Banking and Credit in the Framework of new Economic Policies in Eastern Europe

By this spring, all countries of Eastern Europe, except Rumania, had proclaimed their intention to undertake significant changes in their economies. Taken together, the reforms announced or already initiated amount to a considerable departure from the centrally-planned command economies that emerged in the Soviet Union with the first Five-Year Plan and in the other countries of Eastern Europe with the establishment of communist regimes after World War II. It would make an intriguing study of an intellectual revolution in the making to trace the way in which these changes crystallized and the uncertain progress of the reform until, with the Soviet Union finally joining the movement, it emerged as the most significant change to come out of Eastern Europe. The purpose of the present study is more limited; indeed, I intend merely to focus on those common features of the new economic policies which affect the future role of money, credit, and banking in Eastern Europe (1). This is no easy undertaking because, in spite of the general similarity of the underlying rationale, the actual implementation of the new policies follows somewhat different channels in the individual countries. While in the past it was adequate to discuss arrangements in the Soviet Union to identify the fundamental traits of the working of all centrally-directed economies of Eastern Europe, this is no longer possible; the new policies originated, and first acquired the right of citizenship, in the industrially more advanced countries on the Soviet Union's western border.

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(1) Disregarding, for the purpose of this study, Albania. Yugoslavia, which originated many of the policies now being introduced in Eastern Europe, has by now abandoned most of the specific characteristics of the Soviet-type monetary and banking arrangements.

Profile of the Changes

It is by no means clear in what final guise and when the brave new world of the resolutions that have cascaded from the Communist Party congresses and "plenums" of the last two years will replace the centrally-planned economies in the various countries of Eastern Europe. Nor is it certain what range of macroeconomic decisions will remain in the realm of national political bodies or multinational agreements (under the aegis of the *Comecon* or otherwise). But it is clear that many of the aspects of the new reforms involve a significant change in the role of credit and banking and considerable reliance on the cost of credit as a tool of economic policy. Taken together and pushed to their logical consequences, the new policies represent a decisive move toward the replacement of centrally-directed by socialist market economies. But the course of history is never straight and determined by logic; only the future will show how powerful economic logic is once the process of transformation has started.

What caused the change? No doubt, the verdict of history will encompass a wide range of economic, political, and sociological factors. But, looking at the economic scene alone, I believe that the death knell of the old system was not rung by its failure to achieve a satisfactory rate of growth. It is being changed not because of its failure to solve certain stubborn problems, such as the raising of productivity in agriculture; not because it was incapable of suppressing inflation; and certainly not because communist theoreticians have developed a superior alternative model. It became the victim of some modest success it achieved in increasing the flow of goods to consumers above the basic subsistence minimum. When consumers refused to buy inferior, unfashionable, or overpriced goods, unsalable goods piled up in distribution channels. A planner-directed economy had no mechanism for adjusting automatically to changes in consumer preferences. Something had to be done to prevent the immobilization of working capital in goods nobody wanted — to transmit signals from the consumer to the producer and make the producer respond to these signals. Other shortcomings of the system became exposed as foreign trade developed and as freer travel permitted wider comparison of economic performance, within as well as outside the Eastern bloc. Countries that before World War II engaged in a relatively open system of foreign trade and travel

became more sharply aware of the cost, in opportunities foregone, of adhering to the rigid Soviet patterns of trade bilateralism and internal economic centralization.

And so the countries of Eastern Europe discovered a mechanism that would do the trick: the competitive market (2). This is not the place to reflect on the ideological hurdles that had to be overcome or to ponder over the sparring in theoretical journals about the compatibility of the new approach with the established doctrine. In some quarters the hope still lingers that powerful electronic computers will replace the all-knowing central planning agency and its holy spirit, the Central Committee of the Communist Party, in achieving an optimal allocation of resources and perhaps even a rational price system. Yet it is clear that decisive steps are now being taken toward a system that will rely on material incentives and rewards and on flexible prices, instead of on rigid and detailed production targets, directives, and administrative sanctions, and toward a system in which credit will play a significant role.

Behind the various organizational and procedural changes in the area of credit and financing lies the recognition that some economic principles, long regarded as applicable only to the capitalist system, are equally valid in the socialist economy. The allocative function of the market, the rationing function of prices, and the need for limitations on the power of the authorities to perpetuate disequilibrium situations are now being widely recognized.

The three Eastern European countries on the rim of the Western world — Poland, Czechoslovakia and Hungary — have pioneered in many ways in first removing the most obvious shortcomings of the centrally-directed system copied from the Soviet prototype and then developing the basic principles of a transition to a market socialism. Rumania, which in recent years has achieved a better rate

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(2) It would, of course, be too much to expect the framers of the new policies to acknowledge the insight of VILFREDO PARETO (*Cours d'Économie Politique*, 1897) and ENRICO BARONE (Il ministro della produzione nell'economia collettivista, *Giornale degli Economisti*, 1908), but in view of Oskar Lange's subsequent leading role in communist Poland, one would expect them to have no inhibition about giving due credit to Lange's pioneering papers "On the Economic Theory of Socialism", in the *Review of Economic Studies* (1936-37). The intellectual isolation of the countries of Eastern Europe from one another as well as from the rest of the world, which is only gradually being overcome, is strikingly illustrated by the fact that the first architects of the Yugoslav market socialism were not acquainted with the Lange papers; this is related by I. M. Maksimovič in his contribution to *On Political Economy and Econometrics: Essays in Honor of Oskar Lange* (Warsaw, 1965).

of growth than the other countries of Eastern Europe and which has made good use of its substantial earnings of convertible currencies in developing its economic potential and raising the standard of living of its population, was for a while reluctant even to admit the need for a change. But by the spring of 1966 all the countries except Rumania had decided to embark on reforms, even Bulgaria, the least developed and smallest country of the group, which normally hews close to the policies of the Soviet Union.

The Soviet Union has tried for a long time to make all changes appear as merely improvements in the " steering of the economy " and to minimize the significance of its departures from the old methods. It is still the least ready to make bold changes, preferring to experiment cautiously with alternative methods applied to selected enterprises and, in some cases, making related experiments in the area of plant management, labor compensation, and the like. It commands a broader range of resources than its neighbors in Eastern Europe, and for a variety of reasons is not subject to the same pressures for change. And it has learned from bitter experience that mistakes made by a big, centralized country are usually also big and costly.

The political system based on the philosophy of historical materialism is patently unhistorical. Yugoslavia was a pathbreaker in replacing a Soviet-type economic system by a socialist market economy; yet reference to Yugoslavia is studiously avoided — particularly in the Soviet Union — by the proponents of the new reforms. Yugoslavia also exemplifies the kinds of resistance and difficulties that the reformers of the various countries are likely to encounter before the day is won — including sabotage and downright resistance from the entrenched bureaucracy, inability of local plant managers, reared on executing orders, to make independent decisions, and dislocations resulting from doing away with uneconomic production sustained by subsidies and artificial prices.

The changes contemplated in each country require important adaptation to be put into effect over a number of years, in practically all aspects of economic policy, lines of responsibility, and administrative arrangements. Specific time tables have been adopted in some countries, and everywhere important details, including many in the area of finance, still remain to be worked out. The basic decisions already made involve a radical break with much of what in the past was considered an organic part of a socialist economic

system, but the difficulties that lie ahead in passing from a command to a demand economy are immense. They involve more than the achieving of adequate practical solutions to such questions, for instance, as how to shift to a system of equilibrium prices. Beyond the purely economic questions lies the problem of how to depolitize the operations of the economy so that the process of economic decision-making can follow its own laws, not party dictates, and how at the same time to preserve the control of the communist party.

The new policies generally involve a shift toward decentralization of planning, reduction in the number of physical plan targets, grossing up of the magnitudes determined and controlled from the center, and giving the management of individual plants greater flexibility in achieving the prescribed goals. Equally, if not more, significant is the tendency to place greater reliance on individual initiative, to depend on incentives instead of on orders from the center, to devise a system of " economic levers " that would act as an alternative to administrative intervention, and to replace the excessive range of physical indicators by the profit ratio as the single, or at least the main, success indicator. Under the new system of " steering the economy " the administrative emphasis is shifted from the ministries in charge of specific industries to aggregations of enterprises.

The reforms now being introduced involve significant changes in financial flows and in the role that credit, which is being elevated to the position of a key " economic lever ", is expected to play in the economy. They will increase the role of banks (without significantly changing their character) in channeling (gross) investment funds and in financing the flow of goods through the economic system. A closely related change is a restructuring of the price system which, in addition to achieving other objectives, will recognize capital as a cost factor and introduce a charge for its use. As a logical extension, the financing of fixed investment is shifting from free and nonreturnable budgetary grants to a combination of bank loans and decentralized investment funds accumulated from enterprise profits. As a result, it may be expected that the proportion of national income redistributed through the budget will decline, and that the importance of decentralized investment funds and bank loans will increase in relation to the national product. Taken together, the reforms now projected will not change the basic characteristics of Soviet-type economies — state ownership of the means of

production and central planning the main targets of economic activity — but they will narrow considerably the gulf between command and market economies.

The System to be Changed

Before turning to more specific consideration of the new role assigned to credit and the cost of money and capital, we must look at their place in an economic system that tried to reduce the function of money to that of an accounting unit (or to abolish it altogether, as in the Soviet Union in the early twenties), to make the distribution of credit a by-product of the administrative allocation of resources and products, and to make capital a free good. This system, which I have discussed elsewhere in some detail (3), emerged in the Soviet Union after the credit and banking reforms of 1930-32, and was adopted by the other countries of Eastern Europe when communist governments were established there after World War II. I shall refer to it as the " standard system ".

The system required a specific structure of banking organizations which represents a distinctive characteristic of the economies of Eastern Europe (though some parallels can be found in underdeveloped countries). It is highly centralized, dominated by a single institution that combines central-bank functions with those performed elsewhere by a network of commercial banks. I shall refer to this all-encompassing state bank as the monobank. In some countries — but not in the Soviet Union — there is a separate Agricultural Bank and in most a Foreign Trade Bank. With the exception of Czechoslovakia, all the countries have an Investment Bank, which extends credit to the construction industry but otherwise serves merely as a distributing agent for allocating nonreturnable grants of budgetary funds to finance fixed investment. The countries of Eastern Europe know no credit- granting institutions other than the official banks; no financial assets except money, government savings bonds, and deposits in the single savings bank system; and no financial markets.

The monobank services, with insignificant exceptions, only the socialized sector of the economy. The credit available to the private

(3) *Money, Banking, and Credit in Eastern Europe* (Federal Reserve Bank of New York, 1966), 168 pp.

sector in industry and trade is an altogether trifling part of total credit extended. Since direct lending between economic units is prohibited (though this does not prevent *de facto* indebtedness to suppliers, incurred by delaying payments) the monobank is virtually the sole source of credit to the economy. In addition it is the bank of issue (4) and it performs a number of other functions, such as collecting all budgetary revenue, paying out all expenditures at all levels of government and supervising the financial performance of socialized enterprises.

The difference between the monobank and both the central and the commercial banks of the noncommunist countries is reflected in the structure of the monobank's balance sheet (5). The assets side consists mainly of loans to the various segments of the economy (in some countries including a relatively small amount of housing loans to individuals). It contains an undisclosed amount of gold and foreign exchange, but no government or private securities. Liabilities consist of currency issue and free balances of enterprises, government units, specialized banks, and the savings bank system (6); the balances of the savings bank system are substantial in countries where it makes no loans (Soviet Union, Bulgaria).

In the countries of Eastern Europe, currency and deposit money are not interchangeable. Currency alone serves as a medium of payment for the population (7). The monobank has the responsibility of not putting into circulation an amount of currency that would increase the flow of purchasing power to the population in excess of the economy's ability to deliver consumer goods and provide

(4) The monetary system of the Eastern European countries provides a classical instance of fiat money, the internal value of which is maintained by rigid administrative controls of currency issue.

(5) For a partial reconstruction of the balance sheet of the Soviet banking system for selected years between 1940 and 1961, see Edward Ames, *Soviet Economic Processes*, Homewood, Illinois, 1965, p. 167.

(6) The savings bank system is part of the monobank in the Soviet Union and Rumania. Elsewhere it is independent but supervised by the Ministry of Finance. In effect the single savings bank system, into which all savings institutions and the postal savings system have been merged, is the only source of banking services to the population. It accepts various kinds of savings deposits, collects payments for rents and municipal services, provides facilities for making payments to distant points, and — in some countries — extends consumer and mortgage credit. Eastern Germany has a network of separate municipal savings banks.

(7) In most underdeveloped countries, of course, and also elsewhere, most consumer expenditures are made in cash, the use of checks being confined largely to business payments. But in Eastern Europe this separation of payment circuits is rigidly enforced by law.

services. With fixed prices, such excess, when it nevertheless occurs, results in the disappearance of goods from the shelves and the formation of queues at the stores, which until quite recently were a familiar sight in Eastern Europe. The monobank exercises rigid control over currency circulation to avoid hoarding and unauthorized spending. Thus, for instance, stores must each day deposit all receipts with the monobank. Detailed cash circulation plans are prepared, which are coordinated with the credit plans within which all banks operate. All payments within the socialized sectors — among enterprises and between them and the budget — are made through transfers on the books of the monobank. To facilitate control, each enterprise is required to keep its accounts with a single monobank office — one in whose territory it is located — and it obtains all its credit accommodations from that office. For the same reason the specific method of settling payments is determined by regulation rather than by negotiation between the interested parties. The separation of payments flows into two circuits (currency and deposits) also facilitates planning and control. Obviously, the two flows are interrelated, and both kinds of money are expanded in the same way — through credit creation.

Ownership of money does not give an absolute command over resources, and the absolute order to the bank to make payment from an existing balance is unknown; deposit transfers are made and cash paid out only on the basis of supporting documents. Individual enterprises can make expenditures only in strict conformity with applicable economic plans, and the monobank has wide powers to make sure that payments are effected only for authorized purposes. Particularly detailed and rigid controls are applied to withdrawals of currency for payroll purposes. They are still rigidly applied in the Soviet Union, but in some other countries, notably Poland, monobank control of the wage fund has proved largely ineffective, and it has been given up altogether in Hungary.

In what sense, then, can one speak of credit policy in the countries of Eastern Europe prior to the introduction of reforms which are the subject of the final section of this article? Treatises and textbooks in Eastern Europe typically deal almost exclusively with the practical problems of controlling monetary circulation, crediting production and trade, and financing capital investment, without discussing the role of monetary policy as such, or its relationship to fiscal policy. In the writings of Soviet economists, who so far have

been setting the tone in the other countries of Eastern Europe as well, one would look in vain for an explicit discussion of monetary policy. The authoritative Soviet *Financial-Credit Dictionary* (8) contains no entry for it. Credit policy is defined as " a system of measures in the area of credit, designed to secure the economic interests of the ruling class "; what it is in a socialist economy is not defined, but a short review of its tasks is prefaced by the statement that " In the Soviet Union credit policy corresponds to the tasks that the government places before the country in each phase of the construction of socialism and communism ". " Credit restrictions " are described as " limitations or reductions in the volume of credit, which are put into effect by capitalist banks and the bourgeois state ", and " credit expansion " is " enlargement of credit, put into effect by capitalist banks and the bourgeois state, which exceeds the growth of production, stimulates over-production and the coming about of economic crises ". Similarly, banking officials of the countries of Eastern Europe, in their published speeches and articles, typically focus on how the monobank can best implement the economic plan or party decisions. Such statements clearly reflect the implementary nature of the monobank's activities and characteristically treat the monetary aspects of those activities (credit, currency circulation) on the same footing as routine operations (mutual offsets of transfer payments) or control functions (control over payroll disbursements).

Soviet-type command economies expect to maintain equilibrium conditions and achieve their growth objectives through proper over-all planning of material resources, and not through indirect means of influencing aggregate demand and its structure (9). The allocation of resources is determined by the economic plans, which specify for each enterprise, or group of enterprises, the kinds and sources of inputs and the channels through which output is to be distributed. Consumer prices as well as transfer prices among state enterprises

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(8) Issued in two volumes, in 1958 and 1962, by the official publishing house specializing in financial literature. The quotations are from Vol. I, pages 584-85 and 591.

(9) The credit and financial system of the Soviet Union, which served as a prototype for the other countries of Eastern Europe, has been discussed in considerable detail in English in well-known books and articles by W. B. Reddaway, G. Grossman, D. Hodgman, A. Z. Arnold, F. D. Holzman, Joseph Berliner, and L. E. Hubbard. Marie-L. Lavigne, *Le capital dans l'économie soviétique* (Paris, 1961), Siegfried Friebe, *Der Kredit in der Zentralverwaltungswirtschaft sowjetischen Typs* (Berlin, 1957), and G. Menz, *Das sowjetische Bankensystem* (Berlin, 1963) contain extensive bibliographies of publications in several languages, including original Russian sources.

are set by authority and are changed infrequently. Equilibrium between supply and monetary demand for consumer goods and services is attained by production, price, and wage decisions taken by the planning authorities. Deviations from planned magnitudes, whether arising on the side of production or distribution, are dealt with through administrative intervention rather than through the market mechanism. Adjustments needed to maintain equilibrium are made by the various economic planning and administrative agencies, not by the monetary authorities (10).

From its very origin, financial planning in the Soviet Union has been derivative (11). Monetary flows are planned as the counterpart of physical flows, and adjusted to changes in such flows. Thus, monetary and credit policies, subordinated to achievement of the real goals of the economic plans, are concerned primarily with assuring the efficiency of currency circulation and of the payments mechanism and with facilitating the economic performance of enterprises. Given the institutional arrangements centered on the monobank and its policy goals, most of the monetary tools typically used by the central banks of the noncommunist countries are irrelevant in Eastern Europe. Such changes in the allocation of credit as have occurred in the various countries have resulted from administrative decision, embodied in financial plans, rather than achieved (or attempted) by application of the monetary tools typically used by the central banks of the noncommunist countries. Under the standard system, interest is merely a service charge intended to meet operating costs, and rates tend to be uniform for all loans, irrespective of purpose. The low level of interest rates reflects the view that interest has no place in a socialist economy and that it is tainted by similarity to a particularly objectionable type of "parasite income" in capitalist countries. Even the increased differentiation of interest rates during the last decade merely reflects judgments as to how the cost of credit should be related to costs of products and distribution;

(10) It is, perhaps, significant that in *Economics of Soviet Planning* (Yale University Press, 1964) written by one of the leading authorities on the Soviet economy, Professor Abram Bergson, for a series of studies on comparative economies, there is no chapter on money and banking and only a perfunctory reference to the monobank: "Another major agency concerned with credit and finance [after the Ministry of Finance] is the State Bank" (p. 38).

(11) For a discussion of Soviet financial plans see the author's "The Role of the State Bank in Soviet Planning", in *Soviet Planning: Essays in Honor of Naum Jasny* (Oxford, 1964).

it does not reflect decisions as to how much credit should be used and where — questions that are settled by the economic plans.

The basic function of credit in the countries of Eastern Europe is to supplement the working capital with which state-owned enterprises are endowed. Except in agriculture, the role of credit in fixed capital formation is very minor, although in recent years a certain amount of long-term credit has become available for private and cooperative home construction.

Since the overriding goal of all economic activity in centrally planned economies is fulfillment of production targets stipulated in physical terms, credit is provided whenever it can help to meet those targets ("fulfill the plan"). Thus access to official banking institutions does not depend on profitability or creditworthiness. Indeed, economic plans may provide for some government-owned enterprises to operate at a loss, either temporarily or permanently: the authorities may decide not to recover all production costs during the run-in period of a new facility, or they may wish to subsidize socially-desirable production. Because producers' prices are not equilibrium prices and do not reflect relative scarcities, but are set by the authorities on the basis of considerations that are complex and not necessarily consistent (in particular when several different agencies set prices of materials entering into the cost of a given final product), situations may arise wherein an enterprise operates quite efficiently in terms of physical and technical indicators and yet shows a deficit.

The amount of short-term credit extended in the Eastern European countries is large in relation to output. In the Soviet Union the aggregate amount of loans extended during 1964 was 524 billion rubles ($575 billion) as compared with a national income of slightly less than 190 billion rubles (12). Under the standard system, short-term crediting performs three basic functions: it reduces the need for working capital by automatically financing peak working capital needs (mostly through inventory credits); it assures prompt replacement of working capital after completion of production (through automatic crediting of collection float); and it provides an added

(12) See M. Pessel, "The Bank and the Profits of an Enterprise" in *Den'gi i Kredit*, April 1966. The amount of credit per ruble of national income has tended to rise during the last decade.

means for controlling not only the finances but all aspects of the activities of each borrowing enterprise.

The bulk of short-term credit to enterprises is intended for the financing of inventories. In each country the precise proportion of inventory to be credit-financed is stipulated for each industry (often in great detail for individual types of raw and auxiliary materials) by higher-level administrative authorities, with proper provision for seasonal variations where appropriate. Much of the discussion about credit in Eastern Europe revolves around the determination of the proper share of bank loans in the financing of various types of inventories. Since 1956 there has been a gradual backing-away, at least outside the Soviet Union, from excessive details and rigidity in setting inventory-production ratios ("norms") and determining the share of credit in their financing. In fact, Poland and Czechoslovakia have now given enterprises the right to determine their own norms (which originally were stipulated, and in the Soviet Union still are, by the ministries and other administrative units in charge of the various industries), and more limited moves in this direction have been made in other countries of Eastern Europe.

Despite the bank's efforts — and despite the all-encompassing planning and the absence of cyclical fluctuations — chronic overaccumulation of inventories plagues all communist economies, more severely at some times than at others. Production bottlenecks and unbalanced inventories of raw materials result in a damming-up of goods in process. And, because of lack of market guidance, inventories of finished consumer goods tend to be high and to include a large proportion of wrong sizes and models not in demand; in recent years this problem has been aggravated by consumers' rejection of goods of poor quality and unfashionable design. Thus, although the volume of inventory credit is planned in accordance with rigid ratios, additional credit needs, not stipulated in financial plans, arise whenever there are disruptions in the planned flow of materials and finished products or consumer reluctance to purchase the goods offered.

The second main use of short-term credit is for bridging the collection gap. All deliveries must be paid for promptly upon presentation of shipping documents, but the monobank grants loans to producers for the — usually short — period during which the payment documents are in process of collection. This system amounts to an automatic restoration of the seller's working capital without putting additional pressure on the buyer to discharge his obligation promptly.

As for the control function of short-term credit, this amounts under the standard system to a continuous and detailed audit by the monobank of the enterprises' physical and financial performance. Until the emergence of new trends in recent years, the bank and its customers were involved in a web of impersonal accounting relationships, embracing uniform and rigid rules, few alternatives, a minimum of flexibility, and supervision that reached into the minute details of an enterprise's activities — including the regularity with which it discharged its current financial obligations (maintained a sufficient balance to pay bills and loans when due). The monobank's main criterion for measuring performance of its borrowers was the meeting of production, inventory, unit cost and profit targets as stipulated in the economic plans.

In comparison with short-term financing of the state-owned sector, all other types of credit are considerably less significant. Agriculture is still the most important single economic sector in most of the countries of Eastern Europe, but the amount of credit, both long- and short-term, made available to it by the banking system is relatively small. Short-term lending to collective (cooperative) farms is usually geared to the cash outlays needed for seasonal production and to the amount of produce sold to state agencies in charge of purchasing farm output for urban consumption (and export). Since each collective farm is an independent entity, its working funds do not benefit from infusions or reallocations by higher-echelon authorities, and bank credit is the only means of overcoming seasonal and other shortages of working capital. Long-term credit is extended to collective farms to supplement their own resources for investment in farm equipment and livestock; because of the relatively backward farm technology that still characterizes Eastern European economies, there is considerable unfulfilled need for investment funds in agriculture. Independent farmers, where they have survived in significant numbers, as in Poland, also receive both long- and short-term credit, usually on the basis of contracts committing them to sell their output to the state purchasing agencies; more limited availability of credit and less favorable terms have been widely used as means of inducing them to join collective farms.

Unsatisfactory financial performance of enterprises, evidenced most often by delays in paying bills and repaying loans and by oper-

ating losses that necessitate additions to working capital, has from the beginning posed a serious problem in communist economies. Because of the priority attached to uninterrupted production, the monobank has had to find ways of stretching the rules in order to extend overdue loans — frequently advancing funds under a different heading to repay the original advance. As a last resort, budgetary funds were normally forthcoming to replenish working capital of an enterprise. Penalty rates of interest and similar disciplinary measures had little effect in improving economic performance, and since they merely reduced the amount of the enterprise's profits their cost was ultimately borne by the national budget. Even the application of "financial sanctions" required high-level decisions (13) and usually such sanctions could not be imposed by bank officials on the firing line (who in any case had little interest in doing so). One of the issues currently debated in several countries of Eastern Europe is how to make the monobank directly interested in the profitability of the enterprises to which it extends credit.

While in the area of short-term credit there is at least a superficial similarity between arrangements in the West and in the East, differences in the channels through which investment funds flow are considerable. In the communist countries the national budget is the most important funnel for all payment flows within the socialized sector and between economic sectors. It also fulfills a significant redistributive function, particularly between agriculture and industry and among industries and regions (and transfers are made from it to the lower units of government, which have only minor direct sources of income). About half the national income of each country flows through the budget, a much larger proportion than in the Western countries. Expenditures for the economy, mostly for investment in fixed capital, typically account for about one third of total expenditures. The private sector, which does not benefit from budgetary expenditures, is very small in all the countries, probably nowhere exceeding 5 per cent of total nonfarm output; in the Soviet Union all production except that of artisan cooperatives is carried out by state enterprises and collective farms.

(13) In the Soviet Union the question of what sanctions to apply in each given case depends on decisions of several bodies, up to the various ministries and the Board of Directors of the Gosbank; see I. CHERNOV, "The Bank under the New Conditions", *Kommunist* (Moscow, May 1966).

Almost the entire surplus of state-owned enterprises' receipts over direct production costs is channeled into the national budget, in the form of profit levies and turnover taxes (differentiated by products and designed to raise prices for each product sufficiently to prevent effective demand from exceeding available supplies). For instance, such payments accounted in 1961 for 68 per cent of total receipts in the Soviet budget (14). The relatively minor part of profits retained by enterprises is used to augment enterprise welfare funds and to provide fringe benefits and cash bonuses to the staff.

Under this system, decisions on the division of current output, like all other macroeconomic decisions, are embodied in the central budget. It includes, in effect, a central pool of investment funds from which new industries are created, existing enterprises are enlarged, and working capital needs of a growing economy are met. Enlargement of working capital of individual enterprises (and replacement of capital impaired by operating losses), if it does not occur through monobank loans or through retention of a portion of profits, is effected through grants from the national budget. The main difference is that working capital obtained in the form of credit is onerous, while budgetary grants are free.

Any unit's working capital judged excessive by the supervisory authority (usually a ministry) may be transferred to some other state enterprise. This administrative redistribution of working capital, which has been resorted to more systematically in some countries than in others, contributes toward diminishing the concern of enterprise managers with the proper management of such capital. There is little incentive to build up "owned" funds when these are continuously at the end of a string that can be pulled by the various supervisory administrations. And, indeed, under the standard system the dividing line between the "owned" and borrowed working capital of a given enterprise is without real significance either from an operating point of view or with regard to its effect on the performance record of an enterprise.

For a diagnosis of the drawbacks in the standard system, one no longer need rely on the efforts of a generation of Western stu-

(14) AMES, *op. cit.*, p. 161; Ames (p. 160) shows that in the Soviet Union "for the last generation at least 90 per cent of accumulation [excess of revenue over cost] has ended up in the budget".

dents who have endeavored to extract from fragmentary statistics and the muted criticism of insiders a realistic picture of the inner workings of a command economy. The verdict is on the table: it is spread in the recent resolutions of the policy bodies of the communist parties of Eastern Europe.

The bill of particulars can be reduced to a few main propositions. The financing of fixed capital investment from budgetary resources on a nonreturnable grant basis involved considerable misallocation of resources and costly delays in the completion of construction projects. Failure to include the cost of capital among factor costs resulted in wasteful use of capital, the most precious resource in all developing countries; it also led to distortions of prices for producer and consumer goods and to crass disparities between domestic and foreign prices. Gearing all rewards to the fulfillment of goals specified mainly or exclusively in real terms resulted in a disregard of consumer preferences and a lack of incentives to maximize profits. The extension of credit on the basis of uniform, centrally determined criteria designed to facilitate the fulfillment of production plans rather than to influence the allocation of real resources resulted in almost automatic credit availability and hence, again, encouraged wasteful use of resources. Excessively detailed statistical reporting produced reams of data that made it possible to calculate the degree of "plan fulfillment", in terms of hundreds of separate indicators, but did not generate impulses to trigger adjustment processes.

First Steps Toward Flexibility

The trend toward greater flexibility in the area of banking and credit started in the middle fifties, after the death of Stalin and the insurrectionary events in Poland and Hungary. By the middle sixties, when broad economic reforms were announced, the emphasis placed on detailed credit planning had been considerably reduced, especially in Hungary and Poland, and credit administration had become more flexible. Some of the greater flexibility had resulted from the enlargement of responsibility given to, or initiative taken by, banking officials on the firing line who were better acquainted with local needs and problems than planners at the center. The ability of local banking officials to maneuver was, however, rather narrowly circumscribed by the authorization to transfer limited amounts of unused credit lines among areas, industries, and individual enterprises. In the meantime, the basic objectives, principles, and methods of credit administration remained very much intact. The banking structure, too, continued basically the same. In Czechoslovakia, the investment bank was absorbed into the monobank and the activities of foreign trade banks were generally expanded. By now, all countries of Eastern Europe have separate Foreign Trade banks in charge of conducting all foreign payments and credit operations. Credit policy remained essentially implementary, the bank officials merely verifying whether loan requests conformed with applicable rules, and not deciding whether the intended use of credit was more profitable than an alternative use.

One of the steps toward greater flexibility in the use of short-term credit took the form of "grossing up" the various authorized purposes for which credit could be obtained under the financial plans (which specified the amount that could be extended to each industry for each eligible purpose). Under the standard system these "objects of financing" had proliferated, but in the late fifties they began to be reduced; in Poland, for example, their number was cut from 20 to 7, and in Rumania from more than 13 to 8. Another innovation was to give local managers of monobank offices greater authority in allocating credit funds and in transferring unutilized credit lines between enterprises of the same industry — with the regional banking offices empowered to make similar adjustments among credit quotas assigned to local offices. A further development was the offering of more favorable terms to well run enterprises that showed adequate or better-than-expected profits and otherwise met their targets well. Enterprises that experienced financial difficulties through no fault of their own — as a result of delayed payments by their customers or inability to complete production because of shortages of parts or for similar reasons — were given access to credit on favorable terms to replenish their balances (such as "liquidity credits" in Poland and East Germany).

It came to be no longer regarded as an overriding principle, except perhaps in the Soviet Union, that credit must be an exact counterpart of the movement of goods through production and distribution and that therefore all loans must be collateralized by real

assets (15). Actually the principle had never been enforced literally — as was inevitable if the authorities were to avoid the chain reactions resulting from the failure of some enterprises to pay suppliers or workers. At first the problem was dealt with by permitting enterprises to obtain credit for purposes other than the traditional specific "objects of crediting", such as financing of inventories or of the collection float. These new types of credit were introduced under the headings "transitional", "special", "interim", and "extraordinary" loans; as a matter of fact, all four terms were simultaneously in use during the early fifties in Poland, where the standard system seems to have hit more snags than in any of the other countries. Subsequently the extension of loans for general working capital purposes, including the payment of wages, became more widespread; Poland pioneered in the introduction of such "production credits". A variant of this technique is "crediting of turnover", whereby the amount of credit extended is a fixed proportion of total output or sales, and no longer geared to seasonal peaks of inventories of specific raw materials or fuel. Finally, instead of extending credit to sellers to replenish working capital when customers delayed payments, loans began to be made directly to buyers to permit them to meet their payments on time. Indeed, one of the weaknesses of the old system was that it did not exert pressure on the debtor to discharge his obligations. Thus, without sacrifice of the claim to the superiority of socialist credit techniques, of which so much is made in the banking literature of Eastern Europe, the extension of credit to enterprises gradually came to be geared more to the borrowers' actual needs, conditions and prospects than to the execution of rigid plans passed down from the center. And the enterprises themselves were given a greater role in the framing of credit plans. The departures from rigid credit planning went furthest perhaps in Hungary, but in general credit plans acquired, at least outside the Soviet Union, the status of guidelines rather than of fixed targets.

Since the late fifties a steadily increasing amount of credit has become available to the population, largely through loans made by the savings bank system. The growth of output available for domestic use made it possible to do away with what was in effect the compulsory purchase of government savings bonds and to encourage the use of consumer credit which was introduced in the Soviet Union in 1959, but in some other countries earlier. On the other hand, various techniques, partly adaptations from the West, were developed to encourage savings and to link the availability of scarce goods, such as housing and cars, to the accumulation of substantial downpayments by the population. Various types of savings accounts were introduced to encourage savings for specific purposes and, conversely, loans became available to meet exceptional expenditures (such as weddings, funerals, removal to a new location). Other techniques include in some of the countries numbered accounts, preferential tax treatment of savings, and various transfer services to accommodate the holders of savings accounts.

Private and cooperative housing construction has received official encouragement in the form of long-term, low-interest loans; in some countries, notably Czechoslovakia and Poland, a significant proportion of new urban dwelling units came to be financed in this way, replacing the provision of staff housing by municipalities and factories or other employers. Credit availability to the private sector has been somewhat improved in recent years, particularly in Poland, Hungary, and East Germany, in order to stimulate the output of consumer goods, including items not normally produced by state factories, such as custom clothing and furniture, and to improve service available to consumers, including repair services. Similarly, lending to independent farmers was expanded, especially in Poland, where these farmers account for the overwhelming bulk of agricultural production, and in some countries also to workers on state farms and members of collective farms for carrying on their limited private farming activities. Even the Soviet Union, in a new departure, recently made loans available to members of collective and state farms for their private cattle raising (16).

(15) In the Soviet Union this principle was driven to bureaucratic extremes, making it necessary to have thousands of inspectors to verify inventories in various locations. As late as the spring of 1966, the manager of the Moscow branch of the State Bank of the USSR still pointed with pride to the fact that 99.86 per cent of the loans made by it were collateralized by real assets; see *Den'gi i Kredit*, May 1966, p. 90.

(16) For a loan to buy a cow — the maximum loan amount is 300 rubles for one cow per family, or 150 rubles for a calf — a request must be addressed to the state or collective farm or, in rural or suburban areas where cattle can be raised as a sideline by urban workers, to the enterprise or government unit where the individual is employed. The employer — administrative official of the farm or general manager of the enterprise — decides whether the loan should be granted, and then submits the application to the appropriate bank office. The employer guarantees the loan, acts as collection agent for the bank by withholding the amounts needed for monthly amortization and for interest payments (2 per cent annually), makes sure that the proceeds are actually spent for the stated purpose, and collects the

During this period some liberalization occurred in the extension of medium-term credit, which in all the countries had been used as a means of stimulating small-scale mechanization and technological improvements (17). The terms of such loans were gradually made more favorable and their scope was later extended to include expanded production of mass consumption goods. Investment of this type continued to be hampered, however, by excessively rigid restrictions; new construction, for instance, was typically ruled out. Furthermore, there was usually difficulty in obtaining equipment for projects not included in overall economic plans. More basic, perhaps, was the reluctance to resort to credit financing for such purposes: why pay interest on a loan when a free grant could be obtained by having the project included in next year's economic plan?

Altogether, the various moves taken after the mid-1950s toward a more flexible use of credit resulted, at least in the smaller countries of Eastern Europe, in some loosening of the rigid standard system. But before the mid-1960s these measures did not succeed in making credit a means of achieving a better allocation of resources or of increasing the efficiency of the economic system as a whole.

The Emerging Use of Credit as a «Lever»

The elevation of credit to the status of an "economic lever", with a considerably increased role in the economy, occurred as part of the recent shift in the various countries of Eastern Europe toward a new "system of economic steering". The official resolutions and documents explaining the reasons for the changes, outlining the basic principles, and specifying the institutional implementation (also setting timetables for the changeover) make curious reading, both for their admissions and for their omissions. These documents have a good deal of explaining to do to a generation raised on the notion that "market" necessarily carries the adjective "anarchist" and that

balance due if the animal is sold or slaughtered. These procedures are typical of the bureaucratic handicaps involved in the extension of credit to individuals; the terms — including amortization of a $330 loan over a period of seven years, after one year of grace — reflect the low level of incomes.

(17) For a review of Soviet experience with this type of credit, see G. Grossman, "Gold and the Sword", in *Industrialization in two Systems: Essays in Honor of Alexander Gerschenkron*, edited by Henry Rosovsky (New York, 1966).

profits are identical with exploitation (18). In fact, the difficulty experienced by the communist countries in accepting the proposition that the role of interest is not necessarily linked to the capitalist method of production is matched only by that of some Western economists in viewing profit in a context broader than the capitalist economy.

The resolutions of the various communist party congresses defining the new policy, and the supporting speeches differ in the extent to which they try to make the new system appear to be a linear descendant of the precepts formulated by Marx and Lenin; and they differ in their persuasiveness in demonstrating the compatibility of a market adjustment process with central macroplanning. But all of them spell out in quite substantial detail what is to be done, why, and how. Our interest here is limited to the area of banking and credit, which is given considerable treatment in some countries (Poland and Hungary) and is touched on only slightly in others (19).

The new system of economic steering represents a decisive move away from central planning of production and distribution toward a socialist market economy guided by preferences of final users. It is a move away from detailed sets of targets and norms, handed down to production units by administrative organs, toward reliance on a flexible price system and the profit criterion to guide production and allocate resources, and toward the provision of material incentives as a means of achieving maximum effort (20).

(18) "Profit belongs to that category of the economy that in its essence reflects in a synthesized way the main aspects of the economic activities of the enterprise — the volume and quality of goods produced and sold, the reduction of the prime cost of production, the increase in labor productivity, the use of the capital funds, and so forth". From "Theses on National Economy" of the Politburo of the Bulgarian Communist Party, *Rabotnichesko Delo*, Sofia, December 4, 1965.

(19) The single but significant sentence in the Bulgarian resolution reads: "It will be expedient for the State Bank to grant credits and provide service for the entire activity of the economic organizations by actively influencing the achievement of higher efficiency and better financial results".

(20) "The socialist economy cannot do without using prices as an important instrument for shaping supply and demand... As economic growth progresses, as changes appear in production techniques and, along with this, in the production costs, demand and social requirements, it is increasingly important to use prices as a flexible instrument, in accordance with the law of value and basic economic objectives... We want to reform the planning and management system to bring about an optimum mutual adjustment between directives coming from central planning and initiative coming from below, between the system of directives and the system of economic incentives that influence enterprises and personnel",

The first step in moving toward the new system is the gearing of production to demand. This is to be done in several ways. Factories, at least in the consumer-goods area, will plan production in conformity with negotiated contracts or with orders actually received, in most cases directly, from retail outlets or industrial users. Management will be given greater scope for making production decisions. And its success will be judged not by its ability to hit detailed output targets, but by a small number of key indicators, among which the profit rate has a crucial role.

A related development is the creation of industry associations (in the Soviet Union the so-called " firms " represent a comparable move toward aggregation) thus introducing a major change in industrial organization. These associations of enterprises — sometimes organized on a regional as well as on an industry basis — are designed to decentralize responsibility for production; professional managers and specialists in the associations work directly with enterprise management, thus reducing stifling central control and bureaucratic influence. Among other things, the associations will make possible a greater specialization of output and will place research and development activities and decisions on the use of amortization funds — hitherto made by industry ministries and other central administrative organizations — closer to the production process. In the Soviet Union these groupings are still in the experimental stage and of relatively limited significance. Elsewhere they already include most of the large enterprises and many of the smaller units; in East Germany, for instance, 1,800 enterprises, accounting for about two thirds of total industrial output, belong to 82 such industry associations.

The industry associations constitute and administer funds for capital investment and for supporting research and development, and also industrywide reserve funds for providing temporary financial assistance to their member enterprises in the form of short-term loans and loan guarantees. The associations have considerable latitude in selecting investment projects and in determining financing procedures. Their funds are constituted in part from pooled resources (retained profits) provided by members and in part from credit made available by the banks. The establishment of these association funds

told Stefan Jedrychowski, the chief planner of Poland, to the plenum of the Polish United Workers' (Communist) Party which adopted the new policies. See *Polish Reports*, Warsaw, No. 8/9, 1965.

represents, in effect, the creation of financial institutions for the servicing of specific industries, and thus introduces an entirely new element in the financial structure of communist countries. In addition to the financing provided through the associations, individual enterprises will use that part of profits which they can retain to aliment their development fund to finance their own investment projects (which normally will require approval by the planning authorities) and they will be free to undertake projects on their own responsibility if they can obtain bank financing for the purpose.

Another basic change is in the area of capital formation and cost accounting. Under the standard system, as was emphasized above, no charge was made for capital, on the theory it was public property; the result was misallocation and wasteful use of investment funds, as a larger investment per unit of output was not automatically reflected in higher costs. Another universal consequence was delay in completing construction projects. Now the principle is being introduced that producer prices must reflect the cost of capital (21). Interest is to be charged on both fixed and working capital; and to equalize the cost of new and existing fixed capital (the latter originally supplied on a grant basis), a charge is being imposed on the depreciated volume of capital assets in use. In effect, the capital-use charge means that some of the amounts previously transferred to the budget as enterprise profits will henceforth be paid by the enterprise under the heading of interest (22).

While the underlying principle of recognizing capital as a factor of cost now seems to have been accepted by all the countries of Eastern Europe, its practical application is likely to be gradual and to vary from country to country. In Hungary, a charge on investment capital (at the uniform rate of 5 per cent) was introduced in 1964; in Poland, specific details are now being worked out; and

(21) A recent Soviet experience strikingly illustrates the different practical effects of the two principles. Under the old system of cost accounting, the 1964 profits of the Soviet railway system amounted to 67.2 per cent of direct costs, and it was therefore planned to reduce freight tariffs by 20 per cent. But when a charge for fixed and working capital was taken into account the ratio dropped to 12.6 per cent, which is less than the national average for all state-owned enterprises, and it was decided to leave freight tariffs unchanged. See D. Kondraschev, " The Methodological Basis of the Revision of Wholesale Prices ", in *Den'gi i Kredit*, May 1966.

(22) The ideological reluctance to use this term is reflected in the use in East Germany of the term production-fund contribution (Produktionsfondabgabe) for interest; the Bulgarians call it production-fund tax.

practical implementation of the principle is still being studied in East Germany, Czechoslovakia, and the Soviet Union. One major problem is that the introduction of a charge for capital will increase the number of enterprises operating at a loss. For the new system to fully justify itself, such units must either be made efficient or discontinued; the official comment accompanying the introduction of these measures apparently recognizes this.

While the changes with regard to industry organization, and in particular the operations of industry associations, require considerable modification of past credit policies and procedures, the most significant consequences for banking arise from the redirection of funds to finance investment and related shift of a large part of financing from a grant to a loan basis. Instead of being channeled almost exclusively through the budget, a significant part of the profits of state-owned enterprises will become available for decentralized investment (originally pioneered by Poland), either by the originating enterprise itself, or (as already mentioned), through industry associations or similar groupings.

The new policies will clearly produce significant changes in financial flows and in the allocation of real resources. With the reduction in the portion of investment funds channeled through the national budget, the budget will become more similar in scope to that of Western countries. Budgetary grants will continue to be made, not only for social overhead but also for such priority projects as new industries and major programs for the development of national resources, in some cases with provision for subsequent recoupment of at least part of the initial financing. But the great bulk of investment funds from the budget will be allocated to the State Bank or the Investment Bank (the respective roles of the two in making investment loans is still not clear for most countries) as a revolving loan fund.

The relatively small part of profits previously retained by individual enterprises (known in the Soviet Union as the "enterprise fund") — mainly to provide bonus payments to management and staff, either in cash or in the form of fringe benefits such as housing, vacation trips, nurseries — will be increased significantly. The precise way in which the proportion of profits retained is to be linked to economic performance — primarily the profit rate — differs from country to country, as does the distribution of this share among various uses. In the Soviet Union three different retained-profits

funds will be constituted at each enterprise: one for paying cash bonuses to staff and management ("material stimulation"); one for fringe benefits, including construction of factory housing; and a "development fund" for research and investment. Similar arrangements are being introduced in the other countries, with perhaps greater emphasis on using profits for financing investment projects initiated by the enterprise (or group of enterprises) generating them.

The ultimate objective of the new arrangements is to achieve a more rational pattern of investment in productive capital and a reduction of the investment-output ratio. Financing of investment through repayable loans instead of grants, or from retained profits, which will for the first time become a significant source of investment funds, is counted on to achieve results that administrative decisions and detailed control could not deliver. It is expected to reduce the widely criticized waste of real resources and to cut down the prevalent and costly delays in the completion of new projects.

It is readily evident that the new system of investment financing will have important implications for the price system. All the countries are now engaged in revising their still administratively determined price structures, to make them reflect more closely all relevant factors of production and relative scarcities. In particular, prices of producer goods, artificially held down to stimulate investment, and prices received by the farm sector, kept low to favor industrialization, will tend to rise. The entire price structure of the Eastern European countries is likely to move closer to that of the Western world. This would probably lead to significant changes in the structure and direction of their foreign trade, as did similar changes made by Yugoslavia in the course of recent years.

It is clear that the rise of credit financing of fixed investment and the development of industrywide associations importantly affect the role of the banking system. In several countries specific monobank offices have been put in charge of servicing the banking needs of associations and of centralizing and supervising the planning of their credit and currency requirements while actual operations remain in the hands of the local offices in whose territory the association members are located. A further step was taken by Czechoslovakia in 1965: the creation of special units within the monobank on the industrial rather than territorial principle to service one or several of the newly formed industry associations or the giant individual concerns, such as Bata and Skoda. East Germany has gone even

further in this direction by creating, within the framework of its monobank (the Notenbank), specialized divisions (Industriebank-filiale) that service the credit needs of up to three industry associations. Obviously, credit needs differ greatly among industries and in accordance with specific conditions. The new method of crediting recognizes this and requires a more intimate and current knowledge of the technology, supply and demand conditions, and profitability of each unit than did the old system.

For the first time official banks will become involved in project appraisal and negotiations with prospective investors. Individual enterprises will have to justify the profitability of projects for which they require financing, and their willingness to commit their own funds will also become an important factor in the bank's decision to grant loans (23). With the passage of time the banks, in effect, will be administering a steadily growing revolving investment fund whose resources from loan amortization and interest payments will be supplemented by periodic appropriations from the budget. So long as they do not exceed the centrally accumulated funds available to them for investment lending, they will have considerable latitude in dealing with loan applications. A logical development would be the establishment of a separate national investment fund, completely bypassing the budget; suggestions along these lines have already been made at least in Poland.

The attempt to make credit an " economic lever " involves also a greater differentiation of interest rates on short-term working capital loans and a change in accounting arrangements whereby the cost of such credit directly enters into the determination of profits to be retained by the enterprise. The principle of uniform — and low (in the Soviet Union, mostly 1 or 2 per cent) — short-term rates that prevailed under the standard system began to break down in the mid-fifties, at least outside the Soviet Union, but differentiation tended to be based on the purpose of the loan rather than on the creditworthiness of the borrower, and to be used mainly to discourage loan delinquency and to subsidize socially desirable activities. Under the recent developments, the monobank has greater flexibility in its short-term crediting and is able to take the risk

(23) " Banks must pursue an active credit policy, work out specific conditions under which investment credits are granted, and decide to which enterprise to grant credit ", reads the resolution of the Central Committee of the Hungarian Communist Party on the reform of the economic system.

factor into consideration. And with interest expenditure entering into the determination of enterprise profits and management compensation, credit costs become an important influence on managerial decisions. Publications of the Eastern European countries are full of accounts of how the new policies have had the immediate effect of reducing plant inventories (not many months ago argued by plant managers to have been held at rockbottom levels) — just as the introduction of a charge on fixed capital suddenly revealed that factories could relinquish a considerable quantity of machinery and equipment kept as a safety margin as long as capital was a free good.

Clearly, under the new economic system credit policy is not to supplant planning, but is rather to permit a reduction of its scope and to increase its effectiveness and flexibility. The total volume of credit to be extended and the broad categories of its use will continue to be centrally planned in order to preserve monetary equilibrium. In the framework of the new policies, credit is to be regarded as a tauter string rather than as a looser leash, but it will be used in conjunction with a different set of objectives and criteria. The effectiveness of the new use of credit will depend on the success in actually shifting a considerable part of decision-making from central planners to enterprise managers.

These prospects are relevant to the question whether something identifiable as a " socialist monetary policy " is about to emerge. Even though an answer cannot yet be hazarded, it appears that the new developments are more likely to enhance the role of the monobank as a financial intermediary than to endow it with more attributes of a central bank in the Western sense. They will make the individual enterprise's access to credit increasingly dependent on its profitability, its financial position, and — indirectly at least — the quality of its management. Even significant steps toward some blend of centrally planned and market-oriented economies will not necessarily entail a basic change in the role of the banking system. The monobanker, permitted considerably more flexibility in dealing with microeconomic problems, will have an opportunity to become a more efficient commercial and investment banker, but there is no indication that he will be given wider responsibilities as a central banker.

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