Eastern European Economics A JOURNAL OF TRANSLATIONS – SPRING 1989, pp. 36-49

Economic Reform in Socialism and Inflation[*]

Determinants and Interrelations

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In a manner that is still insufficiently analyzed and described in the literature, one socialist country after another has embarked upon radical economic reforms. This has meant a fundamental restructuring of the way the national economy functions, consisting mainly of restricting the administrative powers of the bureaucracy and widening the field of action for market forces. But as the zone of market relations expands, so does the significance of economic categories connected with the market, and especially that of numerous processes now set in motion or intensified which had previously appeared in a different guise or been absent altogether.

One such process is price inflation. This phenomenon was noticeable in the past as well, but its character, scope, and intensity - in terms of both causes and mechanisms, as well as symptoms and results - were much different from the present day, when socialist economies are faced with the introduction of market relations.

Determinants of and obstacles to economic reform

Economic reforms in socialist countries are conditioned above all by a constellation of internal economic and sociopolitical factors which vary in the case of individual countries.

The exhaustion of the growth capacities inherent in the traditional system of bureaucratic central planning has long been apparent. This realization was most often expressed by formulations about the need to enter a new, "intensive" stage of development. In reality, not a single country with a centrally-planned economy has yet reached this stage; extensive growth patterns still predominate. In a few cases where factors sustaining such growth have been exhausted, we are already dealing with economic stagnation.

The wide-scale introduction of intensive factors, including especially scientific and technological progress, can only take place as the result of economic reforms. The divergent sociopolitical and economic situations obtaining in various socialist countries explains why these reforms are initiated at different times. The ultimate direction of the reforms, however, seems already foreordained - toward the further marketization of economic relations.

The necessity for widening the scope of market relations and their gradual strengthening stems from at least three reasons.

First, the market is an essential source of information about the needs of society.[1] Optimal

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This article is based on studies conducted at the Institute of Economic Development of the Main School of Planning and Statistics within the framework of the research project CPBP 10 1., "Directions of Change in the Structure of Poland's Economy" [Kierunki zmian struktury gospodarki Polski]. It is excerpted from a longer paper given at the Fifth Conference of Economists, held in Cracow, November 27-28, 1987.

satisfaction of these needs is the goal of socialized production in socialism. At the same time it is obvious that this cannot be the goal of production at the micro-level. Thus the creation of a mechanism that would "harmonize" the goals of various levels of the economic hierarchy is - along with the liberation of entrepreneurial energies - one of the main tasks of the economic reforms. Without the information that flows from the market, one cannot even speak of a proper allocation of productive factors - labor as well as capital - with all the structural consequences resulting from that fact. Second, it is objectively necessary to strengthen the role of money and related conceptual categories as a factor limiting the tendency to affect excessive investment. This impulse is a systemic feature of the socialist economy at its current stage of development. Third, the development of the market encourages entrepreneurship and stimulates initiative.

It is obvious that the role of the central plan must be reduced at the same time and, therefore, also that of several interest groups which are strongly connected with the traditional method of managing the economy. However, central planning must remain alongside the market as an integral element in the new economic mechanism. First, this is because the central plan should continue to regulate fundamental macroproportions in the economy, and especially the final shares of national incomes allotted to accumulation and consumption. Second, because the plan must be an active instrument influencing structural changes on the macro-and mesoeconomic scale. Third, because planning should partly determine the basic directions of scientific and technical progress. And fourth, because planning should influence the national economy's participation in the international division of labor.

It is a matter for existing socialism to decide in the coming decades what should be the proper relationship between plan and market as two co-existing subsystems in the system regulating the national economy. On the one hand, it is certain we must proceed much farther with introducing market relationships into the economy than we have thus far, although there are still more unknowns concerning the direction and tempo of market reforms than is frequently understood. On the other hand, there must be full awareness that the process of widening the scope of action for commodity and money relations will bring with it many problems and dangers. Some of these dangers did not appear at all, or did so on a different scale, in the traditional administrative command system. The point is to create a system of economic management in which macroeconomic reproduction will not be subject to the sole guidance of either the "invisible hand" of the market or the more visible one of the central planner.

The ultimate success of economic reforms demands the fulfillment of three basic conditions. First, a measure of public support is essential. Second, there must be political will in the government and determination on the part of individual politicians to carry through the indispensable systemic changes, including the limitation of their own powers of control. Third, economists have to know what must be done. And though economists' knowledge grows richer every year, one can still question whether we in fact have a long-term vision of how a socialist economy should operate and the methods of the implementation of this vision, i.e., a conceptual "pathway".

As concerns the first two conditions, the situation is different in various countries. Public support is visibly waning in Yugoslavia, Poland, and Hungary. This is not the case in China and the Soviet Union. This pattern should not be surprising, since the first three countries have already had an opportunity to become acquainted with the costs of economic reforms, while in the case of the Soviet Union we are still observing the preliminary stage of laying the conceptual and political-ideological groundwork for essential changes in the way the national economy operates, with all the implications thereof. The Chinese case, meanwhile, is one that requires entirely separate treatment, which is why we exclude it from further consideration here.

Finally, the political will of the authorities seems to be working m favor of economic reform, although their lack of consistency and tendency to avoid decisive solutions to many problems by putting them off for future consideration is not reassuring

Intensifying inflation or making it tangible?

It might seem that the "opening up" of inflation is one of the preconditions for success of economic reform in its initial stage. Such an approach postulates that after a certain period (necessary for carrying out certain adapative processes), a rise in prices will occur on a limited scale. This was supposed to be the result of tangible improvements in managerial efficiency and the drying up of surplus demand characteristic of the pre-reform period. In fact, this is not what happened.

Therefore, the theory that holds that economic reform only makes inflation tangible by substituting open (price) inflation for the previously dominant repressed inflation (goods shortage) also requires some rethinking.[2] The importance of such reflection is illustrated by the fact that none of the states far advanced on the road of economic reform has avoided long-term intensification of price inflation. Naturally the question arises, whether states embarking on reforms can avoid this.[3]

Observation of the experience of economic reform in socialism to date leads inevitably to the conclusion that these reforms are essentially pro-inflationary. Inflation measured by the consumer price index has visibly accelerated in countries resorting to wider use of market tools.[4] The explanation is simple. In the context of a flood of surplus demand, basing the [economy's] operating mechanism to a greater extent on market relations, has set a cumulative price escalation into motion. Since there are no systemic barriers to prevent this escalation from affecting the production costs and income of various economic units, this impulse turned out to be a sort of "inflationary shock" which has not been subsequently eliminated.

The lack of “hard budget restraints”[5] means that the role of money in the economy continues to be relatively passive and at the same time of secondary importance compared to “real” (material) processes. Money supply adjusts itself to these processes, and not the other way around. This is why - despite the considerable latitude in price determination - the demand flow still out - strips the flow of supply. Since, in the nominal sense, more is being distributed than created *the actual national income level can only be achieved through inflationary price increases with all of their redistributive effects*, which - given the nature of inflationary processes - cannot be fully controlled.

Table 1	Level of Price Inflation-Goods Shortages Country (Shortageflation)
Bulgaria	6.9
Czechoslovakia	5.1
GDR	3.1
Poland	29.4
Romania	8.3
Hungary	8.9
USSR	4.6

The market mechanism, however, does not function fully even in the reformed national economies, including Yugoslavia and Hungary. Price formation on the market is still state-controlled, by both administrative and political means. In reality, therefore, we are dealing with a situation which to some degree is even worse than the one before the reforms - *inflacja cenowo-zasobowa* [a partly open and partly repressed inflation]. It is characterized by the simultaneous appearance of price inflation and goods shortages. Estimates of the level of the open and repressed inflation in the socialist countries during 1977-1984 appear above (mean annual percentages).[6]

The scale and composition vary, since the range of shortages is different in each national economy, as is the level of price inflation. Apparently, *the combination of open and repressed inflation is a transitional stage for reformed socialist economies.* It will last as long as these countries fail to deal with the structural problems which, along with faulty systemic measures and economic policy mistakes, are the fundamental cause of the inflation.

Let us recall that the stagflation endemic in the capitalist economy during the last one and a half decades is the price paid for a long-term process of structural adaptation, mainly in response to two "price shocks" in 1973 and 1979.[7] The combination of open and repressed inflation is an analogous cost which must be borne, perhaps for a similar period, by the socialist countries. Such is the price of adjusting to new methods of economic management which are unlike those of the past.

The appearance of this phenomenon has been significantly delayed in many cases, but it cannot be postponed forever. Economic reforms, or more precisely, certain concrete elements of the new economic and financial mechanism employed in the reforms, can either multiply or reduce the costs - but they cannot eliminate them entirely.

Accepting *the phenomenon of joint open and repressed inflation as an analogue to stagflation in the capitalist economy*, the question must be raised about the extent to which one can choose between open and repressed inflation in conditions of economic reform.[8] This is because the real socioeconomic mechanism *already* precludes a return to the total repression of inflationary price increases, while it is *not yet* possible - due largely to sociopolitical considerations - to make the complete switch to price inflation. With the systemic changes that have already been introduced - especially in the areas of investment, wage, and credit policy - which are characterized by “soft budget restraint”, shortages will necessarily occur, and as a result they will be accompanied by relics of the old system of management, chiefly various types of rationing.

Undoubtedly, *it is possible to choose between different rates of price inflation or goods shortage in the short term.* As prices go up, shortages decrease - and vice versa. Not all authors fully agree with this view.[9] The dissenters believe that the inflation alternative, or the problem of choice as formulated above, does not exist. *This is so because, irrespective of how the problem of choice would be resolved on this level, the dilemma which gave birth to it would not disappear.*[10]

In the long term, on the other hand, this alternative loses its importance because of the powerful inflationary spiral mechanism which operates in the reformed national economy. Existing shortages reappear at increasing levels of prices (and also costs and earnings).

Based upon the historical experience in Yugoslavia, Poland, and Hungary, one could say that *inflation has become one of the chief barriers to economic reform.*

If it was possible at the outset to believe that setting "real" prices - i.e., adjusting them to the social costs of production and the relation between supply and demand - would facilitate and accelerate the reconstruction of the system of functioning of the national economy, today it is clear that the process has taken on a life of its own and is endangering the success of reform efforts. In other words, *inflation has become less a tool facilitating the adjustment processes necessary to achieve successful economic reform than one of the main barriers to reform.* This barrier is sociopolitical as well as economic.

Economic aspects of interrelations: reform and inflation

There is a huge literature on the link between inflation and economic growth. Despite this, there is still an incomplete clarity of views on the subject. Basically there is consensus that *inflation, at certain levels,* *can turn against economic growth.* But these levels vary according to time and place. Moreover, the interrelations in this field are different in the socialist economy, where inflation (especially in its repressed form)" is one of the means used to intensify accumulative efforts in the national economy and to finance additional expansion of investment.[12] This is not the place to expand on this theme, but it should be pointed out that the excessive price inflation occurring in recent years, for example in Poland and Hungary, has led to a relative decline in economic performance (Figures 1 and 2). The same could be said of other countries, particularly Yugoslavia (Figure 3). This is the case not because we are dealing with inflation as a general category, but because the inflation here is both long-term and relatively high. Repressed inflation is even more destructive to economic growth. One way the negative consequences of inflation on the macro-economic level can be studied is through the behavior of economic units on the microlevel. Here we have only to turn our attention to a phenomenon that could be termed the joint open and repressed inflation syndrome, which undercuts both efficiency and equilibrium and hence runs counter to the aims of the economic reforms. The syndrome is at work when enterprises operating in the socioeconomic and political environment created by economic reform *are not interested in approaching equilibrium prices, either by increasing production and supply* (which is more understandable) *or by raising prices* (which is more surprising).[13]

Thus, even in a situation where there are no administrative restrictions or public pressure against price increases, firms will raise prices, but not enough to reach equilibrium levels. This is because they set prices according to a cost-based formula which guarantees them a specific, satisfactory measure of profit. *In a situation where market conditions are changing rapidly,* one would expect frequent and violent fluctuations in the price of productive factors. Relying on the cost-based formula, the enterprise would then raise the price of its products *and maintain its previous range of profit.* However, if the enterprise had previously set its prices closer to the equilibrium level, maintaining its previous financial position would have required improving efficiency, especially by lowering production costs or increasing output.

In a situation where the demand flow is growing as the result of the inflationary spiral, it is hard to find any limitations on the demand side - i.e., any difficulties in selling. At the macroeconomic level, expenditures by some units become incomes of others. If this income is not saved (which is a common occurrence in the face of strong inflationary expectations), it creates a demand that cannot be fully satisfied despite continual price increases by firms.

If such a process does indeed occur, the task of economic policy should be to encourage enterprises to raise prices to levels equalizing supply and demand. Financial *stability* should then be guaranteed by appropriate monetary, credit, and fiscal policies. In the actual functioning of the socioeconomic mechanism, however, we observe actions which are just the opposite. These actions are motivated by anti-inflationary intentions, *but in effect they stimulate inflationary processes.* Above all, they perpetuate the demand-pull inflationary mechanism.

The specific strategies chosen by actors on the microeconomic level result in shortages on the macroeconomic level. These shortages cannot be accurately estimated. However, many studies indicate that - especially in the Polish economy - their magnitude is economically significant. Leaving aside here a discussion of the usefulness of terms such as “inflationary overhang” in analyzing the monetary and supply situation,[14] it can be accepted that in Poland during 1982-1987 this figure amounted to 15 to 30 percent of the population's purchasing power.[15] In other words, the population possessed a specific demand surplus which could not be satisfied at a given price level or supply volume. It might therefore appear that the liquidation of this pent-up demand would require either drastic price increases or a dramatic jump in supply. This is not so, however. For independently of the necessary activities and processes in the real economy, it is possible to achieve much through changes in the psychology of the public. Here we are referring to a reduction in people's inflationary expectations, which could foster an increased willingness to save and thus help reduce demand.[16] However, this is impossible if the inflation rate is excessively high and unstable or if shortages are too sharp and last too long. In reality we are dealing with another case of negative feedback: *protracted inflation, because it heightens inflationary expectations, acts to prolong the unfavorable state of affairs.*

Reversing these unfavorable tendencies, however, requires specific, concrete action on the supply side. In this context it is worth drawing attention to the fact that shortages on the consumer goods market have largely been caused by disequilibrium on the capital goods market. Here, it appears, we have what might be called the *displacement effect.* This holds that many of the missing productive factors actually do exist, but have been "displaced" by the operations of the economic system to sub-optimal locations.[17] The situation is reminiscent of a child's building kit where only one piece out of a hundred is missing, but as a result the other ninety-nine have had to be moved to different positions and now nothing fits. In short, there is too little of everything at the place and time it is needed. Numerous bottlenecks arise which result in lower output of consumer goods, and which can only be removed by *liquidating the socialist economy's most painful shortage - the lack of efficient organization.*

Improved organization and the liquidation of the often artificial shortages, which the inflationary expectations mechanism breeds, is impossible, however, without far-reaching systemic transformations, especially in the allocation of productive factors. Here we are particularly concerned about the creation of accessible and flexible channels for capital transfers between various economic units. For no equilibrating mechanism can function on the consumer goods market without equilibrium on the capital goods market as well.

None of this will be possible either, without an even more far-reaching introduction of market relations into the economy, and especially without the development of an effective labor market. It should be obvious that, as these markets develop, they will have far-reaching consequences for the functioning of the economy and society, unfortunately, also including some negative ones. Moreover, it should be recognized right away that the creation of these markets by itself will not solve our problems. This is demonstrated by the example of Hungary, where there is a well-balanced consumer market and the beginnings of a capital market, as well as by Yugoslavia where, despite the existence of a capital and a labor market (with 14-percent unemployment!), high inflation persists and the national economy shows signs of stagnation.

Notes

1. Cf. G. W. Kolodko, *Cele rozwoju a makroproporcje gospodarcze,* Warsaw: PWN, 1986.
2. Cf. G. W. Kolodko, "Inflacyjne zagrozenia reformy," *Miesiecznik literacki,* 1982, no. 11.
3. I leave aside here the question of world inflation and the extent of its influence on inflation in the socialist economy. For more on this subject, see S. Ra.czkowski, "Wplyw miedzynarodowych ruch6w cen i inflacji na gospodarke krajow socjalistycznych," *Gospodarkaplanowa,* 1984, no. 1; G. W. Kolodko, "International Transmission of Inflation: Its Economics and Its Politics," *World Development,* vol. 15 (1987), no. 8.
4. As an example one could cite here data illustrating the growth of prices in Hungary. Beginning in 1946, these grew roughly six-fold. As a result, the purchasing power of the forint compared to that in 1946 had fallen to 16.5 percent by 1985. Of this 83.5-point drop in purchasing power, only 5.7 points occurred during the years 1953-1974, while three times that much can be attributed to the 1975-1985 decade, (The remaining 62.3 points are the result of price increases from 1946-1952, when they rose more than 165 percent.)
5. Cf. J. Kornai, *Niedobor w gospodarce,* Warsaw: PWN, 1985.
6. The coefficients and the method by which they were arrived at is presented in the article by G. W. Kolodko and W. W. McMahon, "Stagflation and Shortageflation: A Comparative Approach," *Kyklos,* vol. 40 (1987), no. 2.

7. Cf. M. Bruno, J. D. Sachs, *Economics of Worldwide Stagflation*, Cambridge: Harvard University Press, 1985.

8. Cf. G. W. Kolodko, W. W. McMahon, op. cit.

9. Cf. J. Kornai, *Wzrost, niedobor, efektywnosc,* Warsaw: PWN, 1986; M. Oles, M. Sumliriski, "Alternatywa inflacyjna?" *Finanse,* 1986, nos. 7-8.

10. "... [A]n inflation alternative does not exist as a function of a choice upon which economic policy could be based. The option existed only at the moment the decision should have been made to raise prices or leave them at their customary levels." M. Oles, M. Sumlinski, op. cit., p. 21.

11. H. K. Charlesworth, *The Economics of Repressed Inflation*, London: University Press of America, 1955.

12. Cf. M. Kucharski, *Pieniqdz, dochod, proporcje wzrostu,* 3rd ed., Warsaw: PWE, 1972; J. Beksiak, U. Libura, *Rownowaga gospodarcza w socjalizmie,* 3rd ed., Warsaw: PWN, 1974.

13. Here we are referring to the category of so-called “negotiable” or “free” prices, which can be set by independent enterprises in consultation with their clients (although certain restrictions often occur here). The economic reform presupposes that these prices should be set according to a supply-demand formula, and would thus be market equilibrium prices.

14. Cf. A. Topiriski, "Gdzie ten nawis?" *Zycie gospodarcze,* 1987, no. 30.

15. See among others G. W. Kolodko, *Polska w swiecie inflacji,* Warsaw: KiW, 1987; J6zef Pajestka, ed., *Gospodarka wprocesie reformowania,* Warsaw: PWE, 1986; M. G6rski, G. Jedrzejczak, *Rownowaga i stabilno'sc w gospodarce socjalistycznej,* Warsaw: PWN, 1987.

16. Cf. M. Oles, "Wplyw procesow inflacyjnych na poziom i strukture zasobow pienieznych ludnosci," *Studio Finansowe*, 1985, no. 32.

17. We see this most clearly in the case of labor, where supply shortages are encountered where we would expect a surplus.

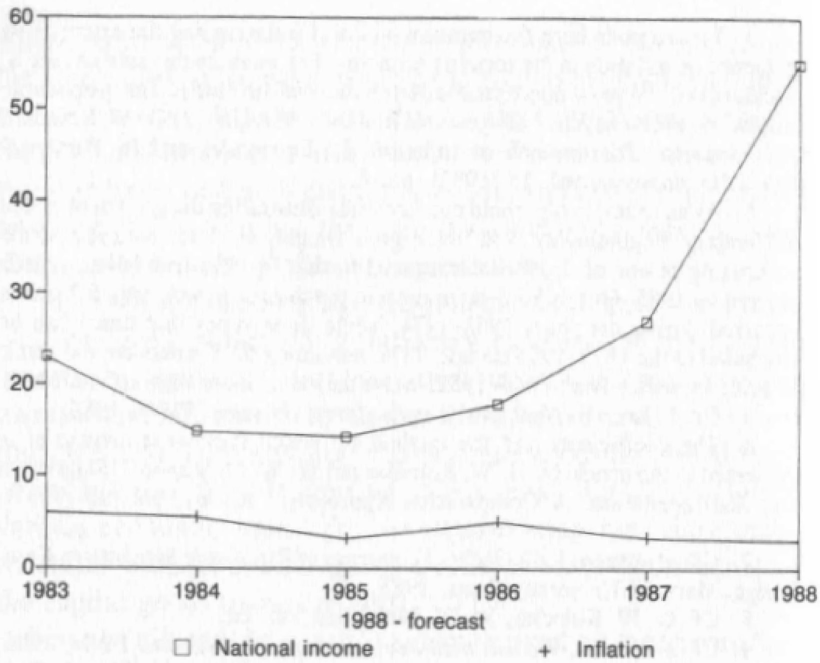

Figure 1. Economic growth and inflation—Poland (in %).

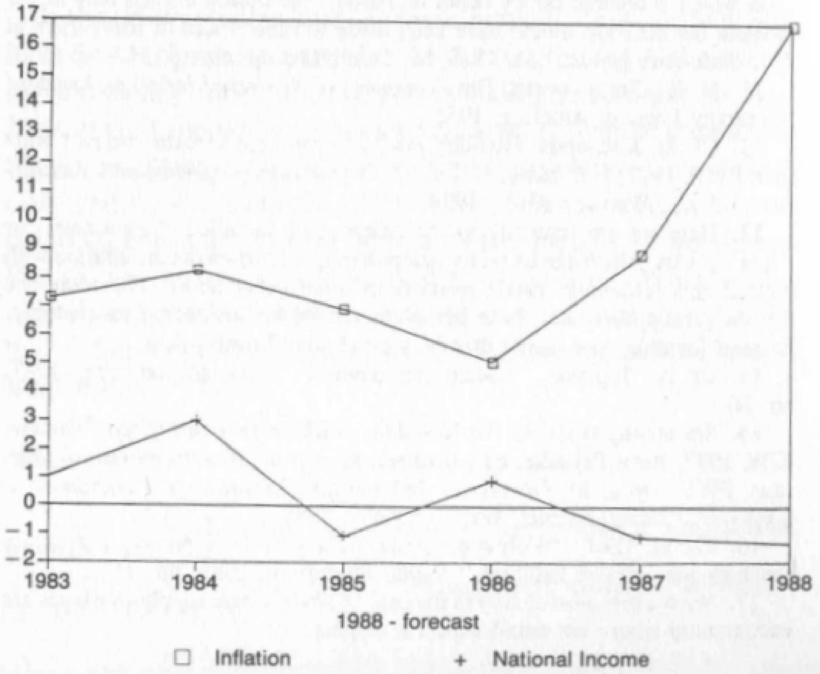

Figure 2. Economic growth and inflation—Hungary (in %).

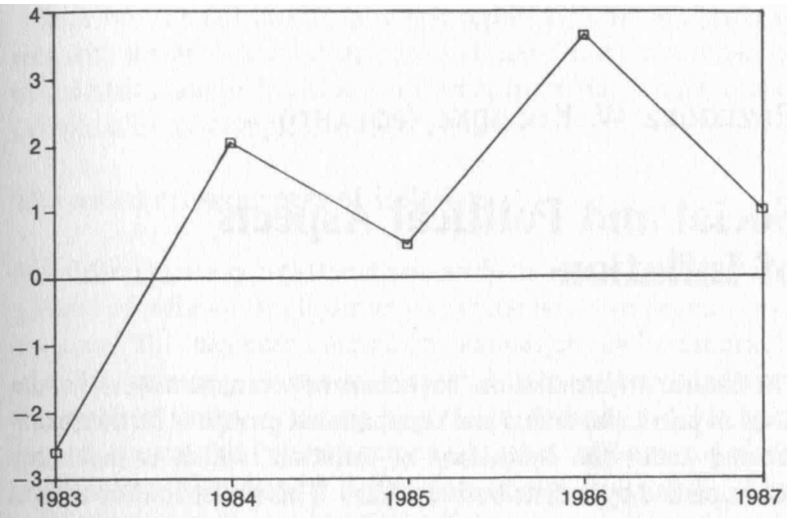

Figure 3a. National income—Yugoslavia (rate of growth in %).

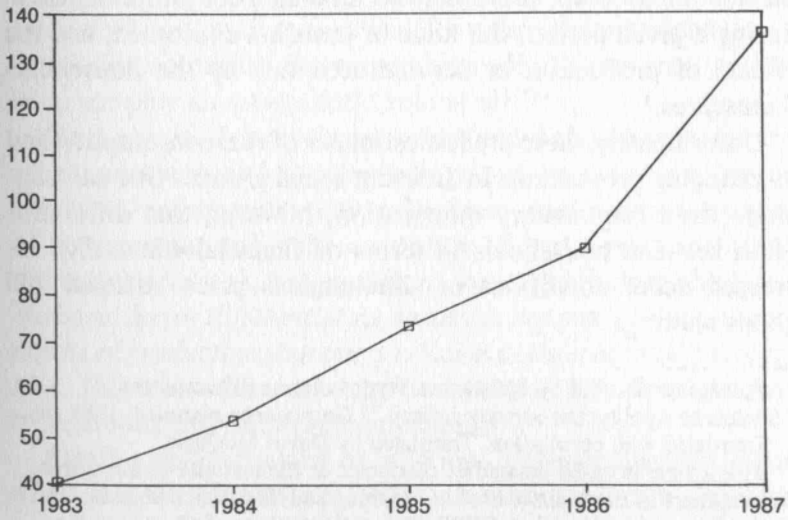

Figure 3b. Rate of inflation—Yugoslavia (in %).