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# USSR: Facing the Dilemma of Hard Currency Shortages

A Research Paper

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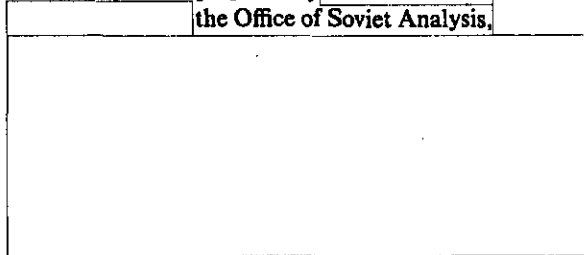


# USSR: Facing the Dilemma of Hard Currency Shortages



A Research Paper

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SOV 86-10027X  
May 1986

**USSR: Facing the Dilemma  
of Hard Currency Shortages**

**Summary**

*Information available  
as of 2 May 1986  
was used in this report.*

Low energy prices, declining oil production, and a depreciating dollar will substantially reduce the Soviets' ability to import Western equipment, agricultural goods, and industrial materials for the rest of the decade. The decline in Moscow's hard currency import capacity—most likely on the order of one-third—comes at a time when Gorbachev probably is counting on increased inputs from the West to assist his program of economic revitalization.

Although projections of future import capacity are fraught with uncertainty, we believe that Moscow faces the prospect of real imports falling to levels comparable to those of the mid-1970s. This estimate allows for some increase in debt to the West, substantial annual gold sales, and an \$18 average price per barrel for Soviet crude oil and oil products during 1986-90. It also reflects our belief that Moscow will be unable to increase substantially nonenergy exports, including arms, during this period.

Possibly caught by surprise and uncertain over the degree of the problem, Moscow reacted to last year's fall in oil earnings with increased borrowing and gold sales. By late 1985, however, Soviet traders' purchasing activity had slowed, and by February 1986 planned purchases were being scaled back. While some orders continue, the cutbacks appear to be across the board and are even affecting imports of equipment for oil and gas fields.

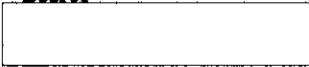
These cuts, in addition to dealing with the immediate scarcity of hard currency, will allow the leadership time to implement a more coherent import strategy—one that reflects the long-term nature of the problem. The import pattern that emerges should give a clearer indication of the relative importance of various economic sectors to Gorbachev's program. Gorbachev faces a difficult time in choosing among competing demands for foreign exchange:

- *The modernization program.* While the success of Gorbachev's modernization program hinges on internal factors, his lofty goals imply that some highly specialized imports from the West for such sectors as energy, machine tools, microelectronics, and telecommunications must be continued, if not increased. Import cuts in key intermediate goods such as specialty steels, in turn, could strain already taut production schedules.

- *Consumer welfare.* A cutback in hard currency agricultural imports would result almost immediately in reduced availability of such commodities as meat, vegetable oil, coffee, cocoa, and some fruits and—depending on the size of the grain crop—could mean slower growth in domestic production of meat, milk, and eggs. [redacted]

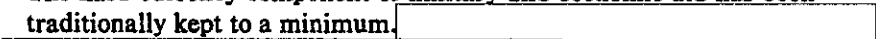
There are several areas where Moscow could take action to counter the adverse impact of the hard currency cuts:

- *Economic initiatives.* Soviet planners will need to revise the five-year plan to account for reduced imports. Moreover, should current efforts to boost productivity and efficiency falter, they might consider bolder economic reforms to carry out Gorbachev's ambitious capital renewal policy without drawing heavily on resources slated for defense.
- *Western involvement in the Soviet economy.* Prior to the fall in oil prices, Soviet planners, including Gorbachev, were reportedly considering altering the nature of the relationship between Soviet entities and Western firms to enhance the effectiveness of the technology and equipment that the USSR will be able to afford. They recently have shown an interest in joint ventures entailing Western profit sharing and managerial presence, closer engineering and production consultations with Western firms, and the creation of more training facilities with Western participation.
- *Political relations with the developed West.* We believe the Soviets will consider ways—short of real concessions on significant political or security issues—to foster a climate conducive to attracting cheap government-backed credits and Western involvement in the Soviet economy. The Soviets could consider, for example, toning down anti-US rhetoric, relaxing restraints on Jewish emigration, and allowing expanded intra-German ties. Flexibility would be strongly constrained, however, by an expressed Soviet policy aim of reducing long-term vulnerability to Western economic leverage.
- *Relations with Eastern Europe.* Moscow is likely to increase pressure on its East European allies to fill some of the gap in hard currency imports; it may also divert some of its oil exports away from the region. But Eastern Europe is not in a position to provide the scale of support the Soviets require. Moreover, as falling oil prices reduce the value of planned



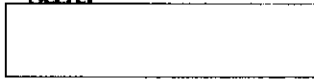
Soviet exports to Eastern Europe, the latter will be in a stronger position to resist Soviet pressures for increased exports.

- *Relations with the Third World.* Moscow's policies toward the Third World, including its clients, are not likely to be significantly affected. The hard currency component of military and economic aid has been traditionally kept to a minimum.



We expect the Soviets to be more aggressive on the international arms market, including an increased willingness to part with state-of-the-art arms and provide military technicians in order to boost hard currency sales.





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### USSR: Facing the Dilemma of Hard Currency Shortages

#### Downturn in 1985

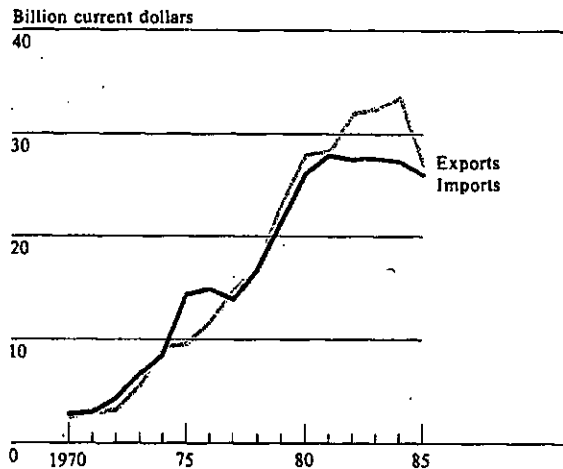
Moscow's hard currency trade surplus dropped from \$4.4 billion in 1984 to under \$1 billion in 1985 as a result of declining export earnings. On the basis of preliminary Soviet trade data for the year, we estimate that hard currency exports declined by over 15 percent to \$27 billion; the lowest level since 1979 (see figure 1). Falling domestic oil production and weakening oil prices took the largest toll, leading to a 20-percent reduction in earnings from oil exports. The available data further indicate a similar percentage decline in Soviet arms exports, while most other commodities remained at about the 1984 level. In contrast, imports fell only about 5 percent, with most of the reduction coming in the second half of the year.

Moscow countered the earnings decline through increased borrowing.<sup>1</sup> According to Western financial statistics, Soviet debt to Western banks increased by \$6.5 billion in 1985. Although short-term borrowing increased, the Soviets took advantage of their strong credit rating to raise about \$2.8 billion in medium- and long-term syndicated loans at favorable interest rates and repayment periods

In addition, gold sales reached approximately 180 metric tons, compared with less than 100 tons in each of the previous two years, earning Moscow about \$1.8 billion. These adjustments, along with cuts in imports, allowed Moscow to rebuild assets from a low of about \$8 billion at the end of March 1985 to \$12 billion by the end of December, about \$2 billion higher than the amount at the end of 1984.

<sup>1</sup> In addition to covering payment for reported imports, Soviet hard currency export revenues are used to meet unrecorded expenditures and debt service obligations. Reported exports overstate actual earnings because of credits—net of repayment—extended to the LDCs. Thus, the drop in hard currency exports last year required the Soviets to look to other sources of funds to a greater extent than had been the case the last few years.

**Figure 1**  
USSR: Hard Currency Imports and Exports, 1970-85



The sharp reversal of Moscow's hard currency position appears to have taken Soviet planners by surprise. Soviet officials, in fact, may have initially viewed the export shortfalls last year as a temporary event resulting from lagging oil production and severe winter weather. Throughout the summer and early fall, trade officials continued to negotiate and sign major contracts with Western firms for projects to be constructed during the 1986-90 period. The failure to come to grips with the problem sooner may also have been due to some confusion in the Soviet bureaucracy as new appointees to top positions in the State Planning Committee (Gosplan) and Foreign Trade Ministry worked to develop strategies that would incorporate new directions proposed by Gorbachev. By late

fall, however, Soviet officials were complaining of hard currency shortages, [redacted]

[redacted] The buildup in Soviet assets, in turn, reflected Moscow's taking advantage of favorable borrowing conditions to provide a cushion against future hard currency needs. [redacted]

**Deteriorating Export Earnings in 1986 and Beyond Slumping Oil Revenues.** The sharp drop in world oil prices this year has dramatically altered Moscow's earnings position. Reduced prices, combined with taut availability of Soviet oil for export stemming from production problems, are likely to push Soviet hard currency exports in 1986 down even further than in 1985; earnings from oil and gas could fall by as much as \$6-7 billion. The bulk of this drop—about \$5 billion—would result from sustained low crude oil prices of about \$15 per barrel or less and lower gas prices.<sup>2</sup> Up to another \$2 billion could be lost if oil production problems lead to a further drop in the volume of exports. We estimate that oil production will at best remain at the current rate of about 12 million barrels per day (b/d) and could fall to 11.6 million b/d by the end of the year. [redacted]

As in 1985, oil exports to hard currency countries would probably bear the brunt of any production declines. With few short-term opportunities at home for stepping up the pace of energy conservation or oil substitution, reduction in deliveries to domestic consumers probably would disrupt production at a time when Gorbachev is placing a high premium on boosting economic growth (see inset on the domestic demand for oil). With hard currency shortages of its own, Eastern Europe would be hard pressed to replace Soviet oil deliveries diverted to the West, despite the fall in oil prices. The region already faces tight energy supplies as evidenced by severe shortages in several countries during the past year, and even modest cuts in oil deliveries could seriously undermine the economic performance of several countries. [redacted]

<sup>2</sup> At present, the condition of the world oil market makes it almost impossible to predict an average oil price for 1986. We have estimated an average price per barrel of \$17 for all exports of Soviet oil, which assumes a world crude oil price of \$15 for the year and also takes into account the relatively high share of refined products in Soviet exports. [redacted]

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### **Domestic Demand for Oil in 1986-90**

*Domestic demand for oil is likely to remain close to the current rate of 9 million b/d as Gorbachev pushes forward with his industrial modernization program. Most of the easy gains in substituting gas for oil have already been made, especially for boiler fuel in electric power generation. A further decline in the power industry's use of oil is possible—as much as 275,000-b/d oil equivalent by 1990 if coal supplies increase, nuclear power plant construction accelerates, and hydropower generation is not constrained by low water levels. Gas substitution beyond this level—though technically feasible—is likely to be constrained by the lack of feeder pipelines and control instrumentation. On the other hand, increased demand for power generation at thermal power stations to offset shortfalls in any of these areas could reduce the potential gain substantially.* [redacted]

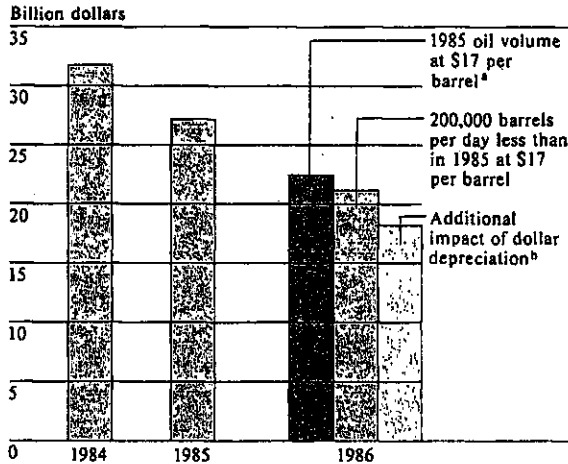
*Forced conservation through reduced oil allocations, though possible, is risky. Most Soviet enterprises lack the proper measurement and control instrumentation to effectively monitor and adjust their expenditure of fuel (either oil or gas). Given the heavy emphasis on rapid output growth in the energy-intensive sectors of the economy, such as machine building and metalworking, it seems unlikely that much forced conservation could occur without seriously jeopardizing Gorbachev's plans for modernization.* [redacted]

*The modernization program will also push up demand for more light fractions in the mix of refined oil products. We estimate that the Soviets will need to refine about 600,000 b/d of additional light oil products (gasoline, jet fuel, diesel fuel) by 1990. Meeting this demand will hinge on the Soviet Union's ability to increase its catalytic cracking capacity. Moscow will need to construct or acquire 15 catalytic cracking units, each with a capacity of 40,000 b/d throughput. The Soviets have built only two such units since 1977. Importing the needed cracking capacity from the West would be the fastest and technically most efficient option, but would cost over \$1 billion in hard currency.* [redacted]

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**Figure 2**  
**USSR: Hard Currency Exports, With**  
**Alternate Estimates for 1986**



<sup>a</sup> Assumes a lagged reduction in gas prices and a slight increase in the quantity of gas exports.  
<sup>b</sup> Assumes impact of a 20-percent depreciation of the dollar, affecting 70-percent of imports that are in nondollar currencies. Values for 1984 and 1985 are converted from rubles to dollars using the average ruble/dollar rate for the given year. In 1984 and early 1985 the Soviets benefited from a 3-percent dollar appreciation.

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**A Declining Dollar.** Moscow must also contend with a sharp erosion in its buying power caused by the rapid fall of the US dollar. Roughly two-thirds of Soviet exports are priced in US dollars, while about 70 percent of Soviet purchases are made in other hard currencies. As a result, a 20-percent drop this year in the value of the US dollar against the market basket of currencies used to finance Soviet imports would decrease the buying power of Soviet export earnings to a level 15 percent below that of last year (see figure 2).

**Over the Longer Term.** Moscow's reaction to current problems will be influenced to a large extent by its estimates of the long-term outlook for oil exports. At

**Outlook for Oil Production**

Oil production has fallen for two consecutive years, and we expect further declines during the rest of the decade. A massive dose of new investment, such as that scheduled for 1986, could stabilize or even increase production for a short time. But this would only be a stopgap measure; we expect depletion and rising maintenance costs to outrun the introduction of new capacity, requiring ever-increasing allocations of investment each year just to sustain production:

- New well flow rates have been declining steadily since 1975. We expect this trend to continue as infill drilling is stepped up and nonflowing wells are put on pump.
- Rising water cuts, which currently exceed 50 percent in Tyumen' and 69 percent nationwide, intensify production problems. The water problem will worsen as the well inventory expands.
- In the long run, new provinces with giant oilfields will have to be found and developed if prospects are to improve. In this context, the Barents Sea may hold considerable potential, but any sizable commercial production from this area is unlikely before the 1990s.

present, the Soviets may not view the problem as long term:

[Redacted]

[Redacted] the Soviets will eventually have to come to grips not only with low oil prices, but also with declining oil production (see inset). Moreover, our projected increases in gas sales of approximately 50 percent will only partially compensate for falling earnings from oil exports as the price of gas—following that of oil—constrains gas revenues.

[Redacted]

**Coping With Revenue Declines**

While the USSR is currently in a healthy financial position, Soviet planners have limited options available to offset a sustained fall in oil earnings:

[Redacted]

- The USSR's excellent credit rating among Western creditors offers the possibility of increased borrowing at favorable rates. For example, Moscow could easily raise another \$1-2 billion in syndicated borrowings this year and additional amounts from other sources. The Soviets may also push for lower interest rates and longer repayment terms on loans that they negotiate.
- We believe that the USSR—with an estimated 2,800 tons of gold in reserve and annual production of 340 tons—could increase annual sales to 300 tons from recent levels of 100 to 200 tons without disrupting the market, and perhaps discreetly sell an additional 150 tons through futures markets and nontraditional buyers. Sales of 300 to 450 tons in 1986 would raise an additional \$1.2-2.7 billion in revenues over the 1985 level of \$1.8 billion.

[Redacted]

- The Soviets may even seek to expand arms sales by offering more sophisticated weapons to a larger number of clients, perhaps on a barter basis as a substitute for what normally would be hard currency purchases.
- Moscow also could look to boost other nonenergy exports such as diamonds, chemicals, nonferrous metals, and wood products by offering the goods at prices below market values or via countertrade arrangements. In the long run, Soviet efforts to expand exports of manufactured items—especially machinery and equipment—by offering greater incentives to producers may also have some success.

[Redacted]

So far this year, the Soviets have actively utilized several of these options to offset the continued decline in their export earnings. Gold sales through February are estimated at 100 tons or more, and the Soviets have raised about \$800 million in syndicated loans in Western financial markets. They also appear to be pressing for government-backed credits with maturities of 10 years or longer and interest rates below 7 percent in an effort to lessen their debt service obligations over the next few years. Although first-quarter statistics are not yet available, Moscow may also have drawn down some of the assets that it rebuilt in the fourth quarter of 1985.

Moscow, however, is unlikely to continue for long with a strategy of heavy borrowing to limit the fall in import capacity. The leadership, recognizing that East-West lending is a political as well as an economic phenomenon, is loath to put itself in the position of being overly dependent on Western banks and their governments. In particular, Moscow is unlikely to undertake any steps—either by large borrowing or excessive drawdown of existing assets—that would jeopardize its ability to finance key imports such as grain in bad harvest years.

[Redacted]

Other than expanded gold sales, the USSR's options offer little potential to counter declining oil revenues. The level of arms sales is heavily linked to the oil market: we doubt that Moscow can expand these exports greatly as long as depressed oil prices weaken the economies of major arms purchasers in the Middle East. Attempts to boost exports of other nonoil commodities—such as machinery and equipment and raw materials—are likely to have limited success given generally weak demand for raw materials and Western resistance to shoddy Soviet-manufactured items.

**Cutting Imports To Close the Gap**

Moscow faces the almost certain prospect of a substantial and sustained reduction in its capacity to

import from the West in 1986 and beyond. The extent of this reduction, however, is highly problematical, with the price of oil the key variable. In our view, Moscow faces the real possibility that its annual import capacity will be cut by one-third from the 1984 level of \$27 billion. The resultant \$18 billion annual average hard currency import capacity estimated for 1986-90 (expressed in 1984 depreciated dollars) is based on the following key assumptions:

- Each year during 1986-90 the volume of oil exports declines by 100,000 b/d. The blended price obtained from the mix of crude and petroleum product sales declines from \$28 per barrel received in 1985 to an average of \$18 per barrel during 1986-90.
- Gas exports rise from 33 billion cubic meters (m<sup>3</sup>) in 1985 to nearly 50 billion m<sup>3</sup> in 1990.
- Gold sales increase to an annual average of 300 tons, but arms sales stagnate at the 1985 level.
- Moscow is unable to increase substantially other nonenergy exports for hard currency.
- Borrowing increases, but not past the point where service on existing debt exceeds 30 percent of hard currency earnings.
- The US dollar declines by 30 percent during 1986-90 vis-a-vis West European and Japanese currencies, with most of the decline occurring in 1986.

The situation is obviously fraught with numerous uncertainties about the level of Soviet exports, the price conditions Moscow will face, and the financial options to be taken by the leadership:<sup>3</sup>

- In the extreme, if a prolonged oil price war cut oil prices to \$10 per barrel, severe oil production difficulties further depressed Soviet oil exports, and

[Redacted]

other nonenergy exports such as arms declined, Moscow's annual hard currency import capacity could drop to below \$10 billion.

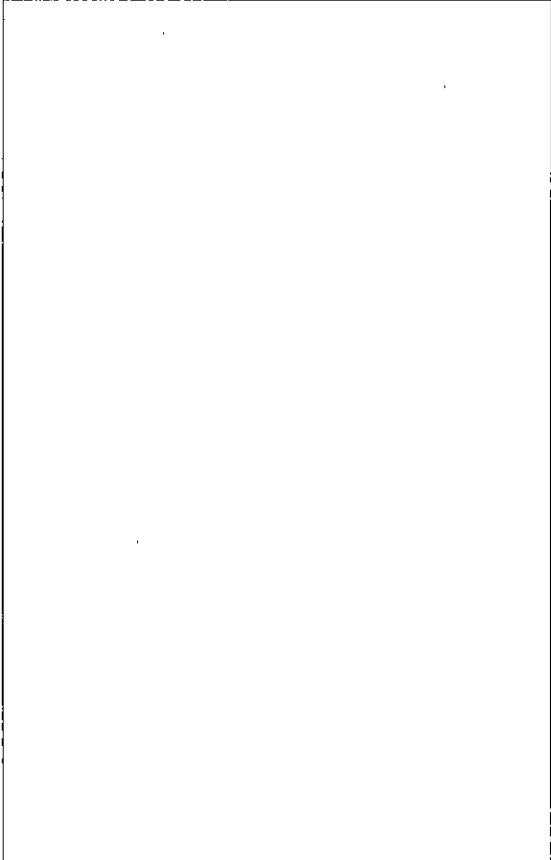
- Conversely, if Moscow undertook draconian measures that held the line on oil production and even boosted oil exports by sharply cutting both domestic consumption and deliveries to its Communist clients, it would be able to raise annual import capacity to roughly the 1984 level. To the extent that external factors, such as rising oil and gold prices, work in Moscow's favor, Soviet policies could be less severe and still allow imports to rise. For example, if world oil prices quickly recovered to \$20 per barrel, Moscow's annual import capacity would climb by almost \$2 billion. [Redacted]

Mounting evidence indicates that Soviet planners are in the process of adjusting the import program for 1986 and beyond to reflect reduced Soviet earnings.

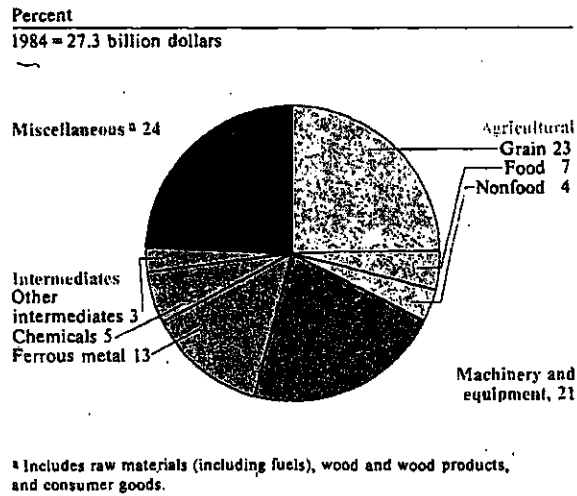
[Redacted]

The decision to cut hard currency expenditures is affecting all types of purchases. The major emphasis at present, however, is cutting equipment imports rather than other items—agricultural products and intermediate goods—needed to meet current output targets:

- [Redacted]



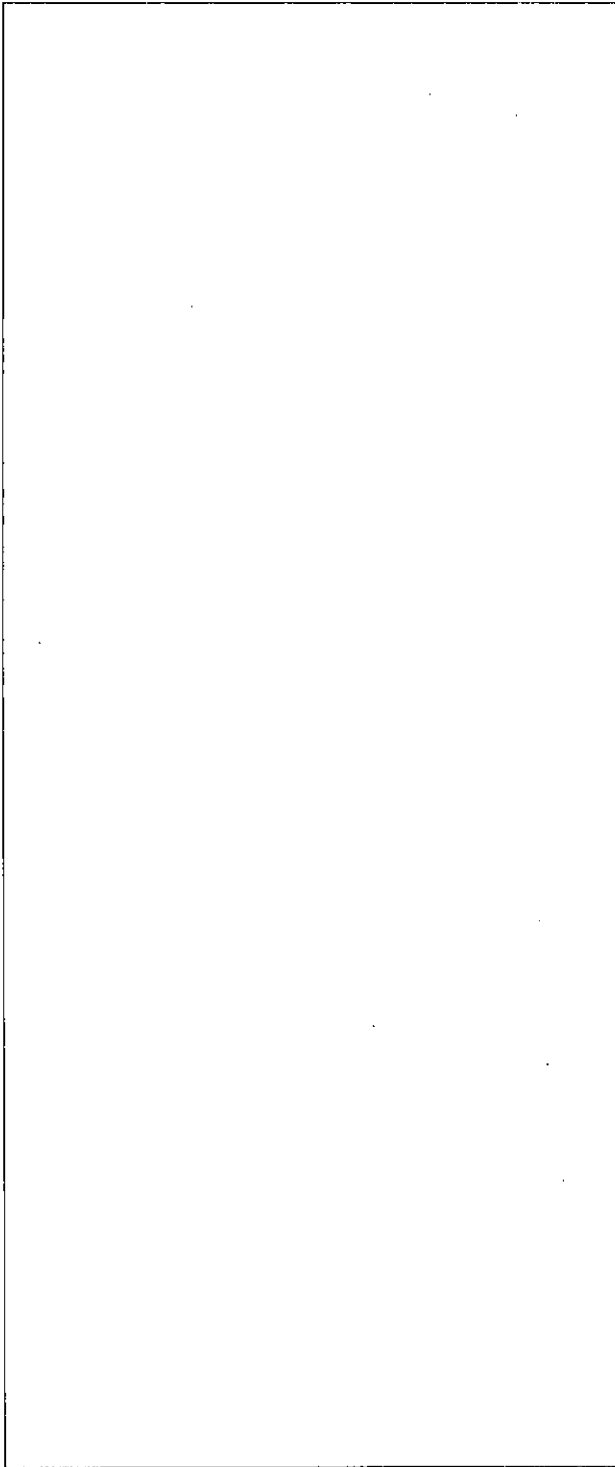
**Figure 3**  
**USSR: Composition of Hard Currency Imports, 1984**



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These cutbacks, in addition to dealing with the immediate scarcity of hard currency, will allow time for a coherent import strategy to be put into place. Soviet foreign trade organizations reportedly were ordered—with some exceptions—not to sign contracts so that planners would have time to revise the investment plans. The import pattern that emerges over the next 12 to 18 months may bear little resemblance to the established priorities of recent years (see figure 3). Soviet decisions on what imports are cut and which remain should give a clear signal of the importance attached by the leadership to various sectors of the Soviet economy. Reassessing import plans may be further complicated, however, by the damage to the domestic economy resulting from the nuclear accident at Chernobyl.

**Gorbachev's Modernization Program.** Because of the relatively small role that trade plays in the economy as a whole, the overall impact of import reductions on



economic performance will be limited. The consequences for several key sectors, however, could be quite serious. The share of machinery and equipment from hard currency countries is, according to our estimates, about 10 percent of total machinery investment. Purchases of Western equipment, nonetheless, have been important in improving production in the defense, chemical, metallurgical, oil and gas, and automotive industries [redacted]

[redacted] Moreover, the modernization program's lofty goals—when matched against a realistic assessment of the capabilities of domestic industries—imply that some highly specialized imports from the West for such sectors as energy, microelectronics, and telecommunications must be continued, if not increased. In addition, in an era of

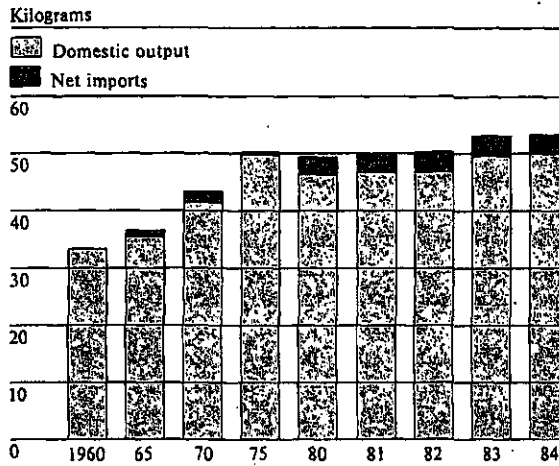
increasingly tight resources, marginal changes in availability of all resources (including hard currency) become more important. [redacted]

Other aspects of Gorbachev's plan to accelerate economic growth are also likely to suffer as import cuts exacerbate already taut production schedules. Shortages of needed intermediate goods and spare parts that have been imported in the past to prevent bottlenecks could slow or even temporarily halt production in some enterprises. Imports of specialty steels, in particular, are important to a number of sectors of the economy, including machine building. In addition, some sectors of the chemical industry require imports of key ingredients such as superphosphoric acid. Imported replacement parts are regularly needed in the energy and mining sectors for pipelayers and heavy earthmoving equipment. [redacted]

**Consumer Welfare.** The consumer, too, is unlikely to escape unscathed from import cutbacks. Imported farm products—over half of which have been hard currency purchases—have played a major role in maintaining dietary quality over the past few years, while agricultural production has been in the doldrums. Large grain imports have kept the livestock program on track, while other imports—including vegetable oil, fruit, sugar, coffee, and meat—have added quality and variety to a nutritionally adequate, but traditionally monotonous diet. For example, only by importing record quantities of meat—an average of about 900,000 metric tons annually during the 1980-82 period—did Moscow keep per capita consumption close to the previous record achieved in 1975 (see figure 5). A reduction in imports of hard currency agricultural products—which have averaged \$10 billion annually since 1980—would result almost immediately in reduced availability of many commodities. Moreover, in the absence of bumper harvests of grain and other feed crops, import reductions would mean slower growth in domestic production of meat, milk, and eggs. This, in turn, would probably lower worker morale and reduce incentives to meet Gorbachev's call for increased worker discipline. [redacted]

\* For more details, see DI Intelligence Assessment SOV 85-10165 [redacted] September 1985, *Gorbachev's Economic Agenda: Promises, Potentials, and Pitfalls*. [redacted]

Figure 5  
USSR: Availability of Meat per Capita\*,  
1960-84



\* Soviet official statistics on meat production are adjusted to conform to Western definitions of retail weight (trim, including slaughter fat and bone, is removed).

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A series of poor harvests would present the Soviet leadership with particularly difficult choices when balancing consumption goals with hard currency constraints. For example, cutting livestock herds to reduce the need for imported grain would postpone achievement of the 1990 per capita meat consumption target. At the same time, hard currency constraints would increase the urgency to successfully implement Gorbachev's domestic policies to improve agricultural performance and reduce waste. Some success here would lessen the impact of import cuts in the long run. [redacted]

**Long-Term Adjustments**

**Changing Economic Initiatives.** In allocating the burden of import cuts among the various claimants, Gorbachev is likely to factor in hoped-for gains stemming from his efforts to improve worker discipline and economic management. Specifically, he

would like to eliminate some high-tech imports needed for economic modernization by substituting equipment that either the USSR or Eastern Europe is currently capable of producing. In addition, Moscow is most likely counting on improved machinery production to reduce the scope of equipment it now needs to import from the West. Hard currency outlays for agricultural products and intermediate goods may also be reduced to the extent that Gorbachev's efforts to improve domestic performance on these fronts begin to bear fruit. Weather, as always, will play a pivotal role; a series of good harvests might allow Moscow to cut imports substantially without jeopardizing consumer welfare goals. [redacted]

We doubt, however, that Gorbachev will be able to achieve the necessary improvements through current economic initiatives. Over time, as gains from discipline and management reorganization fall short of expectations, Gorbachev and his lieutenants may give increased consideration to bolder economic initiatives—greater decentralization, increased privatization—that many Western observers feel are necessary to sustain substantial improvements in domestic economic efficiency. [redacted]

With total imports severely constrained, Soviet planners may also take innovative steps to maximize the benefits from the limited amount of imports that can be obtained. [redacted] Gorbachev believes that the USSR must alter the nature of its relationship with Western firms if it is to increase, over time, the effectiveness of imported technology and equipment and find ways to reduce the immediate hard currency cost of imported technology. Soviet officials are most likely to consider coproduction and equity arrangements with Western firms as the most effective way of tapping Western capital and managerial skills. [redacted]

Even before the sharp downturn in oil earnings, Soviet officials had expressed interest in joint ventures entailing Western profit sharing and managerial presence. According to a Western press report, they are even considering joint-venture regulations along the lines of the Hungarian legislation that permits Western equity of up to 50 percent. [redacted]

joint ventures were being considered as part of an effort to formulate a plan to streamline the foreign trade infrastructure. The Soviets have also taken an interest in engineering, managerial, and production consultation with foreign experts in the energy and chemical sectors and have shown interest in setting up a training school with courses in drilling, well completion, and operation of offshore oil wells. [redacted]

**Foreign Policy Options.** The decline in hard currency imports may also induce Moscow to introduce some marginal changes in its approach to Eastern Europe, the Third World, and the Western Alliance. [redacted]

The USSR could turn to *Eastern Europe* to help carry some of the burden of reduced earnings, either by increasing imports above planned levels or decreasing oil exports to the region. Soviet oil exports to the region of approximately 1.4 million b/d—almost 40 percent of total Soviet exports to Eastern Europe—are the linchpin of current bilateral trade ties. Although Moscow has pledged to maintain the current level of deliveries, it may consider diverting oil to Western markets. [redacted]

Eastern Europe could absorb a marginal reduction in oil deliveries over the next few years, especially if world oil prices remain low. But the region's economies could not cope with cuts of the magnitude necessary to provide substantial relief to the Soviets. Large cuts in oil deliveries would force Eastern Europe to look westward, which runs counter to Moscow's longstanding efforts to increase intra-Bloc trade at the expense of trade with the West. Moreover, such cuts could undermine the ability of the various regimes to maintain the level of stability that has been the rule in recent years. [redacted]

The East Europeans have strong economic reasons to resist Soviet pressures for further increases in exports over the planned level. The past several years have

[redacted]

seen a marked reduction in the size of East European trade deficits with the USSR; by the end of last year, all East European countries, except Poland, had nearly balanced trade with the Soviets. Moscow, moreover, has apparently been successful in getting Eastern Europe to begin repaying outstanding debts. The recently signed trade plans for 1986-90 call for the East Europeans to continue increasing exports—both in quantity and quality—to the point where they will soon be running trade surpluses. The East Europeans agreed to these terms at a time when the CEMA oil price was only marginally above the world price. When the current oil price plunge begins to lower the CEMA oil price, the rate of repayment will accelerate quickly. [redacted]

Soviet economic policies with the *Third World* since the end of the Khrushchev era have been pragmatic, aimed at obtaining the most economic and political benefits while limiting the cost. Economic aid is relatively small and generally tied to Soviet exports, with hard currency outlays kept to a minimum. For this reason, the USSR's policy toward the less developed countries (LDCs) is not likely to change much as a result of Soviet hard currency problems. Moscow will continue to sell arms and offer economic assistance to these countries for economic, political, and strategic reasons. [redacted]

In particular, Moscow will maintain its close ties to client LDCs such as Cuba, Vietnam, and Nicaragua, and continue to supply sufficient trade and aid to keep these economies afloat. It will probably be even more insistent that these countries increase their exports to the USSR and use Soviet aid more efficiently. Such pressures are likely to lead to increased strains in relations between the USSR and these states, but, given their dependence on Soviet assistance and lack of viable alternatives, any fundamental realignments are highly unlikely. [redacted]

The Soviets may focus their economic assistance program with nonclient states even further on selected projects considered to have large economic or political

\* Oil prices are set within CEMA on the basis of average world prices for the previous five years. If crude oil prices average \$15 for the rest of the decade, prices for Soviet oil sold to Eastern Europe will still be above world prices by 1990. [redacted]

payoffs. They could more aggressively compete for projects in the relatively more advanced LDCs with offers of favorable credits. Such projects would increase Soviet nonenergy exports and earnings from related services and costs not covered by credits. Moscow may also increase its efforts to negotiate barter arrangements, particularly for purchases of desired agricultural commodities. Faced with financial problems of their own, the LDCs may become more receptive to Soviet overtures for barter deals. Finally, the Soviets may become more aggressive on the international arms market and more willing to part with state-of-the-art arms. [redacted]

Greater Soviet need for *Western* trade and credits could lead Moscow to take Western attitudes and reactions into account when formulating its foreign policies, but not necessarily to become more accommodating. The likelihood of Soviet flexibility would depend substantially on how much opposition Gorbachev might encounter to such a position within the Soviet leadership, whether he believed that pursuing the issue might be useful in driving a wedge between Washington and its allies, and how vulnerable he perceives his domestic program is to cutbacks in Western imports. In addition, possible flexibility here would be strongly constrained by an expressed Soviet policy aim of reducing long-term vulnerability to Western economic leverage. [redacted]

With these major qualifications, it is nonetheless conceivable that Moscow—while maintaining its sharp competition with the United States in the Third World—might be somewhat more flexible on selected East-West issues in an effort to create a climate more conducive to expanding Western commercial involvement in the Soviet economy. The Soviets could consider, for example, such tactical moves as toning down anti-US rhetoric, relaxing restraints on Jewish emigration, allowing expanded intra-German ties, and improving the atmospherics of Japanese-Soviet relations. [redacted]