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WORKING PAPER
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ECONOMIC COMMITTEE

INFLATION IN THE USSR AND THE EASTERN COUNTRIES

Note by the Chairman.

Attached is a working paper prepared by the Economic Directorate as a basis for the discussion on the above subject to be held at the meeting of experts scheduled for 15th January, 1976.

(Signed) J. BILLY

NATO,
1110 Brussels.

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CONSEIL DE L'ATLANTIQUE NORD NORTH ATLANTIC COUNCIL

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30th December, 1975

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ECONOMIC COMMITTEE

INFLATION IN THE USSR AND THE EASTERN COUNTRIES(1)

INTRODUCTION

1. Theoretically, rising prices, reflecting as they do an imbalance between supply and demand, should be unknown in a centralised economy.

2. Whereas in a market economy supply is tailored to demand through price fluctuations, in a centralised economy money and prices are managed in line with the current Plan.

(i) Capital flow varies in accordance 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).

(ii) Prices, which are instruments necessarily subject to the planners' social and political goals and priorities, are controlled to ensure that the

(1) Sources:

- Inflation in the USSR, Note by the United Kingdom Delegation (to be prepared at the meeting of experts on 15th January, 1976)
- 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, id. p. 101 et seq.
- Imported Inflation, H. Machowski. Note submitted by the German Delegation (to be prepared at the meeting on 15th January, 1976)

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distribution and redistribution of national income follows the desired pattern and that allocated purchasing power corresponds to overall availabilities of goods and services.

3. Nonetheless, inflationary trends exist and this is acknowledged not only by economic experts in the Eastern countries, but also officially.

(i) In the USSR, the economist Kronrod (Gosfinidzat 1960 p. 364) recognised the existence of this phenomenon in the early sixties. On several occasions, Federenko and 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.

4. Inflation stems from the imbalance between the money flow and the goods flow. At the domestic economic level, the reasons for this are manifold:

(i) in many cases, the dates on which the goals set for the different factors of production are actually achieved differ from those laid down by the planners;

(ii) 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;

- (iii) 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);
- (iv) 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; these become more pronounced as the pattern of consumption is diversified and generate pressure on retail prices;
- (v) however, there also appear to be various disrupting factors inherent to the 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. 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, unneeded stocks of materials are allowed to accumulate in different concerns; labour mobility, which is essential if proper use is to be made of the factors of production, is cramped by administrative measures (bailing-out of "lame duck" concerns, retention on the payroll of unneeded workers and absence of "frictional unemployment").

5. 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:

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

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- (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 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 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.

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).

6. The true extent of the imbalance between supply and demand in the Eastern countries cannot be gauged exclusively by reference to official price trends (a rise or a fall in prices does not necessarily denote inflation or deflation):

- (a) the authorities systematically distort the retail price index "barometer", particularly by granting subsidies which tend to conceal the true rise in prices or to ensure that it has no impact at the retail level. However, this policy of subsidies, too, is part of the planning system and is aimed at ensuring that income is distributed according to the desired pattern;
- (b) the lack of a price system leads to phenomena characteristic of a subsistence economy (queuing, rationing, parallel markets, exclusively cash-motivated savings, etc.);
- (c) finally - and this is no doubt the most adverse result of all - inflation in the Eastern countries means that the factors of production are badly distributed and, coupled with other causes, is responsible for low capital and labour productivity.

Part One: THE USSRI. INSTITUTIONAL MACHINERYA. MONEY MANAGEMENT

7. The money supply is tailored to remain in harmony with the broad outlines of the development plan, the purpose being to ward off any overall imbalances through the build-up of surplus credit. At enterprise level, "the two fundamental variables of any monetary system, note circulation and the volume of deposits, are conditional on production plans"(1).

8. The external circuits are closed 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. The non-convertibility of the rouble, decreed in 1928, and again in 1947 and in 1965, following the economic and monetary reforms, 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"(2).

9. Within the centralised economy there are two quite separate monetary circuits:

(i) The bank money circuit, which is used for transactions between enterprises and in which 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 manages the Plan, means that the enterprises are only allowed the capital which they need for their investments, quantitatively speaking. 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 (worker - consumers) and which offers a spending choice limited in principle by the planning system to an official assortment of goods and services.

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

(2) Money, prices and salaries in the USSR. Foreign trade data, Brussels, 19th December, 1975

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10. Consumer preference has no influence on lines of production or even on prices. There is no hire purchase and consumers have to "save up" if they want to buy major durables.

11. Surplus purchasing power, generated in particular by wage increases, has often been absorbed in the past by forced savings. Currently, it is reflected in an increase in private savings deposits.

12. 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 to acquire foreign banknotes (convertible currencies bought from tourists?), investments 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 most cases through the 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.

B. THE PRICE SYSTEM(1)

13. Theoretically speaking, 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. It is true, at least in theory, that for the planners, as for Marx, goods have a value, viz. labour value, and there must always be a correlation between their price and their value: average social labour is therefore the objective basis of the price.

14. In actual fact, 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.

15. In addition, price levels for essential commodities (macro-prices) are fixed with a view to achieving certain required proportions in the process of distribution and redistribution 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.

(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)

16. 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.

17. 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.

18. In addition, as stated in the United Kingdom Note (page 5), 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.

19. 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.

20. The index has remained steady after paradoxically 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 increase in income which averaged 4.6% between 1966 and 1970 and 4% between 1971 and 1975, and which has had a marked 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.

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

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II. THE CAUSES OF INFLATION(1)

A. ENTERPRISE COST INFLATION

22. An analysis of price trends between 1968 and 1973 in industry, agriculture and construction as well as in the armaments industry sector 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 no longer denied: it can be explained, in particular, by the need to create costly infrastructure in remote parts of Siberia;
- (ii) in cases where basic materials and equipment have been brought in from abroad, the pressure of imported inflation seems to have been insignificant until recently: after a certain deterioration in the terms of trade up to 1972, there has been a relative improvement in foreign price ratios. In addition, the small volume of foreign trade in relation to GNP (3.9% in 1973) acts as a barrier to foreign influence, particularly since trade with the industrialised countries of the West accounts only for a quarter of overall Soviet trade. The increase in the price of equipment from the West may, however, affect certain sectors of Soviet industry which are dependent on Western plant and technology;
- (iii) wage increases have been larger than shown by the official statistics. According to the latter, the wage index towards the end of 1975 stood at 144.5 as compared with a terminal figure of 149.3 provided for in the 1971-1975 Plan. These indices do not appear to take account of extra money and

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- (1) We have referred mainly to four studies provided by the United Kingdom and German 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).

bonuses which the enterprises - concerned primarily with meeting the Plan targets - are increasingly paying over and above the legal rates in order to offset labour shortages.

Although wage increases have exceeded the Plan levels, productivity has not risen as much as anticipated. This means that unit wage costs are rising steadily (particularly 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 1974-1975 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. HOUSEHOLD DEMAND INFLATION

24. Purchasing power has increased significantly over the years as a consequence of the steady 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).

Wages:

- (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 workers' 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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- (11) Apart from wages, households receive substantial benefits from the social funds (89 milliard roubles in 1975). 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 purchasing power which is undoubtedly growing faster than the production of consumer goods, the official prices of which remain steady. This being so, the question arises whether there is excess purchasing power in the Soviet Union.

26. There are no reliable statistics which can provide a basis for calculating the volume of purchases or their true price. Among the things we do not know is the exact proportion of overall purchases accounted for by consumer goods obtained on the parallel market, trends in cash holdings by the public, the structure of household expenditure and overall savings, and the pattern of subsidies designed to keep down prices. Consequently, the interpretation of the available data is often hazardous. It is certain, however, that conditions for consumers have improved significantly in recent years, as witness statistics of retail sales, progress reported in the manufacture of consumer goods and data on domestic appliances.

C. RECENT TRENDS (74-75)

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.

28. 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 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(1) 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 which, buttressed by the unfreezing of earlier forced savings, seems to exceed the increase in the supply of consumer goods.

Despite greater production and a steady build-up in the volume of retail sales, there has seemingly been no reduction in the imbalance between supply and demand. On the contrary, and particularly as regards consumer durables, delivery times are tending to lengthen;

- again at the final demand stage, changes are appearing in the pattern of the Soviet consumer purchases, which now reflect more sophisticated tastes. This development, which has contributed to the rising tide of poor-quality goods left on the shelves, is adding to inflationary pressures.

III. SIGNS OF INFLATION

29. It is scarcely possible to attach any absolute significance, inflation-wise, to changes in official prices over a period of time, since these prices disguise or distort the true situation.

30. Inflation reveals itself in other ways: the development of "free markets", increased subsidies from the State budget, increased savings coupled with a scarcity of goods, in short a series of phenomena typical of a subsistence economy.

A. DEVELOPMENT OF "FREE MARKETS"

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

(1) i.e. 95% altogether

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- (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). The annual price rise for these products is from 3% to 5%. In 1973 the estimated ratio of these prices to the official prices was 164 to 100 (1965 = 100 for both series of prices).

- (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 even 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 estimate of price changes to be possible. It is, however, believed that, on the parallel services market, the rate of inflation corresponds at least to the increase in wages.

(c) The "Berioska circuit"

The "Berioska circuit" is another example of official tolerance. It is possible to purchase in this way the majority of everyday products with convertible foreign currency(2), prices being frequently lower than in the State shops.

	<u>Current prices</u>	<u>Berioska prices</u>
Black bread	18 kopecks	18 kopecks
White bread	7-40 kopecks	7-40 kopecks
Meat	1.60-2 roubles	1.80-3.20 roubles
Butter	3.60 roubles	1.45-58 roubles/kg

- (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%
- (2) At the official rate of \$1 = 77 kopecks

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	<u>Current prices</u>	<u>Berioska prices</u>
Milk	30 kopecks	25-32 kopecks
Sugar	90 kopecks	40 kopecks
Coffee	4.50 roubles	1.96 roubles
Tea	50 kopecks	16 kopecks/packet
Oranges	1.40 roubles	70 kopecks
Beer	36 kopecks/bottle	25 kopecks/can
Vodka	3.50-4 roubles/ half litre	1 rouble/1 litre (same brand)
Refrigerator	300 roubles	100 roubles
Washing machine	120 roubles	40 roubles
Radio set	100 roubles	40 roubles
Television set	300 roubles	150 roubles
Gramophone record	1-2 roubles	-
"Giguli" car	5,500 roubles	1,100 roubles
Packet of cigarettes	12-40 kopecks	24 kopecks (Marlboro 27)
Man's suit	130 roubles	40 roubles
Shirt	8 roubles	4.50 roubles
Pair of shoes	35-60 roubles	12 roubles
Man's haircut	40 kopecks	-
Cinema ticket	40 kopecks	-
Theatre ticket	1.50 roubles	-
Concert ticket	1.50 roubles	-

B. INCREASE IN BUDGET SUBSIDIES

STATE BUDGET (milliard roubles)

	<u>1965</u>	<u>1973</u>	<u>1975</u>	<u>1976</u> (forecast)
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, page 12, table updated on the basis of press information.

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32. The Soviet State budget, which regularly shows a surplus and thus does not contribute to inflation by injecting additional liquidity(1), provides large subsidies(2) which are intended either to orientate production along the lines laid down in the Plan or to correct price increases. The total economic subsidies amounted to more than 100 milliard roubles in 1975 but it is not possible to distinguish between these two aims. Such a policy obviously means that the factors of production are badly allocated.

C. INCREASE IN FAMILY SAVINGS

33. 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 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 (television, cars).

34. The payment of a small interest (2% for savings accounts) and the accumulation of liquidity for the purchase of expensive items (cars, dwellings) do not appear sufficient to explain such a high rate of saving (although hire purchase is unknown in the USSR). It is therefore probably an indication of excess purchasing power for which there is no existing or foreseeable outlet; in this connection, moreover, the planners are apparently anxious to avoid any large-scale mobilisation of purchasing power during the days or hours preceding a decision to raise prices and it is for this reason that such 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

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- (1) Subject to Samuelson's remark on the inflationary effect of increased expenditure
 - (2) Particularly subsidies to agriculture, which in the USSR are so large that they exceed the total military expenditure, as shown in official budgets.

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 ANP will be reduced during the next Five-Year Plan (1976-1980) seems to be a clear indication that the planners will have to limit the dangers of increasing inflationary pressures inherent in all rapid economic growth.

IV. LIMITATIONS ON OFFICIAL POLICY

36. The Soviet authorities' attitude towards inflation differs from that of the 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

On the other hand, 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 political requirements and planning priorities which give the first place to the production of capital equipment (military or civilian) 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, however, precisely 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, contributes 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 an inadequate 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

- (1) In the USSR, the State budgets regularly show a small surplus. Thus, no monetary issue takes place without a counterpart. However, a budget may be inflationary, even when balanced, if receipts and expenditure reach increasingly higher levels and if the higher taxes which households are required to pay cause them to save less.
- (2) A fiscal policy (a sharp increase in income tax) and the freezing of savings are sometimes used during periods of severe shortage or of disorganization in the production machinery.
- (3) The economic effects of subsidies, a means used from time to time to moderate the rise in prices, result in an incorrect distribution of the factors of production, both in the short-term and in the medium-term.

(c) Monetary and credit policy

In a centralised economy, the monetary holdings of the public sector - apart from those carried over from 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.

An attempt might be made to verify the hypothesis that, under certain circumstances and at specific periods, the system of controls might have weakened to such an extent that money could play a dynamic rôle in the economy, as in the West. According to Garvey(1), however, there is no evidence that this has ever happened in the USSR on a significant scale since the 1930s.

V. PROSPECTS FOR 1976-1980

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- (a) At the present time, there is no official indication that the Soviet authorities are resolved to bring about a reduction in consumption by sharply increasing retail prices. Such a step would be inconsistent with the

(1) Loc. cit. p. 65

Plan's official concepts and therefore appears unlikely: any price increases for certain articles should, therefore, be only marginal and have only a limited impact.

- (b) With regard to the factors of production, 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 raw materials and energy.
- (c) The emphasis laid on the development of agriculture in the 1976-1980 Five-Year Plan is likely to maintain a permanent climate of inflation, for the attempt to achieve a costly state of self-sufficiency in this area reduces the capital resources, including foreign capital, necessary for other purposes.
- (d) The rise in production costs, especially as a result of the opening-up of resources in Siberia, and perhaps also because of the inadequacy of overall capital resources, will inevitably become more pronounced (c.f. Economic Committee for Europe: Report on the Prospects for 1985) and may also increase inflationary tendencies.

Part Two: THE OTHER EAST EUROPEAN COUNTRIES

A. General inflationary trends

41. Although the other East European countries are also subject to the domestically-generated inflation discussed above in connection with the Soviet Union, the main pressures come from foreign-generated inflation since the economies of these countries are more sensitive to outside influences. Some of them, for example, derive as much as 30% of their national income from foreign trade, a large part of which is carried on with the industrialised Western countries. 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 outside inflationary pressure.

42. It is not surprising, then, that 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 increasingly heavily on the budget.

In some cases, these pressures are making the situation untenable and must lead sooner or later to general price revisions.

44. External inflationary pressure

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%.

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.

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

It must also be remembered that:

- the East European countries have not raised the prices of their exports to the Soviet Union to the same extent (15% only);
- the Soviet Union cannot cover all its allies' energy requirements so 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.

Lastly, the East European countries appear to be encountering serious financial problems in their trading operations with the West. For the period 1970-1973, their deficit totalled \$8 milliards, for the single year 1974 \$4 milliards and for 1975 between \$5 and \$5.5 milliards.

45. 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.

46. 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 for goods and services is costing a crippling amount in subsidies.

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

B. Country-by-country situation

(a) Hungary

47. Hungary has a relatively high per capita income (\$2,100) and is therefore one of the better-off socialist countries. The rapid rise in incomes over the last few years does not seem to have gone hand-in-hand with a corresponding increase in the goods and services available. The result, conceded by the authorities, is an inflationary gap; the official retail price index even points to an acceleration of the trend (a rise of 1.9% in 1974, 3.5% in 1975 and an expected 4.5% in 1976).

48. The trade deficit, which was about \$600 million with the West in 1974, is on the increase. In 1975, the above figure was exceeded within eight months and for the first time there was a deficit of 200 million roubles in trade with the other COMECON countries. The deterioration in the terms of trade, rather than the increase in the volume of imports, explains this trend (-5% with the COMECON countries, -15% with the West, -11% in all)(1).

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

50. To meet these difficulties, the Hungarian authorities have somewhat 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 was revalued on 1st January, 1976 (40 forints to a dollar, as against 43.5 previously), and this should ease the situation as regards essential imports. On the other hand, new taxes have been placed on non-priority imports and, since it has become more difficult to export to the West, some exports will be redirected eastwards. At the same time, certain enterprises which depend for their livelihood on foreign trade are to receive subsidies.

(ii) Generally speaking, the cost of 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.

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

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On 30th November, 1975 the government announced a series of price increases effective from 1st January, 1976 or to be introduced during the year 1976(1).

- 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 fowls and fish the rise will be less steep.

(iii) To cushion the effect of these increases on the public, measures to improve wages and incomes have been officially announced.

(b) Poland

51. There has been a steady rise in wages and incomes in Poland over the last three years. The level of consumption is already comparatively 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.

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

It is by no means certain that this development can be attributed to inflation; the rise in savings would seem to stem rather from the ambition of more and more families to acquire a home of their own or own a motor car, for example. Since there is no consumer credit they must have prior savings to do this and these are deposited for a while in the savings banks.

52. Little is known of recent price trends or of governmental intentions. However, 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. However, he added that "the necessary measures will be taken only after the workers have been consulted".

In any case, it is now considered impossible to hold down the price of basic commodities to their level of five years ago.

53. Priority will also 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".

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) Rumania

54. 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.

55. 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).

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(d) German Democratic Republic

56. It has been announced that wholesale prices of basic commodities will be adjusted as from 1st January, 1976. Official assurances that these increases will not affect retail prices 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 820 marks gross, 600 net.

The decision taken at the start of the 1971-1975 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.

57. There is a big trade deficit:

- the GDR has accumulated a balance of payments deficit of 10.5 milliard valuta marks with the West since 1970 in spite of the unofficial decision to stop importing Western consumer goods; only Western credits have made it possible for the GDR to carry on trading with the West, but this facility may be ended;
- in 1975, the GDR ceased to have a surplus in its trade with the other COMECON countries.

(e) Czechoslovakia

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".

These statements were intended to scotch persistent rumours of impending increases in consumer prices. According to Western observers they do not exclude the possibility of subsequent increases, probably during the summer of 1976. These observers also point to the growing pressure from subsidies and the external deficit.

(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.

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