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N A T O U N C L A S S I F I E D

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## ECONOMIC COMMITTEE

### INFLATION IN THE USSR AND THE EASTERN COUNTRIES

Note by the Economic Directorate(1)

#### GENERAL INTRODUCTION

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 role. Prices are not affected by demand in the State-controlled sector but only on the parallel markets and therefore to a very limited extent.

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#### (1) 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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- (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. They play no part, however, in the income distribution process which is the exclusive domain of the Plan.

2. Inflation therefore, instead of taking the basic form of widespread and overt rises in prices and costs as in the West, is revealed by other signs (a growing volume of idle savings, shortages, queuing, etc.). These often represent a social cost which should be added to the advertised price of the goods and services on offer.

### I. HISTORICAL BACKGROUND

3. However true the economic model is in theory, actual Soviet prices have alternated up and down by wide margins.

- (i) After the 1917 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).

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

- (ii) 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).

In the early 60s, it may be considered that the index has reached the limit imposed by economic factors such as the cost price of manufactured goods, the level of industrial cost-effectiveness and transport costs, to which should be added the bonuses and pay increases made necessary by the general desire for better living standards.

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 essential commodities.

- (iii) 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.
- (iv) From 1965 to 1972 further reductions averaging between 15 and 30% were introduced for textile goods, medicines, preserved foods 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 textiles (clothing); while the cost of luxury goods (caviar, sturgeon, salmon, luxury furs and the like) went up<sup>(1)</sup>. These price changes have been mutually-offsetting, with the official index (1950 = 100) remaining at 74-75 since 1965.

## II. PRESENT CAUSES OF INFLATION

4. Inflationary stresses exist at present in countries with a centralised economy and this is acknowledged not only by the economists in these countries but even by the national authorities.

- (i) 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".
- (ii) 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.

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(1) This is also true of motor cars (not included in the index!) 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

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

- (a) 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.

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 forecast costs. Delays in production actually achieved are frequent. The factors of production 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, un-needed stocks of materials are allowed to accumulate in different concerns.

Actual costs may 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.

At the enterprise level there is also a measure of autonomy: in particular, decisions regarding the use to be made of certain surpluses are taken on a decentralised basis by the works manager concerned(1).

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, which is essential if proper use is to be made of the factors of production.

At the consumer level purchasers of goods and services enjoy a limited degree of autonomy. Their purchasing power produces partial imbalances between supply and

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- (1) i.e. the allocation for decentralised investment purposes of certain profits "achieved" in excess of planning goals (1965 Reform) c.f. George Garvy: Policies and mechanics relating to money - NATO Symposium 1973, p. 61 et seq.

demand; these become more pronounced as the pattern of consumption is diversified and generate pressure on retail prices.

(b) At the international level two additional factors have had a more significant effect in recent years and, in the present context of world inflation, have made the Eastern countries' economies more sensitive than hitherto to foreign-generated inflation.

(i) first, 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 (rehabilitation of the role 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 are affecting domestic price formation, at least for certain commodities;

(ii) this trend is being fostered by the gradual build-up in the Eastern countries' trade relations with the industrialised countries, as a result of which they are being subjected to pressure, even although an effort is being made to prevent imported inflation from directly affecting Eastern price patterns.

6. 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 (4% of national income as compared with 20% to 30% 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).

7. 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. 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.

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In view of the very low capital and labour productivity from which these countries suffer, it might paradoxically be argued that official acknowledgement of overt inflation by a more realistic application of the law of supply and demand and a reduction of the "gimmicks" which shroud economic developments in mystery for the planners themselves is more a sign of health than a weakness.

Part One: THE USSRI. MONEY MANAGEMENT

8. The domestic money supply - i.e. notes issued and the volume of deposits - is 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, quantitatively speaking(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.

9. 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 is 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.

10. 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

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(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.

11. 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 borrowings on the international market - will not create unwanted money.

12. 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. "Export prices are fixed in the light of commercial prospects: the Soviet foreign trade authorities have no hesitation, when they see openings for given goods or equipment, in quoting sufficiently attractive prices to capture the market"(1)

## II. THE PRICE SYSTEM(2)

13. Planned prices are one of the basic component features of economic calculation and socialist planning. They provide the means of implementing the Plan, value-wise. Prices are planned in such a way as to ensure that commodities are commensurate with purchasing power; this must apply not only generally but also for specific groups of products and areas of consumption.

14. 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.

15. 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 impervious to uncontrolled movements and remain extremely steady.

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- (1) Money, prices and salaries in the USSR. Informations du Commerce extérieur, Brussels, 19th December, 1975
- (2) 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)

16. 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 in the selling price of items which are intentionally boosted for social/political or economic reasons.

17. 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.

18. 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 meaningless from the standpoint of inflation.

19. 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.

20. 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.

21. 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

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but remain basically the same. Because of the 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.

In short, the index does not accurately reflect the true situation and tends to disguise a state of inflation which has many causes.

### III. THE CAUSES OF INFLATION(1)

#### ENTERPRISE COST INFLATION

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

- (i) the increase in the extraction costs of basic commodities (iron, manganese, bauxite, oil, natural gas and so on) is explained by the increased utilization of a costly infrastructure in remote parts of Siberia;
- (ii) 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 foreign influence. Since trade with the industrialised countries of the West nevertheless constitutes almost one-third of the overall figure, 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;

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(1) c.f. five studies provided by the United Kingdom, German and United States Delegations:

- (a) USSR - Myth and Reality (United Kingdom Delegation) AC/127-WP/435, dated 14th July, 1974
- (b) Comments by Embassy of the Federal Republic of Germany in Moscow, dated 24th September, 1975 (German Delegation 94.29-5/75)
- (c) Inflation in the USSR (Myth and Reality). Note enlarging on (a), dated 10th December, 1975
- (d) Imported inflation (German Delegation)
- (e) Inflation in the USSR and Eastern Europe (United States Delegation) (AC/127-d/522, 22nd December, 1975, AC/127-WP/451, 9th January, 1976)

- (iii) 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 114.5 as compared with a terminal figure of 149.3 provided for in the 1971-75 Plan. 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.

23. 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.

#### REDUNDANT HOUSEHOLD PURCHASING POWER

24. 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).

- (i) 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.

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- (ii) Apart from wages, households receive substantial benefits from the social funds (89 milliard roubles in 1975)(1). The latter meet the cost of pensions, allowances, holidays and student grants. They account for about 25% of general resources distributed in the form of wages.

25. These various forms of income generate a growing purchasing power which, buttressed by the unfreezing of earlier forced savings, seems to be in excess of the actual supply of goods and services.

The conclusions reached by different experts are, however, far from unanimous. Some of them believe that inflation has weakened during the last years of the present Five-Year Plan. They particularly point out that production of Group B (consumer goods) has increased by 80% between 1965 and 1973, more quickly than the purchasing power. Other experts, on the contrary, draw attention to the lagging development of agricultural output and the lack of flexibility in the supply of services. In addition they note some "local" inflation due to the poor organization of transport. In some areas consumers have to turn to the parallel markets for 20% of their food purchases (compared with an average of 2.2%) in the absence of supplies on the official market.

26. Definite conclusions cannot be arrived at, because of lack of basic information. For instance, we know nothing about the structure of Soviet consumption, about the volume of money in householders' hands or about subsidies allotted in order to keep prices down: in general all monetary or financial data are incomplete or published with a time lag.

RECENT TRENDS( 1974-75)

27. The Economic Survey of Europe 1974 (Economic Commission for Europe - Geneva) includes a number of statistical series enabling the above-mentioned data to be updated.

These statistics confirm that the underlying causes of inflation have gained strength over the past two years for the following reasons:

- (a) In the first place, supply has remained rigid and this is borne out by two developments:

- increases in the factor cost of production have tended to gain momentum in recent years: the

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(1) 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.)

harnessing of Siberia's resources appears to be 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).
- (b) In addition, demand seems to be rising more strongly than hitherto for a number of reasons:
- 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, there is a rising tide of poor quality goods left on the shelves which is adding to inflationary pressures.

#### IV. EVOLUTION OF PRICES (OFFICIAL DATA)

28. 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 situation as it really is. The table at Annex I, which is given simply as an example, shows that the prices charged in 1975 are very close to those charged ten years ago. However 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.

29. In the production sector the inflation diagnosis is based on the increase in enterprise profits not allocated and

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the increase in credits not taken up, as they appear from incomplete data.

30. The growth of free markets, the increase in the subsidies budget (or the reduction in certain fiscal receipts) and the increase in savings for which there are no outlets, are the main signs of inflation at the final demand stage.

PRICE RISES ON EXPANDING "FREE MARKETS"

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

- (a) agricultural products, generally of good quality, grown on individual smallholdings, 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.
- (b) On the parallel market can be 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 regime, 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 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.

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- (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 13%, potatoes 36%. These are only average figures however which vary considerably from one region to the next
  - (2) See Annex II for some examples of prices on the parallel market

INCREASE IN BUDGET SUBSIDIES

	<u>STATE BUDGET</u> (milliard roubles)			
	<u>1965</u>	<u>1973</u>	<u>1975</u>	<u>1976 (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 United Kingdom Note (AC/127-WP/449) p. 13, table updated on the basis of press information

32. 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).

33. 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 those 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).

INCREASE IN FAMILY SAVINGS

34. Paradoxically, 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

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(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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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).

This increase in Soviet family savings cannot be explained by reference 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.

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. In this connection, it is characteristic that the authorities seem to fear a massive mobilisation of available purchasing power, in anticipation of increases in the prices of certain articles: these increases are generally announced at the end of the day and come into effect at midnight.

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

- (1) 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 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;
- (2) furthermore, the announcement that the growth rate in the NMP will be reduced during the next Five-Year Plan

(1976-1980) and the fact that greater emphasis has been placed on improving the quality of goods 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

V. LIMITATIONS ON OFFICIAL POLICY

36. 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.

(a) Camouflaging inflation

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 referred to above.

(b) Correction of inflation

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.

37. Correction of inflation by means of a general rise in prices

It is very difficult to adjust the prices of specific products without jeopardising the interrelations and the complex fabric of the Plan. Thus, changes in the prices of certain products can be designed only to achieve a partial balance, not to restore the overall balance.

38. Correction by increasing the supply of consumer goods

(i) An administrative reallocation of factors or commodities with a view to increased consumption (more cars, dwellings, etc.) is difficult, owing to planning priorities which give the first place to the production of capital equipment and arms and which always seek to maintain the possibility of high future growth. For the planners, production of consumer goods can only increase as productivity improves.

- (ii) It is the bureaucratic and obligatory character of the Plan, as well as the rigidity of the system, that 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 a phenomenon unknown in the East. Normally, a Soviet undertaking which is in difficulty is speedily assisted by the State Bank which, if necessary, takes over from the unsuccessful managers. This practice, which considerably reduces labour mobility, leads to a non-optimal distribution of the factors of production.

39. Correction by adjusting demand

Since it is very difficult to take steps affecting prices and supply, the correction of inflation in a socialist economy is mainly based on an incomes policy, a taxation policy and a savings policy.

(a) Incomes policy

The authorities endeavour to restrain wage 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.

(b) Budgetary and fiscal policy

In the USSR the State Budgets when implemented generally show a surplus. However, due to the fact that budget statistics include certain Treasury receipts (as cited above), 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(1).

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- (1) In addition to this, one cannot forget that 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

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 (but see comment above).

Fiscal policy (increase in income tax and VAT) is currently used in order to reduce the pressure of the purchasing power. In periods of severe shortage or of disorganization of the economy the freezing of savings has also been used (in 1956 for the last time).

(c) Monetary and credit policy

In a centralised economy, the monetary holdings of the public sector - apart from those carried over from the previous years - simply reflect the planners' intentions. Monetary demand by private individuals has no effect either on production or on the prices of consumer goods and services(1).

VI. PROSPECTS (1976-1980) AND CONCLUSIONS

40.

- (1) Price increases in the Soviet Union appear to have been moderate in recent years, averaging out at not more than 2% even taking into account the rises on the parallel markets. The inflationary gap is however tending to widen particularly in the wake of the increase in factor costs: poor agriculture yields, reduction in the return on capital, high cost of harnessing resources in Siberia. To the extent that there may be a slower rate of growth - as anticipated in the 1976-1980 Plan - and that inflation may increase, it will no longer have the marginal importance which it has been given so far and the prospects for real growth may be in jeopardy.
- (2) At the present time, there is no indication that the Soviet Authorities are resolved to bring about a reduction in consumption by increasing retail prices. In fact such a step seems unlikely for two reasons. It would be inconsistent with the Plan's official

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(1) On the strictly passive role of money and the limits of monetary policy, see Garvy loc. cit. p. 65

concepts. In addition, it would have a psychologically adverse effect on the population which still remembers the hyper-inflation of the inter-war period and which seems more ready to accept shortages and direct or indirect forms of rationing than a better distribution of resources through price changes.

- (3) It can be expected that the increases in retail prices which may be announced will be only marginal therefore and have a limited impact. On the other hand, and where factors of production are concerned, it seems likely that there will be steeper increases than in the past in the prices charged to enterprises, the main purpose being to economise on raw materials and energy. Retail prices would be kept in line with wholesale prices, thanks to increased subsidies.

PART 2: THE OTHER EAST EUROPEAN COUNTRIES

A. General inflationary trends

41. The domestically-generated inflation discussed above in connection with the Soviet Union also prevails in the other East European countries. But they are also affected to some extent by foreign-generated inflation since their economies are more sensitive to outside influences (some of them derive as much as 30% 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. The money circuits are no longer completely hermetic, some prices respond to demand pull and the enterprises have greater access to non-allocated funds than is the case with the Soviet model. All this means greater vulnerability to inflationary pressure.

42. It is not surprising, then, that in general inflation should be running at a higher rate in the People's Democracies than in the Soviet Union and that East European leaders are more willing to admit its existence.

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

Corrective measures are inevitable, and have already been taken in some cases, especially since the rise in the cost of imported energy, raw materials and capital equipment has not yet made itself fully felt.

B. External inflationary pressure

44. The gradual opening-up of the 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; Moscow increased the price of its oil deliveries to its allies by 135% and that of other raw materials by an average of 52%.

45. World market fluctuations after 1st January, 1975 will have a more rapid - although muted - effect on COMECON 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.

46. The present oil prices which the Soviet Union charges its allies are about one-third lower than the world prices.

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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). However, since the East European countries (except Romania) are heavily dependent on the Soviet Union for their supplies (90% in the case of oil), price rises are a significant factor in their trade balance deficits (\$1.8 milliard in 1975).

47. Inflationary pressures are aggravated in Eastern Europe by three additional factors:

- (i) the East European countries have not raised the prices of their exports to the Soviet Union to the same extent (15% only);
- (ii) 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);
- (iii) 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.

Consequently 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 milliards, for the single year 1974 \$4 milliards and for 1975 between \$5 and \$5.5 milliards.

48. Drastic economy measures in these countries could, of course, do something to improve the situation, but a curtailment of imports - especially of advanced technological imports from the West - would slow economic growth. So, while keeping a close watch on import trends, the East European planners have decided to establish more realistic ratios between world, intra-COMECON and domestic prices. Most of them have announced quite clearly what are often big increases in consumer prices resulting from the new relationship with world prices.

49. They are all the more inclined to take these measures at a time when enormous pressures are being exerted on the public purse. The maintenance of artificially low prices is costing a crippling amount in subsidies.

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

C. Country-by-country situation(a) Hungary

50. 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). 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.

The fact that prices have recently been rising faster is probably due mainly to external inflationary pressure.

51. 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 (- 8.2% with the COMECON countries and - 15% with the West) rather than the increase in the volume of imports explains this trend(2).

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

53. To meet these difficulties, the Hungarian Authorities have increased restrictions with an eye to bringing domestic prices into line with world prices.

- (i) Various measures have been taken to curtail the external deficit: the forint underwent a 5% revaluation on 1st January, 1976 (41.3 forints to a dollar, as against 43.5 previously), and this should ease the position for essential imports. On the other hand, the forint has been devalued 5% in relation to the rouble (1 rouble = 35 forints). It is likely that since it has become more difficult to export to the

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- (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) An official Hungarian estimate puts the proportion attributable to the deterioration in the terms of trade at 68%

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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(1).

(ii) Generally speaking the cost of domestic subsidies will 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(2) which came into effect 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%.
- 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%.
- 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.

(iii) 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. Be this as it may, however, real wages are bound to suffer.

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(1) The non-commercial forint (used by tourists) rates 20.65 forints to the dollar

(2) This is the third price rise since the beginning of the year; the other two were in January and August 1975

(b) Poland

54. 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).

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

The level of consumption is high and private saving has increased sharply at an average rate of 14%. 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.

55. Little is known about price trends: the cost-of-living index is "cooked" and clearly underestimates the real rise (on the parallel markets it is at least 6%). 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. Gierak 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 1976-1980 Plan anticipates price rises of 13% similar to those of the 1970-75 period.

56. The most important factors limiting Poland's ability to deal with inflationary pressures are:

- (a) the political sensitivity of wages and price policy, which inhibits the attainment of a better balance between wage and price levels;
- (b) a deteriorating balance of trade -- Poland's cumulative foreign trade deficit during the 1971-75 period was probably \$8 billion. It makes a sharp expansion of

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

exports highly desirable, but this results in domestic supplies being kept below the desired levels in order to meet export targets.

In the new Five-Year Plan priority will be given to increasing production both for the domestic and foreign markets. The authorities are on record as stating that the improvement of real living standards remained an essential aim and would continue in spite of the price increases. "However, wages will rise less rapidly than during the period 1971 to 1975 (16% to 18% as against 40%) and will depend on increased productivity".

In order to reach a better utilization 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. Gierak 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) Romania

57. Of all the COMECON countries, Romania (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.

58. 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

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.

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.

Wages have been frozen at a fairly low level; the average is 320 marks gross, 600 net. The new Plan anticipates a very modest rise of incomes (4%) parallel to the increase in the planned supply of consumer goods.

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.

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 apparently ceased to have a trade surplus with the other COMECON countries(3).

(e) Czechoslovakia

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 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.

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

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- (1) Except for certain categories of consumer goods: furniture, carpets, coloured television, which are considered as non-essential
  - (2) Other sources put the deficit at 10 billion marks
  - (3) This new situation may be entirely due to a change in the practices governing trade between Poland and the GDR (fob figures instead of the cif figures used previously)

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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

Although efforts have been made to speed development and industrialisation, Bulgaria seems to be relatively immune from inflation. This is probably explained by its relative isolation from the normal trade circuits, especially those linking East and West, and 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.

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

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TABLE II

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.

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