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Socialist Banking

Domenico Mario Nuti

A moneyless socialist economy, outside the remote prospect of full communism, has been rarely suggested or practised; instances of its suggestion such as Neurath's *Naturalminschafi* (1919), or its practice, such as 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 central eastern European countries (see Arnold 1937; Garvy 1966; Grossman 1968; Nuti 1986).

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In the traditional centrally planned socialist economy the production side of the economy is organized as a single giant firm, a monopolistic corporation entirely owned by the state. Individual production units are administrative subdivisions dependent on branch Ministries and acting exclusively on central instructions. Production tasks are worked out at a central level for the whole economy and stated in a national plan, then broken down by branch and by enterprise as a result of a few (at most half a dozen) iterative rounds of two-way consultations between the centre and the productive units.

Workers are employed by state enterprises at a money wage and have a right/duty to work; in practice they have an entitlement to keep their post or to be redeployed within or by their enterprises. Private enterprise is forbidden or restricted to the use of small amounts of owned or state-rented land or capital goods, with the assistance of family labour and perhaps a few employees, in minor sectors. Prices are centrally fixed, on the basis of average production costs plus actual or implicit subsidies and taxes reflecting government preferences. Once fixed, money prices change infrequently and only through administrative decisions.

In such a system money is primarily an accounting instrument of aggregation and control; financial flows are compartmentalized between enterprises and households, with a bank money circuit for inter-enterprise transactions and cash (or cash convertible accounts) 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' in Western literature).

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. Since both quantities supplied and prices are state-fixed, markets do not necessarily clear.

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 to statutory criteria for investment project selection (such as the necessary recoupment of additional investment outlays through current cost savings within a maximum 'recoupment period', equivalent to the application of a shadow capital charge. Enterprises transfer back to the state budget any surplus which they may realise over and above the financing requirements of their centrally approved investments (or rely on further transfers from the budget to cover their planned losses and necessary investment finance).

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 desired to cover banks' administrative costs. Trade credit between enterprises is forbidden, so that the central bank is not only the lender of last resort, but the only lender: there is no quasi-money.

Fiscal policy takes the form primarily of diversified turnover tax rates or subsidies on commodities; income tax is spurned as an unnecessary internal transfer within the state sector; a modest government surplus is the customary budgetary stance; government deficits are effectively instantly monetized, in view of the small absorption capacity for government bonds; sales of bonds to the population often have a compulsory nature—that is, are a form of taxation.

Thus money in the traditional, centrally planned, socialist system is a unit of account, a two-tier medium of exchange conditionally to plan conformity, and a store of value in competition with inventories of goods rather than with alternative financial or productive assets. It is an instrument for monitoring and controlling plan implementation ('control by the rouble' is emphasized in Soviet literature), not 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.

Traditionally centrally planned economies are regarded as having a propensity for autarkic or quasi-autarkic structure (Wiles 1968). In the process of plan construction first the necessary import requirements of planned levels of gross output are estimated by commodity groups, then export plans are adapted to the foreign currency requirements of the

import plan; if a deficit emerges, over what can he financed out of reserves or fresh borrowing, unless import substitution can fill the gap, output plans are scaled down. Exports are regarded as a 'necessary evil', as a withdrawal from the domestic market. Planned trade is undertaken through large import-export state enterprises, specialized by commodity group, not on behalf of producers but on their own account. Domestic currencies are not convertible into commodities (outside the sphere of consumer purchases by nationals), let alone other currencies; exchange rates have a purely accounting role, with equalization subsidies and taxes tending to make all planned exports equally profitable to producers and imports competitive with domestic substitutes whenever they are available; the economy is effectively insulated from the fluctuations in international prices and exchange rates. As the result of the coordination of national plans, there was planned trade integration within the socialist trading bloc—CMEA or Council of Mutual Economic Assistance (also called Comecon in Western literature; it was founded in 1949 and, at the time of its dissolution in September 1991, it included the USSR, the East European Six, Mongolia, Cuba and Vietnam). Even within CMEA, however, trade flows tended to be bilaterally cleared (moreover within groups of hard and soft commodities), and there was no common currency, balances in the so-called transferable rouble being neither convertible into Soviet commodities nor transferable to countries other than the Soviet Union without prior mutual agreement; intra-CMEA trade prices were usually indexed to a moving average of international prices in convertible currencies. Like national banking institutions, CMEA financial institutions would pay only a symbolic interest rate on outstanding balances. All in all, foreign trade transactions in this kind of system are administratively determined and there is no automatic mechanism transmitting to producers signals about trade opportunities and inducing them to take advantage of any such opportunities (see Wiles 1968; Marer 1972; van Brabant 1973).

It is conceivable that gold and hard currency reserves might allow such a system to introduce and maintain convertibility of the domestic currency, and indeed plans for the introduction of convertibility were considered in the USSR even at the height of central planning. However such convertibility would only be applicable to capital transactions, as

the practice of central planning would have to restrict the convertibility of domestic currency into domestic purchases of goods and services, in order not to disrupt the pattern of planned inter-enterprise transactions (moreover, the insulation of domestic from international prices might have led to inefficient trade flows). Such convertibility into specific commodity groups would have to be fitted into the national plan — that is, multilateral trade clearing could not be automatic, it would either have to be negotiated or lead to hard currency settlements. Hence the nature of the so-called transferable rouble described above.

This system of real and monetary management of the economy was expected to yield price stability, domestic and external macroeconomic balance, full employment of labour and economic growth. In practice—apart from roughly 1950–70—it was broadly characterized by widespread excess demand at controlled process (i.e. repressed inflation visible through generalized shortages), generating full and overfull employment as a by-product, and/or external imbalances financed through external debt; growth performance, impressive until the 1960s though possibly overstated, subsequently deteriorated, and by the end of the 1980s turned into decline.

This disappointing performance is usually attributed to the built-in inefficiency of a system that disregarded, due to administrative prices, substitution opportunities both in production and consumption; and to the informational complexity of planned coordination. An element of strength and weakness was the built-in economic inertia of the centrally planned system, involving both the ability to reproduce itself and the inability to adjust to exogenous shocks, to changes in technology, tastes and world trade opportunities. Probably an even more important factor in the deteriorating performance of these economies was the combination of monetary indiscipline and a misguided commitment to stable prices in the face of excess demand, which, having started variously in 1975–85, by the end of the 1980s had cumulated to significant degrees of monetary overhang throughout the area (less so in Hungary and Czechoslovakia).

Endemic excess demand was due to both macro- and microeconomic factors. The first took the form of a generalized overambition in planning investment, collective consumption, defence and other desirable targets,

and the money wage push unavoidable at overfull employment — all claims validated by an accommodating monetary policy, but incompatible at constant prices. The microeconomic aspect of these policies was the 'soft budget constraint' to which state enterprises are subjected, that is, their ability to replenish their financial resources in the pursuit of planned tasks whenever needed, for instance in the face of higher prices (Kornai 1986; constraints were never infinitely 'soft', but sufficiently flexible to recreate excess demand for the small range of price increases considered by central planners). As a result, the centrally planned economy over time became typically a 'shortage economy' (Kornai 1980), with adverse implications for both consumer welfare and production efficiency.

The actual size and presence of monetary overhang in the 1970s have been the object of controversy, since measurement presumes a reliable estimate of what the demand for money would be if current prices were market clearing (see for instance Portes and Winter 1980); but there is generalized consensus both about its presence in the 1980s and on its significant size, as witnessed by large price differentials between the official level and that prevailing in secondary retrading ('black' or grey markets). Alternative indicators of true inflationary pressure have been attempted, such as the direct recomputation of price indices, the calculation of implicit deflators, the purchasing power parity approach to black market exchange rates, the share of goods officially regarded as 'without supply difficulties', the ratio of cash and non-cash financial assets to income and composite indicators of excess demand (see Nuti 1986).

The opportunity to convert money into goods at higher prices in the 'secondary' economy in a trivial sense made all monetary holdings voluntary, but equilibrium in this limited sense was still consistent with large-scale imbalances at the official price level, as witnessed by the large-scale price increases usually occurring at times of partial or total price liberalization (as in the stabilization programmes of 1990–91 in central eastern Europe).

The monetary regime of an economy affected by endemic monetary overhang can be characterized as one in which money is a peculiar kind of lottery ticket, with a recurring probability p of a prize consisting of access to purchase at official prices at face value, where p is equal to one minus the ratio between monetary overhang and total money supply

(Nuti 1991a). Clearly this peculiar regime—never suggested by anyone for any system—has nothing to do with socialism as such, but was the result of historical accidents and bad policies.

The traditional model was the subject of repeated reform attempts, especially in 1965–89. At first the aim was that of improving central planning, through the use of international prices, actual interest rates and rentals for scarce resources; the use of value instead of physical indicators, including profit and profit rates; and enterprise autonomy and inter-enterprise direct links, government contracts instead of orders or quality controls. Then reform attempts were directed at constructing a model of 'market socialism', which might combine dominant public ownership and macroeconomic management with the benefits of full-fledged markets, to be used as instruments of resource allocation instead of solely for the distribution of centrally decided outputs. This kind of 'radical reform' (in Mikhail Gorbachev's words) included the dismantling of central planning and of administrative supply channels, the replacement of branch Ministries by a single Ministry, sectoral ministry of firms, anti-monopoly legislation, performance related managerial incentives and freer access to foreign trade. In these repeated reform attempts, money recovered an important role (see Brus 1964: for a pioneering detection and analysis of the early stages of this process in the 1900s consolidating the currency; financial flows become fully connected, commercial banking is separated from central banking (as was done in Britain with Sir Robert Peel's Act of 1844, which abandoned the principles of the banking school in favour 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); investment is funded by bank credits, inter-enterprise loans and self-finance; credit is provided not automatically, but at the discretion of banks on a contractual basis and at an interest which is supposed to balance the market; enterprises which are not deemed creditworthy can be forced into liquidation and bankruptcy; and 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.

This design for reform was partially implemented early on in Yugoslavia, where for a long time, and 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 Dimitrijevic and Macesich 1983). However, in Yugoslavia these developments may have been due to its specific systemic features, since income-sharing by self-managed enterprises is expected to favour 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 that investment back at historical cost, so that what appears as equity is effectively a loan (see Uvalic 1989). Yugoslav banks tended to channel private savings to the enterprises that owned them, on favourable terms, acting as a decentralized form of collectivization of enterprise losses, thus raising similar problems to those of less developed monetary systems elsewhere in central and eastern Europe (see Uvalic 1992). The first full implementation of monetary reform along the lines illustrated above took place in Hungary in 1984–9 (see Blejer and Sagan 1991). In 1984 a government decree authorized the issue of bonds to the public by government, local authorities, financial institutions and all enterprises. On 1 January 1987 the National Bank of Hungary hived off its credit activities by transforming its lending directorates and some local branches into associated but separate bank, soon joined by other banks with substantial foreign participation. An obligatory reserve ratio of 20% was established for demand deposits and 10% of time deposits; the discount rate, which until the end of 1984 was decided by the government, was put under the control of the President of the Central Bank. A law on bankruptcy (1986) gave initiative to creditors and established rapid proceedings. A market for share issues by private and state enterprises to the general public was set up from 1 January 1989.

By the end of the 1980s similar measures were being contemplated and had begun to be implemented in other central and eastern European countries (China had been an early starter and a slow mover along this road). However the 1989 revolutions switched the target model from the construction of 'market socialism' to the restoration of capitalism, that is, of a market economy with prevalent private ownership and enterprise. This involved privatization (as well as re-privatization, i.e. restitution to earlier owners), including privatization of financial institutions. In Hungary, again leading the reform process, the 1988 Law on the Transformation of Enterprises and subsequent legislation laid the foundation for the privatization of state enterprises (which had been occurring spontaneously since the mid-1980s); in June 1991 a bank privatization plan was announced, which may permit foreign ownership of up to 20% of even the largest commercial banks. The growth of the private sector, especially in banking and financial activities, has proceeded mostly through new institutions rather than through privatization of the state sector. Throughout central and eastern Europe, including the former Soviet Union (from the end of 1991 a smaller and looser Commonwealth of Independent States), privatization is in progress; by 1992 the old style system is surviving in a precarious form only in a few Asian countries and Cuba.

There are many reasons for the failed implementation of an alternative market socialism project. First, a consistent theoretical model of market socialism, different from a capitalist economy governed by socialist principles and policies, was never fully developed. In particular, the monetary and financial arrangements that might characterize such a model were never satisfactorily addressed, let alone resolved, in either literature or reform projects. Pareto (1902) stressed the immanence of economic categories such as capital and interest regardless of economic system (vol. 1, ch. 6); 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, beside Heimann (1922, 1934), who coined this term, Taylor (1929), Landauer (1931), Dickinson (1933) and Lange (1938) (for a comprehensive survey of prewar literature, see Landauer 1959). The same is true of more recent literature on socialist blueprints, except perhaps Brus's stress on the importance of money in the decentralized model of socialism (Brus 1964). Nove's 'feasible socialism' (1983) only mentions money to say that it must be there and never mentions financial markets. The development of monetary and financial institutions in the 'reformed' socialist economies has simply imitated without change a few capitalist institutions (arguably not even the most appropriate among capitalist financial institutions; see Corbett and Mayer 1992).

Even within the old ideological restrictions on private ownership of means of production and of enterprises it might have been possible to simulate the functions of a competitive market for capital goods and for enterprises as going concerns, and the functions of a stock exchange (see Nuti 1989; this relies on a challengeable self-assessment of capital values by state enterprise managers, and private loans and deposits indexed to the value of chosen state enterprises). However, any such scheme would involve private enrichment through saving and good judgement, and therefore would have represented a needless detour from establishing actual financial markets. Probably the financial arrangements appropriate to market socialism should be accompanied by forms of employee ownership and participation in decision making, like Tibor Liska's 'entrepreneurial socialism' (Liska 1963; Nuti 1991b) or James Meade partnerships (Meade 1989), as well as other extensive forms of economic democracy (basic or citizen income, etc.). Thus to a great extent, the failure to implement market socialism has been a failure of the imagination.

Second, the transformation of the old system has been taking place at an excessively slow pace, subject to experimentations and reversals, leading to an incoherent and contradictory partly planned, partly market-oriented system, or rather non-system, which performed as badly as the old system, if not worse. Such is still (in 1992) the economic system in the former Soviet area.

Third, with the partial exception of Hungary, monetary overhang persisted, while the political class was either unwilling to handle the problem or lacked the necessary political legitimacy to impose the austerity measures necessarily associated with monetary and fiscal discipline, price liberalization and trade opening. Moreover, the old political and economic regime would not have commanded the kind of international solidarity enjoyed by its successors. Thus the former political class could not have undertaken the stabilization programmes which were implemented in 1990–91 by Poland, Czech and Slovak Federal Republic, Romania and Bulgaria, and have been envisaged in Russia and Ukraine in 1992, with the full backing of the IMF, the World Bank, Western countries and the international financial community (including forms of debt relief as well as grants and loans).

For these reasons, by 1990–92 the only course left was a return to capitalism. The feasibility of an alternative model of market socialism—which arguably would have been easier to implement starting from the reform of centrally planned socialism than from that of advanced capitalism—remains an open question, unlikely to be resolved or even posed in the near future.

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