of the apparatus of economic control has not been carried out. The institutional system suited to the former (command economic) control, based on sectoral direction, was retained. Special regulators were used in a wide range and enterprise management was limited by restrictions that were regarded even by the leadership as temporary. Many limits were set to the movement of prices, and the activities of enterprises were strictly regulated. The monopoly organization of foreign trade was also retained. For detailed information on these limitations and compromises, see Antal (1982).

dominant in the 1960s—would give scope to economic laws alien to socialism.

- The decentralization of decisionmaking authority for the enterprises requires a vigorous centralization within the banking system, replacing the former control in kind with a stricter financial control (by the bank). This justified the maintenance of the one-tier banking system that deals with the functions of the bank of issue and with decisions on the loan applications of enterprises within a single organization, as well as the maintenance of the sharp separation of the financing of enterprises and of the population. (Providing loans for the population and collecting their deposits had been the task as well as the right of a single specialized financial institution.)

The banks[3] and financial institutions fulfilling sharply separated functions were institutions of economic control rather than business partners for the enterprises. With respect to the government, they were in a position of dependence on the central plan and on the budget, both of which usually financed the projects included in the plan even if the financial position of the enterprise was not stable, or if the return on the investment was uncertain. The National Bank of Hungary (NBH) had to finance the budget deficit. With respect to enterprises, however, the NBH played the role of an institution of economic control. In its Guidelines for Credit Policy, the NBH separated various target quotas in accordance with the targets of the central plan. Business considerations could be enforced only within these limits: the enterprise able to realize the centrally determined target—or even more, the enterprise better provided with capital—had a somewhat better access to loans. Nevertheless, the primary consideration was whether the aims of the enterprise were in line with central economic and political conceptions. In this way, the government hoped to harmonize central investment policy (as no major investment project could be started without significant loans or central investment grants) and enterprise interest in realizing profitable investment projects and in obtaining fast returns (Antal-Surányi-Várhegyi, 1986).

According to the dominant conceptions in 1968, the function of the capital market in a market economy was to be fulfilled by a combination of the system of state investment grants and loans. Nevertheless, in a marginal way, the enterprises had a possibility of transferring financial capital ("development funds" to use the Hungarian terminology) or capital goods to one another and to found joint ventures on the basis of the profit motive already at the end of the 1960s. This, however, was strictly limited and controlled.

If, for instance, an enterprise made a commercial loan to another enterprise, it could only do so out of its development fund. This was a very strict limitation

3. The National Bank of Hungary, besides regulating the volume of money in circulation, worked out the Credit Policy Principles, which set economic and political targets in providing loans and loan preferences and limitations. In addition it also gave short-, medium-, and long-term credits to the enterprises. The State Development Bank financed and supervised state investment projects. The Hungarian Foreign Trade Bank was established to deal with financial transactions with Western banks (for both the enterprises and the population), and it also gave foreign exchange loans to enterprises in case of cooperative relationships, license, and know-how purchases. The Financial Institute Center dealt with the foreign assets of the population (e.g. inheritance). The National Savings Bank is the bank of the public. Apart from collecting deposits, it also plays a central role in financing housing construction.

by itself.[4] Over and above this, very strict bank control was enforced. The enterprises transferring development funds or participating in a joint venture were subject to much stricter loan conditions than enterprises which used their financial resources exclusively within their own organizations. This tight restriction on the movement of capital among enterprises suited central intentions well. (In addition, the maximum interest to be paid on the transferred capital was regulated centrally.)

It is not surprising that the magnitude of capital reallocations carried out on the basis of market motives was insignificant, not exceeding 4 to 7 percent of annual investment expenditures, up until the end of the 1970s (Antal-Surányi-Várhegyi, 1986). This, by itself, would not have mattered much, but there was neither a functioning securities market, nor financial institutions authorized to obtain capital interests or to arrange risk capital deals. The only possibilities for obtaining nonloan capital were:

- through some kind of state investment grant; or
- through access to some highly preferential, long-term credit that was prolonged when needed at low rates of interest. (These were credits in name only, as the repayment of matured debts was rendered possible by further credits or supplementary state preferences.)[5]

In this system, neither the outstanding development, nor decline or failure of enterprises was based on market performance, but on decisions by the state apparatus, or the bank playing a very similar role. This by itself explains the high degree of dependence of the enterprises on the controlling apparatus and their meager sensitivity to the market.

The basic assumption of the reform was very succinctly formulated in the 1968 reform document.[6] The assumption was that the enforcement of return requirements can be reconciled with centrally chosen (or approved) targets, not only in the case of investments financed with loans, but also in the case of state grants (if the beneficiary enterprise had to pay some kind of interest or a share of the profits earned with the grant).

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4. The development fund is a separate allocation that can only be used for investment purposes or to increase the enterprise's active capital (but not, for instance, to increase wages). Under Hungarian conditions, the development fund is qualified as very "expensive" money. Out of HUF 100 gross (pretax) profits, only HUF 20-25 remained in the development fund after payment of taxes and other obligations. The enterprises had not only to pay taxes, but also to generate a "reserve fund" which they could use only if they made losses or ran into debts against the state or the NBH. The disposable sources of the enterprises were also reduced by this rule, in addition to taxation.

5. "A significant part of the new loan sources of the development funds, however, are needed to replace the old ones," György Tallós summarizes the experiences of the credit system (see Tallós, 1976).

6. "The advantage of investments realized with bank loans from the point of view of the national economy is that it makes the enterprises interested in the rational and economic employment of investment resources, and at the same time, through its credit policy, the central control is able to influence the purpose and time of the employment of investment resources without having to get into detailed investigations and coordination and becoming bureaucratic thereby, or without having to undertake individual decisionmaking. The bank examines the expected profitability of the projects and the security of the repayment of the loan." (From the reform resolution of the Central Committee of the Hungarian Socialist Workers' Party, May, 1966.)

The advantage of investments financed with bank loans was that the enterprise was able to commence on investment projects of magnitudes greatly exceeding its own funds available at the given time, provided its decisions coincided with central credit policy. The responsibility for the investment decision was its own, but it was able to obtain the loan over a simple and quick procedure.

Although the economic mechanism operating after 1968 differed greatly from the earlier (command) system, the reformers' assumption that enterprises would be motivated by the requirements of the market was not realized. Compulsory command planning was abolished, but the most important characteristics of the market economy did not evolve. Supply and demand were not brought into line through prices; the expansionary aspirations of enterprises and their decisions to invest were not primarily guided by their perspectives on the market and their profit expectations; the primary measure of success or failure was not the market. The relations among productive enterprises continued to be characterized by frequent shortages (contrary to the consumer goods market) and the hierarchic dependence of enterprises on the controlling apparatus remained decisive.[7] The former quantitative plan bargaining involving the distribution of materials and production tasks was replaced by regulator bargaining on taxation, the conditions of the financial system, and on obtainable preferential treatment.

Enterprises, taking into consideration that the conditions of taxation could change at any time and that the government had the power even to limit spending of long-term savings of enterprises, tried to spend their revenues as quickly as possible.[8] They also reckoned with the fact that once they had begun a major investment project, the controlling apparatus or the Bank had, in some form, obtained the financial resources necessary for its completion even if the return on the investment or the market outlook was disadvantageous. Understandably, every enterprise tried to develop its own activities independently of profit considerations. Utilizing their financial resources within their own organization, spending them as soon as possible, beginning concrete investment projects and, if possible, incurring debts from the Bank became the fundamental interests of enterprises.

The reallocation of other capital goods (e.g., the sale of assets) occurred only in highly exceptional cases. This was not in the interest of enterprises, but the institutional system of the capital market—the organization, person, or group that would have managed resources as their owner—was lacking. (The short-run interest in raising wages or bonus payments was more important than the long-term development of profits, even for enterprise managers.) Finally, laws hindered integration among the various forms of ownership (by the state, by cooperatives, by private or small-scale enterprises) and the purchase and sale of capital goods.

The lack of a capital market had other disadvantageous consequences. On the commodity market, price rises did not result in an expansion of supply and development of capacity. The positive effects of price rises did not emerge, while

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7. Of the number of analyses of the post-1968 Hungarian economic mechanism, the most recent is Kornai, 1986.

8. The essence of the change is that the role—and the approach—of the financial institutions come to the forefront. Money, however, plays only a very limited role in decisionmaking. See Antal, 1985, and Soós, 1986.

the negative aspects had to be suffered (Soós, 1986). Lacking a capital market and a money market, even the temporary liquidity problems of enterprises could be resolved only with the help of some form of state assistance, which ab ovo precluded consistent enforcement of the Bankruptcy Law (Tardos, 1986).

Several problems arose from the very limited possibilities for reallocation of capital goods, savings, and incomes, and these proved to be difficult to manage within the indirect economic mechanism (the "1968 model"). These problems were:

1. Macro-level regulation of investment demand was very difficult. This had been a recurring problem in the command system as well, but the problem had been of a different nature. The plan expressing the expectations of the central economic controllers (in contrast to the market reflecting the expectations of entrepreneurs) had been overly optimistic in its appraisal of growth potential. With the pressure of the various sectors and investment, the central apparatus had been unable to control the process efficiently.[9] In the post-1968 indirect system, in contrast, the problems which formerly had been manageable through the administrative redistribution of incomes could frequently be resolved only through the generation of surplus revenues, which was enforced precisely by the internal logic of financial regulation. The monetary regulation of macro-level demand, however, did not function, so the fiscal sphere played this role as well, through frequent modification of financial regulations and through taxation.

The frequent modification of the regulators and of the central regulations pertaining to the utilization of financial resources gave rise to uncertainty. Short-term interests came to dominate enterprise management.

2. Lacking any other possibility to let enterprises obtain permanent capital, financial control in this system was forced to seek financing arrangements to imitate the logic of the capital market. Arrangements were needed in which the capital flowing to enterprises with advantageous profit expectations would become a final *surplus* resource (or at least would not have to be repaid in the short term). This, however, was doomed to failure. In practice, the resources provided in the form of state contributions which did not need to be repaid, or were unpaid only at a very slow rate, were qualified as "cheap money" (Antal-Várhegyi, 1987).

The possibility of obtaining extra resources on the capital market (through the issue of shares or other instruments to financial institutes or partner enterprises) depends on a positive prognosis on the dynamism of the firm in question. State contributions, however, were obtained more or less automatically by enterprises that would not have been able to realize their projects out of "harder" financial sources. Final capital contributions were mainly given to unsound enterprises (often indebted for many years) that, however, had development targets approved by the plan.

3. Attempts were made to work out arrangements for state contributions that would, in some way, enforce the criterion of profitability. At the same time, owing to the lack of possibilities for obtaining final capital on the market (but with the abolition of free money from the state), enterprises that had developed quickly with central assistance lost momentum and ran into debt. From time to time,

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9. Central control was able to keep in check investment expenditures only a year at a time. Future expenditures involved in already-made investment decisions could not be regulated. The investments already in progress had to be financed in some way, even if the financial means were not available (Bauer, 1981).

waves of insolvency emerged when the large and growing debts of several large enterprises simply became unrepayable under the given regulations. The enterprise developing at a fast rate (suddenly and greatly increasing its capital) was bound, sooner or later, to run into a tense financial situation (as it was impossible to recover the costs of the investment out of its own yield only).

However, enterprises with a keen interest in obtaining central sources were perfectly aware that they could not possibly be held accountable for the fulfillment of profitability criteria. Hence not only did considerations of profitability not play a decisive role in the shaping of investment decisions, but neither did the feasibility of selling products. The two factors—unrealistic requirements set by regulations and the aspirations of enterprises unchecked by profitability—together caused a strained political situation associated with accumulation of unrepayable enterprise debt. (Thus, for instance, in 1986 the government and the bank wrote off debts linked to centrally approved investments of large enterprises in the magnitude of HUF 21 billion.)

The first major insolvency wave appeared in 1972-74. Enterprises were able to embark on major investment projects primarily through loans. The loans, however, involved rapidly increasing repayment and interest payment obligations. The enterprises, enjoying high growth, could not issue shares or draw in bank capital. They could obtain loans only if the state apparatus or the bank approved their investment projects, for their creditworthiness was deteriorating.

Repayment obligations increased relative to the accumulated resources of the enterprises. While in 1968, repayment obligations had not even reached 10 percent of the enterprises' development funds, by 1974 these increased to 35 percent. At the beginning of the 1970s, more than 40, mainly large, industrial enterprises were unable to meet their repayment obligations. Their debts were rescheduled, and they were given various budgetary subsidies.

The next major insolvency wave emerged at the end of the 1970s. By the early 1980s, the financial tensions related to indebtedness required more than a simple solution by the bank or by the budget—and in most cases it was not even a solution, merely a postponement of the problem for a few years. In 1980, 13 large enterprises' unpaid repayment obligations exceeded HUF 1 billion (Antal-Surányi-Várhegyi, 1986). This amounted to much more than the total capital movement among enterprises in earlier years.

4. The end of the 1970s gave rise to new problems. Economic policy had to give up the goal of developing every sector of the economy (at least, not at the same rate). In the case of the so-called crisis sectors—under present Hungarian conditions these have been metallurgy, coal mining, the meat industry, and building construction—the strategy of withdrawing capital was seriously considered. Under the given legal system (until the introduction of the Bankruptcy Law in 1986 and the establishment of the new forms of association in 1985-86) the sectoral ministries, acting as owners of the enterprises, were supposed to make decisions on the cutting back or termination of enterprises, and involve the financial institutions, the ministry, and the bank in the process. The ministries, however, had no interest in making such decisions. Moreover, the enterprises "condemned to death" enjoyed significant support from the regional state and party leadership. The result was that decisions related to the reorganization of loss-making enterprises and sectors were made after lengthy, bureaucratic bargainings which multiplied the losses of such decisions

(Lamberger-Szalai-Voszka, 1986). Decisions concerning crisis sectors and permanently loss-making enterprises are uncertain to this day.

The 1980s brought fundamental changes. Investments have been curtailed drastically, the government has been pursuing a restrictive financial policy for many years, and the retail price index has been rising steadily by 7 to 9 percent per year. Stabilization of the convertible currency balance of payments became the first priority target (see Erdös, 1982). Changes were also made in the system of economic control, but not as hoped. The most probable reason for the failure was *inconsistency* in the realization of the reform program. Prices have not been freed, the liquidation of enterprises continues to be a decision of the authorities, and administrative interventions by the controlling apparatus are increasing. In addition to open administrative interventions, the pressuring of enterprises, usually to force convertible currency exports, is also gaining in importance (see Kornai, 1986). In 1984, probably owing to the temporary improvement of the Hungarian balance of payments, the reform process came to a standstill. Again the economic policy of forced quantitative growth came to the forefront, but ended in a spectacular failure. The result was not an improvement in economic performance but a rapid rise in demand for factors of production and imports, a very serious deterioration of the balance of payments, and an all-time high budget deficit (Antal-Bokros-Csillag-Matolcsy, 1987).

Despite the contradictory nature of the reform process, numerous significant changes took place in the 1980s. The most important was the development of the institution of the capital market. Another was the widening of the forms of small-scale enterprises and the abolition or easing of regulations restricting these enterprises.

A wide circle of economists (including practicing economic politicians) accepted the fact that an efficient commodity market cannot function without a capital market (see Soós, 1986; and Tardos, 1986). With this view they, in fact, superceded the 1968 reform concept. This, however, did not remain a merely theoretical formulation (which, unfortunately, is frequently the case in the history of the economic reforms of the socialist countries). There were some significant practical changes, the most important of which were:

- the spread of joint ventures and of associations, and the expansion of the legal forms of organization that can be chosen;
- the establishment of the small financial institutions;
- the rendering of new forms of payment (promissory notes, commercial loans, etc.);
- the introduction of bonds and the initial steps toward the establishment of an organized securities market; and
- the introduction of the two-tier banking system on January 1, 1987.

Preparations for the expansion of securities arrangements and for the introduction of shares have already been made. New regulations may be introduced that would not limit the rights of Hungarians to buy shares. The liberalization of the licensing of various forms of international joint ventures, the widening of the choice of forms of domestic association, and the abolition of other restrictions that limit the movement of capital are also planned.

Associations

Enterprises were enabled to found joint ventures already in the 1970s, yet an upswing began only after 1977. Between 1977 and 1983, the assets tied up in joint ventures trebled (Várhegyi, 1987). The rapid growth was linked primarily to tax concessions enjoyed by agricultural enterprises (mainly cooperatives) if they carried out (usually related) industrial activities as well. Later, associations began to spread in industry, too. Benefits to joint ventures or associations included long-term production connections, jointly used infrastructure facilities, obtaining various regulatory advantages, and so forth. Experience shows that the profit motive does play a role, although not a decisive one, in founding and developing associations. Since the mid-1980s, enterprises are also permitted to found shareholders' companies and limited liability companies. (Earlier this was only possible for foreign companies.)

Small financial institutions

At the beginning of the 1980s a number of specialized financial funds were formed to finance investments and contribute equity, within a strictly limited sphere of activities.[10] Later, specialized financial institutions were founded. Their sphere of activities grew and by 1987 most of them obtained the status of banks. Their services cover a wide range: the issue of securities, risk financing, factoring operations, the undertaking of guarantees, leasing, the provision of loans and—for the time being only to a limited extent—the collection of deposits. Generally they function as shareholders' companies. The majority of their shares are, for the time being, in the possession of ministries and large banks, although enterprises are also beginning to show interest in them. Meanwhile, the ministries are trying to keep the small banks under their influence.

By the end of 1986, the small banks' total capital stock amounted to nearly HUF 10 billion. Yet, owing to limitations on the collection of deposits, the role of small banks in financing arrangements is still peripheral. Their significance stems from their entrepreneurial nature: in contrast to the large banks, they do not have to adjust their financing policies to the central plan. They have an important role in financing small enterprises and cooperatives.

Bonds

Although the idea of bonds officially arose as early as 1969, they were introduced only in 1983. Since then bonds have been issued in the par value of HUF 9 billion. (For the sake of comparison, the volume of investments in Hungary is around HUF 200 billion a year.) Most of the bonds are held by the population (see table on the next page). Enterprises invest their savings in bonds only exceptionally.

Issues of bonds that can be purchased only by enterprises or by the population are separated and regulated differently. There is no obstacle to issuing bonds for

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10. For example, the Interinvest limited partnership grew out of the profits of the large foreign trade companies. Fiscal means were used: the foreign trade company that did not invest part of its resources in the limited partnership had to pay a higher tax. The accumulated capital was then used to finance export-oriented investments, for leasing, and to a limited extent to finance its own activities.

purchase by the enterprises, but the permission of the Minister of Finance is necessary for issuing bonds for the population. The reason is that the Budget fully guarantees bonds for the population (including the payment of interest) to create

The magnitude of bond issues
(in HUF billion)

	Bonds purchased by		
Years	*Population*	*Enterprises*	*Total*
1983	0.2	0.7	0.9
1984	0.6	0.3	0.9
1985	1.7	0.5	2.2
1986	3.7	1.3	5.0
Total	6.2	2.8	9.0

confidence in the bonds.[11] In this way, the holder of bonds can obtain an interest rate significantly higher than the one paid on savings accounts, with no additional risk. Some of the bonds issued for the population ensure access to not readily available services.[12]

In 1985-86, several banks began to negotiate securities, at first on a commission basis, and later as a form of investing their own capital. This germinated the securities market. The government is also considering the introduction of other forms of securities, such as shares, treasury notes, and deposit certificates. Although tiny, the securities market has received international attention mainly because it is unusual to use securities in a socialist economy.

Bill of exchange and commercial loan

Before 1985, commercial loans were strictly limited. Refinancing with bank loans was forbidden, and interest rates were centrally regulated. Despite the lifting of restrictions, the commercial loan did not become widespread. Also in 1985, the bill of exchange was rehabilitated. At first its use did not spread, but by the end of 1986 it became popular. In 1986, bills were discounted in more than 1,200 cases, at a value of over HUF 13 billion—not a negligible item in the financing of current assets in Hungary.

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11. Still vivid in peoples' memories are the 1950s, the Rákosi era, when the population practically was forced to purchase some bonds. The bond was not a voluntary form of savings, but a means to decrease disposable income.

12. The holder of the so-called *telephone bond*, for instance, obtained a telephone line within only two to three years.

Bank reform

On January 1, 1987, the functions of the bank of issue and of commercial banking were institutionally separated. Five generally licensed commercial banks were established in the form of shareholders' companies (with the Ministry of Finance holding the majority of the shares). Three of them have nationwide networks (see Ligeti, 1987). Only two commercial banks—Hungarian Credit Bank, and National Commercial and Credit Bank—have very large assets on the books and a significant network of branch offices, and as such can be regarded as potential competitors. Of the five, two banks have no branch offices.

At the time of the reorganization of banks, clients were distributed among the five banks by an administrative decision; after July 1, 1987, however, the free choice of partners was introduced. At present, the clients and the business profiles of the banks are sharply varied. *Legally*, competition is possible among the banks (e.g., the commercial banks can work out their own independent interest rate policies); *practically*, however, there is little sign of this (Bokros, 1987). Bank supervision was also established to safeguard the interests of depositors and creditors and to control and regulate the range of activities and liquidity of the banks.

The relationship between the bank of issue and the commercial banks is characterized by banking means (such as the reserve ratio, rediscounting interest, central regulation of the relationship between capital and the assets on the books, and the determination of refinancing limits). In practice, however, another type of refinancing is also functioning—and not even in a narrow range—whereby the issue of extra loans is linked to expressly political initiatives. In such cases, concrete targets already approved in the plan are financed so that the project can be accomplished even if no more money is spent on it in view of business considerations. To some extent, this is an unavoidable legacy of the past. Because of this, however, refinancing by the bank of issue is not an automatically available line of credit, but a mode of financing concrete targets that has changed only formally.

The bank of issue is still not independent from the state, from the plan (the development targets of the plan are financed by the bank of issue, item by item, through the refinancing credits given to the commercial banks) and from the Budget (the deficit of which at present has to be financed by the monetary sector without limit). At the same time, the range of activities of the commercial banks is also limited: for the time being, they cannot offer their services to the population (collection of deposits and giving loans), nor can they engage in foreign exchange deals.

In summary: most of the institutional and legal conditions of truly commercial banking activity are now established, with the exception of the autonomy of the bank of issue, licensing of banking services for the population and for foreign exchange deals, and collection of deposits by the small banks. Practice, however, does not for the time being reflect the change one would expect from the radical transformation of the system of financial institutions and of the regulations of financing.

In addition to the bank of issue, the five commercial banks with general license, and the small banks, the banking system also includes:

- the National Savings Bank, dealing with the deposits and loans of the population, financing housing construction, and arranging state subsidies

for housing purchase, as well as transacting with small-scale entrepreneurs and providing loans for their investments;

- two insurance companies (the State Insurance and the Hungarian Insurance companies);
- the State Development Institute, which finances government investments and the state subsidies. As it also supervises these, it acts as a semistate institute. (It handles some of its business in the form of commissions given to the commercial banks); and
- a few banks with foreign majority, such as CIB, Citibank (the former being an off-shore bank), and Unicbank.

The 1980s brought truly radical change in the development of the institutional system of the capital market which cannot be considered "cosmetic." Nevertheless, the development of the institutions of the capital market is not the consequence of a consistent reform policy. Nonetheless, development of the institutional system of the capital market is a response to the need for government's long-term restrictive economic policy beginning in the 1980s. The financial restrictions, in contrast to the formulations in political statements and in national economic plans, do not last for two to three years only. Again and again, new restrictions are needed, and this leaves its mark on both tax policy and on the behavior of the financial institutions and banks.

The restrictions were initially aimed at limiting investment to avoid social unrest. In due course we could also find examples of itemized reduction in the costs of investments decided upon earlier. The decisive stabilization factors, however, were the policy of financial restrictions, the raising of taxes, and the tightening of conditions of providing credits. The party organizations and control apparatus participating in the elaboration of economic policy are able to formulate new goals and to allocate productive resources, but not to cut back targets and sources approved earlier. In such cases impersonal money (tax increases, credit restrictions) has to be used.

As part of the stabilization program, financial sources that could be used for investment had to be limited. Therefore, the government tried to withdraw from circulation various enterprise funds. These funds, which otherwise would have been used for investment, formed the original capital for the creation of the small banks. These funds were made available to the small banks not on a voluntary basis, but owing to pressure by the state. The development of the securities market was not much different. The aim was to realize extra savings by the population, while for the experts it proved to be more important that these savings be utilized with a much greater profitability than the deposits collected by the National Savings Bank. The liberalization of joint venture regulations and negotiations were also in part due to the fact that the government tried to counterbalance the drastic investment restrictions with somewhat freer scope for enterprises. The drastic restrictions, tax and interest rate increases, and tight credit were not to hinder small, rapidly realizable investment projects.

The decentralization of the banking system is also a result of grave financial restrictions. As restoration of the balance of payments was given increasing emphasis in economic policy, the National Bank of Hungary (NBH), holding the *exclusive* right to foreign exchange transactions, gradually moved to the forefront. As the autonomy of economic policy in setting the targets for internal growth, accumulation, and standard of living became more and more limited, the

NBH began to push ahead into economic policymaking and into work on the plan that makes the policy concrete. By this time, the NBH could rely not only on its enormous apparatus and on its direct links to the productive sphere, but, monopolizing on its ability to determine the availability of external resources, it also had exclusive dominion over information absolutely necessary for the functioning of the economy. Since 1978-79, it has been impossible to formulate the plan without knowing what external resources could be used. With this capability, the NBH turned from being one of the "extras" into being the main actor of the planning process and of the development of economic policy. This redistribution of power, this exchange of roles, was resisted by other institutions and was further intensified when Hungary joined the International Monetary Fund (IMF) and the World Bank. In the months of the external credit crisis, the NBH making further advances through import regulations and as the leader in the IMF negotiations, demanded and received a place in the development of economic policy publicly, upon conclusion of the first loan agreements. From a certain point of view, the central bank became too strong and as such too burdensome for the planning center. Although this was never stated, one of the factors in decentralization was the intention to restore the earlier balance of power.

To summarize, the institutional framework and regulatory techniques that could lead to the development of a functioning capital market, in the case of a determined political turnabout and a second stage of reform adequate for the purpose, are now established. (This capital market would be potentially capable also of mediating the central structural political conceptions to the business sphere.) Yet sufficient opportunities, or refined limitations, remain, so that should the aforementioned changes not take place, then the new system of financial institutions (including the small financial institutions now advanced to the rank of banks) would still be suitable for the preservation of the former structure of economic control. Thus the changes are a positive step, but they do not amount to a breakthrough and do not guarantee irreversibility of the process.

Replacing administrative restrictions with monetary restriction could ameliorate the paralyzing effects of stabilization and assist structural change which would allow for economic growth in the long run (see Antal-Bokros-Surányi, 1987). The central element of monetary restriction is the strict regulation of the quantity of money. It is important not only that the supply of credit be held in check, but that the full volume of money in circulation be limited if an external balance is to be achieved.

Even if restrictive economic policy was not decisive in the development of the institutional system of the capital market, it still played a very important role. Frequently, the measures by the state serving to liberalize the capital market were intended as compensation for the expressly antireform, administrative state interventions. The new institutions could contribute to the breakthrough of a market-type reform, but it would be an overstatement to say that in today's Hungary the capital market plays a primary role in the allocation of capital.

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10

Socialist Stock Company: The Missing Link in Economic Reform

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The economic reform introduced in Poland foresees the abandoning of the hierarchical planning system and the broad introduction of a market mechanism, in which enterprises are to be given almost total independence in choosing productive targets and in purchasing inputs. Furthermore, a wide range of free prices is foreseen. Central planning is to concentrate on the medium- and long-term planning of strategic problems and to indirectly influence the market by means of financial parameters. Annual central planning is to ensure current financial balance and to coordinate governmental activities, whereas the plans of the enterprises, which will serve the enterprises themselves, will not be aggregated and will not be subject to central approval.

The aforementioned principles were formally introduced by the laws on economic reform passed mainly in 1981 and 1982. Although in practice there remain many exceptions to the above principles, these have been widely accepted by now. Reformed economic systems of this type are operating in Yugoslavia and in Hungary, and seem to be developing along similar lines in the Soviet Union and China.

Decentralization of microeconomic management in itself, even when it is consistently implemented, does not ensure the effective functioning of a market mechanism. Apart from the condition of independence of enterprises, a market mechanism cannot work efficiently without deeply reforming public ownership. In this paper we will try to elaborate on such a reform of public ownership, which should transform public ownership of means of production into public ownership of capital[1] (referred to later as social capital) and solve several problems still troubling a reformed economic system. We will start with a short presentation of some of these problems.

Public ownership model hinders efficiency

The model of public ownership that emerged in the Soviet Union and was later adopted in the majority of socialist countries is characterized by the overlapping

1. The owner of means of production is interested in achieving specific physical outputs whereas the owner of capital is interested only in money return on capital. Means of production have only historical book value whereas capital has a current market value.

of economic ownership[2] with political governance. Such a solution proved successful at the stage of mobilization of underutilized resources, but is becoming increasingly malfunctional in assuring the efficiency and competitiveness at the stage of a relatively developed economy. Political decisions are, and must be, governed by many more different motives than the maximization of future profits. A political actor is interested in achieving various goals, such as the expansion of his spheres of influence, personal promotion, good relations with his/her constituency, support of various lobbies, and the like. Even if one belittles the importance of these behavioral determinants, one cannot ignore the technical and organizational infeasibility of running a complex economy by even the most dedicated bureaucrats.

From the point of view of the economic theory of property rights, the forms of public ownership prevailing in socialist countries resemble communal property. The cost of using public resources is not brought to bear on decisionmakers but on society as a whole, which means that in practice, it remains an external cost for decisionmakers. Therefore, the opportunity cost of social capital is not taken into account when deciding on the allocation of this capital, which is treated as a kind of free resource. This is one of the main reasons for such characteristic phenomena of the socialist economy as overinvestment, misallocation of capital, prestigious investment projects, excessive exploitation of natural resources, and so forth. It also partially explains the existence of an unduly concentrated and inflexible organizational structure of the economy.

In all socialist countries there are relatively few small- and medium-sized enterprises. Enterprises are often too large from the point of view of optimal production scale. This results in an excessive vertical and horizontal integration of production. This is due to the following rule: the smaller the number of enterprises, the easier their supervision. Organizational structures are not shaped to minimize total cost, but to minimize supervision cost. The structure of the economy is also inflexible due to the fact that the institutions administering publicly owned capital are virtually not interested in the creation of new firms and in the liquidation of inefficient ones. This, of course, must exert a negative impact not only on allocational efficiency, but also on the rate of technological progress and changes in the structure of output. The inherited model of public ownership interferes with the efficiency of the market, which is to become one of the main pillars of the reformed economies.

Introduction of new economic mechanism

The introduction of a new economic mechanism has not changed this situation sufficiently. Enterprises are to finance their assets from undistributed profits or from bank credits, but there is no efficiency control over enterprise management. Certain crucial ownership functions are still vested in administrative bodies (e.g., in branch ministries or local authorities in Poland, which are called *founding bodies or enterprises*). The point is that these bodies, as political actors, are hardly interested in the efficiency with which *their* enterprises use social capital. They still do not take into account the opportunity

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2. The attributes of ownership consist of the right to: appoint or dismiss agents directly controlling capital and to determine their remuneration, determine the distribution of profits, transfer capital from one activity to another, merge or divest.

cost of capital. Besides, the entrusting of responsibility for groups of enterprises to administrative organs (such as branch ministries) intensifies the paternalistic attitude of the state toward enterprises.

Workers' councils, the other type of institution vested with substantial ownership rights in some socialist countries, mainly in Yugoslavia and to some extent in Poland, do not operate in an economic regime, either. The rights of employees to the future profits of their enterprises are neither exclusive nor transferable. Therefore, for an individual worker the control over his/her personal income is more attractive then his/her control over capital invested in his/her enterprise. Besides, due to the lack of a capital market, the opportunity cost of capital to a workers' council is only the least efficient opportunity for using the capital within the enterprise. This is one of the reasons for the excessive propensity to distribute net profits in self-managed firms rather than to invest in them. This hinders interfirm flows of capital.

From the point of view of economic efficiency, prevailing forms of public property exhibit several drawbacks also in the reformed mechanism. Agents representing the public are not adequately interested in the efficient utilization of social capital. There is no competition among those who are vested with the responsibility of using social capital. No efficient social capital market can be created. The following outline of our conception of a model of public ownership compatible with the market would, we hope, fill the place left by the missing link in economic reform.

Transform state enterprises into joint stock companies

The first condition of market-oriented reform of public ownership of capital would be the transformation of state enterprises into joint stock companies. The stock company form of enterprise opens a practically unlimited range of ownership structures. In the developed capitalist countries, stock is held mainly by private owners and is quite concentrated. This model of the ownership of capital is usually considered incompatible with the ideological principles of the socialist countries.

It is sometimes suggested that managers in themselves could efficiently run firms if only a new economic system is consistently implemented. This is a naive thought because without ownership control, managerial shirking would thrive. There would be no institution to evaluate managerial performance and ensure competition for managerial posts. Organizational structures and investment allocation would suffer from unconstrained managerial ambitions.

According to a proposal put forward by some supporters of self-management, stocks should be distributed among workers employed by the enterprise only. However, in elections to workers' councils the principle of "one man, one vote" would apply. This solution would encourage workers to maintain interest in the long-term efficiency of the enterprise, though only to a limited extent. Workers retiring, or moving to other enterprises, will have to sell back their shares. Next, the distribution of shares among workers would not solve the problem of external control through the capital market, on which professional investors, experts in the evaluation of a company's performance, are active. There is also little hope of achieving flexibility in the organizational structure of industry.

The idea of attaching the ownership function to banks is sometimes promoted. It seems that putting together different functions in one institution is undesirable, at least as a dominant solution, from the point of view of operation of financial

markets, where both equity investors and money lenders are needed. For example, long-term financing seems indispensable for the majority of enterprises, whereas banks are engaged mainly in relatively short-term financing. Next, the cost of external financing is not linked to the profitability of the enterprise, so that the enterprise, financed in such a way, is exposed to a much greater risk than in the case of equity financing. The prognosis of some economists concerning the growing dominance of capital over other forms of capital has not been fulfilled.

As far as other financial institutions (insurance companies, pension funds, mutual funds, etc.) are concerned, it must be noted that they are financial intermediaries whose aim is to invest only a specific kind of savings. Their role as a source of social capital could not be a dominant one. Besides, financial institutions in socialist countries are not, so far, the institutions the market economy needs. They form a highly centralized system without any possibility of competition. The state guarantees a specified level of pensions, insurance compensations, and payments of interest irrespective of the revenues of financial institutions. The financial reforms begun in Hungary and Poland aim at the demonopolization and commercialization of those institutions. One could expect that the creation of mutual funds would follow. Perhaps voluntary old age insurance payments will develop. However, even with the most favorable evolution, it is not realistic to assume that financial institutions can be entrusted with the main responsibilities for public ownership.

Holding companies to invest social capital

Thus, the question arises whether it is possible to create public institutions whose main interest would be the long-term efficiency of social capital and which could become the basic element of the public ownership structure. It would seem that such institutions could be conceived in the form of public holding companies, that is, special enterprises that would be the principal owners of the stock of "normal" enterprises. The main task of these holding companies would be to invest the social capital vested in them in such a way as to maximize the value of the shares held by them.

This means that the holding companies would be purely financial institutions not linked to specific branches or sectors. Holding companies would buy and sell shares, vote at shareholders' meetings, initiate and approve organizational changes, etc. Holding company managers would be evaluated and remunerated by the supervisory organ, not for accomplishing any targets expressed in physical terms, but for gains resulting from the change in the market value of shares held. Each holding company would be controlled by its board of trustees, which would be appointed by and subordinated to parliament.

The basis of a socialist capital market

The transformation of state enterprises into stock companies whose shares are held and traded by holding companies would be the basis for creation of a socialist capital market.

In perfect capital markets, the price of a share reflects all information concerning the present value of future profits of a company. Managers of enterprises must be able to adapt themselves to changing conditions and plan a strategy taking into account every noteworthy circumstance. The performance of

management is reflected in the market value of an enterprise's shares. The manager of a stock company has to follow the principle of profit maximization if he wants to keep his job.

From experience, capital markets do not accomplish these functions without some failures. The capital market based on the changes in institutional structure outlined here would probably be even more remote from the ideal model. However, even such a capital market could bring significant advantages. In the first place, there would emerge an opportunity to eliminate the tendency to invest social capital without taking into account the future profitability of investment. Holding companies would not be interested in the expansion of some specific production targets. They would be interested in profits only.

The proposed system would help to resolve another problem encountered in socialist economies—the problem of evaluating an enterprise's performance. This problem is usually approached by applying an arbitrary set of criteria, such as production, export, energy conservation, and other targets. The multi-criteria evaluation always gives rise to doubt about the importance of individual criteria about their trade-offs. Evaluations of this kind do not account for the complexity of conditions in which an enterprise operates. The capital market resolves this problem by evaluating different aspects of an enterprise's behavior from the point of view of its future profits. Public holding companies would be compelled to thoroughly analyze the situation and prospects of companies whose shares appear on the market.

The economic reform, being introduced in Poland and Hungary hitherto, could not find a satisfactory solution to another important problem of a market economy: the problem of capital allocation among different sectors of the economy. The savings of one firm could not easily be invested in another firm due to the lack of an appropriate intermediation mechanism. The result is difficulty in changing the structure of industrial output. The system of public property based on stock companies and public holdings would create efficient channels of capital flows among different sectors.

Access to other financial institutions

An efficient capital market cannot be based on a small number of public holdings only. Access to this market should also be given to other public institutions, such as reformed banks and other financial institutions. Nonfinancial public enterprises could become the next group of investors. This is desirable not only from the point of view of broadening the set of capital market participants, but also to create new opportunities for investing the undistributed profits of enterprises.

Access to private investors

The flexibility of the proposed market could be further enhanced by giving private investors some access to it. Freer access to the capital market would mean that more actors would be able to evaluate the prospects and the development potential of various sectors and enterprises. Their buying and selling behavior would influence the relative values of shares.

The argument is sometimes raised against private ownership of capital in a socialist country. The purchasing of shares by private investors could be arranged in such a way that it would only mean a form of deferring

consumption. Various safeguards for taking control over public firms by individuals can be considered—for example, making the majority (say, 70 percent) of stocks of any particular company available only to public investors, or selling to the general public only stocks without any voting rights. In the U.S. capital market, institutional investors hold 30 percent of the stock; the rest is held by private investors. What we propose here differs in the proportions rather than in the mechanism and functions of the capital market.

Depositing private savings in state banks and receiving interest is already possible. Investment in stocks will differ in that it assumes some risk involved in the choice of investment alternatives. If, in a socialist country, the state promotes a wide array of games of chance (lotteries, pools, etc.), where prizes are disproportionally high in relation to the invested stake, why exclude other forms of investment for private savings? The taxation system should take care of controlling excessive incomes from investment in stocks, whatever is thought excessive in a given space and time. Allowing private ownership of shares could help absorb forced savings and thus reduce inflationary pressures.

Coexistence of state ownership with workers' participation

How can the proposed reform of state ownership coexist with self-management or workers' participation in enterprise management in socialist countries? The flexibility of a stock company permits various different types of ownership control structures over companies. For example:

- a workers' council could have a right to obtain shares of the company;
- representatives of a workers' council may sit on the board of stock companies; and
- a statute could provide for the decisive role of a workers' council in certain areas.

Role for entrepreneurs

These reforms should help to solve another acute problem of socialist economies: the lack of entrepreneurship. In the traditional system the initiative for founding a new enterprise was limited to state organs which hardly availed themselves of this function. In the system proposed above, the founding would be entrusted to individuals and the widest circle of institutions. The role of entrepreneurs would be to convince investors (holding companies, banks, etc.) about the financial attractiveness of the proposed project.

Interest of managers

The crucial point of the proposed model concerns the interest of managers of public holding companies in profit maximization. Rules concerning the remuneration of holding company managers should be worked out which will make them deeply interested in the future profits of their company.

Some problems requiring solution would be:

- equalization of the market power of holding companies at the time of their creation;

- depolitization of the process of selecting holding company managers; it suffices that the boards of trustees would be accountable to parliament; and
- supervision in the creation of holding companies (and their operation) to avoid the formation of branch monopolies.

We believe that the above model of public ownership is in itself insufficient for curing all ailments of the socialist economies, but it could be a valuable element supporting the reforms introduced so far.

11

Financial System for Restructuring the Yugoslav Economy

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Recent attempts in many socialist countries to reform their economies through greater reliance on the market cannot be successful without entry of new firms, which in turn cannot occur without massive investment in domestic entrepreneurship. To support this process, a full-scale reform of the financial system is necessary.

Transition from bureaucratic to market coordination

Over the past decade a number of leading socialist countries have started to introduce economic and political reforms which seem to be more serious and far reaching than any similar reforms in the past. The common denominator of these reforms is an open recognition at the highest political levels that without a much greater reliance on market coordination of economic activities as opposed to the existing bureaucratic coordination, future economic development will not be possible. Although many prominent socialist economists have since the very beginnings of the socialist state advocated market coordination as a necessary condition of efficient socialism, it is only recently that this view has also been widely accepted by top policymakers in socialist countries.

This change in ideological position is mainly a consequence of the profound change in global economic conditions which technological advances and shifts in demand patterns led to a rapid shift from mass produced, standardized consumer products to high-quality, diversified products for specialized market niches. This shift made it almost impossible for the socialist countries to follow technological progress and to compete on world markets within the existing framework of bureaucratic economic coordination. If socialist countries wanted to maintain or even enhance their position in the world economy, they had to reconsider their economic organization.

Introduction of market coordination in socialist countries can have positive effects only insofar as the markets will be reasonably efficient, which means that they will have to be reasonably competitive. To achieve competitiveness it is necessary to develop a mechanism of entry and exit of firms and to ensure that the number of firms competing on a market becomes as large as possible.

Empirically, we can observe that in market-oriented economies market structure is characterized by what can be called a normal size distribution of

firms, meaning a healthy mixture of small, medium, and large firms. The small- and medium-sized firms are extremely important for maintaining competitive structure and can be regarded as a vital part of efficient market economies.

When looking at the market structure and size distribution of firms in socialist countries, we find that small firms practically do not exist, particularly in the size range of 10 to 100 employees.[1] This is a direct consequence of bureaucratic coordination, including control over the allocation of investment funds. For years there has been practically no entry and exit of firms, and growth has been mainly achieved through the expansion of existing firms. New firms, if created, are invariably of medium and large size. There is practically no reduction in the size of existing firms in spite of hidden unemployment in most large firms. While in the past there were many instances of growth of firms through vertical and horizontal integration, disintegration of large firms is very rare. It follows that such industrial structure is incompatible with the operation of efficient markets: therefore, future development of market coordination in socialist countries will have to rely on radical changes in industrial structure to eventually lead to a size distribution of firms which will bear a much closer resemblance to the existing size distribution in market economies. The crucial question is how to bring about this change in market structure.

Entrepreneurship and entrepreneurial management

The transition from a highly concentrated and inefficient market structure to a competitive market structure in socialist countries could be attained by:

- entry of new firms; and
- breaking up existing firms into smaller units able to compete on the market.

For the entry of new firms one needs entrepreneurs, and for trimming down old firms one needs entrepreneurial management. A massive entry of firms requires generation of a large number of project ideas and correspondingly a large number of entrepreneurs or entrepreneurial groups to carry out the projects. For this purpose the socialist countries will have to stimulate entrepreneurial behavior to bring about entrepreneurial growth.

In socialist countries the entrepreneurial role was always limited to the state bureaucracy. The system of economic regulation in these countries required and stimulated managers who were good in performing tasks set by bureaucratic leadership. Traditionally such managers tended to exhibit limited initiative, conforming and accommodating to regulations and attempting to utilize the system to the advantage of their enterprise. They were preoccupied with building good connections with economic guidance organs. All this kept them from making entrepreneurial decisions and adopting entrepreneurial behavior. Therefore, the development process was limited to those processes and aspects which were consistent with bureaucratic entrepreneurship, most of which were related to the establishment of big enterprises producing low-quality mass produced products for protected domestic markets. In this development process—with the exception of some farming, handicraft, and personal services—there was

1. A possible exception to this is China.

no room for small- and medium-sized enterprises which would require a large number of autonomous entrepreneurs (Noar and Bod, 1986).

In this paper we argue that the following chain of relationships is crucial for effective economic reform in socialist countries: increased efficiency, efficient markets, competition, competitive market structure, entry of new enterprises, and entrepreneurship.

It is necessary to distinguish two needed types of entrepreneurs with different backgrounds and training. The first type of entrepreneurs are the people who can effectively develop new, particularly small-scale enterprises and make them a market success. The second type of entrepreneurs are those who can effectively break up, trim down, and restructure existing big enterprises and make them viable economic units. The first type of entrepreneurs are entrepreneurs in the classic sense who realize their ideas through new ventures. The second type are managers who can handle big organizations, but who are capable of developing entrepreneurial management within existing organizations.

In socialist countries there is an enormous need for both types of entrepreneurs since the development of competitive market structure requires the filling up of a "socialist black hole."[2] In socialist countries, firms of this size can be brought into being either by establishing new firms or by breaking up existing ones. Although the core parts of the firms broken up may remain quite big, a large number of subsidiaries, plants, and establishments which formerly belonged to bigger firms would become independent enterprises falling within the range of small- or medium-sized firms.

To increase the supply of entrepreneurs and stimulate entrepreneurial management, the socialist countries will have to introduce both macroeconomic measures which will induce managers to accept risk and responsibility and which will develop full institutional support for the development of entrepreneurship. Many market-oriented countries have policies for developing entrepreneurship. Socialist countries should adopt these policies too.

The most important institutional set-up which has to be developed in support of "entrepreneurship-led reform" is financial institutions which would be specifically developed for the promotion of entrepreneurship. In the remainder of the paper we discuss some ideas concerning the development of such financial institutions for Yugoslavia.

Financial reform in Yugoslavia

In the development of the reformed financial system for Yugoslavia, two considerations must be kept in mind:

- Contrary to what one might expect, the Yugoslav economy exhibits a clear "socialist black hole" implying that the industrial structure in Yugoslavia is almost as distorted as in other socialist countries. Therefore, the need for entrepreneurial development is as acute in Yugoslavia as in other socialist countries.

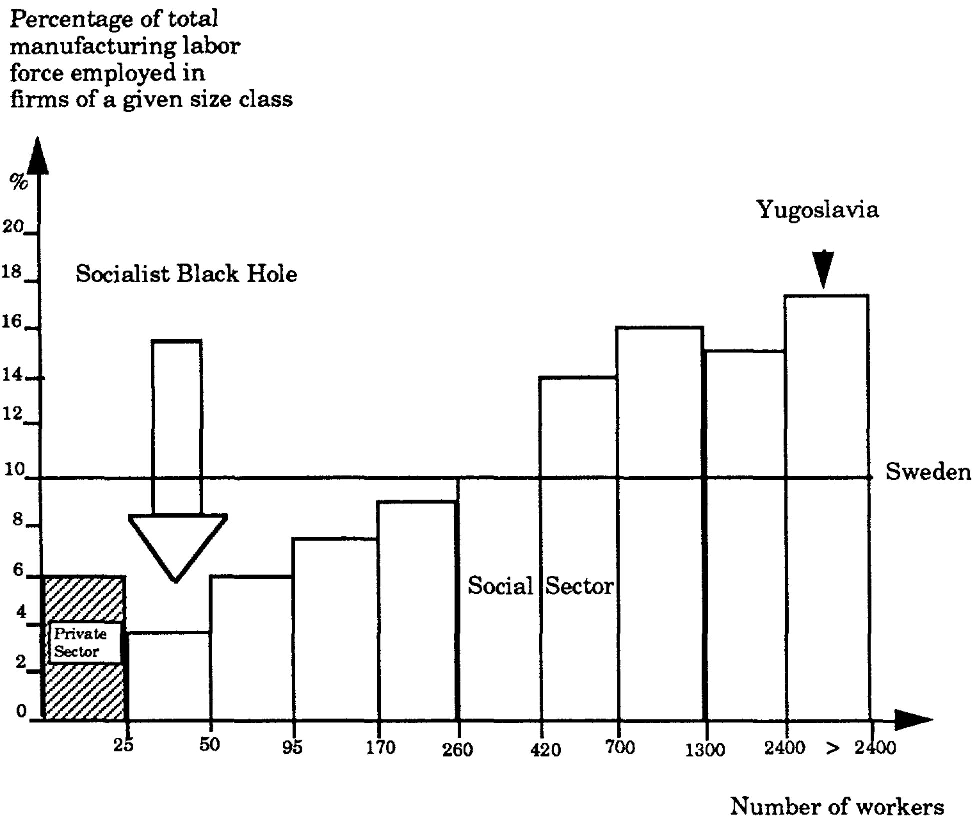
2. The term "socialist black hole" refers to lack of firms employing 10 to 100 employees in all sectors of socialist economies. In entrepreneurially efficient countries, the "black hole" would be filled by such firms.

- Yugoslavia is a self-managed economy; any institutional development must take this into account. Any transplant of existing institutional solutions from capitalist market economies faces additional problems in the case of the self-managed socialist economy. This is particularly true when we deal with financial and capital markets.

The "socialist black hole" in Yugoslavia

The degree of distortion of the market structure in Yugoslavia's manufacturing sector is illustrated in the figure on the next page. The "black hole" in this example is constructed by comparing the size distribution of manufacturing firms in a mature market economy, in this case Sweden, with the

Figure. Distribution of public and private manufacturing enterprises by employment size in Yugoslavia and Sweden



size distribution in Yugoslavia. The total area under the curves represents 100 percent of total manufacturing labor force. The size class limits are derived in such a way that the Swedish manufacturing labor force was uniformly distributed in the size classes, with 10 percent of manufacturing labor force in each. The Yugoslav size distribution of firms is then plotted against the same scale. This presentation shows an almost complete absence of small enterprises in

Yugoslavia. The only small enterprises are at the very low end of the distribution, in the private sector.

The long-run strategy of industrial development should require the "filling in" of the "socialist black hole" by both breaking up large firms and by entry of new firms. This raises a key issue of the political economy of socialism: should the "socialist black hole" be filled in by the private sector, by the socialist sector, or by both. We will not deal with this issue here, but assume that it is possible to carry out efficient restructuring of the socialist sector through promotion of entrepreneurial firms of the self-managed type.

Managerial versus self-managed firms

It is now generally acknowledged that reformed financial institutions in the future market socialist economies would fulfill the tasks performed by the stock exchange in capitalist countries(see papers by Nuti and Iwanek and Swiecicki in this volume). The transplantation of financial and capital market institutions from the capitalist environment to the socialist countries in managerial-type firms is relatively straightforward. The only essential difference between the two situations is that productive capital is publicly owned; therefore, socialist stock market operations are carried out by institutional agents acting on behalf of the state rather than by private individuals acting on their own behalf. Publicly owned firms would be transformed into socialist stock companies (limited liability corporations), and mechanisms would be created to evaluate the market value of the company. Companies would be restructured through a process of competitive bidding for firms by, for example, managerial groups.

This transplantation is not so straightforward in the case of a self-managed socialist economy. A self-managed firm is not a piece of property whose market value can be determined and which can be bought, sold, restructured and in general manipulated by outside agents. It is rather an association of members with certain obligations to the rest of society. These obligations have mainly to do with the conditions under which the firms may use social capital. When the general agreed-upon obligations are met by the firm, no outside agent can interfere with the operation of the firm. The financial statement must take this into account.

Restructuring existing enterprises

In Yugoslavia it is clear that piecemeal and gradual reforms and restructuring yield no tangible results. There is now a growing awareness that radical changes must be carried out in the economic system. This effectively means that one has to take a global view and ask the following question: what should be done with existing production organizations, both in physical as well as in organizational terms, if maximum economic value is to be extracted from them? To visualize the size of the problem we should consider that Yugoslavia's productive sector employs over 5.5 million people, in 20,000 production units, with assets exceeding US$80 billion in value. From the financial point of view, we can visualize these 20,000 units as 20,000 balance sheets, with corresponding assets and liabilities. Under the present distorted financial system, the balance sheet data both on the liability and on the asset side have practically no economic meaning for most enterprises. Identical fixed assets have widely different book values depending on the particular arrangement and time of the acquisition of

assets. The same is true of liabilities. Identical real assets will imply widely differing flow obligations for different enterprises. Therefore, in any serious reform of the financial system, the existing balance sheets should actually be scrapped.

The next step would be to evaluate the current book value of all assets of all firms and enter the equivalent amounts as equity on the liability side of the balance sheets. All equity should be transferred to caretaking institutions which would be charged with the responsibility to manage social capital and would be directly responsible to representative political bodies. This would effectively be equivalent to resocialization of social productive assets which presently are more or less *de facto* in collective ownership by workers' collectives, subject to haphazard outside intervention from political authorities at various levels. We can say that at present the property rights on productive assets in Yugoslavia are not clearly defined: it is unclear which groups of people, agencies, or institutions are responsible for their efficient use. The new balance sheet would be the basis on which the negotiation between the enterprises (workers' associations) and caretaking institutions would be carried out. The main issue in negotiations would be to determine the economic value of the assets, which would be a labor-managed equivalent of the market value of a joint-stock company. Determination of this value is of course not a trivial matter. The key problem is how to motivate all economic agents who have information on the potential use of assets to reveal their knowledge, and so contribute to the objective evaluation of the economic value of the assets in terms of future income earning power. Once the economic value is assessed and adjusted accordingly, the assets would be leased to the collective at the lease price arrived at by applying the prevailing interest rate. The past performance of the enterprise could be used as a benchmark for evaluating the lease price. Initially, one could use a simplified solution by charging to each enterprise as the lease price the difference between the past period's revenue minus the sum of material cost, taxes, and contributions, as well as the imputed labor cost.

After the leasing arrangement is fixed, the firm would be allowed to operate freely on the market without any direct intervention—formal or informal—and would be allowed to distribute all surpluses. The firms would finance working capital requirements through normal commercial bank arrangements, while long-term investment would be financed through bank credit, fixed- or variable-yield bond issue, or through equity investments of the caretaking agency. It would be in the interest of workers and managers to maximize the residual income, which would then reveal the economic potential of the assets and provide a new benchmark for the new leasing agreement. Although the scheme is not fully efficient, since there would be a tendency, at least initially, to undervalue leases, it would be relatively simple to implement and would have the dynamic tendency to improve economic use of assets while at the same time equalize workers' incomes. Not everything should be prescribed in advance, and more detailed arrangements which would define more precisely the roles of various decisionmakers—workers, management, and outside agencies—should be left to participants to decide. The basic idea, however, should be that the basic economic relationship is between the enterprise as a whole—including management, and society represented by a caretaking agency—and not between the society and management alone.

Entry of new enterprises

Due to the magnitude of the problem of massive creation of new enterprises in Yugoslavia, it can be argued that the general reforms of the financial system ensuring independence and commercial behavior by banks would not be sufficient. A highly developed network of financial institutions dealing specifically with the entry of new firms would have to be created. These institutions can be conceived as mixtures of development banks and venture capital firms adopted to the conditions of a self-managed economy.[3]

It would be important for such institutions to have diversified sources of funds to spread the risk of failure over a large number of depositors, and for the network of investors to include relatively big, financially strong organizations. The main source of investment funds would be the lease payments by existing enterprises to the caretaking institutions and banking resources, ultimately the savings of the population. The basic difference between such financial institutions and the traditional financial intermediaries is that such institutions would be much more involved in the preparation of investment projects—including training of entrepreneurs and later supervision of the efficiency of investment—than traditional financial intermediaries. This would ensure that the new enterprises are successful.

Some of the principles for forming these financial institutions would be as follows:

- It is necessary to finance simultaneously a large number of projects; high returns can only be ensured for a large group of enterprises, not for individual enterprises.
- The average expected rate of return of the newly created firms (calculated at opportunity cost of labor) should be much higher than the return on world financial markets.
- Financing of each project must be carried out in phases. After each phase, it is necessary to make a decision on the continuation of the project.
- Each project should account for full costs, including all preparatory work.
- Cumulative costs of unsuccessful enterprises at the moment of the discontinuation of the project should be transferred back to the financial institution.
- Enterprises which eventually succeed must over their lifetime cover all investment costs, including interest on all projects.
- The innovator-entrepreneur of a successful enterprise must receive a share of the extra income.
- When the enterprise begins regular production, it is constituted as a normal self-managed enterprise with business autonomy. In many cases the entrepreneur is supported by the professional management team.
- For the minimization of risk it is important that the financial institution intervene in the enterprise if it determines that the return will be lower

3. Such institutions can be modeled to a large extent after the Mondragon's Caja Laboral Popular, particularly its Entrepreneurial Division.

then expected. An intervention department should be established to follow the activities of new enterprises when expected results are not achieved. The intervention department would not interfere with the self-management rights of the enterprise, but it would only take care of the security of its investment. These organizations would be run according to market principles, and their costs would be included in the costs of financing and would be covered from the income of the newly established firms.

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12

The Role of Small-Scale Industry in Yugoslavia's Economic Development

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Under Yugoslavia's socialist self-management system, where social ownership of the means of production prevails, the role of the private sector in the economic and social development of the country can be illustrated best by the activities of small-scale industry (SSI). Although the development of SSI lagged in the overall economic development of Yugoslavia after World War II, its role has gained importance since the adoption of the Long-Term Economic Stabilization Program.

The term small-scale industry, as used in this paper, covers the following:

- organizations with a small number of workers producing a single product or manufacturing a series of products on a small scale;
- organizations of associated labor which, irrespective of the number of workers, render all kinds of services in the fields of crafts, catering, tourism, transportation, trade, and so forth;
- crafts and other activities pursued by self-employed persons, including handicrafts, tourist accommodation rentals, and bed-and-breakfast services. Also included are all forms of mutual pooling of labor and means of production into cooperatives and other forms of associations, and the pooling of labor and resources with workers in the social sector into organizations of associated labor in accordance with the law; and
- agricultural cooperatives and other forms of associations of farmers, or associations of farmers and workers in the social sector into organizations of associated labor.

Activities of privately owned shops, joint private shops, contractual organizations of associated labor (COAL), cooperatives, and other forms of associations constitute the basic forms of self-employment. Under Yugoslav law (the Social Compact), a joint private shop can be set up by no more than 10 self-employed persons, and each self-employed person can employ up to 20 workers.

Because self-employed persons can perform all economic activities, except those prohibited by law, both their area of work and forms of association are continually expanding. Similarly, COALs offer exceptional possibilities for expanding employment because there are no legal limitations on the number of workers they can hire.

The success of SSI, both in the private and the social sectors, is inextricably linked to Yugoslavia's overall economic development. Unless further division of labor, specialization, and cooperation are achieved within the small-scale sector on the one hand, and between the small-scale sector and the rest of industry on the

other, there will not be significant development in SSI, corresponding industrial development in other branches of the economy, and further industrialization. SSI is vital for the private sector of Yugoslavia because it accounts for all of the production of goods and provision of services to the private sector, including agriculture, with the exception of individual farmers.

Because of the narrow definition of industrialization in development policy, the development of large-scale industrial facilities has been favored in Yugoslavia. In fact, SSI is far less prevalent in Yugoslavia than in medium- and highly industrialized countries. Medium- and large-scale organizations employing over 250 workers account for only 1.5 percent of the industrial and crafts units in Yugoslavia. However, they employ 72 percent of the labor force and generate 76 percent of the value added. The consequences of this low share of SSI in the economic structure of Yugoslavia are, therefore, low adjustment capability, many bottlenecks, and underutilization of available capacity. The underdevelopment of SSI has caused structural imbalances in the Yugoslav economy; this has considerably decreased the economy's total efficiency and competitiveness and has led to constant shortages of certain goods and services.

Because of underdeveloped services and an inadequate range of commodities, many household needs cannot be met. Unless the country achieves a high level of SSI development, it will not be able to increase employment, make better use of household assets (in dinars and foreign currencies)—especially those of guest workers returning home—or accelerate development of the underdeveloped mountainous and frontier regions.

The development of SSI constitutes a prerequisite for:

- extensive and longer-term pooling of personal labor and private resources[1] with organizations of associated labor and socially owned resources;
- increased employment[2] and fuller integration of SSI workers in the socioeconomic and political life of the community (through membership of the sociopolitical communities, self-management communities of interest, and other self-management organizations and communities); and
- further equalization of worker's fundamental rights and duties with the socioeconomic position enjoyed by them in associated labor.[3]

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1. Self-employment as the functional, complementary, and integral part of the self-management of labor is guaranteed by the Constitution "provided the performance of activities with personal labor corresponds to the mode, the economic basis, and possibilities for personal labor and provided it is not contrary to the principle of income earning according to the work performed, or to other foundations of the socialist system" (Constitution of the Socialist Federal Republic of Yugoslavia, Article 64, paragraph 1).

2. The Constitution guarantees workers who independently perform activities with their personal labor and private resources that they may, under conditions stipulated by law, employ the additional labor of other persons. This needs to be done on a self-management basis by pooling personal labor and resources with the labor of other persons under COALs (Articles 67 and 68 of the Federal Constitution). However, in the relationships, all forms of exploitation of others' labor is prohibited. In other words, the labor of another person cannot be employed to usurp its surplus value or social accumulation.

3. The nature of production relations in SSI in the field of personal labor is not determined by private ownership of the means of production, but by the fact that personal labor does not lead to any kind of capital-based relations. In this relationship, the labor and social accumulation of others are neither being exploited nor preempted. Therefore, the Constitution offers this category of working people the possibility of acquiring personal labor-based income.

The Associated Labor Act has provided the needed social, economic, and legal preconditions to ensure that capital-based relations are avoided and that the exploitation of man by man is prevented. Self-employment guarantees stability and voluntarity and is based on free, income-based relations and integration with other self-employed persons and with organizations of associated labor.

The development of SSI through various forms of cooperatives, especially through the establishment of lasting relations with associated labor in the social sector, has not been fully utilized. Yet, the prospects for self-employment in SSI are good because of its free integration with organizations of associated labor for the purpose of cooperation through craft shops, cooperatives, basic cooperative organizations, contractual organizations, and so forth.

Trends in the development of small-scale industry

After World War II, the development of small-scale industry lagged behind the development of the economy at large. The growth rate of the volume of goods produced and services rendered by SSI during 1953-80 was substantially lower than that of the social product in the economy as a whole.

The pace of development of SSI could be divided as follows:

- 1953-60. The rate of growth of SSI production and services was 3 percent per year compared with 9 percent for the overall economy. The maximum capital outlays set aside for large-scale industries accounted for the difference.
- 1961-70. The SSI growth rate during this period increased to 5.2 percent as a result of the increased demand for consumer goods and services. A considerable portion of this demand was met by the SSI. In addition, after the 1965 economic reform, the SSI became more capable of adjusting to new economic conditions.
- 1971-80. SSI growth finally caught up with the economywide growth rate of 5.7 percent.

During 1976-80, the projected SSI growth rate was not achieved, especially among the self-employed and contractual organizations of associated labor. SSI social product grew at a rate of 4.9 percent, the social product of the economy at 5.5 percent, and of industry at 6.8 percent.

However, during 1981-85, adverse economic and social developments affected the overall economy and the industrial sector more severely than SSI. This is understandable, because SSI was able to adjust to these adverse conditions more easily than the rest of the economy. The social product of SSI during this period grew at an annual rate of 3 percent, while the rest of the economy grew at 0.6 percent, and industrial production increased by 2.6 percent. During the same period, employment in the small-scale sector increased by 3.5 percent and in the rest of the economy by 2.4 percent.

The private sector of SSI registered more growth in its social product (averaging 3.7 percent) than the social sector (2.5 percent) during 1981-85. The private sector's share in the social product of SSI also increased: from 17.6 percent in 1980 to 20.8 percent in 1985.

At the end of 1985, SSI in all its organizational forms employed some 567,000 people, including shop owners. This number corresponded to 10.4 percent of the Yugoslav work force. The social sector accounted for 35.2 percent of workers in SSI, and the private sector for the remainder. In 1985, the small-scale industry

accounted for just 5.3 percent of the social product of the economy. This share has remained more or less unchanged over time.

Nevertheless, the fact that the small-scale sector has achieved more favorable development results than the economy at large is encouraging. Economic relations within, and the attitude toward, SSI are changing. A favorable disposition toward the small-scale industry is not an objective in itself; it is rather a means of achieving a fuller and more complementary economic structure. To achieve this, SSI is dependent on the growth of the overall economy, on improvements in the standard of living of the population, as well as on the social activity and support given to its development. On the whole, such support was lacking in the past.

However, subsequent changes in the social and political climate created a more favorable attitude toward SSI. Measures were taken and activities pursued to implement "social compacts" to promote the development of SSI in various republics and provinces. Though modest results were achieved, these measures and activities did not make any significant impact on the development of this part of the economy.

In recent years, SSI has been characterized by unequal growth among regions owing to differences in the level of economic development, needs, and possibilities for its development (see table). Lack of a favorable climate for SSI in the past alone cannot explain the stagnation of small industries in numerous communes and regions. While in some communes, the share of SSI in the

Social product of small-scale industry per inhabitant, 1984

Provinces / republics	*Social product of SSI per inhabitant, 1984 (in dinars)*
Bosnia and Herzegovina	8,355
Montenegro	6,773
Croatia	20,361
Macedonia	11,087
Slovenia	35,023
Serbia (total)	11,980
Serbia (excluding provinces)	12,604
Kosovo	4,337
Voivodina	16,646
Yugoslavia	14,711

economy was as high as 20 percent, in others the share was as low as 1 to 2 percent. Although the development of SSI is affected by economic factors, its low

level of development reflects inactivity and lack of adoption of available economic policies. Often, there was hesitation or open resistance toward development of SSI, especially self-employment.

As illustrated by the table, Slovenia has the most developed small-scale industry. The social product per capita of SSI in that republic is 2.4 times higher than the Yugoslav average. Croatia comes second with the social product 1.4 times the national average, and Voivodina third. The remaining republics registered lower development levels, with Kosovo being three times lower than the Yugoslav average.

These data confirm the conclusion that SSI is more developed in the more developed parts of the country, and that more effective measures need to be adopted in the less developed parts of the country to accelerate the development of SSI in those regions.

Organizations of associated labor

According to the Federal Statistics Office, there were 2,605 organizations of associated labor in the social sector of SSI at the end of 1985. These organizations accounted for 8 percent of the total number of organizations of associated labor in Yugoslavia. The number also included 170 contractual organizations of associated labor and 468 crafts shops and other cooperatives. This sector employed 199,204 persons, or 35 percent of the workers in SSI, or 3.7 percent of the work force in Yugoslavia. The number of organizations of associated labor in SSI increased by 2.4 percent between 1980 and 1985, and the number of workers employed by them increased by 1.3 percent.[4]

The largest number of organizations of associated labor and workers employed in this sector are in crafts (crafts services, repairs, and personal services); they are followed by installation and finishing works in the building industry (organizations with up to 200 workers); and small, series industrial production (organizations with up to 200 workers involved in the production of small series, production cooperation, and production against orders). These three areas account for 93 percent of SSI organizations of associated labor and 92 percent of the workers employed in the social sector of SSI.

Contractual organizations of associated labor

At the end of 1985, there were 170 contractual organizations of associated labor (COAL) with some 5,000 workers. At the end of 1980, there were 91 contractual organizations. The process of establishing contractual organizations is evolving slowly because of problems, including:

- high rate of inflation which does not guarantee founders of these organizations an adequate return on invested capital;
- insufficient efforts by larger organizations to find programs and offer material support for setting up contractual organizations;

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4. These numbers should be taken with some reservation because changes in the status of SSI's basic organizations of associated labor have not been registered regularly. There was also the problem of identifying these organizations in the first years the data on SSI were compiled.

- adequate financial support by commercial banks; and
- inadequate legislation regarding the establishment and functioning of these organizations.

These issues should soon be resolved through agreement between the republics and provinces.

The establishment and operation of contractual organizations have been particularly affected by the lack of confidence by society toward this form of economic activity. For example, organizations of associated labor have refused cooperation with contractual organizations. Better results can be achieved by a greater social affirmation of contractual organizations and their cooperation with other economic entities.

Cooperatives

The development of cooperatives for crafts and other activities, as the most significant form of association for the self-employed, was relatively successful. In 1985, there were 468 cooperatives, a 36 percent increase over 1980. The increase was the result of a greater interest among the self-employed to pool their labor and other resources into cooperatives, for the purpose of establishing various forms of business cooperation with organizations of associated labor on a longer-term basis.

Private sector

Because of increased capacity, the volume of production of goods and provision of services in SSI grew more rapidly in the private sector than in the social sector. Between 1980 and 1985, the number of private shops increased by an average of 5.1 percent per year; the number of people employed in these shops increased by an average of 6.3 percent per year. During the same period, the growth rate of employment in the social sector averaged 2.4 percent per year.

At the end of 1985, the private sector employed 367, 263 people, who included shop owners. This number constituted 64.8 percent of the workers in SSI, or 6.8 percent of the labor force in Yugoslavia. Trade, catering, and transport facilities in the private sector increased nearly 2.5 times between 1980 and 1985. But the total number of private trading shops is still only 1.2 percent of those in Yugoslavia. The second largest increase was registered by catering facilities: their numbers during the period increased by 43 percent and the people employed by them increased therein by 50 percent. However, the type of services rendered by these facilities was not in line with the needs of tourism, which requires meals and accommodation. In 1984, over 50 percent of the facilities were cafeterias and coffee houses; only 23 percent were restaurants. The number of private entrepreneurs offering transportation services increased by 36 percent.

Crafts constitute the most important segment of activities in the private sector, accounting for 67 percent of the private shops in Yugoslavia. Between 1980 and 1985, the number of crafts shops increased by 23 percent while in the preceding five-year period the number dropped by 3.3 percent. During 1980-85 the number of people employed by crafts shops increased by 31 percent and the production of goods and provision of services increased by 19 percent. In 1985, 96,196 workers were employed by private crafts shops. This meant that only one of two shops employed one worker. Republic and provincial legislation stipulated considerably greater possibilities for employment. Because Yugoslavia is counting on the

crafts in the private sector to achieve a more harmonized economic structure and to increase import substitution, exports, and employment, slower growth in capacity and employment indicates that policy measures were insufficient to accelerate the development of this sector.

Measures to accelerate SSI development

A set of measures and activities are under preparation which should lead to the creation of a more favorable climate for carrying out structural changes in the economy through small-scale industry programs. The measures include fiscal and monetary policies, tariff policies, and the expansion of organizational forms that can provide best results. Efforts are being made to eliminate prejudices toward the private sector and to create opportunities for entrepreneurs. Private initiative should not be encouraged among the self-employed alone, but among all forms of associated labor. Other citizens should be encouraged to become founders of organizations of associated labor and to compete for funds. Thus, many opportunities are being opened for entrepreneurship in associated labor and conditions are being created to promote better business practices, initiatives, motivation, and creativity.

SSI significance in structural change

The small-scale industry should become a significant factor in bringing about structural change in Yugoslavia. Additional funding drawn from public savings, especially foreign exchange savings of the Yugoslav workers abroad, should be provided to this sector to supplement the traditional sources of financing these changes.

Service laws have been enacted in the past two years to promote the development of small-scale industry, especially the private sector. In May 1986, the Law on the Procurement of Resources from Citizens for the Expansion of the Material Basis of Socialized Work, better known as the Law on the Purchase of Work-Posts, was adopted. In late 1985, the Law on the Special Condition for the Utilization of Investment Credits and Guarantees, was enacted. It stipulated lower personal participation for borrowers from SSI, similar to that in priority areas. An Agreement on the Regulation of Conditions and Ways of Operation of the Small-Scale Industry is in the pipeline. The agreement would result in uniform rules for regulating SSI. There is also a plan to establish self-management funds for providing a portion of the funds needed for setting up new SSI units. Special selective credits will also be provided by commercial banks for starting new organizations. The tax system will be unified and made more stable, and the tax burden will be commensurate with the economic power of each entity. Incentives will be provided to small-scale industry.

Need for accelerated development of SSI

The present level of material development of Yugoslavia calls for the creation of a more diversified, complementary, economic structure; the production of specialized goods by smaller units; the establishment of small-scale plants and production series which will harmonize with, and be a supplement to, large- and medium-sized industries; the fuller utilization of existing capacity; increases in employment, labor productivity, and rational utilization of social means; and the

establishment of a wide network of smaller organizations sensitive to the market. All of these imply a need for an accelerated development of small-scale industry. In other words, accelerated development of SSI is a part of the overall economic development of Yugoslavia and an important lever in the implementation of the economic stabilization policy and for achieving overall economic development.

There is no need to fear that granting favorable treatment to small-scale industry and greater freedoms for the private sector would threaten the socialist self-management system in Yugoslavia. The basic objective of the Yugoslav self-management socialism is not to create equality in poverty, but rather to create a rich society and rich individuals, a society in which all individuals will have a chance to assert themselves on the basis of their work and will be given an opportunity to dispose of their income earned on investment.

13

Economic Reform and Monetary Cooperation in the CMEA

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There is by now sufficient evidence that more or less major, if perhaps not always root-and-branch, economic reforms have been under way in several member countries of the Council for Mutual Economic Assistance (CMEA) essentially since the mid-1980s.[1] Equally weighty shifts in economic mechanisms are apparently being contemplated, and may soon be introduced, in several other European countries that are members of the CMEA. This more or less generalized movement toward domestic economic reform has not, thus far, clarified the implications for intra-CMEA cooperation. Neither has there been any overt discussion at the highest policymaking levels of how the CMEA economic mechanisms could support ongoing reforms in one or more member countries.[2] This paper offers a review of the most important elements of the CMEA economic cooperation mechanisms that could usefully be modified in an effort to provide support for the domestic reforms.

In light of our present knowledge of policy intentions of the centrally planned economies (CPEs) and the prevailing evidence of what may be in the offing, two key characteristics of the ongoing national reforms are sketched in the first section ("The CMEA and domestic reforms"). The second section ("The concept of a monetary-financial mechanism") provides a brief summary of this mechanism, because I consider modifications in the role of monetary and financial institutions, policy instruments, and cooperation mechanisms to be even more critical in harmonizing the reform process at the regional level than they might be at the scale of the individual national economic reforms considered in isolation (see Brabant 1987d, 1987e). This provides the backdrop to the

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1. In what follows, I shall restrict my commentary to the active European members of the CMEA. In other words, full members such as Albania (inactive), Cuba, Mongolia, and Vietnam; Yugoslavia as an associate member; cooperants such as Angola, Ethiopia, Finland, Iraq, Mexico, Mozambique, Nicaragua, and Yemen; and the many observers among the other socialist and developing countries will be ignored.

2. It is believed, however, that a serious debate about possible reforms of CMEA institutions, policies, policy instruments, and the organization as a whole has been waged largely *sub rosa.*

examination of the key variables and institutions that make up the monetary-financial mechanism of the CMEA in the third section ("The prevailing monetary-financial mechanism"). The principal components of the reform discussions throughout Eastern Europe are sketched in a very cursory fashion in the fourth section ("Key features of domestic economic reforms"). From this, I derive some essential requirements for CMEA institutions, policies, instruments, and behavioral rules to be a solid buttress of the ongoing domestic economic reforms in some member countries ("Implications of reforms for the CMEA"). The likelihood that the changes advocated here will be implemented in the near- to medium-term future is evaluated in the final section.

The CMEA and domestic reforms

There are two key characteristics of the domestic economic reforms underway in some CMEA countries, and of those apparently being seriously entertained elsewhere. First, there is every indication that the goals of the actually contemplated changes in economic mechanisms are unlikely to coincide throughout the region in the next decade or so. This would seem to be the case even if one were willing to search only for the most central elements of economic policies and the functioning of economies that are, or aspire to be, highly intertwined.

Second, the process of moving toward a new configuration of policies, instruments, and institutions, which is precisely what reform is all about, is likely to be a protracted one. It would not be very helpful for policymakers to hope for a seminal breakthrough in terms of the positive impact of any feasible reform on economic performance in the next two to three years. The initially wildly optimistic expectations of would-be reformers in the Soviet Union were quickly revised under impact of reality, including active, if perhaps "subjective," opposition to the reforms. But there were also "objective" factors, as the Hungarian and Polish experiences of the past two decades have so clearly underlined. As a result, policymakers should be prepared to steer along their prevailing economic mechanisms toward a reformed economy over at least 10 to 15 years, provided no further major changes in the envisaged target model will become necessary in the process of implementing the reform—a highly unlikely event. A realistic time horizon for completing the transition phase for some CPEs that have had extensive prior experience with economic reforms may be at the lower end of this time span. However, the Soviet Union is unlikely to be able to avail itself of this opportunity. This circumstance imposes formidable demands not only on the design and intentions of the reforms, but more importantly on how to bring about the processes that may solidify, perhaps after some hesitation and further tinkering, into new institutions and mechanisms that are better suited to dovetail economic decisions than those now in place.

In other words, whatever the concrete process that may unfold in the years ahead, there is likely to be discord over time within the group of Eastern European[3] countries on expectations regarding policy commitments and realistic chances of these intentions being implemented. Yet, economic considerations that

3. Eastern Europe here comprises Bulgaria, Czechoslovakia, the German Democratic Republic (GDR), Hungary, Poland, Romania, and the USSR. For the sake of conciseness, I shall occasionally use the term to denote the six of Eastern Europe proper.

have been motivating policymakers, especially in Eastern Europe, to seek more or less broad-based reforms have been rather similar. Indeed, the marked slowdown in factor productivity growth and the pace of economic progress more generally; the emergency adjustment measures of the early 1980s and their impact on aggregate economic performance, investment, consumption, and trade, and thus the need to adopt positive structural adjustment policies; the need to compete more effectively in both CMEA and East-West markets; and the more restrictive supply of factor inputs, including labor and capital, in the years ahead constitute the root causes of the growing proclivity toward reform (see Brabant 1987a, 1987c, 1987d, 1987e).

An equally common characteristic of this experience and development setting is that the recent emergency adjustment measures and economic crises in Eastern Europe have evolved largely without measurable repercussions to date on the CMEA organization, the collective development and integration policies enshrined in official documents, and the exceedingly passive policy instruments in place. Even at the height of the external financial difficulties of the early 1980s, each CPE had to fend for itself. The CMEA as a regional organization remained exceedingly passive. Similarly, other CMEA partners, excepting in the extraordinary Polish-Soviet relations at the time, exhibited few signs of solidarity or interest in formulating a common adjustment strategy. The latter has been especially surprising in view of the agitation for substantive changes that eventually led to the economic summits of June 1984 and November 1986. It is well known that the policies, institutions, and instruments in place in the CMEA are not well suited to buttress, let alone to enhance, the ongoing shifts in economic policies and mechanisms in some CPEs. This passivity of the CMEA as a regional economic institution is likely to change in view of the ongoing institutional, behavioral, and policy transitions in several member countries.

Because the major decisions regarding CMEA reform have not been finalized as of today, and considering the importance of the CMEA in the external economic relations of all countries included in this analysis,[4] it is reasonable to inquire into two issues. First, given that the envisaged national reforms are by their very nature unsynchronized, what role could be assigned to the CMEA as a regional economic institution, a forum for guidance with experimentation, and a regional "market" in support of the reform attempts? Should this assistance be minimal or maximal, that is, should the CMEA be envisaged as providing a buttress to the CPEs embarking on the most ambitious reform, while protecting the other members of the group that choose to move ahead more slowly? Or alternatively, should changes in the CMEA as a regional organization be targeted at providing support chiefly for the greatest common denominator of the economic mechanisms of the various member countries at any time, in which case they would accommodate at the regional level some features of the countries with the most conservative reform?

Second, considering present policy stances on economic restructuring, modernization, economic reform, *perestroika*, or whatever label is being placed on contemplated structural adjustments, to what extent can one logically search for feasible and desirable adjustments in the CMEA institutions and their

4. I am well aware of the many statistical hurdles to be scaled when one tries to measure external dependence of CPEs in any proper sense. But any plausible measure cannot avoid recognizing the intrinsic importance of the CMEA group for each individual member.

behavior in fostering socialist economic integration (SEI)? With the latter I associate the mechanisms, institutions, and policies underlying the prevailing foreign trade and exchange regimes within the Eastern European regional context. This by necessity affects the conduct, extent, and purpose of economic relations with outside partners.

There is little doubt that the key problems indicated above have been on the CMEA debating table now for at least the last three years; the discussion may in fact reach back to 1980 or 1981 (see Brabant, 1987h). Two economic summits (in June 1984 and November 1986)[5] have recently been devoted to them, and so have several meetings of the Central Committee Secretaries in charge of economic affairs and, of course, all of the CMEA Council Sessions convened since the 1984 summit.[6] Unfortunately, information on what precisely may be in the offing and how SEI may become affected by economic experimentation, if not full-fledged reforms, in key CMEA members, remains highly ambiguous and fragmentary at best (Leznik, 1987). Even so, the process of reforming SEI as a policy goal with all its attendant institutional and behavioral repercussions is likely to center around direct enterprise relationships and the implementation of the scientific-technological cooperation program,[7] perhaps in ways that were not even considered when the document was approved in December 1985. Among the latter, the marked improvement in the monetary-financial mechanisms in general or, as a transition step, particularly in reference to direct interenterprise relations (Vostavek, 1987; Zverev, 1987) appears to be high on the current CMEA policy agenda.[8]

Changes that may be on the debating table are known only very incompletely[9] and are, of course, very unofficial at this stage. Nonetheless, it may be worthwhile to look at the desirable modifications of cooperation mechanisms, the extent to which prevailing conditions are sufficiently mature to facilitate the swift

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5. The November 1986 summit is now being referred to as a "Working Meeting," which is a new designation altogether. It presumably suggests that the summit was not prepared in the usual way but called to order on short notice in view of the slow progress being achieved with SEI under Gorbachev and the foot dragging on the part of some CMEA members in emulating some kind of economic reform to permit changes in CMEA institutions and cooperation mechanisms. This is the message that clearly emerges from the 43rd Session.

6. In fact, the periodicity of the Session has changed markedly since 1984. In 1986, for example, it was not held until early November and in 1987 not until mid-October, although the constitutional time frame of the regular Session is the second quarter of the year. In fact, the Session held on 13-14 October 1987 was an extraordinary one. The postponements in 1984-1987 have allegedly stemmed from serious divergences of opinion on how to proceed with the reorganization of integration processes, particularly the implementation of the program on scientific-technological progress, on which more is written below.

7. The full title of this document reads: *Comprehensive program of scientific and technological progress of the CMEA member countries up to the year 2000*, henceforth referred to as *"Scientific-technological Progress."* It was published in all main Communist Party papers of December 19, 1985.

8. But I doubt that the USSR has been agitating for full convertibility of the CMEA currencies among each other and against the regional clearing currency, as recently reported in *Financial Times*, July 14, 1987, p. 2. The communiqué of the 43rd Council Session (Moscow, October 13-14, 1987) suggests a modest form of regional convertibility to be introduced by interested members for some goods over the next decade or so (see Brabant, 1987g).

9. Leznik (1987) and the reports of the 43rd Session, although still fragmentary, are very revealing in this respect.

implementation of these intentions, and what conditions need to be met for these desirable changes to occur.

The concept of a monetary-financial mechanism

"Monetary-financial mechanism" is an awkward Eastern European term. Typologically, it denotes a component of the economic submechanism of integration, which in addition comprises the planning mechanism of SEI. The recent elevation of that term out of the ideological realm of the Marxist concept of "commodity-money relations" appears to have been in recognition of the fact that commodity-money relations should play an essential role in enhancing regional economic cooperation in the CMEA and its member countries. In what follows, I understand this particular component of the economic submechanism to comprise the policies, institutions, and policy instruments by which the regional economic activities of CMEA members, which themselves are in principle guided by behavioral rules that are firmly agreed upon, are coordinated through the intermediation of "money." I use the latter term guardedly, since most intra-CMEA transactions are in essence nonmonetized. They tend to emerge in the context of bilateral trade and payments agreements (BTPAs) that focus more on the physical quantities to be exchanged than on the values per se of these transactions.

The monetary-financial mechanism therefore envelops a broad range of cooperation issues and institutions. At its center is the "monetary" unit of account—the transferable ruble (TR). Because the TR is issued by the International Bank for Economic Cooperation (IBEC) in support of a wide array of regional transactions and is considered to be (or to become) the key unit for joint capital formation and joint investment cooperation within the context of the International Investment Bank (IIB), these two financial institutions are central. Evidently, other payment and credit flows within the CMEA need to be streamlined; thus the need to include in the analysis the mechanisms by which payments on current account as well as those on capital account are effected. That is to say, the settlements mechanism as well as the degree of capital mobility within the CMEA need to be highlighted. It may be useful to separate the issue of commercial settlements regulated within the context of BTPAs from noncommercial transactions.[10] Furthermore, the degree to which the national currencies of the CMEA members can be converted into goods and other currencies needs to be touched upon. This may be useful, if only because there seems to be considerable disagreement—not to mention a substantial degree of confusion—in the literature about when convertibility could realistically be envisaged, whether generalized convertibility should be considered at all in the short to medium run, in which spheres it already applies and to what degree, and related questions.

Perhaps an unusual element of monetary-financial mechanism is the terms at which goods and factor services are exchanged in the CMEA—that is, pricing

10. Noncommercial transactions are all those that do not constitute merchandise trade and related services. These include tourism, royalties, student stipends, honoraria, unrequited transfers, and local disbursements by diplomats, consular, or trading agents.

in its most general setting.[11] But in view of the critical nature of proper pricing in obtaining the productivity improvements expected from economic reforms, particularly through the links to be forged between trade and domestic prices, it would be unwise to exclude pricing from the inquiry. Regional trade pricing presents an exceedingly complex issue with a host of highly involved ideological, technical, and institutional ramifications. Instead of delving deeply into these sensitive and complex technical matters here,[12] I shall point out the key facets of the pricing debate as it crystallizes in the second half of the 1980s. In addition, I shall identify the direction in which the debate appears to be heading under the ongoing reevaluation of more general economic cooperation endeavors.

The prevailing monetary-financial mechanism

The monetary-financial mechanism of the CMEA is exceedingly primitive and passive. This derives in no small measure from the fact that the economic mechanism in the CMEA is rather simple, geared more to the reciprocal exchange of physical goods and tangible services than to the enhancement of SEI through the indirect coordination of economic decisions. Monetary policies, institutions, and policy instruments at the regional level are virtually nonexistent. The TR is a common unit of account; strict control over the emission of that "currency"—if one wishes to call it that—is in accordance with export imbalances that are either bilaterally agreed upon or that result from overfulfillment or nonfulfillment of a balanced BTPA. The two banks were initially conceived as the counterpart of the IMF and World Bank for CPEs, but they are in fact highly passive, acting more as accountants of measures agreed upon at various levels of the political and administrative hierarchy. The capital market is embryonic, and voluntary labor mobility is nearly completely absent.[13] Dual and separate exchange rate and price regimes are characterized by a set of ill-specified rules for the formation of regional trade prices that are manipulated according to bilateral balancing requirements.

A sharp improvement in at least these aspects of the CMEA monetary-financial mechanism is critical to institute positive adjustment policies in the individual countries and the region to regain a higher growth path in at least some of the CPEs, and to foster SEI as a means to enhancing economic growth. To sketch in what ways these elements of a monetary-financial mechanism may hamper or support the ongoing domestic reform processes, it is useful to highlight the essential elements of each component.

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11. But in recent years the price issue has been squarely placed at the center of the monetary-financial mechanism of SEI. See Leznik (1987) and Petrakov (1987).

12. For details, see my book-length study of the theory and practice of intra-CMEA pricing policies (Brabant, 1987b).

13. Since the early 1980s, Hungary allows its citizens to take up employment abroad, provided a minimum proportion (one fifth) of the earnings is regularly repatriated as savings, and social security contributions are not interrupted. Although it applies generally, and the promulgation of this law has facilitated East-West mobility, it does not appear to have eased the built-in constraints on intra-CMEA labor movements.

The common currency

The TR is given short shrift by Western observers and many Eastern European commentators because that unit is not really currency in the economic sense, as distinct from its legal status. But it is not without interest altogether, if only because officially the TR is the only truly international monetary unit in the world in wide use; it does not depend on any one national currency, or a combination of such monetary units, and its emission is not at all controlled by national monetary authorities.

Many observers from the CPEs, especially Bulgarian, GDR, and Soviet commentators, emphasize that the TR fulfills all the major functions of world money, being a measure of value, a means of payment, an instrument of exchange, and an asset for accumulation. It would perhaps be more accurate to say that there is nothing inherent in the nature of that currency unit that would inhibit it from fulfilling those functions. But the mechanism whereby this unit is actually emitted in the CMEA system considerably weakens the ability of the TR to discharge itself of those functions.

The TR is not really a means of payment because countries as a rule proscribe the exchange of goods and services when this is not explicitly provided for in the context of a BTPA. This does not mean that there are absolutely no transactions taking place in the CMEA that are not the explicit subject of a BTPA. Nor must CPE enterprises or trading units invariably ascertain in the relevant BTPA whether there is room for a particular kind of exchange. However, there are many circumstances under which the TR cannot be used as international money acceptable on demand. In other words, willing holders of that currency do not know when and under what conditions they can liquiditate their money balances if they so desire. In fact, involuntary holders of TR balances grant transaction credit for trade as well as other economic interaction. They may hope to utilize some of these resources for purchases coming under the provisions of the next BTPA, but there is no guarantee that such an agreement can be negotiated or, if negotiated, that it can be carried out.

Precisely because the holder of a TR is restricted in what can be purchased with it now or in the future, even in future BTPAs, and is rather uncertain about the value of such balances, the accumulation, or store of value, role of the TR is highly confined. True, the CPEs have accumulated sizable balances at the IBEC and have committed important resources to activities sponsored by the IIB and to other jointly financed investment projects. But these forms of economic cooperation, as a general rule, come about only after the members conclude a sequence of BTPAs specifically related to the particular project.

The role of the TR in measuring value, and hence as a medium of exchange, is also highly convoluted. It is, of course, true that goods and services exchanged within the CMEA are denominated in TR. However, for some goods these magnitudes are derived solely from modified world market prices (WMPs) observed during some years prior to the exchange.[14] For others, TR prices (TRPs) are either negotiated bilaterally, and any currency unit could be the unit of account, or they derive in some measure from prevailing domestic prices of the exporter.

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14. There exists in fact a continuum of price regimes, some of which have only tenuous links, if that, with WMPs, however defined. For a morphology and classification of separate pricing environments, see Brabant, 1987b.

In other words, the TR cannot play an independent role as a fiduciary intermediary, and its ability to be "socialist internationalist money" is dubious. There is no such thing as a TR policy that could legitimately be imposed upon the CMEA region in the expectation of affecting regional merchandise, labor, and capital flows. Of course, it could not even affect relations with third partners, in spite of various efforts made to extend the TR regime outside the region. Because money is intrinsically associated with some kind of automatism, and TR imbalances do not lead to adjustments other than a possible reconsideration of intended future trade flows, one has to stretch the notion that the "TR is socialist international money" in the economic sense.

The trade and payments regime

Perhaps the most critical component of the trade and payments mechanisms in the CMEA is the existence of a state monopoly of foreign trade and payments (MFT) in each of the member countries. This implies that commercial transactions abroad and indeed the commercial policy[15] of CPEs are, as a matter of course, strictly the province of each nation's ministry of foreign trade, which may delegate that authority to foreign trade organizations (FTOs). Likewise, foreign exchange transactions are the exclusive preserve of the ministry of finance, which may delegate that authority to the national or foreign trade bank, if one exists.[16]

In the classical CPE, domestic economic processes are not directly linked with trading activities or foreign economic cooperation more generally. The price-equalization mechanism ensures a very high degree of domestic price autonomy. Domestic goods for export are purchased by FTOs at fiat domestic prices, but sold abroad at prevailing or negotiated trade prices.[17] Similarly for imports, FTOs pay prevailing or negotiated trade prices abroad but dispose of the goods at home at the prevailing fiat prices. Imbalances between the taxes levied on imports and the subsidies granted for exports[18] are as a rule offset against the government budget. In the case of a net increase in "earnings from foreign trade" beyond what was budgeted, the MFT is able to sterilize such earnings. In the reverse case, there may in time be a sufficient drain on government outlays away from what had originally been planned, as in the late 1970s and early 1980s, to induce some kind of macroeconomic adjustment.

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15. This has been the thorniest issue in negotiations about an agreement between the CMEA and the European Communities (EC).

16. A foreign trade bank presently exists in all European CPEs, except Albania, but not in Cuba and Mongolia. Foreign trade banks are generally active in the clearing of external merchandise and related transactions. The national bank may, however, still play a role in the apportionment of foreign exchange for other purposes.

17. In the case of imports that lack a domestic counterpart, the local currency price may be set according to internal pricing rules, with some exceptions, such as unique imports for which the actual import cost is translated into domestic currency units by way of some exchange rate or coefficient.

18. This is the normal implication of operating with an overvalued exchange rate. But other combinations of the differences between domestic and trade prices are, of course, entirely possible, as shown in Brabant, 1977, pp. 248-253, due essentially to arbitrary administrative price setting.

The MFT implements its foreign trade and currency strategy largely within the context of bilateralism, particularly in relations with other CPEs. Not only do these countries as a matter of course work out BTPAs at regular intervals, they generally do so at a special set of prices. In fact, BTPAs are worked out for various kinds of foreign transactions, including merchandise transactions on regular account, noncommercial transactions, and transactions on special accounts, such as for joint investment financing or the repayment of such loans, or transactions for the enhancement of production specialization. Under conditions of a highly refined set of BTPAs, neither relative prices nor exchange rates matter, except within the specific context of a given BTPA.

The settlements bank and multilateralism

The IBEC was originally entrusted with TR settlements on a multilateral basis through the issuance of various types of short-term loans.[19] As such, it was to generalize the *ex post* type of settlement of imbalances under well-specified conditions provided for in the Warsaw Agreement of 1957.[20] Unlike the latter, the IBEC was called upon to bring about multilateral settlements both in the ex ante sense, that is, during the elaboration of BTPAs, and in the ex post sense, that is, arranging for the reciprocal offsetting of bilateral imbalances sustained as a consequence either of having violated some part of the BTPA or of having exceeded agreed-upon trade values in an unbalanced manner.

Whereas the bank was put in charge of settlements, it was not entitled to play any meaningful role in the negotiation of the all-important BTPAs. As a result, it could not even discharge itself of its constitutional role and thus remained a bookkeeping agency. It can, and does indeed, impose some kind of interest rate on imbalances and accords progressive interest rates on deposits of various terms. Likewise, it has formulated a nominally independent loan policy with a string of maturities. But under the circumstances neither policy has been of much significance. Interest rates are exceedingly low. Interest balances are owed to (or form claims on) the bank and not to (or on) identifiable individual holders of such balances. The latter can therefore rarely be utilized for effecting payments, except for reverse interest flows. Payments for contracted deliveries can materialize only for transactions of goods and services provided for in one or another BTPA, and there is no BTPA on interest rates, of course. Likewise, the bank's loan policy is meaningless from a commercial point of view as it amounts either to simple bookkeeping or to a reconfirmation of loans agreed upon in the appropriate BTPA. It is true that the system enabled countries to incur imbalances at any given moment of time without being compelled to mobilize their own or borrowed convertible currency reserves. But before the creation of the IBEC no such funds were used either.

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19. Until 1970, there were five such types (for seasonal, extra-plan, trade expansion, balance-of-payments, and joint investment transactions). Because this compartmentalization proved to be impossible to apply, these variants were consolidated into a single type in 1970 (see Brabant, 1977, pp. 125-126).

20. The latter attempted to offset ex post imbalances of a high degree of specificity. For details, see Brabant, 1977, pp. 77-88

In other words, the bank is a highly technical institution that is by now sufficiently acquainted[21] with the problems of intra-CMEA trade to institute a more active kind of multilateralism. It has probably also garnered sufficient experience to enable it to activate the TR; to formulate appropriate monetary, interest, and reserve policies; and to act as an embryonic regional bank of issue. However, without a significant downgrading of the BTPAs, and especially the degree of bilateralism associated with them, there is little scope for emerging from the straitjacket.

Joint investments, the CMEA capital market, and the IIB

At various points during the postwar period, some or all CPEs have embraced measures to encourage the transfer of wealth from one country to another—that is, to provide for some sort of capital mobility. This has never been allowed to emerge spontaneously; planned capital flows, however, do occur. It is useful to distinguish among government credits, special-purpose or target credits, investment loans, and institutionalized forms of investment coordination.

Government-to-government loans are by their very nature bilateral and, under most circumstances, highly politicized. They played a major role, in the postwar political and economic transformations of the Eastern European regimes, in alleviating the sociopolitical and economic crises of the mid-1950s; and in coming to grips with other destabilizing events, such as the major adjustment in the calculation of reference TRPs beginning in 1975, the Czechoslovak crisis of 1968, and the Polish crisis of 1981.

Special-purpose credits, as their name suggests, are capital movements initiated for a particular purpose or target project. There have been two phases of these capital movements. During 1957-1962, Czechoslovakia and the GDR extended comparatively sizable loans for ventures in other Eastern European countries. A resurgence of this kind of joint cooperation occurred in the second half of the 1960s, when both countries again "invested" moderate amounts of capital abroad, but this time chiefly in Soviet investment projects.

These kinds of capital contributions were generally *sui generis*, chiefly motivated by the desire of some importers to raise their assured quota of critical primary goods and fuels normally procured from other CMEA partners. The latter, by definition., proved to be unwilling to commit scarce domestic resources to the expansion of some desired production or, in most cases, mining facility. The real economic parameters of the transactions involved in these loans were generally rather difficult to assess. Aside from uncertainty about TRPs, favorable treatment in respect of the quantity or price of other goods, low interest rates, tied sales, and other modifiers complicated the quantitative assessment, and even the qualitative evaluation, of the explicit and implicit benefits and costs of project loans (see Brabant, 1971, 1987a).

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21. It has to be acknowledged that the bank has sharply decreased the delays in effectuating payments transactions and has been able to keep member banks regularly informed of their various accounts. For a discussion of the advantages and drawbacks of the IBEC, see Brabant, 1987a, pp. 299-300.

These difficulties and the debates about the elaboration of the *Integration Program*[22] led the CMEA members to establish a special institution to facilitate joint investment projects and the coordination of investment activity to enhance socialist integration. In fact, the creation of the IIB did not spur regional capital mobility as such, though many Eastern European observers at the time portrayed this as an important feature. Instead, the institution was called upon to organize the process of negotiating "the financing of temporary investment participations" of the CMEA member countries.

"Joint financing" reflects much more accurately what really occurs in the CMEA than the label "joint investment." Joint financing means that the act of cooperating is by definition temporary and that the project remains the property of the country where the project is sited. It also implies contributing the means by which a particular project is to be financed, as distinct from the joint design, construction, management, and exploitation of the project. Because "investors" receive a fixed return—as a rule a low simple interest rate of between 2 to 5 percent, but usually around the lower end of this range—they do not directly benefit from the profitability of the project. In fact, the IIB was created specifically to take care of the latter aspects and thus to ensure that jointly financed projects would accelerate the process of socialist integration.

Perhaps the most elementary stumbling block for the IIB has been the lack of multilateralism and transferability within the CMEA. Unless two or more member countries agree outside the IIB framework to finance jointly a given project and are prepared to appropriate the necessary resources, there is little that the IIB loan can do to expedite socialist integration. In other words, an unsecured IIB loan is just like any other capital flow that is not explicitly associated with commitments to deliver real goods, and is hence difficult to "mobilize." The same obstacles that inhibit the IIB from playing a more positive role beset other forms of credit in the CMEA. In the end, it is very difficult to separate in the economic sense a TR loan granted by the IIB from an intergovernmental loan to finance a joint investment project precisely because the IIB's constitution exhibits the manifold inadequacies of the CMEA capital market.

Price regimes

CPEs have traditionally opted for a high degree of domestic economic autonomy and have regulated their foreign economic relations largely through BTPAs. Where that is not possible, such as in relations with advanced market economies, the CPEs have endeavored to embrace a trading regime that resembles a BTPA as closely as possible. As noted, the *caesura* of domestic wholesale and retail prices from each other and from external prices survives in large measure even in the modified CPE. But the dichotomy on trade prices is less pronounced for wholesale than for retail prices. Moreover, TRPs follow their own logic and are only *grosso modo*, and coarsely at that, related to WMPs or, more to the point,

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22. The full title of this document is: Comprehensive program for the further extension and improvement of cooperation and the development of socialist economic integration among the member countries of the Council for Mutual Economic Assistance. It was endorsed at the 25th CMEA Council Session (Bucharest, July 27-29, 1971).

to East-West trade prices (EWPs) because these are essentially the actual opportunity cost indicators for CPEs.[23]

TRPs are in principle[24] derived on the basis of a common set of price-formation rules that were formally agreed upon in Bucharest in 1958.[25] The latter principles in turn registered key features of actual trading practices that had gradually emerged in the postwar period, usually in individualized bilateral relations. Since 1976, these prices are supposedly patterned after a five-year moving average of WMPs observed before the implementation year and converted in each of the reference years at the official convertible currency exchange rates of the TR as set by the IBEC.[26] The relationship between TRPs and WMPs is more streamlined for raw materials and fuels than for processed manufactures and foodstuffs (Brabant, 1987b). It is also closer for products traded under regular BTPAs than for those transacted outside the planned volumes, for the joint financing of investment purposes, for specialization agreements, and so on (see Uspenskii and Zhdanov, 1987).

Exchange rate regimes

Precisely because the classic CPE desires a high degree of domestic decisionmaking autonomy by divorcing domestic from external markets, the exchange rate becomes a pure accounting unit. Even in the modified CPE, the role of the exchange rate in price formation has been sharply curtailed. Furthermore, there is generally no uniform exchange regime in these countries. Certainly, to actively exploit foreign economic relations, it has become desirable to enact a more positive foreign exchange policy and perhaps formally to introduce a positive foreign exchange regime applicable to all, or at least the major, transactions abroad. Instead of explicitly pursuing such a goal with determination, policymakers have generally held onto their desired domestic decisionmaking autonomy as much as possible. As a result, the reforming CPE

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23. It is, of course, true that EWPs are influenced by all kinds of noncompetitive factors, including discrimination against CPE exports by Western countries, products that are not well adapted to Western tastes, lack of infrastructure in Western markets to offer adequate servicing, and so on (see Marer, 1984, pp. 176ff). But unless the CPE can overcome these obstacles, which is perhaps feasible in the medium to long run, actually observed EWPs constitute the opportunity cost for comparatively small trade diversions. With large diversions, the implicit small-country assumption—that trade can be rechanneled to other partners without a, possibly palpable, impact on prices and the terms of trade—needs to be revised.

24. Actually, matters are much more complex since a distinction should be made among base, reference, contract, and transaction prices, in that sequence (see Brabant, 1987b, pp. 70-71). The Bucharest principles apply only to reference TRPs for regular transactions coming under a BTPA that provides for TR settlements.

25. I do not consider the modification introduced in January 1975 (the so-called Moscow principle) as a major shift away from the Bucharest rules (Brabant 1987b, pp. 92-93). The Moscow ruling was simply the application of one of the technical Bucharest principles; namely, to revise TRPs when the underlying reference WMPs had changed substantially.

26. Prior to 1975, TRPs were patterned after average WMPs of a fixed reference period (five years for transaction years 1965-1974, with some modifications to spread the terms-of-trade effects over two years, and one- or two-year averages before 1965). For 1975, a three-year reference period (1972-1974) was agreed upon as per the Moscow modification of the Bucharest rules.

has separated foreign transactions into different noncommunicating layers, each of which is regulated, if at all, by target surrogates for effective exchange rates. In consequence, one can distinguish for most members among the official, commercial, noncommercial, tourist, black market, special store, joint investment, and other exchange rates or their surrogates (Brabant, 1987a). Some of these rates are interlinked under highly confined conditions. Thus, in some countries tourist exchange rates for convertible currency holders are set in relation to the commercial or official exchange rate. But for most categories, *ad hoc* policies are pursued that are not always based on economic considerations. Hungary and, to some extent, Poland, are exceptions when it comes to convertible currency transactions. Ostensibly exchange rate uniformity prevails. But the official commercial rate is not the real one at which the bulk of foreign exchange is bought and sold. It is not a rate at which domestic and trade prices are actively linked, owing to pervasive subsidies and taxes, most of which are *ad hoc*.

Transferability

Transferability is part and parcel of multilateralism, but the reverse does not hold. Though the TR is nominally transferable, particularly for merchandise transactions, its ability to perform that task is highly confined. There are, however, instances in which TR balances on one account can be transferred to another account, but this is normally confined to a set bilateral relationship. Thus, in principle, balances on noncommercial or tourist account can be translated into commercial TR equivalents via the ruble linking coefficient (Brabant, 1987a), without reference to the specific bilateral relation (Vostavek, 1987). In practice, however, the disparate price regimes for the various categories of TR transactions preclude multilateral transferability. But bilateral transfers are possible in principle and practiced on a regular basis by some CPEs.

Convertibility

Because Eastern European currencies are by definition inconvertible, it may seem odd to suggest convertibility as one of the important components of the monetary-financial mechanism in place. But that depends on what precisely is meant by convertibility. There is indeed a choice among convertibility of goods or purely financial transactions, for all kinds of merchandise and/or financial transactions or only for some kinds of interchange, for all holders of the currency or only for some balances, and other criteria that may usefully be invoked in dealing with the CPEs (see Brabant, 1987a).

While there is a high degree of inconvertibility in the CMEA region, some transactions involve a limited form of convertibility. Examples are the limited convertibility of CPE currencies for tourist purposes and for some other types of so-called noncommercial transactions. This is admittedly a highly confined form of convertibility of the national currencies against each other and of the national currencies into the TR. More automatic and extensive convertibility are two suggestions on how to improve the monetary-financial mechanism of CMEA cooperation, and present instances in which quick gains could be reaped by the respective citizenry (see Brabant, 1987g).

Labor mobility

Though the motivation of people to move across national frontiers can hardly be reduced to simple material rewards and related benefits, and labor mobility as an issue hence fits awkwardly into the major theme of this paper, the lure of such benefits could play an important part in the decision to relocate from one CPE to another. The regional movement of people in Eastern Europe is strictly regulated. To the extent that labor mobility is tolerated, the conditions upon which it may occur usually are strictly laid down in specific bilateral protocols and normally in full agreement with the national labor code of the country of emigration (see Brabant, 1987a). The issues of convertibility of labor rewards are normally dealt with on an *ad hoc* basis.

Just as important as the movement of capital, when assessed on strictly economic grounds, is the ability of people to move across national frontiers. As the example of the EC has clearly demonstrated, a liberal regional labor code does not normally generate a sharp expansion of labor mobility, because there are myriad linguistic, cultural, historical, family, and other inhibitions to moving across national frontiers. In the CPEs, however, labor mobility is as a rule proscribed for ideological, political, social, and economic reasons. The leveling of differences in relative economic scarcities is not expected to be fostered in any major way through labor mobility. This is an unfortunate, chiefly political and ideological, stance, as will be argued below.

Key features of domestic economic reforms

It is a daunting task to summarize the domestic reforms currently underway or contemplated in the various CPEs. Regardless of the incomplete state of the present reform laws or drafts, divergent approaches to "intensifying economic activity" prevail. Nonetheless, some common pointers can be identified by considering the following key areas: the degree of enterprise autonomy, the role of the banks in financing enterprise activity, the role of prices in reaching economic decisions, economic accountability (*khozraschet*) in enterprise operations, involvement in external trade, and proclivity for establishing joint ventures or related joint undertakings. I shall touch briefly on each of these features because they should have some counterpart in the CMEA economic mechanism.

Autonomy of enterprise decisionmaking

One critical reform lever is the devolution of decisionmaking authority and responsibility from the higher levels (the planning offices, the branch ministries, and possibly the enterprise associations) to the economic units. The transition phase of this devolution was initiated only recently. In fact, in most countries the enterprise aspects of the *perestroika* are still on the drawing board. Furthermore, a number of CPEs that have introduced decentralization on an experimental basis realize that management in place is not really prepared to assume full responsibility for making decisions on the basis of *khozraschet*, or as is currently much in vogue in the USSR, of *polnii khozraschet*, or full accountability. Much more time will therefore be required to train a managerial elite capable of honoring the self-accounting requirements. This is even the case in Hungary, where the ability of enterprises to bargain with budgetary authorities over

exceptional resources is much more critical to the enterprise's well-being than its inherent profitability profile and stewardship.

Role of the banking sector

The monobanking system has been slated for decentralization in virtually all European CPEs, except perhaps Romania. The farthest advanced is Hungary, where the central bank is to transform itself into something very much like a bank of issue and domestic lender of last resort, that is, controlling the money supply and administering the financial and monetary system (Ligeti, 1987). The more practical aspects of day-to-day banking are left to specialized banks set up for particular purposes, such as regular banking business, investment, construction, foreign trade, and other activities. In some of these branches, competition is actually being fostered, since July 1, 1987, by letting multiple banks openly compete for business clients, but not yet for private consumers (Ligeti, 1987). These specialized institutions have been called upon to provide banking services to enterprises on a commercial basis within the guidelines set by macroeconomic policy, particularly the monetary policy of the central bank.

A comparatively neglected aspect of financial reforms in the CPEs has been interest rate policies (Kazandzhieva, 1987). This may stem in part from the fact that banking autonomy has made interest rate policy into a commercial "secret." However, not enough attention has been paid to it in countries that have largely liberalized this sector, particularly Hungary. In Romania and the Soviet Union until very recently, ideological inhibitions have kept interest rates at rather modest levels. In Kornai's terminology, firms and banks face a soft budget constraint by virtue of the fact that they have access to loans that are not rationed by the imposition of a proper borrowing cost. Rarely has rationing been enforced quantitatively to maintain control over the money supply.

The role of prices

Price reform is one of the most complex and politically sensitive tasks for reforming economies. It is one that has undone reforms on more than one occasion. Furthermore, it has certainly slowed down the pace of reform in all CPEs that have been bent on introducing moderate to comprehensive modifications in economic institutions, policies, and mechanisms. It is also likely to meet with considerable resistance from the population, enterprises, and entrenched party and trade union interests. For decades, the population in most of the CPEs has been coached to believe that price stability holds under socialism.[27] Furthermore, low prices for essentials and high prices for all but a few key manufactured goods are typical for the classical CPE. The chronic distortion in consumer prices has been upheld chiefly because of government subsidy-cum-retail tax policies that are only partly voluntary and thus in fact generally unbalanced. Because of the price elasticities of demand involved, price reform

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27. According to the orthodox labor theory of value, prices should decline when positive gains in productivity occur (see Brabant, 1987b, pp. 43-44; Miastkowski, 1980, pp. 896-897).

implies a redistribution of income, usually in favor of the better-to-do layers of society.[28]

In spite of their sociopolitical destabilizing effects, price reforms are essential not only to correctly assess economic scarcities, but also to provide entrepreneurs (understood in the broad sense) with the proper indicators of decisionmaking and consumers with more adequate indirect guidelines for how best to allocate their monetary revenues or accumulated wealth. There are several aspects of a price reform concerning both the price level and the structure of prices, the relationship between the various domestic price tiers, as well as the relationship between domestic and foreign trade prices. In addition, intricate questions arise in connection with the desired speed of price adjustment once the basic reform is in place because critical social precepts of a CPE may be adversely affected by the particular political choices made. Finally, there is the question of the comprehensiveness of the reform and at what levels it will be carried out.

With the introduction of the New Economic Mechanism (NEM) in 1968, Hungary envisaged the inauguration of a radical price reform by the early to mid-1970s at the latest. But it is only since 1979-80 that anything of the kind has been enacted. In price reforms, a distinction should be made between:

- the administrative restructuring of prices, basically to reset fiat prices in line with perceived domestic and import costs at a given moment in time; and
- the timely adaptation of the price level and structure over time.

In most countries, the attainment of the former has been incomplete at best. Only Hungary has been committed to realizing the latter form. Other countries, including Bulgaria and Poland, may have the same target ambition, but their current policies still fall short of real implementation.

Price reforms cannot be undertaken at once without introducing major socioeconomic shocks and disturbances that are simply intolerable in a socialist system. The reform is hence a process spread over time, and the architecture of its intertemporal adjustments is critical. In the most ambitious price reform, at least three price categories are usually envisaged:

- fixed prices set through the conventional administrative and planning centers, perhaps as in the traditional CPE;
- "from-to" prices which allow room for mobility up to, from, or between certain limits; and
- free prices that are subject to sociopolitical controls on the size and speed of price movements.

Because of the dichotomy between producer and consumer prices, these categories usually apply variously in the two broad price spheres. Furthermore, the category of fixed prices is usually considerable while that of freely fluctuating prices is quite small. But a comprehensive reform has the ambition at least to reduce substantially the category of fixed in favor of controlled and, to some extent, freely fluctuating prices. Though policymakers may firmly intend to

28. But this effect can be offset by compensating households for the lost price subsidy through income transfers from, say, income taxes. This presupposes a well developed fiscal policy, of course, which is not typically a feature of CPEs. But even Hungary's planned income and value-added tax systems may change matters considerably when they are implemented on January 1, 1988.

intermesh closely retail and wholesale prices,[29] this coveted goal usually is quickly frustrated under impact of various interest groups, including the local party cells and the trade unions. Finally, a comprehensive price reform includes the creation of some formal link between trade and domestic (wholesale) prices.

To anchor such a link, it is critical to establish a realistic exchange rate or a surrogate (multiplier, commercial exchange rate, reproduction coefficient, internal exchange rate, or the like) (see Brabant, 1987a). In fact, the price reform should be intimately linked and intermeshed with the reform of the "monetary-financial" sphere in its entirety (Petrakov, 1987). In most countries, such links are calculated on the basis of average relationships between some domestic prices and the prices of exported goods, usually manufactures, in the given trade structure at some discrete intervals.[30] In most cases, these multipliers are set differently for broadly homogeneous currency groupings and, in many cases, also for different commodity groups. Rarely have CPEs tried to set the exchange rate at some plausible level as an anchor from which it can then find its own sustainable equilibrium, with price adjustments undertaken in line with the government's pricing policy.[31]

Foreign trade and payments regime

The foreign trade and payments regime in most CPEs has been a key pillar in ensuring a very substantial degree of autonomy in domestic policy. Most reforms seek to entrust greater responsibility in trade decisionmaking to individual enterprises or to FTOs. These are now generally called upon to engage in khozraschet operations, quite different from the erstwhile practice. In the traditional CPE, the FTOs are kept afloat through the price-equalization mechanism applied to BTPAs in the case of clearing trade and central prescriptions for trade with convertible currency partners. Reforms usually distinguish between trade operations with convertible currency countries and with clearing currencies, and within the latter between CMEA and other clearing trade.

Regarding convertible currency trade with market economies,[32] producing or trading enterprises are as a rule permitted to engage autonomously in foreign

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29. This factor was heavily stressed in the address of Mr. Mikhail S. Gorbachev to the Central Committee meeting of June 25-26, 1987.

30. In the USSR, however, even the present coefficients continue to be "planned," though some have suggested the need to reset them on the basis of actual prices, to restrict their differentiation to four or five "basic" ones, but to hold them stable for not less than three to five years (Zakharov, 1987). This was apparently also the case in Romania in the late 1970s and early 1980s.

31. A well-placed Soviet specialist told me that the USSR started off its foreign trade reform on February 1, 1987—one month later than originally forecast—with no fewer than 5,000 "internal exchange rate" coefficients. This was considered not too bad since originally the authorities had been planning to introduce about 20,000. By 1990, their number is slated to decrease to about 2,000. In a recent contribution, Zakharov (1987) affirms that there are "about 3,000 coefficients," which vary between 0.3 and 6.0 domestic per valuta ruble. This must render effective decisionmaking very complex.

32. There is some convertible currency trade within the CMEA and between the CMEA countries and some other socialist countries (China and Yugoslavia in particular), but that is usually heavily regulated, much like the normal BTPAs in TRs.

trade to the extent that foreign exchange can be earned from exports and is earmarked for imports. Initially, these operations are subject to government licensing, which usually entitles the bearer to obtain the necessary foreign exchange. But this is normally quickly transformed into foreign exchange licensing (as in Bulgaria) or partially into foreign exchange auctioning (as in Poland).[33] An effort is made in most countries to take into account the real price of trade with convertible currency countries either in the periodic resetting of domestic prices or in actual transaction prices. This is especially the case when a large share of trade in a particular product is conducted with market economies. Real export revenues and import costs are taken into account in guiding the *khozraschet* operations of trading agents.

Trade with clearing currency partners, particularly within the CMEA, is a different story. For the reforming CPE in isolation, such as Hungary for many years, there was little choice beyond buffering domestic pricing and decisionmaking against CMEA currency and trade operations that could not be reconciled with the objectives of the NEM. These constraints tended to ensue chiefly for BTPAs with various degrees of stringency—those with the USSR habitually having been the most restrictive. Now that the USSR is in the vanguard of the reform movement, there is a better chance not only that TRPs will become more realistic but also that there will be much greater scope for direct relations among enterprises.

Economic accountability

One basic objective of any economic reform is to associate enterprise autonomy with self-financing and profitability—in short, economic accountability. But the two need not coincide and in many cases they diverge shortly after the reform is launched because the authorities and managers react to imbalances unleashed by the reform in peremptory ways reminiscent of the dirigistic intervention typical of the traditional CPE. The two can be combined effectively only if the proper signals are given to economic agents and if the latter are able to mold the level and composition of inputs and outputs in accordance with their best interest.

Because of distortions in the valuation criteria typical of a traditional CPE, enterprise accountability cannot be attained until after a long transition phase. With distorted prices, it would evidently be counterproductive to hold enterprises fully accountable for their decisions when these can be formulated at best on the basis of inadequate signals. Though one can hardly expect the right outcome for society as a whole from such instructions, the situation is not altogether hopeless. Enterprises could be held accountable for managing capital and labor resources in a more responsible way than under strict planning, even though interest and wage rates are far from market-clearing. In the same vein, enterprises could be asked to shoulder the burden of excessive inventories, or at any rate to pay more for "hoarding" material and capital resources. Likewise, economic agents could be expected to be more concerned about proper pricing, inventory control, catering to user or final demand, and so on. But this makes good sense only if

33. Because it started only hesitatingly in early 1987 and as yet comprises trifling sums (reportedly just a few million dollars), auctioning in Poland is not yet a transparent market.

ministerial, party, and central planning interest groups do not constantly interfere with entrepreneurial decisionmaking.

The partial ways of entrusting economic agents with greater responsibility in several countries fall far short of full-scale economic decentralization, or *polnii khozraschet* for that matter. But they provide a start toward a more decentralized economic environment.

Interenterprise cooperation

There are few parameters at the disposal of economic agents to devise effective economic contacts among themselves—a consequence of the ingrained, directive material-technical supply system of the traditional CPE. But there are certainly areas of convergence. Clearly, some economic agents are interested in endeavors on which it is difficult to place a true ex ante scarcity cost. Research and development is one such area that depends on budget allocations, even in large market-type enterprises. The purpose is to realize the expected gains, but the latter is usually subject to high uncertainty. The greater the uncertainty and the more exploratory the venture, the greater the scope for enterprise cooperation.

Organization of contacts in actual production and marketing is more complex, though some areas of cooperation are possible. For example, it may be productive to allow the trading of excessive resources either intertemporally or in exchange for resources that are in relative shortage in one area, provided a mutually satisfactory price can be negotiated. This is not likely to mop up all of the excesses and wipe out all shortages because there is a price imputable to the uncertainty of acquiring the resources when they might become needed. But trading of resources that are temporarily idle is likely to enhance economic balance. Even with absolutely fixed fiat prices far removed from reflecting true scarcities, direct enterprise contacts may help efficiency. But the room for socially counterproductive microeconomic decisions by economic agents is likely to be larger than otherwise.

Where the drive toward unmediated and direct interenterprise contacts may lead is anybody's guess. I have the impression that it is still largely a fashionable "slogan." If it is to become a key component of a new development strategy, it must be given more concrete meaning, at least in published disclosures. This applies to both East-West joint ventures or direct contacts as well as to analogous types of cooperative arrangements within the CMEA. In East-West ventures, the CPE is primarily bent on attracting capital and technology from the West and on generating additional revenues in convertible currency from exports. In contrast, the interest of the Western partner is heavily weighted by efforts to capitalize on the relatively cheap labor of CPEs and to conquer other socialist markets, particularly in the case of joint ventures with the Eastern European countries proper.

The role of planning and macroeconomic policy

The effective introduction of indirect coordination instruments and their associated policy institutions is critical to the realization of economic devolution. Just as important are the formulation of macroeconomic policies and the realization of effective institutions for propping up and fine-tuning the policy instruments and guiding behavior. This is especially important to assist decentralized economic units in raising the efficiency of factor productivity.

Another task of macroeconomic policy, and here lies the central role of statewide planning, is structural change and development strategies. These concerns extend to basic large-scale investment projects that determine the structure of a growing economy. Finally, macroeconomic policy and central planning need to maintain control over the so-called nonmaterial sphere, that is, all activities that in a CPE are quintessentially socialistic in nature, including education, medical care, the arts, and basic infrastructure, or that are typically reserved for governmental action, including defense. Every aspect of these activities (major components of the arts, for instance) need not be closely regulated at the central level, but a good deal of state intervention is likely to prevail just the same.

Macroeconomic policies—monetary, fiscal, and income policies—are traditionally very underdeveloped in CPEs, mostly due to the primacy of quantitative planning, but also because of ideology. The traditional management of credit, in line with the so-called real bills theory,[34] needs to be revised so that decentralized banks can make loans that can be used to claim resources to the benefit of economic agents. Monetary policy needs to be activated and extended to many new economic activities to provide macroeconomic stability, to let the central bank act as the effective lender of last resort for decentralized financial institutions, to regulate absorption in line with available domestic and borrowed resources, and to provide greater diversity of assets to holders of currency balances.[35] The regulation of disposable incomes through direct fiscal instruments, in some cases in substitution for the heavy reliance on indirect taxes in CPEs, also needs to be amplified to mitigate the bewildering, pervasive distortions of prices on account of differential turnover taxes.

Implications of reforms for the CMEA

Modifications in the economic mechanism of SEI have been progressing much more slowly, if at all. Regarding financial and monetary policies, at the CMEA level not much more can be achieved than the greatest common denominator of monetary policies in the member countries. Because the regional banking institutions are relatively underdeveloped and one can hardly speak of dovetailed macroeconomic policies, provided they exist at all in the member countries, there is at present not much scope for coordinating interest rates, money and credit creation, exchange rates, and so on. But if interenterprise contacts are to become an important determinant of socialist integration in manufacturing, if perhaps not the key mechanism for the bulk of other transactions, the CPEs need to provide policy guidance, institutional support, and sufficiently flexible and comprehensive mechanisms to synchronize enterprise decisions, and indeed to coordinate a considerable variety of decisions of economic agents more generally.

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34. This theory holds that credit should reflect real flows, in which sense it becomes "productive" and hence conducive to monetary equilibrium. Accordingly, in most CPEs loans are traditionally extended for well-specified purposes, granted for fixed periods of time, secured by real assets, repayable, and centrally regulated or even administered on a planned basis.

35. In this way, they could mobilize deposits for investment and development purposes without necessarily encroaching on the socialist ideology regarding socialized property. For some acceptable ways in which this could be rendered compatible with the socialist market economy concept, see Nuti in this volume.

Ongoing reforms in the member countries are bound to exert pressure for modifications in CMEA institutions, policy instruments, behavioral rules, and policies. But I have argued elsewhere that CMEA reforms should be undertaken simultaneously with domestic reforms in some CPEs and that they should be targeted at the *most ambitious* national economic reform to mitigate the adverse impact of the CMEA as a trading system on the feasible progress with domestic reforms (see Brabant, 1987d, 1987a). But no member should be compelled to emulate the farthest-reaching reform, certainly not immediately. Each should be entitled to shield itself from the "dysfunctional" impacts on its own economy that may emanate from within the CMEA.

CMEA reforms need to be of dual but complementary nature, largely paralleling the characteristics of the domestic economic reforms being pursued in some CPEs. One strand of adaptations involves the institutional set-up and management of the regional organization and its affiliates, including the way in which these entities interact with the component economies and *vice versa*. Another set of shifts would be geared toward economic policies and policy instruments in conjunction with their institutional support (see Aroio, 1987). Since such modifications are likely to mature gradually at best and few of the ingredients are in place, it is difficult to ensure steady progress. It may therefore be constructive to stretch the canvas. This extension is motivated by two factors: past experience with domestic reforms and the absence of a parallel for the latent power of central decisionmakers in any individual CPE at the CMEA level that is acceptable to all participants.

It could be very constructive to conceive CMEA reforms within a constitutional framework for SEI (Brabant, 1987d, 1987e, 1987f). Its realization may require the elaboration of a substitute for the CMEA's charter and *Integration Program*. I envisage such a compact as a firm agreement that encompasses the goals of integration, the mechanisms to be established to foster progress, the institutions to be created to ensure the proper functioning of the policy instruments, and the transition mechanism that helps countries that are not yet ready to go ahead full steam with domestic economic reforms to benefit from socialist integration and its further progress without submitting to "full regional competition."

It would be a serious mistake, however, to attempt to settle the aforementioned matters in detail from the outset, as previous experience with domestic or regional economic reform shows. Such a framework makes sense only if it encompasses the basic commitments as regards purposes, means, and institutions—that is, the ultimate purposes of integration; the distribution of costs and benefits, even if specified only generally; and the policy instruments and related institutional supports to be placed at the disposal of the regional and national centers and agents in matters intimately related to socialist economic integration.

Such a compact is essential if, as policymakers have emphasized especially in connection with *Scientific-technological Progress*, direct enterprise contacts are to become the mainstay of integration, at least in manufacturing activities. It would be counterproductive to expect such interenterprise relations to work profitably if they were based on "a further balkanization of structural bilateralism," that is, if each interenterprise contract had to provide for rather

rigidly balanced exchange.[36] Critical areas for review at the CMEA level, therefore, involve regional pricing, the smooth settlement of accounts, harmonization of regional exchange rates, and perhaps a movement toward regional "convertibility" of the TR and the national currencies.[37] Convertibility would, however, have a different meaning from that usually associated with currency convertibility under the IMF rules.[38]

There is some evidence that the present CMEA "reform agenda" includes a new agreement on regional settlements, perhaps in the form of a new European Payments Union suitably modified to the present and to CPE conditions, with a reformed TR as anchor,[39] and that regional price formation is likely to become more flexible in the near future, especially in the context of interenterprise relations (Haluska, 1987; Leznik, 1987). Nothing, apart from theoretical discussions of the desirable and feasible necessities of direct enterprise relations,[40] would lead me to believe that the scope for direct price negotiations for a major part of manufacturing exchanges in the CMEA will, say, in the next five years be entrusted to individual enterprises.[41]

Currency convertibility could be critical in ensuring room for the smooth expansion of interenterprise contacts, in the setting of effective prices, and in linking those prices with exporting and importing in accordance with regulations. Given disarray in the way scarcities are reflected in the current policy instruments, however, the first step in the direction of a more automatic settlement of accounts should not be convertibility, not even full regional convertibility, of the TR. Instead, it might be feasible for CPE governments interested in bolstering direct relations to negotiate the expected volume of transactions for such interenterprise contacts. These ceilings could be revised, say, on an annual basis. Within such an agreed quota, settlements for all interenterprise transactions (between any two CMEA countries and later among all interested members, perhaps via special accounts kept by the IBEC) should be automatic and anonymous. Transactions exceeding the forecast volume may have to be handled within the regular settlements mechanism unless a

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36. But some authors still see room for "compensatory exchanges" and joint planning or plan coordination, even under the new interenterprise rules (Grinev, 1987, p. 3; Leznik, 1987, pp. 26-27).

37. Krzak (1987a) argues very strongly for making the TR convertible in the true sense of that word. But I suspect that such convertibility should be the logical culmination of the switch in settlements mechanisms, not its engine (Brabant, 1987g).

38. It is surprising that even Soviet authors are now advocating the introduction of convertibility (see Bautina and Shiriaev, 1987, p. 111; Sil'vestrov, 1987, p. 129), but I suspect that they have something in mind other than IMF-style convertibility (see Brabant, 1987g).

39. But suggestions evidently remain very cautious when it comes to the concrete policy agenda at the CMEA level. Useful pointers can be bound in Krzak, 1987a; Rybalko, 1987; Shiriaev, 1987.

40. For some recent suggestions, see Abolikhina, Bakovetskii, and Medvedev, 1987; Bautina and Shiriaev, 1987; Evstigneev, 1987; Haluška, 1987; and Sil'vestrov, 1987.

41. In his address to the June 25, 1987, plenary meeting of the Central Committee, Gorbachev (1987) endorsed, albeit rather gingerly, the need to leave negotiating room over prices to individual enterprises involved in direct relations, at least domestically. Haluska (1987) ventures that it may take one to two years to put such a price mechanism in place. I suspect that this is a wildly optimistic target.

supplementary agreement on incremental trade volumes can be elaborated. Imbalances that arise, say at the end of each calendar year, would have to be offset against the regular commercial accounts as under the present BTPAs, but preferably by loans from a common fund. Any imbalances that remain will have to be settled in an increasing proportion in convertible currency that can be appropriated only to foster interenterprise contacts.[42] Such funds would probably have to be made available in loans at favorable interest rates, primarily to those enterprises that have fostered regional trade and specialization. Perhaps a "CMEA stamp of approval" would have to be issued to forestall the usurpation of the provisions by those who do not contribute to genuine socialist integration.

Payments of imbalances in convertible currency could be undertaken either from a fund set up for that purpose or *ad hoc*. The former might inspire greater confidence and indeed might make it more difficult for any member to renege on its commitment in principle, as happened in the past.[43] The precise size of the fund would depend on the forecast volume of direct enterprise transactions and the settlement modus. A realistic estimate might be as follows: since manufactures account for about half of CMEA trade, and it is unlikely that more than 5 percent of that trade would soon be settled through direct enterprise relations,[44] the volume of transactions would be less than TR 5 billion per year. The bulk would be balanced in any case. If 20 percent were not balanced and initially 10 percent of that imbalance would have to be settled in convertible currency, the fund would need the equivalent of at least TR 100 million. Although this reserve fund would be recycled to bolster the expansion of such direct enterprise transactions from within, the fund would probably have to be somewhat larger, perhaps TR 500 million, to allow for convertible currency loans with a proper maturity to foster direct enterprise relations in these hard goods. Such a convertible capital reserve could be funded through borrowing in international financial markets (perhaps with some input by the IMF), Soviet gold sales, or from real contributions of the countries interested in laying the foundations for convertibility within the CMEA.

Conclusion

The observer of today's CMEA has reason for guarded optimism well beyond the wildest expectations of, say, two or three years ago. Not that I expect swift movement in the economic mechanism of socialist integration; I do not even subscribe to the notion that all European CMEA members[45] can be expected to engage in active interenterprise contacts in the near future. Under the

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42. Liakin (1987) appears to be endorsing something similar but without the introduction of convertible currency settlements.

43. At least two earlier occasions spring immediately to mind: the settlement of imbalances in selected hard goods under the 1957 Warsaw agreement and the 1973 agreement to settle a small portion of imbalances in convertible currency (Brabant, 1987, pp. 273-276).

44. This gauge is derived from a recent estimate by Iurii Konstantinov (1987, p. 54) to the effect that only between 5 and 11 percent of reciprocal trade in machinery is on account of active cooperation in production.

45. To illustrate the degree of realism that is being displayed, it was recently acknowledged in no uncertain terms that interenterprise contacts—read real SEI—are not suitable for the non-European members (Abolikhina, Bakovetskii, and Medvedev 1987, p. 139).

circumstances, it might be useful to rethink the integration mechanism and allow for countries to maintain different degrees of openness to regional trade and other forms of cooperation.

The CPEs that are ready to introduce broad-based domestic reforms attuned to the regional economic mechanism should progress without being stymied by others who choose voluntarily to postpone reforms. The integration mechanism should therefore explicitly recognize that members will remain in different transition phases. The compact could lay down agreement on the degree to which each CPE can shield itself against "unfair competition" either from within or outside the CMEA. But such distinctiveness can be tolerated only if it does not undermine socialist integration from within. The compact should also take issue with the pace at which the differentiation among member countries will be gradually eliminated, and by what means.

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14

Alternative Modes of Financial Organization

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Financial activities, not unlike other economic activities, can be organized in markets or in firms (see Hirschman, 1982). The firms' system is as much the antithesis of the market system as is centralized planning, as it consists of a series of interactions among a hierarchically ordered chain of economic operators which replace equivalent interactions on a market among autonomous economic agents. These agents express demand and supply and generate prices. The larger and fewer the firms in the system, the smaller the number of transactions that take place in the market at market prices.

A country's financial system can develop more along the mode of market or of firms. Since World War II, national financial systems have witnessed the prevalence of firms over markets, although this has not been necessarily true of the international financial system. Although the trend may have been reversed to some extent in most recent years, in most countries the postwar period has been characterized by increasing concentration of financial transactions in the hands of fewer, larger firms. This development goes against the forecast of Anglo-American financial theorists who, by Darwinian logic, had expected the multiplication of agents to perform on the marketplace the more numerous and complex functions required by an ever developing society.[1]

Financial development in most Western countries, however, seems to have followed the opposite path. More complex transactions have been performed by larger, fewer, multidepartmental firms, while the area left to markets has progressively shrunk. In some Western countries in which financial institutions had gone bankrupt in the interwar years, legislation was passed to deliberately reduce the role of markets and foster concentration of financial institutions with central bank control, to safeguard depositors (or, at least, to appear to be doing so). In those countries, the postwar years ironically have seen the development of the opposite trend—toward the unshackling of financial activity from control and an increased role for markets. The prime example is the United States, where a convergence of different interests has favored, particularly in the last decade, a movement toward deregulation of the financial system in the naive hope—which is already being disputed by the facts—that reduction of controls will provoke deconcentration and the development of markets. Although the move toward less control has been more marked under the Reagan Administration, it must be recalled that the Carter Administration embraced, at the time of its inception, a

1. What I describe as the "Darwinian approach" to financial development was made popular by Walter Bagehot. It has been recently proposed again by McKinnon (1973) and by Shaw (1973).

very similar philosophy, and that its actions (when not dictated by emergencies) were inspired by a belief in freer and more efficient markets. The U.S. Congress seemed for a long while to be convinced of the preferability of "rules versus discretion," although most recently it appears to be shifting into reverse under the pressure of unfavorable financial events.

In countries where financial institutions have never been under a cloud of doubt as to solvency and efficiency, as in the United Kingdom and Germany, the process of integration of ever more complex financial functions in ever less numerous and larger financial institutions has continued unperturbed. The exception, for Britain, was the period of rampant neoconservatism in the early 1970s. At that time, the central bank, with the famous policy of "competition and credit controls" let a "hundred flowers blossom," only to be confronted, in a matter of two or three years, with the worst banking crisis of this century, the "secondary banking crisis" of 1975.

In fact, in spite of the clash between a more and more concentrated financial structure and the decentralization wishes of governments and even central banks, in the United Kingdom as well as in the United States, postwar financial history has seen the reconquest of the market by large firms, which have occupied the space left by governments after the war. In the early postwar decades, large banks were able to recover their role as main sources of financial means for industry and trade by getting rid of the enormous holdings of public debt which they had accumulated during the war.[2] They were, in other words, able to concentrate on asset management, as plentiful liquidity could be obtained by the sale of government debt holdings. This phase came to an end around the mid-1960s. It has been followed, especially in the United States, by the phase of "liability management," when banks had to begin looking about for new financial "raw materials." In this phase, large banks have been penalized in the United States by legislation which prevents expansion across state boundaries and thus favors small banks which can have closer relationships with retail savers. To keep their market shares, large American banks have developed the market in certificates of deposit (CD) and have expanded their foreign operations. This latter development consisted of shifting ever increasing chunks of deposits to the Eurodollar market, where small bank competition was almost impossible and where no reserve requirements apply.

The huge growth of these two markets—the CD market and the Eurodollar market—seems to have been caused by the peculiarities of U.S. banking legislation, which was passed in the interwar years and was aimed at favoring financing of home-building, by forbidding the remuneration of deposits and by giving special privileges to thrift institutions which, in turn, financed home-building at fixed rates.

In addition, the American financial system's development in the last 15 years has been profoundly affected by the transformation of the United States from a low-inflation to a high-inflation economy. The new reality of permanent inflation has radically changed the way in which firms and individuals organize their financial transactions. High inflation rates bring high nominal interest rates. It consequently becomes impossible to ignore the cost of idle

2. The structural transformation of financial markets since the war has been analyzed recently by Goodhart (1982), whose excellent paper I have kept constantly in mind while writing this essay.

balances and of alternative liquidity sources. The concurrent electronic revolution has rendered this transformation more hectic and radical. The gist of the change is that economic agents now view themselves as being at the same time borrowers and lenders. As Sir John Hicks (1935) suggested 50 years ago, all economic agents now have financial assets and financial liabilities. This applies to individuals as well as to business firms. Both borrow to finance purchases of everything except the most nondurable consumption goods, and at the same time they hold portfolios of interest-bearing financial assets.

To exploit this new reality, a myriad of new financial institutions has sprung up, especially because juridical impediments prevented banks from catering to the new needs of firms and individuals. The core of these new intermediaries' activity consists in allowing their clients the possibility of maintaining liquidity and accessibility over their financial resources, invested in bonds, primary commodity speculation, common stock, and so forth. Having to observe no reserve requirements, these new intermediaries could perform the miracle of letting their clients have their cake and eat it too. All this was possible due to the "Common Law" approach, according to which "all that is not expressly forbidden, is permissible." The "Roman Law" tradition is, of course, rather the opposite: what is permissible is expressly identified by the written law. In the United States, the Common Law and Roman Law traditions have coalesced, which allow the cognoscenti to play a very profitable "hide and seek" game with lawmakers as sanctions can apply to new realities only *ex nunc*, and by that time the able are somewhere else trying a new trick. Most of what has lately gone under the title of "financial innovation" originates from this juridical peculiarity. To this juridical approach and to the possibilities it presents to the clever operator must be attributed the ever more meaningless American money supply statistics and the accompanying lore of money supply measures. Similarly, we can attribute to this juridical approach, and to the progress in electronic transactions, the increase in the velocity of circulation of calculating interest accruals.

The state of flux of financial transactions in the United States in the past decade has led to the authoritative suggestion that the "euthanasia of the saver" has been consummated and that we must now consider every financial agent as a "financial intermediary," accepting "in toto" Sir John Hicks' suggestion. As a result, the most meaningful magnitude for monetary policy in the near future of the United States may be the spread between banks' lending rates and the yield on financial assets. The whole community of citizens is thus seen as being engaged in a continuous activity of financial arbitrage. In this new world, where liability management has spread from large banks to every individual, authorities' control of traditionally defined monetary aggregates is seriously diminished. If banks are no longer able to rely on stable largely interest-inelastic deposits, banking becomes riskier, which increases the need for bank supervision and necessitates highest capital requirements for banks and other intermediaries.

How do other financial systems stand vis-à-vis the revolutionary changes shaking the U.S. financial system? The trend toward making every citizen a little financial firm cannot be resisted in any country whose interest rates attain high nominal levels; this having been the case in most other Western countries, their financial systems have shown a much greater resistance to change than the American. Generally speaking, the high degree of concentration characterizing Western banking has favored the development of banks into financial supermarkets, and has prevented the rise of alternative financial intermediaries. Where those existed, as in England, the typical British solution has been found of

letting the clearing banks buy them up and letting them survive in a formal independence which may nevertheless have more than a modicum of substance. The development of the Eurodollar system has given large nonfinancial corporations a possibility to escape to some extent from the vice of national financial systems, thus increasing the discrimination of national monetary policy between large and small firms. By and large, however, national financial systems in the major Western countries do not seem to have caught the financial fever that shocked the United States. The reduction of inflation rates, with the ensuing reduction in nominal interest rates, favors the resistance of financial systems to "innovation" of the type that has taken place in America. Also, authorities in the rest of the West have shown a much cooler disposition toward decontrol. Even the ultra-laissez-faire British government does not seem to worry about concentration in English banking, and its free trading spirit does not seem to be hurt by the increasing banking supervision exercised by the Bank of England and by its rather heavy doses of "moral suasion."

The interpretation that a dual evolution of financial systems is taking place in the developed countries, which could be characterized as "the United States versus the rest of the world," should be dispelled by a few additional points. The deregulation movement in the United States was, from the beginning, favored and actively promoted by large money center banks, which had been very effectively shackled by the Roosevelt legislation. Through deregulation these banks have sought to reacquire freedom of movement and market share. The liability management phase must be seen in exactly the same light, as an attempt by large money center banks to grow and increase market share at the expense of tardier provincial banks. The fact that deregulation has not gone exactly in the direction large money center banks would have liked can be compared to the difficulties of making an omelette which involves breaking eggs and a phase when the eggs are broken and the omelette is not yet made. This phase has lasted longer than the banks desired and is yet unfinished. This does not change the view that bank deregulation in the United States would assure, in a temporarily more competitive environment, survival of the fittest, which in the real world means, more often than not, survival of the largest—that is, increased concentration in American banking. The world trend is, therefore, unmistakably toward the prevalence of hierarchies at the expense of markets, in national as well as in international finance. This trend has been powerfully aided by two important elements:

1. *The emergence of large OPEC surpluses in the 1970s and early 1980s.* As those countries had no banking or financial experience, OPEC dollar surpluses were deposited with large American money center banks. (Of course, OPEC nations also actively invested, but only a relatively minor percentage of their surplus.)

American money center banks found themselves deluged with a huge oil surplus to invest where it was easiest: in the developing countries, under the form of sovereign loans because, according to Walter Wriston, "countries cannot go bankrupt." The problems resulting from this strategy have been plaguing the American banking system ever since, but they need not worry us here. What is relevant here is that the concentration of world surplus in OPEC hands for a decade meant a powerful reinforcement of the world trend toward banks and away from financial markets. Only large banks could provide the intermediary function which OPEC countries, with their very high liquidity preference and lack of risk evaluation skills, required.

2. *The emergence of Japan, Germany, and the "four Asian tigers" as holders of the world's payments surplus in the 1980s.* This has reinforced the trend toward a bank-oriented system: financial markets are either nonexistent, or when they exist, they are dominated by banks in their countries.

The management of international payments surpluses has thus been entrusted to large banks for close to two decades. This has caused a marked shift toward bank-oriented finance even in the United States. There, recent years have witnessed a notable return to bank loans on the part of large nonfinancial corporations, which have actively borrowed from banks in order to repurchase their own shares and save themselves from takeover attacks. There has thus been a creation of bank debt and a destruction of equity. (When large corporations issue junk bonds, they are mostly taken up by "thrifts," which need high-yielding assets. They thus end up being held by the banking system.)

Although the "deregulation movement" has plunged the United States financial system into a state of flux for a good number of years, it has been undoubtedly aimed at freeing large banks from the shackles of New Deal legislation, so that they might increase their market share.[3] When the dust clears, the American financial system will be different from what the strategists of deregulation had planned. It will probably contain a few large regional banks and a few very large nonbank new actors, such as Merrill Lynch. But it will definitely have a more marked orientation toward institutions and away from markets.

The indisputable world trend toward greater concentration of financial power in the hands of giant financial supermarkets runs counter to the dictates of the mainstream theory of financial development. This theory is based on the idea that an economic world which becomes more and more complex will have more and more functions to be performed by more and more specialized institutions. Adam Smith's dictum, "This division of labor is limited by the extent of the market," has been interpreted by mainstream financial theorists to mean that as countries proceed to develop, financial functions become so many and so complex as to allow the creation of a plurality of specialized agents to perform them with greater efficiency of allocation of available financial resources.

This financial Weltanschauung, first expounded by Bagehot, and more recently by Shaw and McKinnon, has been reiterated in the last decade by Tad Rybczynsky, a distinguished economic theorist and successful financial practitioner. He has written a series of articles attempting to reformulate this theory.[4]

Writes Rybczynsky:

"Domestic financial systems pass through three different stages: the bank-oriented phase, the market-oriented phase, and the strongly market-oriented phase. In the bank-

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3. The real aims of financial deregulation were revealed, with increasing clarity, by the Federal Reserve Chairman Paul Volcker. He stated more than once that he wanted the U.S. financial scene to be dominated by large universal banks, which would operate nationally. His successor, Alan Greenspan, has made this his aim even more forcefully, in a recent statement to Congress.

4. The longest and latest of his efforts is a World Bank Staff Working Paper, where the evolutionary theory of financial development is expounded at considerable length. See "The Internationalization of the Financial System and the Developing Countries: The Evolving Relationship." Washington, D.C.: The World Bank.

oriented phase the bulk of savings an economy generates is transferred to those wishing to use them through banks. They channel the savings they collect mostly in the form of short-term loans to business. Risk capital is obtained from retained profits and direct recourse to savers, who are few in number. The market-oriented phase is characterised by the increasing reliance of firms on external funds, including risk capital raised from ultimate savers through the capital markets rather than through financial intermediaries. In the strongly market-oriented phase the financial intermediaries also rely on the funds raised through the financial and capital markets, and there come into existence new financial risk-hedging markets.

The world financial system is now in the bank-oriented phase but is moving into a strongly market-oriented phase now beginning to characterize the United States and United Kingdom, while the major European countries and Japan are entering the market-oriented phase."

If we compare this view of the evolution of financial systems with what has gone on in the main developed countries in the last century, we are struck by its normative nature. The evolution from banks to markets, the devolution of powers from few very strong all-purpose institutions to the anonymous, and therefore democratic, auction markets, is what economists of the mainstream Ricardian tradition would have liked—that is, the transformation of money and finance more and more into a veil which cannot influence the working of "real" economic forces.

Financial development in the main industrial countries, on the contrary, actually seems to have begun with banks and to continue with banks. Even Tad Rybczynsky admits that this has been the case in the most successful industrial countries: Germany, France, and Japan. But his view is that they are in an intermediate stage of financial development, which inevitably will give way to the market-oriented, then to the strong market-oriented, phase in which the early developers, the United Kingdom and the United States, already find themselves. A more realistic reading of financial history, both recent and more remote, of these two early developers, is that in both, large banks have always kept growing at the expense of smaller banks and have been prevented from attaining the phase characterized by universal banking—the more realistic, most advanced phase of financial development by the political power of other groups in the form of legislation in the United States and of consensus action in the United Kingdom These groups felt threatened by the emergence of great universal banks and were strong enough to retard this development. We must not forget, however, that around 1900, and until the Great Depression, the United States had universal banks integrated with industry. This phase, which Rybczynsky ignores, coincided with the most innovative age of American industry. In the other recently more successful developed countries, the sociopolitical structure did not cause such financial pluralism to come about or to linger on. Banks could develop, unfettered by opposition toward greater and greater concentration.

"Competition and credit control" in the United Kingdom and "deregulation" in the United States signalled a change balance of financial power in those two countries. Large banks were at the root of both movements and have indeed managed to get rid of most of the obstacles in universal banking. In the United Kingdom the process is virtually completed. United Kingdom banks today can do more or less what they want, subject to prudential supervision from an increasingly bureaucratized Bank of England, which resembles less and less a bank and more and more a government department. In the United States the picture is not yet clear, but it appears that a small number of very large banks will operate across state boundaries. This group will be composed of the money

market banks and a number of successful regional banks and money market institutions.

The international picture will thus be composed of a group of perhaps 100 large banks. They will behave according to the rules of monopolistic competition, which means a highly unstable state of the world, because the monopolistic features will sometimes prevail over, sometimes give way to, the competitive features of the system.

Another element of recent financial development in industrial countries has been the growing integration between banks and industry. Finance capitalism has always been the rule in Germany and Japan, and, to a lesser extent, in France and Italy. It has been present also, though denied, in the United States. There, the links between large money market banks and industrial firms have been traditionally close, as a study of interlocking directorates reveals. But the ties were of a less organic nature than in the other countries. The only country where banks have kept away from industry is the United Kingdom, especially because they have specialized in short-term international finance and retail credit.

Recent events, and especially the somewhat less-than-spectacular performance of the United Kingdom and United States industrial systems, have led economists to doubt the traditional view of financial development, and to consider the possibility that the bank-oriented model may be the one conducive to greater industrial growth and macroeconomic efficiency, even to greater allocative efficiency. The market-oriented model has begun to look more like an expensive detour than the ultimate phase of financial development. This side-tracking of both the United States and United Kingdom financial systems seems to have been caused by the peculiar sociopolitical configuration which has survived in these two countries, where the synergies between banks and industry have not been exploited and where large banks have for a long time been prevented from exploiting economies of scale.

The side-tracking of these two financial systems is increasingly held accountable for the industrial decline in both countries. Instead of being allowed to develop synergies with industry, banks in these two countries have been compelled to grow by cajoling consumers into greater debt, by lending to unsound foreign governments, and by wasting scarce skills in the practice of "liability management." This mode of financial development raises the instability of the financial system and raises the world level of real interest rates.

The causes of industrial decline in the United States and the United Kingdom are certainly more numerous and complex, and the financial systems of those two countries cannot be the sole culprits. It is, however, exceedingly difficult to maintain that Anglo-American financial institutions have been an instrument which fostered recent industrial growth in these two countries.

First of all, there do not seem to be alternative modes of financial development. If the process is left to work itself out unhindered by government intervention, large universal banks will prevail in all developed countries, and all national markets will be dominated by financial oligopolies with deep ties to industry. The need for intermediation and for the socialization of risk is too great to allow for the emergence of a market-oriented system. This will come about only if governments, influenced by pressure groups hostile to large financial institutions, legislate and operate to reduce the dynamism of large banks. Most of the market-oriented dynamics of the American financial system can be explained as attempts on the part of large banks to expand in spite of a

hostile legislative environment. Denied growth as intermediaries, they tried to grow as brokers, or as intermediaries outside national boundaries.

A bank-dominated financial system, in which large universal banks prevail, tends to channel funds toward industrial fixed investment. The great amount of intermediation large banks are able to provide, and the attendant socialization of risk, seem to lower the threshold of feasible industrial projects.

A more direct circuit between savings and investment, such as the one provided by a system of large universal banks, boosts industrial capacity. This does not create problems as long as the ensuing output is partly disposed of by exporting it to developed countries which have decided to weaken the link between finance and industry in their own economies, and have not, as a consequence, added to industrial capacity with the same fervor exhibited by countries where large financial institutions foster savings and investment. What will happen when universal banks are finally allowed to emerge in the United States and again begin to channel funds toward its industry?

We have seen how a universal banking system fosters industrial investment by socializing risk and increasing intermediation. But, paradoxically, would this have been a blessing had the countries where financial development was allowed to proceed unfettered not been allowed to export a considerable part of their industrial output to other developed countries where "financial repression" was at work discouraging industrial investment?[5] Had this outlet not existed, would universal banking not have caused the problems Janos Kornai has exposed as plaguing Socialist countries? Would the absence of export outlets not have resulted in a "production of investment goods by means of investment goods" with the attendant compression of consumption in Germany and Japan?

Universal banking seems to reduce risk in industrial investment. It has therefore to deal with problems of overproduction at the world level if it is extended to all developed countries. Here the experience of Socialist countries is very instructive. The socialization of risk in these countries is complete, and industrial investment is thus completely unfettered by risk consideration. Universal banking seems to lead to similar results, and the circle it unchains is a virtuous, and not a vicious, one, only because export outlets have been found in countries not conquered by universal banking.

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15

The Basis of China's Banking Reform

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Banking is both a product and a means of managing a commodity economy.[1] Since China is introducing a planned commodity economy, it becomes imperative to reform her old banking system.

Forming a framework for a new banking system

The framework for a new banking system has evolved through eight years of reform. For more than 30 years, China's banking management was characterized by government control over revenue and expenditure, centralized allocation of resources, and issuance of both currency and credit. Banks were subordinated to the Ministry of Finance and played a negligible role in regulating the macroeconomy. Now that China is moving from a product economy to a commodity economy, and from managing goods by physical allocation to managing goods based on value-based prices, the old banking system has come under scrutiny.

The breakthrough in banking reform came in 1979 with the expansion of credit activities. In the past, banks were limited to issuing short-term working capital to enterprises; funds for investment in fixed assets were allocated by the Ministry of Finance. Since 1979, bank lending has expanded to include financing the acquisition of fixed assets. In 1987, fixed assets lending totaled 100 billion yuan. In the past, bank loans were only extended to state enterprises. Since the reform, banks have begun to lend to collectives and individuals and to such sectors as education, culture, public health, services, and tourism. This reform has done much to invigorate the economy and has generally been welcomed by the public. Still, the results are only of a preliminary and localized nature.

Since 1984, urban reform has centered on the invigoration of enterprises and has been accompanied by a further expansion of the commodity market. How to strengthen macroeconomic management has, thus, become an outstanding issue that must be addressed by the reform. It is no longer feasible to use stronger administrative means of management or to aim for a balance in the supply and demand of material goods. Therefore, a rational system is needed whereby prices can help achieve a balance in the demand and supply for funds.

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1. In a "commodity economy," the exchange of goods takes place through the market (in contrast to a "product economy" in which allocation is directed through a central plan). This expression has been preferred in China to "market economy" to stress that output and prices will not be determined by market forces alone. - Editor.

Banks have a pivotal role to play in the movement of capital. For banks to be truly effective in macroeconomic regulation, it is necessary to separate the central bank (which issues money and implements monetary and banking policies) and the specialized banks (which handle the deposits of, and loans for, enterprises and individuals) and introduce a two-tier banking system with the central bank in the leading role.

The use of banks to regulate the economy is an important breakthrough in the traditional approach to banking in China. Inevitably, the process of change was accompanied by problems. The loss of control over credit issuance in 1984 indicated that China still lacked experience in using banks to regulate the economy. It also indicated that the central bank had yet to assume its proper role. In view of the excessive demand of the previous year, in 1985 the state decided to use credit as a lever to strengthen the regulatory mechanism of the central bank, start a financial market, guide economic activities, and regulate aggregate supply and demand for finance. With the introduction of reforms in wages and prices in the same year, the initiative yielded good results.

Experience has shown that in the course of commercializing and monetizing the economy, banking has come to play a stronger role in macroeconomic management. Monetary policy and the banks' regulatory role have also helped to control the aggregate supply and demand for funds, the impact of which has been felt in all enterprises and individual households. These developments have enabled people to appreciate the role of banks and have improved the professional skills and capabilities of bank staff. The authority of banks in managing the economy is being restored. Conditions are, therefore, ripe to accelerate banking reform.

At the Fourth Session of the Sixth National People's Congress held in March 1986, Premier Zhao Ziyang said: "In particular, we must strengthen the functions of banks in macroeconomic management and, through the banking reform, gradually develop strong and flexible control and regulatory structures in order to bring into full play the banking system's role in financing, guiding fund flows, improving funds utilization efficiency, and regulating aggregate supply and demand." Again, in his "Report on Government Work" made at the Fifth Session of the Sixth National People's Congress held earlier this year, Premier Zhao said that "financial institutions such as specialized banks and insurance companies at the province level and below should, when conditions permit, operate as enterprises" and that "suitable competition should be promoted among the financial institutions."

The government has determined the basic approach to banking reform and outlined the framework of a new banking system. The main features of the reform are the development of:

- A banking system whose main function is the forceful and flexible indirect regulation and control of the macroeconomy—a system which is able to raise and lend capital, maintain balance in the aggregate supply and demand for funds, maintain basic monetary stability, and promote economic growth and a rational economic structure.
- A credit system with bank credit as the mainstay—complemented by diverse channels, methods, and means of financing—to promote the free flow of capital and to gradually form financing centers and financial markets in big cities.

- A socialist financial system with the central bank as the leader and state banks as the main body, coexisting and cooperating with insurance companies and other specialized financing institutions. The functions of the central bank will be strengthened, while other financial institutions will operate independently as enterprises. Suitable competition will be encouraged among banks to enhance their operational motivation, vigor, and efficiency.
- A modern financial management system to improve the professional caliber of staff, train senior financial managers, and use modern technologies (such as computers) to provide customers with quick access to information, convenience, and quality services.

These four systems will be developed gradually and improved regularly.

The reform will center on three key aspects: developing a financial market, providing conditions for specialized banks to operate as enterprises, and developing a financial management system based on indirect control and regulation. Of these three, the formation of a financial market is the key to reform; this is because the system of macroeconomic management in China has long been plagued by the problem of either extreme rigidity under control or extreme confusion under decontrol. The existence of a financial market would open up a new channel of financing for enterprises, the government, and financial institutions. Should economic retrenchment become necessary, there would be no need to put a squeeze on credit availability; and if credit supply needs to be controlled, the process of structural adjustment would not be seriously affected. In short, a financial market would allow flexibility in regulating the macroeconomy.

Another reason is that under the old system, money and prices served only as accounting tools; they did not reflect market values because material goods were allocated directly under mandatory planning. Now that material goods will be traded on the market under indicative planning, the formation of a financial market becomes a prerequisite to the formation of a commercial market. In China, however, the development of a financial market requires the invigoration of financial institutions, especially specialized banks. Unless these banks operate as enterprises in the true sense, the relationship between the central bank and specialized banks, between banks and enterprises, and between the head offices and local branches within specialized banks will remain irrational, and the supply of free capital and "eating from the big pot" will not really be eliminated. As long as specialized banks still look to the state for funds when they are short of capital, no financial market can develop.

Once the financial market is formed and specialized banks become true enterprises, lending and borrowing by banks will be streamlined. However, effective lending and borrowing policies must be complemented by a stronger macroeconomic regulatory and control system. The reform would fail if the easing of credit controls leads to inflation.

Key measures for deepening banking reform

Once the basic approach to reform and the framework for a new system are determined, the following concrete measures would be needed to ensure that the reform is implemented:

1. *Develop and improve a system of macroeconomic control by the central bank.* Banking is a process through which credit is generated. Because total credit demand currently outstrips total supply, control over credit is the key to regulating aggregate demand.

- Keep the total money supply in step with the availability of goods. In terms of macroeconomic balance, the growth of savings must not exceed the growth of capital goods output, and the growth of consumption funds must not exceed the growth of consumer goods output. An appropriate ratio should be maintained between the two. In the past few years, both saving and consumption have outstripped the growth of national income. Stronger regulation of society's total demand for funds remains a priority of the central bank.
- Maintain a relatively stable monetary policy. Setting a moderate growth rate of money supply has always been an effective instrument in curtailing inflation. The conditions for a relatively stable monetary policy are: (i) determine the growth rate of money supply on the basis of an expected economic growth rate, manageable rate of price rise, and changes in the velocity of money; (ii) ensure that the investment of funds is guided by the available supply of funds; and (iii) provide funds such that working capital has precedence over fixed assets and a balance is maintained in the sources and uses of both long- and short-term funds.
- Make flexible use of regulatory means. A socialist economy is a planned commodity economy, and the basic means of maintaining its macroeconomic balance is still planning. However, mandatory planning and indicative planning should both reflect market values to let the market influence enterprises. Therefore, once macroeconomic objectives are set, they should be realized mainly through economic means.
- As for lending, the central bank will give up direct control and regulate money supply indirectly through regulation of loans issued by specialized banks. Some ideas proposed as next steps in the reform include the following: First the central bank will no longer supply capital to specialized banks, but will let them attract deposits, borrow on the financial market, or issue bonds on their own. Lending can be expanded if deposits expand. Second, the central bank will set strict lending targets for banks to maintain central control over the money supply. Financing will be available to financial institutions every quarter on the basis of market outlook, prices, interest rates, and changes in money supply; and within the central bank's lending and rediscount limits and at its lending and rediscount rates. With the development of the financial market, market financing will expand.
- Achieve a balance between renminbi funds and foreign exchange. Since the open-door policy was introduced, China's foreign trade has been expanding; changes in the international market, international prices, and exchange rate are having an increasingly greater impact on China's foreign exchange revenues and expenditures, which in turn have a direct impact on public finance, prices, and credit.

Consequently, an important aspect of financial reform is the reform of the system of managing foreign exchange and external debt. The urgent tasks for the present period include the following: maintaining an overall balance of foreign exchange and renminbi revenues and expenditures; improving the conservation

and strengthening the centralized control of foreign exchange; revising the exchange rate-setting policy and implementing a managed floating-rate system; stabilizing foreign exchange reserves and establishing an exchange credit fund in the central bank; strengthening the management of external debt, determining the appropriate size, maturities, interest rates, and currency mix, and improving the monitoring system; and studying ways to use the limited foreign exchange market and foreign exchange advantageously.

2. *Develop, set up, and foster financial markets.* Judging by the orientation of reform in China, indirect financing (through the banking system) would be the main channel, and direct financing (through the budget) would be a supplementary channel, of resource allocation. Whatever form of financing is used, market mechanisms should be utilized for allocating funds.

For China's financial markets, the current priority is to increase the flow of short-term funds. At present, an oversupply of working capital and unsatisfied demand for it exist side by side. Clearly, this is not a problem of total supply, but a structural question, a question of efficiency, which calls for a market solution. Money is available for investment from local authorities, but not working capital. The banks alone are not able to cope with this problem; perhaps the market can offer a solution.

In the past couple of years, short-term borrowing within sectors has expanded rapidly and has reached scores of billion yuan. Now, there is a need to expand the financing activities across sectors and provinces, so that financing networks can be formed at different levels and for different purposes, supported by principal cities.

For a long time, enterprises borrowing from banks were not required to send in IOUs; this meant that the flow of funds was divorced from the flow of material goods, which could possibly lead to the inflation of credit. It is important that transactions among financial institutions, between financial institutions and enterprises, and among enterprises themselves be based on commercial bills and papers. Only when this task is accomplished can such practices as bill acceptance, discounting, and rediscounting supplement credit loans. With the use of commercial paper, a new system can be put in place in which business clients choose their bank and banks choose their clients. This will create conditions for overlapping operations and competition and help break down the old system under which banks took care of all the funding needs of an enterprise.

In recent years, short-term notes, including financial notes and certificates of deposit, have been issued. Enterprises will soon be permitted to issue short-term bonds (with maturities of one year or less) which will be transferable. This measure will push enterprises into the marketplace, help them raise more funds directly from the market, and gradually reduce their reliance on the state for funds.

In China, shortage of capital is a very acute problem. Currently, unbudgeted funds have increased alarmingly, and little guidance on self-financed capital investments is being provided to enterprises. On the other hand, investment scale has exceeded the range allowed by the country's economic strength; the state is short of funds for projects of national priority. The development of long-term capital markets is the most effective way to control total investment, regulate the investment structure, and enhance investment results. However, the development of the capital market must be combined with a reform of the investment system.

To change the old ways when the state undertook all funding, some priority projects should be handed over to local authorities, and investment should be

linked to returns. Moreover, the task of investing in more general business-type projects should gradually be transferred to enterprises. Financial intermediaries should play their role in channeling unbudgeted funds for needy projects; they could also serve as bond-issuing agents. Those who raise funds should be permitted to make decisions and bear risks. In this way, the state's fiscal burden is lightened and, at the same time, market mechanisms are used to regulate the investment structure to ensure that funds are available for good projects and competent operators.

Stocks have been issued on behalf of only those enterprises that have formed associations and a few collectives that have received special approval. As financial assets increase, financial markets will be opened up further (some cities are now experimenting with financial markets), and the long-term capital market will become active. The insurance industry—in particular, life insurance, pension funds, and other contractual savings institutions—can become a stable source for the supply of long-term funds. With the "commercialization" of funds, appropriate measures for managing these funds need to be worked out. The state needs to regulate total investment and the size of bond issuance; establish rating agencies to evaluate the creditworthiness of enterprises, and other agencies to oversee market transactions; and improve laws and ordinances for managing these funds.

3. *Deepen the reform to turn specialized banks into enterprises.* Specialized banks now are not held accountable for their profits and losses; they do not gain from the success of their operations; and they are not responsible for bad loans. These limitations restrict the ability of financial intermediaries to mobilize capital efficiently and allocate funds rationally to enterprises that assure good returns. Turning specialized banks into enterprises is, therefore, an important part of the financial and banking reform.

Running specialized banks as enterprises is important to:

- form financing and communications networks with cities as growth centers; and
- break down the traditional separation of ministerial line supervision and local-government administration in order to form economic regions.

To achieve these objectives, the following policies should be implemented:

- A certain amount of credit should be allocated to the basic operational units of specialized banks to enable them to own and manage their own "capital." These funds should not be transferred to the upper-level bank office without compensation.
- Like the decentralization of authority for state-owned enterprises, financial and operational autonomy should be given to banks for granting loans; determining interest rates; allocating after-tax profit; appointing, removing, rewarding, and penalizing staff; and establishing their own internal structures.
- With decentralization, it is necessary to improve the system of accountability for the risks taken; to use the principles of risks and profits as constraints on financial institutions in granting loans, so that in the process of making loans to enterprises, such questions as credit standing, rate of return, and repayment ability are considered to ensure the safety, integrity, and efficiency of loans.

- Profits should be linked to the volume of business and the size of earnings. It is also necessary to gradually change the old practice whereby the head office verified and approved all expenditures and sent its decisions down to lower levels.
- Financial enterprises should be permitted to go after maximum profit, and gradually an evaluation system with profit as its basic indicator should be set up.
- New financial institutions should be developed, and overlapping of financial operations should be permitted, to help break down monopolies. In recent years, a large number of collective banking organizations and other nonbank financial institutions have been set up. The Communications Bank, which handles comprehensive credit operations, has been reestablished; overlapping of operations among specialized banks has been permitted; and mechanisms have been introduced to enable financial organizations to compete in the marketplace.
- Pilot projects have been implemented to separate ownership from operations. In some areas, local savings offices are trying out a contract system. These experiments will be expanded in the future.

These reforms must continue. They are necessary for improving the mechanisms of microeconomic operations and strengthening macroeconomic regulations and controls to form a highly efficient financial and banking system.

External relations of banking and financial reform

Experience of the past several years has driven home the point that the financial and banking reform is extremely difficult to carry out and that it involves many sectors. To be successful, the reform must be coordinated with economic restructuring efforts, and all the reforms' external aspects should be handled carefully.

Banking reform and the planning system

Under the product economy of the past, macroeconomic objectives were determined and implemented through planning. Planning controlled the operations of the economy, level by level and item by item. This type of management by direct control is being changed. To regulate the industrial structure and market, the state will control only a part of the funds and materials and implement mandatory planning only for a small number of products that are critical to the national economy and people's livelihood. However, in the allocation of funds, the state should change the situation in which "the Planning Commission orders the meal while the banks pay the bill"—that is, where decisionmaking is separated from responsibility. The independent character of the central bank to carry out a monetary policy and the autonomy of specialized banks to manage their funds should be strengthened. These are the necessary external conditions for deepening financial reform.

In terms of the reform's direction, planning should be concerned with the total availability and investment of funds, and with macroeconomic stability and balance between consumption and investment. To meet the requirements of economic growth and price stability, the central bank must have the autonomy to

determine the growth rate of money supply and exercise its authority within the scope set down by state planning. The specialized banks should have the authority of choosing their borrowers and investment projects under the guidance of state planning.

Banking reform and the fiscal system

Coordination between fiscal and monetary policies is critical for promoting steady economic growth and for dampening inflation. The current problem with the fiscal system is that local authorities benefit from new sources of revenue under decentralization; but because expenditures are still centralized, they are met by the state. The state's scale of expenditures should be reduced to adapt to changes on the revenue side. If deficits occur, bonds may need to be sold to enterprises and individuals to restore balance. The central bank should not be required to buy the bonds, nor to make direct advances or loans. Because the demand for funds is already enormous, providing bank credit to make up the deficits is apt to weaken the autonomy of the central bank to implement its monetary policy. The relation between the banks and the treasury should be clarified by law.

On the question of profit distribution, banks currently are treated as administrative units; as a result, staff initiative and the progress of financial undertakings have been hampered. As the reform to turn specialized banks into enterprises takes hold, switching their financial systems from the "administrative" type to the "enterprise" type becomes necessary. This would bring banks' operations more in line with their costs and enhance their ability to accumulate capital, initiate internal reform, and grow, thereby paving the way for the creation of electronic networks for communications, transactions settlements, financing, and the flow of information.

Banking reform and enterprise reform

Reforming the internal operations of specialized banks and ending the practice of making them the sole supplier of funds to enterprises is an important external condition for deepening enterprise reform. Currently a number of enterprises are able to maintain their production with large debts, with no restraint on products in excess supply, and no support for products in short supply. Why is it so? It is because enterprises are only responsible for profits and not for losses; and also because they lack internal control mechanisms. Because losses are assumed by the state, enterprises always want to use available funds, whatever their cost. Banks are always faced with the immense pressure of demand for capital. Therefore, reforming enterprises to turn them into genuine producers of merchandise by increasing their operational responsibility is an important external condition for making banks genuine money managers.

The relationship between a bank and an enterprise should be one as between two legal entities. When funds are available, loans should be made; if not, loans should not be made—just like commercial units: if there are supplies, they will sell; if there are no supplies, there is nothing to sell. If enterprises cannot borrow from banks, they need to obtain funds from the market. The cost of borrowing from the market will be a severe test for enterprises responsible for their profits and losses; their internal mechanisms will refrain them from making excessive

demands for funds. Judging by present circumstances in China, enterprise reform and banking reform must go hand in hand.

Banking reform and price reform

Once market mechanisms are introduced, the flow of funds will to a large degree be guided by profit. If price signals do not work, the flow of capital may become erratic, and the adjustments needed in industrial structure and product mix may become difficult. However, the price level will remain the main indicator by which to judge whether total money supply is appropriate. Therefore, reforming the price system should not be overlooked while making efforts to improve the macroeconomic controls over finance.

Banking reform and the legal system

The specialized banks and other financial institutions are legal entities. Therefore, there is a need for appropriate laws to restrict and protect them; to enable the banking industry to operate independently; and to help the central bank manage these institutions. In recent years, the state has promulgated a number of relevant ordinances and regulations, but implementation is weak. It is a question of administration: laws have not been observed, so reform has not been truly implemented. Nevertheless, regulations and ordinances need to be upgraded to make them more systematic and standardized.

16

Balance of Payments Adjustment and Financial Crisis in Yugoslavia

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The Yugoslav economy in the long term is characterized by a chronic investment surplus over domestic savings which results in a permanent need for foreign borrowing. Therefore the following questions are important:

- How to determine the level of capital import in the balance of payments to match the debt repayment burden in the medium term.
- How to ensure the applicability of imported capital to appropriate investment projects to gradually contribute to the reduction of the deficit in the balance of payments.
- How to bring foreign debt into line with the independent financial policy of the federal government to ensure an optimal money supply for stable economic growth and stable domestic prices.

The achievement of a dynamic equilibrium in the markets for goods as well as capital requires balancing of demand and supply of financing through interest rates and through rates of return on capital as the important allocation instruments. Economic policy is needed which would allow the autonomous functioning of supply and demand; in Yugoslavia, the autonomous functioning has always been limited in the financial markets. Prices (that is, interest rates) have not substantially influenced the allocation of loanable funds.

Indebtedness causes misfunctioning of the financial system, the consequences of which appear as:

- inadequate exchange rate policy;
- misalignment of interest rates;
- the need for various forms of administrative restrictions on foreign exchange holdings;
- the administrative determination of terms and mode of indebtedness; and
- the limited role of the banking system in foreign exchange transactions.

The consequence has been a crisis of the financial system in the period of forced balance of payments adjustment since 1980. Uncovered (deferred) capital losses of the financial sector, especially those of the National Bank of Yugoslavia (NBY), are a visible form of the crisis. These appear as the result of capital losses transferred from firms and government to the financial system. Commercial banks and the NBY have become the main net foreign currency debtors toward the rest of the world and households. At the same time, the financial system has granted subsidized dinar credits to firms and the government. Subsidized, negative real interest rates have enabled these sectors to earn high inflation

profits. Thus "artificial" net wealth (capital gains) of the enterprise and government sectors has been created by the capital losses of the financial sector. Moreover, disequilibrium of the financial system has resulted in expansionary monetary policy. Through rapid growth of monetary aggregates, excessive domestic demand has created inflationary pressure. Adjustment of domestic supply and demand to the balance of payments constraint has appeared only ex post, at the expense of increasing inflation.

The paper first analyzes the main reasons for balance of payments adjustment in the late 1970s. We continue with an analysis of the impact of capital losses on excess demand as a result of expansionary monetary policy. In the end, some suggestions are given for short-term stabilization of the financial system.

Foreign indebtedness since the early 1970s

The period of growth of net foreign debt

The chronic surplus of investment demand over domestic savings has resulted in permanent indebtedness. Domestic savings were in surplus only in the years 1972, 1973, and 1976.[1] The Yugoslav government has not succeeded in putting into force a policy to diminish the pressure of excessive investment.[2] Suitable stimulants to savings were not developed. A permanent disequilibrium in the market for disposable funds has resulted. The use of foreign funds has become more expensive (in dinar costs) than the use of domestic savings. The latter has been inflationary as it has increased by excessive money creation. The shortage of domestic savings forced the government into additional indebtedness which had a further negative impact on domestic savings.[3] The difference in the condition of enterprises which could get credits abroad, and those which could only act on the domestic market, grew. The traditional export-oriented enterprises also needed imported technology and, in most cases, had to pay higher costs for foreign credits. This policy did not necessarily cause problems in the balance of payments because foreign funds were mostly allocated to more efficient enterprises, via supplier credits. That also enabled the economy to raise loans mostly to ensure foreign exchange reserves through the banking system and through the NBY.

The capital imported through commodity credits remained mostly in export-oriented economic sectors. At the same time, the instruments for stimulating domestic savings grew less efficient, especially in the sectors oriented toward the domestic market; yet an exaggerated demand for investments simultaneously occurred in those sectors, many of which were development priorities. The foreign economic relations system enabled enterprises to get into debt abroad directly, provided favorable supply of capital on international financial markets after 1972, and thus directed the excess demand to foreign debt. It also had a negative

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1. See Table A-1 in the Appendix.

2. See Table A-2 in the Appendix on the share of investments in social product and the effectiveness of investment in this period.

3. On the possible negative impact of additional foreign indebtedness on domestic savings in developing countries, see Thirlwall (1974).

influence on financial policy and on functioning of the banking system. Also, between 1976 and 1979, the maturity of debt was extended by delaying the social agreement between enterprises and the administration.

The growth of indebtedness made undisturbed intervention by the NBY on the foreign exchange market possible, but the credit character of such foreign exchange sources was lost. It was more favorable for enterprises from particular republics or autonomous provinces to buy foreign exchange from the NBY than to raise a loan abroad themselves.

Between 1976 and 1979, total medium-term debt increased to $7.8 billion, surpassing the need for current deficit financing of $6.3 billion in that period. One part of the surplus went to foreign exchange reserves and the other toward export credit financing and for settling short-term debt. Foreign indebtedness was influenced not only by import needs for equipment and other goods; many enterprises sold the foreign exchange obtained from foreign loans due to a shortage of savings in dinars.

Despite the responsibility of enterprises for foreign debts, their obligations gradually were diminished by converting foreign exchange into dinars and by selling foreign exchange on the foreign exchange market. The banks had more of a role of transmission rather than allocation because their foreign indebtedness did not occur on their behalf. Banks, the formal debtors, gradually made more capital losses (caused by deferred negative foreign exchange differences), but foreign debts became the principal source of their dinar claims. Money supply control was lost since foreign exchange transactions enlarged the money supply autonomously.

The additional foreign capital stimulated domestic aggregate demand and diminished exports to the convertible currency area. The overvalued dinar exchange rate, which in the period of net indebtedness (1976-80) was possible without serious problems in the balance of payments and in foreign exchange liquidity, became the principal obstacle to export expansion. Disequilibrium in interest rates and expanding financial policy were the main reasons why domestic demand could not calm down. Savings collected and distributed mostly through the banking system, and more and more via credits supplied by the NBY by converting foreign loans into dinars and by "subsidizing" dinar credits, retarded needed changes in the banking system.

The period of stagnation of net foreign debt

The second oil crisis in 1979 and the accumulated foreign debt made it no longer possible to finance the balance of payments deficit. The accumulated debt also caused a net foreign exchange outflow. Short-term debt "exploded" due to greatly diminished net inflow of medium-term foreign loans. Already in 1979, short-term debt increased by $497 million; in the next two years it increased by an additional $393 million; and, at the end of 1981, it reached $2.3 billion. In the first phase, a gradual diminishing of the balance of payments deficit was possible (and preserved at least the low positive rates of economic growth), but very quickly foreign debts were refinanced. This has been going on since 1983.[4]

The situation required radical administrative import restrictions (mostly by limiting foreign exchange) and export stimulation (by considerable depreciation

4. Table A-3 in the Appendix shows the balance of payments between 1971 and 1986.

of the exchange rate in real terms). One part of import demand was set free and caused "the explosion" of hidden inflation, due to the fact that there was still a "lax" incomes policy. Despite temporarily diminishing base money as a result of small net repayments of foreign debts after 1981, financial policy did not succeed in reducing the surplus of domestic demand over supply; the result was a growth in inflation. Credit supply by the NBY remained dynamic. Informal financial markets to some extent replaced the formal banking system, but financial policy could not influence these informal markets.

The crisis in the financial system became more expensive (that is, the relative margin in the banking system was raised). Besides hidden tax reduction, enterprises passed on charges via inflation and subsidized rates of interest. The accumulation of foreign loans and the restrictions on financial policy continued the process of credit limitations, making the financial system less capable of effectively transforming financial claims and allocating them to investment projects.

Deterioration of the financial system after 1979

The resulting financial and banking system crisis caused a deterioration in savings mobility from surplus to deficit sectors. In this forced transfer of savings, the main instrument was not fiscal policy, but the financial system. Since the level of financial market development and multilateral instruments is relatively low, and since the fiscal system is mainly used for budgetary expenses, only indirect financial instruments and institutions are available to transfer savings into the main deficit sectors. As the financial system consists mainly of banking institutions which, at the same time, are the institutions of money supply, the banks play a main role in savings transfers; the principal transfer instruments are bank credits. Such an indirect savings transfer would be quite suitable if it did not have unnecessary costs, including inflation, by ensuring that nominal bank credits correspond to real (ex ante adjusted) investment demand and real savings, which, in Yugoslavia after 1979, they did not.

Instability of the general price level caused a decrease in the dinar's external value, leading to changes in the balances of domestic nonfinancial and financial sectors. In the principal deficit sector, that of firms,[5] net debt rose in current dinar terms, especially regarding two sectors: the rest of the world and commercial banks. This increase in net indebtedness was financed mainly by long-term liabilities in foreign exchange and by short-term bank credits. The explicit changes in structure, evident from the period 1983-84, were the result of a formal transfer of one part of direct foreign debt onto domestic commercial banks.

Thus in the last four years, savings and wealth have been redistributed mostly to the benefit of firms and to the disadvantage of commercial banks, especially the NBY. The process was partly due to high nominal growth of subsidized bank credits to the firms and partly due to revaluation of banks' liabilities, denominated in foreign exchange. This did not cause the diminution of resources for real investment, but rather a rapid growth of nonperforming

5. See Table A-4 in the Appendix.

claims of commercial banks toward firms and of the NBY toward households and the rest of the world.

The impact of uncovered capital losses on aggregate demand

Uncovered capital losses actually constitute capital gains for some sectors, such as households and the rest of the world, and "postponed" capital losses for others, such as firms and government (see Hibbert, 1983). The redistribution of wealth and revenues is not transparent; the unusual capital loss of financial institutions causes them to lose two of their basic functions: increasing financial intermediation and efficiency in allocating financial resources from the surplus to deficit sectors.

Capital profits (and wealth effects) enable the sector with windfall profits to save less and spend more. Sectors incurring capital losses just simulate the same behavior through inflationary increase of their own funds due to devaluation of their financial obligations denominated in the domestic currency. They in fact spend their losses. This ex ante imbalance leads to inflation, or shortages, or both.

To analyze the effect of capital losses on aggregate demand, let us use a few simple equations:[6]

(1) $Yn = Cdp + Idp + Cg + Ig + (X - M)$

and when net domestic taxes (T) are included:

(2) $(Yn - Cdp - T) - Idp + (T - Cg) - Ig = X - M$
(3) $(Sdp - Idp) + (Sg - Ig) = - Sf$
(4) $Sf = (Idp - Sdp) + (Ig - Sg)$
(5) $Idp + Ig = Sdp + Sg + Sf$

where:

Yn - disposable national income
Cdp - current expenditure of firms and households
Sdp - net savings (accumulation) of households and firms
T - net domestic taxes
Idp - net investments of firms and households
Sg - net government (public) saving
Cg - current government (public) expenditure
Ig - net government (public) investments
X - exports of goods, factor and nonfactor services, and transfer payments abroad
M - imports of goods, factor and nonfactor services, and transfer revenues from abroad
Sf - savings of rest of the world—that is, current balance of payments deficit.

We assume no uncovered capital losses in the national economy—that is, all capital losses are covered in the accounting period in which they arise by reducing their own net wealth or by reducing current revenues at the disposal of

6. Capital gains and losses out of business activities in fact accrue to "owners," that is, to firms, in the case of banks' gains/losses; and to the state (federation) in the case of NBY gains/losses.

saving and investment, respectively (taking into account equation 5). In this situation, balances of financial claims and obligations of the central bank are also in equilibrium, making effective the use of instruments of monetary, interest rate, and exchange rate policies upon the course of aggregate nominal demand; that is, upon investment and saving.

Problems arise when one or more sectors spend more than the other sectors are prepared to save voluntarily. When uncovered capital losses occur, firms should reduce their expenses by preventing the distribution of that part of revenues which originates out of unsettled capital losses. Delimitation of these losses means that losses are transferred onto the account of the creditors of the firms.[7]

In case of delimitation of losses caused by obligations denominated in foreign currencies, the firms' losses are directly transferred onto the financial system, which is the main net debtor in relation to foreign countries and to households. Losses in the banks and in the central bank, partly as a consequence of their own indebtedness and partly as the result of the debts of firms in these banks, transfer the burden onto the financial system. These two final debtors (firms and the government) do not acknowledge the need to reduce consumption, despite the fact that their real disposable income has been reduced, since it has increased for the sectors of the net creditors (households and foreign countries). So it comes to compulsory savings in the sector of final net creditors, but only ex post; that is, under rising inflation. Ex ante, these two sectors (the final net creditors) are able to adjust their consumption to the increased disposable income (as a result of the capital gains), yet by doing so they only put pressure on inflation.

In our conditions of uncovered capital losses, equation 5 has to be written (ex post) as follows:

(6) $Id + Ip + Ig = Sd + Sg + (Sp+Dp) + (Sf+Df)$

(7) $(Id\text{-}Sdp) + (Ig\text{-}Sg) + (Gd+Gg) = (Sp+Gp\text{-}Ip) + (Sf+Gf)$

where:

Id - net investments of firms
Sp - net savings of households
Sd - net accumulation of firms
Ip - net investments of households
Gp - capital gains of households
Gf - capital gains of foreign countries
Gd - capital losses of the firms
Gg - capital losses of government (federal budget)
Dp - capital gains of households
Df - capital gains of foreign countries

Capital losses of firms (together with the losses of business banks "owned" by the firms and those of the government, with the losses of the central bank) do not reduce their consumption. This makes expansive growth of aggregate demand (and investment) possible.

Therefore, in the first phase of reforming the national economy, it is probably necessary to prevent the continuation of unsettled capital losses. Equation 6 should be written as follows:

7. For a more comprehensive explanation of the economic substance of the foreign exchange differences, see Bajt (1983).

(8) $Id + Ip + Ig = (Sd - Gd) + (Sg - Gg) + (Sp + Dp) + (Sf + Df)$

(9) $(Id + Gd - Sd) + (Ig + G - Sg) = (Sp + Dp - Ip) + (Sf + Df).$

This means less investment for the sectors with capital losses, whereas the sectors with capital gains are able to invest more if they do not spend this surplus at the time it arises. In the financial statements, this means that part of the real assets of the sectors with the accumulated capital losses is net wealth of the sectors with accumulated capital gains, yet in the country this is not in accordance with the letter of the law.

To steer the sectors with surplus disposable revenues (savings) toward effective investment projects, it is necessary to adjust interest rate policy to reduce and gradually eliminate the differences between disposable ex ante savings and desired (ex ante) investments. At first, such an interest rate adjustment will make more domestic disposable savings available and will result in the inflow of foreign capital. At a higher real interest rate, it is possible to reach a higher level of real investments through a higher level of voluntary saving.

Impact of capital losses of the central bank on aggregate demand

Capital losses arising in the central bank's balance sheet should be settled (adjusted) by the state (federal) budget—as soon as the process of the financial reform starts—with the relative reduction of its current and/or investment expenditure. In the opposite case, aggregate demand expands by the overissue of base money.

The situation which occurred in our country after 1980 was very similar to the hyperinflation in Israel (see Liviatan, 1986; Williamson, 1985). As in Israel, our central bank, or the state, extends credits at a subsidized rate of interest. As in Israel, our central bank, or the state, receives credits at the market rate of interest, only that in Israel the main creditors are the domestic sectors whereas in this country the creditors are foreigners, and foreign debts are denominated in foreign currency. The final effect in Israel is a direct burden on the state budget, while in this country the burden is indirect through accumulated uncovered losses of the central bank. The main difference is that Israel, before hyperinflation, did not have as great a share of deficit and state budget debt in national product financed through revenues from money creation as does Yugoslavia.[8] For example, the Israeli government's "profit" from growing inflation by the reduction of its real debt shown in the stock of base money (windfall gains) is smaller than that of Yugoslavia.[9]

Despite the considerable "inflation tax" taken by the government (or by the NBY) through the issue of base money under conditions of growing inflation, these revenues from money creation do not succeed in covering losses arising from the disproportionate share of unpaid interest from financial assets in the central bank's balance sheet, and inadequate structure of its net foreign asset position. Table A-5 in the Appendix shows indicators of seigniorage, inflation tax, and capital losses of NBY or the federal budget for the 1980s.

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8. Revenues from money creation in Israel during 1978-1983 were approximately 1.6 percent of GNP, while the state budget deficit was approximately 11.4 percent of GNP.

9. Between 1978 and 1983, the effect in Israel was approximately 2.7 percent of GNP.

The NBY uses more than 80 percent of its revenues (together with the isolated revenues of the national banks of individual republics and autonomous provinces) to finance interest payments on foreign debt. The amount of interest-bearing financial assets and/or the rate of interest paid is hardly enough to cover this expenditure. The surplus of the capital losses over cheap deposits (base money) shows that the NBY takes more of the capital loss shares arising in other institutional sectors.

In spite of the relative growth of revenues from the NBY money creation as measured by the increased share of base money in social product (which increased from 2.4 percent in 1981 to 4.6 percent in 1985), capital losses have reached a bigger share in social product (from 3.3 percent in 1981 to 11.8 percent in 1986).[10]

Neither the NBY nor the federal budget (which in the last years was formally balanced) has tried to stop the growth of these losses denominated in foreign currency, let alone start settling these losses. Additional net foreign exchange commitments of the NBY and capital losses arising from them have accumulated. Possible ways to solve this problem are:

- Inclusion of the capital losses in the federal debt, which would then be serviced, e.g. by the federal government emitting bonds (with the index clause) with long term maturity and competitive interest rate. The federal government would actually have to secure revenues for paying off the real positive interest rate by adapting its expenditures to revenues without additional increase of the latter.
- Acquisition of the means for financing the overdue annuities on the foreign debt (in dinar equivalent). From the standpoint of regulating aggregate domestic demand, the acquisition would mean, in the short term, an additional expense, when the debt would be repaid by the federal budget.
- Apart from pure fiscal sources, all the surpluses from the nominal balance of the NBY system could also be used by the budget for this purpose, under the supposition that monetary institutions will lead to a more active interest rate policy, not because of capital losses, but also to secure stability of the domestic currency. Settling the accumulated capital losses in the NBY is an important contribution.

Impact of central bank's capital losses on monetary policy

Officially, monetary policy during 1980-86 was restrictive and contributed to the slowing of aggregate demand during this period. Such estimation is based on a comparison of nominal social product movements and average money supply (M1), or average income velocity (V1), which shows quick growth. Yet, this does not consider other financial instruments that have an influence on the growth of aggregate demand. Different forms of nonmonetary deposits denominated in foreign currencies exist, which are automatically revalued via depreciation of the domestic currency. If these instruments are also considered, as is done in Table

10. The value of the marginal money multiplier shows the division of these revenues between the central bank and the total monetary system. Its falling from 2.27 in 1981 to 1.11 in 1985 shows that the share of the central bank grew bigger. In 1986, the money multiplier (1.97) jumped considerably, which explains the relatively satisfactory revenue results in the banks and worsening of the position of the central bank.

A-6 in the Appendix, then monetary policy becomes much less restrictive. The comprehensively defined average income velocity (V4) has stagnated since 1980.

Differences in growth dynamics between V1 and V4 show that monetary policy was adapted to inflation and influenced the slowdown of demand for most liquid financial instruments (see Newlyn, 1977) and the increase of demand for financial instruments which can preserve real purchasing power. This is seen from the relation between M1 and M4 in which the M1 share constantly fell in the years 1980-85, and from the real rates of return per individual financial instruments in households and in firms.

Unsuitable nominal interest rate policy with respect to the growth of inflation also influenced the rapid fall of real rates of return, above all on currency in circulation and on sight deposits which form the M1 aggregate. A similar, though less intensive, tendency could also be seen with other deposits which, besides M1, form the main element of the M3 aggregate.[11] The increasing income velocity of the most comprehensive aggregate M4 (V4) in the years 1985 and 1986 shows that real rates of return on other nonmonetary deposits, denominated in foreign currencies, also dropped to such an extent as to slow down demand for them as well as increase the income velocity (V4) of M4. In conditions of high inflation, aggregates more comprehensive than M1 have to be considered to evaluate monetary policy.

In spite of the officially restrictive monetary policy, the share of firms' deficit in social product has become bigger. This shows that there are other important flows for deficit financing besides those which are directly controlled by monetary policy. In addition to interfirm credits,[12] whose share in social product grew during 1980-85, other instruments of "financing" include uncovered negative foreign exchange differences, which the firms and the state transferred to the banking system, especially to the NBY. Uncovered negative foreign exchange differences (turned into money as the result of unsettling in certain periods) in the NBY are of special importance in monetary policy.[13]

To be able to define and estimate the concept of the monetized negative foreign exchange differences (capital losses), we have in Figure 1 and Table 1 analytically rearranged the balance sheet of the NBY into two segments. The first represents the effective monetary functions of the NBY. The second represents the operations of the NBY which are not of primary importance for the functioning of the monetary system.

In the first segment, we have taken into account those credits to domestic clients the NBY itself calls "credits from the primary issue," net foreign exchange transactions abroad (in nominal terms), and that part of the domestic currency liabilities of the NBY which should represent base money or "autonomous flows of base money." In the second segment are the rest of NBY domestic and foreign exchange liabilities: prevailing household deposits of foreign currency savings in the NBY, and the rest of the short-term claims together with the "remaining" capital losses, that is, negative foreign exchange differences. The negative foreign exchange differences are those which were not

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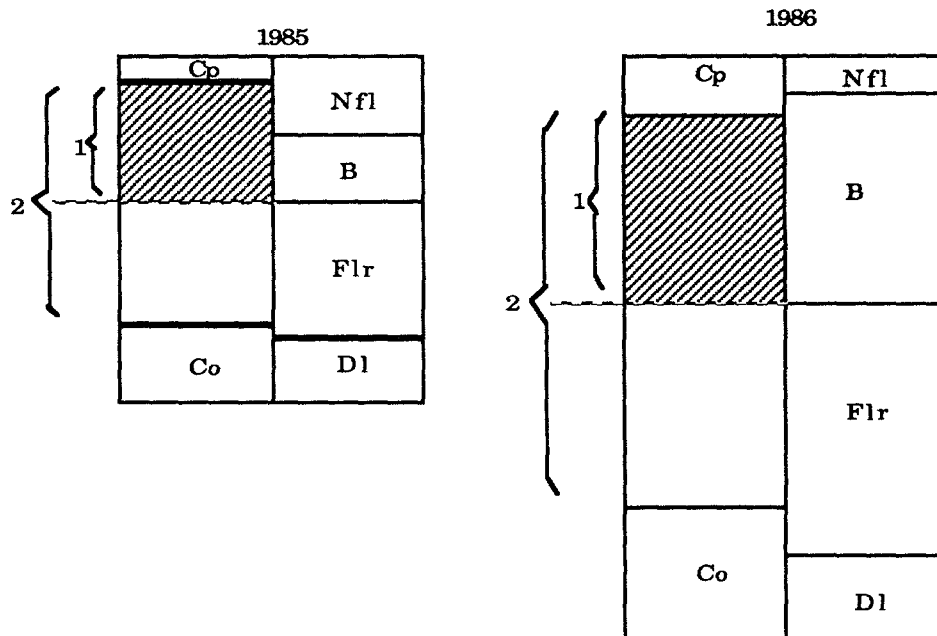
11. See Table A-7 in the Appendix.

12. See Table A-8 in the Appendix.

13. Such interpretation of the capital (exchange) losses or negative foreign exchange differences can be found in Ribnikar (1986).

monetized or those which have foreign exchange liabilities primarily from households as the counter-entry in the NBY balance sheet.

Figure 1. NBY's balance sheet for 1985 and 1986
(changes in billions of dinars)



Cp - Credits in domestic currency (officially defined as "primary emission.")
Co - Other assets in domestic currency.
Nfl - Net liabilities denominated in foreign exchange to the rest of the world.
Flr - Net liabilities denominated in foreign exchange to residents.
Dl - Other liabilities in domestic currency.
1 - Monetized negative foreign exchange differences.
2 - Total negative foreign exchange differences.

Source: Table 1.

Table 1. Monetary effects of uncovered negative foreign exchange losses of NBY, 1980-86 (in billion dinars)

Item	*1980 Stock*	*1981 Changes*	*1982 Changes*	*1983 Changes*	*1984 Changes*	*1985 Changes*	*1986 Changes*
Emission subbalance							
1. Dinar credits (Cp)	251.9	76.1	77.2	95.8	163.3	203.4	347.8
2. Net foreign exchange liabilities (Nfl)	85.5	18.2	135.5	277.0	410.0	514.8	246.7
3. Base money (B)	239.0	54.0	106.6	71.4	279.4	531.8	1,033.4
A. Monetized NFED (1-2-3)	-72.6	—	-164.9	-252.6	-526.1	-843.2	-932.3
Residual subbalance							
4. Other dinar credits (Co)	217.9	46.5	90.5	174.1	207.2	387.0	848.8
5. Other foreign exchange liabilities to residents (Flr)	208.1	95.2	151.3	440.5	441.4	742.0	2,079.4
6. Other dinar liabilities (Dl)	33.4	-28.1	1.5	42.5	79.3	363.2	433.3
B. Unmonetized NFED (4-5-6)	-23.6	-76.8	-62.2	-308.8	-313.5	-718.2	-1,663.9
C. Total NFED (A + B)	-96.3	-72.9	-227.1	-561.4	-839.6	-1,561.4	-2,596.2
Effects of financing of monetized NFED on base money (3-A)	166.4	—	-58.3	-181.2	-246.7	-311.4	101.1
Volume of NBY credits required to neutralize financing of monetized NFED (2 + A)	324.5	—	242.1	348.4	689.4	1,046.6	1,280.1
Minimal volume of base money required (currency and bank's liquidity reserves)	146.0	47.9	68.3	44.0	174.5	352.8	630.9

Note: NFED = negative foreign exchange differences.

Source: KNJ-BIFO, National Bank of Yugoslavia, Belgrade.

The basis for the definition of the monetized negative foreign exchange differences (capital losses) in the NBY lay in the following: considering the importance of financial transactions, it can be argued that it comes to actual financial flows and therefore also to changes of the base money at the moment when financial claims or commitments have been realized (Hibbert, 1983; Cukierman and Mortensen). At the moment of transaction these financial instruments also include the corresponding share of the capital losses (gains). Therefore their transactional value does not only include their initial value, but also a corresponding share of the capital losses (gains).

Table 2. Curent capital losses, savings, and joint income of the main institutional sectors in Yugoslavia, 1981-86

		Current losses		*Capital losses*[a]		*Savings and joint income*		*Capital gains*[b]	
Year	*Sectors*	*Values*[c]	*(%)*[d]	*Values*[c]	*(%)*[d]	*Values*[c]	*(%)*[d]	*Values*[c]	*(%)*[d]
1981	Firms	-29.0	-1.3	..	..	257.9	11.7	..	..
	Banks	—	—	-54.6	-2.5	9.8	0.4	31.6	1.4
	NBY	—	—	-113.1	-5.1	..	..	23.5	1.1
1982	Firms	-66.1	-2.3	-134.6	-4.6	333.9	11.4	37.5	1.3
	Banks	-0.1	—	-116.3	-4.0	7.2	0.2	11.9	0.4
	NBY	—	—	-240.1	-8.2	..	..	39.0	1.3
1983	Firms	-117.6	-2.9	-400.2	-9.9	481.5	11.8	119.4	2.9
	Banks	-0.7	—	-252.6	-6.2	15.2	0.4	62.1	1.5
	NBY	—	—	-726.8	-17.9	6.2	0.2	108.7	2.7
1984	Firms	-132.8	-2.1	-645.1	-10.2	866.7	13.7	214.4	3.4
	Banks	—	—	-386.7	-6.1	46.3	0.7	1.4	0.0
	NBY	—	—	-967.5	-15.1	17.1	0.3	162.7	2.6
1985	Firms	-317.9	-2.8	-253.0	-2.2	1,276.1	11.3	353.3	3.1
	Banks	-2.0	—	-654.5	-5.8	179.5	1.6	50.9	0.5
	NBY	. —	—	-1,825.7	-16.2	58.5	0.5	290.1	2.6
1986	Firms	-633.8	-2.9	-225.4	-1.0	1,827.4	8.3	586.5	2.7
	Banks	-0.7	—	43.8[e]	0.2	385.4	1.8	1.8	..
	NBY	—	—	-2,928.5	-13.3	128.2	0.6	558.6	2.5

.. Data not available.
.. Not applicable.
a. Or negative foreign exchange differences.
b. Or positive foreign exchange differences.
c. Annual values in billions of dinars.
d. As percentage of social product.
e. The positive number indicates decrease of negative foreign exchange differences.

Source: Annual Reports of COALs and Banks, Social Accounting Office, Belgrade; KNJ-BIFO, National Bank of Yugoslavia.

The significance of differentiating the monetized (realized) capital losses from the total accumulated capital losses lies only in the fact that the tendency to settle the costs for accumulated capital losses, which are integrated in the obligations with contractual terms longer than is the usual standard (one year), can be defined in a satisfactory way.

For the NBY, this means that all those capital losses out of commitments denominated in foreign currencies have been monetized in the actual financial transactions with its domestic and foreign consignors, but through this base money has not been diminished. If the NBY settled these losses out of "real sources," that is, through its own revenues or through taxes in the federal budget, the amount of base money would diminish. The corresponding space could be filled by its credits (depending on the targets of monetary policy), which would be transparent interest-bearing financial claims, which of course the monetized capital losses are not. Table 2 shows estimates of the amount of capital losses by sectors. Table 1 shows the monetary effect of settlement of NBY capital losses from "real sources" as well as the whole and/or the monetary effect of the compensatory credits of the NBY.

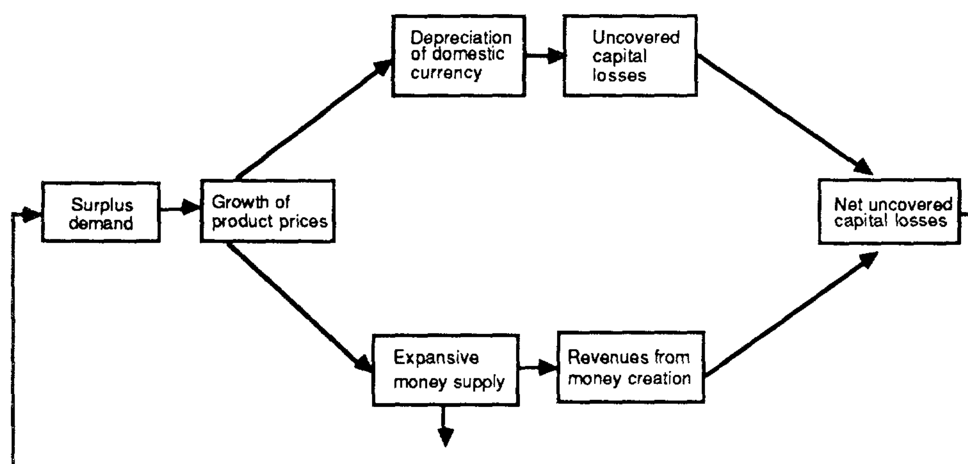
Monetized capital losses in the NBY had a direct expansive monetary effect which, in the past, made monetary policy for stabilization impossible. Expansive aggregate demand under conditions of balance of payments adjustment caused

restriction in disposable product. While monetary policy was formally restrictive, it was in fact sanctioning inflationary expectations and behavior.

Short-term policy changes for financial stability

Capital losses in some sectors (firms, state) have not been settled in the past. These sectors have shown constant surplus demand. At the same time, these losses have been transferred onto the monetary system, which has tried to lessen their burden by revenues from monetary creation and inflation tax. These arose because the NBY encouraged the inflation of aggregate demand and prices via excessive supply of base money at a relatively stable money demand. This is shown in Figure 2.

Figure 2. Effects of expansionary monetary policy in Yugoslavia



Thus, on the one hand, expansive monetary policy contributes to the growth of revenues from money creation, though the revenues are not used or are too small to settle the transferred capital losses from the nonfinancial sector to the financial sector. On the other hand, it acts upon domestic prices and necessary depreciation of the domestic currency[14] through financing surplus demand. This automatically increases the capital losses of the financial sector as the cost of financing this excess demand is unbalanced interest rate policy (a real negative interest rate).

To interrupt this "endless flow"—one of the conditions of the stabilization process—it is necessary to suppress the need for growing revenues from money creation of the financial system (in relation to social product). All depends on diminishing surplus demand in firms and the state, which demonstrates itself via uncovered capital losses in the financial sector. It is a question of the correct

14. On account of limitations in financing the balance of payments deficit.

short-term application of fiscal and monetary policy.[15] The two macroeconomic policies should reduce the financial deficits in firms and in the federal budget.

As the form of these deficits is primarily a capital loss in the financial system—most of all in the NBY—to stabilize the balance sheet of the NBY, interest rate policy has to be changed. In this way, a transfer of costs to settle NBY losses through commercial banks back to the firms would occur. At the same time, the federal budget should also take over one part of these costs by relative reduction of its expenditures with regard to disposable revenues, that is, without additional taxation of other nonfinancial sectors. Such a solution would be suitable for settling the capital losses arising in the future when individual foreign liabilities and/or commitments toward residents are overdue.

The present state of the uncovered capital losses demands special solutions. The losses, which in fact are federal budget debt, could be financed by the budget via emission of suitable financial instruments (such as indexed federal bonds).[16] The actual paying off would be postponed.[17] The cost for the postponement of debt payment should be the payment of real positive interest on this debt.

In our present economic situation, we consider the warnings of A. van Agtmael, who sets the following six conditions for functioning of nascent financial markets:[18]

- political stability and economic growth,
- adequate demand for securities;
- required supply of these securities;
- government policy which encourages such markets;
- adequate control of the functioning of these markets;
- "open door" to foreign investments in these markets.

Fulfillment of the first three conditions is not easy, so the functioning of financial markets is only possible within limits. Yet we could start at least with simple forms of such financing in our economy (see Nuti, in this volume). Some short-term measures in financial policy which would enable, or at least would not prevent, the beginnings of a simple financial market in our country are the following:[19]

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15. Of the numerous articles on the different possible combinations of development and stabilization policy in developing countries two good articles are Khan (1987) and Fisher (1986).

16. The possibilities for marketing financial instruments in developing countries are discussed in Drake (1977). The possibility of using indexed state bonds (real Treasury bonds) with special reference to the experiences in Italy after 1980 can be found in Monti, Cesarini, and Scognamiglio (1983).

17. "As regards national debt policy, it should be noted that the issue of indexed securities would allow the Treasury to run up its debt at a cost fixed in real terms and would make it possible to effect a considerable extension in the average maturity of the national debt (which would otherwise be impossible or very costly)." See Monti et al (1983).

18. "Blowing away the whiff of the casino," The Economist, October 19, 1985.

19. Institutional arrangements of conducting monetary policy together with the available instruments of this policy in Yugoslavia are presented in Chart A-1 and Chart A-2 in the Appendix.

- Eliminating the practice that the federal budget is financed by credits from the NBY at deeply subsidized interest rates.
- Eliminating the practice of differential (selective) interest rate for credits of the NBY intended for preferential economic purposes and sectors. In both cases it is necessary to proceed to a uniform NBY discount rate which should reflect the expected inflation rate, but not "the programmed low inflation rate," at least for as long as we have not overcome the balance of payments crisis, because such a "nominal anchor" would cause insolvency abroad.
- Abandoning the policy of selective financing from the credits of the NBY. The present situation can be transformed (by "linear arrangement" of the credit-granting activities of the NBY) by a temporary solution.
- Individual banks (if they remained the main NBY clients, in place of the federal budget) could get approximately the same share of credits from the NBY as at the end of the present regime, yet under new terms (rate of interest) and according to monetary policy targets. Already, in the phase of the temporary regime, a stricter selection between banks should be made by fixing their creditworthiness rating. This, at the same time, demands application of financial reliability of the state (government), approaching the required principles of "sound finances." This can be verified on the financial market, where the state sells securities.
- Changing the methods of federal budget financing, which should be oriented more toward financial markets and less toward direct credits of the NBY.
- Revoking credit restriction, especially at the level of individual commercial banks, considering the demands for respecting legal regulations which settle illiquidity, insolvency, and financial unreliability (credit incapacity) of the commercial banks.
- Settling capital losses as quickly as possible.[20]

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20. The systemic problems of financing the economy under conditions of socially owned resources are omitted here. See Ribnikar (1985).

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Table A-1. Value of social product, gross investment, and savings in Yugoslavia, 1971-86 (in million dinars)

Year	*Social product (Y)*		*Gross investment (I)*		*Gross saving (S)*		*Investment in fixed capital (IFC)*	
	Current prices	*Constant 1972 prices*	*Current prices*	*Constant 1972 prices*	*Current prices*	*Constant 1972 prices*	*Current prices*	*Constant 1972 prices*
1971	204,476	235,540	74,754	86,385	69,385	79,927	63,085	72,668
1972	245,395	245,395	80,729	80,729	82,539	82,539	73,977	73,977
1973	306,326	257,684	102,102	85,886	111,749	94,002	85,502	77,074
1974	407,221	279,685	177,071	121,615	161,936	111,220	117,385	84,054
1975	503,007	289,893	215,201	124,028	199,067	114,729	163,287	92,181
1976	595,814	301,191	243,531	123,107	246,558	124,963	207,283	99,689
1977	734,304	325,321	314,383	139,280	282,067	124,963	267,956	109,109
1978	901,815	347,799	385,697	148,751	369,381	142,459	357,314	120,589
1979	1,165,417	372,317	525,493	167,878	459,734	146,870	447,581	128,330
1980	1,553,089	380,864	726,733	178,217	670,279	164,373	545,664	120,717
1981	2,208,250	386,371	924,225	161,707	904,385	158,236	684,961	108,885
1982	2,924,794	388,174	1,149,720	152,590	1,143,885	151,816	854,816	102,892
1983	4,064,289	383,132	1,695,258	159,808	1,736,030	163,651	1,029,500	92,900
1984	6,325,800	390,781	2,807,313	173,424	2,925,309	180,713	1,458,400	83,982
1985	11,284,700	392,735	4,990,167	173,670	5,264,300	183,211	2,608,800	80,875
1986	22,062,700	406,873	9,155,100	176,704	9,572,000	184,749	4,893,700	82,493

Source: "The Statistical Yearbook of Yugoslavia 1970-1986," Federal Statistical Office, Belgrade; "The Flow-of-Funds Accounts 1970-1986," National Bank of Yugoslavia, Belgrade.

Table A-2. Growth in social product, share of investment and savings in social product, incremental capital-output ratio, current account balance, and net foreign debt in Yugoslavia, 1971-86

Year	(ΔY)[a] (million dinars)	$\Delta Y/Y$ (%)	$\frac{IFC_{(t-1)}}{\Delta Yt}$	IFC/Y (%)	I/Y (%)	S/Y (%)	B (million US $)	ΔZ (million US $)
1971	17,593	8.1	..	30.9	36.7	33.9	-357	841
1972	9,855	4.2	7.4	30.9	32.9	33.6	419	72
1973	12,289	5.0	6.0	29.9	33.4	36.5	485	553
1974	22,001	8.5	3.5	30.1	43.5	39.8	-1,183	672
1975	10,208	3.6	8.2	31.8	42.8	39.6	-1,032	1,146
1976	11,298	3.9	8.2	33.1	40.9	41.4	165	1,220
1977	24,130	8.0	4.1	33.5	42.8	38.4	-1,582	1,406
1978	22,478	6.9	4.9	34.7	42.8	41.0	-1,256	2,301
1979	24,518	7.0	4.9	34.5	45.1	39.4	-3,661	3,287
1980	8,547	2.3	15.0	31.7	46.8	43.2	-2,291	3,335
1981	5,507	1.4	21.9	28.2	41.9	41.0	-750	2,164
1982	2,000	0.5	54.4	26.5	39.9	39.1	-464	888
1983	-5,042	-1.3	-20.4	24.3	41.7	42.7	274	30
1984	7,649	2.0	12.1	21.5	44.4	46.3	504	-379
1985	1,954	0.5	43.0	20.6	44.2	48.7	833	-300
1986	14,138	3.6	5.7	20.3	41.5	43.4	1,100[b]	700

Note: B = current account balance.
Z = net foreign debt
The subscript t denotes the current period; t - 1 the previous period; Δ denotes an annual change.
For explanation of other symbols, see Table 1.

a. In constant 1972 prices.

b. Current foreign exchange rate.

Source: Same as Table 1.

Table A-3. The Yugoslav balance of payments, 1971-86 (in million US dollars)

Items	*1971*	*1972*	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Current account	-357	419	485	-1,183	-1,032	165	-1,582	-1,256	-3,661	-2,291	-750	-464	274	504	833	1,100
Net loans																
Medium and long term	476	366	619	625	1,137	1,390	1,673	182	1,496	2,103	983	92	1,108	-11	166	-1,188
Short term	124	168	-68	181	-223	-85	-50	53	186	633	436	-306	-1,635	-411	-129	1,773
Relations with IMF	93	-39	-75	142	20	187	123	-74	322	412	711	588	410	12	-66	-271
Net financing to rest of the world (–increase)	-16	-42	-56	-115	-100	-100	-213	-105	-150	-215	-234	-200	-156	-102	-89	-218
Changes in foreign exchange reserves (–increase)	-73	-661	-658	328	180	-1,632	198	-442	1,832	-169	-890	207	299	-92	-642	-1,366
Errors and omissions	-247	-289	-247	-5	18	105	97	—	-25	-468	-256	83	-300	100	-73	150

a. Current foreign exchange rate.

Source: "Monthly Bulletin," National Bank of Yugoslavia, Belgrade.

Table A-4. Net financing of changes in firms' net liabilities by sectors and financial instruments in Yugoslavia, 1981-86 (in percent of social product)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*
Net financing by sectors	-9.67	-10.43	-35.33	-19.76	-18.84	-19.55
Federal government	—	—	—	—	—	—
Local government	0.12	-0.02	-0.15	-0.15	-0.19	0.13
Noneconomic sector	-0.57	-0.33	-0.42	-0.92	-1.25	-2.75
Households	-0.02	-0.11	-0.06	0.14	0.17	0.34
National Bank of Yugoslavia	-0.18	0.26	0.34	0.05	0.25	-0.01
Commercial banks	6.72	-9.34	-15.94	-16.51	-14.24	14.42
Other financial institutions	0.86	0.94	-15.94	0.82	.73	.84
Rest of the world	-2.06	-2.03	-19.12	-2.85	-3.41	-3.38
Errors and omissions	-1.10	0.20	-1.00	-0.35	-0.90	-0.30
Net financing by financial instruments	-9.67	-10.43	-35.33	-19.76	-18.84	-19.55
Money (M1)	1.77	2.03	1.18	2.72	0.69	2.76
Other liquid assets	0.01	1.25	0.66	1.54	-0.11	0.35
Other financial assets	2.10	1.67	0.99	1.32	1.01	1.78
Short-term credits	-6.59	-4.76	-5.97	-6.39	-6.23	-10.34
Supplier credits of/to firms to/from other nonfinancial sectors	(0.42)	(-0.34)	(-0.34)	(-0.91)	(0.05)	(-2.01)
Long-term credits	-3.35	-3.24	-3.24	-5.18	-3.42	-5.35
Short-term claims/liabilities in foreign currencies	0.86	-1.95	-0.39	-2.54	0.26	0.16
Long-term claims/liabilities in foreign currencies	-3.45	-5.60	-27.55	-10.88	-10.37	-8.62
Relation among internal banks and commercial banks	0.09	0.03	-0.01	—	0.02	0.01
Errors and omissions	-1.10	0.20	-1.00	-0.35	-0.90	-0.30

Note: Sectors with positive signs are those financing changes of net indebtedness of firms, and vice versa. Financial instruments with positive signs mean net financial claims of firms on other sectors and vice versa.

Source: Analysis and Research Department, National Bank of Slovenia.

Table A-5. Indicators of seigniorage, inflation tax, and capital losses of NBY or federal budget as share of nominal social product, 1980-86 (in percent unless indicated)

Item	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Social product (SP), current prices, in billion dinars	1,553	2,208	2,926	4,064	6,326	11,266	22,063
Implicit deflator of social product (π)	30.3	40.1	31.7	40.4	52.5	77.5	88.7
Federal government's budget balance (F), billion dinars	-18.3	-4.7	-3.6	-8.1	0.8	13.5	10.7
Seigniorage[a]	..	2.4	3.6	1.8	4.4	4.7	4.7
Inflation tax[b]	4.7	5.3	4.3	4.7	6.2	8.8	9.4
Net inflation tax[c]	4.2	4.9	3.9	4.2	5.6	8.4	9.0
Capital losses of NBY[d]	..	-3.3	-7.8	-13.8	-13.3	-13.9	-11.8
Federal government's budget deficit[e]	-1.2	-0.2	-0.1	-0.2	0.02	0.1	0.05
Effective federal government budget deficit[f]	..	-3.5	-7.9	-14.0	-13.3	-13.8	11.7

.. Data not available

Note: L = capital losses; B = base money.

a. B/SP

b. (B/SP) . π

c. [(B/SP) . π] - n; with n= interest rate on reserve requirements of NBY

d. L/SP

e. F/SP

f. (F + L)/SP

For detailed explanation of seigniorage and inflation tax from emission (and stock) of base money, see Melnick and Sokoler (1984); and Liviatan and Piterman (1984).

Source: Table 1 and *Social National Accounts of Yugoslavia 1980-1986*, Federal Statistical Office, Belgrade.

Table A-6. Indicators of effectiveness of monetary policy, 1980-86

	Social product		*Monetary aggregates*			*Indicators of effectiveness of monetary policy*					
	SP 72	*SP CP*	*M1*	*M3*	*M4*	*V1*	*V3*	*V4*	*M1/M4*	*Mk/SP*	*FD/SP*
Year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*
1980	2.3	33.3	37.2	25.5	21.2	3.71	2.01	1.22	33.0	37.9	8.9
1981	1.5	42.2	36.5	31.4	25.0	4.22	2.18	1.27	30.2	41.6	6.7
1982	0.5	32.4	35.5	32.6	26.6	4.42	2.17	1.25	28.2	43.2	4.1
1983	-1.0	39.0	45.7	33.1	23.0	4.99	2.27	1.19	23.8	47.0	7.4
1984	2.0	55.6	53.9	41.0	32.7	5.86	2.50	1.20	20.5	47.4	9.5
1985	0.5	78.4	59.1	49.6	45.1	7.20	2.99	1.34	18.7	44.2	13.3
1986	3.6	95.5	62.9	72.1	83.7	7.66	3.40	1.62	21.1	41.7	15.1

M1 - Official definition of money supply, that is, currency and deposits (annual growth rates of average M1).

M3 - Official definition of total liquid assets, that is, M1 + other time deposits + other liquid assets (annual growth rates of average M3).

M4 - Nonofficial aggregates including M1 + other nonmonetary dinar and foreign exchange deposits in nominal terms (annual growth rates of average M4).

SP 72 - Annual growth rates of social product in constant 1972 prices.

SP CP - Annual growth rates of social product in current prices.

V1 - Velocity of M1 (absolute values).

V3 - Velocity of M3 (absolute values).

V4 - Velocity of M4 (absolute values).

M1/M4 - In percentage.

Mk/SP - Average annual values of interfirm credits as percent of social product.

FD/SP - Annual values of firms' financial deficit as percent of social product.

Sources: "National Accounts of Yugoslavia, 1980-1986," Federal Statistical Office, Belgrade; "Flow-of-Funds Accounts 1980-1986," NBY, Belgrade.

Table A-7. Real rates of return on selected financial assets of households and firms, 1980-1986

	1980	1981	1982	1983	1984	1985	1986
Household assets in dinars							
Currency	-28.2	-28.6	-23.2	-36.7	-33.9	-44.1	-47.9
Sight deposits	-22.8	-23.2	-17.4	-32.0	-28.9	-39.9	-44.0
3-month deposits	—	—	—	-26.6	-13.7	-7.9	-19.2
Deposits over 1 year	-21.6	-22.1	-14.8	-25.3	-12.7	-7.7	-14.3
Household assets denominated in DM							
Currency	-2.8	-13.0	-9.8	10.2	-2.1	5.9	-4.8
Sight deposits	4.5	-6.5	18.0	18.4	5.2	13.8	0.9
Deposits over 1 year	5.9	-5.2	19.6	20.1	6.7	15.4	2.1
Firms' assets in dinars							
Sight deposits	-28.5	-27.3	-19.6	-33.4	-32.3	-43.0	-37.9
3-month deposits	-27.0	-25.8	-18.4	-32.6	-15.3	-2.6	0.3
Deposits over 1 year	-26.3	-25.1	-15.6	-25.7	-12.2	-8.4	-0.7

Source: Sluzba Drustvenog Knjigovodstva Jugoslavija (Social Accounting Service of Yugoslavia).

Table A-8. Interfirm credits and credits to other nonfinancial sectors in Yugoslavia, 1980-86
(stocks at end of period, in millions of dinars)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Inter-firm credits	1,079,331	1,481,829	2,019,043	3,161,713	5,034,641	8,699,277	14,473,091
Money substitutes	521,788	744,573	1,008,119	1,627,208	2,601,319	4,562,464	8,104,437
claims, secured by promissory notes	270,750	367,335	499,365	716,140	1,048,334	1,846,209	3,030,543
claims, secured by letters of credit or guarantees	166,591	264,421	346,488	611,560	1,038,344	1,710,264	3,258,973
claims,unsecured by any financial instruments	84,447	112,817	162,266	299,508	514,641	1,005,991	1,814,921
Payments in advance	145,739	194,169	305,728	502,890	795,982	1,450,372	2,097,572
Direct credits:	411,804	543,067	705,196	1,051,633	1,637,340	2,686,441	4,271,062
credits to other firms	213,404	292,097	366,389	601,390	960,730	1,681,084	2,583,122
trade credits	76,234	90,427	107,872	133,172	180,882	242,732	408,370
credits to cover losses	3,486	4,219	7,482	8,695	12,205	15,412	23,640
credits according to SPC legislation	118,680	156,344	223,452	308,386	442,497	673,918	1,048,370
current accounts in internal banks	—	—	—	—	41,026	73,295	207,580
Firms' credits to nonfinancial sectors	64,544	79,135	100,827	181,026	288,897	488,663	635,132
consumer credits	40,972	40,711	38,065	35,827	45,784	66,454	152,715
credits to residents of foreign countries	23,572	38,424	62,762	145,199	243,173	422,209	682,417
Total	1,143,875	1,560,964	2,119,870	3,362,739	5,333,536	9,187,940	15,308,223

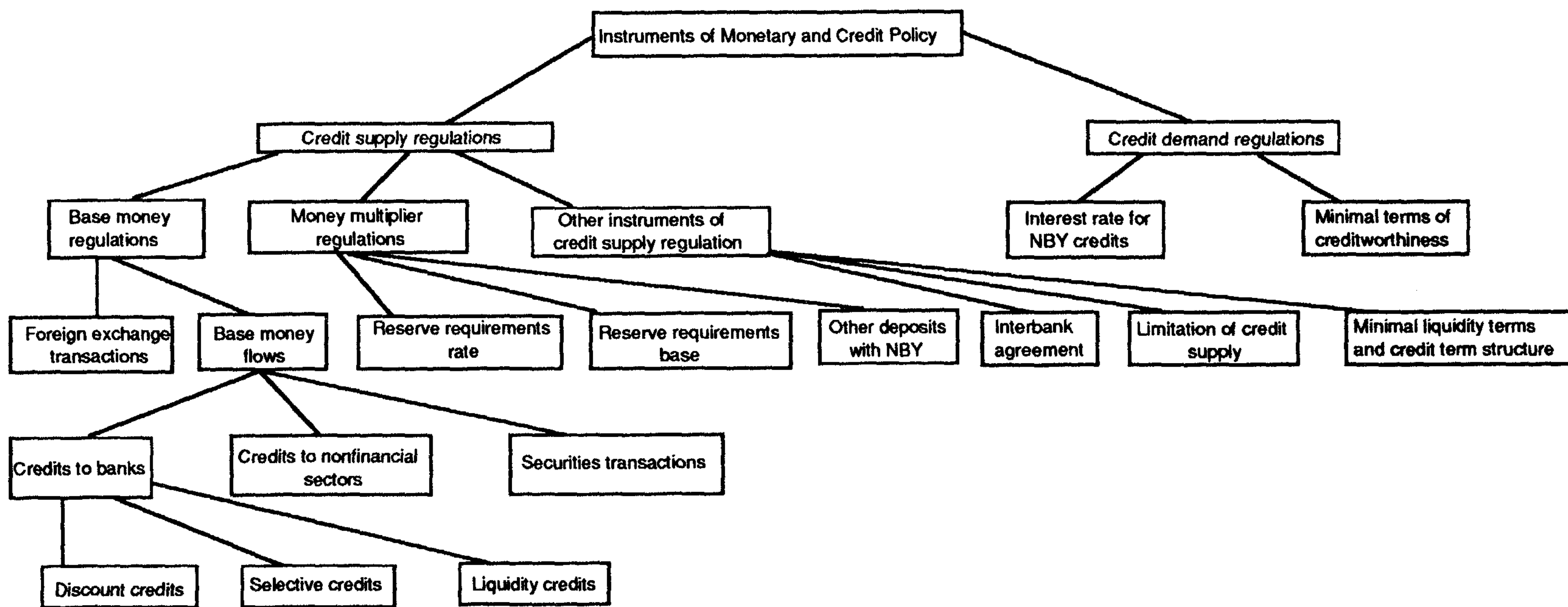
Source: Sluzba Drustvenog Knjigovodstva Jugoslavija (Social Accounting Service of Yugoslavia).

Chart A-1. Basic organizational features of acceptance and execution of monetary policy in Yugoslavia

Institution	*Federal Assembly* (1)	*Federal Executive Council* (2)	*National Bank of Yugoslavia* (3)
Documents	A = Medium term social plan B = Yearly social plan C = Yearly act of monetary policy targets	D = Yearly act of fulfillment of monetary policy targets	E = Yearly act of NBY credit terms F = Projection of monetary policy (analytical and methodological documents)
Acceptation Mode	Adjustment of republics' and autonomous provinces' delegates	Adjustment of republics' and autonomous provinces' executive councils	Adjustment in the Board of Governors
Documents' Contents	Monetary policy targets concerning M1 and bank loan growth Basic directions on how to fulfill monetary policy targets	Quantitive extent of M1 and bank loans growth, to be realized by NBY measures and instruments Base money quantum and structure	Terms of NBY credits for different purposes Terms of securities purchasing Terms of credit and deposit interest rates
Documents' acceptance time - limit	1A = For five years 1B = Yearly, December 1C = Yearly, December	2D = In one month time limit after 1B and 1C	3E = In one month time limit after 2D 3F = Appendix to 1C
Control over realization	Commission for monetary and credit system and policy in the Federal Assembly	Federal Executive Council Interrepublic Committee in Ministry of Finance	Board of Governors
Arbitrage	Final decision	Nonadjusted views	Nonadjusted views

Source: Sluzba Drustvenog Knjigovodstva Jugoslavija (Social Accounting Service of Yugoslavia).

Chart A-2. Instruments of monetary and credit regulation in Yugoslavia



Source: M. Voljč: Vloga in učinkovitost denarno-kreditne politike v Jugoslaviji, Master's thesis, page 42, University of Belgrade, 1976.

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