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ECONOMIC COMMITTEE

INFLATION IN THE USSR AND THE EASTERN COUNTRIES

Note by the Chairman

Please find attached for your attention the revised version of the paper on inflation in the Soviet Union and Eastern Europe.

2. In preparing this modified version the Economic Affairs Directorate has taken full consideration of suggestions and recommendations proposed by delegations.

(Signed) J. BILLY

NATO,
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This document includes: 5 Annexes

N A T O R E S T R I C T E D

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INFLATION IN THE USSR AND THE EASTERN COUNTRIES

GENERAL INTRODUCTION(1)

1. In a centrally planned economy, money and prices are theoretically managed in accordance with the Plan.

(i) Capital flow varies in line with actual movements in goods and services (under the "balanced approach" for example, anticipated consumption is geared to family income: Aggregate wages, allowances, pensions etc. must be commensurate, in fixed price terms, with the value of the goods and services offered by State shops and co-operatives).

- In the production circuit, money provides a passive indication of the way the economy is working.
- In the ~~consumption~~ circuit, money also plays this passive rôle. Prices are not affected by demand in the State-controlled sector but only on the parallel markets and therefore to a very limited extent.

(ii) Prices are controlled to ensure that the distribution and redistribution of national income follows the desired pattern and that allocated purchasing power corresponds to overall availabilities of goods and services.

2. Inflation in the COMECON countries instead of taking the basic form of widespread and overt rises in prices and costs as in the West, is revealed by other signs such as a growing volume of idle savings, shortages, queuing, etc. which in the latter case represents a social cost to be added to the advertised prices.

(1) General sources:

- Inflation in the USSR, Note by the United Kingdom Delegation (AC/127-WP/449)
- Soviet Inflation, Keith Bush, NATO Symposium, January 1973, p. 97 et seq.
- Consumer goods availability and repressed inflation in USSR: Gertrude Schroeder, NATO Symposium 1975, p. 37 et seq.
- The Soviet parallel market, Dimitri Simes, idem p. 91 et seq.
- Disguised inflation in USSR, Katsenelinboigen, idem p. 101 et seq.
- Imported inflation, H. Machowski. Note submitted by the German Delegation (AC/127-D/522)

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I. HISTORICAL BACKGROUND

3. After the 1971 revolution, the Soviet Union was subject to continuous inflation - for some years at an enormously high rate - until 1947. (In the smaller East European countries inflation lasted until about 1953-54.)

4. This was followed by a period of deflation (1948-1964). Since 1965 prices have been virtually stable.

5. Successive downward adjustments in retail prices between 1948 and 1964 reduced prices by about 30% (on the basis of 1950 = 100, the index has dropped to 74 in 1964). These reductions occurred in connection with various monetary manoeuvres (withdrawal of part of the purchasing power in circulation and forced savings).

6. It is generally considered that in the early 1960s the official retail prices, as reflected by the indexes, were correct taking into account the cost price of manufactured goods, the level of industrial cost effectiveness and transport costs.

7. It was possible to argue at the time that, after the severe hardships of the war and post-war rationing (which only ended in 1947), the basic requirements of the public had been met, bearing in mind the regular increases in pay, scholarships, pensions and various allowances which accompanied the reductions in the price of essential commodities.

8. In 1962 a number of agricultural price rises (meat + 30%, butter + 25%) were introduced in order to improve the incomes of the kolkhozniks, but in spite of the rise in the cost of agricultural inputs, the official selling prices have not since been raised.

9. From 1965 to 1972 further reductions averaging between 15 and 30% were introduced for a number of consumer durables and perishables while the cost of luxury goods went up. The main purpose of these increases was to discourage consumption of these goods or to absorb what was considered too high a level of liquid assets. These price changes have been mutually-offsetting, with the official index (1950 = 100) remaining at 74-75 since 1965.

II. PRESENT CAUSES OF INFLATION

10. Inflationary stresses exist at present in centrally planned economies and this is acknowledged not only by the economists in these countries but even by the national authorities.

11. In the Soviet Union as far back as 1960, Federenko and Z. Atlas refer in veiled terms to "unsatisfied demand", "latent demand" and "forced savings". I. Konnik (Ekonomidzat 1963, p. 243) also expresses concern at this trend and only recently Mr. Brezhnev himself (speech of April 1975 reported in "Le Monde" of 16th December, 1975) deplored the existence of "repressed inflation".

12. In the other Eastern countries the limits and shortcomings of planning are not admitted, inflation being attributed to external causes, and especially to contagion from the non-Communist countries. The highest authorities (Gierek, Husak) contend that inflation is unavoidable as a result of the world-wide rise in prices and are giving notice of price increases and psychologically preparing the public for them. For example, it is being explained that prices in Poland will go up after the workers have been consulted and without jeopardising adequate increases in real wages.

13. Inflation stems from the imbalance between the money flow and the goods flow. Its reasons are both domestic and external.

14. At the domestic economic level there appear to be various disrupting factors built in the planning system itself. Centralised planning cannot be completely rid of certain incongruities or inflexible elements attributable to economic and political factors.

15. For example investment planners invariably set goals that are incommensurate with available resources and the resultant stresses are accentuated by the systematic under-assessment of forecasted costs. Delays in production actually achieved are frequent. The factors of production in many cases are inefficiently or inadequately used: Plant capacity is adversely affected by poor maintenance and shortages of spare parts; after work has begun on new installations, lengthy delays occur before completion; owing to fears of shortages, unneeded stocks of materials are allowed to accumulate in different concerns.

16. Actual costs may also turn out to be higher than anticipated as a result of inadequate productivity or poor co-ordination between different levels of a concern. In both cases it becomes necessary to accord the enterprise affected additional credits without any corresponding "trade-offs" in the flow of goods.

17. As far as labour is concerned, determination to maintain compulsory full employment at all costs by various administrative rescue measures (bailing out of "lame duck" concerns, retention on the payroll of non-essential workers and absence of "frictional unemployment") hampers labour mobility and adds to the production costs per unit.

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18. At the consumer level purchasers of goods and services enjoy a limited degree of autonomy. Their purchasing power produces partial imbalances between supply and demand which become more pronounced as the pattern of consumption is more diversified.

19. The Eastern European economies have become more sensitive than hitherto to external inflation. Indeed, the economic reforms that have taken place in certain Eastern countries (particularly in Hungary and Poland) have led to the adoption of control machinery similar in some respects to that used in the market economy countries (partial rehabilitation of the rôle of prices and profits, financial decentralisation in enterprise management, etc.). This machinery has created a more direct link between foreign and domestic prices. As a result, foreign inflationary pressures which have been particularly high during the last five years are affecting domestic price formation, at least for certain commodities; this trend is being fostered by the gradual build-up in the Eastern countries' trade relations with the industrialised countries.

20. These two factors are more apparent in the Eastern countries than in the USSR, which has undertaken scarcely any economic reforms and whose economy is much less receptive to foreign trade (8% of national income as compared with 20% to 40% for the Eastern countries). However, in all the COMECON countries including the USSR, transactions with the West are on the increase (accounting for approximately 30% of overall exports and imports, as against less than 20% in 1960).

21. The true extent of the imbalance between supply and demand in the Eastern countries cannot be gauged exclusively by reference to official price trends. The official retail prices index, for instance, does not reflect actual price trends, especially because it only takes account of transactions on the official market.

22. Apart from the question of doctrine, the authorities are spurred on by the attitude of the people of these countries who have been conditioned by the period of extremely high inflation between the two wars and seem to prefer the present system to one providing better distribution of resources through price changes.

PART I: USSR(1)

Inflation in recent years and prospects

23. Inflation in the USSR at a moderate rate is a permanent feature as evidenced by the analysis, given in Annex I, of money and prices mechanisms.

24. The following analysis deals with specific causes and manifestations characterising the last decade. It is only part of a long-term development of inflationary phenomena.

I. THE CAUSES OF INFLATION

A. ENTERPRISE COST INFLATION

25. An analysis of price trends between 1968 and 1973 in industry, agriculture and construction points to the existence of moderate inflation.

26. The increase in the extraction costs of basic commodities (iron, manganese, bauxite, oil, natural gas and so on) is explained by the increased utilisation of a costly infrastructure in remote parts of Siberia.

27. Repeated price adjustments for imported basic materials and equipment has also resulted in some inflationary pressures. However, the small volume of the Soviet Union's foreign trade shields it from marked foreign influence(2). Since trade with the industrialised countries of the West constitutes almost one-third of the overall USSR imports, a rise in price of the equipment from the West may affect certain sectors of Soviet industry which are dependent on Western machinery and technology(3).

28. Wage increases seem to be larger than shown by the official statistics. According to the latter, the wage index towards the end of 1975 stood at 119.7 (1970 = 100) as compared

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- (1) cf. (a) Inflation in the USSR (Myth and Reality)
(AC/127-WP/449 of 10th December, 1975)
(b) Imported inflation (AC/127-D/522 of 22nd December, 1975)
(c) Inflation in the USSR and Eastern Europe
(AC/127-WP/451 of 9th January, 1976).
- (2) The inflationary pressure resulting from the deterioration in the terms of trade with the West was nil till 1973 and only a fraction of 1% a year during 1974 and 1975.
- (3) On the other hand it is possible in a centrally planned economy to shield enterprises from a rise in import prices by using the revenues deriving from higher export prices directly to pay the increased import bill.

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with a terminal figure of 122.4 provided for in the 1971-75 Plan(1). These indices do not appear to take account of extra money and bonuses which the enterprises - concerned primarily with meeting the Plan targets - are increasingly paying in order to offset labour shortages. When productivity has fallen short of wage increases unit wage costs have risen steadily. This phenomenon is particularly noticeable in agriculture and in construction.

29. Planning does not appear to take sufficient account of the quality of goods or the wishes of consumers. We have here two reasons for the failure of supply to satisfy demand, leading to the creation of large stocks of unsold goods. In an effort to run down these stocks, the authorities earmarked 2.4 milliard roubles in the State budgets for 1974-75 to subsidise price cuts. This measure does not appear to have been too successful since at the end of the period, 1.3 million washing machines and 120,000 refrigerators were still unsold. According to certain Soviet publications, such unwanted items accounted for some 15% of commercial stock in 1974.

B. EXCESSIVE HOUSEHOLD MONETARY HOLDINGS

30. Purchasing power has increased significantly over the years as a consequence of the improvement in hourly wage rates and the increase in welfare benefits. In real terms, growth has been even greater than wage statistics would seem to show, given the underlying downward trend recorded in the consumer price index (see above).

31. The system of minimum wages was introduced in the Soviet Union in 1956. At that time, the minimum wage rate was fixed at 27 roubles a month in rural areas and 30 roubles in urban districts. At the present time no-one earns less than 70 roubles and the average wage is 140 to 150 roubles depending on the industry concerned. Since a husband and wife frequently both work, a wage of 250 roubles is not unusual in a worker's household. Engineers and technicians earn between 220 and 250 roubles a month and trust managers about 400 roubles. If account is taken of the low cost of rents (5% of income) and of items of everyday use, nominal purchasing power is relatively high.

32. Apart from wages, households receive substantial benefits from the social funds (89 milliard roubles in 1975)(2). The latter meet the cost of pensions, allowances, holidays and student grants. They account for about 25% of general resources distribution in the form of wages.

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- (1) These indices correspond to an average wage figure of respectively 146 and 149.3 roubles.
- (2) Not all these funds are devoted to cash allowances, however, part being granted in the form of free perquisites (educational, health and cultural services, etc.).

33. All these revenues are reflected in the existence of a growing purchasing power which, together with the availability of earlier forced savings, would appear to exceed the growth of disposable goods and services. However, the experts are not in complete agreement in their conclusions on this issue.

34. Certain experts believe that the inflationary gap should tend to narrow in the light of the substantial increase in consumer goods (Group B); the availability of such goods on the official market in increasing quantities has improved living standards. Moreover, there is no doubt that in the longer term the Soviet consumers' needs have been increasingly met, especially during the 1960s.

35. Trends during the Ninth Five-Year Plan (1971-75) however seem less clear. The Plan provided for an upturn in Group B output of 48.6%: This target was far from achieved, in contrast to the quasi realisation of the planned progression of revenues. Looking at the Plan in aggregate terms, it may be inferred that the lag in consumer goods output coupled with shortcomings recorded in the housing sector and with two poor harvest, only further contributed to the imbalance between supply in goods and services and household demand. Nevertheless, although developing less rapidly than planned, in 1974-75 output of consumer goods grew at a faster rate than the evolution of purchasing power.

36. On the whole a substantial gap remains between household needs and the level of satisfaction of the consumer. This gap is doubtless even more qualitative than quantitative.

37. Additionally, it should be noted that poor transportation facilities are at the basis of a number of "local inflation" phenomena: In certain areas the consumer, unable to find the foodstuffs they wish on the State markets, are obliged to turn to the parallel market for over 20% of their food purchases as against an average estimated at around 2.2%.

38. Both the wholesale, as well as the retail price indices show a smoothly rising trend, which is only a partial tribute paid to overt inflation. Repressed inflation at the final demand stage manifests itself mainly through the increase in savings for which there are no outlets, the growth of free markets and the increase in the subsidies budget (or the reduction in certain fiscal receipts).

(1) The wholesale price index

39. On the basis of the industrial wholesale prices under evolution, it appears that, in real terms, unit output costs were about 4% higher in 1973 than in 1965 (see Annex II).

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40. There are, however, statistical shortcomings in the wholesale price index which suggest that this figure might be too low. The relative stability of the index is due to the fact that price rises in most branches of industry are said to have been offset by price cutting in engineering(1). Given the admitted increase in the price of fuels and metals, as well as of wages, this supposed downward trend seems to be due mainly to the methodology used by the Soviets when calculating the index. The Central Statistical Administration apparently ignores all machines introduced since 1961, including those which are modifications of existing types and produces its figures on the basis of a fixed sample of goods available in that year. As these items have come into mass production their prices have fallen and so pushed the index downwards. Western procedures would probably indicate less of a fall, and perhaps a rise, in engineering prices and so suggest a steeper rate of overall inflation than shown in the Soviet figures.

41. In the production sector the inflation diagnosis is based on the increase in enterprise profits not allocated and the increase in credits not taken up, as they appear from incomplete data. Until 1972 the statistical yearbooks detailed the breakdown of monetary funds which the enterprises could, in principle, utilise freely. It was at that time possible to link the evolution of self-financing arrangements to the actual utilisation of credits allocated within the framework of these arrangements. It was noted that the rate of utilisation of these credits was low, i.e. it reflected the fact that the enterprises in question were unable to purchase the equipment for which they had arranged finance. Since 1973 only credit utilisation data are published, and a link-up is no longer possible. By contrast, it may be seen that in absolute figures there is a tendency for a further decline in credit utilisation.

(2) The retail price index (official data)

42. It is scarcely possible to attach any absolute significance inflation-wise to changes in the official price indices over a period of time since the prices mask or distort the actual situation. The table at Annex III, which is given simply as an example, shows that the prices charged in 1975 are very close to those charged ten years ago.

43. If reference is made to the implicit deflators of the Net Material Product - as deduced by comparing current price and constant price statistics, it will be found that there is a slight price increase. This increase, which has averaged 0.8% per annum over the past three years, differs according to the types of accounts aggregates examined: It is apparently only 0.3% in the case of consumer goods as compared with 1.7% for capital goods and stocks.

(1) In Soviet terminology "machine building and metal working industry"

44. These small adjustments in retail price index generally result from mutually-offsetting price changes of specific commodities. For instance, from 1965 to 1972, reductions averaging between 15 and 30% were introduced for textile goods, medicines, preserved food and a number of consumer durables, such as television sets (reduced several times), ciné cameras, electric razors, washing machines, scooters and motor bikes, as well as chemical goods and clothing, while the cost of luxury goods (caviar, sturgeon, salmon, luxury furs and the like) went up.

(3) Free markets

45. Apart from the official markets, there are indeed various "free markets".

46. Agricultural products, grown on individual smallholdings and generally of good quality, are sold on the kolkhoz market. Prices vary according to supply and demand(1). Their average annual price rise seems to be around 6.5%. In 1973 the estimated ratio of these prices to the official prices was 164:100 (1965 = 100 for both series of prices). In view of the marginal nature of this market, the repercussion of the increases on retail prices is very limited. But the number of kolkhoz markets appear to be expanding (from 6,500 in the late 1960s to over 7,000 now).

47. On the parallel market are found practically all the commodities that cannot be obtained at official prices. They range from everyday consumer goods to semi-durables and include domestic services (painting, repairs, paper-hanging, plumbing and electricity) and professional services (lawyers, doctors, private tutors, etc.). This market sometimes enables factory managers to procure raw materials that cannot be delivered in time, if at all, through official supply channels. It is not, therefore, a passing phenomenon but, on the contrary, a covert "institution" of the Soviet régime, whose operation is in fact connived at by the authorities. Officially, it is strongly condemned by the Soviet leaders, but it is tacitly admitted that anyone is entitled to make use of it in so far as he can afford to do so. The market is too diversified for any global estimate of price changes to be possible(2). It is, however, believed that on the parallel services market the rate of inflation corresponds at least to the increase in wages.

(1) According to the Soviet press, the percentage of products sold in this market, compared with total production is as follows: Milk 6%, eggs 12%, vegetables 13%, meat 17%, wool 18%, potatoes 36%. These are only average figures however which vary considerably from one region to the next.

(2) See Annex IV for some examples of prices on the parallel market.

(4) Family savings

48. Family savings are large and are growing rapidly. By mid-1975 overall savings accounts holdings totalled 84.4 milliard roubles (as against 53 milliards in 1971). As there are some 100 million accounts in existence, the average amount per account appears to be over 800 roubles. Savings thus seem to represent some 40% of the total volume of annual retail sales and 5.5 months of average earnings; an amount which is strikingly large in the context of a rather low standard of living and a lack of household equipment (televisions, cars).

49. This increase in Soviet family savings cannot be explained by reference only to Western criteria. The confidence in monetary stability and in the savings banks as a whole (security by comparison with cash holdings) seems fairly widespread. This being so, the interest rates (2% for current accounts and 4% on money deposited for a year) are not as small as they may seem and may provide part of the explanation. Furthermore, confidence in money is currently increased by the fact that people no longer expect recourse to forced loans.

50. Money will also be saved for long-term purchases particularly since consumer credit has hardly got off the ground: **cash** is therefore accumulated for expensive items (housing, cars). On the other hand, there is also a tendency to save as a precautionary measure (in anticipation of retirement). But savings in the Soviet Union are undoubtedly a sign of a certain surplus of purchasing power for which no use can be found. And the fact that increases are generally announced at the end of the day, to come into effect at midnight, may be reasonably interpreted as a means of preventing mobilisation of available purchasing power.

(5) Rôle of budgetary policy

51. State budget (milliard roubles)

	<u>1965</u>	<u>1973</u>	<u>1975</u>	<u>1976</u> <u>(forecast)</u>
Receipts	102.3	187.8	220.3	223.7
Expenditure	101.6	184.0	217.6	223.5
Surplus	0.7	3.8	+2.7	+0.2

Source: See AC/127-WP/449 p. 13, table updated on the basis of press information

52. The budget seems to be constantly in balance. But budget receipts include not only the taxes accruing to the State but also sales of government stock, personal savings, advance

tax on income yet to be earned and even Central Bank loans to the State. This means that monetary demand may be created by injecting liquidity into the system. In addition, budget expenditure includes major subsidies designed either to keep down increases in the price of products or to orientate production along the lines laid down in the Plan(1).

53. The increases in indirect taxes levied on certain products can be motivated by a number of different reasons depending on whether or not there is a concomittant increase in the supply of these products. In the first case, the price increases which they trigger off will be designed to centre inflation on these products (luxury goods, including leather, furs and jewels); in the second case, it will no longer be a matter of soaking up purchasing power but of discouraging consumption of goods for which there is no priority (motor cars).

(6) Recognition of inflation

54. Two recent decisions may be interpreted as an unofficial recognition of underlying or potential inflation.

55. The price revisions applied to exports to the COMECON countries since the beginning of 1975 and the new price fixing machinery (sliding averages) must no doubt be primarily interpreted both as a means of adjusting to the new world economic environment and of improving the USSR's terms of trade, which had sharply deteriorated in previous years. However, they must also be seen as precautionary measures intended to forestall foreseeable shortages in the medium term. Nonetheless, the marginal volume of Soviet foreign trade and the need for political reasons to avoid pressing too far the advantages which the USSR possesses over its allies, limit the impact of such price revisions in the USSR.

56. Furthermore, the announcement that the growth rate in the NMP will be reduced during the Xth Five-Year Plan (1976-1980) and the fact that greater emphasis has been placed on improving the quality of goods whilst the proportion in Group B output will be limited to 2.7% annually - could be an indication that the planners are anxious to reach a better balance between supply and demand and to avoid an increase in stocks of non-marketable products.

(7) Further prospects

57. The underlying causes of inflation are also to gain strength over the next years for the following reasons.

(1) Particularly subsidies to agriculture, which in the USSR are so large that they exceed the total military expenditure, as shown in official budgets

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58. In the first place, supply remains rigid and the factor cost of production tends to gain momentum. The harnessing of Siberia's resources appears to be especially beset by growing extraction costs and sharp increases in infrastructure expenditure, while the marginal productivity of capital is tending to fall, certain shortages, particularly in agriculture, have appeared recently (especially as regards grain) or are foreseeable (meat, because of the large-scale slaughtering currently in progress to cut down on the use of grain for animal feed).

59. In addition, demand seems to be rising more strongly than hitherto: Pressure on the available basic resources (raw materials and energy) is rising as a consequence of demand both at home and in the COMECON countries: The Soviet Union is no longer meeting almost all the oil needs of its allies as in the past and it is believed that the latter's imports from the OPEC countries will rise fourfold in volume between now and 1980; at the final demand stage the continuing increase in the wage bill is boosting purchasing power. The Soviet consumer having developed more sophisticated tastes, the gap between purchasing power and potential demand might increase and reinforce the inflationary pressures in the coming years.

PART II: THE OTHER EAST EUROPEAN COUNTRIES

I. GENERAL INFLATIONARY TRENDS

60. The domestically-generated inflation also prevails in the other East European countries. These are also affected to varying degrees by foreign-generated inflation since their economies are more sensitive to outside influences (some of them derive as much as 40% of their national income from foreign trade, a large part of which is carried on with the industrialised countries of the West). A further reason is that economic reforms, especially in Hungary and Poland, have reintroduced certain market economy mechanisms through which some prices respond to demand pull. At the same time enterprises have greater access to non-allocated funds than is the case with the Soviet model; this entails greater vulnerability to inflationary pressure.

61. It is not surprising, then, that in general inflation should be running at a higher rate in the East European countries than in the Soviet Union and that their leaders are less reluctant to admit its existence.

62. The twin effects of inflation are a growing foreign trade deficit and subsidies, which are weighing heavily on the budget.

63. The gradual opening-up of many socialist economies to world markets in recent years, coupled with the rise in the price of most raw materials since 1973, led to a revision of the intra-COMECON price system from 1st January, 1975; as far as trade between the USSR and Hungary is concerned, Moscow increased the price of raw materials by an average of 52% and among them oil, by 135%. Further information regarding other East European countries is not yet available.

64. The present higher oil prices which the Soviet Union charges its allies are still about one-third lower than the world prices, although they are rising. For the other raw materials and basic commodities (phosphate, cellulose, pig iron) the world prices would seem to be between two and two and a half times higher than those asked by the Russians(1). Since the East European countries (except Rumania) are heavily dependent on the Soviet Union for their supplies (90% in the case of oil), price rises, although smaller than those observed on the world market, are a significant factor in their trade balance deficits (\$1.8 milliard in 1975).

65. Consequently world market fluctuations will have a more rapid - although muted - effect on COMECON raw material and oil prices than in the past, since the latter will be determined each year on the basis of the flexible world price scale over the preceding five years.

66. Inflationary pressures are aggravated in Eastern Europe by three additional factors. The East European countries have not raised the prices of their exports to the Soviet Union to the same extent (perhaps 15%); the Soviet Union cannot cover all its allies' energy requirements so some of the latter will have to buy more and more on the world markets, and particularly from the Arab countries (a development which must certainly increase their financial difficulties); the world-wide recession, by reducing the demand for Eastern exports (particularly as they are often of doubtful quality), has further worsened the balance of payments situation of the East European countries.

67. The East European countries are encountering growing financial problems in their trading operations with the West. For the period 1970-73 their deficit totalled \$8 milliard, for the single year 1974 \$4 milliard and for 1975 between \$5 and \$5.5 milliard.

II. COUNTRIES SITUATION

A. Hungary

68. Hungary has a relatively high per capita income (\$2,100). The rise in incomes over the last few years has been rapid (wages increasing at a pace of 14 to 16%; pension allowances also rising in 1975 and 1976).

(1) Source: Le Monde, 25th February, 1975, page 22

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69. The evolution in the purchasing power has gone hand in hand with a satisfactory increase in the goods and services available. A slight inflationary gap has nonetheless appeared. The authorities do, in fact, concede an increase in the official retail price index: An average of 1.9% up to 1974, 3.5% in 1975 and an expected 4.5% in 1976.

70. The fact that prices have recently been rising faster is due mainly to external inflationary pressure. As a result the trade deficit, which was around \$600 million in 1974, is on the increase. For the first nine months of 1975 it apparently reached around \$775 million, 600 million of it with the West(1). The deterioration in the terms of trade in 1975 (-8% with the COMECON countries and -6% with the West)(2) rather than the increase in the volume of imports explains this trend(3). This could lead to further inflationary pressures of external origin.

71. Subsidies to offset the increased cost of imports are nine times higher than in 1973.

72. To meet these difficulties, the Hungarian Authorities have increased restrictions with an eye to bringing domestic prices into line with world prices. Various measures have been taken to curtail the external deficit: The forint underwent a 5% revaluation on 1st January, 1976 in relation to the dollar (41.3 forints to a dollar, as against 43.5 previously), and this should ease the position for essential imports from the West. On the other hand, the forint has been devalued 5% in relation to the rouble (1 rouble = 35 florints). It is likely that since it has become more difficult to export to the West, some exports will be redirected Eastwards. At the same time new taxes have been placed on non-priority imports whilst certain enterprises, which depend for their livelihood on foreign trade, are to receive subsidies(4).

73. The cost of domestic subsidies will also be gradually reduced; a stage-by-stage alignment of consumer prices on producer prices and of producer prices on international prices is being introduced. On 30th November, 1975 the government announced a series of price increases(5) which came into effect

- (1) Hungary has transacted a fairly large volume of business with the Soviet Union, Poland and perhaps other CEMA states in hard currencies. Taking the resulting surplus into account, Hungary's deficit in convertible currencies was less than \$500 million
- (2) Following a much stronger deterioration already felt in 1974
- (3) An official Hungarian estimate puts the proportion attributable to the deterioration in the terms of trade at 68%
- (4) The non-commercial forint (used by tourists) rates 20.65 forints to the dollar
- (5) This is the third price rise since the beginning of the year: The other two were in January and August 1975

on 1st January, 1976 or will be introduced during the year 1976. On 1st December, 1975, the price of sugar went up 50% in order "to relate consumer prices as closely as possible to current costs and producer prices". On 1st January, 1976 there were price increases for certain building materials, furniture and paper and office supplies, as well as for a number of services. Building materials went up by about 22%, furniture by between 3% and 4% and paper and supplies (except for schools) by between 10% and 15%.

74. International postage and railway rates have also been adjusted; the cost of sanitation services, and even of domestic waste disposal, has been increased and the prices of asphalt, motor oil and dye products are going up by between 10% and 15%.

75. Lastly, it is planned to raise the cost of meat and meat products by another 32% or 33% on 1st July, 1976; for poultry and fish the rise will be less steep.

76. To cushion the effect of these increases on the public, it has been officially announced that measures to improve wages and incomes will be implemented in July 1976. But these wage increases should not compensate for the rise in prices.

B. Poland

77. There has been a steady rise in wages and incomes in Poland over the last three years. Salaries have in fact risen faster than productivity and have also outstripped the increase in the goods and services available(1) so it is reasonable to speak of the existence of cost-push and demand-pull inflation in Poland. (A fairly large proportion of foodstuffs are purchased on the parallel markets.)

78. Poland's most serious domestic economic problems stem from sharply increased liquidity, which has not been fully absorbed by either production or price increases.

79. The level of consumption is high and private saving has increased sharply at an average rate of 44.5% during the 71-74 period. Savings at present represent two and a half months of an average salary. However, this development cannot be exclusively attributed to inflation; the rise in savings would seem to stem rather from the ambition of more and more families to acquire a home or consumer durables, a motor car, for example. Since little consumer credit is available, they must have prior savings to do this and these are deposited for a while in the savings banks.

(1) Savings and employment have been decentralised from 1973 onwards. On the other hand, prices are still managed by a central authority

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80. The retail price index has jumped from 101.1 in 1973 to 108.4 in September 1975(1). But this index is "biased" and probably underestimates the real rise. However, the Polish Government seems to have accepted the need for a return to more realistic prices and at the Congress of World Communist Leaders in Warsaw in December 1975, Mr. Gierek stated that "the five-year old freeze on food prices would be ended in 1976". In any case, it is now considered impossible to hold down the price of basic commodities to their level of five years ago. The 1976-80 Plan anticipates price rises: A 2% implicit price rise appears for 1976 along this line.

81. The most important factors limiting Poland's ability to deal with inflationary pressures are the political sensitivity of wages and price policy, which inhibits the attainment of a better balance between wage and price levels and a deteriorating balance of trade - Poland's cumulative foreign trade deficit during the 1971-75 period was probably \$6.5 billion (\$7.5 deficit vis-à-vis the West and 1 billion COMECON). It makes a sharp expansion of exports highly desirable, but this would result in domestic supplies being kept below the desired levels.

82. Consequently in the new Five-Year Plan priority will be given to increasing production both for the domestic and foreign markets (respectively +7% and +14%). The authorities maintain that the improvement of real living standards remains an essential aim and would continue in spite of the price increases. However, as stated by Mr. Gierek "wages will rise less rapidly than during the period 1971-75 (16% to 18% as against 40%) and will depend on increased productivity".

83. In order to reach a better utilisation of the available resources (especially imported) and to avoid excessive indebtedness which could be detrimental to the capacity of the country to import essential capital goods in the future, Mr. Gierek called for "better work organization, savings in energy and raw materials and an end to waste and all forms of negligence". It has also been announced that a tax on imports will be introduced shortly.

C. Rumania

84. Of all the COMECON countries, Rumania (along with Poland) is the least dependent on the Soviet Union for energy and raw material supplies. At the same time, it is one of the most open to trade with the West and so bears the full brunt of world inflationary pressures.

(1) See Annex III

85. Although the government denies it, there are indications that price rises have taken place in recent years and that they were big enough to cause some discontent and even, according to reports from emigrés, to spark off local strikes. Price rises were announced by the authorities as early as last summer and have been explained as resulting inevitably from the floods which reduced agricultural output and the supply of certain consumer goods produced locally (mainly fuels, building materials, leather and textiles).

D. German Democratic Republic

86. Of all the East European countries, the GDR is certainly the one with the most manipulated and least reliable statistics. This makes it extremely difficult to judge the actual economic situation and the degree of inflation.

87. It was announced that wholesale prices of basic commodities would be adjusted as from 1st January, 1976. Official assurances that these increases would not affect retail prices(1) sound very hollow, since average price levels are steadily creeping up as a result of inexpensive goods being quietly replaced by almost identical but more costly ones of slightly better quality.

88. Wages have been frozen at a fairly low level; the average is 820 marks gross, 680 net roughly. The new Plan anticipates a very modest rise of incomes (4%) parallel to the increase in the planned supply of consumer goods.

89. The decision taken at the start of the 1971-75 Five-Year Plan to give priority to consumer goods and promote higher living standards thus seems to have misfired; external pressures appear to be largely responsible for this.

90. There appears to be a big trade deficit: According to OECD statistics, the GDR has accumulated a balance of payments deficit of 3 billion valuta marks with the West since 1970(2). Only Western credits have made it possible for the GDR to carry on trading with the West, but this facility is gradually being run down in spite of the unofficial decision to stop importing Western consumer goods. In 1974 the GDR reached a trade surplus of 400 valuta marks in its COMECON trade.

E. Czechoslovakia

91. This country has to face certain domestic difficulties arising from an antiquated industrial apparatus, a serious manpower shortage and the uncompetitive nature of its goods on

(1) Except for certain categories of consumer goods; furniture, carpets, coloured television, which are considered non-essential

(2) Other sources put the deficit at 10 billion marks

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foreign markets (both COMECON and Western). However, there are no signs of a serious disparity between supply and demand (except for housing where the shortage is severe). Inflation is running at around 1%; since productivity has risen slightly faster than wages, there is no cost-push inflation. The general **retail** price index is remarkably stable; prices are frozen at the 1971 level.

92. Several times in November 1975 Mr. Husak and Mr. Strougal voiced the government's intention to keep the general **retail** price level unchanged "at the beginning of next year". The 1976 Economic Plan is based on unchanged consumer prices. According to Western observers, the official declarations do not exclude the possibility of subsequent increases of prices, possibly during the Summer of 1976, for although trade remains in balance there is growing pressure from subsidies (with all the risks of inflation stemming from budgetary transfers and subsequent price rises).

F. Bulgaria

93. Although efforts have been made to speed development and industrialisation, Bulgaria seems to be relatively immune from inflation. This is probably explained by the special relationship which exists with the Soviet Union, which gives its "least-developed" ally substantial economic assistance and even seems prepared to boost its aid sufficiently to offset all the increased cost of Bulgaria's imports.

94. Bulgaria is consequently not known to have considered formulae for relating domestic producer or consumer prices to world or COMECON trade prices. Nevertheless, the Bulgarian Communist Party "Theses" on raising living standards up to 1990(1) stated that "retail prices of goods and services must still further correspond to necessary social labour outlay, to quality and fashion requirements": This would appear to be a warning of possible consumer price increases, similar to that made by Party Leader Zhivkov in a Burgas speech in August 1975. The message seems to be that in the medium-term, quality improvements will no longer be subsidised but must be paid for by the public, i.e. increased production costs will be passed along to the consumer.

III. PROSPECTS

95. Drastic economic measures are to be taken in all these countries in order to diminish the growing burden of subsidies and to restore more balanced external accounts.

(1) Published on 22nd February, 1976 subsequent to the experts meeting

96. Two of them - Hungary and Poland - having reintroduced certain market mechanisms in the sphere of prices and wages have already taken or unequivocally announced consumer price increases. They are aiming at establishing a more realistic relationship between world, intra-COMECON and domestic prices. The other four which up to now try to stick to centralised planning and to avoid price rises do not seem able to resist indefinitely, the more so since the increased costs of imported energy, raw materials and capital equipment have not yet made their full impact, the USSR being unable to meet all the future energy needs of its allies.

97. Furthermore, in order to reduce their external indebtedness, all East European COMECON countries consider limitations of imports of less essential products. However a curtailment of advanced technological imports from the West which would slow economic growth will be delayed as late as possible especially through increased recourse to loans that the Western countries stand ready to allocate in order to maintain their exports flows.

98. In such conditions the improvement in living standards - theoretically a fundamental aim of the 1976-80 Five-Year Plan - will not only be jeopardised in the next few years but will also indirectly depend more heavily on foreign credits (whether they come from Moscow or from Western assistance).

MONEY AND PRICE MANAGEMENT IN USSR

I. MONEY MANAGEMENT

1. The domestic money supply - i.e. notes issued and the volume of deposits - its tailored to remain in harmony with the development Plan, and kept in line with the financial needs of production and consumption. Theoretically no overall imbalances can arise through the build-up of surplus credit. Above all, those two circuits are cut off from each other.

(i) The bank money circuit, is used for transactions between enterprises, and deposits, under the watchful eye of the Central Bank, are kept at the minimum level compatible with production requirements. The "rouble control" applied by the Central Bank, which both implements and controls the Plan, means that the enterprises are only allowed the capital which they need for their investments.(1) The purpose of this form of control is to prevent the build-up by the enterprises of illegal raw material stocks or reserves.

(ii) The fiduciary circuit, which is restricted to private individuals (workers - consumers) offers a spending choice limited in principle by the planning system to an official assortment of goods and services.

2. Production is not guided nor prices themselves affected by consumers' preference. Consumer credit exists as an institution but is very little used as yet and its still not authorised for the purchase of some items such as cars; consumers must therefore save up in advance for the purchase of the major durables. Surplus purchasing power, generated in particular by wage increases, has often been absorbed in the past (this was last done in 1956) by forced savings. Currently it is reflected in an increase in private savings deposits.

3. Little is known of the final use which the many "middle men" operating illegally, make of their profits. Their options are limited: no direct investment abroad, occasional opportunities (extremely few and far between) to acquire foreign banknotes (convertible currencies bought from tourists), investments in works of art, in gold or in jewellery. Money is undoubtedly invested in housing (it is believed that one-third of all households own their apartments which are obtained in

(1) Erik Egnell et Michel Peissik ; URSS, l'entreprise face à l'Etat (USSR : the enterprise and the State) (Seuil, Paris 1974).

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most cases through production co-operatives), in "dachas" or in motor cars. It seems likely, however, that most of the proceeds of illegal activities are reinvested in stocks to be sold on the parallel markets.

4. The external circuits are cut off from the domestic circuits to ensure that any inflow of foreign currency - whether produced by a trade surplus or by borrowing on the international market - will not create unwanted money.

5. The traditional non-convertibility of the rouble, which was even maintained in 1947 and 1965 when economic and monetary reforms were carried out, makes for two price systems: prices for the internal market and prices used in foreign trade contracts.

II. THE PRICE SYSTEM (1)

6. Planned prices are not of the basic components of economic calculation and socialist planning. They provide the means of implementing the Plan (expressed in current prices). Prices are planned in such a way as to ensure that commodities are related to purchasing power; this must apply not only generally but also for specific groups of products and areas of consumption.

7. Price levels for essential commodities (macro-prices) are fixed with a view to achieving certain required proportions in the process of distribution of the national income. A State Committee, formerly connected with the Gosplan and now responsible to the Council of Ministers itself, determines these prices (the 1965 reform made no fundamental alterations to this system). In the case of other prices, the Committee lays down general guidelines and leaves it to the decentralised bodies at regional level to take decisions on an item-by-item basis.

8. Thus State prices encompass the whole range of goods and services. Their control is regarded as a "sine qua non" for the development of planning and for economic balance. They are normally impervious to uncontrolled movements and remain extremely steady.

(1) c.f. Mahmoud Abdel Fadil, Planification des prix en économie socialiste (Price planning in the Soviet economy) (PUF 75) and articles in "Le Monde" (19th August, 30th September and 16th December, 1975).

9. The progress in productivity is :
- either used to offset the unavoidable rise in cost of some factors or of import prices;
 - or used to enable wage increases to be granted;
 - or passed on by reducing the selling price of items whose consumption is intentionally promoted for social/political or economic reasons.

10. As selling prices usually include indirect taxes as well as the manufacturers' production costs and profit margins, it is possible to peg them to some extent, even in the face of increasing costs, by reducing the tax on turnover or, when this tax has been reduced to nil, by granting budget-funded subsidies.

11. The wholesale price indices reflect industrial sales prices which are set, for each enterprise, at a level which normally covers production costs and allows for a small mark-up. Since, however, the prices of the inputs are themselves arbitrary, some being subsidised, the wholesale price index cannot be read in the same way as in a market economy and its movement upwards or downwards over a period of time is an inaccurate indicator of inflation.

12. In addition, the very structure of the wholesale price index mainly indicates average prices calculated on the basis of a fixed sample of goods which have come into mass production and have therefore decreased in price. For this reason, and for others too, a cautious view must be taken of the methodology used in preparing the index.

13. The retail price index is linked with the wholesale price index, i.e. in principle, with the production costs of the enterprises. It also incorporates "downstream" price factors such as transport, distribution, the profit of the distributing enterprise and, where appropriate, taxes or subsidies.

14. The index has remained steady after showing a long-term downward trend between 1950 and 1965. This overall stability is achieved by different increases and decreases in individual items which are intended to offset one another. Here again, however, the index is heavily slanted since it probably over-estimates the value of "improved quality" and takes account neither of prices paid on the parallel markets nor of the many price violations which occur on the official markets. It includes few new items (the list of articles has hardly changed since 1950), and thus over-emphasises the effect of decreasing costs, nor is it affected by price increases in goods which are reputedly new but remain basically the same. Because of the

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increase in income which averaged 4.6 % between 1966 and 1970 and 4 % between 1971 and 1975, and which has had a market impact on the pattern of consumption, the goods listed in the index now account for only 50 % at most of overall household expenditure. In other words, the stability of the official price index relates to only half the goods and services used by an average household.

III. LIMITATIONS ON OFFICIAL POLICY

15. The Soviet Authorities' attitude towards inflation differs from that of Western governments : this is because the aims and the means that can be employed to combat it are not identical. In the East, anti-inflation policy consists first and foremost in camouflaging the phenomenon and preventing it from becoming apparent, by means of various techniques like manipulations of index, subsidies, etc... When it comes to balancing supply and demand and combating excessive purchasing power (whose growth cannot be controlled indefinitely, even in an authoritarian system), the action the authorities can take is strictly limited.

16. First, it is very difficult to correct inflation by means of a general rise in retail prices without jeopardising the inter-relationships and the complet fabric of the Plan. Only limited changes in the price of specific items are designed to achieve a partial balance between supply and demand.

17. Second adjustments by increasing the supply of consumer goods by reallocating factors or commodities towards automobile industries, construction of dwellings, etc.. clash with planning priorities given to the production of arms or capital equipment. For the planners production of consumer goods can only increase as productivity in these sectors improves. But the bureaucratic and mandatory character of the Plan, as well as the rigidity of the system, prevent any lasting increase in productivity and hence of production. The disappearance of marginal firms which, in a liberal economy, contribute to the optimum allocation of the factors is relatively unusual in the USSR, although perhaps more frequent in Eastern Europe. The Gosbank plays an important role when an enterprise gets into financial difficulties, normally providing additional funds and advice where necessary. In the last resort, the Gosbank can even declare an enterprise insolvent and generally take over, reorganise and manage the bankrupt plant.

18. Since it is so difficult to take steps affecting prices and supply, Socialist Planners like the authorities in the have recourse to a third way in order to avoid inflation : they constantly try and adjust demand by incomes, budget and saving policies. For instance, they endeavour to restrain wages rises to increase the non-monetary element of remuneration (provision of free medical, social, educational and recreational services) and to extol the advantages of consuming intangibles (e.g. culture) or collective items, as this does not entail an increase in

tangible commodity output to match the monetary demand.

19. The State Budgets of the USSR, when implemented, generally show a surplus. However, due to the fact that budget receipts include in addition to normal taxes certain Treasury funds, some doubts can be raised as to their true meaning. Even when the Budget is apparently balanced, expanding expenditure may increase the money stock without a counterpart and thus be inflationary. In addition a balanced budget may be inflationary with receipts and expenditure reaching increasingly higher levels, if the higher taxes which households are required to pay cause them not to spend less but to reduce their savings.

20. In addition to that, subsidies - a means used from time to time to moderate the rise in prices - lead to an incorrect distribution of the factors of production both in the short-term and in the medium-term. Their effect is not necessarily inflationary provided that they are financed by higher taxes.

21. Fiscal policy (increase in income tax and VAT) is currently used in order to reduce the pressure of the purchasing power or the desire to procure certain goods which are in short supply (cars, apartments).

22. Finally, in periods of severe shortage or of disorganization of the economy, the freezing of savings has also been frequently used, for the last time, in 1956. Experts do not anticipate any further recourse to such a technique of soaking up the purchasing power, which would be dramatically resented by the population.

INDUSTRIAL WHOLESALE PRICES (including turnover tax)

	<u>1965</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>
1. Index (1949 = 100)	60	59	64	64	63
2. Structure (percentage) wholesale price	100	100	100	100	100
of which					
Costs	74.7	73.0	73.3	73.5	74.1
Profits	9.4	14.2	13.4	13.6	13.9
Turnover Tax	15.9	12.8	13.3	12.9	13.0
Sources : Narodnoe Khozyaistvo	1972 p. 200, 1973 pp.252, 253				

RETAIL PRICES - MOSCOW 1965-1975

	Quantity	1965	1970	1972	1975
Beef	kg	2.00	2.00		2.00
Bacon	kg	2.60		3.10	3.20
Potatoes	kg	0.10	0.10	0.10	0.10
Sugar	kg	0.90	0.90	0.87	0.87
Butter	kg	3.30	3.60	3.60	3.60
Margarine	kg	1.50	1.80		1.70
Cheese	kg	3.00	3.00	3.00	2.80
Coffee	kg	4.50	4.50		4.50
Tea	100 gms		0.96		0.76
Milk	lit.	0.30	0.30	0.30	0.30
Vodka	$\frac{1}{2}$ lit.		2.90	2.90	3.60
Eggs	10	0.90		1.20	1.10
Refrigerators (Dnepr)			320		260
Washing machines			100	86	
Television sets			360	320	280
Rents (per Sq/m)		0.15	0.15	0.15	0.15
Bus fares			0.05	0.05	0.05

PRICE OF BLACK MARKET GOODS IN THE SOVIET UNION
(roubles)

ITEM	OFFICIAL PRICE	BLACK MARKET PRICE (1)
Skirt	15	60-70
Ladies Tights	7.50	20
Ladies Stockings (synthetic)	2.50-3.00	12
Gent Shoes (Leather) Italian	45	200
Ladies Shoes (Winter) Italian	75	180-200
Leather Gloves	12	30
Tape Recorder - Various types	140-500	To 7000
Western Style Jeans	na	80
Sports Jacket	70-100	200

(1) These prices are given as mere instances because they are based on very limited sample of observations.

POLAND : Price Index for Retail Trade Commodities (1)
and Services

1970 = 100

	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975(2)</u>
Total price index	100.4	100.4	101.1	107.1	108.4
Total price index	100.4	100.3	100.6	106.5	107.8
Commodities	102.5	102.4	102.7	109.1	109.1
among them : Foodstuffs					
among them :					
Retail trade of the state and cooperatives	101.5	100.7	100.6	102.2	102.8
Restaurants	101.6	99.6	99.8	117.2	119.2
Free food markets	107.6	111.9	114.3	135.1	132.8
Alcoholic beverages	100.0	100.0	100.0	124.6	127.3
Other commodities	97.2	96.9	97.1	98.6	100.6
Services	100.5	101.2	103.4	109.5	111.5

1) Including restaurants and free markets

2) January to September

Source : Biuletin Statystyczny N° 11/75