Why interenterprise credits grow

Consider (with apologies to Adam Smith) an efficient pin producer selling half her production in the convertible currency market (where buyers are picky) and the rest in the domestic market to inefficient, financially shaky (state-owned) enterprises. The pins are similar but not identical, with only good pins sold in the convertible currency market and both good and bad pins in the domestic market. The firm can switch from producing one to the other with some retooling, but gearing up to sell more in the convertible currency market requires time and effort.

The pin producer buys the necessary labor and steel each morning, ships the goods each afternoon, receives payment, and in turn pays suppliers and labor. The pin producer therefore has neither a cash surplus nor a deficit. To keep things simple, there is no banking system.

One afternoon an inefficient pin buyer tells the producer that he cannot pay that day but promises to pay the next day for both days’ shipments—that is, he asks the pin producer to raise the interenterprise credit outstanding from zero to one day’s production overnight. Now the pin producer is in a quandary: to keep her production lines open, she must either produce fewer pins (producing...
only for the convertible currency sales) or find additional credit, perhaps from the steel supplier.

Producing fewer pins would leave some workers idle. Firing workers destroys firm-specific human capital. So even though the pin producer may doubt the buyer’s ability to pay as promised, she maintains production and ships pins as before, raising interenterprise credit from its earlier level of zero. Suppose the pin buyer does not pay. As the pin producer finds alternative markets, shipments to the defaulting domestic buyer stop and the accumulation of arrears ceases. If these arrears accrue (unpaid) interest, their stock still rises, but that is just an accounting measure and does not imply that resources are misallocated. So why all the fuss? The “problems” are examined in turn.

**Charge 1: Interenterprise credit misallocates resources**

The example makes plain that the increase of interenterprise credit enabled the pin producer to keep skilled staff while she finds new markets. She weighed the costs of closing production lines and laying off workers against the likelihood of the domestic buyer’s not paying as promised. Even if she did not know the extent of the pinbuyer’s troubles, the interenterprise credit gave the pin producer breathing space to decide what to do. But she could not continue to dither unless she in turn obtained more credit (or the pin buyer paid up). Undiminished production therefore requires a continual, real increase in the stock of interenterprise credit. Rolling over an unchanged stock of interenterprise debt, even at revalued prices, would not suffice: new credit is required each period to maintain undiminished production. With inflation, nominal credit may seem to grow precipitously, but it is real growth that matters.

The pin producer might later regret her decision, but mistakes occur in business, and those who make too many lose their business. The point is that in the example, resources are not misallocated in an ex ante sense. When banks are unresponsive, collateral laws are weak, and credit markets function poorly, these supplier credits perform a vital function. The fault is not with the credit, but with lenders who do not care to collect.

**Charge 2: Interenterprise credit frustrates monetary or credit policy**

It is sometimes claimed that a large stock of interenterprise credit frustrates “monetary policy”—that it makes it impossible for the central bank to enforce credit ceilings effectively. This claim is fallacious because governments (or central banks) have always been able to directly constrain bank credit, but never nonbank credit (whether from other enterprises or households).

As an illustration, consider a modified version of the earlier example. The pin producer has a working capital loan from a bank that is rolled over each day to pay for wages and steel. Thus, she borrows from a commercial bank each morning to pay for labor and materials and repays the loan from sales proceeds at the end of the day. If monetary authorities see the collapse of the traditional market as permanent, they may decide to halve credit growth. If commercial banks reduce credit to all borrowers, the pin producer’s two choices are the same as before. If the pin producer uses interenterprise credit to “get around” the tightening of bank credit ceilings, the stock of interenterprise credit may show an “alarming rise.” But that could happen only if enterprises with cash surpluses continually lend (continually increase the real stock of credits) to enterprises with cash deficits.

**Charge 3: Interenterprise credit is inflationary**

A variant of the “frustrating monetary policy” charge is that interenterprise credit growth is inflationary. Underlying this claim is the assumption that the credits—especially if extended through the banking system—are a form of “money” whose growth would raise the price level.

To paraphrase Tobin, this confuses the fountain pen of enterprise managers (and their ability to persuade banks to grant credit) with the printing press of government. The proximate cause of inflation must be the government printing press—the monetary base or currency. An increase in inside money—commercial bank loans or inter-
enterprise credits, for example—cannot be inflationary. This is most easily seen by analogy: when General Motors issues commercial paper that other enterprises hold (interenterprise debt), inflationary worries do not arise, so why would they if the GM paper were held through banks?

Charge 4: Interenterprise credit hurts good enterprises

When bad enterprises can use interenterprise credit to avoid restructuring (closing down loss-making activities and firing workers), it is alleged that good enterprises (creditors) get hurt. But good enterprises would not extend credit unless they perceive a likely benefit or, as the earlier example showed, would extend credit only as a sensible temporary measure while they search for new markets.

A possible exception would occur if enterprises with cash surpluses were forced to lend to bad enterprises. But private owners of enterprises with cash surpluses are unlikely to be coerced by governments, and few state-owned enterprises would have such surpluses. As a group, state-owned enterprises have a cash deficit. The few cash surpluses are more likely to occur in well-run private enterprises (or in the household sector, which usually lends only through banks).

Charge 5: Interenterprise credit is bad because it causes a domino effect

Interenterprise credit and the resulting losses when the debts go unpaid are alleged to have a domino effect on the economy. Applying the metaphor of falling dominoes is misleading for two reasons. First, enterprises are linked because the output of one is used by another, and any disruption in production would affect all the links in the chain irrespective of any arrears buildup. In other words, dominos would fall even if there were no arrears. Second, the economic losses are incurred when credits are extended to maintain unnecessary production, not when (because) accounting losses are realized. Reverting to our example, the pin producer incurred losses when producing pins for the defaulting domestic buyer, not when the unsold inventory (or the receivables from the insolvent buyer) had to be written off. That the pin producer chose to continue shipping pins to the defaulting buyer suggests that the likely losses of shutting down production lines (violation of implicit labor contracts, etc.) were greater. The government should not be second-guessing such business decisions.

There is a sense in which the domino effect could be fatal. The more sound enterprises that an unsound one can get enmeshed in its problems, the larger its political constituency and the more calls to the government for a bailout. A determined government should heed Ulysses’ example when passing the sirens, but far too many believe that a large stock of debt not being serviced is a problem they must fix.

Fatal medicine

Although the losses from unpaid arrears are sunk, how are they to be allocated? In a market economy, the creditor, the bank, or the taxpayer (deposit insurer) bears the loss. But in transforming economies, taxpayers bear the losses regardless of which state-owned enterprise in the chain realizes them. The suggested solutions to the “problem” of interenterprise arrears are of two kinds: blanket solutions to clear the entire stock of interenterprise credit, and the case-by-case approach to provide relief selectively. Blanket solutions—a government-initiated cancellation or socialization of debt (replacing enterprise debt with government debt, as in Romania)—are dangerous because they relax the cash constraints on state-owned enterprises. Cash-rich enterprises would lend again to defaulting enterprises, expecting the government to bail them out again. The government would eventually have to service its own debt by printing money, which would lead to inflation. The case-by-case approach may seem less risky, but it too invites rent-seeking from the politically powerful enterprises. That is not a risk worth taking when government intervention is unnecessary.

In conclusion: A chimera

A “hard budget constraint” on enterprises is universally acknowledged to be vital, but enforcing this discipline is easier said than done. Trying to solve the interenterprise arrears “problem” inad-
vertently loosens the constraint. There are generally two major sources of interenterprise credit (besides the budgeted subsidies or transfers): suppliers and banks. This Note has argued that supplier credits are a self-correcting leak and that the government should limit bank credit, which is more likely to eventually be monetized.

The self-correcting nature of supplier credits is not well recognized, and reformers worry when interenterprise credit mushrooms. Two points are worth noting here. First, if interest accrues on interenterprise credits, the balance sheets of both debtor and creditor would show interenterprise credit continually rising (even in real terms if nominal interest rates exceed inflation), but this accrual accounting would not violate the cash constraint. That the creditor's asset (or the debtor's liabilities) is likely worth far less than stated should worry accountants, not reformers. Second, only enterprises with cash surpluses could extend credit to others, and if there were state-owned surplus enterprises, they would be eminently privatizable. Large arrears to or from an enterprise do not thwart privatization. Indeed, many buyers make a deal with creditors before they bid, and a privatized creditor often shows great ingenuity in collecting seemingly incollectible debts.

Surplus enterprises may not actually show a surplus even if they have one. Enterprise managers, having learned long ago that they lose control over surplus funds, have developed ways of squirreling away reserves in excessive inventories or worker benefits. Surpluses are best sucked out by imposing an alternative minimum tax on corporate assets4 and subjecting each enterprise to a binding cash constraint. Enterprises cannot, of course, pay what they do not have, and tax arrears could rapidly build up. But the problem is enterprises that could pay but do not. So, better tax administration is required. Meanwhile, even if the government did not collect what it is owed, egregiously value subtracting industries (those whose revenues are less than input and net-of-taxes wage costs) are still bound by the constraint.

In conclusion, interenterprise credit is a phenomenon that needs watching (to see how rapidly enterprises are adjusting), not a problem demanding a solution. The stock of such credit will rise, but asymptotically level off in real terms. How long such credit grows depends on how rapidly enterprises transform their operations. And how long it takes for the elevated stock to decline depends on the restructuring of enterprise claims, which may require privatization of enterprises. Even if privatization takes time, there may be no resulting harm because resource allocation is unaffected by the stock of interenterprise credit.5

References


1 The assumption here is that the payments system functions well. Otherwise, the selling enterprise may not be paid even when the buying enterprise has paid, and the central bank would allow credit to be extended to compensate for the delay. This makes the central bank's task impossibly difficult because it would have to distinguish delayed payment from nonpayment.
2 Tobin (1963) discusses why commercial-bank-created money (and, by implication, all inside money) is not a source of inflation.
3 Greater commercial paper issuance could lead to a change in the price level only if associated with a change in bank intermediation, thereby altering the demand for base money through required reserves (a component of base money). Ramachandran (1986) examines the links between alternative measures of money and inflation.
4 Calvo and Frenkel (1991) emphasize this channel.
5 Transformation to a market economy requires the government to raise revenues through taxes rather than requisitioning resources as owner. Initially, excise taxes, trade tariffs, and wage taxes (for administrative ease) yield most of the revenues, but as incomes become more unequal, taxes on personal and corporate incomes are quickly introduced.

Corporate income taxes generally yield little revenue because of evasion and because few corporations show a profit. An alternative minimum asset tax on corporations (a resounding success in Mexico, where inflation eroded the corporate tax base and evasion was a serious problem) is both easy to administer and has the merit of not increasing the tax burden on profitable and honest firms. In transforming economies, such a tax has the added merit of tightening the cash constraint on genuinely unprofitable firms and thus prompting them to restructure more quickly.

6 See “Bankruptcy’s Role in Enterprise Restructuring,” FPD Note 88.

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