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Enterprise Arrears in Russia: Causes and Policy Options

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Abstract

This paper examines the causes of the large buildup of enterprise arrears in Russia during 1992, and evaluates policy options to deal with them. Noting the experience of Eastern European countries, the paper emphasizes that the settlement of arrears through wholesale extension of credit would only achieve a temporary reduction of arrears while inviting moral hazard problems and creating expectations of future bailouts. Instead, emphasis should be placed on measures that instill financial discipline and promote necessary structural changes. These measures should be supported by adequate legislation, effective supervision, and credible sanctions against defaulting enterprises and their managers.

JEL Classification

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Table of Contents

	<u>Page Nos.</u>
Summary	iii
1. Introduction	1
2. Enterprise arrears in the first half of 1992	2
a. Macroeconomic factors	5
b. Delays in clearing and settlement	7
c. Delays in interrepublic payments	7
d. Erosion of financial discipline	8
3. Enterprise arrears in the second half of 1992 and early 1993	10
4. The experiences in Eastern European countries	13
5. Preventing further accumulation of interenterprise arrears	16
a. Penalties	17
b. Bankruptcy proceedings and liquidation	17
c. Changes in payment procedures	18
d. Other measures	18
6. Policy options for dealing with the outstanding enterprise debts	19
7. Conclusions and summary of main recommendations	23
Bibliography	26

Summary

A rapid buildup of interenterprise arrears took place in Russia in the first half of 1992 and continued unabated through the second half of the year. Together with an accumulation of tax arrears and mounting enterprise debt to commercial banks, this buildup exerted severe pressure on the payments system and vastly complicated both the management of the economy and privatization efforts. This paper not only analyzes the causes of these developments and evaluates alternative policy options to deal with them but also briefly reviews the experience of East European countries that faced similar problems, drawing lessons where relevant.

Measures designed to settle the existing debts of state enterprises to other enterprises, the Treasury, and banks are distinguished from those aimed at preventing the accumulation of new payment arrears. In the absence of proper preventive measures, the complex operation of netting out and settling the outstanding arrears undertaken in Russia in the second half of 1992 was rapidly frustrated by an accumulation of new arrears due in part to the moral hazard created by the original operation. The analysis emphasizes that neither technical measures to streamline the clearing process nor credit operations to eliminate arrears can, by themselves, succeed in solving the problem unless accompanied by measures aimed at instilling financial discipline in the system and accelerating needed structural changes in state enterprises.

The paper's perspective is that measures to instill financial discipline in the payments system and prevent the accumulation of new arrears must take precedence over measures to settle existing debts. In particular, the practice of repeatedly extending credit to bail out indebted enterprises and clear up arrears should be avoided. Although some credit extension may be necessary to prevent massive unemployment due to a widespread collapse of state enterprises, new credit should be made conditional on the ability of individual enterprises to create detailed plans for restructuring their operations, as well as on their performance in carrying out these plans and meeting their payment obligations. The success of such measures will depend on well-conceived preparatory work that includes a clear and binding timetable for their implementation, a comprehensive legal framework, and the establishment of the institutions necessary to supervise the process. Otherwise, efforts to solve the problem through credit expansion will only exacerbate inflationary pressures and allow enterprises to delay indefinitely the necessary adjustments in production and employment.

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1. Introduction

The rise in interenterprise arrears in Russia during the first half of 1992 was both striking and alarming: in just a few months these arrears increased from less than 3 percent to more than 150 percent of broad money, or by about rub 3 trillion. ^{1/} By comparison, total outstanding credit of the banking system to the economy, except for credit to the Government, was less than rub 2 trillion by end-June 1992. Despite extensive efforts to settle the outstanding stock of arrears in the second half of the year, they have remained a serious problem in Russia and throughout the ruble area.

The rise in interenterprise arrears evolved in steps. From end-December 1991 to end-March 1992, the arrears increased by some rub 640 billion while enterprises also accumulated large arrears to banks as well as tax arrears. On April 1, changes in the regulations of the Central Bank of Russia (CBR), requiring all payments to be processed through the CBR cash settlement centers, slowed down the clearing process and contributed to a surge of rub 1.2 trillion in interenterprise arrears, which then totaled more than rub 1.8 trillion. In May and June, the recorded arrears grew further, to over rub 3 trillion. In July, the CBR made extensive efforts to settle outstanding arrears in a campaign that lasted more than four months; nevertheless, a survey of industrial enterprises ^{2/} indicates that interenterprise arrears continued to grow in the subsequent months, despite massive extensions of credit from the CBR (through the banking system) to state enterprises. The credit provided by the CBR at highly subsidized interest rates has allowed enterprises to meet their wage bills and some of their payment obligations to other enterprises and to their banks, thereby slowing down the rise in interenterprise arrears. At the same time, credit fueled inflationary pressures, and, since October, consumer prices have risen at monthly rates of 25-35 percent.

The buildup of interenterprise arrears and the massive flow of credit to state enterprises severely complicate macroeconomic management and undermine the economic reforms for a number of reasons. *First*, interenterprise credit was used "as a substitute for both transactions and precautionary money holdings, interacting with the economy by influencing the velocity of circulation," thereby making it more difficult for the monetary authorities to predict the demand for money. ^{3/} In the first half of 1992, the wide use of informal interenterprise credit not intermediated by the banking system obviated the need for debtor enterprises to borrow to meet their commercial obligations, thus reducing the demand for loanable funds and depressing the interest rates. It may also have provided an incentive for payments in cash, thereby raising the demand for cash and

^{1/} The recorded stock of interenterprise arrears is the aggregate amount of payment demand orders that have been presented to the banking system but have not been executed because of insufficient funds in the account of the payer.

^{2/} Since July 1, 1992 the banks are no longer reporting the arrears.

^{3/} Ferris, J.S. (1981).

compounding the problem of the scarcity of banknotes. *Second*, large receivables of uncertain realization on the enterprises' balance sheets made the assessment of their net market value by banks and by potential investors far more difficult, distorting their creditworthiness, and complicating privatization efforts. *Third*, the erosion of financial discipline, evidenced by the accumulation of large debts and reinforced by the massive extensions of directed credit, also eroded the other controls of the central authorities over state enterprises, encouraging tax evasion, capital flight, fraud, and unchecked spending. *Fourth*, as long as enterprises are permitted to run arrears and to finance their operations through periodic credit extensions, they have no incentive to adjust their production and employment levels to the new market conditions. Neither the market reform nor the macroeconomic stabilization effort can be effective, however, unless enterprises make these adjustments.

The purpose of this paper is to analyze the origins of the rise in enterprise arrears in Russia, evaluate the broad effects of the arrears on the economic reform, and examine policy options for dealing with the problem. Since Eastern European countries have experienced similar problems in the past two years, and to various degrees are still struggling with them, a brief review of their experiences is conducted and the lessons are noted.

Section 2 examines the origins of the breakdown of the payments system in Russia, and analyzes the initial buildup of interenterprise arrears in the first half of 1992 and identify its causes. Section 3 reviews the developments in the second half of 1992, including the operation to settle the outstanding arrears that was conducted by the CBR. Section 4 reviews similar developments in a number of Eastern European countries and the policy measures implemented in these countries to deal with these problems. Section 5 suggests measures to prevent the accumulation of new arrears in Russia, and Section 6 examines policy options for dealing with outstanding enterprise debts. Section 7 offers some conclusions, and summarizes the main recommendations.

2. Enterprise arrears in the first half of 1992

The payments system crisis in Russia, marked by a massive accumulation of interenterprise arrears, is a direct outcome of the breakdown of the command economy system. The payments system in the Soviet Union has always been slow and relatively inefficient, stemming in part from the centralization of all noncash payments clearing through the Central Bank, which tried to monitor every transaction in the economy and maintain a paper trail of

every transaction. 1/ Nonetheless, the payments system as a whole continued to function as long as the controls of central planning were tight and effective, and there was no room for payment defaults. However, as these controls were abandoned, and in the absence of any alternative binding legal framework to regulate financial transactions and monitor their execution, the payments discipline eroded rapidly and arrears became a problem. These points can be seen more clearly by analyzing the main components of the payments system: (a) the enterprises; (b) the banks, and (c) the processing of payment instructions.

Under the centrally planned system, the main task of enterprises was to transform inputs into outputs to meet production targets. Profitability and product marketability were not a concern. Prices were set so as to ensure that the cost of production and salaries were fully covered. Interenterprise payments were guaranteed by the centralized payments system, and negotiations between enterprises therefore had to do only with the quality and timing of deliveries. There was virtually no room nor any need for discussions on financial arrangements between enterprises.

Banking also had different objectives and modus operandi than those of profit-oriented banks in a market economy. The main functions of the banks in the Soviet economy were to "lubricate" the system with enough credit to make sure that the plan would not be derailed because of a lack of funds, and to monitor the financial behavior of the enterprises to ensure that they made their tax payments and did not waste resources. For the most part, the banking system's activities were limited to providing or denying financial resources to enterprises according to instructions received from the Government. Thus, financial or market analysis had practically no role in the process of credit approval. When an enterprise did not have sufficient funds to cover payments to another enterprise, a loan was extended by the bank almost automatically.

The payments system reflected the precedence of production and deliveries over financial transactions. 2/ Until June 1992, *payment demand orders*, by which an enterprise that provided goods or services to another enterprise submitted a request for payment to the enterprise that received those goods or services, were the most important payment instrument. *Payment orders*, by which an enterprise instructed its bank to trans-

1/ Outmoded, paper-based methods of transferring funds have slowed the system still further, often causing considerable delays in settlement (float). Indeed, some buildup of arrears and frequent gridlock (enterprise A couldn't pay enterprise B because it had not yet received payment from enterprise C), also occurred in the past--and were resolved through nearly automatic extension of credit by banks, and, periodically, also through cancellation of cross debts of enterprises. The outstanding balance of arrears was presented to the Central Bank for financing at least once a year.

2/ For further details on the payments systems in the Soviet Union, see International Monetary Fund, FSBD (1992).

fer payment for goods or services it had received from another enterprise, accounted for some 20 percent of the total noncash payments, while checks and letters of credit accounted for less than 10 percent. A payment demand order was submitted by the seller to its bank which, in turn, forwarded the order form to the bank of the buyer. The bank of the buyer notified its client that a payment order would be issued in three days. Unless instructed otherwise, the bank of the buyer issued the payment order after three days without verifying that the payment demand order had been accepted by the buyer--although the payments system (through the so-called MFO accounts) provided for reversing such payments later if the buyer refused to make the payment. 1/ The bank of the buyer normally debited the account of its client on the day it submitted the payment order to the cash settlement center (CSC). Payment demand orders were sometimes credited to the account of the seller as soon as they were lodged with its bank, although normally the bank of the seller credited its client's account on the day (or the day after) receiving the payment order from the CSC. 2/

Clearing and settlement procedures required much manual work; payment instruments were not sufficiently standardized; and payment instructions were often sent through the mail. The results were delays in clearing of up to three weeks (and even longer for long distances) and a significant debit float, which increased the liquidity available to the nonbanking sector. This payments system could function in a more or less orderly fashion as long as there was almost no inflation and all enterprises had a full guarantee that all the expenditures made in accordance with the objectives of the annual production plan would eventually be paid.

The economic reforms were aimed at changing the behavior of all economic agents in Russia and the rules by which they operate. Enterprises were expected to restructure their production lines toward the production of goods and services that were in high demand by end users, and guide their operations on the basis of profitability considerations. In practice, however, little changed in the operation of enterprises, even though prices changed many times over and effective demand at the retail level declined sharply. As a result, many enterprises were no longer able to cover even their wage payments from the proceeds of the sale of their products, let

1/ "Refusal to pay" occurred when a payment demand order that had been processed needed to be reversed. These reversals were included in a separate account (the debit side of 830). The amounts in that account increased from rub 130 billion to 330 billion during the two-month period from March 1 through April 30, 1992.

2/ When a payment demand order was presented for execution but the buyer's account did not have sufficient funds, the bank notified the buyer and placed the payment demand order in an off-balance-sheet account denominated File No. 2. Gross interenterprise arrears refer to the aggregate amount of funds in File No. 2; net arrears represent the involuntary extension of credit from the net creditor enterprises to the net debtor ones. File No. 2 does not include wage and tax arrears, nor the "refusals to pay."

alone their outstanding payment obligations to other enterprises. With the increase in the number of enterprises that could not meet their payment obligations, the rise in "refusals to pay," and the growing reluctance of banks to provide financing to enterprises that submitted payment demand orders, these payment backlogs were transmitted to the entire economy, leading to an accumulation of large arrears that affected all enterprises, viable and nonviable alike.

For a while, Gosbank (as long as it was still operating--until December 1991), and later the Central Government, stepped in and provided all enterprises with enough cash to meet their wage payments in an effort to prevent unemployment and a sharp drop in incomes. However, the gridlock created by the accumulation of arrears had a snowball effect on the entire payments system, and commercial banks were flooded with payment demand orders that could not be settled because their clients did not have enough funds to execute the payments. When this had happened under the previous system, the monetary authorities had stepped in and organized an economy-wide settlement of all payment arrears through the cancellation of all the cross debts of enterprises (by liquidating the arrears in File No. 2) in order to prevent payment defaults. However, the increase in arrears in early 1992 was far more rapid than in the past, and the logjam in the payments system reached near crisis proportions before the CBR finally intervened in early July. Expecting a central bailout operation, many state enterprises appear to have deliberately delayed their payments to other enterprises, to the Government, and (though initially on a much smaller scale) to the banks, while neither creditors nor the central authorities have been able to enforce the collection of the overdue payments. It is worth noting that the collapse of the command economy system created similar problems of enterprise arrears in other states of the former Soviet Union (FSU), as well as in other Eastern European countries.

Hence, whereas in early 1992 the accumulation of arrears had been spurred mostly by changes in macroeconomic conditions such as spiraling prices and the tightening of credit policies, and had later been compounded by technical problems in the payments system, it reached its present dimensions primarily as a result of the collapse of financial discipline and the emergence of a new structure of incentives that, in practice, rewarded enterprises for suspending payments. A more detailed discussion of these factors follows.

a. Macroeconomic factors

Price liberalization in the early phase of economic reform brought large price increases and, in the period from January through June 1992, industrial producer prices rose by more than 2,000 percent. This rise, in itself, explains about one third of the overall rise in the volume of interenterprise arrears during that period. The accelerated inflation also gave an incentive to delay payments. The sharp price increases, together with the shift in government priorities away from investment and defense products, spurred a fall in demand for a broad range of products and a consequent realignment of relative prices.

Facing steep declines in sales and growing inventories, many enterprises found it increasingly difficult to mobilize the funds necessary to meet their payment obligations to other enterprises, to their banks, and to the Government, and their debts ended up being transmitted, through mounting gridlock, to the entire economy. Moreover, since by law the payment of wages and taxes had to take precedence over all other payments, enterprises had great difficulties in paying their suppliers.

Most enterprises that experienced a decline in sales opted, however, to delay any adjustment in their production rather than scale down their operations, partly in response to pressure from the workers' councils to avoid employment cuts, and partly in the expectation that the Government would be forced by strong political pressure to step in and provide them with financial assistance. Furthermore, long-term interenterprise linkages and expectations for the traditional clearing of arrears encouraged suppliers to continue deliveries of goods without taking the necessary precautions to secure payment, or to use alternative, less risky payment instruments.

In an effort to control the escalating inflation, the monetary authorities began, in early 1992, to curtail credit expansion and restrict further increases in banks' indebtedness to the Central Bank. In addition, enterprises tried to reduce their bank balances as a way of delaying their tax payments in order to reap inflationary gains, since tax arrears carried no interest payments. As a result, the banks faced mounting liquidity problems and a deterioration in the quality of their assets. 1/ Indeed, in April, the CBR had to grant emergency credit to the commercial banks (pending proper verification of payment instructions) in order to avert a sharp overall liquidity squeeze. Nevertheless, a bank in Moscow was declared insolvent shortly afterwards and practically all the other banks became increasingly burdened by a massive accumulation of nonperforming assets.

In the subsequent months, the banks tried to be more selective and discretionary regarding credit extension as the enterprise arrears mounted. Since it was becoming more and more difficult to identify the solvent and creditworthy enterprises, however, and since commercial banks had no prior experience in screening credit applications, many of their loans were granted under political pressure rather than on the basis of economic considerations. Nevertheless, the large excess reserves accumulated by commercial banks at the CBR by mid-1992, provide some evidence of the banking system's reluctance to lend. 2/

1/ Another cause of the banks' problems, particularly at the end of first quarter, was the delay in adjusting their interest rates in response to the increase in CBR interest rates and reserve requirements.

2/ Excess reserves of banks at the CBR as measured by the correspondent accounts increased from rub 220 billion in March to rub 900 billion in May. Initially, however, some of that increase was involuntary, resulting from a growing payments float.

The credit squeeze caught many enterprises with almost no working capital. Under the previous system, enterprises had very little need for working capital since the flow of payments was regular, albeit slow, and there was no inflation. Their needs for working capital rose sharply in early 1992 as inflation accelerated, the payments system slowed down, and a growing number of transactions, especially with enterprises in other FSU states, were conducted against cash payments. However, enterprises were sluggish in making the necessary adjustments and in building up working capital. In an effort to avert the excessive reduction, in real terms, in enterprises' working capital, the Government initiated a scheme that allowed specific enterprises to recover their past (i.e., under central planning) levels of working capital--after adjusting for the price increases--through CBR rediscounting of working capital loans extended by the banking system. This mechanical adjustment of working capital took no account, however, of the current needs of enterprises stemming from the changes in relative prices.

b. Delays in clearing and settlement

Although the severe buildup of interenterprise arrears since the beginning of 1992 appears to be primarily the result of factors other than payments system gridlock, delays in settlement and the inefficiencies in the payments system contributed to worsening the arrears situation. The volume of payments in the process of settlement (float) on April 1, 1992 is estimated to have been rub 159 billion (around 65 percent of currency issue in Russia). To regain its control over the clearing process, the CBR issued, on April 1, 1992, a regulation requiring all payment instructions to be processed through the cash settlement centers individually, thereby closing the door on all interbank or even intrabank clearing and netting operations. The concentration of the clearing process created large backlogs in the processing of paper payment instructions, exacerbating payment delays. The problems created by this decision were so serious that the CBR had to rescind it--first in Moscow and St. Petersburg on April 26 and then in all the other areas, as of May 11, 1992. Nevertheless, long delays in settlement still persist for noncash payments.

c. Delays in interrepublic payments

Several factors contributed to clogging the interrepublic payments system in the first half of 1992. First, with the dissolution of the Soviet Union, many enterprises and banks delayed the settlement of payment demand orders that had been submitted under the previous system until the new clearing and settlement arrangements related to interrepublic payments became clear. Second, changes in CBR regulations that were enacted on January 1, 1992 required all interrepublic payments to be cleared through

bilateral correspondent accounts of the national banks. 1/ These changes resulted in long delays in processing, and the new rules and regulations lacked clarity. Unsettled payments of state enterprises in Russia to counterparts in other FSU states (as reported in Accounts 990 and 991 of the CBR) totaled rub 226 billion in April 1992; 2/ gross arrears outside the suspense accounts were much higher, perhaps as much as rub 700 billion. Third, some of the delays may have been the result of deliberate efforts by the Russian authorities to slow down interrepublican trade--especially their exports to the other republics--in order to limit the implicit credit granted by Russia to the republics and the transfers associated with their highly subsidized exports. 3/

d. Erosion of financial discipline

The large buildup of payment arrears from the second quarter of 1992 onward was due increasingly to the erosion of financial discipline and the expectations of the enterprises and commercial banks that the Government and the CBR would intervene to bail them out. As the crisis deepened and widened, it appeared more and more likely that the Government would have to intervene--both by providing cheap credit and by assuming part of the enterprises' debts--at least in order to allow the state enterprises to meet their wage bills and to prevent the collapse of the commercial banks. Although these expectations had already played a role in the buildup of arrears in the early months of the year, as the delays in payments became more widespread, the managers of the state enterprises must have realized that any payment on account of their debts would merely represent lost revenues when the Government and the CBR finally intervened. It is also likely that they realized that while punitive measures could have been taken against a few isolated debtors in order to deter potential offenders, the Government could not afford to initiate widespread sanctions against all the defaulting enterprises. Furthermore, lacking a bankruptcy law and having no authority to threaten bankruptcy and foreclosure, the Government and the banks were unable to enforce contracts or take credible punitive measures.

1/ Unsettled payments were placed in suspense accounts--Account 990 before April 1, 1992, and Account 991 thereafter until July 1, 1992--in the Central Bank of Russia until confirmation was received from the payee through its central bank. When that confirmation arrived at the central bank of the payer, funds were shifted from that account to the correspondent account of the central bank of the payee at the central bank of the payer. The value outstanding in that account is equivalent to the gross interrepublican arrears. These payments in process of settlement (CBR Accounts 990 and 991) were not included in the interrepublic netting process.

2/ It should be noted though that settlement payments recorded in CBR Accounts 990 and 991 do not enter the payments process.

3/ Also, Russian enterprises paid their domestic suppliers first, knowing that most of their suppliers in the other FSU states would continue to deliver their products owing to the continued use of state orders supporting intergovernment barter agreements and to a lack of alternative markets.

The apparent inability of the Government, the CBR, and the commercial banks to take preventive or punitive measures, in turn, fed the expectations of a wholesale government bailout. Those expectations prompted managers of state enterprises to delay payments, and the mounting delays further increased the moral hazard. In short, the more acute and more extended the crisis, and the larger and more widespread the buildup of arrears, the greater the expectations that the Government would have to intervene. At the same time, the central planning mentality encouraged enterprises to continue the delivery of goods and services to other enterprises, even though they did not expect to be paid, trusting that if they met their production plans, the Government would be obliged at least to cover their wage bill.

The decision that managers of state enterprises had to make--namely, whether or not to settle the payment obligations of their enterprise to other enterprises posed a dilemma: if all enterprises were to make their payments on time, as was more or less the practice under the previous system, at least the viable ones would be able to cover their expenses and possibly even make a profit. 1/ However, if all other enterprises made their payments on schedule and only the enterprise in question was able to suspend its payments without being penalized--as the new rules (or lack of) seemed to allow, and since interest rates on arrears were very low (generally zero)--its revenues and profits would obviously be much larger. If only that enterprise made payments to others without receiving any payments from them, it was bound to suffer very large losses and faced the risk that the Government would close it down or change its management, whereas if all enterprises suspended their payment obligations, all would suffer losses, but in that case their managers had reason to expect (quite rationally, as the recent experience shows) a government bailout that would reduce their losses and allow them to continue their operations. The worst problem that they would potentially face under these circumstances would be to have to pay their debts later without interest or severe penalties. Presented with this pay-off matrix, the only rational decision that the manager of a viable enterprise--let alone the manager of a nonviable one--could make was to suspend payments as much as possible. 2/

The erosion of financial discipline, the deterioration of central controls over the production apparatus in mid-1992, and the absence of effective penalties allowed the managers of state enterprises to suspend due payments, and this in turn precipitated the erosion of these controls. Evidence that the accumulation of enterprise arrears was due to deliberate decisions to suspend payments, even when enterprises had sufficient funds, can be drawn from the considerable rise in the foreign currency position registered in 1992. In the absence of penalties or interest charges on

1/ The "dilemma" would be even sharper if all enterprises were viable and all could make some profits in the cooperative solution.

2/ In the case of two viable enterprises, the (Nash) equilibrium: [do not pay; do not pay] is therefore Pareto-dominated by the solution: [pay; pay] and hence the "dilemma."

suspension of due payments, these enterprises had no incentive to reduce their foreign currency positions to meet payment obligations. The key to a resolution of the arrears problem therefore lies in restoring financial discipline and creating a structure of incentives and penalties that can effectively deter the managers of state enterprises from defaulting on their future payments.

3. Enterprise arrears in the second half of 1992

In mid-July 1992, when gross interenterprise arrears reached the level of approximately rub 3 trillion, the CBR implemented a netting out operation in an attempt to resolve the problem. The CBR instructed the commercial banks to identify in File No. 2 all payment arrears of Russian state enterprises to other state enterprises within Russia and to set up special balance sheet accounts that would record all credit and debit instructions related to the gross arrears as of July 1. Once the arrears were identified and registered in that special account (No. 725), the banks sent payment notices on behalf of their debtor enterprises to the banks of their creditors. The bank of the debtor enterprise debited the special account of that enterprise upon sending the notice and the bank of the creditor enterprise credited the special account of its client upon receiving that notice. At the end of the process, the special account of each enterprise was debited by an amount equal to all its outstanding debts to other enterprises as of the cutoff date and credited by an amount equal to all the outstanding payments due to that enterprise by other state enterprises in Russia as of the cutoff date. After netting out all the payables and receivables in the "payment notices," net debtor enterprises found themselves with debit balances of rub 480 billion in the special account, while net creditor enterprises had credit balances of rub 450 billion--the difference being due to errors and omissions in the notification and clearing process. The process was concluded in October and meant that interenterprise arrears were reduced to about rub 450-480 billion. 1/

On October 15, the CBR instructed the commercial banks in Russia on how to deal with the remaining credit and debit balances in the special accounts. Credit balances of each net creditor enterprise with other Russian enterprises (in Account 725) were used to service its debts to commercial banks. After this operation, the remaining credit balances were very small and, after having been frozen for a month, were transferred to the current accounts of these enterprises. Debt balances of net debtor enterprises were settled with funds in their current account, if balances were available, and with a loan granted by their bank, if they were not. To the extent that the bank did not have enough loanable resources, the funds were provided by the CBR, and will be due for repayment on March 31, 1993.

1/ In August, a similar process was initiated to net out arrears between Russian enterprises and state enterprises in the other FSU republics. For that purpose, separate special accounts (No. 721) were set up and "payment notices" were sent for the interrepublican arrears. The completion of this process was slowed down by disputes.

Although the netting operation may have substantially reduced the enterprise arrears outstanding on July 1, 1992, new arrears seem to have been accumulating even while the netting process was being implemented. Unfortunately, on July 1, the authorities also ordered the closing of File No. 2, so that interenterprise arrears are no longer recorded in the banking system. ^{1/} As a result, the accumulation of arrears after that date is recorded only in the balance sheet of the enterprises (as debt obligations to, and claims on, other enterprises), making it difficult to establish precisely what has happened since then with enterprise arrears. To fill this information gap, the Goskomstat has been producing estimates of the stock of arrears of some 22,000 industrial enterprises, including the arrears of enterprises in other FSU republics to Russian enterprises. These estimates are not directly comparable, however, with the figures in File No. 2 in terms of their coverage and definitions. Nevertheless, in August, these estimates indicated that the gross arrears were rub 1.8 trillion, far above the level attained as a result of the netting operation started in July. Data for September show a further increase in arrears, to rub 1.9 trillion, indicating a tendency for stabilization, though at a very high level. What seems clear is that efforts by the Government to tighten its control over the money supply early in the third quarter quickly met growing political resistance as more and more enterprises began to have problems paying wages. Faced with the threat of massive unemployment, the Government began de-emphasizing financial discipline and concentrating its attention on the use of credit extension as a kind of social safety net.

In the third quarter of 1992, bank credit to the economy rose by more than 100 percent and in the fourth quarter it rose further, by 65 percent, mostly reflecting the expansion of CBR lending to commercial banks in the form of earmarked loans to particular sectors and regions. It is estimated that in 1992 as a whole the CBR provided rub 2.8 trillion worth of credit. These loans carried highly subsidized rates and were directed, predominantly, to state enterprises and sectors that were structurally net debtors. During the second half of 1992, the interest rate on CBR credit rose only marginally from a monthly rate of 6.2 percent in July to 7.3 percent in December, while the monthly inflation rate rose from 8 percent in July to over 25 percent from October forward. ^{2/} The main result of this credit expansion was a weakening of financial discipline and a rekindling of inflation pressures in late 1992. In addition, it made it impossible to use

^{1/} Except for arrears of enterprises in the railways and the nuclear energy sector.

^{2/} Monthly percentage change of the urban CPI. The hybrid CPI rose by an average monthly rate of 10.6 percent in the third quarter, and by an average of 25 percent a month in the period from October 1992 through January 1993.

financial intermediation mechanisms to secure an efficient allocation of resources. 1/

The cheap credit provided by the CBR succeeded, for better or worse, in keeping the enterprises--many of them nonviable--operating by allowing them to pay their employees and even meet some of their payment obligations to their suppliers and to the banks. Thus, one can say that at least in part, this credit expansion represented a replacement for arrears accumulation. Nevertheless, despite the increase in credit and in budgetary transfers to enterprises, it appears that since the generalized netting out and clearing of interenterprise arrears by the CBR in July 1992, substantial new interenterprise arrears have again accumulated. The trends in the second half of 1992 seem to give added weight to the argument that without financial discipline it is not possible to correct a situation of widespread enterprise arrears, even when a large credit expansion is providing additional resources to the enterprises.

In mid-1992, the CBR also intensified its efforts to control the interrepublic payments, especially between enterprises in FSU states in the ruble area, in order to tighten its monetary controls and contain the transfer of resources from Russia to these states through price subsidies and lending. As of July 1, 1992 all payments between central banks had to be effected through the CSC in Moscow, and as of August 6 banks were required to obtain prior permission from the CBR to open correspondent accounts with commercial banks in another republic. These restrictions did not apply to commercial banks in the Baltic states nor in Ukraine after they introduced their own national currencies. Commercial banks took additional measures to reduce their exposure to interrepublican payments risks, primarily by insisting on matching payments, whereby a payment obligation of a FSU republic enterprise to a Russian enterprise had to be matched by a payment obligation of the Russian enterprise to an enterprise in that republic. These arrangements appear to have slowed down the flow of payments and, gradually, the flow of trade between the republics as well. At the same time, the limits on the amounts effected through the correspondent accounts of the national banks at the CBR were not strictly enforced, and intergovernmental settlements could be effected via the correspondent accounts of commercial banks, bypassing the correspondent accounts at the national banks.

1/ Commercial banks have often been reluctant to lend their own funds and have grown highly selective in the face of a large demand for funds by enterprises and sectors. They have provided principally short-term loans at relatively high interest rates that rose from 63 percent in July to nearly 100 percent toward the end of 1992 and to 105 percent in February 1993. Nevertheless, these interest rates were still negative in real terms.

4. The experiences in Eastern European countries 1/

Interenterprise arrears became an endemic problem in practically all the previously centrally planned economies (CPEs) once the economic reform process began, and they all had to cope with a legacy of nonperforming enterprise loans in the portfolios of the commercial banks. In Czechoslovakia, interenterprise arrears grew rapidly after 1990 and the nonperforming loans accounted for nearly 20 percent of total bank debt. During 1991, the ratio of gross arrears to broad money rose from 9 percent to 24 percent and, at the end of 1991, the stock of the arrears reached its peak at Kcs 170 billion, or some 17 percent of GDP. In Poland, interenterprise credit reached a level of about 160 percent of the total bank credit to enterprises in early 1990, and the nonperforming loans accounted for some 40 percent of the total loan portfolio of the banking system. 2/ By the end of 1991, the level of interenterprise credits had declined somewhat, to 125 percent of credit to enterprises, or about 21 percent of GDP. In Romania, gross interenterprise arrears grew almost 18-fold during 1991, bringing their value at the end of that year to 53 percent of GDP and more than 200 percent of broad money.

Interenterprise arrears were somewhat less marked in Hungary and Bulgaria, although nonperforming loans constituted a considerable portion of the total bank debt. In Hungary, the stock of gross interenterprise arrears reached about 8 percent of GDP and 17 percent of broad money in April 1992. 3/ Most of the arrears were concentrated in a relatively small number of large insolvent enterprises. Nonperforming loans were estimated to be 20 percent of the total debt of the banking system.

In Bulgaria, accumulation of arrears was discouraged by strong disciplinary measures such as a penalty rate on overdue payments, instructions to enterprise managers to stop deliveries to clients running up arrears, penalties on senior management of enterprises in chronic arrears (over 60 days overdue), including claims on their remuneration, and possible liquidation of the insolvent enterprise. These measures seem to have been effective in discouraging the accumulation of arrears. Nevertheless, nearly 40 percent of the total portfolio of the commercial banks remained nonperforming.

1/ For more detailed information on interenterprise arrears in Eastern Europe, see, for example, Begg and Portes (1992) for Czechoslovakia, Bofinger (1992) for Poland, and Khan and Clifton (1992) for Romania. This section also benefitted from access to unpublished memoranda by V. Koen and S. Schadler.

2/ Data on interenterprise arrears are not available in Poland.

3/ These figures represent the amount of interenterprise credits of enterprises effectively declared insolvent by the National Bank of Hungary (NBH) by its refusal to rediscount their bills of exchange. Therefore the total amount of arrears is understated.

Measures to eliminate arrears varied widely between countries. In Hungary, the Government initiated a privatization plan and implemented a new bankruptcy law that required the institution of compulsory bankruptcy proceedings for enterprises with gross payments arrears--including arrears in taxes and social security contributions--and gave defaulting enterprises 90 days to reach an agreement with their creditors. ^{1/} After that period, if an agreement were not reached, liquidation would have to be initiated. This process could last up to two years, during which time production in that enterprise could continue. In addition, penalties for noncompliance could be imposed against the managers of these enterprises. The initial privatization effort was only partly successful, however, and later the Law on Economic Transformation removed state enterprises from the jurisdiction of enterprise councils and gave them company status in order to ensure their restructuring and financial discipline. Furthermore, since some of the privatization was initiated by managers of state enterprises looking for potential buyers, these managers had a strong incentive to secure the payments that were due to their enterprise. In the coal mining industry, the Government assumed the enterprises' debts on a case-by-case basis, liquidating some of the nonviable enterprises and demanding of others a clear recovery plan with a strictly enforced budget constraint.

In Romania, a broader range of measures was used. In mid-1991, the authorities opened a refinancing line for banks, which were instructed to extend credit to net debtor enterprises for the sole purpose of clearing arrears. That scheme did not work, and credits were not repaid as planned, thereby merely shifting the arrears from the enterprises to the banks, and ultimately to the National Bank of Romania (NBR). In July 1991, the authorities asked banks to record all claims that enterprises had against each other, so that the NBR could extend as much credit as necessary, through a special ("compensation") account, to enable all enterprises to service the claims against each other. A scaled-down version of the scheme was implemented in late August without making any sizable change in the balance of gross arrears.

In December 1991, Parliament passed a law that implemented a "global compensation" operation and instructed banks to extend credit, under government guarantees, to clear the *gross* amount of interenterprise arrears. The compensation credits had a six-month maturity with interest rates at market levels. That eliminated all known interenterprise arrears, but it brought an increase of 17 percent in the money supply and contributed to doubling the supply of broad money during the year.

To resolve the moral hazard problem and convince enterprises that there would be no further compensations, the Government instituted a detailed monthly reporting system for all state enterprises. The system provides up-to-date information on the financial position of each enterprise, including

^{1/} However, it was possible for enterprises to obtain an extension of this period.

any arrears, and thus enables the Government to take action on a *selective* basis against enterprises that run arrears.

A new draft law has declared economic agents with 30-day past due payment obligations insolvent and directed financial institutions to make the identity of these agents public. Moreover, following a court decision confirming insolvency, creditors can act to liquidate the unsettled claims through a court-ordered sale of defaulters' assets. Also, creditors are able to initiate bankruptcy proceedings against debtors if an agreement on overdue payments cannot be reached, and the Cabinet, on its own initiative, may take measures against some of the largest defaulting enterprises. These measures include accelerated privatization, full or partial liquidation, and management changes. While there are already signs that enterprises are changing their attitude, it may take some time, considerable structural change, and possibly additional measures before the practice of indefinitely delaying payments is eliminated.

In Poland, the privatization of larger, state-owned enterprises is proceeding very slowly and the Mass Privatization Law on public participation in share ownership has already been under discussion for two years, but progress has been slowed by delays in legislation. By early 1993, some 15 percent of state-owned enterprises had been privatized through liquidation by the sale or lease of their assets to new companies set up by their employees. The bill on mass ownership proposed by the Government envisages the simultaneous privatization of 500 state enterprises currently under treasury ownership. Every adult citizen would be entitled at a nominal cost (10 percent of monthly income) to a government share certificate representing a predetermined portion of the enterprise's assets. Shareholders would be subsequently free to sell their holdings or keep them as an investment. Each certificate would represent a shareholding in one of a number of National Investment Funds (NIFs), which, in turn, would hold 60 percent majority stakes in the newly privatized companies. The remainder would be divided between the employees of these enterprises (15 percent) and the Government (25 percent). After one year, certificate holders would be able to convert their certificates into ordinary shares, which could be traded on the Stock Exchange. The proceeds from the sales of the share certificates and from the subsequent sale of the Government's share of the certificates on the stock exchange would be used to settle the outstanding arrears.

A similar mass privatization scheme has been implemented in the Czech Republic. Under this scheme, the vouchers that were offered for sale to the public could be used for direct acquisition of enterprise stocks or for deposit with investment privatization funds in exchange for shares in the funds. The National Property Funds used proceeds from the vouchers issued under this scheme, with a value of Kcs 50 billion (equivalent to about 5 percent of GDP) to write off outstanding enterprise debts and recapitalize banks. Although the debt was relatively small, the banks were not able to prevent the accumulation of new arrears after they were recapitalized and further government intervention has become necessary.

There are several lessons that can be drawn from the experience of East European countries to deal with interenterprise arrears. *First*, the expansion in interenterprise arrears was primarily due to the breakdown of financial discipline, which was spurred by rapid macroeconomic changes and the collapse of central controls, and was only to a lesser degree due to technical problems in the payments system. *Second*, credit expansion in itself has failed to solve the arrears problem, although it certainly fuelled inflation. Nevertheless, some credit expansion was necessary in all countries to prevent a rapid and widespread collapse of enterprises. Keeping the enterprises operating by providing them with credit was, first and foremost, a deliberate decision of the Government in these countries to prevent mass unemployment and poverty. *Third*, the threat of bankruptcy proceedings leading to liquidation, combined with penalties on the managers of state enterprises that failed to meet their payment obligations, proved to be an effective deterrent. *Fourth*, with the advent of macroeconomic reforms and the progress in privatization, the arrears accumulation appears to have levelled off, both in real terms and in relation to domestic credit.

5. Preventing further accumulation of interenterprise arrears

The starting point for prevention of new interenterprise arrears must be a change in the structure of incentives that guide enterprises in their operations. In a free market, competitive prices guide enterprises in their operations and secure their efficiency while preventing them from extracting more than the normal profits. However, the presence of monopolies may require government intervention to prevent enterprises from raising their prices and extracting higher profits at the expense of consumers and of the economy at large. The Government would have to design a structure of incentives and apply adequate controls in order to discourage delays in payments, reward financial discipline, and reduce expectations that the Government and the CBR will repeatedly step in and bail out the state enterprises. In planning the specific incentives, it is necessary to take into account that, for the time being, state enterprises--and their managers--are not likely to operate as textbook firms, guided primarily by profit considerations. Hence, incentives that promise higher profits or lower losses for a state enterprise in the future may not in themselves motivate the managers of that enterprise or its employees to alter their present payment practices or adjust their production and employment levels.

The key to the success of any plan to avoid a new accumulation of arrears is the implementation of a series of credible measures that will convince the managers of state enterprises and their employees to make the desired changes and adjustments on their own initiative and out of their own self-interest. Such a plan must be comprehensive and cover all state enterprises on a systemwide basis, but it must also include adequate controls that will allow the central authorities to supervise the implementation of the reform measures in each individual enterprise. As a first step in that direction, the Government will have to announce a cut-off date beyond which no further accumulation of arrears will be tolerated. Enterprises and their managers should be made liable for any damages caused by

their failure to meet overdue payment obligations beyond that date. ^{1/} The following specific measures should also be considered for inclusion in such a strategy:

a. Penalties

Financial penalties should be applied to all enterprises maintaining arrears and suspending due payments after the cutoff date. These penalties should take the form of positive real interest rates on new arrears so as to provide a strong incentive for enterprises to meet all their payment obligations on time rather than allowing them to erode with inflation. Under the present conditions, however, financial penalties by themselves may not be effective, as interest and penalty charges would just be added to the outstanding indebtedness of state enterprises. To achieve the required results, penalties against managers of enterprises that fail to meet their payment obligations should also be applied. Such penalties have been implemented in Bulgaria and Hungary, and have proved highly effective. They should be aimed at blatant disregard for payment contracts when funds are available, and should not penalize managers simply for the poor economic performance of their enterprises. ^{2/} The Government will have to put in place the legal framework and establish institutions to monitor the implementation of these measures, while targeting as much as possible individual offenders that can be singled out as examples to discourage others.

b. Bankruptcy proceedings and liquidation

The Bankruptcy Law, adopted on November 11, 1992, took effect on March 1, 1993. This law opens the door for bankruptcy proceedings against defaulting enterprises, possibly leading to their liquidation, and thus providing a potentially powerful threat to discourage the accumulation of arrears. It may take some time, however, for the legal institutions to gain experience in the implementation of that law and a number of well-publicized liquidations will have to be carried out before bankruptcy can become a viable and credible option for enforcing payment contracts and providing an effective deterrent. In the longer run, the threat of bankruptcy proceedings against an enterprise is likely to make its creditors more aware of their potential losses if they continue to provide funding to a defaulting enterprise.

^{1/} The theoretical literature emphasizes the effectiveness of "personalized prices" in preventing "free riding," even in the context of public goods. These are sometimes referred to as "Lindahl-Samuelson prices." See, for example, Bigman, D. (1992).

^{2/} Proper accountability of managers for the performance of their enterprises is, of course, a relevant factor in the rehabilitation of the productive sector in Russia. However, this will have to be solved by better shareholder oversight. Privatization would be the best way to ensure that this objective is achieved.

c. Changes in payment procedures

As noted earlier, improvements in the payments system cannot prevent the accumulation of enterprise arrears, but they are a positive factor in fostering an economic environment that discourages arrears accumulation. In particular, the CBR, in its role as supervisor of the payments system, should take measures to minimize the size of the float. These measures should include the following: (i) creating clearinghouses wherever payments activities are large enough to justify it; (ii) speeding up the delivery of payment instructions, especially for large-value payments; and (iii) synchronizing the timing of debiting and crediting of correspondent accounts to reduce float. The CBR should also take measures to expedite the clearing and settlement process by encouraging banks to settle transactions between their different branches directly. New payment instruments--supported by an appropriate legal framework--should be encouraged, such as wider use of certified checks and letters of credit against the delivery of goods and services. It may take some time, however, before banks are able to provide letters of credit since that may require banks to develop prior verification procedures. Enterprises should be encouraged to widen the use of prepayments and greater responsibility should be placed on the creditor enterprises to deter them from granting additional credit to other enterprises that will merely increase their debts. To reduce payment risks, the use of collateral for receivables may also be a viable option.

d. Other measures

The following additional measures can strengthen the reform and raise its credibility:

- (i) Information on the creditworthiness of enterprises should be shared more widely among banks, enterprises, and the public in general. This will require the Government to both set up agency for that purpose, and establish rules for such disclosures.
- (ii) State enterprises should be moved out of the jurisdiction of the branch ministries and their managers should be given much more autonomy and responsibility. ^{1/} The incorporation of all large and some medium-sized enterprises in Russia during 1992 has been the first step in that direction.
- (iii) The settlement of the outstanding debts of state enterprises must also include incentives and conditions that will deter the accumulation of new arrears and reduce the moral hazard associated with that settlement. We return to this issue in the following section.

^{1/} A similar reform has been carried out in Hungary under the Law of Economic Transformation.

- (iv) Tighter supervision over banks' lending practices should be enforced to ensure that their lending operations are based on solid economic considerations.

The privatization of state enterprises has often been advocated as the most efficient avenue to securing the necessary adjustments and encouraging financial discipline. The privatized enterprises are less likely to expect government interference in the form of repeated credit extensions or debt forgiveness and they would have to streamline their operations in order to increase the prospects of future profits. Privatization is, however, a complex and lengthy process and, under the present disorderly market conditions, it may not be sufficient in itself to secure financial discipline. Nevertheless, it should be noted that during 1992, nearly 20 percent of the some 250,000 state and municipal enterprises have been privatized, most of them small-scale enterprises. In addition, by the end of February 1993, more than 300 enterprises had been sold at the voucher auctions. In addition, 674 large and 886 medium-sized enterprises were transformed into joint-stock companies and issued stocks for sale as a first step toward privatization. Another 1,595 enterprises had their privatization plans approved by the State Committee for the Management of State Property. ^{1/}

6. Policy options for dealing with the outstanding enterprise debts

At the outset, it is important to note that the elimination of existing arrears, while critical for unburdening the enterprises from the mistakes of the centrally planned era, is not equally crucial to restoring normalcy to economic transactions and activity. The large credit expansion in the second half of 1992 has checked the growth (in real terms) of interenterprise arrears--at the cost of a rise in debts to the banking system--while the escalating inflation has reduced the real value of the outstanding arrears. Accordingly, the value of past arrears is rapidly losing its economic significance and may soon become a minor consideration, provided that no new arrears are allowed to accumulate.

To the extent that the authorities feel that they have to move aggressively to normalize outstanding enterprise arrears, they should keep in mind that any policy for dealing with this problem should be designed to deal simultaneously with several dimensions of the problem: the settlement of the outstanding debts of enterprises to banks, the settlement of tax arrears, and the settlement of interenterprise arrears proper. Our emphasis is on the latter. The authorities' approach to resolving this problem must not encourage the accumulation of new arrears; on the contrary, it should help instill discipline in the enterprises' payment practices. To that end, the settlement of the outstanding debts should be part of a systemic reform, but its implementation must be monitored at the level of the individual enterprises, and the managers of these enterprises should be required to meet predetermined conditions before their debts are settled and any new

^{1/} In the following section we discuss some specific details of alternative privatization options.

credit is extended to them. The management of each state enterprise that is included in that settlement should provide specific plans for restructuring the enterprise, and make a specific commitment to meet all the payment obligations of the enterprise. 1/

The first step in the settlement of the interenterprise debts should be a clear assessment of the size of the outstanding debts in order to prevent inflated claims, possibly by creating an agency or a clearinghouse to record all the mutual claims. While the process of settling the debts need not wait for that assessment to be completed, it does require the authorities to determine a cutoff date that separates the outstanding arrears from the new ones. It will also be necessary to specify what types of claim are acceptable, the methodology that will be used to net out the existing claims, and any other conditions attached to that operation. Every enterprise participating in the netting out process will have to agree to these conditions before its claims are registered.

Options to settle the outstanding interenterprise debts, include the following:

(a) Clearing up the net arrears with CBR loans

The Russian authorities followed this approach when they carried out their operation to clear up the outstanding arrears in mid-1992. Since the records of the arrears are no longer maintained in the banking system through the use of File No. 2, one option for the future would be to extend credit to the net debtor enterprises and use their current accounts with the banking system in order to pay their net indebtedness to other enterprises, thereby removing the gridlock in the payments system and permitting the settlement of the gross indebtedness. In the absence of central records, however, the difficulties in identifying the net debtors may result in credit extensions that far exceed the net outstanding arrears. In Belarus, for example, officials reported that in a similar operation to clear interenterprise arrears, only some 60 percent of the reduction in the outstanding arrears was achieved by canceling out mutual claims and some 40 percent had to be funded from the central bank. The Eastern European countries that conducted this type of operation found that it was only partly successful in reducing the outstanding interenterprise arrears. In Russia, enterprises used some of the credit extended to them in October 1992 to finance their wage payments and other operating expenses. This option will therefore require close supervision to ascertain that enterprises indeed use the credit that is made available to them--either directly from the central bank or indirectly from their debtors--to repay debts to other enterprises, to their banks, and to the budget.

1/ A similar procedure was applied in Israel in debt-rescheduling schemes for the industrial conglomerate (Koor) owned by the trade union federation, the Histadrut, and for the Kibbutz movement.

(b) Clearing up the gross arrears with CBR loans

Another option is for the central bank to provide enough credit to enterprises to allow them to repay their *gross* debts to other enterprises, thereby effectively replacing all the interenterprise debts with debts to the central bank (or with government bonds). This option will involve a much larger expansion of credit (and of the money supply), although the settlement process may become simpler and faster. Clear conditions will have to be specified--and their execution carefully monitored--in order to guarantee that the credit issued will indeed be used to settle the outstanding arrears. These conditions will have to be met by all enterprises that apply for credit. In the absence of clear, closely monitored and strictly enforced preconditions at the level of the individual enterprise, the moral hazard associated with this measure is likely to frustrate any efforts to ensure that enterprises will indeed meet their payment obligations and repay their debts to the central bank on account of the credit that has been extended to them. While it is true that the CBR could take some compensatory measures to ensure partial sterilization of the credit expansion required to eliminate arrears, such a large and unconditional bailout is likely to be interpreted by the managers of state enterprises as permission to continue past practices instead of making the necessary operational adjustments, thereby introducing the likelihood that new arrears will again accumulate.

(c) Central clearing of the debts with government bonds

Under this scheme, a central clearinghouse will be established with the authority to determine all the claims that enterprises have against each other. It will then proceed to clear the outstanding arrears by converting the bilateral claims of individual enterprises into debts to, and of, the clearinghouse. After the clean up of the claims that enterprises have against each other, the remaining net debts will be replaced by government bonds.

(d) Securitization of outstanding interenterprise debt ^{1/}

Under this scheme, the clearing house would securitize the arrears of net debtor enterprises by creating bonds that would then be used to pay the net creditor enterprises. These enterprises would have three options: to retain these bonds until maturity; to discount them with banks; or to sell them to the public. The net debtor enterprises would have time until the maturity of the bonds to repay their arrears to the clearinghouse. The clearinghouse would use these funds to retire the bonds. To the extent that these payments are insufficient to cover the retirement of the bonds, the bond holders would be paid on a pro rata basis only.

A working group formed by the Russian Government in 1992 developed a scheme to transform the debts of state enterprises into 13-month promissory

^{1/} See Sachs, J. and D. Lipton (1992).

notes. According to this plan, the promissory notes would be sold to the public through the stock market and would be freely transferable. The proceeds from this sale would be used to repay the net creditor enterprises. When the notes mature, the net debtor enterprises would be expected to either repay the holders of the notes or convert the notes into shares, thereby automatically becoming a joint-stock company. Alternatively, if a majority of the creditors so chose, the enterprise could also be dissolved and the proceeds from the liquidation used to repay creditors in accordance with the prevailing bankruptcy rules. In enterprises where the Government elected neither to privatize nor to liquidate, these promissory notes would be converted into a special government debt obligation. The initiation of mass privatization through the voucher plan has superseded this scheme.

The main advantage of options (c) and (d) is that they achieve the same objective as options (a) or (b) while injecting much less liquidity into the system. However, lack of information and cumbersome documentation methods are bound to make the central settlement process tedious and lengthy, and an injection of credit may be necessary in the interim period. Furthermore, the replacement of net arrears by government debt, or even the extension of credit by the banks backed by government guarantees--as in the "global compensation scheme" implemented in Romania--will entail an increase in cash outlays through the budget on account of interest payments (or realization of guarantees). To the extent that the scheme is successful, this will be a one-time operation. But any new round of arrears will further increase the fiscal costs of the scheme. Also, since many of the enterprises in arrears will not be able to meet their debt payments to the Government, the fiscal costs are likely to be higher than those predicted at the outset. Replacing the arrears with government debt may lead to a still smaller increase in liquidity, if the arrears are replaced with government bonds that are nondiscountable with the central bank.

Option (d) has the additional advantage that it will reduce the cost of the settlement to the Government by forcing net creditor enterprises to absorb the major share of the clean-up costs, thus encouraging them to be more careful in the future. In all cases, it is important that net debtor enterprises that are unable to repay their loan/bonds according to the agreed timetable be subject to either liquidation procedures or privatization.

(5) Privatization

Privatization of state enterprises can be an effective way to precipitate the necessary structural changes and instill financial discipline. The financial resources that can be mobilized through privatization are, however, likely to be rather small and fall far short of the amounts necessary to settle the outstanding debts of enterprises. So far, only a few of the some 6,500 large-scale enterprises have been privatized, and a few others have been leased with an option to buy.

There are a number of reasons why, in the short run, privatization is unlikely to offer more than a very limited solution to the arrears problem.

First, many, if not most, of the medium- and large-scale state enterprises in Russia will not be attractive to potential buyers. Included are many net debtor enterprises, most of which may not be viable under normal market conditions; and net creditor enterprises with large nonrecoverable financial assets. These enterprises are the prime reason for the gridlock in the payments system, and the main obstacle to the development of a well-functioning market economy. At the same time, they are the largest employers and the Government is unlikely to allow them to cease operations. *Second*, state enterprise employees--and their managers even more so--may fear that under privatization they will lose their jobs, and, thus, may not be sufficiently diligent in implementing measures that are necessary to make their enterprises better candidates for privatization. To secure their cooperation, privatization plans must contain built-in economic incentives--possibly through equity participation--that can reduce incentives to keep the enterprise in government hands through, among other things, the accumulation of large debts. *Third*, the process of privatization is certain to be long, and during that process additional financial resources will be required to meet the immediate needs of enterprises. Indeed, the experience in Eastern European countries shows that rapid privatization, while desirable, is not easy to achieve. *Fourth*, the lack of financial data complicates the calculation of the net worth of state enterprises and the assessment of their viability. The vast changes in relative prices caused by the sharp drop in output and the inflation spiral in the latter part of 1992 make this assessment much more difficult. As a result, privatization through sales of shares in state enterprises, which was initially hailed by many advisers, proved to be too complex in most cases.

Nevertheless, privatization offers the main long-term hope for implementing the necessary structural changes. During the entire privatization process, a central authority would have to remain in charge and overview the operations of the newly privatized enterprises. The central authority could also play an important role in settling outstanding debts by assuming all the nonrecovered financial assets of the privatized enterprises--mainly the debts of other state enterprises. The reason is that although these debts may not be recoverable for potential *private buyers*, a central authority may be able to apply stronger pressure and recover some of the debts, or else use them to initiate bankruptcy proceedings.

7. Conclusions and summary of main recommendations

The massive buildup of interenterprise arrears and the accumulation of large debts to the banks brought the payments system in Russia to a near standstill in mid-1992. This problem was temporarily resolved by a netting out operation and by a large expansion in CBR credits in the second half of the year. However, many enterprises have been reduced to performing nominal productive activities from which they are able to recover only a fraction of their overdue payments, making them totally dependent on a new credit injection to cover input costs and, most importantly in a country that does not have a social safety net, their wage bill. As a result, new arrears have emerged and the banking system is again faced with a growing portfolio

of nonperforming loans. What does it take to stop this vicious cycle of arrears accumulation/credit expansion?

The experience of Eastern European countries that faced a similar crisis suggests that the authorities' efforts to resolve this problem should focus primarily on measures to prevent the accumulation of new arrears, while carrying out the necessary macroeconomic and structural adjustments. Measures to settle outstanding arrears should be implemented only after financial discipline has been restored and should not distract the authorities from their need to control inflation through tight monetary and credit policies.

A successful adjustment program will necessarily entail the control of monetary expansion. Thus, credit to the Government and to the economy will have to remain tight if inflation is to be reduced to more reasonable levels. Any such effort will require the rationing of the credit expansion to enterprises. Given the absence of an adequate social safety net and the lack of sufficient information to establish the long-term viability and creditworthiness of the enterprises, the Government will still have an important role in the allocation of credit, even if this may seem paradoxical in a period of systemic transformation into a market-based economy. Our proposed strategy has four key ingredients.

- ▶ First, an adequate macroeconomic framework should be in place. In particular, the Government should establish overall ceilings for bank credit and for government transfers to state enterprises that are consistent with the macroeconomic program.
- ▶ Second, enterprises should be informed that no new arrears will be tolerated. A cut-off date should be established. Banks should not be allowed to lend to enterprises that have accumulated significant new (post-cutoff-date) arrears.
- ▶ Third, the Government should require that all state enterprises submit detailed plans for gradual adjustments in production and employment to the ministry in charge of that enterprise. These plans, which should be approved by the Government, should commit the enterprises, and their managers, to the necessary structural changes and to keeping their payment obligations current. They should include detailed proposals on how the enterprise will finance its operations during the period when it is not yet fully profitable. The Government will use these plans to set borrowing ceilings for each state enterprise and the amount of budget subsidies, if any, that it would be willing to provide to that

specific enterprise. ^{1/} Banks will use these plans and ceilings to determine how much they would lend to each enterprise.

Fourth, progress in implementing the proposed program should be carefully monitored by the Government. The Government should require improvements in accounting procedures and more timely provision of financial information in order to be able to better perform this task. Those enterprises showing close compliance with the agreed plan--and good progress toward becoming self-supporting in the new market-oriented environment--would qualify at a later date to a debt reduction scheme aimed at eliminating outstanding pre-cutoff debts and restoring a proper debt/equity ratio to the enterprise.

A definitive solution to the problems of enterprise arrears in Russia cannot be found until financial discipline is restored through firm measures that would provide "sticks and carrots" to state enterprises with the aim of guiding them through a meaningful adjustment to the new market-based environment. In particular, the resolution of the enterprise arrears problem should not be allowed to deteriorate into a series of wholesale government bailouts leading to continuous extension of credit to clear recurring arrears. These practices would only delay the necessary adjustments, erode financial discipline, and fuel inflationary pressures.

The role of the Government in resolving the problems raised in this paper will be a crucial one. It will not only have to establish an overall ceiling for the total amount of authorized credit and government subsidies to be provided to state enterprises--in the context of a consistent macro-economic program--but it will also have to distribute these ceilings on an enterprise-by-enterprise basis. In undertaking the latter, the Government must weigh many factors--including employment generation, speed of adjustment, long-term viability, and existing financial situation--to craft a forward-looking sharing arrangement that would ensure a viable adjustment path for the economy as a whole. Can this be achieved? It will not be easy, but there does not seem to be any other viable alternative.

^{1/} In the second half of 1992, the Government has assigned the primary responsibility for overseeing credit distribution decisions to a Credit Policy Commission (CPC). It is not clear, however, that the decisions of the CPC are (a) based on individual remedial programs presented by the state enterprises and (b) are consistent with the overall credit limits required to slow down inflation.

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