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REMONETISATION AND CAPITAL MARKETS IN THE REFORM OF CENTRALLY PLANNED ECONOMIES

by
DOMENICO MARIO NUTI

European University Institute, Florence

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE

DEPARTMENT OF ECONOMICS

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DOMENICO MARIO NUTI

BADIA FIESOLANA, SAN DOMENICO (FI)

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European University Institute
Badia Fiesolana
– 50016 San Domenico (FI) –
Italy

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Domenico Mario Nuti,
European University Institute,
50016 Florence, Italy.

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1. Introduction.

Since the mid-1950s there have been repeated attempts at reforming the Centrally Planned Economy (CPE) of the Soviet Union and other Soviet-type economies, i.e. decentralising economic decisions, activating markets to replace plans, using incentives geared to performance at market values. The frequency of these attempts and their reversals indicates both the intense pressure for reform and the difficulty of its successful implementation. The current round of economic reform involves the Soviet Union, with the "perestroika" launched by Gorbachev on his accession to power in March 1985; Hungary, where the process started in 1968 has entered a new phase in the last three years; Poland, in spite of a spell of military rule; Bulgaria and - from a higher achieved degree of marketisation - Yugoslavia. Reform appears to have restarted, more recently and slowly, in Czechoslovakia; in Eastern Europe the only countries without signs of reform are the GDR, where pressure for change is reduced by its privileged relationship with the FRG and by its more flexible vertically integrated structure, and Romania which is regressing towards the Albanian model. However significant reforms are also taking place in socialist countries outside East Europe, notably in China and Algeria.

The current round of reforms differs from earlier qattempts in several respects. This time the lead comes from the Soviet Union; it is accompanied often by political renewal (see Soviet emphasis on glasnost!); it is more widely understood that a technological and sectoral restructuring of the economies to be reformed is necessary, and that reform implies abandoning traditional policies of overambitious investment, unconditional commitment to price stability and protection of job rights (and perhaps full employment itself); there is greater opening to direct foreign trade with other economic systems and to foreign investment, while the burden of servicing a large external debt forces the maintenance of these conditions. However the most visible, sometimes spectacular aspect of the current round of economic reform is the revamping of money and monetary policy, followed or to be followed by more or less developed capital markets.

This paper characterises the traditional CPE monetary, and financial system (section 2), illustrates the extent of current changes (section 3) which will be discussed further in the papers presented at this session by Zsigmond Jarai and Ales Vahčic; retraces the steps in the argument for and the actual sequencing of monetary and financial reform (section 4); discusses some systemic constraints and their impact on feasible further developments (section 5). The paper by Wlodzimierz Brus and Kazimierz Laski considers whether the full-fledged model of market socialism might be able to avoid labour unemployment or handle fluctuations in the level of economic activity; Richard Portes considers the international aspects of introducing capital markets in Eastern Europe.

2. Money and finance under central planning

In the traditional CPE money is primarily an accounting instrument of aggregation and control; financial flows are compartmentalised between enterprises and households, with a bank money circuit for inter-enterprises transactions and cash (or cash-convertible accounts) for transactions involving households as sellers or buyers, i.e. wage payments and consumption purchases. These financial flows are adjusted passively to planned physical flows and to the degree of their implementation by a single bank monopolising the functions of commercial as well as central banking (therefore dubbed "Monobank" in Western literature). Households savings (whether voluntary or, when intended purchases exceed supply at centrally fixed prices, involuntary) can take the form of a small range of durables including some production goods, or cash or a limited range of financial instruments (deposits, bonds, insurance, lottery tickets); the balance of revenues and expenditures of the population is closely monitored and forms the basis of cash issues; ideally it is balanced ex ante through price and incomes policy. Enterprises can only use finance for purposes specified in plan documents; in this sense Berliner (1976) talks of "documonetary" economy.

Investment is centrally decided and allocated in real terms while finance is provided automatically and interest-free from the state budget to investors, who are subject to straight line amortisation charges on the historical cost of their investments and transfer back to the state budget any surplus which they may realise (or rely on further transfers from the budget to cover their planned losses; however official regulations for investment selection imply a shadow capital charge, see Nuti 1971b). Credit is mostly short term and is also automatically available to enterprises to finance their working capital requirements necessary to fulfill their planned tasks; it is granted by the Central Bank at an almost symbolic interest rate designed to cover banks' administrative costs. Trade credit between enterprises is forbidden. Thus money in the traditional system is the unit of account, a two-tier medium of exchange conditionally to plan conformity, a store of

value in competition with inventories of goods rather than with alternative financial or productive assets. Money is an instrument for monitoring and controlling plan implementation ("control by the rouble" is emphasised in Soviet literature), not an instrument for economic management, except when planners lose control over financial balances, in which case monetary policy can be an important instrument for restoring that balance. Fiscal policy takes the form primarily of diversified turnover tax rates or subsidies on commodities, and is indistinguishable from profit; income tax is spurned as an unnecessary internal transfer within the state sector; a modest government surplus is the customary budgetary stance; government deficits are effectively instantly monetised.

Traditionally CPEs are regarded as having a propensity for autarkic or quasi-autarkic structure (Wiles, 1968). In the process of plan construction, first the necessary import requirements of planned levels of gross output are estimated by commodity groups, then export plans are adapted to the foreign currency requirements of the import plan; if a deficit emerges, over what can be financed out of reserves or fresh borrowing, unless import substitution can fill the gap output plans are scaled down. Exports are regarded as a "necessary evil", as a withdrawal from the domestic market. Planned trade is undertaken through large import-export state enterprises, specialised by commodity group, not on behalf of producers but on their own account. Domestic currencies are not convertible into commodities (outside the sphere of consumer purchases by nationals), let alone other currencies; exchange rates have a purely accounting role, with equalisation subsidies and taxes tending to make all planned exports equally profitable to producers and imports competitive with domestic substitutes whenever they are available; the economy is effectively insulated from the fluctuations in international prices and exchange rate. There is planned trade integration within the socialist trading bloc - CMEA or Council of Mutual Economic Assistence (also called Comecon but only in Western literature; at present includes the USSR, the East European Six, Mongolia, Cuba and Vietnam) - as the result of the coordination of national plans. Even within CMEA, however, trade flows tend to be bilaterally cleared (moreover within groups of hard and soft commodities) and there is no common currency, balances in the so-called transferable rouble being neither convertible in Soviet commodities nor transferable to countries other than the Soviet Union, without prior mutual agreement; intra-CMEA trade prices are usually indexed to a moving average of international prices in convertible currencies. All in all, foreign trade transactions are administratively determined and there is no automatic mechanism transmitting to producers signals about trade opportunities and inducing them to take advantage of any such opportunities (see Brown and Neuberger 1968; Holzman 1974, 1976; van Brabant 1973).

In theory the CPE's Monobank is the custodian of economic equilibrium; in practice it presides over a regime of almost permanent excess demand, internal and external, to the point of leading to the identification of the economics of socialist planning with "the economics of shortage" (Kornai 1980, 1982, 1986); this is the result of overambition at all levels and price downwards inflexibility but is ultimately made possible by the acquiescence of the banking system. Hence the move towards market discipline, including credit discipline instead of automatic credit.

3. The extent of monetary and financial reform.

Monetary and financial reform presupposes the prior dismantling of central planning as a set of detailed physical commands to enterprises and sectors, and the implementation of a degree of enterprise autonomy and financial identity, subject to government policy exercised through indirect instruments. Thus the monetary and financial institutions of Yugoslavia, which first moved away from central planning, are the most developed in Eastern Europe (see Dimitrievic and Macesich, 1973, 1983); but especially in the last two years the pace of monetary and financial reform has been fast and accelerating.

The Yugoslav banking system includes - beside the central bank NBY plus the national banks of the federation members - 166 basic banks and the associated banks formed by basic banks, other financial institutions such as the Post Office Savings bank, the Yugoslav Bank for International Economic Cooperation YBIEC and internal banks (i.e. closed financial institutions internal to enterprises accepting deposits from enterprise workers and BOALs). NBY controls commercial banks through liquidity ratios, reserve requirements, credit ceilings, refinancing. In 1972 the commercial banking structure changed from one consisting of commercial banks and investment banks to a mixed bank system engaged in both short and long term operations. Basic banks are formed by enterprises, internal banks of enterprises, and other non-government institutions; they are regulated by organs composed of representatives of founding enterprises; until recently founding members of banks had unlimited liability. Associated banks formed by basic banks pool resources and usually handle foreign exchange operations, and tend to operate along regional lines.

In 1985 a new law was introduced, with which banks were to comply before the end of 1986. The new law raises capital requirements of commercial banks, defines the limited liability of banks shareholder enterprises, requires the build up of reserves and encourages inter-regional competition. A new accounting law from 1-1-1987 eliminated the possibility of deferring current foreign exchange losses in enterprise budgets. The purpose of these reforms is that of eliminating the drawbacks of the Yugoslav banking system to date: the financial indiscipline in the enterprise and banking sectors, the taking over by the NBY of foreign exchange risk on enterprise foreign borrowing, the negative interest rates, the lending to enterprises at rates lower

than the cost of finance, the socialisation of enterprise losses all round.

In Hungary, with effect from 1-1-1987, first commercial banking has been separated from central banking by the Monobank - as it was done in Britain with Sir Robert Peel's Act of 1844, which abandoned the principles of the banking school in favour of those of the currency school); then competition has been introduced in commercial banking by turning the Monobank lending directorates and some regional departments into autonomous banks and creating additional commercial banks (competing commercial banks were already present in the USSR in the early stages of NEP, see Arnold 1937; Carr and Davies 1969). Three of the new banks have been set up with the participation of Western capital, namely Citibank Budapest, the Central European International Bank and Unicbank; commercial banks however do not yet compete for households deposits, reserved to the National Savings Bank. The change implies the gradual integration and connection of all financial flows, and the replacement of budgetary grants and automatic credit with contractual relations with banks based on credit-worthiness, and at an interest which is supposed to balance the loans market. Central Bank control of credit expansion is exercised through indirect instruments such as reserve and liquidity ratios, rediscounting scale and rates, open market operations (initially consisting of primary issues of short term securities); the way is paved for active monetary policy. At present it is felt that both the scale of refinancing and reserve ratios are high by international standards, two elements offsetting each other but perhaps adding up to a higher degree of direct central control than desirable or intended. A thorny question is the verification and treatment of the portfolio inherited by banks, some of which consists of doubtful loans made under the earlier financial regime. Another is the organisation of housing finance, which is precondition for the unification of the two monetary circuits of households and enterprises.

Hungarian style monetary reform has been adopted in Poland and Bulgaria (see Daviddi 1987), and its necessity has been maintained in the Soviet Union by leading reformers; a first step in the USSR has already been made with the setting up of six new specialised banks, decreed in July 1987. Credit-worthiness and financial discipline requires strict procedures for the recovery, liquidation and bankruptcy of non financially viable enterprises; such procedures are now in force in Hungary, Yugoslavia, Poland and the Soviet Union, and a handful of bankrupt firms - mostly in construction - are proudly listed by reformers as a major achievement.

In Hungary since 1983, i.e. already before the banking reform, a bond market has operated with primary issues and secondary trading, for both enterprises (non state guaranteed) and households (guaranteed), with issues growing by over thirty times (100 times for households) in five years to almost 30 bn Forint in 1987. Shares have also been issued and retraded though until now exclusively within state enterprises. The next tasks of the financial reform are the development of the role of financial investors (insurance companies, pension funds, savings association etcetera) and of an integrated money market with a unified interest rate structure, and the development of an equity market extended to households (announced for 1-1-1989); this will require a parallel development and generalisation of joint-stock companies, at present limited in number and scope.

Similar financial facilities have been available since 1986 on an experimental basis in China, where commercial banking has developed and the first stock exchange was opened on 1 September 1986 in Shanghai, followed by Guangdong and other provincial initiatives; there are eight "over the counter" centers in Shanghai and Shenyang (in the Liaoning Province; by November 1987 the value of bonds quoted had reached Yuan 300 mn, or US$85 mn at the official exchange rate; see Ellman 1987; on early experiments see Xu Jing'an 1987). Shares are still illiquid, having to be held for substantial minimum periods, and do not carry a vote. At China's 13th Party Congress in October 1987 it was agreed that stocks and bonds have a positive role to play in the Chinese economy at its present stage of development (Ellman, 1987).

In Algeria, following liberalisation measures for enterprises and banks (maintained in existence by the 1962 nationalisation but otherwise operating as in a traditional CPE model), January 1988 legislation has decreed the financial restructuring of state enterprises, which have been given new capital and turned into state-owned joint stock companies; their shares are given a value calculated and revised by accountants and government officials. In May 1988 eight state-owned but independent Trust Funds ("Fonds de Participation") were established, partly but not completely specialised by sector (mining, investment goods, construction, petrochemicals, electronics, food processing, miscellaneous industries, services); they have the function of managing state ownership. In the Algerian approach Funds managers, rewarded according to the financial performance of their portfolio, which they can alter by trading with other Funds, are expected to effectively simulate the functioning of capital markets.

In mid-August 1988 a special Yugoslav commission headed by Mr Branko Mikulic, the Prime Minister, proposed a radical reform of enterprises and of socialist ownership, which would allow Yugoslav and foreigners to buy shares in them; the proposal will be considered in the autumn by the Federal Assembly (FT, 17 August).

Other countries have been more cautious in developing capital markets, but some have been bolder in other directions: for instance, since September 1987 once a fortnight the Polish Export Promotion Bank has been

auctioning foreign exchange worth millions of dollars, to importers on behalf of exporters, at a realistic rate of exchange increasingly close to the black market rate.

In the Soviet Union joint-stock companies are reported to have been set up "spontaneously" by state enterprises or agencies, seeing that inter-enterprise agreements of this kind are not actually forbidden by Law. For instance, in Leningrad there are now two "commercial joint stock" banks, set up by the Ministry of Chemical Equipment (Minkhimash) and that of Energy Technology (Energomash) to finance export promotion and domestic ventures, apparently empowered to issue bonds and accept deposits in foreign currencies as well as in roubles (FT, 12 August 1988). At the end of July 1988 Vnesheconombank - the Soviet Bank of Foreign Economic Affairs - and the Eurocard/Eurocheque and Mastercard organisations signed a licencing agreement extending credit card and cheque facilities first to foreigners (in competition with Inturist which has signed a similar agreement with Visa) then, in the second year of operation, to 150,000-200,000 Soviet diplomats, business executives and technicians with convertible rouble accounts at the Foreign Economic Affairs Bank. Savings banks also have been involved in discussions about issueing credit cards on their own account - a step towards a cashless society but definitely not moneyless society. At the signing ceremony of the licencing agreement Mr Viktor Geraschenko, the Soviet Union first deputy chairman, took delivery of a three feet by five foot Eurocard (FT, 1 August). This is perestroika.

4. The "sequencing" of reform

The importance of money in the reformed socialist model was stressed by Brus (1964); a pioneering detection and analysis of the early stages of this process in the 1960s can be found in Garvy, 1966 and Grossman, 1966 and 1968; a great deal of attention has also been paid to monetary imbalance and the definition and measurement of "repressed inflation" (see for instance Portes 1983; Nuti 1986). Otherwise the role of money and financial institutions under market socialism has been conspicuously neglected both in the classical literature on market socialism and - until very recently - in the blueprints for economic reform in Eastern Europe. Yet there is a compelling logical sequence in the argument for monetary and financial reform, which can also be identified as an actual and indeed normative sequencing in reform implementation. It bears out Maurice Dobb's contention that elements of different economic systems cannot be mixed in just any proportions, as one can with a cake varying ingredients to taste: once limited markets for products are introduced, the argument escalates in favour of further extensions.

The starting point is the inefficiency of central allocation of production targets and given physical resources to enterprises in the consumption goods sector: it soon becomes apparent that it is more efficient to let consumer indicate their preferences for the kind of goods that can be produced with those resources, by signalling demand prices, instead of leaving output structure to a central decision (even socially desirable and undesirable goods can be regulated by taxes and subsidies instead of direct commands). The second stage is the extension of this reasoning to inter-enterprise allocation of current inputs, still within an overall allocation of intermediate inputs to consumption; the third stage is the redeployment of a given amount of planned investment, allocated to consumption goods, between different sectors and enterprises. Gradually, in the fourth and fifth stages, both the level and the structure of investment are argued to be best decentralised to the level of enterprises. A parallel development opens enterprise purchases and sales to international suppliers and purchasers.

These piecemeal extensions of the basic efficiency of market redeployment of scarse resources towards their most productive uses trace a natural path and sequencing of economic reform of the CPEs. First the market for consumption goods, then for production goods, demand remonetisation, i.e. the use of value indicators to measure enterprise performance and to take the given resources to their most productive uses. Then the market for factors of production, i.e. for labour, land and capital, both financial capital and productive assets; financial capital first between enterprises, then between enterprises and their own workers, then between enterprises and households as sectors; first for loan capital, then for risk capital. There is a tendency towards a cascade or domino effect from the acceptance of markets as i) automatic ii) self-regulating mechanisms iii) raising the productivity of resources. Of course the extension from micro to macro of the argument in favour of markets is not water-tight; taking investment out of the planning sphere raises the possibility of labour unemployment; indeed some labour unemployment becomes necessary to accomodate the structural change produced by decentralisation. This problem, tackled by Brus and Laski in their paper at this Session, is often easily forgotten, since the comparative macroeconomic performance of socialist countries in recent years has been so poor as to tip the balance in favour of markets even in the macrosphere; or at least experience has shifted the burden of proof.

In an economy such as Yugoslavia, where workers are entitled to a share of their enterprises' value added after deductions for interest, amortisation and reinvestment, the introduction of shares makes it possible to recognise - by means of free share issues - workers' contributions to self-financed investment and to entrepreneurial success (Uvalic, 1987). Without such a recognition, the Yugoslav-type enterprise seems subjected to a propensity to underemploy labour and respond perversely to short term price changes (Ward 1967; Vanek 1970), as well as underinvest in self-financed projects (Furobotn and Pejovich 1972, Furobotn 1980). Shares also enable the cooperative-style Yugoslav enterprise to tap outside risk capital, without which it is permanently dependent on central capital or relegated to small scale labour intensive sectors.

5. Systemic constraints and reform alternatives

Once the necessity of remonetisation and some kind of capital market is accepted two problems arise: i) systemic identity, i.e. whether a fully reformed market socialism is reconcilable with the systemic and ideological premises of socialism; ii) feasibility, i.e. whether it would be possible to develop further financial institutions while still satisfying systemic or ideological restrictions.

Can capital markets or quasi-markets be reconciled with socialism? The boldness of the Hungarian or the Chinese projects may suggest that this is an idle question. Yet we must take into account the small scale, experimental nature and unfinished implementation of these projects, which may still be opposed, suspended or reversed precisely in the name of systemic orthodoxy.

The question has a qualified positive answer. In all socialist economies there is a possibility of appropriating consumption goods for postponed consumption; why not then let people save in the form of money rather than hoarding goods, so that there is more to go round for those who wish to consume or for the state to undertaken more productive investment or more social consumption. If there is money there is a positive nominal interest to induce people to part with their liquidity-yielding cash (too much liquidity in the hands of the population is potentially unstable); in all socialist economies there are also lotteries. If private shareholding is diffused, as in the capitalist ideal of a "property owning democracy", and if shareholders' voting powers were restricted or removed, private shareholding would be no different from a combination of fixed interest savings and lottery tickets, except that its yields would be more justifiable than those of a pure game of chance. If shares were regarded as conflicting with socialist principles then the very ability to save would have to be challenged on the same grounds. But suppose a further restriction - which will certainly remain at least for some time in a number of socialist countries - that shareholding should be public not private. Would it be feasible to replicate the functioning of capital markets under these restrictions?

There seem to be two ready made solutions. The first is the development of a German-type banking involvement in the management of enterprises; the second is the more specialised use of Algerian-type Fonds de Participation.

Banks control over companies is exercised in Germany through the appointment of representatives to the

Boards of borrowing firms, through direct shareholding (found to be 9 per cent of share capital in a study of 74 representative quoted companies, Eckstein, 1980) and above all through proxy voting on behalf of those shareholders (by and large the majority) who have lodged their shares with their banks (see for instance Cable 1985a and 1985b). This institutional pattern was introduced as a consequence of the underdevelopment of capital markets in late nineteenth century Germany and is naturally suited to the rudimentary capital market of a reforming socialist country. Public shareholders, possibly also private shareholders without voting rights, could entrust competing commercial banks with the task of overviewing their companies and monitoring and promoting their profitability. However, the merits of German-type supervision of industry by banks are controversial and the system has come under strong criticism recently, especially in Germany (Gessler Kommission 1979; Eckstein 1980; Vittas 1983). The system is widely regarded as a second-best option; the dominating rôle of banks in the stock exchange is resented, especially in view of conflicting interests vested in different functions of banks as lenders, shareholders and advisors to investors, their emphasis on short term performance and the dangers of monopolistic practices (which have attracted the attention of the Monopolkommission, see Cable, 1985a). Moreover the German system generates a certain insulation between the real world of production and the world of financial values, which prevents the fulfilment of one of the main functions of a capital market, that of stimulating efficient redeployment of assets. More to the point, the German system coexists with a full-fledged stock exhange and cannot possibly be expected to function as a substitute for a stock exchange.

The second feasible development involves exclusively state holding companies in market-making and the management of state investments; it is the Algerian solution. The establishment and the mode of operation of Fonds de Participation are very ingenious and original means of administering state ownership and simulating the operation of the wanted capital markets. Three problems can be anticipated, however: i) the arbitrary and necessarily accounting-oriented valuation of enterprise assets, which remains an administrative act divorced from market verification; ii) the understatement of profits if only cash flows are considered, ignoring the component of enterprise profits which is made up of capital gains brought about by enterprise success, with resulting conflicts between Fonds and enterprises as to the distribution or reinvestment of profits; iii) the incentive structure of individual administrators of the Fonds raises a dilemma: individual benefit can be seen as undue participation in the returns to national savings; yet without some form of participation the incentive/penalty structure of Fonds administrators is defective, and only too likely to be dominated by Ministerial presence in their shareholders' assemblies, leading to a perpetuation of central administrative control on enterprise capital.

A third possibility can be imagined, of relying on a competitive valuation of enterprise assets, generated within the state sector, as a basis for an implicit valuation of enterprise shares, with individuals barred from ownership but able to take risks and associated rewards and penalties by means of loans and deposits indexed to the performance of shares of their choice (or by means of bets such as can be taken today in capitalist economies on a share index). Such competitive valuation of enterprise assets would start from a self-assessed valuation by enterprise managers. Realistic valuations of assets would be obtained if managers were forced to sell them to other enterprises that might wish to buy them at the declared prices or to revise prices so as to make such transactions unattractive (capital taxation being used to avoid overvaluation by managers; for a more detailed description and account of the possible mode of operation of such a scheme see Nuti, 1987 and 1988).

Such simulation of capital markets would not violate any of the systemic-ideological restrictions indicated above, yet would have no side effects other than those of a true capital market. Although the effects on efficiency and distribution of such a simulated market would be qualitatatively similar to actual capital markets with private shareholdings, the impact of individual gambling on share valuations would be regulated at will by government policy through the agency or agencies entering indexed transactions or taking bets with private individuals. The basic equivalence of actual and proposed capital markets has an important corollary; if capital markets can be replicated without violating the strictest systemic/ideological constraints, in this way or in some other way they ought to and most probably will be implemented.

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