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**Inter-Enterprise Arrears in Transforming Economies:  
The Case of Romania**

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by

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Abstract

This paper reviews the experience with inter-enterprise arrears in Romania during 1991 with the purpose of extracting lessons that might prove useful for other economies in transition to market-based systems. While the rapid growth of inter-enterprise arrears poses a serious policy problem in all the transforming economies of Eastern Europe, the case of Romania is perhaps most striking; gross inter-enterprise arrears grew almost eighteen-fold (to about 50 percent of GDP) in only 12 months. This paper discusses the development of these arrears and the policies implemented by the authorities to resolve the problem.

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## I. Introduction

The rapid growth of inter-enterprise arrears poses a serious policy problem in all the transforming economies of Eastern Europe; this phenomenon is now evident as well in the republics of the former Soviet Union. Undoubtedly some part of these arrears can be considered "voluntary" credits, in the sense that they represent credit extended by one enterprise to another as part of normal business practice, much as the case of trade credit in market-based economies. However, it is generally acknowledged that the bulk of the arrears is involuntary, with enterprises simply not making payments to each other (as well as to banks and the government), and creditors unwilling or unable to enforce the due payments. Given the interlocking nature of enterprises in Eastern European countries--a legacy of the centrally-planned system--such involuntary credits can balloon out of control very rapidly, as they have in several of these countries.

If allowed to grow unchecked, inter-enterprise arrears can, as argued recently by Begg and Portes (1992), place the whole reform process in jeopardy. To start with, hard budget constraints are softened and relative price changes become less meaningful. As a result, enterprises continue to behave as in the past and restructuring to conform to market realities is delayed. This delay in the structural transformation of the economy, as well as the weakening of contract enforceability, are perhaps the most important adverse effects of inter-enterprise arrears.

But inter-enterprise arrears have significant macroeconomic consequences as well. First of all, arrears can undermine monetary control and thus limit the effects of tight credit policy on inflation and the

balance of payments. More specifically, recourse to arrears to finance expenditures can lead to shifts in the demand for bank credit and in the income velocity of money that make it more problematic for the authorities to design and execute monetary policy. 1/ Second, inter-enterprise arrears can lead to inefficiencies in, and the eventual breakdown of, the payments mechanism, with obvious adverse effects on production and output. As enterprises bypass the banking system and arrears begin to reach a level considered undesirable by them, cash transactions become more and more prevalent. The "cash-in-advance" constraint on transactions becomes binding and if the authorities are unwilling to provide the needed currency, production begins to suffer. 2/ Finally, the arrears of state-owned enterprises represent a potential fiscal liability of the government. At some point in time the government would have to cover these quasi-fiscal deficits, thereby affecting private sector behavior both now and in the future.

Since large-scale restructuring that involves closures and privatization does not seem to be in the cards in the short run, and indeed it is because of the absence of such restructuring that arrears have emerged and grown the way they have, the government has to find a solution, but in a way that does not give rise to a moral hazard problem. A generalized "bail-out" runs the risk of creating expectations of future bail-outs, with enterprises having an incentive to run up arrears again. Of course the government can

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1/ In many respects this is the same problem that arises in economies where there are significant informal or curb markets for credit. See Montiel, Agenor, and Haque (1992).

2/ While lack of credit may be a factor in the decline in output, as argued by Calvo and Coricelli (1992), arrears can compensate for this, at least partially. Eventually, however, it is the lack of currency that becomes the more important factor.

ignore the problem and let it resolve itself over time. Eventually arrears will stop growing and some type of adjustment will occur, but this adjustment is bound to be a disorderly one. All enterprises, viable and non-viable alike, will suffer as a chain reaction of closures occur. Production collapses and soaring unemployment will certainly create difficulties for the reform process. Governments in the transforming economies are thus searching for a solution that will fall somewhere between the two undesirable extremes of a general bail-out and doing nothing.

While the inter-enterprise arrears problem is evident in other Eastern European countries, 1/ the case of Romania during 1991 is perhaps the most striking. Gross inter-enterprise arrears 2/ grew almost eighteen-fold (from lei 100 billion to nearly lei 1,800 billion) in a space of 12 months, giving rise to many of the adverse consequences mentioned above--inflation was substantially higher and output much lower than had been expected at the beginning of 1991. Also, at the end of the year the authorities were forced to take actions to clear these arrears. This paper reviews the Romanian experience of 1991 with the express purpose of extracting lessons--both positive and negative--which might prove useful for other economies in transition.

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1/ See, for example, Begg and Portes (1992) for Czechoslovakia and Bofinger (1992) for Poland.

2/ Gross arrears are the total stock of arrears before netting out bilateral and multilateral payables and receivables.

## II. Developments in Inter-Enterprise Arrears

### 1. Practices under the centrally-planned regime <sup>1/</sup>

Under the strict system of central planning that was operative in Romania until December 1989, the Government had virtually complete control over enterprise management and finances. The authorities also had complete discretion in determining the tax burden on individual enterprises. Thus, the distinction between whether state-owned enterprises--which covered virtually all means of production except for a small proportion of land cultivated by private farmers--were actually paying taxes or were just transferring to government the profits that already belonged to it in its capacity as owner of the enterprises was not clear. The tax burden of enterprises steadily increased during the 1980s as the Government needed to generate large fiscal surpluses as part of the policy to repay the external debt. As a result, enterprises were left with inadequate funds to finance current operations and investment, and often with substantial after-tax losses. These losses were financed by the extension of bank credit, but to the extent these loans were unserviceable, the quality of the banks' balance sheets was eroded. In addition, bank credit was typically extended to clear domestic payments arrears. Thus, under the centrally-planned regime there were no inter-enterprise arrears as such. All arrears were to banks since they provided credit automatically to enterprises that needed to make payments and did not have the resources to do so. These arrears simply showed up as bad debts on the books of the banking system.

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<sup>1/</sup> For details of economic developments and policies during the pre-reform period see Demekas and Khan (1991).

## 2. Developments since 1990

### a. Unserviceable bank loans

After the change of government in late 1989, the bad debts of enterprises to banks resulting from the practices of the centrally-planned regime started being written off against government bank deposits from past fiscal surpluses. In this way, all enterprise bad debts from years prior to 1989 and most from 1989 (a total of lei 265 billion) were eliminated. As of mid-1990, after government deposits were exhausted, an amount of lei 96 billion of 1989 bad debts remained on the books of banks carrying a 0.5 percent interest rate. These credits were refinanced by the National Bank of Romania (NBR) at the same rate. Part of these (about lei 5 billion) were cleared in the last two months of 1990, leaving lei 91 billion of 1989 bad debts (already refinanced by the NBR) with banks.

Enterprises realized further losses in 1990, and some of these (especially in the mining and energy sectors, as well as in the food industry) were covered by budgetary subsidies. However, because not all enterprises were covered by budget subsidies an amount of lei 41 billion of 1990 losses was left. This was mostly covered by automatic bank credit as in the past (about lei 31 billion). Thus, at end-1990, there were about lei 122 billion of enterprise bad debts to banks (lei 91 billion from 1989 and about lei 31 billion from 1990). In 1991 the amount of bad debts outstanding declined as enterprises were forced to clear their overdue bank debts using the proceeds from sales of revalued stocks.

In order to increase the effectiveness of credit policy and to ensure that the past losses of enterprises were not a burden on the financial

system, the authorities decided to eliminate the remaining amount of 1989 and 1990 unserviceable bank loans from bank balance sheets with the issuance of long-term government debt instruments. This operation began in August 1991 and was formalized on February 5, 1992 when the Romanian Parliament approved Law 7 transforming 90 percent of these claims on enterprises into a special public debt account. The other 10 percent of loans was to be charged off against banks' profits. The principal and interest payments are to be covered by, inter alia, the sale of state assets and the recovery of outstanding claims of enterprises.

b. Inter-enterprise arrears

Starting in late 1990, enterprise payments difficulties--in addition to the problem of bad debts to banks--appeared in the system. They were reflected in mounting inter-enterprise payments arrears, which on a gross basis at end-1990 reached an estimated lei 100 billion. <sup>1/</sup> As banks began to be more selective in granting credit, partly because of the tight credit policy in place that was implemented through bank-specific credit ceilings, enterprises started running arrears among themselves as a way of financing current operations. By end-March inter-enterprise payment arrears had reached an estimated lei 400 billion (see Table 1 and Chart 1).

The growth of arrears accelerated sharply in the second half of 1991. Two factors were primarily responsible for this development. First, inflation was much higher than projected while credit expansion through September was kept on target (consistent with a lower projected rate of

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<sup>1/</sup> No information is available on inter-enterprise credits as distinct from arrears. Starting in late 1990 direct payments between enterprises stopped being documented by the banking system.



Table 1. Romania: Money, Credit, Inter-Enterprise Arrears  
and Industrial Production

(In billions of lei)

|           | Broad<br>Money  | Credit<br>to<br>Nongovernment | Inter-<br>Enterprise<br>Arrears | Industrial<br>Production <u>3/</u> |
|-----------|-----------------|-------------------------------|---------------------------------|------------------------------------|
| Dec. 1990 | 514             | 684                           | 100                             | 100.0                              |
| Jan. 1991 | 519             | 703                           | 206                             | 89.6                               |
| Feb.      | 546             | 731                           | 307                             | 89.6                               |
| Mar.      | 517             | 756                           | 400                             | 96.7                               |
| Apr.      | 525             | 765                           | 482                             | 101.1                              |
| May       | 568             | 788                           | 550                             | 101.8                              |
| June      | 567             | 811                           | 600                             | 104.0                              |
| July      | 595             | 839                           | 637                             | 94.1                               |
| Aug.      | 600             | 806                           | 691                             | 90.8                               |
| Sept.     | 602             | 749                           | 800                             | 91.4                               |
| Oct.      | 671             | 839                           | 1,000                           | 87.4                               |
| Nov.      | 815             | 899                           | 1,317                           | 78.8                               |
| Dec.      | 885 <u>1/</u>   | 954 <u>1/</u>                 | 1,777                           | 76.6                               |
| Jan. 1992 | 1,066 <u>2/</u> | 1,312 <u>2/</u>               | -- <u>2/</u>                    | 78.4                               |

Sources: Romanian authorities; and Fund staff estimates.

1/ Excludes the effect of the global compensation of December 1991.

2/ Includes the effect of the global compensation of December 1991.

3/ Index, December 1990 = 100.

inflation). Real credit thus declined far more than had been envisaged and enterprises were put under considerable strain. Second, from about mid-year it became increasingly evident that the Government was going to have to take action to arrest the progressively deteriorating economic situation. Output continued to fall, and this was partly attributable to the so-called blockage of the payments system brought about by inter-enterprise arrears (Table 1). <sup>1/</sup> In July, for example, industrial production fell by nearly 10 percent, and then again in August by a further 3.5 percent. Enterprises were very vocal at that time in blaming the financial payments blockage for these developments, and began pressing hard for a resolution. Thus, a bail-out looked very likely and by September-October the issue was even being discussed in Parliament. Enterprises therefore had an incentive to further increase arrears, and did so in the expectation that they would receive government assistance to cover them.

On a gross basis the arrears rose to lei 1,777 billion at end-1991, representing about 50 percent of GDP valued at December 1991 prices. Net arrears, that is the amount of payments owed by the group of net debtor enterprises to other net creditor enterprises, plus arrears to the state largely for tax payments, were lei 426 billion at end-1991. <sup>2/</sup> Tax arrears amounted to about lei 40 billion at end-1991. The growth of gross inter-enterprise arrears closely matched the rise in the consumer price

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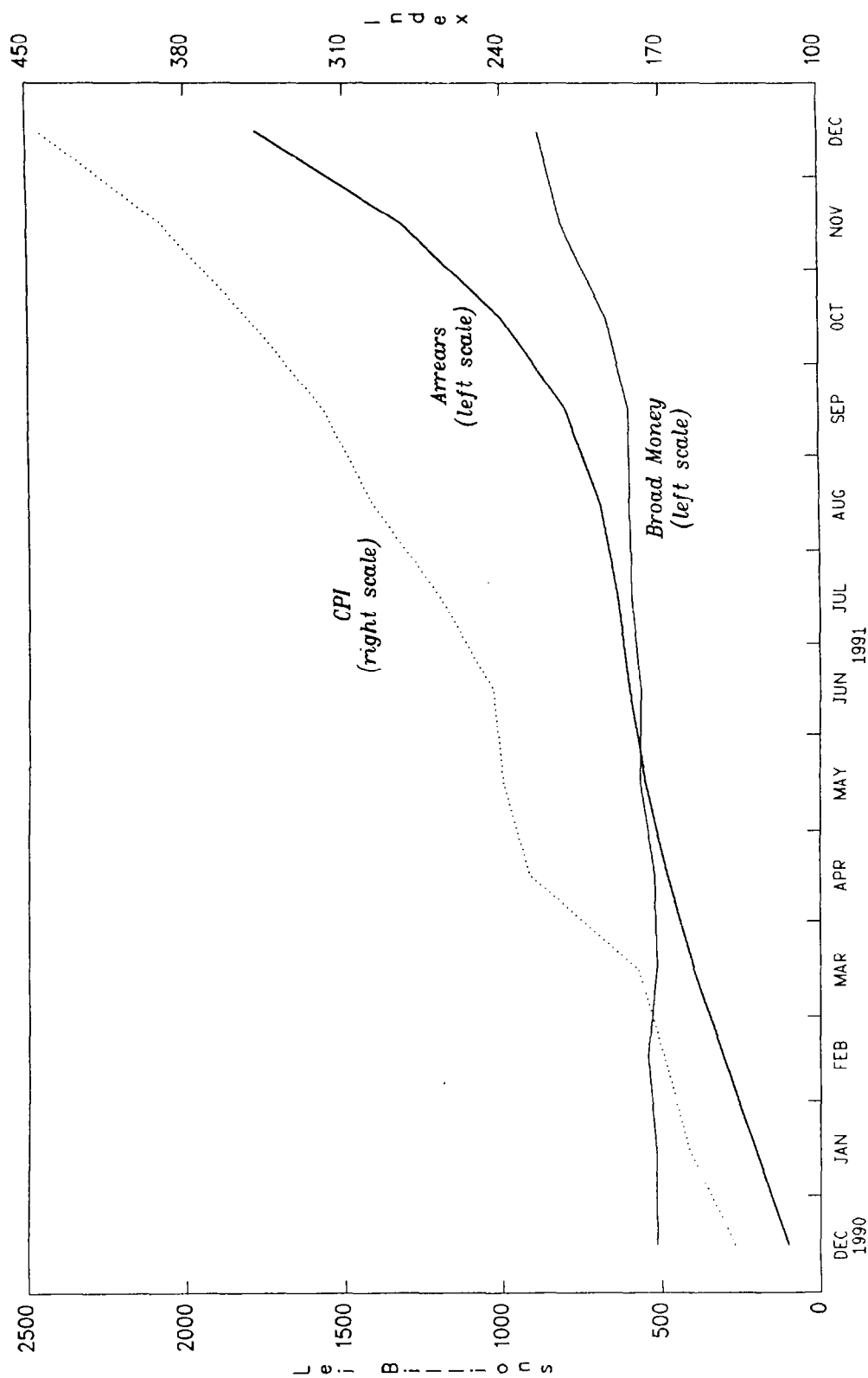
<sup>1/</sup> As mentioned earlier, cash transactions became more prevalent. For example, the ratio of currency to deposits rose from 20 percent in January to 32 percent by September-October. For a discussion of the factors behind the decline in output see Borensztein, Demekas, and Ostry (1992).

<sup>2/</sup> Historically, net arrears have been approximately 20-30 percent of gross arrears.

CHART 1

Romania

# Broad Money, Inter-Enterprise Arrears, and the CPI (1991)



Sources: Romanian authorities and IMF staff estimates.

level during 1991 (Chart 1). It appears that the arrears were implicitly indexed to the price level, as when creditor enterprises were not paid on time they would re-bill the debtor enterprises at the new higher prices.

Reflecting a tight monetary policy stance, broad money grew by 17 percent through September 1991 while bank credit to the non-government grew by 10 percent (inflation was 132 percent over this period). However, starting in October the NBR began to allow an expansion of bank credit to enterprises to reduce the problem of inter-enterprise arrears, and bank-specific credit ceilings were suspended. Through December 1991, broad money grew by 71 percent and credit to non-government grew by 40 percent (compared to a cumulative inflation of 223 percent). At end-1991 gross inter-enterprise arrears were equivalent to 208 percent of broad money and 194 percent of credit to the non-government.

The income velocity of broad money rose from around 1.8 in 1990 to 3.9 in September 1991 before falling back to 3.6 in December (Chart 2). Inter-enterprise arrears were, of course, also liquidity being provided to the system in addition to the normal money supply. The effects of this additional liquidity can be judged by including inter-enterprise arrears with broad money. The ratio of GDP to the sum of gross inter-enterprise arrears and broad money was 1.2 in December 1991 (Chart 2). A similar calculation using net inter-enterprise arrears yields a value of 2.4, which is close to the average velocity observed during the early 1980s, and considered to be "normal" velocity.

### III. Policies to Control and Clear Inter-Enterprise Arrears

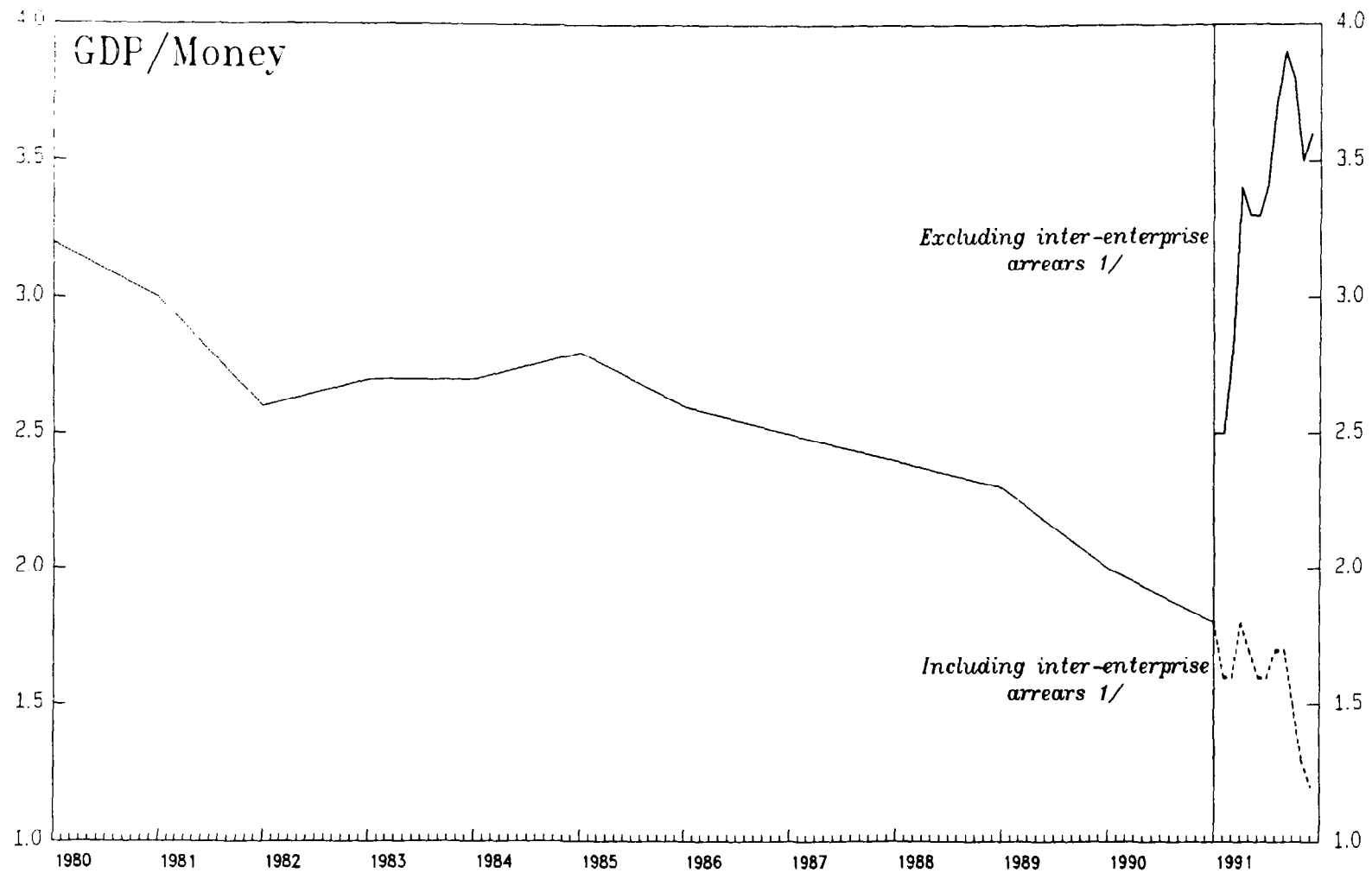
To combat the inter-enterprise arrears problem a series of selective measures were considered and/or adopted starting in May 1991, culminating in the generalized scheme, termed "global compensation," in late December 1991.

#### 1. Early attempts

To reduce the inter-enterprise arrears problem, on May 8, 1991 the NBR opened a refinancing line of lei 15.5 billion for banks, which were instructed to extend credit to net debtor enterprises. These credits were extended through special accounts, so that the banks could ensure that they were used solely for the clearance of arrears. The operation was to last through end-June, by which time banks were supposed to close the special accounts and repay the lei 15.5 billion to the NBR. In the following two weeks, lei 10.5 billion of credits were extended to enterprises under this scheme. However, the operation did not work as expected. About lei 65 billion of gross arrears were cleared by end-June, but the special NBR credits--plus an additional lei 5 billion extended through the same special accounts in June--were not repaid as planned. In effect, the arrears were shifted from the enterprise sector to the banking system and ultimately to the NBR. By end-June 1991, gross inter-enterprise arrears had reached an estimated lei 600 billion.

In July the authorities developed another plan to clear inter-enterprise arrears. The new arrears-clearing scheme envisaged the coverage of all losses and arrears through bank credit entirely refinanced by the NBR and extended through special accounts. After banks recorded all enterprise claims against each other (a process that was to be completed by end-July).

CHART 2  
Romania  
Income Velocity of Money  
(1980-1991)



Sources: Romanian authorities and IMF staff estimates.

1/ Monthly data for 1991.

they were to extend as much credit as necessary to enable all enterprises to service claims against them through a special account ("compensation account"). The settlement of inter-enterprise claims was to take place in the first two weeks of August. By August 15, all enterprises would have no claims outstanding against each other, and as a result some would be in a net creditor position in their compensation accounts with banks, and others would be in a net debtor position. By August 28, banks were to close the compensation accounts by consolidating them with the current accounts of enterprises. Net creditor enterprises would find their overall bank debt reduced by the amount of net credit compensation accounts, whereas compensation credit extended to net debtor enterprises would be reclassified as regular credit, and normal interest rates would apply. It was estimated that clearing the inter-enterprise arrears through this scheme might require a net infusion of credit on the order of lei 150-300 billion. 1/

However, the authorities decided not to implement the scheme until more accurate estimates of the size of inter-enterprise arrears were available. The NBR was instructed to collect data on gross inter-enterprise arrears and to reconcile them with independent estimates from the Ministry of Industry (which were substantially smaller). It was then to estimate the net position of the enterprise sector vis-à-vis the banking system and the Government, as well as to identify the "worst offenders", i.e., enterprises with large net debtor positions. Once this information became available, the NBR was to determine the amount of bank credit that would need to be

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1/ Gross inter-enterprise arrears were estimated at the time to be around lei 600-700 billion (Table 1).

extended for the operation. Moreover, the compensation scheme was to be combined with the closing down of insolvent enterprises.

A scaled-down version of the arrears clearing scheme was implemented in late August. Affected enterprises deposited 10 percent of their current receipts into a special account, which was used to clear overdue payments between enterprises. <sup>1/</sup> These deposits, together with certain payments by the Government and very short-term credits extended by banks, were used to clear some inter-enterprise arrears. As a result of the program, about lei 150 billion of gross arrears were cleared. However, the authorities estimated that at the same time approximately another lei 150 billion of arrears arose, so that the balance of gross arrears at the end of the clearing procedure remained at about lei 800 billion. In the authorities' view, the operation was not a success because it was basically a voluntary operation on the part of enterprises and the net amount of credit that was injected into the system was considered too little.

## 2. Global compensation

On December 23, Parliament passed a law (Law 80) calling for a generalized expansion of bank credit to clear all inter-enterprise arrears. This global compensation operation was completed on January 27, 1992. Under the global compensation scheme, enterprises were asked to list their arrears to other enterprises and to the state, and banks were instructed to expand credit, carrying a government guarantee, to clear the gross amount of inter-

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<sup>1/</sup> The affected enterprises covered all but 100 of the some 6,000 enterprises in Romania.



enterprise arrears. 1/ The initial bank credit extended under the scheme was lei 1,777 billion. All payments under the scheme were made by overdrafts from special "compensation accounts" and the same accounts were also debited with all payments received by enterprises. Thus the gross amounts of credit extended were automatically transformed to the net amount. The net amount of arrears--lei 426--was retroactively reflected in bank balance sheets as of end-December 1991. Of the net credit extended under the global compensation scheme, only lei 163 billion was refinanced by the NBR at the normal refinance rate; the rest was financed by banks out of deposits. The compensation credits had a six-month maturity with interest rates at market levels. As many enterprises that were net creditors of other enterprises were net debtors to the banking system, much of the net credit extended under the scheme went initially to reducing overdrafts with banks.

Some enterprises--mostly agricultural cooperatives--chose not to participate in the scheme as they were receiving, in effect, an interest-free loan in the form of arrears. However, it is believed that the number of debtor firms that refused to participate in the global compensation was small. All large enterprises participated in the scheme, and as a result almost all known inter-enterprise arrears were eliminated.

Following from the global compensation operation, the money supply increased by an additional lei 149 billion in December to reach lei 1,033 billion by end-year. Thus the increase in broad money over the year was 99

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1/ Basically Law 80 was closely related to the July scheme that had been considered and then rejected by the Government.

percent compared to a programmed 15 percent. Also, through end-December, the net domestic assets of the banking system increased by lei 522 billion, compared to a programmed lei 96 billion. The increase in prices over the year was 223 percent, as compared to a projected increase of 105 percent.

3. Resolving the liquidity and moral hazard problems

The first order of business after the global compensation scheme had been completed was to sterilize the injection of liquidity to prevent an upsurge of inflation. In February 1992 the authorities introduced a 10 percent reserve requirement on deposits in the banking system. This was followed by additional measures, including requiring some enterprises and banks to repay certain credits that had not yet matured, and importers to make payments to cover letters of credit that had been guaranteed by the Government. As a result of these sterilization measures, the money supply rose by only 4 percent between December 1991 and end-April 1992 in the face of a cumulative inflation of 54 percent. Bank credit to the non-government declined by 6 percent over the same period.

While controlling the expansion of liquidity was necessary, it was the moral hazard problem that was the more serious consequence of the global compensation. At issue was how to convince enterprises that there would be no future compensations and that the Government was determined to control inter-enterprise arrears. Towards this end, the authorities instituted a system to monitor arrears and introduced legislation designed to control the arrears.

As part of a general reporting system established in 1991, all of the 6,000 state-owned enterprises are required to provide the Ministry of

Economy and Finance with operating accounts on a monthly basis, balance sheets on a quarterly basis, and more detailed accounts annually. This reporting system was expanded in 1992 to cover arrears. The buildup of new arrears will be reported on a monthly basis for: domestic suppliers (inter-enterprise arrears), foreign suppliers, other credits (including wage arrears), and foreign services (e.g., freight charges). Overdue payments to domestic suppliers will be reported according to three categories: over 30 days overdue, over 90 days, and over one year. Information on arrears on loans to banks will be reported monthly by commercial banks through the NBR. With these reporting systems in place the authorities expect to have up-to-date information on the financial position of each enterprise, including any arrears, and thus be in a position to take action on a selective basis against those enterprises running arrears.

The actions to be taken are spelled out in a new draft law on enterprise financial discipline. 1/ This new law specifies the precise procedures that are to be followed by all enterprises irrespective of their form of ownership. The more salient items in this law include the following:

i. . . Effective on the date the new Law comes into force, economic agents that have overdue payments obligations which remain unsettled for more than 30 (calendar) days after the due dates, shall be considered insolvent. Payments insolvency has to be communicated to debtors by any creditors, including the State, after the period of 30 days has expired (Article 9).

ii. The list of economic agents that have been declared to be in a state of payments insolvency shall be made public (Article 12).

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1/ The full title of this new law is "Concerning Measures to Reimburse Credits Extended in Connection with the Global Compensation Operation, to Introduce a New Regime of Payments for Economic Agents, to Prevent Payments Insolvency and Financial Blockage."

iii. Following a court decision confirming insolvency, creditors can take action to "liquidate" the unsettled claims they have on their debtors; economic agents having unsettled claims shall be sued and be subjected to "forced" payment or the sale of their assets in accordance with the Law in the following order: monetary means, including deposits in banks, inventories of raw materials and finished products; claims and fixed assets; and other estate items (Article 10).

This draft law is in the final stages of passage by Parliament. In the meantime, the Government adopted two decisions (Decision 82 and Decision 162) to enforce the provisions of the draft law. If enterprises are unable to reach agreement on overdue payments, creditors will be able to initiate bankruptcy proceedings against debtors under the provisions of the existing commercial code. However, the Government will henceforth be involved actively in the process. The largest, most important arrears problems will be considered by the Cabinet, which will decide on measures to be taken against the defaulting enterprise, including accelerated privatization, full or partial liquidation, directed labor shedding, financial restructuring, and management changes.

The Government has also launched a public campaign to convince enterprises that arrears are to be avoided and no further bail-outs are likely. 1/ Already, there have been some important positive signs of a change in attitude by Romanian enterprises. For example, at the end of 1991 RENEL, the electric power company, cut off electricity supply to certain large industrial customers who were overdue in their payments. Not

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1/ In addition, a World Bank Structural Adjustment Loan also puts a condition on the level of arrears for second-tranche release--the ratio of arrears of state-owned enterprises to state-owned enterprise turnover should not exceed 7.5 percent. Since turnover is approximately twice nominal GDP, this condition would imply that gross arrears could not exceed 15 percent of GDP--as compared to 50 percent of GDP in 1991.

surprisingly, the affected enterprises found the means to cover their overdue payments very quickly. However, changing the culture of nonpayment, which had become pervasive in 1991, will be a major task for the Romanian Government.

#### IV. Conclusions

Transforming the enterprise sector in Romania, as in other formerly centrally-planned economies, has proved to be a much slower and drawn out process than had originally been thought. Two years into the reform effort a network of large state-owned monopolies still dominate the economy. The required downsizing, restructuring, technological upgrading, and reorienting of Romania's production sector remains to be done.

One of the major fall-outs of the slow transformation was the phenomenal rise in inter-enterprise arrears in 1991. Enterprises, faced with a new environment in which banks were no longer willing to supply credit passively, in effect created their own means of payment. Running arrears became a substitute for bank financing, and this obviously had adverse implications for the stabilization effort. Eventually output suffered as the payments system became progressively inoperative and cash transfers became the principal means of settlement.

The global compensation scheme implemented by the Government at the beginning of 1992 was successful in clearing most of the inter-enterprise arrears and thus in unblocking the payments system. The particular way this scheme was designed minimized the net injection of liquidity into the economy, and even that was largely sterilized by the authorities. All in all, the monetary consequences of the operation were fairly small, relative to

the size of the gross inter-enterprise arrears. To combat the moral hazard consequences of the global compensation scheme, the Government introduced a new law that laid out specific procedures for controlling any future enterprise arrears and thus the need for any further compensation operations.

While the new law on financial discipline creates definite disincentives for enterprises to go into arrears, a permanent solution has to involve restructuring and/or privatization of state-owned enterprises. The Government of Romania is also proceeding in this direction. For example, it has selected a number of major enterprises, primarily in the chemical, metallurgy, and machine-building sectors, for restructuring. The Government is also in the process of implementing the Law on Privatization that was passed in 1991. Certificates for 30 percent of the share capital of enterprises--"vouchers"--started to be distributed in June 1992 to Romanian citizens. Under the law, the National Agency for Privatization is responsible for developing the privatization strategy with the aim of promoting a more competitive industrial structure through enterprise restructuring.

Jointly, the restructuring and privatization plans are expected to restore the financial health of enterprises in Romania. Once this is achieved, and the appropriate legal framework established and operative, the inter-enterprise arrears problem will presumably take care of itself, as in Western economies (Begg and Portes, 1992). This is not to suggest that government-sponsored bail-outs will never occur. Even the experience of the most-developed market economies shows that governments have needed to intervene financially to support financial sector institutions and other large

enterprises. But this intervention is selective rather than industry-wide, and thus can be rationalized.

The Romanian experience of 1991 with inter-enterprise arrears and the attempts to resolve the problem has lessons in it for other countries that bear spelling out. These lessons include, for example, the following:

- The problem of inter-enterprise arrears is a serious one, and if not addressed, arrears can explode and create serious difficulties for both the stabilization and reform efforts. As the owner of the enterprises running arrears against one another, the state has a direct responsibility to intervene to resolve the problem, and cannot take a hands off approach.
- However, once the government has decided on a course of action to resolve the arrears situation, it should proceed rapidly to implement the chosen measures. Public discussion over an extended period of time, as the Romanian experience shows, creates obvious incentives for enterprises to run larger arrears.
- The selected scheme should aim at clearing most or all arrears if it is to be undertaken at all. Too limited a scheme will not resolve the problem and will further set up expectations of extensions and repetitions.
- In any scheme to eliminate arrears, the monetary consequences of the operation must be taken into account. It must also be clear as to who pays for the operation--enterprises, the banking system, or the budget--otherwise behavior will not be changed.
- The scheme also must be designed so that any credits extended go only towards the clearance of arrears and there are no leakages. The use of special compensation accounts in the Romanian operation prevented

enterprises from using the credits to finance current expenditures and making wage payments.

- A method of ensuring that arrears to do not reappear must be adopted in conjunction with any chosen scheme, such as the Romanian law on financial discipline, to minimize the moral hazard problem. Closing down a large non-viable enterprise may provide an important signal of the government's commitment to enforce financial discipline. This, however, has proven extremely difficult in all transforming economies.

- Government will have to take the lead in initiating bankruptcy proceedings against defaulting enterprises. As experience has shown, it is highly unlikely that banks and other creditors will be prepared to take debtor enterprises to court. Aside from the fact that the state is the owner, the government has to become involved anyway when it comes to enterprises considered "too big to fail." In Romania, for example, past location decisions emphasized geographical dispersion of enterprises, leaving many towns hostage to the fortunes of one or two large enterprises. Liquidation of these large "Kombinats" would cause serious unemployment and severe regional distress, making government intervention necessary anyway.

- Ultimately, privatization will be the solution, and the faster this occurs, the faster arrears will disappear. In a largely private system inter-enterprise credits will be part of normal business, and overdue payments will be handled appropriately through the legal system.



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