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Multilateralism in Trade and Currency Convertibility  
under the Soviet bloc Economic Systems

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## 1. Introduction

During the past two years there has been a renewal of speculation about the possibility of multilateralization of the foreign trade of the Soviet bloc countries and about the convertibility of their currencies. It has been occasioned by the economic reforms introduced, experimented with, or intended by the Soviet bloc countries. The present paper examines the compatibility of the economic system of each country in the Soviet bloc with the conditions necessary for the achievement of multilateralism and currency convertibility.

For purposes of analysis multilateralism in foreign trade is assumed in this paper to exist where there is an absence of bilateral arrangements, i.e., of arrangements according to which each of the two partner countries obligates itself (a) to buy from the other specific goods or any goods up to a defined total value, and (b) to pay for them through the accumulation of claims of the same or different defined total value by means of counter deliveries of specific goods or any goods. Bilateralism is not confined to arrangements under which the mutual deliveries of goods are of equal value. It exists wherever the choice of imports is limited to any extent to one country by an agreement, and, where monetary claims on the partner country arising from exports can be made good at least in part through imports from that partner country.

Convertibility of a currency exists where claims expressed in this currency may be used in payments to any third country, and thus transferred to any third country.

In the context of this paper "economic system" means the economic mechanism or set of rules by which any national economy functions or is operated. It does not have here a socio-economic meaning. The paper does not contrast communist with capitalist systems and does not limit the theoretical possibilities of practical multilateralism and currency convertibility to any specific socio-economic system. That the capitalist system has a monopoly of multilateralism and convertibility, to the exclusion of any other imaginable system, has not been proven, and the present paper does not deal with such issues. It discusses only the ability of specific economic systems (in the narrow sense of the word), in a specific place and time, to develop multilateralism and currency convertibility.

Neither does the present paper consider whether the reforms introduced or planned by the Soviet bloc countries represent a retreat from the socio-economic system of communism and a movement toward the socio-economic system of capitalism. It appears that this issue has engendered some emotionalism, which may have some practical implications. While, on one side of the controversy, such things as "market forces", "profits", and consumer choices are thought to belong only to the realm of capitalism, on the other side, these and similar words like the "price of nature" and "price of capital" seem to be anathema to communism. Such emotional attitudes may act as a brake on a reformist movement.

References in this paper to such issues in the Soviet bloc countries as the deviations of prices from "values", interest on capital, consumer choices and profits do not imply any judgment as to whether they do or do not represent purely capitalist notions, or whether they fit or do not fit communism. Prices in those countries have always deviated from value (as defined by the labor theory of value) and this fact has been officially recognized in them. Moreover, interest on short-term bank loans does exist in the Soviet bloc countries and, therefore, there is no conceptual, theoretical, or dogmatic reason why it should be doctrinally impossible to charge interest on another form of capital, viz., fixed capital. Consumers always have had some choices; the scope for them has been increasing in accordance with the official policies, and there is no reason why it should not increase further, while still falling short of the ownership of capital. The notion of profits was accepted by Lenin himself. In this paper the discussion of such issues and of the reforms in economic systems is neither complete nor detailed. They are considered only to the extent necessary for the main subject--multilateralism and currency convertibility.

Until 1956 the economic systems of the Soviet bloc countries were invariably modeled on that of the U.S.S.R. There existed differences in the application of the Soviet economic system, but these were immaterial for the present discussion. Until 1956 it was safe to assume that observations made in relation to the economic system existing in the Soviet Union would, for all practical purposes, be also valid for other members of the Soviet bloc. It will therefore be sufficient to consider the possibility of multilateralism and currency convertibility under the system prevailing in the U.S.S.R. itself. This discussion is continued in Section 2.

The year 1956 inaugurated an era of criticism of the Soviet economic model, both in the Soviet Union itself and in the other Soviet bloc countries. Certain economic reforms followed in some of these countries. In subsequent sections the developments after 1956 are discussed separately for each country or group of countries, so that account can be taken of dissimilarities in developments in them--dissimilarities which may be important for the main subject of this paper. This does not imply that the pre-1956 Soviet economic model is a thing of the past. On the contrary it will be seen that its features which are most important in relation to multilateralism and currency convertibility still remain in force.

## 2. Pre-1956 economic system of the Soviet bloc countries

### a. Price formation

Under the pre-1956 Soviet economic system there were two main categories of prices: those which were administratively established and from which sellers and buyers could not legally deviate, and those which were the result of bargaining between the buyers and sellers. Prices of

the first category are here called "list prices". Prices of the second category appeared only on "kolkhoz markets", i.e., markets where farmers sold mostly foodstuffs produced on their individual plots, or goods obtained as payments in kind for their work on cooperative farms ("kolkhozes"). Every country of the Soviet bloc (and apparently also China and Albania) has a market corresponding to the kolkhoz markets. The volume of goods sold on these markets in most Soviet bloc countries represents only an insignificant part of the total turnover in consumer goods.<sup>1/</sup> For this reason and also because of government influences prices on these markets in a very strong though indirect way, this category of prices is not here discussed.

In the pre-1956 Soviet system list prices were fixed centrally for all producer goods and for an overwhelming part of consumer goods. The centralization of price fixing did not by itself disqualify prices from performing the economic function of allocation of resources. The socialist system of allocation conceived by Enrico Barone<sup>2/</sup> and the system of price formation presented by Oskar Lange<sup>3/</sup> have never been tested in practice, but for purposes of this paper, they should not and need not be repudiated: they may very well fulfill the function of guidance, even though they provide for administratively set prices. It is here argued that the Soviet price structure was disqualified as a guide for the allocation of resources, not because prices were administratively established, but because of the way in which they were established and maintained.

Under the pre-1956 system prices were stabilized (particularly prices of producers' goods) for a very long time. In the Soviet Union the prices of producers' goods were maintained without much change between 1948 and 1959.<sup>4/</sup> It would be unrealistic to expect that any price structure, even if originally appropriate, could continue for such a long time to express correctly the relative scarcities of goods and to serve as guidance for the allocation of resources.

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1/ In Poland "free market" prices corresponding to the Soviet kolkhoz market prices are much more extensively used. This, however, does not change the over-all picture of the price formation in the Soviet bloc countries.

2/ "The Ministry of Production in the Collective State" by the late Professor Enrico Barone, published in the Collectivist Economic Planning, edited by F.A. Hayek, 1935.

3/ Oskar Lange and Fred M. Taylor, On the Economic Theory of Socialism, The University of Minnesota Press, 1938.

4/ See Morris Bornstein "The Soviet Price Reform Discussion", Quarterly Journal of Economics, Vol. LII, No. 1, March 1962; Vol. LXXVIII, February 1964.

It must be realized, however, that while the rigidity of prices disqualified the actual Soviet price structure, it did not necessarily disqualify the particular Soviet method of administrative price formation. If the stiffness of prices had been the only disqualifying characteristic, the situation could perhaps have been remedied by some organizational and technical improvements (e.g., the use of electronic computers) that would enable the authorities to change prices more frequently to match changing circumstances.

The pre-1956 Soviet method of price formation was disqualified from giving guidance because prices obtained by the particular Soviet method did not provide any even at the moment when they are established. Prices could never be established appropriately by the methods employed in the pre-1956 Soviet system.

The reasons for the main features of the pre-1956 method of price formation in the Soviet bloc countries should be sought in the belief which prevailed in the Soviet Union that only such method conformed to communist doctrine, and specifically to the Marxist labor theory of value, according to which the value of each commodity is equivalent to the socially necessary amount of labor embodied in it.

There was a strong tendency in the Soviet Union to believe that prices somehow should conform to this value. In view of admittedly very significant deviations of actual prices from this value--deviations admitted by Marx himself--the prevalence of this belief is difficult to understand. It might be expected that, once the practical necessity for such deviations had been recognized (and it was recognized in the Soviet bloc countries) the deviations of prices from values would be allowed to arrange themselves in such a way as to equip prices for the function of guidance. Marx did not, nor did Lenin, define or even hint at the organization and economic mechanism of a socialist society, and one might expect that such matters as price formation should be decided pragmatically rather than dogmatically. But, as Professor Oskar Lange has stated, "(Marxism) was preoccupied with ... criticism of capitalism (and) it was poorly qualified to tackle (economic) problems of socialism".<sup>1/</sup>

Under the pre-1956 Soviet method of price formation, there were no prices for the factors of production which may be summarized under the general term "nature". Prices for capital were largely absent. Interest was charged only on short-term banking loans to enterprises. There was apparently a doctrinal objection, difficult to understand even within Marxist economic thinking, to extending interest also to fixed capital. The absence of a price on the use of fixed capital led to an unlimited demand for capital for various capital-intensive projects,

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<sup>1/</sup> Oskar Lange in an interview published in *Zycie Gospodarcze* (Economic Life), under the title "Planning and the Coordination of Economic Research", Warsaw, December 20-27, 1964.

and since the administrators had been deprived of any objective guiding mechanism, less rational investment was undertaken than would have been practicable had appropriate interest rates been established. This became particularly obvious to the Soviet economic authorities when the initial period of building basic investment was over. Investment decisions then began to require much more subtle logical foundations than those used by Soviet planners.

Under the pre-1956 Soviet price system, inequalities in the average cost of production caused by differences in natural conditions, or in the skill of management, were not allowed to become a source of quasi-rent. Economic scarcity was not a working concept in the formation of prices, and in theoretical thinking the concept of marginality was anathema. This concept had no practical significance in actual economic decisions--not even implicitly, as it has in market economies.

It is conceivable that the prices of goods may initially be obtained haphazardly, almost at random, and yet subsequently change under the influence of economic forces, either automatically or through the equivalent process of adjustments in list prices conceived by Lange, so as to represent an approximately consistent system of prices capable of guiding the allocation of resources. In the pre-1956 Soviet economic model, such adjustments were not possible for two doctrinal reasons: first, the absence of a price for the use of nature and capital, and second, the inability of enterprises to choose freely among the available factors of production, and by doing so to influence the aggregate demand for various producers' goods and their relative prices. Managements of enterprises were not empowered to choose among agents of production, apparently for fear that this would lead to uncontrolled "speculation" or profits (in the sense of Western economics) accruing to managers or to small managing groups, or even to all workers in an enterprise. Managers of enterprises performed only technical administrative functions and had almost no power of making economic decisions.

Each enterprise (which might be composed of one or more plants) received from the planning authorities a detailed plan which might be quite different from what the enterprise itself had proposed.<sup>1/</sup> The plan received from the planning authorities prescribed exactly the over-all volume of production, the volume of production of individual goods or categories of goods, the strength of the labor force of the enterprise (even according to categories of labor), wages and the wage bill, the composition of input and output and their prices.

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<sup>1/</sup> Even if an enterprise's own proposal were accepted, the method of the formation of prices, and the performance of enterprises (in executing the plan) as ordered from above would prevent such a plan being rational, in the sense that it would not be at all close to the equilibrium point of the individual firm.

The plan prescribed everything. "A technical project for a steel mill in the Soviet Union comprised 91 volumes, totaling 70,000 pages. On these pages, all technical details were described, including the smallest screw and nail. It had to be so, because the manager of the enterprise was a kind of a messenger boy who was not allowed to take any initiative. He could order the necessary goods only if he was authorized to do so by the Plan, at prices established by the Plan, and most of the time from sources prescribed by the Plan".<sup>1/</sup>

In the context of this paper the fact that such planning was cumbersome and that it involved high social cost, is of lesser importance than the effects of two inseparable aspects of the system on the prices of producers' goods: first, they did not reflect the relative scarcities of goods and did not perform the function of guidance; and, second, the mechanism of price setting did not provide for corrective forces that would lead to adjustments in prices.

Wages and salaries are paid in the Soviet bloc countries predominantly in terms of money and consumers have freedom of choice among the goods available to them. However, the adaptation of the supply of consumer goods to the tastes of consumers--tastes which could not be suppressed in the money economy--was achieved under the pre-1956 system not so much by regulating the volume of production of various consumer goods as by means of varying rates of "turnover" tax (a form of sales tax), which tended to bring the volume of demand for each consumer good into conformity with production.

Subsidies and price fixing in market economies may distort the economic magnitudes that would otherwise emerge from the purely free market forces, but they do not eliminate these market forces. On the contrary they would not be able to exist without the existence of such forces. Under the pre-1956 Soviet system, the market or equivalent forces were absent, for all practical purposes. Regulations related to prices and allocations introduced entirely new economic magnitudes independent of any market forces and in complete disregard of them. These regulations could not use and distort market forces as in the case of price subsidies and price fixing in market economies, because such forces were not allowed to emerge.

The above characterization of the pre-1956 economic system of the Soviet bloc is not an invention of a Western economist. Professor Oskar Lange said: "... the need for rapid industrialization imposes the necessity of high centralization of planning and management. Thus, the first period of planning and management in a socialist economy ... has always been characterized by administrative management and administrative allocation of resources on the basis of priorities centrally

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<sup>1/</sup> Quoted from "What Next in Soviet Planning?" by Leon Smolinski, Foreign Affairs, July 1964.



established. Economic incentives are in this period replaced by moral and political appeals to the workers ... I think that essentially it can be described as a war economy sui generis."<sup>1/</sup> The Polish Deputy Premier, Piotr Jaroszewicz, characterized the Soviet economic system in Poland as follows: "Our economic system is an abracadabra of prices, costs and wages. Nobody is able to discern what is and what is not profitable".<sup>2/</sup>

b. Foreign trade organization<sup>3/</sup>

Under the pre-1956 economic system, the foreign trade operations of the Soviet bloc countries were conducted by specialized foreign trade state organizations. They usually specialized in trading in a limited assortment of goods. In most cases there were separate exporting and importing foreign trade organizations.

Each foreign trade organization received a plan of the volume and types of exports and imports. This plan was coordinated, within the over-all national plan, with the production and investment plans of producing enterprises, and with the plan for consumer goods. Consonant with their plans, the individual foreign trade organizations entered into agreements with the domestic suppliers of exportable goods, with domestic investors, and with the domestic trading organizations.

Domestic producers, investors, and inland trade enterprises did not have any direct contact with foreign markets, with foreign exporters, or with importers. A lack of direct contact between the producers of one country and buyers of another country is not unusual; it must be considered normal for small producers, and particularly for producers of consumer goods and the individual users of such goods. Only large producers (or buyers) can afford to have direct contacts with foreign buyers (or producers). Nevertheless, in the market economies the preferences of buyers do penetrate even to small producers; they are transmitted by trading, exporting and importing enterprises. In the pre-1956 Soviet system, however, the foreign trade organizations represented a real barrier between the domestic producers, investors and consumers and the respective foreign suppliers and buyers. The responsibility for the "barrier" lay with the planning and price formation methods, fortified by the organization of foreign trade and by the foreign exchange system.

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<sup>1/</sup> Oskar Lange, The Political Economy of Socialism, Polish Institute of International Affairs, Warsaw, 1957, pp. 15-16.

<sup>2/</sup> Trybuna Ludu (Polish daily), November 18, 1956.

<sup>3/</sup> For detailed description and analysis of the Soviet bloc foreign trade system, see The Communist Foreign Trade System by Frederic L. Pryor, particularly Chapter II, The M.I.T. Press, 1963.

The foreign trade organizations could not respond to the comparative advantages of foreign trade.<sup>1/ 2/</sup> First of all, the domestic producing enterprises could not maximize profits by shifting sales toward the exporting organizations. They sold at list prices (in terms of domestic currency) to any approved buyer. There was no economic incentive for any enterprise to produce for foreign markets in preference to domestic markets or vice versa. Producers sold to the foreign trade (exporting) organizations at domestic list prices, which applied also to domestic sales, and received payment in domestic currency, which was not in any way related to foreign price quotations.

For the foreign trade organizations to secure the "comparative advantages" of foreign trade, the purchases of domestically produced goods for export, and the importation of foreign goods for resale on the home market, would have had to be governed by the relative scarcities of goods on the domestic market and abroad. In market economies, relative scarcities broadly speaking tend to be expressed by prices. However, prices in the pre-1956 Soviet bloc system did not reflect relative scarcities. Under this system the purchase for export of domestic market goods which were comparatively the least expensive and which would secure highest prices abroad (at given exchange rates) would have tended, true enough, to maximize the profits of the trade organizations. But at the same time, such purchases could disrupt domestic planning, and perhaps lead to the exportation of goods which were domestically scarcer (as determined by the plan) than other goods, or than of some imported goods. This might occur because goods which were relatively scarce did not necessarily command relatively higher prices. Similarly, there might be imports of producer goods which were relatively less scarce than other producer goods, even though the latter were priced (on the domestic market) lower than the former. Only if unrationed consumer goods were imported could domestic prices be expected, by and large, to correspond to relative scarcities.

The Polish economist, M. Orlowski, characterizes the Soviet bloc foreign trade system as follows: "The government enterprise participating in foreign transactions does not have a direct enough interest (the incentive created by the bonus system for employees of these enterprises usually has very little effect), nor does it influence the calculation of production costs, or determine the choice of contractor, or the selling or buying price abroad."<sup>3/</sup>

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<sup>1/</sup> The following reasoning assumes, for the sake of convenience, the existence of an explicit exchange rate (or of explicit fixed multiple rates).

<sup>2/</sup> See Industrial Progress in Poland, Czechoslovakia, and East Germany, 1937-1962, by Alfred Zauberman, p. 328; Oxford University Press, 1964.

<sup>3/</sup> M. Orlowski, "The Problem of Exchange Rates in the Socialist Economy" (in German), Zeitschrift für die Gesamte Staatswissenschaft 116, Bund/1, Heft, 1960.

c. Foreign exchange system

The foregoing discussion of the pre-1956 foreign trade system of the Soviet bloc countries assumed the existence of an exchange rate or of exchange rates, and the use of such rates in foreign trade transactions in the way they are used in market economies--as a price of foreign exchange, i.e., as one of the economic magnitudes guiding economic decisions. In fact under the pre-1956 Soviet system, the exchange rate or rates did not guide foreign trade merchandise transactions for one reason at least: the exchange rates were not prices.

At first glance this assertion may appear strange. After all, a resident of a Soviet bloc country, once permitted to travel abroad, did buy foreign exchange at his bank and pay for it an amount of domestic currency at an official exchange rate, i.e., price. And he also sold foreign exchange to his bank at a certain price. If he was a tourist, his decision to spend his vacation in a foreign country might depend on the exchange rate. So the exchange rate was a price and an active element of his economic decisions. Also, exchange rates for various currencies were quoted by central banks of the Soviet bloc countries. In order to clear up the matter, the following discussion deals separately with exchange rates appearing in certain international service transactions (export and import of services) and with exchange rates related to foreign trade merchandise transactions.

In service transactions like tourism, where in order to purchase services it is necessary to transfer from one currency to another, exchange rates were involved and they were prices of Soviet bloc currencies. This was where the exchange rates were "relevant".<sup>1/</sup>

In foreign trade merchandise transactions, exchange rates of the Soviet bloc currencies were not prices, they did not enter any calculations, nor perform the function of guidance. Such a state of affairs was not a result of an independently conceived foreign exchange system, causally unrelated to other elements of the system, but was, as will be seen, an integral part of this economic system, a logical consequence of the planning and pricing methods.

As mentioned above, the foreign trade organizations bought goods destined for export from domestic producers at domestic list prices, and paid for these goods in domestic currency. Foreign exchange rates did not enter at all into these transactions. There is nothing unusual about this--it happens in other types of economies too. The situation starts to seem unusual as soon as it is realized that the foreign trade

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<sup>1/</sup> See M.R. Wyczalkowski, "The Soviet Price System and the Ruble Exchange Rate", Staff Papers, September 1950.

organizations sold goods thus obtained at prices (expressed in terms of the currency of the foreign trade partner, of a third currency, or of a "clearing currency") which had no causal or uniform relationship to the domestic list prices paid in the domestic currency to domestic producers. To enter into such export transactions, the foreign trade organizations did not need even to be aware of any specific relationship of this kind. Such a state of affairs was a direct consequence of the Soviet planning and pricing methods.

If the foreign trade organizations had offered to foreign importers goods at foreign prices which reflected the domestic list prices of the goods and a uniform exchange rate, foreign importers would probably have wished to buy some only of the whole assortment of goods offered them. They would have bought those for which the prices were low, but would have refrained from buying other goods because their prices would be too high. This would have disrupted the Soviet export plan and made the whole planning of the country subject to price fluctuations on world markets. Even if this result had been acceptable, there would not have been enough responsiveness (in terms of time and the allocation of resources) to such price fluctuations in the Soviet Planning practice. In the pre-1956 system a uniform foreign exchange rate would have allowed the exportation of the whole assortment of goods prescribed by the plan only if the rate were low enough to make the price of the most expensive (marginal) commodity still attractive to foreign importers. Such a procedure, resulting in a reduction, probably very severe, in the foreign exchange proceeds from exports, would have made sense only if the producers of exported goods could have been affected by such a uniform rate, and could have made changes in their inputs and outputs that would have led to changes in the assortment of goods produced in favor of the most profitable ones. This, however, would have implied that the domestic producers were not paid (by the foreign trade organizations) the list prices, but prices which were the outcome of foreign prices and of a uniform exchange rate. This in turn would have made sense only if the chain reaction started by domestic producers, striving to adjust themselves to the demand conditions abroad, had continued throughout the whole economy influencing and accepting influences from the prices of other goods, wages, etc. This was not possible: a uniform exchange rate which would have assured the movement of all (or nearly all) planned exports would only have led to a reduction in the total export proceeds in terms of foreign exchange. Or, to put it in other words, there would have been no point in introducing a uniform exchange rate for merchandise export transactions unless planning and pricing methods had been adjusted so as to make prices in the whole economy reflect the relative scarcities of goods. Otherwise, with the planning and pricing methods remaining unchanged, a uniform exchange rate would have brought only losses and no advantages.

The above conclusions were derived from an analysis of exports. An analysis of imports of the Soviet bloc countries leads to identical conclusions.

In actual practice no uniform exchange rate was applied to foreign trade merchandise transactions in the pre-1956 system. Foreign trade organizations sold to foreign importers at prices quoted on foreign markets, or at "negotiated" prices based on foreign quotations. No exchange rate entered into such transactions. Exchange rates could be obtained from a comparison of the domestic price paid for the item and the foreign price received for it, but they would be different for almost every exported commodity; in fact, any identity between two or more rates for two or more goods would be only coincidental. Moreover, the exchange rates thus derived did not represent any active economic magnitudes in the sense that they influenced economic decisions; they were simply passive results of arithmetical calculations without any characteristics of a price. They were implicit and multiple, as a logical consequence and an integral part of the pre-1956 system.

d. Bilateralism

In this system foreign trade, both intra-bloc and with the outside world, was governed by the principles of bilateralism. It may not appear so at first glance: the U.S.S.R. and other Soviet bloc countries had trade agreements with the United Kingdom and other Western countries under which there were no strictly agreed lists of goods to be exchanged, and no bilateral clearing accounts. It may appear that, since it takes two countries to arrange a bilateral trade and payments agreement, bilateralism in payments was not an inherent feature of the system. A more thorough analysis, however, leads to a conclusion that though the non-Soviet bloc countries were able to conduct foreign trade with the non-bloc countries on a formally non-bilateral basis, they were not able to rid themselves of those aspects of bilateralism which represented an antithesis of multilateralism of trade and of convertibility of currencies. Most Soviet imports under the pre-1956 system were producer goods, needed to support detailed investment and production plans--plans which were not expectations or expressions of desirability, but commands. Such imports had to be secured or else the plans would not have been fulfilled. Goods for export had also to be secured, to pay for imports, and the plan had accordingly to obligate both the producers of such goods and the foreign trade organizations. This could only be done by constructing plans--commands, including export and import plans, i.e., lists of goods to be exported and imported.

In trade with non-bloc countries, particularly those with convertible currencies, these lists bound only the Soviet bloc country. Collectively, the non-bloc countries with essentially unrestricted foreign trade and with convertible currencies represented a practically unlimited market for Soviet foreign trade. Any Soviet country could obtain on this market the goods it needed and could sell any goods for which there was a demand, without entering into trade agreements predetermining the composition of goods to be exchanged. The situation was quite different in intra-bloc trade, where the need to fix lists of exports and imports existed, on both sides.

Another feature of bilateralism is the lack of convertibility of payments balances. Economic literature on bilateral payments agreements deals predominantly with bilateralism in non-Soviet bloc countries, where it is usually considered as something temporary, or at least not inherent in the economic system. It is considered that only an adverse balance of payments situation or some special market considerations can justify bilateralism, and neither of these reasons can be considered as something of a permanent nature, even if they are expected to exist for many years. A second argument for bilateralism--price distortions (without which it may be difficult to find a sufficient balance of payments justification for bilateralism)--is now disappearing from market economies. But this was exactly the strongest reason for bilateral payments agreements of the pre-1956 Soviet system and the main reason why they could not be considered temporary. To have a convertible currency, one must first have assured convertibility of goods, i.e., convertibility of currency (foreign exchange) into any commodity.<sup>1/</sup> Such convertibility did not exist under the pre-1956 Soviet bloc economic system, and it could not exist so long as the planning and pricing methods described in the preceding sections were in existence.

A resident of a non-Soviet bloc country could not buy export goods of his choice in a Soviet bloc country and pay for them with the same country's currency (assuming that he was allowed to obtain it) or with any other currency. His inability to do so was caused, not merely by the existence of state foreign trade monopolies, but by the fact that his action could easily have been contrary to the interests of the Soviet bloc country: he would naturally have chosen the least expensive goods (compared with price quotations in other countries including his own) and in doing so, he might easily have chosen goods which were relatively scarce (from the point of view of planned investment and production) in the Soviet bloc country.

It may be noted that the Soviet bloc currencies differed from the currencies of the non-bloc countries not only in their international relationships, but also in their domestic functions. In the Soviet bloc countries, money represented a general claim on the available goods only in respect of consumer goods, and even then only insofar as they were purchased directly by the consumers.<sup>2/</sup> In all other respects, money was not quite a universal claim: to obtain a commodity, one

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<sup>1/</sup> The conditions for convertibility of the Soviet ruble and the role of convertibility into goods were discussed in "The Soviet Price System and the Ruble Exchange Rate" by M.R. Wyczalkowski, Staff Papers, September 1950, pp. 217-219. See also "Russian Gold and the Ruble" by Oscar L. Altman, Staff Papers, April 1960, pp. 430-435.

<sup>2/</sup> Ruble banknotes obtained on black markets outside the U.S.S.R. might be used by tourists visiting the U.S.S.R. for direct purchases of consumer goods, but not for any other purchases.

needed not only money but also an allocation decision of the planning authorities. Thus, for producers, money to some extent resembled a theater ticket or a ration card--it was valid only for a specific service or commodity.

It is sometimes suggested that although the method of price formation described above might have alienated the Soviet system economically from the western markets, its uniqueness made consistent the price structure of the member countries within the Soviet bloc--at least in the sense that multilateralization of payments, and something like the convertibility of the ruble, were feasible within the bloc. Such developments would have become possible, however, only if price patterns could have emerged in the Soviet bloc countries that would simultaneously have corresponded to the relative scarcities of goods in each country. However, under the pre-1956 system, all Soviet bloc countries strove to introduce the same (Soviet) method of pricing and as long as this approach prevailed not only did prices in each country diverge from relative scarcities, but the divergence was different in each Soviet bloc country and no bloc price pattern could emerge.<sup>1/</sup>

Domestic price labels attached to commodities in each of the Soviet bloc countries could not be used as guides for intra-bloc foreign trade transactions even in the absence of foreign trade monopolies, for the same reason that they could not be used in any Soviet bloc country by an outsider who had accumulated either a bloc currency or a convertible currency. In intra-bloc trade these reasons applied on both sides. In economic relations with the outside world, any Soviet bloc country could benefit from the existence of non-bloc convertible currencies. In intra-bloc trade, this was not possible and could not be achieved by imputing a gold content to any or to all Soviet bloc currencies, or by minting gold coins.<sup>2/</sup>

The Soviet bloc countries' inability to use their own prices in intra-bloc trade is evidenced by the fact that all Soviet bloc countries used world market prices for the valuation of exports and imports in intra-bloc trade. This method led to bilateral balancing of exports and imports at values, which (except by accident) were completely alien to the price patterns in each bloc country. Under the pre-1956 system there was no set of prices that would ensure a "true" valuation.

It may be concluded that the pre-1956 Soviet bloc system of pricing and planning did not allow multilateralization of trade of the bloc with the outside world or of intra-bloc trade, and that it excluded convertibility of any bloc currency in terms of non-bloc currencies or within the bloc itself.

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<sup>1/</sup> "The Soviet Price System and the Ruble Exchange Rate", l.c., p.221.

<sup>2/</sup> See the discussion of this subject by Oscar L. Altman, l.c., pp.427-429.

### 3. Economic discussions and reforms since 1956

#### a. Reasons and motives of reformist trends

The pre-1956 planning and price formation system was not left without criticism even before the post-1956 thaw. The Soviet newspapers, and newspapers of other Soviet bloc countries, were full of such criticism, voiced most of the time in good faith and with a sincere belief that "mistakes" were of the nature that could be alleviated by an improvement in administration, and without any need for a change in the basic system of planning and price formation.

The post-1956 liberalization released intellectual inquiry which led to more profound criticism and to reform proposals. There is perhaps more reason for intellectual inquiry into economic problems being awakened by practical necessities under the Soviet bloc economic system than in countries with market economies. "The social necessity for ... an allocation (of resources) among the competing ends is not self-evident to the individuals in western society where the allocation results from the impersonal operation of the price system. In the Soviet economy ... the allocation ... (of) resources among alternative uses is a highly visible and operational process, which calls out for some sort of theoretical conceptions...."<sup>1/</sup>

In some Soviet bloc countries there was a tradition of economics; in others, economic analysis was a natural outcome of the practical complexities of industrialized countries. In the Soviet Union itself "economist" meant rather an office grade than a profession. But at the same time, the ranks of intellectuals swelled and there was a stress on mathematics and strict sciences where thinking was not influenced (except in biology) by dogma. It is in those ranks that the liberalization and practical necessities of economic life found a response in the form of ingenious, inventive and original economic thinking and economic reformism.

The development of the Soviet economy, the end of "war conditions" where investment decisions were relatively simple and where the number of goods, both producer and consumer, was rather limited, and an improvement in the standard of living, brought to the fore a realization of the immense interdependence of magnitudes and decisions, and of the inadequacy of the existing planning and management of the national economy, of industries and of individual enterprises. It was estimated in the U.S.S.R. that to accommodate the needs of the expanding economy, the number of people engaged in planning would have to increase between 1962 and 1980 thirty six fold.<sup>2/</sup>

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<sup>1/</sup> Robert W. Campbell, "Marx, Kantorovich and Novozhilov: Stoimost' versus Reality", Slavic Review, Vol. XX, No. 3, October 1961, p. 405.

<sup>2/</sup> Pravda, November 20, 1962.



One of the reasons why the faults of planning, pricing and management have become painfully apparent was, perhaps paradoxically, an improvement in the organization of money and banking. Before, during and for some time after the war, the economies of the Soviet bloc countries were permeated with inflation, which from time to time was cancelled by drastic monetary reforms. The current money incomes of the population were notoriously larger than the stream of goods at list prices. This led to black markets, not only for consumer goods but also for producer goods, and to official double price levels for the same consumer goods. It led to queues in front of stores--comprised of people who wanted to buy the most desired goods at list prices--and to spending the remaining money on almost anything that was available. Under such conditions, the structure of the supply of consumer goods did not have to correspond to consumers' tastes, at least not to any significant extent. When inflationary tendencies were largely arrested, the lack of adaptation of the output of consumer goods to the tastes of the population became painfully apparent. At the same time the savings habits of the population developed, supported by a more stable value of money, and inventories of unsalable consumer goods increased. The daily press of the Soviet bloc countries is full of examples of such maladjustments.

Finally, economic reforms in Yugoslavia gave a tremendous impetus to economic discussions and to the reformist movement in the Soviet bloc countries.

Economic discussions, criticism of the existing method of management of the socialist economy, and proposals for reforms have been, within bounds, encouraged in some Soviet bloc countries by the governments and the communist parties, and they have been widely publicized. Economic writing has developed, particularly in Poland, the Soviet Union, East Germany, and lately also in Czechoslovakia. There has been "experimentation" in economic systems in all Soviet bloc countries, and economic reforms in some. The meaning of these experiments and reforms is discussed in the following sections, always bearing in mind the question whether the reforms, or reforms assumed in principle, permit the fulfillment of conditions for the introduction of trade multilateralization and currency convertibility.

b. Reformist movement in the Soviet Union

In the Soviet Union the discussions of the theoretical foundations of economic reforms are centered in a few universities. The participants are mostly of academic standing, although high government officials participate in some exchanges of views. There has been almost no participation by practical economists, and their relationship to the academic discussions seems to have been about the same as the relationship of medical practitioners to biologists. However, the discussions have been given very wide publicity, not only in university textbooks, but also in professional journals and in newspapers--an obvious sign of the official approval and encouragement of discussions.

The participants in the discussions have had access to libraries where western economic writings could be found. This opportunity makes the fact that almost all Soviet reformist writings bear a distinct mark of originality of special significance; it inspires admiration for the intellectual prowess of Soviet economists. They did not seek guidance from Wicksell or from Barone, not even from Lange. Perhaps the fear of infection or alleged infection by the alien forms of thought held them in check. It appears, however, that the most important reason for the independent thinking of Soviet economists lies in the entirely different practical economic environment in which they live--conditions which gave rise to different intellectual models than those of their western colleagues. In market economies the economist discovers the scientific laws which express actual conditions; in the Soviet-type economy, the economist creates the laws in spite of, or contrary to, actual conditions, and proposes to adapt reality to the laws thus created. The path of thinking is entirely different. In addition, perhaps the most important contribution to Soviet economic thought was made by a mathematician, who became deeply interested in economics only after he had solved one of its basic problems. Subsequently, Soviet mathematicians and economists proficient in mathematics have rediscovered almost the whole structure of western economic theory.

Before the beginning of World War II, a factory producing plywood turned to the Institute of Mathematics and Mechanics of the Leningrad State University for help in resolving a practical difficulty. The factory was turning logs into plywood, using different types of machines which had different technical productivities. The question was how to assign different kinds of logs to different machines in order to maximize output. The Institute of Mathematics and Mechanics assigned the task to a professor of mathematics, Leonid V. Kantorovich. Kantorovich, who found the problem fascinating, soon realized that an objective solution could not be found without some assumption as to the prices of logs and products. He made his answer dependent on the existence of objectively given "multipliers" which were equivalent to prices.<sup>1/</sup>

Kantorovich's contribution to economic science in the Soviet Union, or strictly speaking, to the theory of production, was overlooked at the time it was made,<sup>2/</sup> but was rediscovered later, and Kantorovich was recognized as the original inventor of linear programming. The Academy of Sciences of the U.S.S.R. published in 1959 a book by Kantorovich on the economic calculation of the optimum utilization of resources.<sup>3/</sup> In this book, Kantorovich has, in effect, recognized the significance of his multipliers as prices. He has integrated the theory of value and the theory of allocation.<sup>4/</sup> He called the multipliers (prices) "objectively determined valuation", i.e., valuations determined as a result of the interplay of demand and supply.

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<sup>1/</sup> Robert W. Campbell, l.c., pp. 406-407.

<sup>2/</sup> Robert W. Campbell, l.c., p. 407.

<sup>3/</sup> Translated into English by P.F. Knightfield under the title The Best Use of Economic Resources, 1965, Pergamos Press.

<sup>4/</sup> Robert W. Campbell, l.c., pp. 408-409.

Kantorovich's discoveries have been fortified by Professor Victor Novozhilov, who in effect rediscovered the western concept of opportunity costs.<sup>1/</sup> Kantorovich's and Novozhilov's writings and discussions undermined the existing pricing method, and pointed out that scarcity and the need for "valuation" applies not only to labor but also to capital and "nature". "... Novozhilov vanquishes a good share of the problems that confuse the Soviet planner and economist. ... he parts those Gordian knots that Soviet economic theorists have worried fruitlessly ... How can the ... performance of enterprises in unlike circumstances be compared? ... Price goods not at (value) but at their opportunity cost!"<sup>2/</sup>

The next step was to think up the process, the mechanism, by which such appropriate, objectively established prices could be obtained. The most widely discussed but not the most revolutionary and controversial proposal, made as early as in July 1956 by E. Liberman, Professor at the Kharkov Engineering and Economics Institute, and in March 1957 by I.S. Malyshev, was to allow Soviet enterprises to strive to maximize their profits. The profit issue became known after an article of Liberman in Pravda, published on September 9, 1962, in which the author proposed that enterprises should not be directed by numerous indicators imposed on them by planner, but should be motivated to a large extent by the incentive of profits.<sup>3/</sup>

The article provoked vigorous discussions and voluminous writings. The proposal represents a compromise between the centralized system of allocation, with its detailed administrative management of the economy, and the freedom of individual enterprises to make their own decisions. Central planning authorities would continue to decide what should be the volume of production of each enterprise, and what broad assortment of goods it should produce. They would also continue to fix prices. The rest--the volume of capital and labor to be used, wages (partly paid in the form of participations in the enterprise's profits) and the detailed composition of output would be left to the free decision of enterprises which, Liberman asserted, know better what exactly should be produced and how. For this purpose enterprises would enter into more direct contact with buyers of the goods that they produce. Liberman did not dwell on speculations on the reform of the price formation. His proposal that prices would still be fixed centrally while deliveries of goods would be based on commercial considerations suggests that he might have had in mind list prices which would be changed according to demand and supply conditions, along the lines proposed by Professor Oskar Lange. Perhaps his pragmatic and realistic approach to the palatability of economic reforms in the Soviet Union made him leave the issue of prices to future consideration and development. He seems to have been conceptually, or

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<sup>1/</sup> See Novozhilov's article in The Use of Mathematics in Economics, English edition, edited by A. Nove, Oliver and Boyd, 1964.

<sup>2/</sup> Robert W. Campbell, l.c., p. 412.

<sup>3/</sup> For more detailed discussion, see "The Liberman Proposals" by Alec Nove, in Asian Survey, April 1963.

as a result of considerations of political realism, satisfied with a reform that would ensure an improvement in the quality and, in a strict sense, also in the composition of output of consumer goods on the basis of planned inputs and predetermined prices of both input and output.

Professor Nemchinov went further than Liberman and proposed that there be no planning of production or allocation of intermediate products, and that central planning of production should be limited to the broad lines of final products.<sup>1/</sup> Intermediate products, instead of being allocated in an administrative way, would be procured by enterprises through commercial contracts at centrally fixed prices. Thus, a market in such products would emerge. Such an arrangement would reduce the powers of central planning authorities to determining the general volume of investment and major investment projects, relative rates of growth of various sectors of the economy, the general pattern of production in the country, and price fixing.<sup>1/</sup>

In order to assure that individual enterprises act in a most rational way, Liberman proposed a revolutionary innovation in the State economy--an introduction of the profit motive. He proposed a "profitability rate" as the main indicator of the performance of enterprise. He defined this rate as the relationship, expressed as a percentage, between the amount of profit attained in a year and the value of the enterprise's fixed and working capital. On the profitability rate would depend the amount of funds retained by the enterprise for various purposes including the amounts for distribution as bonuses among the workers. The profitability rate would increase with a reduction of the volume of capital used and with a reduction of costs or an increase in revenues, and each of these actions would benefit not only the enterprise but the whole national economy. A slogan emerged: "What is good for the Soviet enterprises, is good for the Soviet Union".

During the ensuing discussion of Liberman's proposals, weaknesses were found in his reasoning and further progress was made in Soviet economic theory. Views were voiced that rational prices could not evolve from the competition of enterprises for intermediate products unless a "charge" on the use of capital was introduced. The concept of "charge" was identical with that of interest. Difficulties were seen in reconciling Liberman's and Nemchinov's concept of "commercial relations" between the enterprises with the fixing by the central planning authorities of list prices of all goods and of quantities of "final products" to be produced. These led to much bolder proposals than those of Liberman.

A Soviet economist, Birman, "... proposes to do away with all physical output targets except for two or three dozen key products such as steel, oil and electric power. For all the other millions of products,

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<sup>1/</sup> See Alex Nove, l.c., pp. 114-115.

the enterprise itself would decide what to produce, so as to maximize its profits on the basis of orders received from wholesale trade and from industrial consumers ... The enterprises' compliance with the planners' broad goals would be assured primarily by indirect regulation through prices, incentives, credit and financial policies, rather than direct controls."<sup>1</sup>/ What Birman, in effect, proposed was almost to copy the Yugoslav economic system.

When the Yugoslavs embarked early in the 1950's on reforming the (Soviet) economic system, they had an advantage of being able to reject it as a foreign invention. In addition this system had functioned in Yugoslavia for only a few years. In the Soviet Union the system is an invention of their own, and has been in operation for decades. Already a second generation of bureaucracy has been indoctrinated with it. If a new system of planning and management is to be introduced, it must be introduced by bureaucracy; and bureaucracy will grasp and accept only practical, tangible things, not theories--particularly theories which, being new and difficult to comprehend, are feared to be heretical.

While comprehensive theoretical models of the type of Kantorovich, Novozhilov and Nemchinov have not been widely accepted, the deficiencies of the present system are almost universally recognized. Deficiencies are practical, tangible and seemingly manageable. The theories are not only hard to comprehend and often heretical, but also, it has to be admitted, not so elaborated as to be ready to be put into operation. In these circumstances the only practical way of removing at least some deficiencies in the existing economic system is to deal with specific practical problems. One such problem is the divergence between the plans for the production of consumer goods and consumer preferences; another is inefficiency in Soviet enterprises. For years there have been thousands of examples of such divergencies widely publicized in the Soviet newspapers. One of the recent ones concerned sewing machines. These used to be scarce and several factories were built to provide them. Production increased, the market became saturated, and annual production surpassed annual demand. Still factories continued to produce undiminished quantities of sewing machines. Inventories of sewing machines increased and continued to increase, and still nothing was done about it.

In such circumstances in the past, managers of factories were blamed, the distribution network denounced, and the inefficiency of local party leaders exposed. Now the fault has been found with one facet of the system: once factories get their production plan, they can produce goods happily without regard to the utility of their output. They sell the produce to the trade network according to plan, and the administrative setup is such that the trade network cannot reject goods it receives, nor can it withhold payment for them. If the goods are not sold, inventories

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<sup>1</sup>/ Leon Smolinski, "What Next in Soviet Planning?", Foreign Affairs, July 1964, p. 610.

within the trade network increase, and the volume of (formally short-term) credit granted to finance inventories increases.

All these practical difficulties have become increasingly intensive in spite of patch up work aimed at improving the efficiency of the traditional system of economic planning and of management of enterprises. Thus, the political and economic leadership of the Soviet Union found itself facing, on the one side, growing practical difficulties which demanded urgent solution and, on the other side, a body of theoretical reformist thinking, the acceptance of which, in the view of many, could undermine the basic dogmas of Marxism and bring about an upheaval in the national economy.

Under such conditions, the only reform proposal which could be accepted was that presented by Liberman. It was oriented at tackling in a practical way the most immediate economic faults: the inability of the present administrative management of economic enterprises to adapt production to the preferences of consumers and to assure a higher rate of increase in production of such goods. It did not propose to dethrone central planning or to deprive it of its main tasks, allocation and price fixing; it did not propose to introduce interest on fixed capital or to reject the labor theory of value; it was on a low level of abstraction and easy to comprehend.

Liberman's proposals to give enterprises more freedom of decision and to allow them to enter into a more direct contact with the consumer were accepted as suitable for experimentation. The aim was to find ways of removing the divergence between the production of consumer goods and consumer preferences, and improving the productivity of labor in enterprises producing consumer goods.

In the middle of 1964 a few enterprises producing consumer goods were allowed to experiment with Liberman's ideas. They were allowed to produce an assortment of goods for which they found a real demand (on the basis of direct contacts with their commercial outlets). But the experimental enterprises could not influence the kinds of producer goods that they received from other enterprises. If they had been allowed to do so, a substantial part of the national economy would have been strongly and, temporarily, adversely affected; some goods (semi-manufactures from the point of view of the "reformed" enterprises) which have been produced according to plan would have been rejected. The economy would have been disrupted. It was not without reason, therefore, that the enterprises selected for the experiment were some producing such consumer goods as garments and shoes--industries which, from the same type of fabric or leather can produce a great variety of finished goods.

The experimental enterprises are allowed to retain a certain part of their profits to pay bonuses to the workers, but consonant with Liberman's proposals, they cannot freely (by negotiations with the trade network) establish prices for their produce. Such an experiment may

lead to an immensely better adaption of production to consumer choices than was ever achieved by the traditional system, and perhaps contribute to an increase in the rate of economic growth. But as long as the experimental enterprises cannot influence the structure of their input, and as long as bargaining within the "commercial contacts" is not allowed to determine prices, but only the assortment of goods produced (by the experimental enterprises) at list prices, the experiment cannot directly create forces leading to a rational price formation on a national scale.

Experimental enterprises are operating in the midst of traditionally managed enterprises and within the established bureaucracy which, quite naturally, does not like losing its powers. The experiments are not looked upon favorably by all. A high official of the garment industry, Mme. Kuznetsova, wrote in Pravda that the experimental enterprises were limited in their ability to satisfy their customers because the factories did not have suitable material (since they themselves had to buy what was offered them by other producers). She stated also that the experimental factories had lower profits than planned, partly because a pair of trousers required four inches more material than under the old type of management, because the demand for larger sizes had to be taken into account. This, according to Mme. Kuznetsova, was strongly criticized by the Ministry of Finance, which reportedly insisted that the experimentation in this system of management should be abandoned.

Apparently, however, the need for a solution of the problem of misadjustment of production of consumer goods to consumer preferences--and perhaps more importantly the need for a more rational allocation system in general--are considered particularly pressing by the Soviet Union authorities, and the results of experimentation are regarded as encouraging. At any rate, after considerable preparations and studies, it has been decided to extend the experiment to 400 factories widely spread over the U.S.S.R. and representing 25 per cent of the total production of garments, 18 per cent of textiles, 28 per cent of shoes, and 30 per cent of leather. This decision was announced early in January 1965, and the transition of selected enterprises to Liberman principles of management is to take place gradually during most of this year.

The decision means more than just a confirmation of the success of the pilot experimental enterprises and an increase in the number of experimental enterprises. First of all, the selected enterprises do not belong only to the last stage of production. Shoe and garment factories produce ready-made consumer goods, but leather and textile factories produce intermediate goods used by the shoe and garment factories. In the pilot experimental enterprises, general categories of shoes and garments were produced in quantities and at prices centrally regulated and from materials centrally allocated--but the kind of shoes and garments was decided by the pilot factories on the basis of "commercial contacts" with the distribution network, which was at least informed about consumer tastes. Under the extended program, the output of some intermediate products is influenced by the "commercial contact", i.e., in effect by consumer choices. The experimental enterprises are allowed to determine

their wage bills and to pay bonuses from profits of up to 40 to 50 per cent of basic wages..

When Premier Kosygin delivered his speech in December 1964, in which he criticized the abstract theories of "mentors", he also announced that reforms along the line of Liberman ideas would be extended. He said: "... we will proceed along the way of planning on the basis of customers' orders, not only in the industry manufacturing consumer goods, but also in other branches of the economy". Accordingly, a few enterprises in the "heavy industry" and a coal mine have adopted principles of "planning and management" similar to those adopted by the selected enterprises in light industry. More recently, the Soviet authorities have announced that the principle of direct contact between the producers and users of goods would be extended to the machine-producing industry.<sup>1/</sup>

Without a market (or an appropriate substitute for it) for all goods in all stages of production, and without interest on capital, no rational price and allocation system can emerge in the Soviet Union and, in the absence of such a system, the multilateralization of foreign trade and convertibility of the ruble cannot be attained. The present reforms do create some pressures on the central planning authorities to adjust prices to changes in demand. However, the introduction of profits as a source of remuneration of workers may strengthen the tendency to employ too much capital relatively to other agents of production--a tendency which exists as a result of the absence of interest on fixed capital. Corrective action, in the form of price adjustments and of the introduction of interest on fixed capital, cannot come as an automatic or natural response to a force within a cybernetic system; it must come in a form of a conscious decision, and as such cannot be predicted.

#### c. Economic reforms in Poland

Poland's strength from the point of view of economic reformism lies in the fact that it has quite a few excellent economists, some of world reputation. There seems also to have been some continuity preserved in economic education, and a number of younger economists carry on the tradition of their masters. It appears, however, that the country has not taken advantage of this intellectual wealth. In fact, Poland shows that good economists, courageous in their proposals and prolific in their ideas and writing, do not suffice to obtain a rational economic system. In Soviet bloc countries, reforms depend, first of all, on the reformist spirit of communist parties. In actual reforms, Poland has been left behind some other Eastern European countries.

When in 1956 Polish economists, together with intellectuals in other fields, regained a large degree of freedom to express their views, they did not have to rediscover economics or to discover what was wrong with the existing economic system. They were aware, at the same time, of the doctrinal requirements strictly defining the bounds within which all reform proposals would have to be contained.

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<sup>1/</sup> New York Times, July 9, 1965.



It may be interesting to note that neither Lange nor his colleagues ever openly proposed to work out a practical implementation of Lange's economic theory of socialism, and that the first reform proposals came in a burst of enthusiasm not from well known economists but from much younger circles. For example, the proposal to charge interest on capital and to use profit in enterprises as an incentive and indicator of their performance was presented as early as in May 1956<sup>1/</sup> (i.e., before the "Polish October" and the assumption of power by Gomulka).

After Gomulka assumed power, a "State Economic Council" was instituted, with renowned economists included in its membership. The task of the Council was to advise the authorities on all economic matters. In 1957 the State Economic Council presented to the Government its "Theses"<sup>2/</sup> which, it was thought, represented the maximum demands still acceptable to the political leaders. The "Theses" included proposals to introduce interest on capital, a profit motive, and a shift in the basis of determining bonuses for workers in enterprises from the volume of production to the volume of profits. The Council proposed also that the methods of cost calculation and price formation be changed so as to make the structure of prices (primarily of producers' goods) correspond to relative scarcities. This was to be done, first of all, by raising the list prices of those goods which were being sold by producers below the cost of production; this would lead to the abolition of subsidies to producers and to a more rational allocation of such underpriced goods. The Council also tried to have list prices fixed at what amounted to the cost of production of "marginal" enterprises, i.e., those whose cost of production was the highest among all the enterprises producing the same commodity.

These proposals for the reform of prices were largely accepted and a far-reaching and meticulously prepared price reform was implemented in 1960. This reform gave enterprises a much more rational price structure than the one it replaced, and it removed, at least temporarily, an extremely complicated system of subsidies. But the reform produced only a better structure of prices, not a better method of price formation. Interest on capital was not introduced, and since there is also no profit motive or any equivalent to it in the decision-making of enterprises, the economic system does not offer any guidance on the allocation of capital. The marginal principle has not been accepted: each of the plants producing the same goods delivers its products to the branch association of enterprises at its planned cost of production, plus a fixed markup for profits--not at the cost price of the enterprise with the highest cost of production. This represents a further impediment to a rational allocation of resources. Finally, the initiative of individual

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<sup>1/</sup> Henryk Fiszel, "Zagadnienie cen i rachunku ekonomicznego" (The problem of prices and economic accounting) in Nowe Drogi (New Paths--a monthly), No. 5/83/1956.

<sup>2/</sup> "Theses of the Economic Council Concerning Changes in the Economic Model", published in Zycie Gospodarcze (Economic Life), June 2, 1957, and "Theses of Economic Council Concerning the Structure of Prices", ibid., December 22, 1957.

enterprises in regulating the structure of input and output remains about as limited as in the U.S.S.R. Under such conditions, rational price formation, where prices would represent relative scarcities and offer at the same time guidance to decisions on the allocation of resources, cannot be secured.

Nothing notable has been done so far in this field, although numerous enterprises are carrying out experiments. They have been given more autonomy in arranging their production according to market requirements, in assigning labor to various tasks, and in using the fund for paying premiums to workers for their efficiency. The value of production of these enterprises represents 35 per cent of total industrial production. But the experiments do not go very far. Liberman's profit principle has not been adopted in practical life to any significant extent, even though it was accepted in principle.<sup>1/</sup> To counteract the trend to capital-intensive methods of production, the degree of "labor absorption" has been accepted as a guide to decisions on the desired composition of output--instead of introducing interest on fixed capital.<sup>2/</sup>

The new price structure introduced as a result of the "Theses" has remained basically unchanged, and owing to extraneous circumstances, such as bad crops, balance of payments difficulties, and technological changes, it has become increasingly inappropriate, although probably still superior to the former one.

The Council also proposed certain technical improvements in the evaluation of the performance of enterprises, such as a reduction in the number of indicators of enterprises' performance, and a better analysis of demand, and these proposals have been treated favorably by the political leaders.

In the field of foreign trade direct contacts have been permitted and encouraged between the industrial associations and foreign importers and exporters. More important proposals made by an interdepartmental "Committee for the Inquiry into the Rentability of Foreign Trade", instituted in 1961 under the chairmanship of M. Kalecki, have been implemented only to a limited extent. The recommendations of the Committee, which were accepted by the Central Planning Commission as guidance for further inquiries, included a proposal to introduce the principle of marginality into the formation of foreign exchange rates. These recommendations, and the problem of the "effectiveness" (a Soviet bloc euphemism for profitability) of foreign trade, have been widely discussed in Poland. The Committee's proposals may be summarized as follows:

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<sup>1/</sup> The Resolution of the Council of Ministers of July 29, 1964. "Concerning Economic Progress in the Socialized Economy and the Organization of Economic Services", *Zycie Gospodarcze*, August 23, 1964.

<sup>2/</sup> Recently the discussion of interest on fixed capital was revived, and it appears that the authorities are inclined to follow the example of East Germany and Hungary.

Enterprises and their associations would propose for the consideration of the planning authorities lists of goods which they could produce for export in the course of the ensuing year. The lists would include information on the cost of production per physical unit of each commodity offered for export. These lists, and information on foreign prices of the commodities offered for export, would enable the cost of obtaining a unit of foreign exchange to be calculated for each export commodity in terms of domestic currency.

All the goods which enterprises and their associations propose to export would be then put on a common list arranged in order of increasing cost of a unit of foreign exchange (in terms of Polish currency). In the annual economic plan the over-all minimum amount of export proceeds would be fixed. This would also determine a cut-off point on the above-mentioned common list of exports. This point would correspond to the maximum permissible cost of a unit of foreign exchange (i.e., the marginal exchange rate of foreign currency). Only goods the export of which secures foreign exchange at this maximum cost per unit or below it would be exported. In other words, actual exports would take place at or below the marginal exchange rate of foreign currency (in terms of Polish currency).

The list of export goods could be then analyzed in conjunction with conditions on various foreign markets with the view of finding the most advantageous markets, and could be further differentiated according to the cost of imports from various countries.

A full acceptance of these proposals would provide Polish foreign trade with much more rational foundations than it seems to have now, but the marginal cost of the unit of foreign exchange would still not represent a uniform exchange rate for the zloty. It would represent only an abstract exchange rate beyond which the cost of obtaining foreign exchange (or of imports) should not be allowed to rise, or an indication that goods which give a lower exchange rate for the Polish currency should not be exported. Exports and imports would continue to pass at multiple implicit exchange rates as long as the latter would be below the marginal cost of obtaining foreign exchange. The proposed method certainly offers a much more rational method of selecting exports than the Soviet system of designating goods for export by means of purely administrative decisions. Nevertheless, it does not change these aspects of the pre-1956 Soviet system which are responsible for the multiplicity of (implicit) exchange rates and for the bilateral payments method.

No doubt Professor Kalecki and his associates realized these limitations of their proposals. It was probably because of this realization that they inserted in their proposals a suggestion which would tend to make foreign trade and the principle of marginality a vehicle for making the price formation method and the price structure in Poland more rational. They suggested that production of goods which earned foreign exchange at lowest cost should expand, and those involving higher cost (a lower implicit exchange rate) contract. This, assuming a rational

method of formation of domestic prices, would tend to unify the now multiple exchange rates at the level of the marginal exchange rate.

It appears that the cost of foreign exchange is, in fact, calculated in Poland and that, in a considerable number of enterprises working for export markets, output is influenced by the effect on foreign exchange earnings. But the extent to which the results are used as guides for economic decisions seems to be limited. In the context of this paper, however, the extent to which the proposals related to foreign trade have been implemented is not of immediate practical importance. Even if fully implemented, multiple implicit exchange rates and a bilateral payments system would remain, as long as the reforms in the field of foreign trade were not supplemented and supported by a reform of price formation methods, or, to be more exact, by the introduction of a rational price formation mechanism (market or equivalent) and by a decentralization of planning and, specifically, of allocation of agents of production.

d. Economic reforms in East Germany

Almost from the beginning of the reform program, East Germany became first among the Soviet bloc countries in terms of the scope and implementation of economic reforms. Discussions of economic reforms started, with the approval and encouragement of official circles, very soon after Liberman published in September 1962 his proposals to accept profit as the main incentive of economic activity in Soviet enterprises. A few associations of state enterprises started experimenting with Liberman's ideas on profit, cautiously applied, and with the decentralized method of planning. In the middle of 1963, the Council of Ministers, and soon after that the State Council, approved blueprints of economic reforms as presented in "Guidelines on the New System of Economic Planning and Management".<sup>1/</sup>

The implementation of the reforms has been energetic and by now the whole of state industry, representing an overwhelming part of total industry,<sup>2/</sup> work on the new principles. The main features of the reform are the acceptance of profit as one of the main indicators of the rationality of the economic activity of enterprises, and the decentralization of planning of production and of the management of enterprises.

A great deal of hitherto centralized power in the field of planning and management of enterprises has been progressively and speedily transferred from the central administrative organs to the associations of enterprises. These, as in other Soviet bloc countries, comprise factories specializing in identical or similar lines of production. The structure

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<sup>1/</sup> Neues Deutschland, July 17, 1963.

<sup>2/</sup> In addition to state industrial enterprises, there are in East Germany local (Bezierk) enterprises and some mixed--state-private enterprises.

of output has been made, to a significant extent, dependent on "contracts" between the buyers and the suppliers, equivalent to the "commercial contacts" in the Soviet Union. These are not limited, as they are in the U.S.S.R. to contracts between the producers of consumer goods, on the one hand, and the trade outlets and the suppliers of intermediate products, on the other hand; they extend to all stages of production. The new system is not limited to the consumer goods industry (as, to a large extent, it is limited in the U.S.S.R.) but extends to all industries. The degree of dependence of the structure of inputs and outputs on contracts, and so on an analysis of demand, seems to be increasing only gradually, parallel with changes in the price structure.

The profit motive has the role of ensuring that enterprises will produce what is demanded most. Earnings of workers have been increasingly made dependent upon the profits of the enterprise; the share in total earnings of premiums paid out of profits is gradually increasing.

Among other features of the reform is the introduction of interest on fixed capital. Each enterprise pays a "production fund levy" calculated as a fixed percentage of the "fund of productive resources" (a euphemism for capital employed by the enterprise). Investments, though still centrally determined, will as a rule have to be financed from the resources of the associations of enterprises or borrowed from banks; only in exceptional cases will investment funds be provided from the government budget.

Decentralization, the scope of contracts between the suppliers and buyers, and the dependence of the work of enterprises on the volume of profits are enlarged only parallel with changes in the price structure, distortions which are only gradually being eliminated. Distortions are considered to exist where prices are below costs of production, and where consequently subsidies have to be provided. In April 1964, and on January 1, 1965, the prices of many basic materials were increased and the volume of subsidies greatly diminished. It is believed in East Germany that unadjusted prices, being wrong prices, would lead to wrong decisions in enterprises and in their associations.

Prices remain centrally planned. The East German authorities declared themselves against any "automatic" formation of prices. Instead, the authorities aim at making prices elastic, i.e., making frequent changes in list prices, apparently according to the results of official market analysis. In this way it is hoped to make prices "an effective planning and guidance norm".<sup>1/</sup> However, the price reform has not progressed yet to the stage where such flexibility could be practically considered. For the time being prices of consumer

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<sup>1/</sup> Walter Kelbinalet, Speech to the Berlin Economic Conference, June 24, 1963.

goods are frozen to guard consumers and the cost of production (wages) from violent changes in prices and real wages which could imperil the whole reform. It is believed in East Germany that the price reform and with it the introduction of the whole new system, will be completed in 1966 or 1967.

For the time being, though East Germany seems to lead in the practical reformist movement, the reforms have been more in breadth than in depth. The allocation of agents of production is still, to a large extent, centralized, and the price reform, as in Poland, has introduced a new price structure, not a new price mechanism that would enable prices to perform the function of guidance.

e. Reformist trends in other Soviet bloc countries  
(excluding Czechoslovakia)

In the remaining Soviet bloc countries, other than Czechoslovakia, the reformist movements have been less advanced and the discussions of reforms have not approached the refined levels reached in the Soviet Union and Poland. In all these countries the need for reforms is recognized and new forms of management of the economy are sought, through experimentation in "Libermanism" and in decentralization of planning.

On January 1, 1964 Hungary introduced interest on fixed capital-- until now one of only two Soviet bloc countries to do so. A considerable number of enterprises experiment with linking wages with profits and with the decentralization of planning, leaving enterprises a degree of freedom in deciding what to produce, on the basis of a better demand analysis, out of the centrally allocated agents of production. Both inputs and outputs remain at centrally established list prices.

For some time past a number of Hungarian factories have enjoyed the right to make direct contacts with foreign buyers of their products. Some of these enterprises are also permitted to import direct, without the intermediary of the foreign trade organizations, and to pay for such imports out of a part of export receipts which they are allowed to retain.

In Bulgaria experiments in the "new system of planning and management" are applied in factories representing about 40 per cent of total industrial production, and the scope of experimentation is being extended to the remaining enterprises. Profit, as one of the main incentives and indicators of the performance of enterprises, is being gradually introduced, but the main feature of the reform is the decentralization of planning: more freedom is left to enterprises to decide on how to produce out of allocated agents of production. Prices remain centrally fixed. Bulgaria experiments also with the decentralization of planning in agriculture.

In Rumania experimentation in the new system is on a small scale.

f. Economic reform decisions in Czechoslovakia

Czechoslovakia was late with the "de-Stalinization", intellectual thaw, and economic reforms. For a considerable time economists were largely isolated not only from Western, but even from Russian and Polish theoretical economic writings and reformist movements. In 1958-59, in an experiment based on the Yugoslav experience, a number of enterprises were freed from the tutelage of strict planning and given the right to decide what and how to produce, but the attempt ended in failure. As the economic reformists have subsequently stated, the experiment was called off because "the (attempt) of 1958 was not carried out according to intentions"<sup>1/</sup> and because "naturally, such reorganization produces new difficulties and ... the political leadership did not have the nerve to overcome them."<sup>2/</sup>

After this poor beginning Czechoslovakia has become in 1964 the only country in the Soviet bloc with blueprints of an economic reform which, if implemented, may eventually lead to a rational price formation method, and to the fulfillment of the basic conditions for multilateralism and currency convertibility.

It appears that the Czechoslovak reformists turned the delay in the political thaw to their advantage: the delay eventually brought severe criticism, from within and from without, of the political leadership in Czechoslovakia, and a loss of popularity by this leadership. The younger, more imaginative, and less orthodox group, composed mostly of those who joined the Communist Party after the coup of 1948, became relatively more influential and definitely more outspoken.

The next event, which also was skillfully turned to advantage by the reformists, was a serious deterioration in the economic situation in Czechoslovakia. In 1962 and 1963 industrial production did not increase--a state of affairs which in Soviet bloc countries is considered catastrophic. The lack of economic progress was correctly attributed to the inefficiency of economic planning and of management of enterprises. Czechoslovakia, as one of the two economically most developed, most industrialized, countries of the Soviet bloc, has been plagued by the pre-1956 Soviet system ever since she adopted it. The complexities of a developed economy, which in the Soviet Union became apparent only relatively recently, have been present in Czechoslovakia for a long time.

The need for a reform of the system was recognized, although it is possible that the old guard did not realize how far the reformists would go in their proposals. And they went far. Some criticized not only the present type of implementation of the socialist system, but the

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<sup>1/</sup> "Brain Trust on the Model for Us" in Mlady Svet, (The World of Youth), November 27 and December 12, 1964.

<sup>2/</sup> From "The Thaw Continues", East Europe, December 1964.

principles of the system themselves. And such criticism was published in newspapers and journals, which in the Soviet bloc countries are invariably under strict government supervision.<sup>1/</sup>

Ota Sik, member of the Academy of Science and, more importantly, member of the Central Committee of the Communist Party, is a leader of the reformists. In a speech delivered at a session of the Central Committee (December 18-19, 1963), Sik stated that the socialist economic system should work on the basis of market forces. He also made some remarks directed to the conservatives: "Unfortunately overcoming antiquated ... views often entails not only a matter of difficulties in understanding but ... (also) unwillingness to accept new findings. This unwillingness has its roots in various vested interests, ambitions, prestige factors, etc."<sup>2/</sup>

After two years of discussion a proposal for reform was formulated and presented by Ota Sik to the Presidium of the Central Committee of the Communist Party. In September 1964 the Presidium approved the proposal, apparently after having introduced some significant changes,<sup>3/</sup> and subsequently approval was also granted by the Plenum of the Central Committee. The main features of this revolutionary reform are as follows:

(i) Central economic plans will not, as they do now, prescribe the detailed activity of enterprises, input and output, employment, wage bills, prices and other economic magnitudes. All these markets will be left, with some limitations, to the decisions of managements of enterprises and to their associations. The function of the central, national, annual plan is to be mostly the prognostication of economic developments, and a determination of over-all conditions of development. More detailed planning, but still without its present administrative and imperative nature, is to be the task of various associations of enterprises. Detailed plans will be worked out by the enterprises themselves on the basis of their analysis of markets.

(ii) Decisions on investment of over-all national importance will be made by the central planning authorities. Investments in specific branches and all smaller investment projects, will be the prerogative of individual enterprises and their associations. General principles governing decentralized investments will be worked out centrally.

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<sup>1/</sup> See Z. Haba in "Against Dogmatism for a Creative Development of Economic Science", Hospodarske Noviny (Economic News), November 8 and November 15, 1963.

<sup>2/</sup> Kulturny Zivot (Cultural Life), September 28, 1963.

<sup>3/</sup> The approved version was published in Rude Pravo (Red Law), in the issue of October 17, 1964.



(iii) Decisions as to the structure of input and output, including employment and, to a large extent, wages (or, rather, the total earnings of workers), will be left to enterprises, which will be motivated in their decisions by the desire to maximize profits. Profits are defined as in western economies, except that (as in Yugoslavia) the wages bill is not included in the costs of production.

(iv) Minimum wages will be established centrally, but earnings of workers and employees will be strongly influenced by the size of profits made by enterprises.<sup>1/</sup>

(v) Interest on fixed capital will be introduced.

(vi) Prices will be established in such a way as to eliminate the need for subsidies. There will be three categories of prices;

Fixed prices established by the central planning authorities. These prices will apply to basic raw materials and to basic consumer goods. In fixing prices for these goods, the authorities will take into account market conditions,

Ceiling prices established by the central planning authorities, for "standard products" to eliminate "speculations" by enterprises,

Free prices emerging from market forces.

(vii) It appears that there will be a shift in the source of government revenues from indirect to direct taxes. Profits of enterprises will be taxed at rates that will, at first, be differentiated according to the performance of enterprises, but eventually will become uniform for all enterprises.

(viii) A "proper relationship" is to be established between domestic and foreign prices, to enable exporters to make rational decisions. (This implies a decision to fix an appropriate exchange rate for the Czechoslovak currency, although it cannot be expected that such a uniform rate can be obtained soon after the implementation of other facets of the reform.)

The Presidium of the Central Committee of the Communist Party originally decided that the new system should be introduced gradually during 1965, so that the 1966-70 plan could be entirely based on the new economic order. However, the beginning of the introduction of the main principles of the new system is to be postponed until January 1, 1966.

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<sup>1/</sup> This will tend to cause underemployment in enterprises, i.e., employment below what in a "capitalist" enterprise of the same kind is considered an equilibrium point.

It appears that this delay has been caused by the need for more detailed blueprints of the new system. The Czechoslovak authorities may also be apprehensive about the cost of possible mistakes, and even of the mere cost of the transition from the old to the new system, particularly in view of the lack of external aid, such as Yugoslavia received while making a similar transition.

On the occasion of his New Year broadcast, President (and the first Secretary of the Czechoslovak Communist Party) Antonin Novotny stated: "With the preparation for the 1966-70 plans, are linked the beginnings of putting into operation improved forms of organization and management in our national economy, which are inseparable from the preparations for the fourth five year plan ... We must realize that if we left ... (present) forms of management in operation ... they would become a brake on progress". It appears that Czechoslovakia is on the threshold of revolutionary changes in her economic system.

4. Economic reforms and the conditions for multilateralism and convertibility

Economic reforms in the Soviet bloc countries have been carried out to a varying degree but, except for those in East Germany, they remain experimental. The common features characterizing the various reforms, experiments, and reform proposals are the decentralization of planning and management of the economy, the introduction of a profit motive as the main indicator of rationality and efficiency in the economic activity of enterprises, and a degree of freedom for enterprises in selecting the structure of output on the basis of market analysis.

All these features represent an immense rationalization of the economies (or sections of the economies, depending on the scope of the reforms or experiments). None of the Soviet bloc countries, however, has gone so far as to create conditions for the multilateralization of trade and convertibility of currencies. In this respect the key issue is the system of "guidance"--i.e., of price formation and the allocation of agents of production; in no Soviet bloc country has it been solved satisfactorily, at least for the time being.

Two approaches have been developed with respect to solving the issue of guidance. One is the adoption of market forces. This method has been accepted only in Czechoslovakia, and so far in principle only, since the intended reform has not yet been implemented. Another approach is that of "equivalent forces", i.e., forces equivalent to the free market. Under this method prices are to remain centrally controlled, as are the present list prices, but the planning authorities are to keep prices "flexible" by changes made as frequently as the market requires. It is not known how this method would work in practice. So far, the only articulate example of this method is East Germany.

Even there, while the method of "equivalent forces" has been adopted in principle, the economic reforms have not yet been carried out to such an extent as to introduce and test the method. In the Soviet Union, mathematical economists seem to have developed methods of price formation by "equivalent forces", which are on a lower level of abstraction than, e.g., Pareto's general equilibrium. But these methods are not ready to be translated into practical terms, nor seems the leadership of the Soviet Union to be ready to consider them actively. There seems to be a search for something more concrete. The authorities of the other Soviet bloc countries think, for all practical purposes, solely in terms of a price structure, not of a price formation method which would provide lead prices to an ever new point of equilibrium.

For purposes of this paper, it is enough to conclude that neither the market method nor the "equivalent force" method has been implemented in any Soviet bloc country, and that the necessary conditions for multilateralism and convertibility have not been met by any post-1956 Soviet bloc economic system.

##### 5. Intra-bloc "multilateral" settlements

In October 1963 member countries of the Council for Mutual Economic Aid (Comecon)<sup>1/</sup> signed an agreement aiming at multilateral settlements, in "convertible gold rubles", of claims arising out of the intra-bloc commercial transactions. This agreement provided for the establishment of the "International Bank for Economic Cooperation" and the Bank was organized and put into operation at the beginning of 1964. Economic periodicals in the Soviet bloc countries declared that the shift from bilateral to multilateral settlements of claims arising out of foreign trade between the member countries thus initiated represented one of the most important events in the history of the socialist countries. According to the majority of reports in the Soviet bloc countries, the first full year of operation of the International Bank for Economic Cooperation (IBEC) has been successful, and it is gradually extending the scope of its activities. Only in Poland was the operation of the Bank given a mixed appraisal.

The Bank's basic unit of account and of a store of value is the "convertible" ruble with a gold content of 0.987412 grams of pure gold. The capital of the Bank is to amount to 300 million of "convertible" rubles, subscribed (unequally) by the central banks of member countries and to be paid in in five annual installments. The Bank Board is composed of representatives from member countries--one from each. Each country has one vote. The same is true for the Bank's executive body--Bank Administration. The Bank may accept various kinds of deposits in convertible rubles or in other convertible currencies (i.e., of Western countries), but it cannot sell convertible currencies for "convertible" rubles. It loans convertible currencies on a short-term basis.

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<sup>1/</sup> Bulgaria, Czechoslovakia, East Germany, Hungary, Mongolia, Poland, Rumania, and the U.S.S.R.

The establishment of the Bank is considered in the Soviet bloc countries an important event permitting a transition from strict bilateralism to a system of multilateral settlements of claims arising out of foreign trade between the member countries. "... In the early years when the world socialist system was still in its formative stage ... bilateral payments agreements and bilateral clearing accounts represented the only practical form (of settlements). ... However ... under the conditions of ... the ... socialist division of labor and ... an increase in the volume of foreign trade, early forms of bilateral payments agreements and settlement of clearing accounts ceased to meet the new requirements. We know that under bilateral settlements ... the balance ... in favor of one country cannot ... be used to pay for imports from another country, and countries were compelled ... to reduce imports ... or export ... The subsequent stage of economic development required a new method ... These requirements are fulfilled ... by the new system of multilateral settlements...."<sup>1/</sup>

While the above description of bilateralism is clear and accurate, the claim that the IBEC has introduced multilateralism and convertibility cannot be accepted. Behind such familiar terminology as "multilateralism", "convertibility", and "gold ruble", there is an epistemology entirely different from the one of the western world. The language used in Soviet bloc economic periodicals to explain the reasons for the introduction of the new "multilateral" system of settlement is misleading because it is so familiar to us while describing unfamiliar phenomena.

The important element in understanding the working of the present Soviet bloc payment system is the decision of Comecon taken in June 1962 on the "Fundamental Principles of the International Socialist Division of Labor". This agreement laid the basis for the coordination of the economic development plans of the Soviet bloc countries, and for specialization by these countries in various lines of production.

Under the new system of payments, negotiations for the exchange of goods and for payments are conducted in two stages: in the first stage, pairs of countries enter into bilateral understandings on the exchange of goods between them. In arriving at these understandings, countries are guided, among other things, by the requirements of the specialization of production within the Soviet bloc. Such requirements are, of course, agreed on before any actual exchange of goods and payments take place. At this stage of negotiations, the total values of goods to be exchanged between each pair of countries do not have to balance.

In the second stage, trade negotiations are conducted on a multilateral basis. The movements of goods between all the member countries are so arranged that payments by each country are balanced on a multilateral basis, although they may not be balanced for each pair of countries.

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<sup>1/</sup> P. Nosko: "A New System of Settlements", Vneshniaia Torgovlia, (Foreign Trade), No. 7, 1964.

Temporary imbalances which may emerge for individual countries in the course of the execution of the "multilateral" trade plan are covered by "convertible" rubles, which the Bank has obtained from the subscriptions to its capital or from current inflows of temporary surpluses of other countries. The Bank may grant members short-term, seasonal, and medium-term advances.

There is no doubt that the establishment of the International Bank for Economic Cooperation tends greatly to benefit the member countries. While in the past it was difficult to arrange even a triangular trade and payments agreement, it is now possible to enter into "multi-angled" trade transactions. While in the past it was necessary to balance bilateral accounts by curtailing imports, under the new system the country with an adverse balance has a breathing space, because the creditor country can use its accumulations of "convertible" rubles to pay for deliveries of goods from other Soviet bloc countries. The right of the Bank to extend advances to member countries should also contribute to an increase in the volume of the intra-bloc trade. If the Bank in addition becomes a holder of temporary surpluses of convertible currencies (of the non-bloc countries), the reserves of such currencies needed by all the Soviet bloc countries may be reduced--more realistically, the actual total amount of such reserves may become less inadequate. The Bank will thus increase the over-all liquidity of the Soviet bloc countries.

Nevertheless, the new system does not make the ruble convertible and does not result in any multilateralization of trade. The ruble used in "multilateral" settlements by the IBEC is not the ruble circulating in the Soviet Union. As long as the valuation of goods exchanged between the Soviet bloc countries is divorced from price quotations in any and all Soviet bloc countries and instead is based on world market prices, the "gold" ruble is in reality as much foreign currency in the Soviet Union as is the U.S. dollar or pound sterling. All that the Bank does is to make the ruble a unit of account and permit a "multi-angular" trade. The ruble has not even attained the status of a conditionally convertible currency on a purely regional basis such as that of the pound sterling in the sterling area before it became convertible on a wider basis.

A necessary prerequisite for the attainment of the convertibility of the ruble is the creation of conditions for the "convertibility of goods" discussed in Section 2(d) above. This condition has not been fulfilled in any single Soviet bloc country. Prices in these countries still do not reflect relative scarcities of goods and they do not perform any guidance function in the allocation decisions. Rubles accumulated at the International Bank for Economic Cooperation cannot be converted into any commodity in any member of the Soviet "multilateral" settlement scheme. They do not represent a general claim on goods in any Soviet bloc country. This is so, not because of the existence of monopolistic foreign trade organizations, but because a free use of accumulated "convertible" ruble on markets of the Soviet bloc countries,

including the Soviet Union itself, might very well mean--to repeat--the export of goods which are scarcer vis-à-vis domestic requirements than other goods, even though the latter may have relatively lower prices.

For these reasons credit balances in rubles accumulated with the IBEC cannot be used for purchases of goods at domestic list prices. The prices used in intra-bloc trade continue to be world market prices. "Foreign trade prices expressed in rubles are stable. They are determined (through Comecon negotiations) on the basis of average weighted price quotations on major world markets over a period of years, and they are not subject to fluctuations. Changes in these prices are made ... through agreements among the participating countries, with due consideration accorded to interests of these countries."<sup>1/</sup>

Moreover, the use of the "gold ruble" in intra-bloc settlements is strictly dependent not only on the valuation of goods exchanged at world market prices but also on agreements as to what goods can be exchanged. These agreements determine the quantities of each commodity exported or imported in accordance with each country's plans of production, investment and consumption. And the agreements themselves are influenced by the intra-bloc agreement on the specialization of production and the division of labor in the Soviet bloc countries. In constructing plans for foreign trade, and in negotiating agreements as to which goods should be exchanged, the important elements are not domestic prices but administrative decisions which have no relationship to the comparative advantages of foreign trade.

The ruble accounts accumulated with the IBEC thus do not represent general purchasing power; their use and usefulness is strictly limited. The only difference between the new and the former system of payments is that at the second stage of trade negotiations, the lists of goods are agreed on multilaterally. "... difficulties that may arise with respect to the volume and assortment of goods exchanged at the stage of bilateral negotiations (first stage) can be solved during multilateral negotiations (second stage), where mutually advantageous decisions are reached ..."<sup>1/</sup>

It appears, however, that the member countries have not availed themselves even of the opportunities offered by the Bank. Henryk Kotlicki, Director General of the (Polish) Ministry of Finance, in an interview given on the occasion of the first year of operation of the Bank stated that the member countries tend to continue to balance their trade bilaterally not multilaterally<sup>2/</sup> (or rather multi-angularly). Another author said that there was no tendency to expand exports to other member countries because export surpluses could not be used due to a lack of supply of needed goods or of their poor quality.<sup>3/</sup>

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<sup>1/</sup> P. Nosko: "A New System of Settlements", Vneshniaia Torgovlia, (Foreign Trade), No. 7, 1964.

<sup>2/</sup> Interview published in the Polish daily, Trybuna Ludu (People's Tribune), April 27, 1965.

<sup>3/</sup> S. Albinowski: "The Transferable Ruble and Gold" published in the Glos Pracy (The Voice of Labor), May 5, 1965.

Mr. Kotlicki found also that interest rates on debit balances were too low to provide for an incentive to eliminate such balances (apparently he meant cancelling balances through an expansion of exports by the debtor country). He thought however that the main cause of deficiencies in working of the Bank was the lack of convertibility of balances in "convertible" rubles into gold or into convertible currencies (i.e., currencies of non-member countries). He proposed that creditor balances maintained over a longer period of time would be converted up to a certain proportion (e.g., 10 per cent) into gold or into convertible currencies. The debtor would be required to pay a part of his negative balances, e.g., 10 per cent of it, in gold or in convertible currencies. The proportion of payments into gold or convertible currencies would be increased in stages until a 100 per cent convertibility would be attained. Such a reform, the author correctly asserted, would create incentives to expand the intra-bloc trade and to improve the quality of exported goods.

While some economists in the Soviet bloc countries realize the limitations of the new system of intra-bloc payments, they seem to consider them temporary and they have great hopes for the future role of the Bank. "The system of multilateral settlements in convertible rubles may subsequently and in a gradual way bring the domestic prices in (Soviet bloc) ... countries into accord with each other, inasmuch as the use of the ruble as a measure of value makes it possible to compare the production costs and prices of commodities in ... (Soviet bloc) countries, to make a concrete evaluation of the economic benefits of exports and imports, and to take steps to bring about necessary reduction in the cost of production of specific commodities ..." <sup>1/</sup>

This reference to the adjustment of domestic costs and prices seems to sound encouraging. However, the cost structures of Soviet bloc countries can be made more rational through forces stemming from foreign trade, only if the price formation methods in these countries are changed (including an introduction of interest on capital) so as to be able to transmit the forces from without. It should also be kept in mind that within the Soviet epistemology, the expression "the reduction of costs of production" should be understood as related to goods, of which the exchange (on an intra-bloc scale) is determined by decisions related to the intra-bloc specialization in production. It is neither comparative advantage nor relative costs which determines this specialization, but the other way round.

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<sup>1/</sup> P. Nosko: "A New System of Settlements", Vneshniaia Torgovlia, (Foreign Trade), No. 7, 1964.