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ID	Doc Type	Document Description	No of Pages	Doc Date	Restrictions
168877	MEMO	N. BAILEY TO W. CLARK: SOVIET BLOC ECONOMIC AND FINANCIAL SITUATION UPDATE #21	4	5/7/1982	B1
168878	CABLE	RE USSR	2	4/28/1982	B1
168879	CABLE	RE USSR	2	5/4/1982	B1
168880	CABLE	RE USSR	2	4/29/1982	B1
168881	CABLE		2	4/30/1982	B1
168882	CABLE		2	5/4/1982	B1

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168884	CABLE		5	4/28/1982	B1
168885	CABLE	291110Z APR 82	2	4/29/1982	B1
168886	REPORT	RE USSR ***PAR 10/8/2010 CREST NLR-748-19-35-10-8***	1	5/3/1982	B1
168887	REPORT	RE SOVIETS (PP. 5-9 ONLY) ***PAR 10/8/2010 CREST*** NLR-***748-19-35-11-7***	5	ND	B1
168888	REPORT	RE USSR ***PAR 10/8/2010 CREST NLR-748-19-35-12-6***	1	5/5/1982	B1
168889	REPORT	INTERNATIONAL ECONOMIC AND ENERGY WEEKLY ***PAR 10/8/2010 CREST NLR-748-19-35-13-5***	2	4/30/1982	B1

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The White House

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Jacque Hill	3	J	
Judge Clark	4		I
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Staff Secretary			
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ID	*Document Type* *Document Description*	*No of pages*	*Doc Date*	*Restric-tions*
168877	MEMO N. BAILEY TO W. CLARK: SOVIET BLOC ECONOMIC AND FINANCIAL SITUATION UPDATE #21	4	5/7/1982	B1

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MW

MEMORANDUM 3263

168877

NATIONAL SECURITY COUNCIL

May 7, 1982

SECRET

INFORMATION

MEMORANDUM FOR WILLIAM P. CLARK

THROUGH: NORMAN A. BAILEY NB

FROM: ROGER W. ROBINSON RWR

SUBJECT: Soviet Bloc Economic and Financial Situation Update #21

25X1

Soviet Union

-- On April 23, a senior official of Eksportkhleb (the Soviet grain purchasing enterprise) informed a [redacted] that he had received instructions from the "Politburo level" not to make any purchases of U.S. grain until further notice with the objective of forcing the U.S. to the negotiating table for a new long-term agreement on grain sales (Tab A). (S)

-- The Soviets have engaged Wesserhulte Corporation of West Germany to install upgraded unloading facilities on the Black Sea on a crash basis for completion by October 1982. The facilities would reportedly increase Soviet unloading capabilities from 40 million metric tons to 55 million metric tons. The Soviets did not solicit bids on the contract or haggle over price (Tab B). (C)

-- In March, the Soviets already began to collateralize short-term loans with gold with a major Swiss bank. The bank buys the gold at prevailing market prices and agrees to sell it back to the Soviets, usually within 90 days, factoring in about 12% interest. The Soviets have also begun to approach small Italian banks for loans in the range of $5-20 million (Tab C). (S)

-- In late March, a new directive was issued to Moscow Narodny Bank, London (MNB) from the Bank for Foreign Trade Moscow (BFT) to provide detailed monthly reports on the bank's assets and liabilities. The purpose of the reports is to ascertain what assets MNB could sell off to provide Moscow

SECRET
Review May 5, 2012
Derivative Classification by CIA

SECRET

3

with enhanced liquidity. To assist this effort, MNB is attempting to gain eligibility from the Bank of England to offer discount-acceptance services and thereby attract additional funds from the acceptance market to finance Soviet trade bills (Tab D). (S)

-- The Soviet-owned Donau Bank, Vienna, Austria has established a bad debt loss provision for selected loans to Poland and a separate account for interest arrearages for Romania. Although no amount is available on Poland, the establishment of these accounts reflects Donau Bank doubt that their entire portfolio to Poland and Romania will ever be collected (Tab E). (S)

-- Since spring of 1981, the Soviets have sharply reduced (30,000 to 15,000 metric tons) speciality steel purchases from a Japanese consortium used in the manufacture of rotating machinery for industrial and military use due to shortages of hard currency (Tab F). (C)

25X1

-- The Soviets continue to be plagued by problems associated with their Northern Mining Operation at the Yakutsk mine in Neryungri, USSR. U.S. and Japanese mining executives have been brought in to tour the mine and offer suggestions (Tab G). (C)

-- In April, Deputy Minister of Foreign Trade Sushkov commented [redacted] that the Soviet people are becoming more demanding because of exposure to Western imports -- hence the need for enhanced product quality both domestically and for export. Minister Patolichev was partially paralyzed with a stroke and plays only a nominal role (Tab H). (S)

-- Despite improved unloading equipment, the Soviet grain import capacity does not exceed 48 million tons/year (Tab I). (S)

-- A CIA report concludes that during the 1980's the Soviets will be increasingly forced to choose between guns and butter (Tab J). (S)

-- The Soviets are forcing their Western banks to reduce lending to Eastern European countries in order to free up funds for themselves (Tab K). (S)

-- A CIA report concludes: "Even moderate declines in hard currency imports would greatly complicate Soviet economic problems and make allocation decisions more painful." "It is unlikely that Soviet military and foreign policy programs would go unscathed if sizable cuts in allocations of foreign exchange are imposed. The economy is so taut -- indeed, it is already rent with widespread shortages -- that the repercussions of any substantial cuts are bound to spread widely, even to military industries with all their traditional immunity. Even such programs as aid to Cuba or Third World countries would encounter greater opposition" (Tab L). (C)

Eastern Europe

-- A new feature of the Romanian commercial debt rescheduling is the effort to separate supplier credits from the bank rescheduling. The proposal calls for suppliers credits of under $500,000 to be repaid immediately with larger amounts rolled for one year. However, this will be a contentious issue, among several others that will cause the rescheduling to flounder. The IMF and banks are coordinating closely (Tab M). (C)

25X1

-- In an April 30 meeting, Polish banking officials advised [redacted] that Poland is completely unable to meet interest payments due in 1982. Although some West European governments may eventually split off to reschedule 1982, it is unlikely any commercial banks will reschedule separately at this time (Tab N). (S)

-- In addition to proposing the rescheduling of interest, the Poles will also request a longer maturity schedule, a longer grace period, an increase in reschedule principal from 95 to 100%, receipt of short-term credits and interbank deposits. If all this is achieved, they will still require $1.5-2 billion to meet payment obligations and an additional $5 billion to fuel the economy. Poland intends to default if conditions are not met (Tab O). (S)

-- Hungary's Central European International Bank (CEIB) (66% owned by five Western banks) has been unsuccessful in securing new U.S. bank credits. CEIB is attempting to further diversify its portfolio (60% to Eastern Bloc countries) in order to improve its creditworthiness (Tab P). (C)

25X1

[redacted]

5

25X1

[redacted]

cc: Don Gregg
Tom Reed
Richard Pipes
Paula Dobriansky
Henry Nau

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A

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168879	CABLE RE USSR	2	5/4/1982	B1

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168880	CABLE RE USSR	2	4/29/1982	B1

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168881	CABLE	2	4/30/1982	B1

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168882	CABLE	2	5/4/1982	B1

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168883	CABLE	2	5/6/1982	B1

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168885	CABLE 291110Z APR 82	2	4/29/1982	B1

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168886	REPORT RE USSR	1	5/3/1982	B1

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168886

USSR: Grain Import Capacity

The Soviets have improved unloading equipment at major ports and expanded use of minor ports, but a shortage of railcars, in particular, and other problems limit their capacity to import grain to about 48 million tons per year. (S NF)

During the last half of 1981, the Soviets imported almost 22 million tons of grain--an average of 3.6 million tons per month and a record for a six-month period. So far this year the Soviets have been importing an average of 3.8 million tons per month, and they will try to bring in some 4 million tons per month in the next two months. (S NF)

Early last year the Soviets installed large floating grain unloaders at several ports, and, more recently, they added smaller pneumatic equipment in some ports that helps unload grain during bad weather. The maximum rated capacity of the grain unloading equipment at the 17 major grain ports alone now stands at roughly 5 million tons per month. (S NF)

25X1

Comment: The Soviets' ability to move grain inland from the ports evidently has not kept pace with improvements in port equipment and has become the main constraint on grain imports. The shortage of railcars, inadequate storage, and inefficiencies at the ports probably are among the chief problems. Regardless of the rated capacity of the port equipment, the Soviets probably can import no more than about 4 million tons of grain per month. (S NF)

25X1 25X1

May 3, 1982

J

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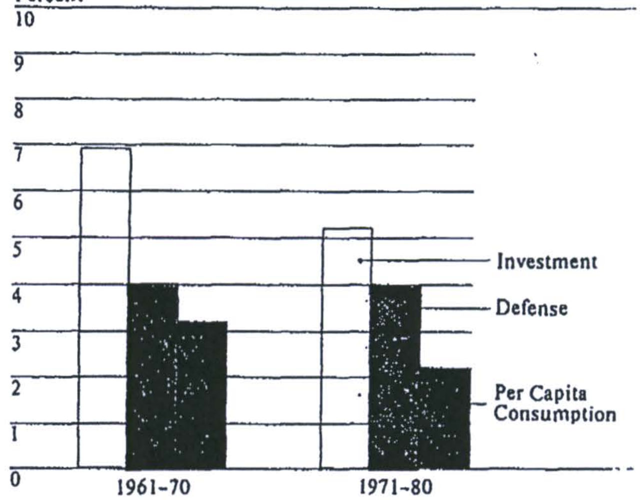
Guns and/or Butter in the 1980s (U)

Since the early 1960s, the Soviets have not had to choose between more guns or more butter. The rapidly expanding economy, fueled by large annual increases in labor, capital, and industrial raw materials, ensured enough resources for both (see figure 1). Although the economy has expanded more and more slowly over the last two decades, its growth has permitted Moscow to (1) amass an ever increasing arsenal of new weaponry, (2) provide the population with steady increases in living standards, and (3) stoke the economic furnace with rapidly growing quantities of investment goods. (U)

This is no longer the case. Soviet economic growth has fallen from nearly 4 percent per year during most of the 1970s to about 1 to 2 percent per year since 1978. Stagnation in the production of key industrial materials has crippled growth in machinery output—the source of military hardware, investment goods, and consumer durables. Oil production is virtually flat and the output of coal and steel is falling. Soft world oil prices and no growing demand for Soviet arms are limiting Moscow's hard currency earnings. Three consecutive poor grain harvests have disrupted the USSR's livestock program and worsened its hard currency payments position. And persistent food shortages and increased prices for luxury goods have left many Soviet consumers with less on their tables and less in their pockets. (S)

Figure 1
USSR: Average Annual Rates of Growth



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586367 4-82

The Economy in the 1980s

More important, we expect this trend to continue through much of the 1980s as the costs and difficulties of obtaining industrial raw materials and fuels rise and the increments to labor and capital fall. First of all, whether or not oil production falls, energy output is clearly going to increase more slowly and become more expensive. The entire increment in energy production must come from Siberia, where costs are high and infrastructure minimal. Thus, large new investment must be made in roads, rail lines, and pipelines—items with heavy up-front costs and long leadtimes. Shifting the fuel balance toward natural gas will require a large buildup of distribution and storage facilities (that is, more investment). Because only small annual increments in total investment are planned for 1981-85, energy exploitation and associated infrastructure will absorb an increasing share of investment resources. (U)

On top of the investment crunch, increments to the labor force—declining since 1977—will continue to decline until 1986 and will not regain present levels until after 1990. With growth in labor productivity nearly at a standstill, demand for labor—especially skilled workers—is likely to increase (figure 2). But most of the new entrants into the labor force will be from the Muslim areas of the USSR, where labor is

25X1

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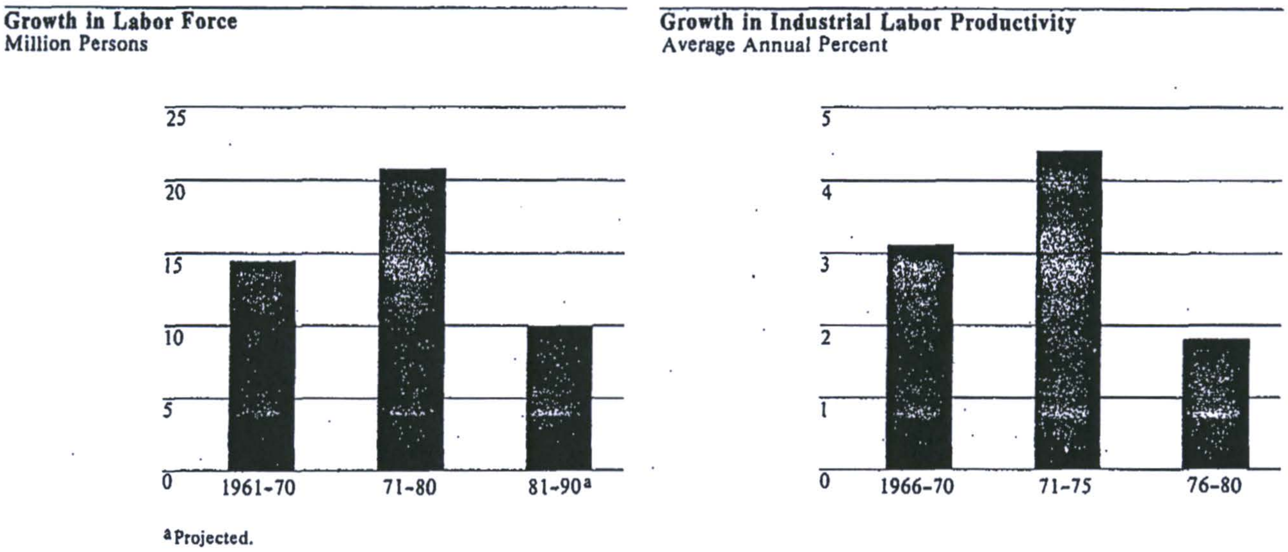
Figure 2
USSR: Growth in Labor Force and Industrial Labor Productivity



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586368 4-82

generally less skilled and less mobile. Thus, we expect industry will do well to achieve an average annual growth of about 2 to 3 percent. The outlook for agriculture is no better. A marked—but temporary—improvement in output is likely over the next year or two if the USSR gets a break in the weather. But we see no reason to believe that sustained increases in crop yields or livestock production will be forthcoming. On balance, we expect economic growth to be only 1 to 2 percent per year by the mid-1980s and to hover near the 1-percent level through the 12th FYP (1986-90). (U)

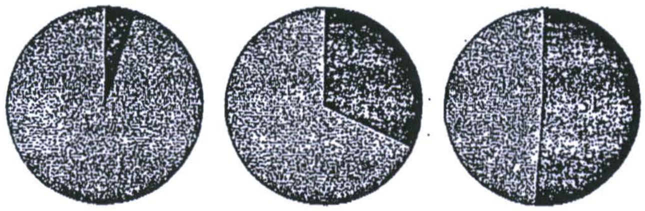
The Defense Bite in the 1980s

Under these conditions the competition for resources will be fierce—especially if defense spending is to continue increasing at its historic rate of about 4 percent per year. We estimate that defense will continue to grow at this rate through 1985 and that the defense share of GNP will be at least 15 percent by mid-decade. If these trends are not changed in the 12th FYP, the defense burden might approach 20 percent of GNP by the end of the decade. More important, the defense share of the annual increment to GNP could increase from the current level of one-fifth to as much as three-fourths by 1990. This would drastically reduce the ability of the Soviet leadership to allocate additional resources to investment and consumption, further eroding the annual growth dividend that is so important in balancing the competition for resources and stimulating productivity. (U)

Even though the Soviet leadership has acknowledged that defense impinges on the economy, programs now in train as well as investment in defense facilities through the late 1970s suggest that the Soviet Union had planned to at least maintain the historical 4-percent annual growth rate of defense spending. It is equally evident, however, that the USSR's 1981-85 plan fails to account properly for the economic difficulties the Soviets are facing and for the declining ability of the economy to offset slow labor growth

Figure 3
USSR: Energy's Share of the Investment Increment

Percent



[a] Planned.

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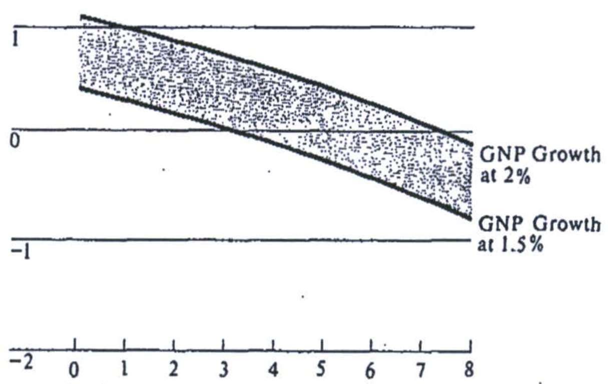
Figure 4
USSR: Defense-Consumption Growth Trade-Offs (Average Annual Growth Rate 1981-1990)



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with more capital investment. The opportunities for growth from substituting capital for labor will be limited by the continuing decline in capital productivity as well as by the need to sink most of the investment increment into capital-intensive projects (for example, energy and associated infrastructure) whose return is long deferred (see figure 3). All of this suggests that by mid-decade the Soviets will face a larger defense burden than they currently anticipate. (U)

Dynamic Defense Burden

The share of GNP devoted to defense spending in a given year can be called the *static burden* of defense as it represents a snapshot picture of the burden. In addition, defense spending also influences economic performance over time through its cumulative effect on economic variables. This cumulative effect is called the *dynamic burden* of defense spending. The most revealing measure of this burden for a country's population is the change in the average annual growth rate of per capita consumption associated with a change in the growth rate of defense spending. (U)

Figure 4 illustrates the trade-off between these two economic variables assuming that the economic trends described above result in an average GNP growth of 1.5 to 2 percent per year for the decade (with growth in the first half of the 1980s higher than in the last half). Under these conditions, continued growth in defense spending at its historic rate could well lead to declines in living standards. Per capita consumption probably would continue to grow marginally for the next few years, but by mid-decade would almost certainly be in decline.[1] (C)

Even at the high end of the GNP range (2 percent per year) the trade-off between per capita consumption and defense spending would not present a comforting picture to a leadership bent on maintaining the steady increases in defense that over the past two decades have moved the USSR into a position of strategic

[1] This judgment is reinforced by the possibility (discussed in the annex to this article) that the projections of GNP rest on productivity assumptions that may be too high in light of recent experience. (U)

parity with the United States. Growth in per capita consumption would average less than 1 percent annually—an imperceptible gain to the man in the street. In any case, the proclivity of the present set of Soviet leaders to continue the historic pace of defense spending may leave the new leadership, soon to arrive, with a legacy of problems carrying high political, social, and economic risks. (C)

Implications

The combination of current economic difficulties, the cumulative effect of defense spending on economic performance, and the desire to shift from an extensive to an intensive growth mode will increase the pressure for change in Soviet resource allocation decisions by mid-decade. A decision to slow the growth of defense in the 12th FYP (1986-90)—while risky politically for a new leadership, especially if international tensions are high—may be given greater currency in Moscow's deliberations, the more so if Soviet leaders perceive that a slowdown in defense spending would have little impact on the USSR's total military power. (U)

Because military programs require long leadtimes, many running 12 years or longer, a reduction in the rate of growth of defense spending is likely to have little impact on Soviet military capabilities during this decade. Soviet weapons that will be in the field through the 1980s will consist primarily of systems already in the forces as well as those now entering production and in the late stages of development. Decisions to scale back defense procurement—that is, to reduce the acquisition of military systems at the margin—are unlikely to have a major impact on the overall character of deployed forces until the 1990s. Finally, although a reduction in the rate of growth of defense spending in the mid-to-late 1980s could delay force improvements in some areas and pose difficult choices for Soviet defense planners, moderating the growth of spending for selected weapon systems could facilitate the allocation of additional resources to critical bottlenecks in the civilian economy. (U)

Annex: Estimating the Dynamic Burden of Defense

To estimate the dynamic burden of defense, an econometric-optimal control model of the Soviet economy called SOVCON has been developed. This annex sets forth some of the broad considerations behind its specification. (U)

Gross Output–Final Demand Linkage

Conventional macromodels of the Soviet economy frequently incorporate only a general consistency between production of goods and their final uses—consumption, investment, and defense. SOVCON emphasizes this linkage by incorporating the following input-output sectors:

- Energy
- Industrial Materials and Infrastructure
- Civilian Machinery
- Weapons Production and Repair
- Construction
- Consumer Goods and Services and Other.

These six sectors support the production of consumer goods, producer durables, and defense hardware and permit the model to account for generalized bottlenecks that may occur in the economy (for example, shortages of raw materials). The model also assumes that existing capital cannot be transferred between any of these sectors in the short run (that is, within one year). This assumption is particularly relevant to the civilian machinery and weapons production sectors because it is normally assumed in econometric models of the Soviet economy that capital is transferable from defense to civilian machinery production on demand. (U)

Allocation of Labor and Investment

Most macromodels assume that labor and investment are allocated to sectors of the economy based on historical trends or Soviet plan data. When a change in the end-use composition of GNP is specified, say between consumption and defense, the composition of the supporting gross outputs—energy, industrial materials, and so forth—and the allocation of labor and investment to the sectors will vary. However, to allocate labor and investment to the various sectors of the economy, some criterion is needed. SOVCON assumes that the objective of the planners is to increase consumption as much as possible given a specific rate of defense growth between 1980 and 1990 and a specified average annual growth rate for GNP. (U)

Soviet Production Relationships

The production functions in the model summarize the relationship between the growth of output and the growth of resource inputs in each sector. The results for 2-percent growth shown in figure 4 were based on a Cobb-Douglas production function that assumes that the growth of output per worker bears a fixed relation to the growth of capital per worker. This fixed proportion is a measure of the responsiveness of output with respect to capital. (U)

In the Soviet Union the responsiveness of output to infusions of new capital has been declining rapidly—a fact that complicates the estimation of Soviet production relationships and markedly biases the trade-off relationship obtained using Cobb-Douglas production functions. (U)

There also are production functions in which the capital-responsiveness of output is not a constant. For example, a nonlinear relationship between the growth of output per worker and the growth of capital per worker, called the Variable Elasticity of Substitution (VES) production function, "explains" the historical data since 1960 more satisfactorily than the Cobb-Douglas function. The resulting trade-off curve gives much more pessimistic results for per capita consumption than the Cobb-Douglas function. However, the use of the VES production function may fail to sufficiently credit the Soviets with an ability to arrest the decline in capital responsiveness in the late 1980s and may therefore result in a somewhat pessimistic forecast. Nonetheless, the limited availability of resources through the mid-1980s, together with the declining trend in capital and labor productivity, suggests that the outlook for per capita consumption may be somewhat worse than depicted in figure 4. (C)

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168888	REPORT RE USSR	1	5/5/1982	B1

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168888

USSR: Tougher Loan Policy

Moscow's urgent need for hard currency reportedly has led it to direct its banks in the West to reduce loans to other Communist countries. [redacted] 25X1

Moscow Narodny Bank in London in late March was asked to raise $260-320 million for the USSR. The chairman of the Soviet Foreign Trade Bank advised the bank to meet $160 million of this requirement by forcing the East Europeans to repay at least some of their loans as they come due. [redacted] 25X1

Yugoslavia and Czechoslovakia reportedly would have to pay off all their loans coming due, while Hungary would be required to pay half of its maturities. Bulgaria, East Germany, and Cuba would have only one-fourth of their maturing principals called in. [redacted] 25X1

Comment: This is the strongest sign to date that Moscow is trying to alleviate its hard currency problems by diverting funds from its allies. The Soviets already have reduced oil deliveries at subsidized prices to some East European countries. [redacted] 25X1

The cutbacks in loans will aggravate the East Europeans' search for hard currency credits. Although the loans proposed for recall by the London bank represent only 1 to 2 percent of the financing requirements of the East European countries affected, probable actions by the six other Soviet banks abroad would multiply the impact. [redacted] *-CIA, INR, NSA-* 25X1

[redacted] 25X1

5 May 1982

[redacted] 25X1

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168889	REPORT INTERNATIONAL ECONOMIC AND ENERGY WEEKLY	2	4/30/1982	B1

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International Economic & Energy Weekly (U)

30 April 1982

Perspective

Darkening Soviet Hard Currency Outlook *(U)*

Moscow's options in dealing with a continuing economic slowdown will narrow in the next several years because of the USSR's limited prospects for generating hard currency for vital imports. Although the overall weight of hard currency imports in the economy is small, these goods play an important role in raising energy production, sustaining technology and productivity, and making up for unexpected shortfalls of key products, particularly food. Shortages of hard currency will make even more difficult the decisions Soviet leaders must make among key priorities—sustaining growth in military programs, feeding the population, modernizing the civilian economy, and supporting its overseas clientele.

While the Soviet need for Western goods and technology is rising, Moscow's hard currency earnings are likely to decline:

- Not only will the volume of oil exports gradually fall, but soft oil markets may well keep real oil prices from increasing for several years.
- Gas exports will grow substantially if the pipeline to Western Europe is built, but not enough to offset the drop in oil exports. Furthermore, gas prices also are being held down by the weak oil market.
- Hard currency earnings from arms sales are unlikely to increase much, because LDC clients will be less able to pay.
- Many other exports suffer from production problems or an inability to compete on a large scale in Western markets.

Bleak prospects for hard currency earnings means that any attempt to achieve a substantial increase in imports would quickly push up hard currency debt. Indeed, just to maintain the current level of imports would require a doubling of Soviet debt by 1985 and a quadrupling by 1990. The debt service ratio would nearly double, approaching 30 percent by 1985—a level high enough to cause concern in financial circles.

A decision by Western governments to restrict the volume and harden the terms on government-guaranteed credits would place the Soviets under substantial pressure. A leveling off of new Western lending would result in stagnation or even a decline in import volume during 1982-90. The effects would be even greater if, as is likely, reductions in government-guaranteed credits are accompanied by sharply curtailed private lending.

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Even moderate declines in hard currency imports would greatly complicate Soviet economic problems and make allocation decisions more painful. Large agricultural imports are essential to the growth of meat consumption even in normal crop years. Expansion of gas consumption and exports requires massive purchases of Western equipment. Large imports of metals and chemicals are an integral part of Soviet economic plans. Orders of Western machinery and equipment have already been sharply curtailed; further cuts would certainly impinge on priority programs in steel, transportation, agriculture, and heavy machine building. Moscow's import priorities will be even harder to establish if the issues become politicized during succession maneuvering.

It is unlikely that Soviet military and foreign policy programs would go unscathed if sizable cuts in allocations of foreign exchange are imposed. The economy is so taut—indeed, it is already rent with widespread shortages—that the repercussions of any substantial cuts are bound to spread widely, even to military industries with all their traditional immunity. Even such programs as aid to Cuba or Third World countries would encounter greater opposition.

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