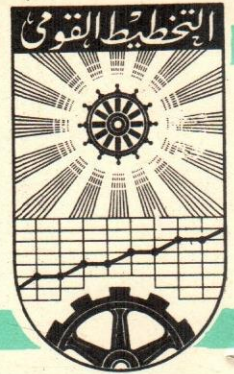


UNITED ARAB REPUBLIC

THE INSTITUTE OF NATIONAL PLANNING



Memo. No. 761

Credit Planning
and State Supervision Function
of Banks in the GDR

By
Prof.Dr.habil.Erhart Knauthe

April 1967

Contents

Page

1

2

5

10

14

16

20

Introduction

I. The banking system.....

II. Essential points regarding money circulation and clearing

III. Essential points regarding capital allocation of working capital (limitation of stocks).....

IV. How is to determine the share of own working capital in public enterprises?

V. Credit planning of the bank

VI. The tasks of bank in supporting the annual planning of enterprises and general organizations

Introduction:-

The UAR is going ahead in its industrialization very speedily. The more planning and programming the more following-up is necessary. The problem can not be solved only by statistical reports or by the responsibility of the managers. It is in this context that the socialist banks have to play their role. New functions of ~~credit~~ and interest arise after having public ownership of enterprises and banks. All bank activities have to be linked with the targets of national plans. The bank should participate in enterprise planning, especially in financial planning. The financial flow discovers the achievements of every enterprise permanent. Therefore, banks are able to serve with a supervision function. In the socialist countries banks are considered as the centre of permanent supervision.

In order to explain under which preconditions such a system is workable the experiences of the German Democratic Republic in the last 15 years are concerned in this paper. I recommend to read my memorandum "The functions of banks in financing public enterprises" (INP. No. 743) first. Besides this it also should be read the memorandum "Concepts of investment financing with reference to the GDR Investment Bank and the UAR Investment Fund", published by M.A. Elhamy and E. Knauth. (INP. No. 747)

I. The banking system

There are the following banks:

The National Bank (Deutsche Notenbank) as the issue bank and the branch bank for all branches except agriculture and foreign trade. This bank is also ~~acting as~~ the state bank keeping all ~~on-~~accounts of state bodies and organizations.

The Investment Bank as the centre of following-up investments. This is not a fully developed bank, but, it is more a state supervision authority than a bank. The financial ~~sources~~ determind for investment have to be accumulated at special purposed accounts of the enterprises and general organizations opened at National Bank as the branch bank.

That means, depreciations, profit shares, ~~grantings~~ from the budget and also credits for investments have to be collected at this special investment accounts (Investment funds of enterprises and general organizations). It doesn't ~~matter~~ whether investment credits are spent from Investment Bank or National Bank.

The Investment Bank has to approve all withdrawels of financial means from this investment funds (accounts) accordingly with the carrying-out of the ~~stages~~ of investment projects. This approvals are in fact a system of unblocking of means based upon a supervision on the spot.¹⁾ It is expected to incorporate the Investment Bank into the National Bank as a special supervision department for investment financing and carrying-out. Nevertheless, that will not affect the supervision function in the field of investments. On the contrary, it may increase the efficiency of supervision, because the experiences in current and investment supervision can be used simultaneously.

1) Cp. Elhamy/Knauthe: Concepts of investment financing with reference to the GDR Investment Bank and the UAR Investment Fund, INP. Memo. No. 747.

The Agricultural Bank is the centre for financing of current operations and investments of cooperative and public farms.

The Foreign Trade Bank is responsible for financing the foreign trade companies and for international clearing as well as for credits in foreign currency.

The local cooperative banks are responsible for private and cooperative handicrafts, private retailers and innkeepers (current accounts, credits).

The local saving banks are responsible for private savings and consumer credits as well as for financing of public housing.

It is impossible to open a private account at National Bank, Investment Bank, Agricultural Bank, and Foreign Trade Bank. All private accounts are to be opened at the local saving banks. Naturally, everyone is allowed to open so much saving accounts as he likes. Also salaries are to be transferred to accounts opened at saving banks as far as payment by cash is not desired by the employee. A special kind of saving banks is the post saving bank. But, despite that, the post office is the general agent of all other saving banks, too. Therefore it will accept payments and withdrawals on account of every other saving bank. In this case the post will book the payment or withdrawal in the submitted saving book, cash or pay and inform the relevant saving bank.

All these banks are public banks (with the exception of the local cooperative banks which are working under state control). Public banks are an essential precondition for having a planned national economy. There are at least two functions of banks in a planned national economy.

First : The distribution function. The banks are collecting deposits which represent preliminary free means of the national reproduction process, and, these means are preliminarily distributed with the help of credits;

Second: The state supervision function. The banks concentrate and canalize the ~~money~~ circulation and, especially the financial flow in such a way that a comprehensive following-up of the reproduction process of every public enterprise and branch is ensured.

There are also other bank functions like organizing the money circulation, keeping stability of national currency and organizing national and international clearing systems as well.

II. Essential points regarding money circulation and clearing

In order to link banking system with a planned national economy it is necessary to organize and canalize money circulation and financial flow. Under this precondition banking system can be used for following-up the fulfillment of national economic plans. In a socialist economy banking system is considered as the centre of operative and permanent supervision of economic processes. It is in this context that socialist banks are acting in a state supervision function. But banks can not play this role by public ownership of banks only. In order to use the money circulation and the financial flow as a signal it is necessary to organize and canalize them.

Good preconditions for organization and canalization of money and financial flow in the UAR are given by public banks and their specialization on branches. But, it is necessary to have more special regulations in order to link the banking system completely with the requirements of planning and following-up in public sector. The GDR started in the early 50's some measures aimed at better money circulation and financial flow.

Every enterprise is allowed to be connected with one bank only.

Thus the bank is in the position to be permanently linked with the same enterprises and to accumulate experiences in financing and supervision with reference to certain

branches. Since in the GDR do not exist different branch banks for industries there are departments for every branch.

More specially speaking the following system or scheme of organization is applied: Every public enterprise is in touch with the local bank department which is keeping the accounts. But on the spot of the general organization responsible for a branch (or group of articles) there is established a branch department of the bank (National Bank). This department is responsible for credit planning regarded to the enterprises in the branch and for analysis and supervision of observance of the targets. The branch department is without cash operations. On the basis of the approved credit plan every enterprise is allowed to fix credit agreements with its local bank department.

Obligation for keeping bank accounts preventing cash operations between enterprises.

All enterprises are obliged to have business accounts at their banks. Deliveries and services must be paid by transfers and are not allowed to be paid in cash. Salaries and wages are paid in cash or transferred to private accounts opened at the saving banks. Payment and transfer of salaries and wages must be in accordance with the annual plan and its fulfillment. This is to check on by the bank. Every enterprise has only a small cash for its purposes the amount of it is limited by the bank. Exceeding cash money is to be paid to the bank daily. Retailers, innkeepers, gardeners, handicrafts and companies with all kinds of services must

pay in their turnover proceeds daily as far as the cash limit laid down by the bank is exceeded. All this is stated by a public law concerning the cash money circulation. As a matter of fact the result are two spheres of money circulation: The money transfer system and the cash money circulation.

As to the cash money circulation it is limited on privat consumption. Therefore, the amount of circulating money is a function of the cover or supply of commodities and services since savings in cash are not usual by the GDR population. . On the other hand the daily paying-in of turnover proceeds in cash at bank accounts is an exact mirror of fulfillment of the retail sale in every region. By reason of these measures the speed of money circulation is relatively high.

Obligation of payment for deliveries and services in a short run resp. application of a compulsory clearing system.

In order to prevent commercial credits between enterprises payments for deliveries and purchases have to take place as soon as possible. With a public law concerning regulations of clearing systems this problem is solved. In principle we can distinguish between two kinds of clearing (terms of payment):

First: The enterprise is obliged to pay immediately after reception of the goods. In this case there is a commercial credit granted by the supplier. The time for such credits should be strongly limited. In the GDR it runs normally to 10 days; in some exceptions to 30 days.

Second: The bank of the enterprise, which is the supplier, is managing a clearing with the bank of the customer immediately after getting a copy of the bill. The supplier will get his proceeds from his bank immediately. In this case the commercial credit is limited on 1 to 3 days necessary for giving the bill to the bank and for getting the credit note. This system is usually applied for deliveries of mass products.

Separation between current accounts and funds for accumulation.

Every enterprise is obliged to transfer taxes and profit shares to the general organization resp. to the budget monthly. Very great enterprises are obliged to transfer the turnover taxes every fifth day. As far as profit shares are determined for investments in the same enterprise, for bonus to be spent to the workers and for reserves, a monthly separation of means must be ensured.

In fact there are no remarkable reserves in GDR public enterprises because reserves are to be formed at central level and by the general organizations. For investments and bonus fund special purposed accounts must be opened. The depreciations must also be separated monthly. Usually they are to use for investments and consequently, to transfer to the enterprise investment account which is under the supervision of the Investment Bank. As far as depreciations are not to be used for investments in the enterprise they have to be transferred to the general organization monthly.

To sum up: In order to ensure a highly effective supervision by banks the cash money circulation and the terms of payment (clearing system) must be organized and canalized. The main items in this field are in the GDR:

- a) Every enterprise is connected with only one bank;
- b) All payments except wages must be transacted by money transfer,
- c) Proceeds in cash are to be paid in daily as far as the cash limit set up by the bank is exceeded;
- d) The time for payments is limited accordingly to the terms of payment issued by government. In fact the time is so short that commercial credits are prevented by a bank clearing system resp. the time for payment is strongly limited by law;
- e) Every public enterprise has to separate or to transfer the profit the taxes and the depreciations monthly at least.

Under these preconditions the bank is in the position to follow up money circulation and sale. The deviations of sale between targets and effective sale will be discovered in this way.

III. Essential points regarding capital allocation of working capital (limitation of stocks)

Working capital of public enterprises should be limited accordingly with the targets of output. The main items of working capital are : raw material, unfinished goods, finished goods, and money funds (current accounts including active debts). The financial cover of working capital can be own working capital, current debts and credits granted by the bank. Since a clearing system is applied, current debts are strongly limited and, consequently, own working capital and bank credit remain as the two main sources for working capital in enterprises. The limitation of working capital is on first place a matter of physical (material) limitation of stocks (raw material, unfinished and finished goods) and not so much a matter of financial sources.

The physical stocks of working capital depend on the extent of output, the time of production and sale, and the development of cost which determine the value of stocks.

Consequently, the necessary working capital is determined by the development of output and cost lowering as well as by the shortening of time for production and sale. On the contrary : Every deviation from a normal production flow will result in higher stocks of working capital in case of higher cost and longer time for production and sale. An over-fulfillment of output targets will result in higher stocks of necessary working capital. An under-fulfillment of output targets may lead to a reduction of working capital, but, it may also result in higher stocks if it is connected with higher cost and longer time for production and sale.

All deviations should be analysed. In order to be able to do it an annual planning of working capital is necessary in every enterprise. The normal stocks of working capital should be determined accordingly to output; cost and time for production and sale. The annual enterprise plan of every company includes a so called standard plan for working capital in the GDR economy. The normal amount of working capital and the financial cover are fixed in this plan. It is to approve by the general organizations. The bank is taking part in elaboration of this plan, and it gets a copy after approval. Thus, the basis for normal financing and credit-agreements is available.

Since all other financial sources are eliminated by the help of a system of organization and canalization of money flow as introduced in the preceding paragraph the stocks of working capital can be covered only by financial sources approved in the standard plan.¹

For instance: the standard plan limits the working capital to 100 and the own working capital to 30. The difference of 70 is the credit limit. The planned own working capital fund is to form by comparing the effective own working capital with the new standard. Let us say the effective own working capital is 25, the enterprise in question will get additional 5 units from the general organization or is allowed to use profit for

1. As to the methods suitable for calculation of the necessary working capital for an enterprise, please, compare my memorandum: "The functions of banks in financing public enterprises", INP. No. 743.

these purposes. The credit (70) is a credit limit. In the frame work of this limit the bank will grant credits under normal conditions. Naturally, the bank will not grant these credits automatically. But, the limit outlines the normal process of production and sale.

In case of deviations the enterprise will need more credit. Since all other financial sources are canalized the only solution is to get credits for overstocks. The bank is allowed to grant additional credits under two preconditions:

- much higher interest rate (i.e. 8, 10, 12 % instead of 2, 2.5 or 3 %)
- the enterprise must submit a rationalization programme.

Examples :

1. The enterprise has too much stocks of raw material caused by an uncorrect organization of stock piling. The rationalization programme should mainly be concerned with improvements in the inventory control system.
2. The enterprise has stocks of finished goods higher than planned, because marketing research was not up to date. The rationalization programme should include measures aimed to change assortment, quality and fashioning of the products.
3. The enterprise has too much stocks of unfinished products, because the final products can not be completed. The suppliers didn't observe the contracts concerning fittings and accessories with respect to assortment, deadlines and quality. The rationalization programme should be aimed to improve the cooperation and production flow in the enterprise and in the premises of its suppliers as well.

The rationalization programmes are considered as tool for changing the situation and as security for the credit, too. They should be signed not only by the director of the enterprises but also by the director of the general organization. The date for paying - off the credit for overstocks is determined by the measures included in the rationalization programme.

As we see the bank is acting in its state supervision function in this model. The supervision function is based on the following items:

1- The bank accounts appear a comprehensive picture on the reproduction process of the enterprise. Especially, the fulfillment of output targets will be permanently discovered by the compulsory clearing system.

2- The bank is taking part in the elaboration of enterprise standard plans which determine the necessary working capital. The experiences of the bank in its supervision function can be used in this process especially regarding to the optimal standard days for laying in store.

3- The credit limit is the basis for credit agreements between enterprise and bank.

4- All deviations from the credit contracts (paying - off not in time) and requirements for additional credits discover overstockings which will lead to sanctions imposed by the bank.

IV. How is to determine the share of own working capital in public enterprises?

In the GDR industry there are several stages in the development of this problem. We are always trying to find out an optimal solution. The stages are:

- 1 - Fix relations between own working capital and credit.
Own working capital was spent for 70% of stocks of raw material, 100% of unfinished and $33\frac{1}{3}$ % of finished goods. Since the output is usually changing in the quarters of a year - let us say it is slowly increasing - the own working capital must be adjusted quarterly which necessitates budget operations. A high growth rate will require investments in working capital permanently, that is a burden for the state budget.
- 2 - Full cover by own working capital.
In this model the main idea was to make the enterprises independent from the bank if all operations are in frame of the plan and to concentrate bank activities on overstocks. Thus the bank is more connected with bad enterprises. This system appears as not workable because the burden of the budget is very high, and, on the other hand, the credit resources are not used. With increasing output the deposits are also increasing and should be used in the socialist financial system.
- 3 - Fix relation only for the first quarter of the year and changing credit limit in the other quarters.

In order to save budget means the own means were determined by 70% of the stocks of raw material, unfinished and finished goods in the first quarter of the year.

Since usually the output increases from quarter to quarter, the additional financial need is covered by credit.

Example:

planned working capital	100	110	115	125
own working capital	70	70	70	70
credit limit	30	40	45	55

With this model the fixed share of own working capital is practically abolished by different rates of growth in the different enterprises.

4 - No general relationship .

The actual system in the GDR public enterprises is going without a certain relationship. The general organization determines **annually** the share of own working capital with the approval of the financial plan. An increase of own working capital is to cover by own profit realized in the last period or by allocations from the general organization or the budget. There are two general statements considered as a rule:

The own working capital share should be great enough to make the enterprise independent from the bank in daily work.

The credit share should be great enough to ensure a permanent state supervision function of the bank, tied with credits for working capital (volume, paying-off).

In practice there are relationships from 20 - 80 to 70 - 30. But, only 20% own means are considered as very low and the general organization should plan an increase of own stocks in the following year.

It appears that the relation between own working capital and credit is without theoretical importance. It also appears that credit resources are available easier.

V. Creditplanning of the bank

The credit planning of the banking system is necessary in order to balance the requirements with the deposits. Moreover credit planning is a precondition for financial balancing in national scale. The basic model of the credit plan of national bank is as follows:

Credit Plan

credits for

- 1- planned working capital
(standard plan credit)
- 2- planned investments
(investment credit)
- 3- additional investments
(rationalization credit)
- overstocks of working capital
(overstock credits)
- temporary cover in case of
illiquidity (stopgap credit)
- too high expenditure for
investments
- realization of profit share
for self financing later
than planned
- Losses in current produc-
tion
- clearing
- refinancing of other banks
- government

Total

Cover

- 1- deposits of
 - public enterprises
 - private enterprises
 - cooperatives
 - state administration
 - state organizations and
institutions
 - public organizations
 - state budget and local
budgets
 - insurance companies
 - other banks
- 2- own bank capital minus
reserves

Total

The Investment Bank, Agricultural Bank, Foreign Trade
Saving Banks have also to draw up such a scheme. Since
specialized banks the scheme will be more simple according
specialized tasks. The National Bank is responsible for
the different credit plans and for using all sources.

Usually it happens that the saving banks have much more deposits than credit requirements by handicraft cooperatives, ~~privat~~ handicrafts, traders, and citizens. Therefore the National Bank will take care that the credit resources of saving banks can be used in national scale.

The deposits are put in the credit plan based upon a careful estimation of development. The credit requirements have to be planned in different ways. The standard plan credits can be derived from the enterprise standard plans which determine the credit share of working capital as an annual and quarterly average as well. The bank is getting copies of these standard plans.

The investment credits can be derived from the copy of investment plan every general organization has to hand over to the bank .

The bank is taking part in elaboration of the standard plans and investment plans of public enterprises and general organizations since it is considered as a kind of bank service. This respective service is in fact an important part of the state supervision function of the bank. Banks are taking part in planning in order to get optimal plans.

The two positions mentioned above will probably be the most important share of credit fund. The remaining must be estimated by the bank.

Since additional investments do not claim 3% of total investment it is easy to put an amount into it. Usually the fund is not fully used by reason of material c

The stopgap credits must be estimated accordingly to experiences and including reserves for the disposal of the bank. The granting of such credits must be tied with the financial plans of enterprises and general organizations. It is considered as a rule that stopgap credits are allowed to be spent only after using the reserves of the general organization. Besides this, they must be connected with a sharp rationalization programme to be signed by the director of the general organization. As to overstock credits, please compare the third paragraph of this paper. Overstock credits and stopgap credits are applied connected with sanctions or, we can say, they are in fact sanctions. The bank will act as a socialist advisor in such cases in order to limit the losses of society. The board of directors of the general organization and of the respective enterprise must discuss the necessary measures under assistance of the bank. Also the elected worker's councils must share these efforts. It may happen that the director of the enterprise has to stand an account on the deviations from the targets.

The last group is concerned with internal bank affaires. Clearing credits are in fact no credits agreed with enterprises. They are an outcome of the clearing system applied and a kind of working capital of the bank itself. The refinancing of other banks is a special credit to be agreed by the board of directors of the banks concerned with the matter.

The government credits are to be approved by both council of ministers and board of the bank.

Credits with normal conditions (especially normal interest rates) are: Standard plan credit, investment credit, rationalization credit.

Credits with sharp conditions are: ~~Overstock~~ credits and stopgap credits. Clearing credits are without interest rate because the credit appears as a result of applying compulsory clearing system.

Refinancing credits and government credits are granted under special conditions in every case.

VI. The tasks of bank in supporting the annual planning of enterprises and general organizations

In this paragraph as bank ~~are understood~~ the activities of National Bank, Investment Bank and Agricultural Bank.

The bank has to support the enterprises and general organizations in annual planning. The bank has to submit proposals on how to make best utilization of material and financial funds based upon its experiences in current bank activity and own calculations and assessments as well.

In the planning process the enterprises need the opinion of the bank, especially whether the bank is willing and able to finance the projects which are to be included in the plan. Therefore, the enterprises have to apply for preliminary credit approvals. It is in this context that the bank will submit the enterprises its own calculations and that, accordingly, the bank will act as an advisor. The bank advise is aimed to maximizing national income as far as a bank can do it by the help of credit, interest and sanctions.

The bank checks on before giving a preliminary credit approval.

1 - in case of credits for working capital

- the acceleration of turnover of working capital (i.e. shortening of time for stockpiling and production);
- that the enterprise accumulates an own share of working capital in accordance with the ratio of own working capital to credit, which is considered as normal;

2 - in case of investment credits

- the fund profitability compared with other projects in the same field;
- the observance of standards and norms determining the minimum recoupment period of investments;
- that the normal periods for construction and completion are observed;
- that economic indicators like productivity and production effect of investments (= commodity production)¹⁾ are improved;
investments
- that the paying-off of credits is possible in an economically justified time.

The bank is allowed to refuse credits fully or partly or to grant credits only with higher interest rates if the above mentioned conditions are not observed.

The bank follows up the currying-out of plans by the help of spending credits, unblocking of the enterprise investment accounts and clearing system.

1) Cp. Knauthe, The Criteria for Investment Decisions, INP.
Memo. No. 716, page 8.

As to current production the bank follows up the observance of output (sale) targets and of the planned stocks of working capital.

In the field of investments the bank follows up the accumulation of the enterprise investment funds (self-financing according to the financial plan), the existence of the technological documentation legally founded, the material cover of investment programmes by contracts with the supplier, the observance of deadlines, and the investment expenditure.

In case of heavy deviations from the targets or legal regulations the bank is obliged to inform the superordinate authorities and also the elected bodies in enterprises and branches (workers committees) and in local communes (town councils).

In all these cases the bank has to submit proposals how to ensure the planned targets and how to increase productivity or liquidity of the enterprise in question.

The bank is obliged to cancel or refuse credits if the preconditions for granting credits appear as insufficient.

The bank is also allowed to grant credits only dependent on participation of own capital funds of the enterprise are to be spent for the project. The bank can claim that credits not paid off in time become returned by extraordinary profits (over-fulfillment) by accumulated funds determined for self-financing and by reserves of the general organization.

All these items discover the active role of banks in a socialist national economy :

In underestimation of banks would be a great mistake. Therefore, the experiences of socialist countries should be discussed in those developing countries which are going with a planned economy on a socialist path.