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MONEY AND FINANCE IN YUGOSLAVIA

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0. Introduction

Formerly, it was a characteristic of the Yugoslav economy that it was different from the centrally-planned or command type of economy on the one hand, and from the (capitalist) market type of economy on the other hand. This disparity extended to almost everything—including finance. But it is becoming increasingly clear that finance has some basic characteristics to which it must conform, even in such an idiosyncratic country as Yugoslavia; and we are interested precisely in those features of finance which are necessarily the same everywhere, irrespective of their specific socio-political environment.

What appears on the surface, for interest, is a highly negative interest rate or the lack of any financial discipline;[1] but all of this has its roots deep in the bases of finance—and this is the first topic of this article. From these roots stem such peculiarities as the way in which new or expanding business enterprises are financed, and the way in which business enterprises expand their "own" funds, for instance; and these topics will form the second and third sections of this article. In the subsequent two sections we will deal with commercial banks and the central bank. The final section will explain how the Yugoslav financial system could become a normal one.

1. Financial Deficits and Surpluses, and Self-Financing

Those looking at the Yugoslav financial system from abroad are not able to understand what it is all about. We have money and various other financial assets; financial institutions such as banks; a central bank and instruments of monetary policy; credits, interest rates—almost everything that market economies have. But real interest rates have been generally negative, in some periods indeed so negative that it has been appropriate to talk about "compulsory grants" given by lenders to borrowers, especially if we take into account that some borrowers have been so powerful that they have not been repaying their debts at all. The old medieval dictum: "Lend not to him who is mightier than thou, or if thou lendest, consider thy loan as lost"[2] comes to mind. It is obvious that borrowers have more power than lenders, otherwise the system of "compulsory grants" would not have been able to exist. But we should not jump to hasty, premature conclusions, for instance about how simple it is to change this awkward situation simply by stubbornly insisting on a positive and fairly high real interest rate.

To explain this situation one must start from the bases of finance—from financial deficits and surpluses—and how the official doctrine views them, from the way in which investments in fixed assets are financed or from the way in which new business enterprises are born. Who provides the capital, and how? How are the financial surpluses and deficits of various regions (the territories of individual banks, which are predominantly very small) being financed?

Financial surpluses and deficits of economic units (business enterprises, households, etc.) are not considered to be the normal state of the world; they are treated as an aberration that should be tolerated only for a while. The normal state of the world is complete self-financing. How, otherwise, may we explain some very strange institutional arrangements, for instance the fact that business enterprises and individuals (residents and foreigners) are not allowed to have a stake in Yugoslav business enterprises? They may invest only for a certain stipulated time period, so that business enterprises starting out or expanding must repay the debts which were the basis on which they financed their fixed assets. Taking into account the fact that the question of equity capital has not yet been touched upon (business enterprises are being permanently merged and/or split by the political will of those who have the power, there being no equivalent to "equity capital" to play any role), we will pause for a while to consider the consequences of the idiosyncratic system of financing the fixed assets of Yugoslav business enterprises.[3]

When we broke with the system of a central-planned economy in the early 1950s, we changed first of all the method of financing business enterprises, namely, their fixed assets. We stopped financing them by grants through the federal and other budgets, and started financing them by credits: at first through the newly-created investment funds, later through banks. We were however not ready to make any radical changes in politics, and so we did not introduce other necessary changes which would enable business enterprises to exist normally without permanent interference from the state or from politics. The changes which we did not make were in the field of finance, in the first instance. Since the early fifties we have had a system of abnormal finance, of "compulsory grants," and of permanent interference from politics.

2. How New or Expanding Businesses are Financed

If a new business enterprise happens to come into existence, it starts with no funds of its own—if by "funds of one's own" we mean the funds that an enterprise is not obliged to repay, i.e., something remotely similar to equity capital.[4] At the beginning, credits are almost equal to the firm's real assets. The situation is more or less the same when an existing business enterprise builds a new plant—and this is the normal situation, as there have been very few entrants, probably because of the perverse system of financing as well.[5]

A highly-geared business enterprise is more vulnerable in the uncertain world because of its contractual obligations to creditors in the form of interest, but we may put this question aside for now. Newly started or expanding business enterprises are much more vulnerable because of their obligations to start repaying their debts (i.e., the increasing equity:debt ratio) immediately. Generally, they are required to repay their debt in a relatively short period, of five to ten years.[6]

Under normal conditions—where by "normal" we mean that enterprises are unable to increase the prices of their products—there is no inflation to make the debt burden easier; enterprises do not use depreciation funds to repay their debts, for they keep reinvesting their depreciation funds to sustain the unchanged real assets; and they do not obtain short-term credits to repay the long-term debts—they would simply go bankrupt, since their cash inflow would not permit them to repay the debt. They become, and stay, non-liquid and insolvent. They are kept alive only by permanent subsidies and by grants provided by the state, i.e., by politics. Politicians are very important, and in great demand.

What follows is that business enterprises start increasing their prices—obligations toward creditors being one of their "cost" items. Older enterprises are in a much better financial position, as they have almost no debt burden. Most of their capital is "owned" by them; they do not need to repay it any longer. They may be technologically backward, but new entrants are not a threat to them; they are however not a threat to these new entrants either, for they all exist under inflationary circumstances. New or expanding enterprises can increase prices to cover higher "costs" (the debt service burden[7]) and old business enterprises participate in the higher prices to cover their higher costs (due to their older technology) and, probably, to increase wages. If a newcomer is producing something unique, it is still less of a threat to the existing business enterprises, and they are less of a threat to the newcomer. Even if prices are under control the administration will give in and allow prices to be set high enough for enterprises to be able to service their debt.

All this is happening under inflationary circumstances. Policy makers are aware of the fact that restrictive monetary policy may produce a series of bankruptcies, shutdowns, and an increase in unemployment, and may initiate social unrest. It is, according to the judgment of politicans, better to make provision for an inadequate system to work somehow, rather than face the unpleasant reality which would force them to make changes that would encroach upon the existing distribution of power.

Finance becomes somehow normal in an abnormal situation, namely when there is inflation, as the debt burden of a newly created or an expanding business enterprise becomes lower and is reduced to the approximate level of interest payments. What we have are business enterprises which obtain external funding as permanently as capitalist or centrally-planned enterprises do. The "only" difference is that our business enterprises appropriate funds, or wealth, from their creditors. The process of usurpation of creditors' wealth occurs on a permanent basis, in order that the system may be able to function somehow. In a way, we can talk of a permanently revolving process of the "original accumulation" of "social capital."[8] Only in this way can we perhaps understand the otherwise nonsensical process of permanent revolution which is dear to the heart of politicians.

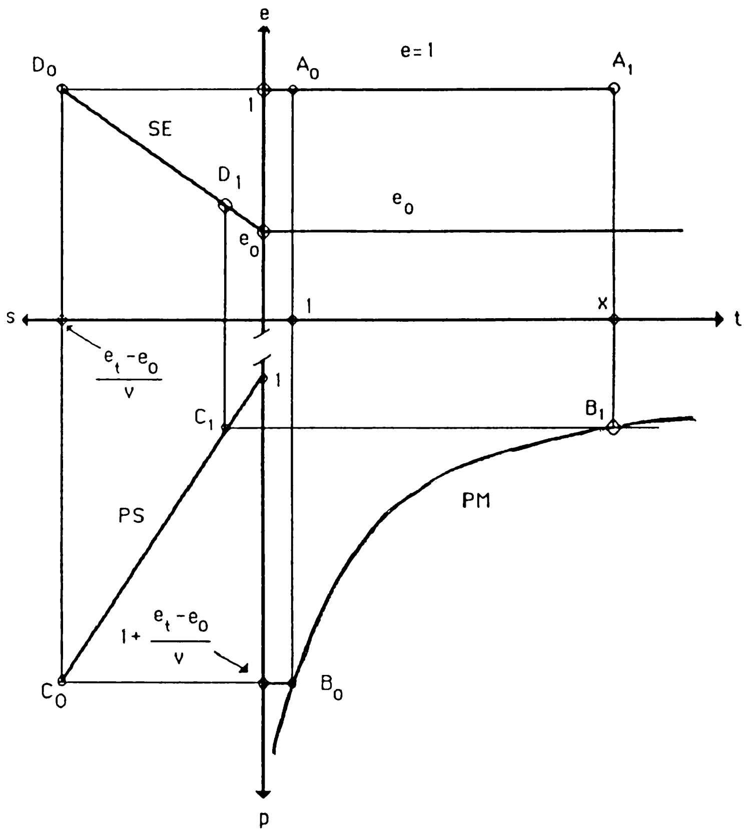
What this means is that, because of the permanent revolution and/or the permanent original accumulation of "social capital" we have had a permanently unstable economy and a permanently unstable society as well.[9] Even if we disregard their uncertainty, business enterprises can service their debt burden (which originates from the perverse system of financing their fixed assets) if the burden decreases because of inflation. So, inflation becomes a natural habitat for our finance, our economy, and our society. Beyond all of this is the more fundamental question of how to abolish the centrally-planned economy without really introducing in its place a market economy with all its social, political, cultural and ideological consequences.[10]

3. How our Business Enterprises Increase their own Funds

The problem may be illustrated by means of DIAGRAM I. Here, we are looking at a newly established or expanding firm, at the stage after it has become a going concern with no further investment or disinvestment (i.e., its real assets remain unchanged). We are interested, first, in its real assets; or, more precisely, in its fixed assets. (Inventories are financed more or less in the same way everywhere—even in Yugoslavia.)

In the northeast quadrant of this diagram we have two equity ratio lines—to the extent that we can talk about equity at all—line $\mathbf{e_0}$, which represents the equity ratio at the beginning,[11] and the curve $\mathbf{e} = \mathbf{1}$ which represents what is achieved when all debts have been repaid. In the northwest quadrant we show the savings and equity ratio curve (**SE**). If the debt should be repaid completely, i.e., if **e** becomes **1**, the savings must, in terms of total annual revenue, amount to $(\mathbf{e_t} - \mathbf{e_0}) / \mathbf{v}$, where **v** is the ratio between the total annual revenue of the firm and the value of its real assets.[12] It is a kind of velocity or turnover rate. In the southwest quadrant we have **PS**, the price and savings ratio curve. If the debt need not be repaid at all—if, for example, it is continuously financed—the price level may stay unchanged at the level of **1.O**. If the debt must be repaid, prices have to increase, and the amount of increase depends on the length of the period in which the debt must be repaid.

Chart 1 How our business enterprises manage to pay debts, i.e. increase equity to debt ratio (e)



t - time
s - saving ratio (savings to total revenue)
e - equity ratio (equity to assets)
p - price level

In the southeast quadrant we have **PM**, the curve representing the price and maturity of the debt.

If the debt must be repaid over a period of one year, we represent this as points $\mathbf{A_0}$, $\mathbf{B_0}$, $\mathbf{C_0}$ and $\mathbf{D_0}$. In this case, the price must increase to the level of $\mathbf{1 + (1 - e_0) / v}$. Only under these conditions and with all other conditions unchanged will there be enough room in the total revenue of the firm for the savings that are needed to repay the debt within one year. If the debt is to be repaid over a relatively long period (i.e., over the period extending from **0** to **x**), we are dealing with points $\mathbf{A_1}$, $\mathbf{B_1}$, $\mathbf{C_1}$ and $\mathbf{D_1}$. The price increase is much lower because the portion of savings in the total revenue of the period is considerably lower.

But things do not operate exactly in the way represented by Diagram I. Prices charged by other producers do not remain constant: they change too, and hence our producers can not find any room for savings in the nominally increased total revenue. Nevertheless, they succeed in decreasing their indebtedness because inflation is permanently decreasing their debt and increasing their own funds. Price increases must however be much higher than is represented in Diagram I. The relation between price level and the length of the period over which a change of the ratio from $\mathbf{e_0}$ to $\mathbf{e_t}$ is to be achieved, is as follows:[13]

$$\mathbf{p = [\ (1 - e_0) \ / \ (1 - e_t)]^{\ 1\text{-}t} - 1.}$$

4. Commercial Banks

As the system of permanent original accumulation of "social capital" takes place predominantly through the banks, it follows that banks are continually losing their assets, while their debtors—mainly business enterprises—increase their wealth (equity to debt ratio). But banks are just intermediaries, and so we must look at those who lend to them and at what happens to these lenders. There are two very different kinds of lender. First, there are those who have deposits expressed in dinars; and second there are those who have deposits, or (usually) claims, expressed in foreign currencies. Deposits in dinars are constantly decreasing in value because of inflation; since depositors are aware of this, they have to be persuaded by force to maintain their deposits in dinars; and banks behave more and more like institutions of power toward business enterprises, and toward non-private institutions in general.

Normally, deposits and liabilities in foreign currencies do not lose their value, whatever the inflation rate. But those who borrow from the banks are constantly increasing their wealth since they have credits only in dinars, and the banks' assets are shrinking in relation to their liabilities. Commercial banks have not tried to cover these differences (out of profit, special reserve funds, or their capital); they have just kept them in their balance sheets under the term "negative foreign exchange differences", or they hide them somewhere under "other items."

These "black holes" in the commercial banks' balance sheets are not however excessively large, because most of them are concentrated in the central bank. Most of the foreign debts and most individuals' foreign exchange deposits have been taken over by the central bank in a rather ingenious way that makes them invisible.[14] Nevertheless, commercial banks must have an enormously high interest rate spread, if they are to avoid losses—they have some "black holes" anyway: there are various non-earning, or very low-earning, assets and they have to keep large reserves with the central bank. An extremely high interest rate spread means that commercial banks cannot compete with direct financial flows between surplus and deficit economic units. They need protection on the part of government to keep them alive.

The idiosyncrasies which we have seen as the basis of our financial system therefore make our banks abnormal too: they make them into governmental institutions without political power. Our commercial banks have many more bad debts than usual and their deposits are much more volatile than usual, because they are generally small and have non-diversified customers. They are a closed type of institution. They do not allow the normal outflow of funds, as there are no "generalized claims" which would enable them to open up by making financial assets available which would be suitable for financing payment deficits and surpluses among various banks.[15] They are the ones that need protection on the part of local, regional or federal politics; and this protection is willing provided for them.

We may say that the core of the economic and socio-political system requires a monobank; but, because we have had a formally decentralized system (a two-stage banking system, with a large number of small commercial banks) it can function only in times of inflation. If, by some miracle, inflation were to disappear, the banks would be bankrupt.

5. The Central Bank

Our central bank—the National Bank of Yugoslavia, or since there are nine national banks, our National Bank System—is in the first place responsible for the working of the financial system, even though the system itself is basically wrong. It is in the central bank's balance sheet that we find most of the consequences of the permanent redistribution of wealth to the benefit of business enterprises, which finance their fixed assets (and their working capital needs) with bank credits provided on the basis of foreign loans and individuals' foreign exchange deposits.

Both these sources of bank funds—foreign loans and individuals' foreign exchange deposits—have been needed to meet the very high propensity for investment;[16] investment has secured a relatively low growth rate because of a very low investment efficiency. Credits to business enterprises are given in dinars, in the same way that credits are provided on the basis of dinar deposits.[17] Individual commercial banks would not be able to survive with such a high foreign exchange risk, as their foreign exchange liabilities would be many times greater than their foreign exchange assets. Authorities have not been prepared to face the truth and effect radical changes.[18] They have, rather, absolved the commercial banks from almost all the foreign exchange risk by absorbing this risk on their behalf. Because the central bank has made no provision to protect itself from a great foreign exchange risk of this kind, the negative foreign exchange differences have started to accumulate in its balance sheet. This is merely one of the clear items of evidence that we have in fact had a monobank system.[19]

Through the "generosity" of the central bank, the system works somehow; but, as time passes, it functions with greater and greater difficulty. Inflation is high, investment activity is very low, and there is no increase in productivity. The authorities normally play with interest rate policy: nominal interest rates are trying to catch up with the inflation rate and even overtake it. The problem of interest rates is however only what we see on the surface. At the core of the problems of finance and of what underlies finance are the problems of politics, i.e., whether the authorities are prepared to make the necessary changes in the society and in the economy which would make it possible for the economic and financial system to be decentralized in a non-inflationary environment.

6. How to Normalize the Yugoslav Financial System

Because of permanent increases in that part of the central bank's balance sheet which is designated as "negative foreign exchange differences," base money is being created, predominantly by the "monetization" of foreign exchange differences, i.e., by the monetization of non-performing or non-existing assets. In essence these negative foreign exchange differences are a government debt,[20] which is—for the time being—not recognized as such by the government. But if we are to have a normal financial and monetary system, this debt must be recognized by governmental authorities. This is one of the conditions required to make our financial system a normal one.

If this were to occur, we would arrive at more or less the same financial structures that can be seen in other market economies—those of capitalist countries, for instance. Business enterprises would finance their fixed assets predominantly with funds that did not need to be repaid—others would be able to have a permanent stake in enterprises—and the huge government debt would be apparent which originated in the 1970s and the 1980s, during the lifetime of the 1974 Constitution and the socio-economic system built upon it. Once it became public, the government debt would perform a very important financial function: government funds would be able to take over the function of "generalized claims" in the portfolios of commercial banks, which would make possible the normal financing of deficits and surpluses between regions by individual banks. Banks would then be open to the flow of funds, i.e., of capital.

We may ask ourselves: is it possible, finally, to have such an idiosyncratic financial system as we have, without strong coercion? The answer is: no. If we are to have a normal society and a normal economy, we must make provisions that will enable us to have normal finances, such as other market economies have—without regard to whether or not they are capitalistic. If, due to certain political or ideological considerations, it is impossible to have a normal financial system, built on the fundamentals of finance, then it is equally impossible to have a normal economy or a normal society. We prefer not to subscribe to such a fatalistic view. All other institutional arrangements in the society should take it for granted that they are not normal if they do not allow normal finances, i.e., a normal financial system, to function. Moreover, we consider the institution of "social property" to be one of these institutional arrangements, indeed we even give it foreground consideration.

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NOTES

* The ideas found in this article were first mentioned, very briefly, in my pamphlet *Emisija primarnog novca*, (Ljubljana/Belgrade: Narodna banka Slovenije & Institut za spolnu trgovinu, 1973) 49-50. They were further developed in "Finansiranje privrede i inflacija," *Socijalizam* (Belgrade) 9: 1243-61, 1984. In this version, further insights are added. It should be noted that since the present article was written, there have occurred significant changes in Yugoslav legislation with respect to business enterprises—thus, legal entities and real persons may have a permanent stake in a business enterprise—but it is still not certain whether or not this is something that will be implemented and remain as permanent.

1. These are the problems seen by our political and economic-theoretical establishment, although in our opinion these problems are endogenous variables of our socio-political system, and are determined by its idiosyncrasies, which are not noticed by the establishment.
2. This dictum can nowadays be encountered in connection with "sovereign debt" or "risk." Are our business enterprises like sovereign states, which can disregard their contractual obligations? Indeed, behind the bigger business enterprises one can find states, politics or politicians at various levels and in various forms.
3. This idiosyncrasy has other dimensions as well. Uncertainty and/or risk is not assumed to be something intrinsically connected with every economic activity. Central planners or politicians making business decisions are not like ordinary mortals: they can not only foresee the future, but they can force it to be what they want it to be, according to their own wishful thinking.
4. "Own funds" are social; but who is to carry the risk and reap the benefits? Is it the state, or maybe the workers employed in the enterprise?
5. As there are almost no entrants, there are no exits either. If we wish to make provisions for exits, we should make provisions for entries.
6. According to the established thinking, this is the just solution. In this way, funds or savings are available for other business enterprises as well. But the funds are available for others only if our business enterprise is repaying its debt by disinvesting (decreasing its real assets). Otherwise, the saving is provided from abroad (as was the case in the 1970s) or, in an inflationary way, by forced saving—as it has been since the inception of the self-management system.

7. It is something quite normal to see, among the cost items, besides depreciation charges also the debt burden ("annuities").
8. This happened through the confiscation or nationalization of privately-owned business enterprises, and it should not be repeated permanently thereafter.
9. In Yugoslavia, according to H.P. Minsky's definition, we can talk about speculative or Ponzi finance; see Minsky, *Stabilizing an Unstable Economy* (New Haven: Yale University Press, 1986) 200-204.
10. Or, how to abolish the centrally-planned economy without fundamentally changing the distribution of power, which is filtered down from above in small rations.
11. By equity ratio we refer to the ratio of "own funds" to debt or to all funds, i.e., to all assets or liabilities.
12. For the debt to be repaid completely, the savings ratio ($\mathbf{s = S/A}$), i.e., the ratio of savings ($\mathbf{S}$) to assets ($\mathbf{A}$) must be equal to the ratio $\mathbf{(A - E_0) / A}$, where $\mathbf{E_0}$ is the amount of equity capital, if the velocity $\mathbf{v}$ (the ratio of total revenue to assets) = **1**. Otherwise, we have to divide by $\mathbf{v}$: $\mathbf{s = (1 - e_0) / v}$ or $\mathbf{s = (e_t - e_0) / v}$, if we are to change the ratio $\mathbf{e}$ from $\mathbf{e_0}$ to $\mathbf{e_t}$.
13. We arrive at the expression in the following way: starting from the state where assets ($\mathbf{A_0}$) are equal to equity ($\mathbf{E_0}$) and credits or debts ($\mathbf{C_0}$), we arrive at the state where assets are expressed as follows: $\mathbf{A_t = E_t + C_0}$. Assets are nominally higher by the factor $\mathbf{(1 + p^t)}$ and credits remain unchanged: $\mathbf{A_t - A_0 \times (1 + p)^t}$, that is, $\mathbf{A_0 \times (1 + p)^t = E_t + C_0}$. Finally, we arrive at the expression via the following equation: $\mathbf{1 = e_t + (1 - e_0) \times 1 / (1 + p)^t}$.
14. For an explanation, see I. Ribnikar, "Emisija primarnega denarja in država," *Ekonomska revija* (Ljubljana) 1 (1987) 13-44.
15. The expression, and the general concept, may be found in J.C. Ingram, "State and regional payments mechanism," *The Quarterly Journal of Economic* 4 (1959) 662. What is happening in Yugoslavia is described in I. Ribnikar, "Financiranje gospodarstva in države ter territorialna zaprtost gospodarstva in bank," *Bančni vestnik* 3 (1988) 40-57.
16. Winiecki's explanation of the high propensity to invest in centrally planned economies is valid also for Yugoslavia; see J. Winiecki, "Distorted macroeconomics of central planning," *Banca Nazionale del Lavoro Quarterly Review* 157 (June 1986).
17. There should be no discrimination against those who obtain credits on the basis of dinar deposits. They should in any case be able to service their debts, i.e., to increase their "own funds" without really making savings.
18. The unpleasant truth is that the highly praised system, unique in the world, can function only in inflation.
19. In essence it has been the monobank system which has had the appearance of a two-stage banking system with decentralized (unit) banking systems, if we think of commercial banks.
20. An explanation may be found in various papers, e.g., in Ribnikar, "Emisija primarnega denarja." We may talk about external bank deposits if we wish to give an accurate theoretical designation to those foreign exchange deposits which are in excess of banks' earning assets. As foreign exchange deposits are claims on the central bank, they are—via the central bank—claims on the government, if the central bank has "black holes" on the asset side of its balance sheet. Therefore, "black holes" amount to a not yet recognized government debt.

POVZETEK

DENAR IN FINANCE V JUGOSLAVIJI

Čeprav se zdi, da je v mnogočem podoben normalnim zahodnim finančnim sistemom tržnega gospodarstva, je jugoslovanski finančni sistem v resnici zelo nestabilen. Ker investicije v tem sistemu v glavnem slonijo na bančnih kreditih, je večina jugoslovanskih poslovnih podjetij težko zadolženih; če pa hočejo ostati solventna, se ta podjetja morajo zanašati na večne subvencije, državne podpore ali na višanje cen. To pomanjkanje finančne discipline in inflacija povzročata erozijo finančnih aktiv komercialnih bank in akumulacijo nepokritih negativnih deviznih razlik v centralni bank, do katerih prihaja s prekomernimi provizijami bančnih kreditov od tujih posojil. Ker je večji del te finančne nestabilnosti in inflacije rezultat političnega vmešavanja v finansiranje poslovnih investicij in ekonomske aktivnosti, normalizacija jugoslovanskih financ in denarja mora navsezadne biti odvisna od tega, da politične oblasti priznajo potrebo po decentralizaciji ekonomskega in finančnega sistema v neinflacijskem okolju.