

RADIO FREE EUROPE *Research*

EAST EUROPE

Economics/4

5 March 1968

"REFORMING" PRODUCER PRICES IN EAST EUROPE --

SEVERAL CASE STUDIES

Summary: The problems associated with the reform of producer prices and the harmonization of domestic with foreign prices in Hungary and Yugoslavia are wide ranging. They not only affect the immediate parties involved but also the sub-suppliers, the fiscal agency and even the foreign trade ministry. Attempts at partial harmonization bring with them charges of injustice. The remnants of past economic mismanagement set the stage for new drives for the adoption of protectionist institutions and special treatment which in part become equally undesirable substitutes for the old methods which the new economic reforms were to correct.

* * *

Anomalies, irregularities, contradictions and irrationalities became apparent in the new Hungarian producer price system soon after the reform of wholesale prices was introduced at the beginning of the year. Illustrative of the complexities in each case is the domestic iron ore price dispute reported by Radio Budapest on February 13 and the claims of "unfairness" attached to the domestic price for aluminum wire which were discussed in Magyar Nemzet of February 14.¹

Iron Ore Price Dispute

The iron ore price dispute involved the managers of Rudabanya Iron Ore Mine and the ore reduction plants at Diosgyor and the Ozd Metallurgical Plant. Under the new reform of producer prices

1) Erno Keseru, "Appeal of Foundry Workers," Magyar Nemzet, 14 February 1968, p. 1

in Hungary, the price of domestic iron ore is to be determined by the parties directly involved, the mining and processing enterprises. The determination of the price for domestic iron ore was to be "freely" decided.

The Rudabanya Iron Ore Mine is the only significant producer of domestic ore, employing about 1,500 workers. During 1966, the national consumption of iron ore was 3.4 million tons, of which 700,000 tons was produced domestically. Most of the imported ore came from the Soviet Union, approximately 95 per cent of total Hungarian imports in 1966.

Under the new factory price system, foreign produced iron ores are usually priced to the domestic user at the import price as adjusted with a foreign trade factor reflecting the total cost of all imports from the particular source of supply. The foreign trade factor for a particular country is determined by dividing the total domestic cost of the Hungarian exports to that country by the total valuta value of imports paid for with the Hungarian exports. In turn, this quotient or factor is generally applied to the valuta price of each import and the resulting product (i.e., valuta commodity price multiplied by the foreign trade factor) becomes the producer price to the domestic user. The Hungarian authorities reasoned that since the adjusted price of imported iron ore is relatively low, the price of domestically produced iron could be "freely" set by the iron ore mine enterprises and the processors of iron ore. According to the complaint of the iron ore mine managers, the price the processors are willing to pay for the domestic iron ore is below domestic production costs. An impasse was the result and the price dispute has been sent to the price authorities for settlement.

A number of alternate "solutions" are available to the price authorities. They may close the mine, either by phasing out production or by terminating the enterprise in one fell swoop. They may also provide subsidies temporarily, hoping that the production costs for domestic iron ore will improve in the long run. These subsidies may be obtained by raising the price of all iron ore consumed regardless of origin. The additional profits from the sale of imported ore could be utilized as subsidies for domestically produced ores. The price authorities can also apply the lower price of the imported iron ore to all regardless of source or cost. In this case, the subsidy to the domestic mines would have to be provided by funds from the governmental budget.

The choice of any of these solutions is fraught with many undesirable side effects. They are discussed below in conjunction

with the Yugoslav experience with lead and zinc prices. The immediate conclusion which can be drawn from the Hungarian domestic iron ore price dispute is that in determining prices one cannot ignore the price of "close substitutes" or "identical" alternatives, in this case the price of imported Soviet iron ore. In the case at hand, it was certain from the beginning that the buyer would prefer to select the cheaper imported alternative and be unwilling to pay the higher price for a similar domestically produced raw material.

Aluminum Wire Price Dispute

The second Hungarian case involves the pricing of two very similar products manufactured by different processes. The price of the qualitatively superior aluminum wire produced with the use of Western machines was set by the central authorities at a level below that of the inferior "pressed" wire type manufactured by conventional methods.

Ironically, the difficulty has arisen because the pricing authorities operated on the same assumption held by the producer of the superior product, namely that it is a better and hence a product different from the "pressed" type. By maintaining that the products are different, then the differential in costs becomes a basis for determining non-equal prices for similar products. The lower-cost but superior aluminum wire made by modern Western machines had a lower fixed price determined for it by the central price authorities. The higher-cost and qualitatively inferior "pressed" wire had a higher fixed price. This price inversion relative to quality was due to the fact that both prices were determined on a cost-plus-profit basis. The higher the cost the higher the price and profits.

The price anomaly results from following a policy which fixes prices primarily on the basis of costs, thereby emphasizing only the supply side and neglecting the price of "near substitutes." One curious omission in the discussion is found in the lack of any indication why buyers do not choose the superior and lower-priced commodity to the exclusion of the inferior pressed aluminum wire. Reference is only made to the lower profits for the superior product, which presumably precludes higher internal accumulation for investment and provide a false investment profitability index to those in control of central investment funds. Perhaps the allocation of raw aluminum is also centrally determined and this in turn would provide an additional reason for a lack of expansion in the production of the "superior" aluminum wire. Nor is there any indication from the discussion in Magyar Nemzet which would shed light on whether the old system of the assignment of suppliers of aluminum wire to specific consumers continues under the initial phase of the NEM.

The producer of the superior wire has appealed the fixed price, claiming unequal treatment which results in not only sacrificing the enterprise's interest but also society's.

Yugoslav Price Case Studies

Price reform in Yugoslavia has a longer history and provides some interesting insights into the difficulties faced when switching from a price system largely based on directive principles to one which emphasizes a more flexible price system within the guidelines of an established public price policy. These cases shed particular light on the difficulties encountered when internal prices are brought into closer harmony with world prices. The three examples chosen are: copper, pig iron, and lead and zinc, as cases which are of particular interest.

Yugoslav Copper Price Dispute

The dispute over the domestic price of electrolytic copper dates back to the introduction of the current phase of price reforms which began in July 1965. By the end of March 1966 the Business Association of Copper Producers and Manufacturers was able to obtain the approval of the Federal Economic Chamber for a change in the copper price from 10,800 to 12,000 new dinars per ton.² As part of the proposal it was agreed to allow an increase in the price of copper products only in proportion to the increased copper costs resulting from the electrolytic copper price change. It was not until June 1966 that the necessary approval of the Federal Institute for Prices was obtained.³

Copper delivered after 2 June was billed at the new price. It was estimated at the time that the price change would increase the total receipts for the Mining and Smelting Basin "Bor" by a little over 3.5 milliard [old] dinars by the end of the year." The new domestic price still fell short of the world price. "Bor" rightly felt that the prohibition against selling copper on the world market deprived "Bor" of potential earnings and in effect granted a windfall to the Yugoslav manufacturers utilizing domestically produced copper.

Meanwhile prices on the world copper market continued to rise and "Bor" asked for higher prices. The Business Association of

-
- 2) "12,000 New Dinars for a Ton of Electrolytic Copper?" Borba, 30 March 1966, p. 6.
 - 3) Dj. Vranjesevic, "Price of Copper Increases by 120,000 Old Dinars Per Ton," Borba, 11 June 1966, p. 7. Note: 120,000 old dinars equal 12,000 new dinars.

Copper Producers and Manufacturers was able to agree on a price and submitted a proposal for a 15,200 dinar per ton price.⁴ The Yugoslav Government had also adopted the new "Law on the Formation and Social Control of Prices," which established the new procedure for "defreezing" prices, effective 15 April 1967.⁵

World copper prices declined and at the beginning of April the Executive Committee of the copper business association revised its proposed price from 15,200 down to 13,500 new dinars.⁶ Except for "exceptional cases," the Federal Institute for Prices then refused to decide on proposals for price changes until the new law became effective on 15 April.

Increasingly it became clear that the procedure of filing for new domestic prices whenever world copper prices changed significantly was cumbersome and unsatisfactory to both parties, the copper producer and the manufacturer using copper. On 29 June 1967, the Executive Committee of the copper business association agreed on a new proposal which was more permanent and contained a provision for an automatic price adjustment in response to world price changes.⁷ This needed the approval of the proper authorities according to the procedures provided in the new price law which became effective 15 April 1967.

The plan called for the billing of domestic electrolytic copper each month at the average of prices officially quoted on the London market during the previous month. The new London market price would prevail for one month after which the new monthly average world market price would become effective. The parties proposed that the new system go into effect on October 12. Until then, the administratively determined price of 13,500 was to prevail. A number of differences still existed and the approval procedure still stood in the way of final adoption of the plan.

During the discussion it was evident that the manufacturers using copper wished to protect themselves against "excessive oscillation of prices" on the world market. They suggested that a lower price limit of 304 British pounds sterling⁸ and an upper limit of 380 be set. Should the average price exceed this limit then the processing and manufacturing enterprises would enter into consultations to decide the magnitude of the compensation, i.e., the transfer of extra profit or sharing of extra losses. Representatives of "Bor" would only agree if the provision were made retroactive, thereby assuring "Bor" compensation for

-
- 4) "New Copper Prices, Ekonomska Politika, 8 April 1967, p. 440.
 - 5) Sluzbeni List SFRJ, No. 12, Belgrade, 15 March 1967, pp. 278-282.
 - 6) Op. cit., Ekonomska Politika.
 - 7) "From October 12, Prices of Copper to Be Determined in Accordance with Monthly London Stock Exchange Quotation," Privredni Pregled, 30 June 1967, p. 1.
 - 8) Pre-devaluation.

past losses due to the previous deviations of domestic from world prices. The parties could not agree and the profit-loss sharing provision fell by the wayside.

Another provision of the proposal needed the approval of the government. The Executive Committee of the Association agreed to seek a revision of tariffs which would increase the protection of the manufacturers processing copper into commodities. The proposal asked that the current five to seven per cent tariff be raised to 10-15 percent, the specific customs rate depending on the type of product imported by Yugoslavia.

One other issue remained open, the question of what dollar rate of exchange should be applied to the world copper prices. By the end of September the parties agreed that the rate of 12.5 new dinars per dollar (or official rate) should be applied instead of the 12 dinar rate.⁹ The Association price plan first proposed at the end of June was still awaiting official approval three months later. At that time, September 1967, it was estimated that during the first nine months after the price reforms of July 1965 the "Bor" domestic copper prices were 8,410 new dinars per ton on the average, below the prices registered at the London Metals Exchange. From June 1966 to May 1967, the domestic prices on the average were 3,740 new dinars per ton below the world prices. During the period May to September "Bor's" "loss" was estimated at 700 to 800 new dinars per ton.

Anticipating the possibility of a further delay, "Bor" and the copper manufacturers agreed that if their proposal for the free setting of copper prices were not accepted, then for the next six months the domestic price should equal the average copper price on the London Market, using the 12.5 new dinar per dollar rate of exchange.

A secondary requirement which was particularly galling to the "Bor" enterprise was the official prohibition placed on "Bor" which prevented the export of copper, even that processed from foreign ores. During 1967, until the first of December, "Bor" was permitted to process some 13,000 tons of foreign raw material and could only collect a fee for refining the foreign ore.¹⁰ The refined copper had to be returned to the owner which then could be sold by the foreign owner for a profit either on the world market or to Yugoslav manufacturers using copper.

The December action by the Federal Secretariat for Foreign Trade permitted "Bor", for the first time since the war, to

9) T. Milinovic, "Bor Seeks World Copper Prices," Borba, 25 September 1967, p. 5.

10) R.C., "Export of Copper from Imported Raw Materials Approved," Politika, 1 December 1967, p. 9.

export and sell copper on the foreign market, but only that copper which was refined from imported raw materials or from copper tailings.¹¹ It is estimated that "Bor" will have an unused capacity available for processing about 16,000 tons of copper for the world market under the new provision.

This rather long account of the Yugoslav copper price dispute has been employed to illustrate the difficulties encountered in the attempt to adjust domestic prices to those prevailing on the world market. Of equal interest is the pig iron price dispute.

Yugoslav Pig Iron Price Dispute

The grey pig iron price dispute between the Yugoslav foundries and the metallurgical plants resulted from the price differential between the domestic and foreign supplies.¹² Unlike the copper case, here the domestic price was higher than the price for imported pig iron. The domestic price was 110 dinars per kilogram as against 70 dinars for imports.¹³ The domestic users of pig iron, the foundries, wanted to import larger quantities of the cheaper foreign produced pig iron. The Association of Steel Producers petitioned for a complete halt of imports. A third party, the Federal Secretariat for Foreign Trade, saw in the imports of pig iron an opportunity to reduce balances owed to Yugoslavia, particularly by East European countries, and wished to include grey pig iron in its commodity lists.

The steel producers' association offered to reduce the domestic price by 5.5 per cent and argued that unless a halt were made to imports, the domestic industry would suffer irreparable damage. Martin Jakuben of the Sisak Steel Works contended before the committee for Socio-Economic Relations of the Federal Assembly that its plant would have to shut down. The result would be that in the future about 200,000 tons would have to be imported at about 46 dollars a ton and the domestic capacities largely would remain idle. The Yugoslav steel producers provided a little over 200,000 tons in 1966 and the new Skoplje plant would provide another 50,000 tons of capacity. Stocks were about 80,000 tons. In spite of the pleading it was decided that 50,000 tons would be imported from East European countries in 1967. The foundries found the price reduction offer of 5.5 per cent unacceptable.

-
- 11) Ekonomska Politika, 16 December 1967, p. 1555.
 - 12) M. Boskovic, "'Case' of Grey Pig Iron," Privredni Pregled, 27 December 1966, p. 6.
 - 13) Radio Belgrade, 9 January 1966, 1500; also J. Brkic, "Businessmen on the Reform: Without Imports There Is No Cheaper Production," Borba, 10 January 1967, p. 5. He quotes Ranko Sotra of the IMT Works of Belgrade as saying the domestic price of steel purchased from the Ilijas Steel Mill to be between 105 and 110 dinars and that provided by the West and East as being between 70 and 72 dinars.

The opportunity for the next confrontation of the contending parties was provided at a regular press conference held in the Federal Economic Chamber on 9 January 1967.¹⁴ For two hours the protagonists of various views bombarded the press conference with their remarks. Slavko Vukovic of the Rakovica Steel Mill argued that the price differential represented three or four times the earnings for all workers of his factory. Only imports have helped to break up the domestic monopoly and without the purchases from abroad local suppliers would not have ever offered the five per cent price reduction. He rejected the claims of the metallurgical plants that dumping was involved by noting that the import prices hadn't changed for years. Jovan Stojanovic of the "Ivo Lola Ribar" Plant in Zeleznik suggested that the domestic suppliers of pig iron "reorient themselves" if they could not meet the foreign price which was 42 dinars cheaper.

In response to the many attacks by the various users of pig iron, Dusan Todic, a representative of the Council for the Metal Industry in the Federal Economic Chamber, made the following somber observation at the press conference:

The operation of the reform in 1967 has already yielded the first difficulties and the first commotions -- the first revolt against imports. But they all are only the first swallows.

On January 11 the parties to the violent discussions agreed in the Federal Economic Chamber to create a joint commission which would draw up a plan for long-term cooperation.¹⁵ The Borba reporter noted that the talks in the Chamber were beneficial because:

they unambiguously reject the illusion that it is possible to return to premiums, subsidies and the like, which means they have recognized the demands of the reforms as the basis for future cooperation.

As part of this future cooperation the joint commission was to help the parties to develop "mutual dependability and technological-economic links" throughout the various production phases of the interdependent industries.¹⁶

14) Op.cit., J. Brkic.

15) R.B., "After the Dispute Regarding Imports and Prices of Grey Pig Iron," Borba, 12 January 1967, p. 1.

16) "Announcement by Yugoslav Iron and Smelting Works," Politika, 13 January 1967, p. 5.

By April 1967 a conference of the Association of Yugoslav Steelworks refuted the conclusion that "domestic prices should correspond to the export prices of foreign producers, which, as a rule are lower than domestic prices of steel."¹⁷ The conflict between the producers of pig iron and the foundries continued.

Buyers of pig iron turned more toward foreign suppliers in the face of the non-competitive domestic price. For example, the Sisak Iron Works sold less pig iron in 1967 than in the previous years.¹⁸ Thus while in 1965 the 15 largest buyers bought 17,000 tons from Sisak this declined to 10,000 tons in 1966 and the same declining trend continued in 1967. In the end, Sisak had to retire its blast furnace from production in June 1967. Other Yugoslav pig iron producers were similarly affected because of the rising imports which reached 108,000 tons in 1966. Unsold reserves of domestically produced pig iron continued to climb even though some enterprises offered a price rebate of 12 per cent per ton.

To save itself Sisak offered to match import prices and was willing to sell at 850 new dinars per ton or as much as 150 new dinars less than the domestic price level before foreign imports of pig iron came on the Yugoslav market in large quantities. The Sisak Iron Metallurgical Works made proposals to a number of domestic firms, including "Djuro Pjakovic," "Prvomajska," and Belgrade's IMT on the basis of a long-term arrangement. Sisak was willing to make the lower price offer even if it would mean a significant reduction in its depreciation account. According to the September 20 Borba report Sisak felt that the loss of investment funds provides "a still more favorable and promising solution than the present situation."

The buyers responded to the 850 new dinar offer with a counter-proposal price of 800 new dinars per ton. Both parties agreed at the Republican Economic Chamber of Croatia that the differences were "practically reduced to the minimum." Sisak then turned to the business association of Yugoslav metallurgical enterprises to obtain their support and thereby save the domestic industry. Simultaneously, as part of the same program to save domestic producers of pig iron, the local producers were asking that the "question of the protection of domestic production be solved as soon as possible, this time, however, with import instruments which would directly affect economically the interests of domestic buyers."

17) A. Husaric, "Conference of the Association of Yugoslav Steelworks," Borba, 28 April 1967, p. 4.

18) A. Zibar, "Talks of Producers and Consumers of Pig Iron," Borba, 20 September 1967, p. 6.

The Yugoslav pig iron case is, in some ways, very similar to the Hungarian iron ore example. In both cases domestic prices were above the import prices. The Yugoslav example, however, indicates how the pressure of the external market forced the domestic producer to match more closely the import prices. This could occur only so long as the domestic buyers enjoyed an alternate source of supply in the foreign market.

Yugoslav Lead and Zinc Price Dispute

Perhaps it is the Yugoslav lead and zinc price dispute which reveals more fully the complexities surrounding the problem of a closer harmonization of domestic and import prices.¹⁹

The sale of lead and zinc operates under a two-price system in Yugoslavia. A lower price is charged for foreign buyers than is paid by the Yugoslav users of the two domestically produced metals. Following the price reform in the middle of 1965, domestic prices were adapted to world prices. The usual formula was followed, namely the London market price, less transportation cost from Yugoslavia, i.e., f.o.b. the Yugoslav border. The lead price was set at 3,240 new dinars per ton and zinc at 3,600 new dinars. At the time the price of lead was about 720 below the London price and zinc was 290 dinars less than the quoted London metal exchange price. Since then the domestic price has remained the same despite a significant drop in the prices of the two metals over the last two years. Hence the price conflict between the domestic buyers and producers.

Since about 60 per cent of these metals produced by Yugoslav enterprises is sold on the world market at prices which are below production costs, it appears that the profits made as a result of the higher domestic prices are being used to subsidize Yugoslav metal exports. An additional source of complaint by Yugoslav manufacturers employing these domestically produced metals as raw materials in production results from the fact that they are required to repay foreign credits or acquire foreign exchange in order to buy spare parts and other materials. This can be done by selling finished products containing domestic high-priced metals in the face of foreign competition made more formidable because the foreign competition enjoys lower-priced Yugoslav metals subsidized by their Yugoslav counterpart! To add insult to injury the Yugoslav exporters of the finished products incorporating these metals are subject to higher tariffs than are imposed on the raw metal exported by

19) "Market and Prices: Obstacles to Development of Lead and Zinc Production," Ekonomika Politika, 12-28 January 1968, p. 84.

Yugoslavia. This factor only widens the disadvantage experienced by the Yugoslav manufacturers.

The Yugoslav metal producers say they are willing to lower domestic prices but plead higher costs in self-defense. These higher costs are, to a significant extent, due to the unequal application of the principle of harmonizing domestic and foreign market price. Thus the lead and zinc industry pays about 20 per cent more for the ferrous metallurgical products utilized in production than if they bought them on the world market, 25 per cent more for explosives and flotation reagents, about 30 per cent more for coke, and 30 per cent more for equipment and spare parts, largely due to Yugoslav tariffs. The ban on purchases of foreign coke which was placed on the domestic producer in order to support domestic coal mining costs the largest lead and zinc producer, the "Trepca" mine, about four million dinars per year.

In support of their higher domestic prices, the lead and zinc producers point to similar situations found in a large number of countries. Thus in France the domestic price for lead is seven per cent higher than the London metal exchange price, it is four per cent higher in West Germany, 30 per cent more in Italy, 37 per cent larger in the US, 20 per cent more in Japan. Similar deviations of domestic from foreign prices also exist for zinc. Other protective measures are also paraded, such as the provisional import ban, import quotas and the like which are established to protect the domestic producer in other countries. All of this was related by the metal refiners in order to provide a basis for a plea for higher Yugoslav tariffs. The Yugoslav metal producer noted that the Yugoslav tariff on metals is only three per cent, whereas it is six to seven per cent for products manufactured from these metals.

What frightened the domestic producers to call the press in order to explain their woes was the fact that "not a single contract has been concluded so far with customers."

Some metal producers thought it would help if their business association created in the middle of 1967 were transformed into an "associated enterprise." But it was concluded that the members could not solve the problem alone and they presented two possible alternative plans.

The first plan calls for a full joining of the international market. This implies the removal of the protection for the domestic products which the metal producers must buy.

The second plan calls for an increase in the tariff on

imports. The funds from the customs tax would be used to bring the domestic price down into line with the domestic price paid by manufacturers of other countries. It was claimed that this new level of tariffs would only be necessary for a "short time," the time necessary for the Yugoslav enterprises to attain the latest know-how, thereby enabling them to match the world level of productivity.

Lessons from the Price Case Studies

A number of lessons can be learned from the Hungarian and Yugoslav cases used to illustrate the problems associated with the "reform" of producer prices.

It becomes quite clear that one of the major errors committed has been to change producer prices without regard to the level of prices for the near substitutes. With the abandonment of subsidies, which in themselves carried with them very undesirable consequences, and with the introduction of self-finance, the charging of different internal prices for the same or similar product depending on origin can be considered to be unjust and indefensible for this reason. Whenever domestic production costs are high relative to the price of imported goods then the question of closing down the domestic plant and the resulting unemployment becomes one of serious concern. Interests will be aroused in support of the continuance of production with financial support from the state thereby recreating a situation which the new reforms were to eliminate.

The multi-directional effects which are generated whenever harmonization of domestic and world prices is attempted become most difficult to deal with successfully because so many different interests are directly affected. The difficulties are intensified all the more whenever a partial harmonization is attempted. The Yugoslav pig iron and the lead and zinc producer price disputes are especially instructive on this problem. One need only recall how the desire of the Yugoslav pig iron producers to restrict imports. This request affected the plans of the Federal Secretariat of Foreign Trade which saw in the import of pig iron an opportunity to reduce the balances owed to Yugoslavia by East European countries. The lead and zinc price dispute illustrates how unfair it is to ask a domestic producer to meet world prices when it has to buy its own supplies from local sources at prices above world levels. This aspect of the case study illustrates the difficulties encountered in, if not the folly of attempting, a program of partial harmonization of domestic and foreign prices. The "domino effect" also applies to the reform of producer prices.

Finally it becomes clear from these studies how difficult

it is to convert a subsidized industry which pays little attention to the level of production costs and technological developments into one which becomes cost-conscious and not only is willing but also able to finance investments and to obtain the resources necessary to introduce changes which will enhance its competitive abilities vis-a-vis the enterprises in the world market. Until now, frequently the program followed by the enterprise which is threatened by outside competition under the new economic reform has been to seek the protection of various foreign trade restrictions, claiming that such measures need be only temporary.

The Yugoslav copper case indicates that it is wrong merely to introduce a domestic price which is harmonized with world prices at a given period of time. Dynamic market forces result in flexible world prices and the old problem of price divergencies reappears. The Yugoslav copper price proposal points to one way for narrowing this difficulty within manageable limits to the satisfaction of all concerned.

It seems most probable that throughout East Europe various interim solutions will be developed which will be makeshift to varying degrees. These particularistic approaches frequently will be in direct violation of one of the basic principles underlying the new economic reforms which call for the avoidance of administrative solutions applied to specific situations and for a greater reliance, instead, on general control methods.

Harry Trend