Secret

National
Foreign
Assessment
Center

F.6

USSR: Economic Issues Facing the Leadership

An Intelligence Assessment

Secret

ER 81-10009
January 1981

Copy 028

Page Denied

Approved For Release 2007/04/20 : CIA-RDP83B00140R000100020026-5

National
Foreign
Assessment
Center

Secret

USSR: Economic Issues Facing the Leadership [redacted]

25X1

An Intelligence Assessment

Research for this report was completed on 2 January 1981.

The author of this paper is [redacted] Soviet Economy Branch, Office of Economic Research. It was coordinated with the Office of Political Analysis, the Office of Strategic Research, and the National Intelligence Officer for the USSR. Queries may be directed to the Chief, Soviet Economy Branch, OER, [redacted]

25X1

25X1

Secret
ER 81-10009
January 1981

USSR: Economic Issues Facing the Leadership [redacted] 25

Key Judgments

As the Soviet Union begins its 11th Five-Year Plan (FYP), economic prospects are gloomier and policy choices more difficult than at any time since Stalin's death. Shortfalls in industrial production and back-to-back harvest failures have reduced the growth in gross national product (GNP) during the past two years to its lowest rate since World War II and have left the leadership looking for ways to alleviate economic pressures at home without weakening political control or generating unrest in Eastern Europe. [redacted] 25

Moscow's basic problem is that the formula for growth used over the past 25 years—maximum inputs of labor and investment—no longer works. During the past few years, the USSR has experienced:

- A sharp slowdown in oil production growth and a decline in coal production.
- A major rise in energy costs.
- A fall-off in investment and labor-force growth.

In addition to these problems, and partly because of them, labor productivity growth has slowed sharply and chances for a turnaround are bleak. How to raise productivity is the key economic challenge facing Soviet leaders during the 11th FYP. [redacted] 25X1

Because Soviet problems cannot be easily overcome, and will get progressively worse as the decade passes, President Brezhnev and his colleagues must make some tough choices regarding resource allocation. Their problem is that annual increments to national output in the early 1980s will be too small to permit:

- The increases in investment in industry, agriculture, and transportation needed to revive the economy in the latter part of the decade.
- Continued growth in defense spending at the rates of the past (4 to 5 percent per year on average since 1965).
- Greater support to Eastern Europe.
- Any substantial increase in consumer welfare.

Simply stated, something will have to give. [redacted] 25

Moscow apparently has decided to pay the price of higher military spending. Despite the heavy defense burden and the problems facing the economy, there is no evidence to indicate a basic shift in priorities or a reallocation in resources to benefit the consumer. All indicators of future defense spending, [redacted] suggest a continued momentum well into the 1980s. At the same time, the planned growth 25 rate for investment—2.6 percent annually during 1981-85—is lower than that achieved in any previous five-year period. Although only a few specific details are available, the leadership has indicated that investment will probably again be concentrated in heavy industry, particularly the energy-related sectors. 25

With defense claiming a larger share of GNP and investment allocations favoring energy and heavy industry, little, if any, growth is likely to occur in consumer-related programs. The food situation will be especially bad, with severe shortages of meat expected throughout the country. Although the turbulence in Poland is unlikely to be repeated in the USSR, consumer frustration will rise and worker morale and productivity could drop sharply, further jeopardizing Moscow's efforts to maintain even low rates of economic growth. 25

Because of its domestic economic problems, the Soviet Union for the past few years has been attempting to improve its terms of trade vis-a-vis Eastern Europe and thus to reduce its substantial subsidization of these countries. The events in Poland, however, have caused Soviet leaders to provide additional economic support. During 1980 the Soviets extended about $2.3 billion in assistance to Warsaw, most of it since the strikes in Poland last August. Although Moscow is currently in a strong financial position to provide increased hard currency support, Poland's long-term hard currency financing needs probably exceed Moscow's capabilities. 25

In contrast to Eastern Europe, Moscow wishes to expand its trade links with the West, including the United States. Despite public statements to the contrary, Moscow needs, more than ever, access to Western technology, equipment, and grain. Nevertheless, the Soviets are quite willing to sacrifice the benefits from US trade for what they perceive as overriding political or military goals. Indeed, they remain sanguine that they can elicit trade agreements from Western Europe even in the face of US opposition. 25

Contents

USSR: Economic Issues Facing the Leadership [redacted] 25

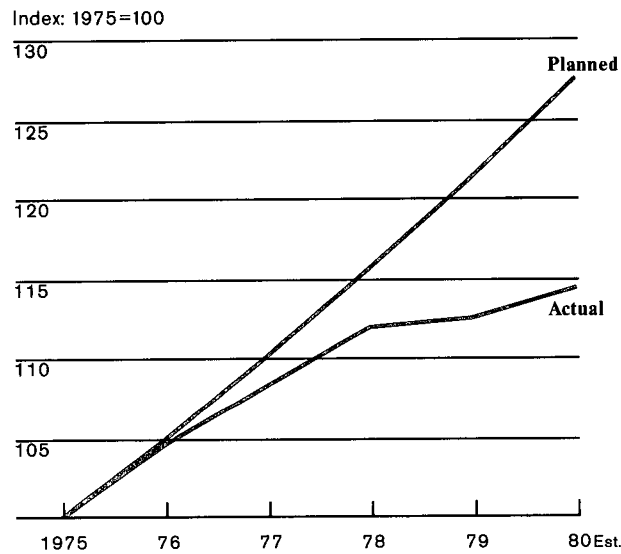
Introduction

The Soviet economy is in trouble. Shortfalls in industrial production and back-to-back harvest failures have brought the economy to near stagnation and have driven home to the leadership the fact that rising resource costs, impending energy and labor shortages, and sluggish labor productivity cannot be overcome easily or quickly. This paper reviews the USSR's economic situation and discusses its impact—present and future—on Soviet resource allocation policy and relations with Eastern Europe. It also reviews the options Soviet leaders have for coping with their problems. Finally, it touches on the effect a new leadership might have on Soviet economic policy. [redacted] 25

The Economy's Recent Performance

Trends in GNP. As Soviet leaders embark on their 11th FYP (1981-85), they confront an economy that has performed increasingly poorly in recent years. The GNP growth rate has declined steadily since 1976 and was only about one-half of the rate planned during 1976-80 (see figure 1). [redacted] 25

Figure 1
USSR: Planned Versus Actual Increase in GNP



[redacted] 25

583453 1-81

The economy's performance over the past two years has been especially poor. The average annual GNP growth rate of 1.1 percent in 1979-80 was the lowest for any two-year period since World War II. Farm output declined sharply during the period, primarily as a result of two major grain crop failures, while growth in almost every major sector of the economy fell considerably below that of previous years (see table 1). [redacted]

Agriculture: A Major Catastrophe. Agriculture has been Moscow's biggest economic headache. Consecutive harvest failures in 1979 and 1980—unprecedented in recent Soviet history—have left the agricultural sector in disarray and dashed any hopes Soviet consumers may have had for improving the quality of the diet in the near future. The 1980 grain harvest of 185 million metric tons—together with declines in production of most other crops—caused farm output to drop 6 percent. [redacted]

The poor harvests, coupled with the US grain embargo, have put the Soviet livestock program in serious jeopardy. Because of the sanctions, Soviet grain purchases from the United States were reduced 17 million tons during the 1979/80 long-term grain agreement year (1 October 1979–30 September 1980). Moscow was able to make up only half of this deficit from other sources. Moreover, since grain stocks are lower this year than last, the Soviets do not have much of a cushion to draw on. As a result, the USSR will be forced to reduce livestock herds. [redacted] 25

Soviet consumers, already facing widespread shortages of meat and other quality foods in the wake of the poor 1979 harvest, will be even more hard pressed by the 1980 crop failure. While distress slaughtering may 25

Table 1 Percent

USSR: Average Annual Rate of Economic Growth

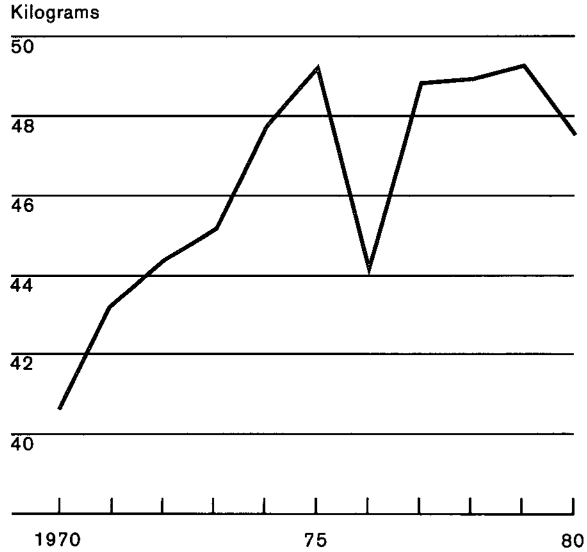
	1970-74	1975-76	1977-78	1979-80
GNP	4.9	3.2	3.5	1.1
Agricultural production	3.8	−0.5	4.0	−5.4
Industrial production	6.1	5.0	3.9	2.6

increase meat supplies this winter, less meat will be available later on and future recovery will be seriously delayed. Following a more than 3-percent decline in 1980, per capita meat consumption could therefore drop substantially again in 1981 (figure 2). Moreover, large shortfalls in the 1980 potato, sugar beet, and sunflower harvests will require extra hard currency outlays to offset domestic deficits. [redacted]

The deteriorating food situation represents a major setback in the regime's efforts to boost living standards. At present, per capita consumption in the USSR is less than one-third of that in the United States. Although the gap narrowed somewhat in the 1960s, it has widened during the 1970s as Soviet growth trailed off. In terms of per capita meat consumption, the Soviets still lag behind their East European allies—a contrast of which they are keenly aware (see figure 3). [redacted]

Industry Stagnates. Although Soviet farm problems and their impact on the consumer have grabbed most of the headlines, industry, the traditional growth leader, also has been doing poorly. Faltering under the strains of transportation snarls, inadequate supplies of raw materials, and sluggish labor productivity, Soviet industrial growth continued its downward slide. The annual rate of 2.6 percent in 1979-80 was the lowest since World War II. Shortfalls in the production of key industrial commodities—especially steel, oil, coal, construction materials, and chemicals—contributed to an abrupt slowdown in the production of investment goods and halted growth in construction activity. Although production shortfalls are common in the Soviet economy, the stringencies during the past two years have been unusually severe and reflect problems that have become mutually reinforcing. [redacted]

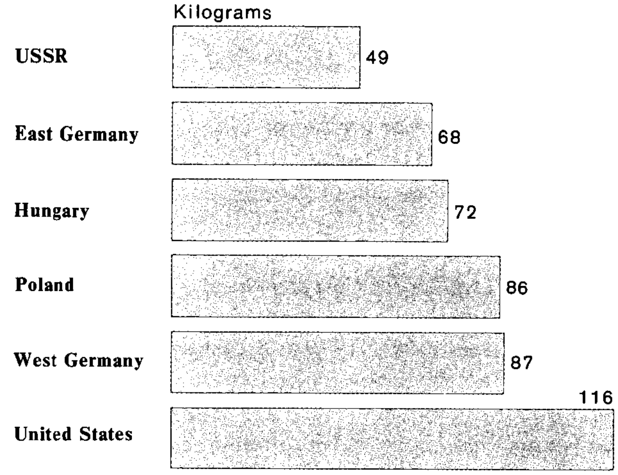
Figure 2
USSR: Per Capita Meat Consumption



[redacted]

583454 1-81

Figure 3
USSR: Per Capita Meat Consumption Comparison,[a] 1978



[a] Including all meats and edible offals on a comparable basis.

[redacted]

583455 1-81

Economic Prospects

While the economy's recent poor performance is attributable, in part, to unfavorable weather in agriculture, the severity and wide-ranging nature of the slowdown reflect more fundamental problems. During the past few years, oil output growth has slowed sharply and coal production has dropped; raw material costs have climbed; and investment and labor force growth have declined. In addition to these problems, and partly because of them, the growth of labor productivity has declined substantially and prospects for a turnaround are bleak. Because these problems cannot be easily overcome—and in fact will get progressively worse in the coming decade—economic growth will slow through much of the 1980s. [redacted] 25

Energy Problems. Growth of Soviet energy production is expected to continue to slow, from about 5 percent during the early 1970s to perhaps 1.5 to 2.0 percent in the 1980s, even with much larger investment in this sector (see figure 4). [redacted] 25

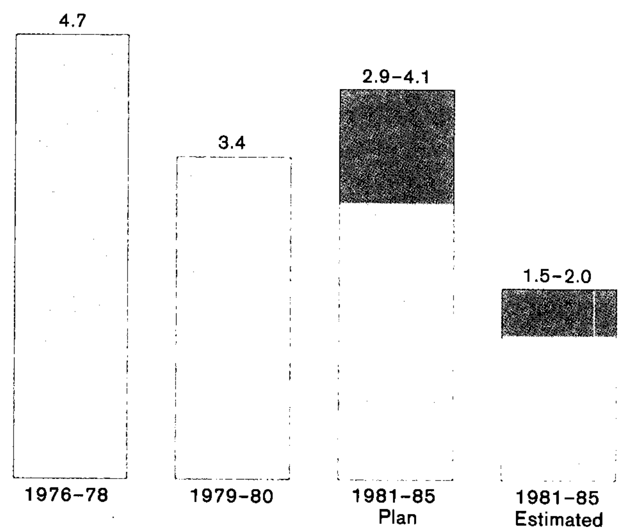
Oil production should begin to decline within the next one to three years. The Soviets have been able to hold up production so far by pursuing an all-out drilling program in West Siberia, but this strategy cannot be successful for long because of the rapid depletion of easily accessible high-flow reserves. Coal production, too, is on a plateau, and the chances of a major boost in output are slim. In fact, the recently announced 1985 target of 770-800 million tons is below that originally planned for 1980. [redacted]

Increases in nuclear power production can have only a small impact on the Soviet energy balance in the 1980s. Although Soviet planners regard nuclear power as the most promising future source of growth in electricity production, the nuclear power program is lagging badly. Output of nuclear-generated electricity in 1980 was about 68 billion kilowatt hours and accounted for about 1 percent of primary energy output. Even if the Soviets meet their ambitious production goals, nuclear power will comprise less than 4 percent of all energy produced by 1985. [redacted]

Increases in energy production in the 1980s must come mainly from natural gas. Gas output is scheduled to grow about 7 to 8 percent a year during 1981-85. Although Soviet gas reserves are ample, their distant location makes exploitation difficult and extremely costly, making achievement of this goal problematic. Gas pipeline construction, which uses a great deal of Western pipe and other equipment, is required on a massive scale and probably cannot be expanded beyond present plans. [redacted] 25X

Figure 4
USSR: Primary Energy Production

Average Annual Percent Change



[redacted] 25

583456 1-81

Energy conservation, moreover, will be very difficult. Most energy is consumed in heavy industry; households use little energy and energy use in transportation is already quite efficient. The USSR has had a high-priority energy conservation policy for the last three years that relies mainly on central directives and exhortations, but energy consumption has continued to increase more rapidly than economic activity. [redacted] 25X1

Labor Stringencies. The natural increase in the working-age population will decline from about 2 million persons annually in the 1970s to only about 400,000 per year by the mid-1980s. Moreover, from now until the late 1980s, increments to the labor force will come almost exclusively from the less-skilled and less-mobile Turkic population of Central Asia and the Transcaucus republics. [redacted] 25

Forced migration of labor from the Turkic republics of Central Asia to the labor-short areas of Siberia and the western USSR is not a practical option for Soviet planners charged with ensuring an adequate regional distribution of labor (figure 5). For a number of reasons, the Turkic population is probably unwilling to move in sufficient numbers, and the "host" Slavic population would not welcome such migration. First, the orientation of these people toward irrigation agriculture, warm climates, and large families makes it unlikely that they could adapt readily to the living conditions and vocational demands in either the European or Siberian regions of the country. Second, housing accommodations for immigrants are badly lacking—particularly in Siberia but also in the western USSR. Finally, differences in language, culture, and education would be an impediment to migration.

Industrial Bottlenecks. Shortages of several key industrial commodities will probably become more severe during the early 1980s. Lagging steel production, in particular, threatens to disrupt planned increases in machinery production. Although raw material shortages have hampered steel production, inadequate investment in almost all sectors of the industry from iron ore mining to rolling and finishing steel products has been the main reason for the industry's deteriorating performance in recent years. As a result, construction of new steelmaking capacity has lagged badly, and most of the potential for squeezing additional output from existing facilities has already been tapped.

The transportation sector—also a victim of inadequate investment and woeful management—is becoming increasingly strained. Delays in the delivery of key industrial commodities have become commonplace. The situation probably will get worse as raw materials are transported over much longer distances.

In short, what has developed here is an economy in growing disequilibrium, where problems in one sector degrade the performance in another. Since these imbalances did not spring up over night—and in large measure reflect past mistakes in allocating investment resources—they cannot be overcome quickly.

Growth Prospects. The impact of these assorted problems on Soviet economic growth cannot be softened unless Moscow is successful in using labor, capital goods, and natural resources more efficiently than in the past. Soviet development differs from that of other industrial nations in that the USSR has not relied on increased labor productivity for a major share of its economic growth. Now, however, this policy of growth based on abundant resources must give way to one of growth based largely on technological progress. Boosting productivity is Moscow's one hope for maintaining economic growth in the 1980s. 25X1

Growth in labor productivity, however, has been declining for some time. In industry, for example, growth in labor productivity, which averaged 4.5 percent annually during 1971-75, fell to only 1.9 percent during 1976-80. The chances of reversing this trend are slim. Soviet efforts to increase worker incentives—and with it labor productivity—will be stymied by slower growth in living standards. At the same time, construction bottlenecks and shortfalls in the production of key industrial commodities will frustrate Soviet attempts to bring new capacity on stream. Widespread introduction of new, more technically advanced equipment is essential if Moscow is to raise labor productivity, but this cannot be done quickly, given Soviet technological lags, leadtimes, and competing demands.

Because the prospects for an upsurge in labor productivity are dim, we expect growth in GNP to continue at low levels in the early 1980s—averaging about 2 to 3 percent annually for the next few years and then dropping below 2.0 percent in the mid-1980s as the manpower situation becomes worse.

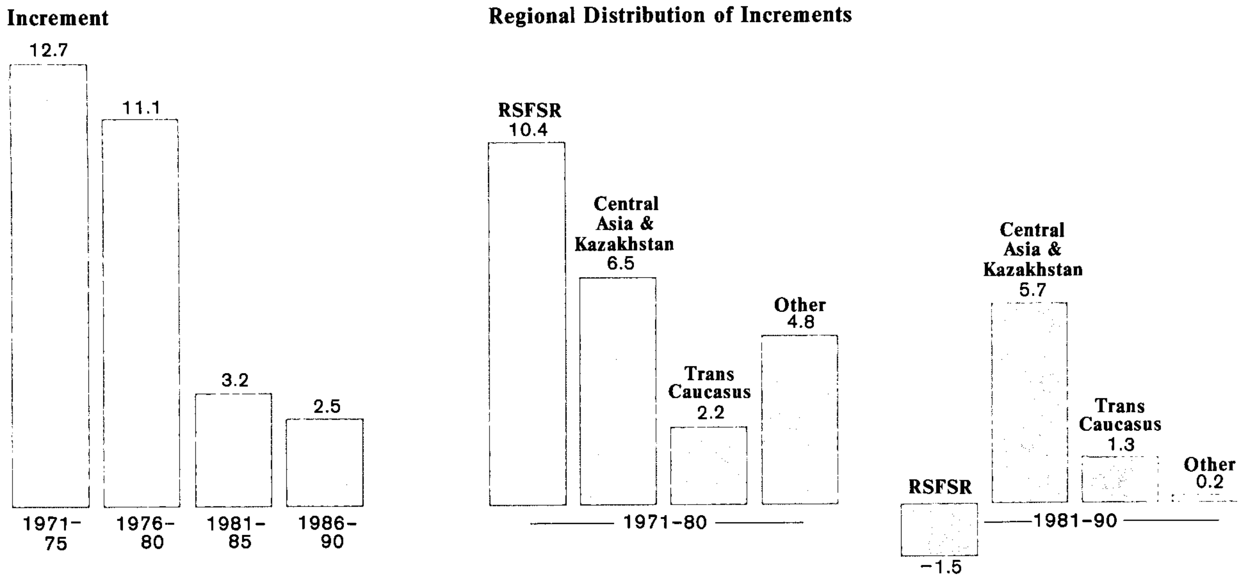
Impact of Economic Problems on Resource Allocation

President Brezhnev and his colleagues must make some tough choices regarding resource allocation. Their problem is that annual increments to national output in the early 1980s will be too small to permit:

- The increases in investment in industry, agriculture, and transportation needed to revive the economy in the latter part of the decade.
- Continued growth in defense spending at the rates of the past (4 to 5 percent per year on average since 1965).
- Greater support to Eastern Europe.
- Any substantial increase in consumer welfare.

Simply stated, something will have to give.

Figure 5
USSR: Working Age Population
Million Persons



[redacted] 25

583457 1-81

Defense Remains Paramount. President Brezhnev and other top officials have frequently alluded to the weight of the arms burden on the economy. Still, there is no evidence of a shift in priorities or a reallocation in resources to benefit the consumer or increase investment. Soviet leaders in all their public speeches have indicated that defense remains paramount. They view the international situation as particularly uncertain and are concerned about projected Western strategic programs, a substantial modernization of NATO forces (especially theater nuclear forces), and the possibility of military cooperation between China and the West. [redacted]

[redacted]

[redacted] 25

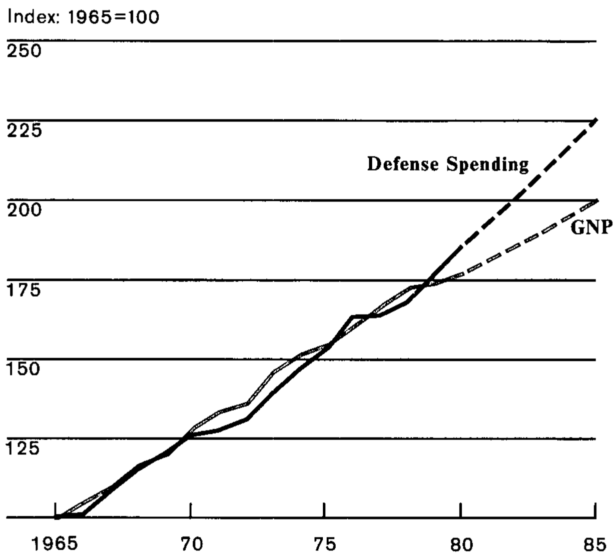
On balance, overall defense outlays should continue to rise at a rate of 4 to 5 percent annually through the early 1980s—adding further to the defense burden. Between 1965 and 1978, Soviet defense spending accounted for a relatively constant share of GNP—11 to 13 percent—because defense spending and the economy were growing at about the same rate. With overall growth slowing, the defense share of Soviet GNP could rise to about 15 percent by 1985. More significantly, by 1985 the *increase* in defense spending could absorb one-third of the *increment* in GNP, so that fewer new resources would be available for the civilian economy (figure 6). [redacted]

25

25

25

Figure 6
Growth in Soviet Defense Spending and GNP



[redacted]

583458 1-81

This continuing priority to defense spending at a time when the economy is faltering may appear paradoxical. Actually, the current leadership ever since its rise to power in the mid-1960s has emphasized the expansion and modernization of its armed forces. Soviet leaders appear to believe that the political utility of a strong military has already been demonstrated by the prestige gained in acquiring strategic parity with the United States and by the USSR's ability to carry out aggressive policies in Angola, Somalia, Yemen, and Afghanistan [redacted]

Squeeze on Investment. Because Soviet defense will retain its priority in the near term, the bind on investment programs will become increasingly tight. The recently released directives for the 1981-85 Five-Year Plan indicate that investment is scheduled to grow at 2.6 percent annually—lower than that achieved in any five-year period. While few details are available, the leadership has indicated that investment again will be concentrated in energy extraction and industry. Moscow already has announced an ambitious list of energy development programs. Total development drilling for oil and gas in the whole country, for example, is scheduled to double in the 11th FYP compared to the 10th. In addition, exploratory drilling is to be expanded in West Siberia from less than 4 million meters in 1976-80 to 12.5 million meters in 1981-85. [redacted] 25

The machinery sector will also absorb a large share of investment allocations. New fixed investment, particularly the replacement of obsolete machinery and equipment with advanced models, is the most expedient way of assimilating improved technology. Brezhnev last year emphasized the priority machine building would be given in the new FYP when he declared that "We consider the accelerated development of the machine-building industry the most important prerequisite for technical progress in the entire economy." [redacted] 25

Consumer Outlook. With defense claiming a larger share of GNP and with investment skewed more heavily to heavy industry, little, if any, growth is likely to occur in consumer-related programs. The food situation will be especially bad as the supply of livestock products fails to keep up with rising money incomes. As a result, consumer perceptions of stagnation in living standards will be reinforced. [redacted] 25

Consumer patience is likely to shrink along with food supplies. The Soviet population is more preoccupied with food shortages than with any other domestic problem. Recently, foreign newsmen conducted film interviews in Moscow foodstores and homes. Randomly selected people complained about the food supplies and were not afraid to identify themselves [redacted] 25X1

[redacted] 25

Moscow thus faces a conundrum. It is relying on increases in efficiency and productivity throughout the economy to ultimately raise consumer welfare. This strategy will not work, however, without a better motivated work force. Unless the leadership provides large increases in quality foods and goods now for a populace less willing to defer material satisfactions to the future, hoped-for improvements in productivity will be hard to realize. [redacted] 25

Economic Relations With Eastern Europe: Walking a Tightrope. The USSR has been trying for several years to improve its terms of trade vis-a-vis Eastern Europe and thus reduce its substantial subsidization of these countries.[1] The USSR has also indicated its intent to limit exports to Eastern Europe of energy and some other raw materials to roughly 1980 levels in 1981-85. The Polish situation, however, could impel the USSR to adopt a less stringent policy. [redacted]

The Soviet Union extended considerable economic aid to Warsaw in 1980—$2.3 billion—most of it since August to help sustain the Kania regime. About half this amount was in hard currency credits. Moscow is currently in a strong position to provide Poland with increased hard currency credits. The USSR's trade and payment situation is the brightest spot in the Soviet economy right now; high oil prices have put the USSR in its strongest financial position in years. Moscow's hard currency exports totaled a record $20 billion in 1979—about half of which came from oil sales of 1 million barrels per day (b/d). The boom in commercial exports, coupled with higher revenues from gold and arms sales, allowed the Soviets to earn a hefty $4 billion current account surplus in 1979. Despite the need to import a record amount of grain, the surplus could total another $1-1.5 billion in 1980 [redacted]

The long-term hard currency financing that Poland requires, however, is probably beyond Moscow's capabilities—even if it were willing to provide such aid.[2] Exports of oil to the West—Moscow's major hard currency earner—will fall within the next few years as oil production begins to decline. Moreover, the Soviets probably wish to avoid setting a precedent for other East European countries. Moscow, in fact, probably prefers to have the West provide extensive hard currency loans as long as it perceives no serious threat to Soviet domination. [redacted]

[1] Over the past year or so, however, primarily because of the sharp rise in world oil prices and because the prices the USSR charges Eastern Europe reflect world prices only with a lag, Soviet subsidization with respect to CEMA has again increased [redacted]

[2] The Poles have asked the West for more than $10 billion in assistance, primarily by rescheduling repayments due in 1981-83 and by export credits. Poland's gross financing requirements in 1981-83 total some $40 billion to meet ongoing current account deficits, interest payments, and payments of principal on loans to the West. [redacted]

Trade With the West: Business as Usual. In contrast to Eastern Europe, Moscow is trying to expand its trade links with the West. Despite public statements to the contrary, Moscow needs, more than ever, access to Western technology, equipment, and grain. The best example of Soviet intentions involves Moscow's plans for a $10-15 billion natural gas pipeline project to carry gas from the USSR to Western Europe. To the Europeans, the project offers at least $6 billion in new equipment sales in return for substantial deliveries of gas at a time when they face uncertain deliveries from traditional suppliers. To the USSR, the project offers a way of offsetting part of the loss in hard currency earnings expected from the drop in oil exports to the West. By the late 1980s, Soviet gas exports could triple to 1 million b/d oil equivalent. [redacted]

Moscow also wants to continue its dealings with the United States. Currently, for example, the Soviets are anxious to renew the US-USSR long-term grain agreement. The Soviets also have indicated that they prefer sophisticated US technology and equipment where possible. They continue to seek US compressors for their gas pipelines rather than somewhat less advanced ones from Eastern Europe. Nevertheless, as shown by Afghanistan, the Soviets are quite willing to sacrifice any benefits from US trade for overriding political or military goals. Indeed, they remain sanguine that they can elicit trade agreements from Western Europe even in the face of US opposition. [redacted]

Long-Term Policies: A Tougher Line Likely

Thus, during the next few years no major policy shifts are likely. Domestically, spending on defense and investment in heavy industry will continue to receive top priority; funds for expanding consumer-related sectors will remain scarce. Internationally, economic support for Eastern Europe will continue, although Moscow will try to walk a tightrope between the increased needs of Eastern Europe and the needs of its own economy. Similarly, trade with the West will be pushed, but only to the extent it does not interfere with other higher priority political or military goals. [redacted]

25X1

Over the longer term, however, we believe this strategy is untenable. Soviet economic problems are too severe. As a result, Soviet leaders will probably be pushed in

25X1

one of two directions by the mid- or late 1980s. As the country's economic problems become more acute, Moscow could impose more austerity at home to support military spending. Consumption would suffer greatly. To gain public support, Moscow would probably evoke an image of heightened danger from the West or China. This policy also could result in less reliance on economic relations with the West and less tolerance toward Eastern Europe. [redacted] 25

Alternatively, a new generation of leaders, less committed to the status quo, might come to power and view a change in resource allocation policy in favor of consumers as a more viable way of maintaining "superpower" status. A change of leadership in the early 1980s seems likely. Brezhnev is in poor health and most of those who hold key positions are in their seventies. Even a new leadership, however, would be hard pressed to make changes in the short run. First, any new leadership would need time to consolidate its power. Moreover, because a shift in priorities away from defense and heavy industry would run counter to so many vested interests, it probably would require the convergence of:

- Economic problems at home severe enough to raise questions concerning internal political stability.
- An international environment that does not press the Soviets (for example, resurgence of detente).
- A stable Eastern Europe.

Because these conditions are unlikely to be met, Moscow is more likely to move in the direction of the first strategy—that is, adopt a tougher line at home—as it experiences difficulties and failures in achieving the goals of the 1981-85 Plan. [redacted] 25